A Collection of Case Studies on Russian Enterprises

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Table of Contents

1. How Insolvent Russian Enterprises Function:  
   A Report on a Case Study of a Saratov Enterprise

2. Producing and Selling Consumer Goods in Russia:  
   A Report on a Case Study of a Moscow Enterprise

3. The Role of the Internal Legal Department:  
   A Report on a Case Study of an Ekaterinburg Enterprise

4. Building a Business in Post-Soviet Russia:  
   A Report on a Case Study of an Ekaterinburg Enterprise

5. The Challenges Facing Intermediate Russian Producers  
   A Report on a Case Study of a Moscow Enterprise

6. Minimizing the Risk of Financial Loss by Using Dealers:  
   A Report on a Case Study of a Saratov Enterprise
How Insolvent Russian Enterprises Function:
A Report on a Case Study of a Saratov Enterprise
Introduction:

The case study of the Saratov Plastics Plant (SPP) was undertaken in early 1998 as part of a research project funded by the National Council for Eurasian and East European Research (Contract No. 813-16G) and the National Science Foundation. I spent two weeks at SPP, interviewing managers and reviewing documents in an effort to understand its strategies for coping with economic difficulties, including the use of law and legal institutions. I was given a desk in the legal department, and used this as a base from which to observe and to talk with key managers. SPP had participated in a survey fielded in the spring of 1997 on these same issues, and had consented to my doing this follow-up research.

By any objective standard, SPP is insolvent. It is unable to pay its current obligations to the government or to its suppliers. In Russia, demands for payment of such debts are presented to the debtor's bank and when the funds are insufficient, the debts are placed in a file (kartoteka) and are paid automatically when funds become available. There are two kartoteki, one for government debt and another for private debt. In the case of SPP, both exist and are enormous. This has been the situation for several years at SPP, yet bankruptcy is not viewed as likely. In this report, I explain how SPP carries out basic functions of obtaining inputs and selling output with this apparent sword of Damocles hanging over its head.

Some background information about SPP is necessary to understand the context. SPP began operations in Saratov in 1943. It was moved from Leningrad as part of the more general transfer of

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1 The name of the enterprise has been altered in order to preserve its anonymity.

2 The survey included 328 Russian enterprises divided among 6 oblasts and 9 industrial sectors. On the survey portion of the research, I collaborated with Barry Ickes, Peter Murrell, and Randi Ryterman. The survey was funded by the World Bank, and its implementation in Russia was coordinated by Dr. Alla V. Mozgovaya of the Institute of Sociology of the Academy of Sciences.
industry eastward during World War II. It produces parts made of hard plastic for automobiles and
industrial machinery. During the Soviet period, it produced parts for weapons, but demand has
evaporated for such goods. In recent years, SPP’s main output is the casing for car and tractor batteries.
It makes some consumer goods, but this is regarded by all as a minor sideline. Thus, SPP has little
opportunity for direct sales to consumers, and its potential customers among Russian industrial
enterprises is finite. Its financial health depends on the fate of the automobile industry. As that industry
has declined in Russia, SPP has fallen on hard times. In 1992, it had 1,700 employees. By 1998, this
number had been more than halved, to about 800. By 1996, the practice of reducing the work week for
production-line workers had become routine. In 1997, SPP shutdown production entirely for several
months. Indeed, production was suspended during the time I spent at SPP, and employees had not been
paid for four months. There is a palpable sense of despair among SPP managers. They feel like they are
in a dead-end situation. They claim that the machinery cannot be retooled to produce other goods, and
they lack resources to purchase new equipment. They have no hope of outside investors, believing that
the plant has little to offer.

SPP is far from unique among Russian enterprises. Borderline insolvency is remarkably
common. The question of how SPP survives takes on a significance that goes beyond its own fate. It is
important that Western policymakers have a realistic sense of how business is actually being done in
Russia, and the extent to which operating without cash has become the norm.

**Selling in a Cash-Poor Environment:**

The sales manager acknowledges that SPP’s biggest problem is a lack of cash. By this, he is
referring not just to SPP’s own internal financial difficulties, but the more general lack of cash in the
Russian economy. As an intermediate supplier, SPP has limited access to consumers, who do have cash.
Its trading partners are downstream industrial producers, who use SPP’s output in their own products.
Indeed, as a producer of a key input for car batteries, SPP is two steps away from the final sale.

SPP survives only on the basis of barter. The sales manager estimates that 90% of SPP’s sales
are carried out via barter. When it ships the battery casings to the producers of batteries, it is “paid” in
the form of batteries. It then uses these batteries to pay for needed inputs or as a means of exchange.

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1 Efforts to sell to producers in Turkey and various Middle Eastern countries have failed. These producers
report that they can obtain analogous goods at cheaper prices elsewhere.
Car batteries are, of course, not a terribly liquid commodity, and SPP often has to absorb losses. Its willingness to participate in barter transactions that produce clear and immediate losses for them depends entirely on how badly SPP needs whatever the other side is offering.

Yet another pattern arises when the customer itself provides the raw materials. Assume that the customer (C) wants a particular good (AA). Although SPP has the right machinery and the trained workforce needed to make AA, it lacks the necessary raw materials and has no cash to pay for them. SPP and C agree that SPP will produce AA, but that C will supply the raw materials. C pays only for the cost of labor and the use of the equipment. Sometimes this payment is made not in cash, but in extra quantities of the raw material, which SPP can then use to produce additional quantities of AA for sale to other customers. Obviously this pattern reflects a relatively low level of trust among SPP and its customers. Otherwise, in this scenario, C could simply have prepaid an amount sufficient for SPP to buy the raw materials itself. But C is worried that SPP will use this cash to pay wages or other current obligations, rather than buying the raw material needed to produce AA.

One of the challenges facing debt-laden enterprises in Russia is how to avoid using their bank account. Once debts are placed in the kartoteki the bank is obligated to pay any money that appears in the account to these debtors. As a result, the debtor enterprise has no control over its own bank account. Some cash-poor Russian enterprises respond by not using their bank accounts. For example, they might have customers pay suppliers directly, bypassing the debtor bank account. According to SPP's sales director, this loophole is slowly closing. Banks are increasingly refusing to process such payments.

Even in Russia, an enterprise cannot function without some cash. Certain transactions cannot be carried out on a barter basis. Cash is required. For example, the railroad demands prepayment for transport costs. SPP has altered its transport strategy, and now ships more goods by truck, but cannot entirely avoid the railroads. Sometimes SPP can find an enterprise who is a creditor of the railroads, and can arrange a trade of batteries for obtaining this credit. (Often the commodity desired by the creditor enterprise will not be batteries, and so SPP will have to draw other enterprises into the trading circle. These arrangements can quickly become very complicated.) SPP can then use this credit to ship its

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4 This practice occurred during the Soviet period, but for a different reason. In those days, difficulties often arose in obtaining deficit goods. Sometimes customers had better access than the producers, and so would obtain raw materials on behalf of a producer. Now the central issue is ability to pay.

5 As a general rule, wages are paid in cash. On occasion, however, SPP workers have been paid in batteries, which they then have to sell themselves. According to a presidential decree, federal taxes now have to be paid in cash, but SPP managers claim that there are ways around this requirement of cash.
output, obviating the need for cash.

Beginning in 1996, SPP began to require full prepayment from all its customers. When the payment is in the form of goods, then the exchange has to take place simultaneously. In this way, SPP has virtually eliminated customer arrears. Although most sales take place pursuant to a written contract, the sales manager views its provisions as largely irrelevant in the presence of full prepayment. As he sees it, the concurrent exchange of goods is the beginning and end of the transaction. Even though there is an underlying contract that usually remains in place for the calendar year, its detailed provisions about the consequences of non-fulfillment are rendered extraneous. All that matters is the one-page memo (spetsifikatsiya) that lists the quantities and prices of the goods to be traded.

The SPP sales personnel claim that they are increasingly not bothering with a contract. Of the six Russian enterprises I studied, SPP was the only one that admitted to foregoing contracts on a regular basis. Rather than formal contracts, sales are made on the basis of an exchange of letters. From a legal point of view, there is not much difference since the letters constitute an offer and acceptance. The details of liability will be filled in by the default provisions of statutory law. But it is an intriguing and logical development in light of the high level of barter at SPP and the futility of looking to the long run.

**Obtaining Inputs Without Access to Cash:**

The foregoing begins to tell the story of obtaining inputs. Once again, the key is barter. The supply (or procurement) director estimates that 90% of supplies are obtained through barter. The currency is batteries, not money. She explained how the task of supply departments had changed over time. During the Soviet period, the goal was to find and obtain deficit raw materials and finished goods needed for SPP's production. Now if SPP had money, it could get any input it desired. Thus, like the sales manager, she regards the lack of cash as SPP's key problem.

For a short period following privatization, SPP prospered. In the view of the supply director, this brief period of prosperity resulted from the fact that SPP had built up a reserve of inputs, which it

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6Some debts persist from the pre-1996 period when SPP allowed customers more flexibility, but these are gradually being removed from the books. The SPP sales manager holds out little hope of collecting. SPP has one arbitrazh case pending against a large customer in Irkutsk. SPP won a judgment, but has been unable to collect. Following the decision, it entered into a settlement agreement (mirovoe soglashenie) with the customer-defendant, pursuant to which SPP agreed to forego penalties in return for speedier payment of the basic debt. The customer has also defaulted on this agreement, and SPP is now working with the bailiffs in Irkutsk in an effort to recover some property of value from this enterprise.
obtained at the old Soviet prices, which it was then able to sell at market prices. This gave rise to short-
term profits.

In recent years, however, there have been no profits. Instead, shortages of raw materials have
frequently caused the shutdown of production. SPP has been unable to maintain relations with the
suppliers it used during the Soviet period. Despite the fact that SPP had worked with them for decades,
these suppliers refused to work with SPP once it became a serious debtor. As a result, SPP often has to
work through intermediaries. These intermediaries are willing to take batteries (or other goods) in
payment.

