

PD-ABG-766  
Inv. 84388

**LATVIA PRIVATIZATION  
ASSISTANCE**

**PHASE 1 REPORT**

**DECEMBER 6, 1991**

**REFERENCE CONTRACT NO.  
EUR-0014-C-00-1058-00**

**DELIVERY ORDER #4  
LATVIA PRIVATIZATION  
ASSISTANCE**

**December 6, 1991**

**Mr. Mark H. Karns  
EUR/RME/ED  
Room 6923 NS  
Department of State  
320 21st Street, N.W.  
Washington, D.C. 20523**

**Dear Mr. Karns:**

We have completed Phase 1 of the privatization project involving the Government of Latvia (Contract No. EUR-0014-C-00-1058, Delivery Order #4) and have prepared the attached report which outlines the current situation in Latvia, privatization objectives and options, and sector and enterprise screening criteria. The report also contains two appendices which are overviews of the legal issues and of the financial/capital markets. In addition to the written report, I would like to summarize in this letter the general approach of the team in Phase 1, the major issues raised by senior officials in the Latvian government and by the managing directors of certain enterprises, as well as the plan for Phase 2.

### General Approach

The team was comprised of seven individuals, including Russell Muir (Coopers & Lybrand-London), David Stafford (Coopers & Lybrand-London), Gustav Plato (Coopers & Lybrand-Washington, D.C.), Maija Blaubergs (Steptoe & Johnson-Riga, Latvia), Jonathan Cahn (Steptoe & Johnson-Washington, D.C.), Thomas Parr (Chemonics-Washington, D.C.), and me (Coopers & Lybrand-San Francisco). The Coopers & Lybrand team has had prior Eastern European privatization experience in Hungary, Yugoslavia, Poland, Romania, and Czechoslovakia. The law firm of Steptoe & Johnson is well known for its reputation in mergers and acquisitions and establishing an appropriate legal framework for the privatization process.

During our field visit to Latvia (November 4-19), we met with either the Deputy Minister or the Minister of the following areas: Taxation, Forestry, Transport, Trade, Social Services, Economics, Finance, and Industry. In addition, we met with the Deputy Prime Minister (Mr. Kalnins) on two different occasions, the Head of the Agrarian (Land Reform) Department, the Head of the Privatization Department, and the steering committee for the Latvian Chamber of Commerce. (It is important to note that

the political situation in Latvia has been changing and that we did not discover the "point man" in the Latvian government who would be our liaison until the final days of Phase 1. We believe that this person is Mr. Kalnins based on our two discussions with him). Finally, we met with the senior officers of RITMS (a textile factory), the Institute of Electronics and Computer Sciences, Software House Riga, Daugava (a major agrofirma), Arta (a manufacturer of zips and other accessories), and Adazi, Inc. (a large agrofirma).

### Major Issues

The major issues raised by the senior officials in the Latvian Government or by the senior officers of the enterprises included the following:

1. In what currency to privatize;
2. Who should have the right to own property (i.e., only citizens or all residents of Latvia);
3. Restitution to former owners of real property;
4. Equity (fairness) in the privatization process;
5. The need for specific assistance (i.e., assistance in privatizing a few companies or instruction in proper valuation methodology) versus general privatization consulting.

Perhaps the most important issue is the need for specific assistance. Whereas the terms of reference for this project include more issues relating to the broad framework for privatization, both the Head of the Privatization Department and the Deputy Prime Minister stressed their dislike of general strategy and their need for specific assistance.

### Plan for Phase 2

Due to the major government reorganization which took place at the end of our field visits in Phase 1, the Government of Latvia needs time to reassess its privatization strategy. It is therefore premature to discuss with them in detail issues such as appropriate privatization methods and institutional arrangements.

Mr. Mark H. Karns  
December 6, 1991  
Page 3

The next phase of our work (from December 1 until the end of the year) will focus on a review of the current inventory of state owned enterprises (item 4 of our Scope of Work). The purpose of this work will be to identify sectors, sub-sectors or individual enterprises which appear suitable for early privatization. We might also identify other categories of enterprises such as those for which liquidation should be considered because they are a net burden on the economy.

We discussed this proposal with the Minister of the newly formed Ministry of Economic Reform, Mr. Kalnins. He agreed that this work would represent a sensible next stage, but is anxious that the work should lead quickly to early action. The remainder of the work in Phase 2 might