Amazingly, SPP has only three suppliers that it pays through the banking system.\(^7\) The inputs
provided by these three suppliers give them considerable power over SPP. SPP feels it has no choice but
to go along with the suppliers’ terms. One of these suppliers is Lukoil. According to the supply
manager, Lukoil will not accept cash, nor will it accept payment from a third party (such as a customer).
It will only accept payment via bank transfer. Although it is an exception, it makes life difficult for
SPP.

Most of SPP’s suppliers require prepayment. Given that many of these transactions go through
intermediaries, and are based on barter, what this means in practice is that goods are exchanged
simultaneously. It is important to note that the price of inputs obtained on a barter basis are typically
20% higher than if payment came in cash or via bank transfer. This supplement pays for the transaction
costs (time, expenses) associated with multi-sided barter deals.

**Conclusion:**

This brief glimpse into how SPP does business provides some insight into how insolvent
companies currently survive in Russia. It is unrealistic to expect that they will voluntarily seek
bankruptcy protection or that their creditors will push them into bankruptcy. Companies like SPP have
grown accustomed to functioning without cash. It is no longer regarded as a crisis situation, but merely
business as usual.

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\(^7\) The supply director would not give me an estimate of the total number of suppliers. She said that the
increased use of intermediaries made such figures unrealistic.
Producing and Selling Consumer Goods in Russia: A Report on a Case Study of a Moscow Enterprise
Introduction:

The case study of the Moscow Household Goods Plant (MHGP) was undertaken in early 1998 as part of a research project funded by the National Council for Eurasian and East European Research (Contract No. 813-16G) and the National Science Foundation. I spent two weeks at MHGP interviewing managers and reviewing documents in an effort to understand how it deals with business challenges. I focused on the use of law and legal institutions. I was based in the legal department, and used this as a base from which to observe and to talk with key managers. MHGP had participated in a survey fielded in the spring of 1997 on these same issues, and had consented to my doing this follow-up research.

Description of the Business:

MHGP began its life in the 1920s. It has always produced consumer goods, which means that it was somewhat marginal during the Soviet period. But, given this limitation, the plant enjoyed great success. It has a display case full of awards received from the Soviet government.

The main output is shavers. It also produces a variety of other electric consumer goods, such as tea pots and hair dryers, but these are sidelines. MHGP has not performed so well under market conditions. Top management reports that serious difficulties began in 1994, when MHGP’s goods began to face serious competition from foreign imports. Often these imports were both cheaper and higher quality than MHGP’s goods. MHGP has been forced to lay off workers. In 1992, there were 1,000 employees. Now there are only 350.

MHGP was privatized in 1993. As a result, management and workers initially held a majority ownership share. The Moscow city government received stock in the privatization process, and has held onto it. The current board of directors includes a representative of the Moscow government. MHGP management feels fortunate to have this close relationship with the city. As a rule, there is a meeting

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2 The survey included 328 Russian enterprises divided among 6 oblasts and 9 industrial sectors. On the survey portion of the research, I collaborated with Barry Ickes, Peter Murrell, and Randi Ryterman. The survey was funded by the World Bank, and its implementation in Russia was coordinated by Dr. Alla V. Mozgovaya of the Institute of Sociology of the Academy of Sciences.
between someone from MHGP and a city government official every day. According to the general director, the board member from the government acts as a lobbyist on MHGP's behalf with the tax inspectorate and other governmental entities. He feels that, without such help, MHGP would have no hope of getting a fair shake from the city authorities.

The majority ownership of insiders has dissipated. MHGP was always structured as an open joint stock company, which means that shares could be sold to anyone. The difficulty, of course, was finding buyers. There is no active secondary market in MHGP's shares. When opportunities have arisen, both workers and management have taken advantage of them. For a time, one of the larger Moscow banks held a 10% stake. It sold these shares following the October 1994 crash of the Russian financial market. Over the past few years, an American manufacturer of consumer goods has begun gradually accumulating shares. At this point, it owns about 40% of the company. MHGP management facilitated these acquisitions.

Although the relationship between MHGP and the American stakeholder remains cordial, top management is disappointed by the failure of the Americans to take more decisive action. They expected capital investment from the Americans, and help in seeking customers. Instead, the Americans have remained on the sidelines. They do not maintain a permanent presence at the enterprise, but visit on a monthly basis. The general director is clearly annoyed by what he views as the patronizing attitude of the Americans. He notes that they are eager to teach him how to manage MHGP, but are unwilling to take the time to learn about the specifics of the Russian market. He comments that the Americans ought to come over and sit in his "chair" for awhile. Perhaps then they would understand how truly difficult it is. The general director is not entirely sure why cooperation has been so slow to take off -- he assumes the Americans are waiting until they hold a majority share. This explanation is not convincing, since management is eager for any help from the Americans. Of course, I heard only the Russians' side of the story. It is quite possible that the Americans believe that they have tried to institute reforms of the production process, but have been stymied by Russian management.

MHGP also has a joint venture with a Swiss company. This company (like the American stakeholder) is a producer of consumer goods. The planned joint production would be complementary to the existing production profile, with an eye to improving overall production standards and quality. For

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3The general director says that the Americans come, stay at the Metropole (an expensive Moscow hotel catering to foreigners) for a few days and then go home. He does not believe that they can possibly gain an accurate impression of the Russian marketplace.
example, I was shown space that had been renovated in anticipation of this new production. In contrast to MHGP’s production space, which was cluttered and dirty, these refurbished areas were pristine. At this point, joint production has not begun. Once again, stories of misunderstandings emerge. There seems to be a tendency on the part of MHGP’s management to make assumptions and to take idle comments more seriously than their partners intend. (This is not unique to MHGP, but is found in many cross-national collaborative ventures.) Not surprisingly, these misunderstandings lead to frustration on both sides and sometimes poison the environment for future cooperation. What will happen with regard to MHGP’s relationships with the Americans and the Swiss remains to be seen.

Responses to Financial Instability:

Like many Russian enterprises, MHGP has accumulated tremendous debts, including amounts owed to the government, to its workers, and to its suppliers and other private entities. In Russia, requests for payment are submitted to the debtor’s bank and, if funds are insufficient, the debts are placed in a file (kartoteki) and are paid according to the priority established by law. Its close relationship with the Moscow government is helpful in dealing with municipal debts, but does little to assist in working out debts owed to the federal budget and is of no help with private creditors. When these files or kartoteki exist, any and all funds that are paid into the bank account go automatically to pay the debts according to the statutorily-established priority. Not surprisingly, many Russian enterprises respond to this situation by going around the banking system. There are a variety of schemes that have emerged.

MHGP’s bank account is loaded down with debt. It has both a kartoteka for government obligations, and another for private debt. Once again, the consequence is that any money paid into the account by customers will go automatically to pay these debts. Banks have no choice but to transfer such funds. If they fail to do so, then they open themselves up to substantial fines and potential licensing issues. It is important to note that, as a rule, Russian enterprises pay for goods through bank transfers. Checks are unknown. Contracts routinely include the bank name and account of both parties so that

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4 MGHP is currently about three months behind in paying wages.

5 See art. 855, Civil Code, RF. Top priority is given to debts owed to tax authorities. In second place are wage arrears. Private debtors do not enjoy a high priority.
payment can be made.

If MHGP operated in perfect accordance with the law, it could not stay in business. The legal route would be to continue to have its customers send payment for MHGP’s goods to MHGP’s bank account. In this case, the money would be siphoned off to pay debts. As a result, MHGP would have no funds to pay for inputs or to pay its workers, and would be forced into bankruptcy.

No one at MHGP regards bankruptcy as a likely outcome for the enterprise. In this, they are like other Russian enterprises who seem to be drowning in debt. The survival strategy adopted by MHGP is likewise not unusual. MHGP has created a new company, known as the Moscow Shaver Factory (MSF), that is ostensibly independent from MHGP. MSF is not a subsidiary of MHGP, nor is there any overlap between management. From the outside, they look like different companies. In reality, however, MSF is totally controlled by MHGP. The president of MSF acts according to instructions from MHGP management. The key to this scheme is that MSF has its own bank account that is completely free of debt (or kartoteki). MHGP sent letters to all of its customers, explaining that sales of MHGP products would now be carried out by MSF, and that all payments should be sent to MSF’s bank account.

Thus far, the scheme is working. The tax authorities have not objected to MHGP running its business through this shell corporation. A few customers have balked at dealing with an entity that is completely unfamiliar to them. MHGP does not force them to accept the change, but does insist that such customers make their payment in cash, rather than via bank transfer. For MHGP, the bottom line goal is to keep money out of its bank account.

Although this strategy can be regarded as successful from MHGP’s point of view, in that it allows its continued existence, the broader consequences are disturbing. Those whose obligations are reflected in the kartoteki are legitimate creditors. For the most part, debts cannot be placed on the kartoteki without a court order which, in turn, cannot be received without a full hearing on the substance of the contractual or other obligation. By turning a blind eye to schemes that allow debtors to sidestep these debts, the effect is to discourage creditors from pursuing legal remedies through the courts. After all, under the scenario described above, none of the creditors on the kartoteka of MHGP will ever be paid. (The tax authorities are a different issue, since they have greater powers of coercion, and are more likely to get some sort of compensation.) The effect may be to encourage extra-legal solutions. It certainly undermines the efforts to develop trust and respect for the law and for legal institutions, such as the courts, since court decisions are rendered virtually unenforceable by this approach.

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Role of Law:

All of MGHP's sales of output and purchase of inputs takes place on the basis of contracts. It has its own form sales contract, which was revised at the end of 1997. As a rule, it insists on the use of its form. Given that MGHP sells to retail outlets and to the public, it has a large number of customers and considerable customer turnover. It lacks the resources to engage in prolonged negotiations with individual customers. It will debate individual points of its form contract if customers object to them, but it will not start from scratch with a customer. If it is unable to come to agreement with a customer relatively quickly, it prefers to walk away.

As is typical in Russian contractual relations, if a customer dislikes its supplier's contract, it will send back a "protokol of disagreements" (protokol raznoglasii), in which it proposes new wording for the disputed sections. (This stands in contrast to the U.S. practice, in which the customer would likely respond by sending its own form contract.) The supplier can accept the new wording for the disputed sections, in whole or in part or, alternatively, can insist on its original text or propose yet another version.

For the most part, the negotiations relating to the substance of sales contracts (including protokols) take place in the sales department. Conversations with the woman who is charged with processing contracts reveal that, of the 200 contracts she handled during 1997, 25 customers (12.5%) proposed protokols. Of these, contracts were ultimately concluded with 8 (32%). Thus, MHGP frequently terminates negotiations if the changes proposed are too fundamental or if the customer is unwilling to yield on points MGHP views as critical.

MGHP has a one-person legal department. This lawyer views her role as largely technical. In principal, she is required to sign off on all contracts entered into by MGHP. The sales department generally honors this in-house rule, and submits sales contracts to her for approval. Other departments within MGHP comply less often. The lawyer does not feel that it is her role to comment on the business sense of the proposed transaction. She simply states her opinion about whether the contract is legally binding. Perhaps this seemingly peripheral role is understandable when we consider that it was

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6 The use of the protokols of disagreements originated during the Soviet period, when the freedom of contract of enterprises was severely constrained by the ministries. The post-Soviet civil code gives them full freedom of contract, yet the old patterns of behavior persist.

7 Like lawyers everywhere, the MGHP lawyer complains that often she doesn't see a contract until a problem has arisen, and that often she could have prevented the problem if the contract had just been shown to her before it was signed.
the lawyer who developed the form contract. She does not have to review the terms of the contract, but only changes made. She also verifies that the person who signs on behalf of the customer is, in fact, authorized to do so.

One intriguing feature of the contracts is that they seek to collect both interest and penalties. This represents a break with the current trend in contractual practice in Russia, which is to settle for interest. In the past few years, the courts have increasingly refused to award both interest and penalties, regarding them as duplicative. At the same time, a good argument can be made that they compensate the seller for very different injuries. Interest obviously compensates the seller for the fact that it has lost the use of the money while unable to collect the debt from the customer. Penalties, in contrast, are punitive. They punish the customer for its failure to honor its contractual commitments. Further buttressing this argument is the difficulty of collecting damages in the form of lost profits. Thus, merely collecting interest does not truly make the seller whole again, which is typically the goal of contractual remedies. In order to deal with this issue, the MGHP form contract states that interest and penalties are not duplicative, and includes an affirmative statement from the customer that it agrees to pay both.

MGHP finds its customers at trade shows. It goes to trade shows with a stack of pre-signed contracts, which it hands out freely. Indeed, on one of the desks in the room housing the sales department is a similar stack of pre-signed contracts. (Note that the contract is in the name of MSF, not MGHP.) The MGHP sales department does not view the signature on behalf of MSF as binding the company to anything. Even when the customer signs, it is not regarded as an operational contract. Before truly committing itself to a customer, MGHP has to decide whether it is going to pay. Sometimes this gives rise to requests for additional documents from the customers. Sometimes the fully executed contract simply sits in the file.

The high turnover among customers creates challenges for MGHP. It is constantly trying to

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8 This requires a review of the corporate charter of the customer and the power of attorney that the person signing has. If the person signing on behalf of the customer is not properly authorized, then the contract may be declared invalid, and MGHP will be unable to collect via the courts for the amount owed.

9 The 1997 version of the form contract capped penalties that could be collected from delinquent customers at 30% of the debt owed. This term had been suggested by a MGHP vice president who was new to consumer business. Both the sales department and the lawyer were openly contemptuous of the clause (and the vice president), regarding it as solely in the interest of the customer, and not at all helpful to MGHP. This clause was removed in the 1998 version of the form sales contract.

10 See art. 395, Civil Code, RF.
devise better methods of assessing potential customers’ ability to pay. There are no credit rating agencies. MGHP is on its own. At the beginning of 1998, MGHP instituted a new and tougher policy that increased the burden on potential customers. The sales department is now supposed to obtain documents from the customer’s bank verifying that it has money in its account and that it presently owes no debts, along with a certificate from the tax inspectorate.

All agree that this can be helpful, but they further caution that there is a lively business in forging such documents, and they cannot be sure that they are genuine. Moreover, the bank certificate is only a snapshot. The money can be withdrawn or transferred a day later. In an ideal world, MGHP would like to demand full prepayment from its customers. This is the only sure way of protecting itself. But they do not believe this is realistic. As the sales director noted, “we aren’t selling bread here.” Her point was that electric shavers are not a necessity, and if MGHP is too demanding, it will simply lose customers. It compromises by requiring prepayment for the first shipment, and then gradually decreasing the amount that has to be prepaid. Long-term trusted customers are generally required to pay within 20 days of receipt of the goods (though the time period varies).  

Even though it tries to guarantee payment, MGHP’s customers do not always pay on time. Most non-payment problems are handled by the sales department. Telegrams and letters are routinely sent on the day of shipment or soon thereafter. Sales department personnel spend considerable time on the phone reminding customers of their obligation to pay. These workers confirm that the existence of a personal relationship with a customer can be helpful in getting them to pay, but they don’t regard this as essential.

When informal pressure to pay proves unfruitful, a letter threatening court action is sent. Usually this letter is prepared with the help of the lawyer. It is possible to observe a pyramid effect. The majority of delinquent customers pay after being reminded by phone. Most of those remaining pay after getting the official warning letter. Only a few disputes persist to court. The court cases are handled by the lawyer. During 1997, the lawyer estimates that MGHP filed about 50 cases. They won all of them. The lawyer was quick to note that this impressive track record was due less to her skills than to the open-and-shut nature of the cases.

Unfortunately, winning rarely translates into collecting the judgment. The MGHP lawyer is

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1. MGHP is extremely wary of individual, physical persons as customers. Many of these are the so-called “shuttle traders” who buy these goods in Moscow, and then sell them in Ukraine or some other part of the former Soviet Union. The MGHP sales personnel cannot be sure these traders will ever return. Typically they are required to pay in cash.
passionate in her criticism of the current system of enforcing court judgments. She is well-aware that new laws have been passed to create a system of “bailiffs” (sudebnye pristavy) that are to have more authority in this regard. She has little hope that things will improve. The procedural requirements for seizing property remain almost impossible to meet.

**Conclusion:**

Through this report on MGHP, we begin to understand the difficulties faced by Russian enterprises who are end producers. Many are deeply in debt, and have devised innovative schemes for avoiding debt. But these schemes have unfortunate collateral effects on their creditors, and suggest that “playing by the rules” is a losing proposition in Russia.
The Role of the Internal Legal Department:  
A Report on a Case Study of an Ekaterinburg Enterprise
Introduction:

The case study of the Ekaterinburg Machine-Building Plant (EMBP) was undertaken in the spring of 1998 as part of a research project funded by the National Council for Eurasian and East European Research (Contract No. 813-16G) and the National Science Foundation. EMBP is one of the largest and politically-prominent enterprises in Ekaterinburg. Enterprise management is highly-preoccupied with security, and arranging any sort of access was extraordinarily difficult. EMBP had participated in a survey fielded in the spring of 1997, and had consented to my doing this follow-up research. At first, EMBP agreed to allow a one-day visit. Ultimately, they permitted me to stay for two days. But my access was strictly limited to the legal department. Given that these were full eight-hour work days, I had sufficient time to talk with the head of the legal department and many of his subordinates, as well as to review selected contracts and case files in a number of court cases. An intriguing picture emerged of an activist legal department fully engaged in the decision-making process of the enterprise.

A bit of background information about EMBP is necessary to appreciate the context. During the Soviet period, EMBP was a nationally prominent enterprise. Several of its general directors have gone on to successful political careers, both in the Soviet and post-Soviet eras. In 1992, it employed 22,000 people. By 1998, the labor force had been reduced to 19,000. EMBP produces large industrial machinery. Typically its output is custom-ordered, meaning that if a customer defaults, the goods cannot easily be sold elsewhere. Among its most important customers are the major metallurgical factories in Nizhny Tagil, Magnitogorsk, and Lipetsk. It has had extensive contacts with Western businessmen, and two joint ventures have been underway since 1992.

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1 The name of the enterprise has been altered in order to preserve its anonymity.
2 It involved a seemingly endless series of faxes and telephone calls between the "protokol" (or security) department of EMBP and the Institute of Sociology, who did the logistical work in connection with all of my case studies. Once I had arrived in Ekaterinburg, I received daily calls from this protokol department asking more questions.
3 The survey included 328 Russian enterprises divided among 6 oblasts and 9 industrial sectors. On the survey portion of the research, I collaborated with Barry Ickes, Peter Murrell, and Randi Ryterman. The survey was funded by the World Bank, and its implementation in Russia was coordinated by Dr. Alla V. Mozgovaya of the Institute of Sociology of the Russian Academy of Sciences.
Like virtually all Russian enterprises in the machine building sector, EMBP is struggling to find its place in the post-Soviet market as well as in the global market. It is technically insolvent. It cannot keep up with its tax obligations, nor is it able to pay many of its suppliers in a timely fashion. As a result, any money that comes into its main bank account is automatically sent to the government to pay down these tax obligations. After the tax obligations have been fully satisfied (which few anticipate in the foreseeable future), any money that comes into the account will go to the private debtors.

No one at EMBP regards this situation as particularly perilous. Rather it is seen as normal. EMBP has responded to the inability to use its bank account by increasingly inventive uses of commercial paper, barter, and other means quasi-monetary exchange. Yet the prominence of the factory means that it cannot engage in some of the more popular methods of avoiding payment via the main bank account, such as funneling the money through affiliated companies or having customers pay suppliers directly. Such practices were rendered illegal by a 1996 presidential decree (though they remain in widespread use). EMBP’s restraint in this regard was rewarded earlier this year when the tax inspectorate mounted a verification of its compliance with this very decree, from which EMBP emerged with only minor infractions.

The Role of the Legal Department:

Organization. Of the six enterprises that I studied in connection with this project, EMBP had the largest legal department. It has 17 people employed in its legal department. By contract, none of the other enterprises had more than two full-time lawyers. The size of EMBP’s legal department had decreased slightly since the Soviet period. At its largest, 20 lawyers worked in this department. When the inevitable layoffs came to EMBP in the mid-1990s, the legal department had two vacancies, which were eliminated. Thus, no actual person was ever laid off from the legal department.

The chief deputy to the head of this department explained that the legal department had

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4EMBP’s bank account is subject both to kartoteka 1 (tax debts) and kartoteka 2 (private debts).

5The order of satisfying creditors is established by article 855 of the Civil Code.

6EMBP has the largest legal department of all the enterprises in the survey. The next largest legal department employs 12, and there was only one such enterprise. Thirty-nine percent of the surveyed enterprises (200) have legal departments. Of these 26.5% (34) have one lawyer, and 43% (55) have two lawyers.
traditionally been both large and well-respected at EMBP. She conceded that this was an exception among Soviet enterprises of any size, where legal departments are usually marginalized. She believes that the situation at EMBP is different because the general directors have always understood the importance of having lawyers who are able to appreciate the legal consequences associated with different strategies and because they have had a series of highly qualified men serving as the head of the legal department. In this regard, she described them as “lucky.” Indeed, neither of the reasons she gave are structural; both are personality-driven.

The lawyers are evenly divided into two groups. The first is occupied with economic law. Their primary duties are reviewing contracts, handling tax matters, and preparing cases for the arbitrazh courts.7 The second group deals with social issues, and handles labor disputes. Not only can this distinction be seen in substantive terms, but also in temporal terms. The first group is occupied with market-related issues, whereas the second group continues to deal with the social sphere and other issues that were critical during the Soviet era. My interests in the role of contracts meant that I spent more time with the lawyers in the first group than in the second.

Contracts. In 1996, EMBP’s general director issued a set of guidelines (polozhenie) for concluding contracts. Not surprisingly, the legal department actually drafted this document. It was deemed necessary because so much of the actual work in negotiating and drafting contracts is done by low-level workers in the supply (or procurement) and sales departments. Such workers do not have legal education. Interestingly, the guidelines are written in highly technical language -- Russian legalese. The head of the legal department told me that he knew that not all of those in the target audience would be able to understand the text, yet he felt he had no choice. Had the document been written in more conversational language, then many of the important nuances would have been obscured. In order to bridge the gap, the legal department periodically conducts seminars on various legal topics for the benefit of those without legal education.

The guidelines explain what steps are necessary in order for a contract to be considered legally concluded. Equal focus is placed on the substance of the contract and the need for obtaining approval of different departments within EMBP. As to the substance, the guideline sets forth options that might be used, depending on the business goals of the transaction. Such choices become important in the area of payment terms and penalties for non-performance. EMBP has an elaborate process of internal review.

7Russia has a divided court system. Economic-related cases that are filed by legal entities are heard in the arbitrazh courts. All other cases are heard in the courts of general jurisdiction.
The legal department is always the last to give its approval (or viza) in order that it can study all of the changes made in the review process. Only after obtaining all of the necessary approvals can the sales or supply department get the corporate seal affixed, which is essential for the contract to be legally binding. Copies of all contracts are retained in both the department responsible for implementing them and in the "department for defending commercial secrets."

Attached to the guidelines is the standard form contract of EMBP. It looks different from the form contracts at the other enterprises I have studied. Rather than having blanks to be completed, the EMBP form allows greater flexibility. With regard to key clauses relating to payment terms, it includes alternatives with different phrasing and, consequently, different legal consequences. The lawyers report that this approach has been somewhat problematic for them. In their view, the supply and sales workers were typically unwilling to take responsibility for making these choices. Instead, they would come to the legal department and get the lawyers to make these tough choices. As a result, the process became more time consuming. This situation was related to me in a matter-of-fact manner, not as a complaint. The lawyers regard this intensive consultation with the supply and sales departments as an inescapable part of their job.

For the most part, difficult choices are required with respect to the payment provisions. Given the high production costs of EMBP's output, obtaining some sort of prepayment or advance is critical. Yet no customer could possibly afford to pay the full purchase price in advance. This gives rise to installment payment schemes. Equally problematic is the lack of liquidity of many of EMBP's customers. This means that non-monetary means of payment in the form of barter or veksels (negotiable promissory notes) have to be found and agreed upon. The practical result is that there is, and can be, no single standard payment provision that will work in all circumstances.

The EMBP form has some unusual aspects, and it has changed over time. The changes are most obvious in the area of penalties. Russian contract law permits penalties to be assessed in case of non-performance. The sharp decline in contractual discipline that accompanied the collapse of the Soviet administrative-command system in the late 1980s and early 1990s gave impetus to the growth in the use of penalties.

Pursuant to a 1992 presidential decree, penalties of 0.5% per day of the amount of the

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8 Penalties, which are forbidden under US contract law, are a standard part of civil contract law systems, such as Russia. Depending on the agreement of the parties, they may come into play in case of late or non-payment and/or late or non-delivery.
outstanding debt were permissible. For several years, penalty clauses reflecting this extraordinarily high rate were routinely included in EMBP's contracts. In the past year or so EMBP has begun to reevaluate its use of this sort of clause. The reason is that the arbitrazh courts are increasingly balking at enforcing these absurdly high penalties. The Civil Code gives the courts the right to decrease penalties if they are unfair. In the place of the 0.5% rate, enterprises (including EMBP) have begun to rely on the Civil Code section that allows them to recover interest at the annual discount rate of the Russian Central Bank. Though the rate is substantially lower, the ability to recover it is more certain. EMBP has changed its form and practice accordingly. In those contracts that persist in the old approach, the rate is often lowered to 0.3 or 0.1% per day, and often the total amount of penalties that can be assessed in any event is capped at a specified percentage of the total value of the contract.

Another section of the form contract that is somewhat unusual relates to the handling of disputes. During the Soviet period, before filing any case in the arbitrazh courts, the petitioning party had to send a letter to the other side seeking performance. A change to the law in the mid-1990s eliminated this requirement to send these letters, known as pretenzia. But the parties can agree in the contract to use this system of pretenzia. The advantage is that it provides notice of an intent (or at least an inclination) to file a lawsuit, and gives the parties a chance to come to a negotiated settlement, and to avoid the costs associated with litigation. EMBP's form contract includes such a provision.

According to the procedural code governing the arbitrazh courts, jurisdiction over disputes rests with the court in the region where the defendant resides. This is merely a default rule; it can be changed by agreement of the parties. In a number of the other enterprises I have studied, the form contracts specified that jurisdiction was to be exercised by the court where that enterprise is located. None of these other enterprises have the level of power or prestige of EMBP. Consequently, I was surprised to find that the EMBP form contract made no effort to shift jurisdiction to the Ekaterinburg arbitrazh court.

Conversations with the EMBP lawyers reveal that they feel a distinct advantage when litigating on their home turf and feel disadvantaged when litigating elsewhere. The reasons for these perceptions were bound up in the comfort that comes from working with the same group of judges year after year, and the ease of responding to requests for additional documents when in the same city. Critical to their analysis was the reputation of the legal department for integrity and competence within the Ekaterinburg

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9 Art. 333, Civil Code, RF.

10 Art. 195, Civil Code, RF.
arbitrazh court, which was not easily transferable to another locale.

Notwithstanding these preferences the lawyers felt it was counterproductive to include a forum clause in their form agreement. They believe such a shift in jurisdiction would rarely be accepted by their contractual partners, and so would end up being struck out anyway. Time would be lost in quibbling over the clause. What was surprising is that an enterprise of the size of EMBP does not feel self-confident enough to put forward the standard contract that is most protective of its interests. Even this sort of high-profile plant engages in second-guessing about how its terms will be received by its partners, and worries about alienating its customer base.

Litigation. Another way in which the EMBP legal department stood out was in its attitude toward litigation. As a general matter, the cases could be divided into two categories. Some were pursued simply to collect the money. Such cases are no different than those observed elsewhere. Deciding to go to court involves a calculation of whether the debtor-customer actually has money or other liquid assets that could be recovered. In all such cases, EMBP's hope is that matters will be settled before the lawsuit is filed. The lawyers often send several pretenzia. In some cases they send the complaint to the putative defendant several days before actually filing it with the court. Often the debtor-customer pays immediately after receiving the complaint, eliminating the need for either side to pay the filing fees (gosposhлина). Frequently EMBP settles these non-payment cases via barter rather than money. The goal is always to end up with something of value.

A second category of cases are pursued in order to establish a legal principle. It is this category of case that I have not found elsewhere. As a general rule, Russia does not recognize precedent: rulings are limited only to the parties to the case. But EMBP is not seeking to change the rules of the game for everyone, just to establish norms to govern its relations with its contractual partners.

One example of such a case involved a customer that had ordered an expensive piece of machinery. The contract called for a 30% prepayment. Even though the customer satisfied only part of this obligation, EMBP went ahead with production. When production was completed, it notified the customer that the equipment was ready to be paid for and picked up. At that point, the customer informed EMBP that it was canceling the order. The equipment was produced specially for this customer and was not saleable to others. EMBP had incurred substantial costs in the production that it needed to recover. Even more important was that EMBP felt that customers could not be allowed to behave in this manner. As permitted by the Russian Civil Code, it filed suit against the customer.
seeking the full amount of the production costs. The customer was located in another oblast, and it was there that the case was heard. EMBP lost at the trial level, which the lawyers attributed to local favoritism, but won on appeal.

The defendant-customer in the case filed for bankruptcy soon after EMBP’s case against it had been decided. The EMBP lawyers are resigned to the fact that they will never see a kopeck from this company. For them, however, this was never the point of the lawsuit. Rather, the point was to send a signal to the business community that EMBP would not stand for this sort of behavior among its customers, and that it would fight with all the ammunition available.

Conclusion:

Among the enterprise legal departments I have studied, the EMBP legal department represents an anomaly. Its uniqueness stems not just from its unusually large size, but also from the behavior of the lawyers and the role of the legal department within the enterprise. It is not marginalized from business decision-making. Its lawyers are not mere technicians, concerned only with the basic legality of contracts and other documents.

Instead, they are more akin to advisors: they are routinely consulted by top management about the legal implications of various possibilities. The attitudes of the lawyers themselves toward their work constitutes a remarkable combination of pragmatism and idealism. They accept certain limitations, and work within them. At the same time, they take on cases merely to make a point to the defendant and, more interestingly, to the broader business community. They do so even knowing that a favorable court decision cannot be enforced against someone uninvolved in the case. Ambiguities in law and problems with enforcement are reasons why such an activist and adversarial legal department has developed in an enterprise such as EMBP.

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\(^{11}\)See art. 515, Civil Code, RF.
Building a Business in Post-Soviet Russia:
A Report on a Case Study of an Ekaterinburg Enterprise
Introduction:

The case study of the Ekaterinburg Women’s Apparel Factory (EWAF) was undertaken in the spring of 1998 as part of a research project funded by the National Council for Eurasian and East European Research (Contract No. 813-16G) and the National Science Foundation. Of the six case studies undertaken pursuant to these grants, EWAF was the only “new” enterprise, i.e., not a privatized state enterprise. Moreover, with only 300 employees, it was also the smallest. Like the other subjects of case study, EWAF had participated in a survey fielded in the spring of 1997, and had consented to my doing this follow-up research. In this report, I focus on the strategies adopted by EWAF management in dealing with their customers and suppliers. It might be hypothesized that new companies, like EWAF, are more likely to resort to the courts or other formal mechanisms of resolving problems since they lack the embedded network of contacts of the former state enterprises. Interestingly, I found just the opposite. This new enterprise generally eschews the law, preferring to trust in the strength of their relationships with suppliers and customers.

Creation and Development of Business:

A bit of background information about the enterprise is necessary to put its behavior into context. EWAF is not a spin-off of a larger enterprise, nor is it located on the premises of a larger enterprise. EWAF can fairly be regarded as a post-Soviet start-up business. EWAF is a closed joint-stock company. All of the stock is held by seven of its managers, who refer to themselves as “co-owners” (sovladetsy) rather than as “shareholders” (aktsionery). The general director holds the largest

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1 The name of the enterprise has been altered in order to preserve its anonymity.

2 The survey included 328 Russian enterprises divided among 6 oblasts and 9 industrial sectors. On the survey portion of the research, I collaborated with Barry Ickes, Peter Murrell, and Randi Ryterman. The survey was funded by the World Bank, and its implementation in Russia was coordinated by Dr. Alla V. Mozgovaya of the Institute of Sociology of the Russian Academy of Sciences.

3 EWAF is located on the outskirts of Ekaterinburg. It is not easily accessible by public transportation. As a result, EWAF provides private bus service to and from the enterprise. A subsidized cafeteria is also available for employees.

4 Of the firms participating in the survey, 12% (40) had never been state owned, indicating that they were “new” enterprises.
share and, even though he does not control a majority interest, his vote is regarded by the others as
decisive. All of these “co-owners” have been with the company since its founding in 1992. The
common link is the general director. Prior to creating EWAF, he worked at a large defense plant. Seeing
that such plants were doomed to failure in a market environment, he left in the late 1980s. He raised
capital by trading in computers, and decided to invest this money in a manufacturing concern. He
convinced several of his former colleagues at the defense plant to work with him.\(^5\)

None of the initial EWAF management team -- neither the general director nor any of the co-
owners -- knew much about manufacturing. Their production profile was, therefore, dictated by
perceived market niches rather than by expertise. The general director believed there was an untapped
market in Russia for good-quality women’s underwear. Such goods had not been a priority during the
Soviet period. Indeed, there were no factories in Russia: the production facilities were in Latvia and
Belarus. From the beginning, EWAF’s production was focused on women’s underwear. For a few
years, there was also a production shop (tsekh) making television parts. This odd combination resulted
from the general director’s connections in the television industry. It did not persist. As the production of
televisions declined in Russia, EWAF shut down this tsekh.

This experience illustrates the flexibility that often comes with smaller companies. It further
suggests that EWAF’s management is willing to take advantage of opportunities as they arise, but does
not cling to policies when they are clearly not working. This already marks them as different from
management at many privatized state enterprises who find it difficult to let go of unprofitable product
lines.

EWAF has enjoyed considerable success. Its labor force has grown from 90 to 300 over the six
years of its existence. The general director identifies several factors that have contributed to this success.
He argues that many enterprises founded in the late 1980s and the early 1990s failed because they
grabbed the easy credit available during this period, and then were unable to repay the loans. EWAF’s
growth has been deliberately slow, but relatively steady. Also important, in his view, is EWAF’s
commitment to high quality production. At this point, EWAF is one of the top five medium-sized
enterprises in the Sverdlovsk oblast. In contrast to most other Russian enterprises, it has no trouble
obtaining bank loans. At this point, it has its choice of bank partners. It has a line of credit from a local

\(^5\) By 1992, some of them were no longer working at the defense plant.
bank and a short-term (1 year) loan from the Ekaterinburg office of a Moscow bank.\

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\[6\] Having this relationship with a Moscow bank is helpful because payments from Moscow customers are cleared more quickly through this bank than through Ekaterinburg banks. The interest rate on EWAF's loans are tied to the Russian Central Bank's discount rate. For example, its credit line has an interest rate equal to the Central Bank rate plus three percent. This is the rate offered to preferred customers. The Central Bank's decision to raise the rate to 50% and then to 150% in May 1998 greatly complicated life for EWAF.
Thus far, the co-owners have been able to maintain a harmonious relationship with one another. The success of EWAF has given rise to generous profit distributions. Certain issues loom on the horizon that raise questions about how long this harmony will last. One particularly thorny issue is whether to reorganize EWAF as an open joint stock company. Doing so would make it easier to attract and absorb investment. The general director and some of the co-owners oppose “opening” the company, believing that EWAF is not yet sufficiently strong. Other co-owners believe that EWAF has gone as far as it can as a closed joint-stock company, and that maintaining this “closed” status will cause the company to stagnate. At the moment, the general director has gotten his way, but there is open grumbling among some of his key lieutenants.

Despite encouraging a “team” image, there is a relatively clear caste system among EWAF managers. At the pinnacle of the system is the general director. Virtually every manager commented on his “toughness” or “strictness.” He makes virtually all the decisions about design, not including his sales managers in this process even though they know a great deal about customers’ likes and dislikes. He also travels to industry trade shows, and single-handedly picks the suppliers. He also selects EWAF’s regional dealers. This sort of management style may become problematic as EWAF seeks further expansion.

Below the general director in this status hierarchy are the co-owners. They are insiders, and have a relatively full sense of what is going on at EWAF. Managers who are not co-owners are less well-informed. In conversation, they often explain their lack of knowledge about one or another issue by saying that they are not co-owners. It seemed that they were saying that, given their lack of ownership stake, they weren’t entitled to information about the future plans of EWAF.

**Strategies for Dealing with Customers and Suppliers:**

How EWAF deals with its customers and suppliers reflect certain strategic choices. Like all companies, it has a range of options. In this report, I focus on four possible strategies, and analyze the extent to which EWAF makes use of them.

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7For example, EWAF applied for a loan guaranteed by the European Bank for Reconstruction and Development. Its application for a $600,000 loan was approved, but EWAF ultimately declined the loan because it would have forced them to become an open joint-stock company.
Reliance on Law. One obvious choice is to rely on law. This scenario contemplates a company focusing on the contract as the means of protecting its interest, and appealing to the courts when customers or suppliers default. As I noted above, it might be thought that a “new” company, such as EWAF, would be more likely to adopt this sort of strategy because it lacks political protectors or a network of contacts within the industry.

On a superficial level, EWAF relies on contracts. As a rule, all of EWAF’s sales of its output and purchases of inputs are memorialized in the form of a written contract. Exceptions are rare, and are usually due to time pressures. But looking below the surface, the strictly formal role of contracts within EWAF quickly becomes apparent.

Supplies. EWAF purchases many of its supplies abroad. Due to the absence of a viable women’s underwear industry during the Soviet period, many of the inputs (both raw materials and finished goods) needed are simply unavailable within Russia. Some can be bought in Latvia, but about half of all supplies come from non-CIS countries. EWAF managers regularly attend trade shows, and are always looking for new materials. Indeed, this is an industry in which innovation -- both in design and in materials -- is critical. EWAF’s first foreign suppliers were Italian, and they remain the most important of the foreign suppliers. It works with approximately 20 other foreign suppliers from countries all over Europe and East Asia.

The director of supply (of procurement) for EWAF knows all of these suppliers, and could answer detailed questions about his interactions with them. When I started to ask about the contracts, however, I hit a brick wall. The supply director had a vague sense that EWAF entered into contracts with its suppliers, but knew none of the terms. He did not bother to read the contracts before signing them. All that concerned him were the price, quality, and delivery terms. He said that he left the legal details to EWAF’s lawyer. Yet my conversation with this lawyer was substantially the same. He too said that he was unconcerned with the substance of the contract, and that he felt that if EWAF did a good job in picking its partners, then there was no need to worry about legal consequences. He pointed out that, to date, EWAF had never been sued (or had to sue) one of its suppliers. Any problems had been resolved through informal negotiation.

When the supply director dug out a contract to satisfy my curiosity, I discovered a clause that required all disputes to be submitted to a private arbitration tribunal, organized under the auspices of the Moscow Chamber of Commerce. I asked if he knew what this was. He said no, but was obviously unconcerned. He explained that, while disputes arose fairly frequently (usually relating to quality), he
has always been able to reach some accord with the supplier. Usually they strike a deal giving EWAF a
discount on its next purchase. He does not regard the courts as a serious option, not because of any
shortcomings in the courts, but because they are unnecessary.

Sales. The situation was slightly different in the sales department. EWAF has its own
form contracts. There are two variants: one is used for sales to individual stores, and the other is used for
sales to regional dealers, who then sell EWAF’s goods to stores. With the exception of sales to Moscow
stores, EWAF uses its own form when selling its goods.\textsuperscript{8}

EWAF’s two-page form takes a number of measures to protect itself. In all of the contracts, a
clause is included that imposes penalties on customers if they do not pay on time. The amount varies;
the form contains a blank to be filled in by the sales person. EWAF also shifts jurisdiction over any
disputes to the Ekaterinburg court, rather than accepting the legislative default of ceding jurisdiction to a
court where the defendant is located. In the dealer contracts, EWAF reserves the right to terminate the
contract unilaterally if the dealer fails to meet a minimum order.

Yet this proactive attitude reflected in the text of the form contract is absent from EWAF’s
dealings with customers. Like all Russian businesses, EWAF’s customers are often late in paying, and
arrears mount. No one could remember an instance in which penalties had been assessed. When
payment is late, an EWAF employee calls to remind the customer. If payment is still not forthcoming,
then they send a letter. Sometimes the letter threatens court action, but EWAF managers openly
acknowledged that all their customers know that such threats are empty. They are empty not just
because EWAF prefers to avoid court but, more importantly, because even if EWAF went to court and
obtained a judgment against the customer, it would probably be unable to collect. One of the sales
managers commented that a threat is only as strong as the person or institution standing behind it, and the
arbitrazh courts are too weak to constitute a meaningful threat.

The negative attitude toward the courts was based primarily on one experience. EWAF had filed
a lawsuit against a Nizhny Novgorod store. Although it won the case, it has been unable to collect. The
assets have been drained from the legal entity with which EWAF contracted, and the store now operates
under a different corporate identity. This has left EWAF management frustrated and bitter.

\textsuperscript{8}Moscow is the most important market for EWAF and, in order to get a toehold in the most prestigious
stores, EWAF has been willing to accept any terms offered by these stores. The contracts are often outrageously
one-sided, but EWAF believes that if it suggested revisions, the Moscow stores would stop trading with them.
Although the details are different, the basic behavior is the same in both the sales and supply departments. Contracts are signed, but have little meaning thereafter. It is the relationship and not the contractual technicalities that determine whether the two parties continue to work together.

Reliance on Government. The logical hypothesis for a start-up company is that it would lack the longstanding contacts necessary to be able to rely on the government for assistance in customer and/or supplier relations. (This, of course, assumes that the founders of the company did not previously work for the government or have strong government contacts.) This hypothesis is borne out by EWAF’s behavior. Although all of the co-owners were members of the Communist Party, they were too junior to have established any strong political patrons. None of them regard their Party background as relevant to their current business.

The general director regards the government as a potential hindrance, rather than help. His subordinates echoed this attitude. EWAF tries to exist independently of government, to the extent possible. All of the managers stressed that they have never asked the federal or local government for special treatment. When asked why not, they often responded that medium-sized companies such as EWAF have little hope of obtaining them. Thus, whether their failure to obtain subsidies (direct or indirect) was the result of a conscious policy to go it alone, or a perception that efforts would be fruitless was not clear. There are indications that the regional and local governments are beginning to pay more attention to EWAF. Sometimes such attention is unwanted. A telegram from the oblast government congratulating EWAF on its success during the last year was followed by a notification that the tax authorities would soon be visiting to verify that this success had been achieved through legal means.

Also interesting is the revelation EWAF does not always take advantage of the benefits generally available to them. For example, by hiring women, EWAF is eligible for certain tax privileges. It took advantage of this once, but found that the resulting burden on the enterprise, in terms of submitting reports, more than outweighed the benefit gained in terms of decreased taxes. As a result, even though eligible, it has not taken advantage of these benefits again.

In contrast to many other Russian enterprises, EWAF is usually able to pay its taxes on time. Its bank account reflects no amounts owed to either state or private actors. This greatly reduces the need to petition the government for assistance and to engage in questionable schemes to avoid taxes.

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9One of the co-owners was the chairman of the Komsomol committee at the defense plant where so many of them worked.
Reliance on Private Enforcement. Many scholars have argued that the shortcomings of the Russian legal system are pushing many otherwise law-abiding companies into the arms of the mafia in order to enforce their contracts. This is, of course, a difficult issue to research. Among EWAF's employees are security guards. Overlooking the entrance gate to EWAF's territory is a tower. Guards with submachine guns sit in that tower. When I asked why this was necessary, the male managers explained that the mostly female work force had to be protected. While the level of protection may seem extreme, it is hardly unusual in contemporary Russia.

Whether these guards or others like them are used to "convince" customers to pay is less clear. Certainly no one came out and said as much. One of the sales managers is responsible for doing security checks on potential customers. But in a world without reliable credit rating agencies, this is also not unusual. The fact that this particular sales manager has a background in Soviet law enforcement raises suspicion, but proves nothing. To reiterate, I found no evidence that EWAF engaged in strong-arm tactics to obtain payment. Thus, the hypothesis that private businesses are using the mafia to enforce their contracts was not confirmed.

Reliance on Self-Enforcement. Another option for companies who doubt the capacity of the legal system is to structure its transactions so as to provide strong incentives for both sides to perform, without need to resort to the formal legal system. Companies may, for example, require prepayment from customers before shipping any goods. I found considerable evidence that EWAF employs this strategy. Similarly its suppliers structure their relationships with EWAF on this basis.

Almost all of EWAF's suppliers require full prepayment in advance of shipment. This can fairly be regarded as a self-enforcement because it gives the supplier an opportunity to pull out of the transaction if EWAF fails to perform. No action of the part of courts is required. Neither side is liable for damages. To be sure, EWAF's reputation may be diminished in the eyes of the supplier, but this can be remedied through better performance in the future, if EWAF is given such an opportunity.

In contrast, EWAF does not require full prepayment from most of its customers. Such a policy would not be realistic, in the view of its managers. EWAF is in a relatively competitive market. All of its customers can obtain women's underwear from alternative sources. EWAF is working to establish its place in this market, and to convince customers (both stores and consumers) that its output is of a better quality than its domestic competitors and on the same level as foreign producers. But this is an ongoing process. At the moment, EWAF management believes that it would lose many customers if it adopted an across-the-board policy requiring full prepayment.
EWAF demands prepayment only from new customers and from those with a poor payment record. Detailed payment records are maintained. At a minimum, no additional goods are sent until full payment has been received for the last shipment. The policy to require full prepayment from new customers is fixed. In the absence of a reliable credit rating service, EWAF can never be entirely sure whether a new customer is reliable. Only experience tells. With regard to its regular customers, the decision about whether to demand prepayment (either full or partial) is highly contextual.

What is clear is that prepayment is viewed as a more realistic method of guaranteeing a customer’s performance than are more legalistic methods, such as going to court or seeking penalties.

*Reliance on Relationships.* In both its dealings with suppliers and customers, EWAF chooses its strategies based on the nature of the underlying relationship. Everyone with whom I spoke stressed the importance of relationships. The general director spoke about the process of building EWAF’s reputation by attending trade shows and making others in the industry aware of its goods. He stressed the importance of trust when selecting regional dealers. In his view, trust evolves gradually. EWAF’s dealers are all entities or private entrepreneurs with whom the general director has worked for many years.

The supply director echoed this sentiment. He said that the only suppliers that were willing to ship without prepayment were the Italian firms with whom EWAF has been working since its inception. Their flexibility stems from a feeling of partnership between the two companies, and a recognition by the Italians that EWAF will pay in due course. He notes that EWAF has more quality problems with first-time suppliers. He thinks this is because such suppliers are not sure that EWAF is a serious company. Once he is able to convince them that EWAF is no fly-by-night concern, their attitude toward EWAF changes, and the quality problems are rarely repeated in subsequent shipment. Moreover, these suppliers often begin to offer better terms (discounts) once some trust develops. The supply director sees a direct connection between good relations and productive business dealings.

The sales directors also base their policies toward individual clients on the nature of the relationship. As I noted above, there is a gradual transition. The first sale is made on the basis of full prepayment. The second on the basis of 50% prepayment. Only after EWAF feels confident of the customer’s ability and willingness to pay is it willing to extend credit by allowing for payment within several weeks following delivery. Once again, the key is some modicum of trust.
Conclusion:

Although a post-Soviet start-up, EWAF has succeeded in embedding itself within a strong network of suppliers and customers, and in establishing relationships of trust with these trading partners. The trust is not given blindly, but is based on a solid track record of performance. In some cases, the record is still being built, and so prepayment is required. Even though pursuing this path of relying on relationships was not necessarily the most direct route to guarantee payment by customers, the EWAF managers believe it is the only way to build and maintain its business. Using the courts or other legalistic methods to protect its interests remains an unattractive option for EWAF management, not only because of their dissatisfaction with how the Russian legal system works but also because it would have the effect of undermining the constructive relationships they have worked so hard to create.
The Challenges Facing Intermediate Russian Producers:
A Report on a Case Study of a Moscow Enterprise
**Introduction:**

The case study of the Moscow Generator Factory (MGF) was undertaken in early 1998 as part of a research project funded by the National Council for Eurasian and East European Research (Contract No. 813-16G) and the National Science Foundation. I spent two weeks at MGF interviewing managers and reviewing documents in an effort to understand its strategies for coping with economic difficulties, including the use of law and legal institutions. I was given a desk in the legal department, and used this as a base from which to observe and talk with key managers. MGF had participated in a survey fielded in the spring of 1997 on these same issues, and had consented to my doing this follow-up research.

**Description of Business:**

MGF produces generators that are used in Russian automobiles, trucks, and tractors. Traditionally, it has sold almost none of its production directly to the public. Its most important customers have always been, and continue to be, the assembly plants whose abbreviated names are familiar to all Russians, e.g., ZIL, GAZ, VAZ, etc. MGF began production in 1929, and it is housed in the low sturdy brick buildings that are typical of industrial construction of that early Stalinist period. Until the late 1960s, it was not a separate legal entity, but was a subdivision of a much larger plant. As part of one of the Brezhnev-era economic reforms, MGF was separated, and since that time, has operated independently. It is still housed on the premises of this gigantic factory, and its corporate offices and production facilities are in different corners of a large physical plant.

MGF was privatized in September 1994 via Option 2. It is currently an open joint stock company, in which insiders (workers and managers) hold approximately 38% of the stock, and outsiders

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1 The name of the enterprise has been altered in order to preserve its anonymity.

2 The survey included 328 Russian enterprises divided among 6 oblasts and 9 industrial sectors. On the survey portion of the research, I collaborated with Barry Ickes, Peter Murrell, and Randi Ryterman. The survey was funded by the World Bank, and its implementation in Russia was coordinated by Dr. Alla V. Mozgovaya of the Institute of Sociology of the Academy of Sciences.

3 See Aslund (1995) for a detailed discussion of the options available to enterprises undergoing privatization.
hold the remaining 62%. No single individual or entity has a controlling interest.

The post-Soviet period has not been easy for MGF. The collapse of the Russian automobile industry has had the expected ripple effect. During the Soviet period, when inputs were always in short supply, MGF had to struggle to keep up with orders from its customers. Now it has to scramble for every sale, and it faces stiff competition from other Russian manufacturers of generators. The workforce has declined from 5,500 in 1992 to approximately 1,500 today. The production rhythm is uneven. The assembly line frequently has to be temporarily shut down due to shortages of a needed input. In contrast to the Soviet era, however, the contemporary shortages have their source in a lack of money rather than the unavailability of the inputs themselves. Somewhat paradoxically, the efforts on the part of Yuri Luzhkov and others to revive the big assembly plants have had little effect on MGF because these bail-out efforts are usually tied to tax relief packages for the assembly plants.

**Survival Strategies:**

Like most Russian enterprises, MGF is plagued by non-payments. Its customers lack the cash to pay for generators and, consequently, MGF lacks the cash to pay its suppliers or its workers. As of March 1998, it was four months behind in paying wages. It is likewise unable to pay its taxes or other state obligations in full.\(^4\) As a result, liens have been placed on MGF's bank account. Any monies that are deposited in its accounts are automatically transferred to MGF's creditors, in the preferential order set forth in the civil code, with first preference going to the tax authorities.\(^5\) The problems associated with non-payments have persisted for so long that no one remembers how it all began or even what life was like before.

What coping strategies has MGF adopted?

First and foremost, it has virtually ceased using its bank account. Recognizing that any sales revenues that go through the bank account will be lost to it, MGF has found alternative routes. Its form sales contract includes a provision that allows MGF to order the customer to pay a third party. In this

\(^4\)The non-payment of these obligations gives rise to penalties, which are assessed at rates as high as 1% per day (or 365% per annum).

\(^5\)Art. 855, Civil Code RF. The Russian Constitutional Court recently altered the legislative preferences to give the tax authorities first call on any resources. Only after all obligations to the state and to its workers have been satisfied can private creditors hope to collect.
way, MGF’s customers pay its suppliers directly, bypassing MGF itself. MGF has also set up a subsidiary for the sole function of accepting payments. Only through this sort of subterfuge is MGF able to gain any value from the sale of its goods.

While this strategy brings a short-term benefit to MGF, the larger implications of such behavior are troubling for the system as a whole. The tax authorities and private creditors who have obtained court judgments and court orders against MGF’s assets are entitled to payment. Management at MGF exhibit little sympathy for the tax inspectorate, commenting that the system is so confiscatory and irrational that companies can only survive by evading taxes in whatever way possible. Such sentiments are echoed by other enterprise officials in my interviews and in the Russian press more generally. No doubt there is considerable truth in their complaints.

But opting out of the banking system is an extreme solution. On the positive side, it allows survival. But on the negative side, it destroys the credit rating of the enterprise, making it virtually impossible for companies like MGF to obtain loans from reputable banks. Certainly foreign banks, which may be unfamiliar with the debt patterns in Russia, would react in horror to such a financial history. Moreover, it is creating a bizarre business culture in which it is perfectly acceptable to not honor debts. Even the tax authorities have been co-opted. According to the MGF managers, the tax inspectorate is well aware of what the company is doing, and has taken no steps to stop this circuitous flow of money and resources.

Looking past the tax authorities, this strategy also works a hardship on private creditors who have taken the time and trouble to obtain a court judgment and to attach it to MGF’s bank account. From an institutional point of view, efforts should be taken to encourage creditors to pursue legal action, since it promotes orderly and fair distribution of the limited resources of cash-strapped companies. Even if it does not always achieve these noble goals, it is certainly fairer than allowing the debtor to repay according to principles of favoritism. By looking the other way when enterprises such as MGP bypass their bank accounts in order to stay in business, the authorities endorse this extra-legal behavior. In a society in which law is still somewhat marginalized, this seems to be sending the wrong message.

The attitude of MGP managers toward their private creditors -- toward debts owed to their trading partners -- is markedly different from that exhibited toward the tax authorities. They bear their creditors no ill will, and fully acknowledge the debt. But they do not view their behavior toward them as fraudulent in any way. When I lay out the logic, namely that by paying current obligations rather than preexisting debt they are defrauding creditors, they usually shrug and ask what else can they do. Their
defense is that everyone uses the same tactics, and so the creditors are forewarned. There is little sense
of shame, and little adverse reputational effect to not paying debts.

When we see this behavior on the level of one enterprise, it may seem like a valiant struggle. But when it becomes widespread, it has a profound negative impact on the effort to create and institutionalize the legal infrastructure typically found in market economies. Looking further into the future, it will certainly not be helpful to Russia's effort to become a more active participant in the global economy.

The second strategy used by MGP to cope with non-payments is barter. Lacking cash, MGP routinely engages in transactions that require no cash. The procurement director reports that MGP pays only one of its almost 100 suppliers in cash. All others are paid with some form of in-kind exchange. This has caused a number of important changes in how MGP organizes its business transactions.

On the supply side, MGP deals more with intermediaries or brokers than with the actual manufacturers of needed inputs. These brokers take on the task of organizing the chains of exchange. Sometimes they involve many enterprises, as each seeks to obtain something of value. On the sales side, MGP also deals with brokers. As might be expected, MGP is often paid in the form of cars, which are sold by brokers. MGP prefers to be paid upon delivery of the cars to the brokers, but sometimes has to wait for the sale to obtain the proceeds. Even from this brief description, the high transaction costs associated with barter are apparent. Recognizing this, MGP usually places a 20% surcharge on goods obtained via barter (over the cash price).

All of the managers I interviewed bemoaned the reliance on barter, but regarded it as a necessary evil. Top management is trying to decrease barter, but as intermediate suppliers, their flexibility is extremely limited. I asked the deputy director for economic issues what ZIL would do if MGP informed them that it would only sell under conditions of full prepayment. Without hesitation, he responded that ZIL would find another supplier of generators who would deal on conditions of barter. MGP has strong competitors, which further limits its options.

A third strategy, which is more forward-looking, is to sell its generators directly to the public. MGP has recently hired a marketing director, who is working to develop packaging and advertising for these generators. As automobile ownership increases within Russian society, it stands to reason that the auto parts market will also expand.

Use of Law:
To what extent does MGP incorporate law in its coping strategies? There are two points at which law might be helpful. The first is at the start of a transaction. At that point, contracts can be used to frame the transaction to the advantage of one side or the other. Alternatively, contracts can be used in a looser way, simply to establish a mutual obligation, but not delving into details. The second point at which law becomes relevant is when problems arise, e.g., when a customer fails to pay or otherwise defaults on contractual obligations.

As a rule, contracts serve as the basis for MGP’s sales and purchase transactions. On occasion, however, transfers occur without supporting contracts. In the words of the MGP lawyer, “the relationship exists, but the contract does not.” MGP has instituted safeguards in an effort to minimize such occurrences. Per order of the general director, all contracts have to be “registered” with the legal department. Until they are stamped as being so registered, the enterprise authorities will refuse to affix the corporate seal, without which the contract is not valid. Over the two weeks I spent in the legal department, hardly a day went by when someone would come in after having naively tried to obtain this seal without registering the contract. The bureaucratic requirement has a substantive goal. Before registering any contract, the lawyers review it to ensure that it meets the legal requirements. They also go beyond the technical requirements of the law. For example, they would check for penalty provisions, and would sometimes insist that the penalties for late payment be lowered.

MGP usually uses its own form contract when selling its output, and relies on the form contract of the other side when purchasing supplies. This is the common practice in Russian industry -- it is a carryover from the Soviet days. I came across no exceptions to the practice of using the seller’s form when buying inputs. I did, however, find a number of transactions in which MGP had acceded to the demand of a customer to use its form when selling its generators. Most prominent among these was AvtoVAZ, which insisted on the use of its own detailed seven page document that was completely skewed in its favor. The MGP sales director explained that AvtoVAZ was perceived as being the best automobile assembly plant, and being its supplier was considered prestigious. He complained that AvtoVAZ took outrageous advantage of suppliers and that MGP had decided that it could no longer afford to trade with AvtoVAZ. But he had no doubt that another generator manufacturer would be quick to take MGP’s place.

MGP has separate form documents for cash and barter sales. They are substantially similar, with small differences in the sections dealing with penalties for late payment. The form for cash sales is
designed to be sufficiently flexible to accommodate all forms of payment. While prepayment is preferred, it also contemplates barter and other non-cash forms of payment (including barter and commercial paper). This suggests that MGP views contracts as a means to establish the existence of mutual obligation, but then allows the relationship to develop naturally. MGP managers consistently stated that it could not afford to alienate customer by insisting on full or even partial prepayment. A sense of desperation was in the air. MGP was willing to take whatever sort of payment the other side could manage.

When payment was not forthcoming, MGP rarely took legal action. MGP has only 20 permanent customers (though it sometimes sells to individuals and entities who are in the auto parts business in spot transactions). Although all of these 20 customers were seriously in debt to MGP, it did not file lawsuits against any of them. A review of the correspondence between MGP and some of these bit auto assembly plants indicates that they are locked into a relationship of mutual dependence. Letters go back and forth. ZIL, for example, tells MGP that its assembly line was shut down due to the late delivery of generators. MGP responds by telling ZIL how its late payment (or non-payment) has contributed to the four-month delay in wages. Each side has plenty to complain about, but few alternatives. In contrast to letters asking for payment that I have reviewed at other factories, these are unusual in that they include no threat of legal action. Both sides seem to recognize the futility of dragging the courts into their dispute.

Top management at MGP claimed that the futility stems not just from the fear of alienating customers (given that the number of potential customers is limited and finite), but also from its perception of the bias of the commercial (or arbitrazh) courts. The chief financial officer scoffed at the idea that MGP could sue AvtoVAZ on its home turf. He assumed that the arbitrazh courts in Togliatti would be firmly in the pocket of AvtoVAZ. It is worth noting that MGP had never actually sued AvtoVAZ or any of the other big assembly plants, and thus no concrete evidence of corruption or even bias exists. But the perception is quite real to the MGP managers, and effectively limits their options.

MGP filed no lawsuits during 1997. It is currently preparing to file a complaint against one of the brokers (or intermediaries) that sells cars that MGP receives in payment from GAZ. MGP is willing to pursue this debt through the courts because the -relationship with this broker is irretrievably broken already. It has tried with no success to obtain repayment via letters that include threats to go to arbitrazh court.

Conclusion:
Thus, legal remedies are pursued only under very limited circumstances. MGP's willingness to go to court is circumscribed both by its market position and by its perception of the political influence of the auto assembly plants.
Minimizing the Risk of Financial Loss by Using Dealers: 
A Report on a Case Study of a Saratov Enterprise
Introduction:

The case study of the Saratov Food Factory (SFF) was undertaken in early 1998 as part of a research project funded by the National Council for Eurasian and East European Research (Contract No. 813-16G) and the National Science Foundation. SFF had participated in a survey fielded in the spring of 1997 on these same issues, and had agreed in principal to follow-up research. Notwithstanding this preliminary consent, access was highly problematic. Since the time of the survey, SFF had been taken over by a local holding company. As a result, no one was aware of the survey. The takeover was accompanied by major physical renovations of the space occupied by management, which created an overall sense of disorder. In typical Russian fashion, no one ever actually refused to allow me to come to the plant. Instead, after a few initial visits, they simply found excuses to delay my return until I ran out of time. My time at SFF was more limited than at the other enterprises I studied as part of this project, but the interviews I completed were sufficient to provide a clear picture of the strategies adopted by the plant.

SFF manufactures mayonnaise and sour cream. In that it does not suffer from many of the maladies plaguing other Russian enterprises, it provides an interesting contrast. Not only has it reported profits during the past few years, but has had sufficient resources to acquire new production equipment. Management has been successful in meeting its obligations, both to the tax authorities and to private creditors (e.g., banks, energy companies, and suppliers). One important practical consequence of this payment pattern is that SFF has full access to its bank accounts, which means that it need not engage in subterfuge to pay its bills or to obtain payment from its customers. This is relatively unusual in Russia.

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1 The name of the enterprise has been altered in order to preserve its anonymity.

2 The survey included 328 Russian enterprises divided among 6 oblasts and 9 industrial sectors. On the survey portion of the research, I collaborated with Barry Ickes, Peter Murrell, and Randi Ryterman. The survey was funded by the World Bank, and its implementation in Russia was coordinated by Dr. Alla V. Mozgovaya of the Institute of Sociology of the Academy of Sciences.

3 SFF management refused to give me a pass that would allow me to enter the plant. They insisted on sending a ... to bring me to the plant. The usual delaying tactic was that a car was unavailable or that all of the managers with whom I needed to speak were busy. The unreliable phone lines in Saratov also contributed to these difficulties, since I frequently could not even get through by phone to SFF.

4 When Russian enterprises owe money to state or private creditors, their bank accounts are blocked such that any money that comes into the account goes automatically to pay these outstanding debts. The enterprise (bank account holder) has no control over these funds. Many Russian enterprises respond to having their bank accounts...
today. SFF is also unusual in its ability to weather the post-privatization period without the need for retrenchment. In 1992, SFF had 885 employees. By 1997, the number had dropped to 805, but the decrease was a product of natural attrition rather than layoffs. An even better indicator of the stability in labor relations is the fact that SFF has not had to resort to reducing the work week and has generally been able to pay wages on time.

SFF is more typical in that it has difficulty getting its customers to pay. In this report, I analyze how the new management of SFF is attempting to deal with this problem.

**Developing a Dealer Network:**

Traditionally, SFF dealt directly with its customers. Most of them were retail stores that sold SFF’s products to the general public. Not surprisingly this led to a proliferation in the number of customers, and created difficulties in managing these relationships. Further complicating matters is the high turnover in the retail business. SFF reports that 80% of its customers were new since 1992. Management had great difficulty in assessing the credit-worthiness of their customers.

When the Management Company (MC)' acquired control of SFF during the latter half of 1997, its first task was to develop a strategy to lower customers’ arrears. The primary mechanism of achieving this goal is to create a network of dealers. Rather than selling to hundreds of retail outlets, SFF is working to find regional dealers. The plan is to sell the SFF output to the dealers on a cash (non-barter) basis. The dealers would then be responsible for working with the retail outlets.

This plan is appealing to SFF management because its effect is to shift the risk of non-payment from SFF to the dealers. These regional dealers have to pay for SFF’s goods via bank transfer, which is the lowest cost method of payment in Russia. SFF will not work with dealers who cannot make payment in this manner. This represents a shift in strategy from the prior management team, which was willing to take payment in any form. The MC managers recognize that barter and other cash equivalents increase the transaction costs, and are vehement in their refusal to work with customers on a barter basis.

SFF and the dealers work on a contractual basis. The payment method varies. Depending on the nature of the relationship it may be a percentage of the amount sold or it may be a fixed sum. In some blocked by finding ways around the banking system, such as having customers pay suppliers directly.

*SFF's name has been changed to protect the identity of the new owners.*
cases, SFF will agree to pursue joint projects with the dealer and/or to provide funding for advertising campaigns. Similarly, SFF has no firm policy as to whether dealers are required to pay in advance or can pay after delivery. According to management, this decision will be made on a case-by-case basis, and will be affected by the business reputation of the dealer and the prior payment record (if any).

Once the dealer network is in place, SFF will terminate its contractual relationships with retail customers. They will obtain SFF’s output from the dealers, with whom they may have a contractual relationship. SFF places no conditions on the content of that dealer-customer relationship. It is up to the dealer to obtain payment. Whether this is accomplished through bank transfers or bartered goods is solely within the discretion of the dealer. Difficulties in obtaining payment from customers does not excuse a dealer’s non-payment to SFF. The burden of extracting payment is completely on the dealer.

MC, on behalf of SFF, can adopt this sort of aggressive policy because it feels confident of the demand for its goods. SFF management believes that the quality of their output puts them in the driver’s seat in terms of selecting dealers. It allows them to set the conditions. If some dealer candidates balk at them, then SFF feels confident that other potential dealers are waiting in the wings. SFF is not concerned about the influx of imported food products. They believe that Russians are accustomed to the specific taste of Russian-made mayonnaise and sour cream, and are not likely to desert them in favor of foreign products that are loaded with preservatives and other artificial ingredients. SFF management concedes that they could be doing a better job in terms of packaging and marketing of their goods. Improvements in this arena are supposed to accompany the other changes in sales strategy.

At the same time SFF has adopted a strict no-barter policy vis-a-vis its customers, it still makes every effort to pay for its inputs with bartered goods. This double standard is in the best interests of SFF. Management argues that its output -- mayonnaise and sour cream -- is accepted eagerly by most suppliers and other creditors. Creditors are willing to accept SFF’s goods in payment because they are highly marketable. Workers will accept wages in the form of foodstuff without any fuss. Similarly, the suppliers of SFF’s suppliers will also accept payment in this form. SFF resorts to paying its debts in barter whenever possible because it prefers to save cash for debts that can only be paid with cash, such as federal taxes.

SFF is in the early stages of assembling its dealer network. Interestingly, it is looking at all potential partners. No special preference is being given to long-term trading partners of SFF. To some extent, this is understandable, since the managers who are making the decisions are all new to SFF. But the cavalier attitude toward the difficulties of assessing the financial stability of potential dealers was
striking and quite unusual in Russia. The new SFF management seemed to feel that a thorough investigation would reveal any latent problems. Their investigatory style is also somewhat laid-back for Russia. Low level SFF workers have called around to check on the credit-worthiness of possible dealers and have talked with existing SFF customers in the region to learn of the dealer’s reputation.

**Conclusion:**

The strategy adopted by SFF for dealing with customers’ non-payments is optimal. SFF has shifted the risk from itself to its dealers. Its ability to do this is dependent on its production profile and customer base. SFF’s output is intended for direct sale to the public. Moreover, the public has an almost insatiable demand for these goods. Under such circumstances, SFF can place stiff demands on potential dealers without fear of chasing them away. Few other Russian enterprises have the luxury to adopt similar strategies. Enterprises lodged in the middle of the production process have little leeway in their customer base, and find themselves at the mercy of these customers. SFF is also lucky to face no serious threat from foreign imports. Even domestic competitors are a minor threat, since the threat of spoilage means that the markets are limited geographically.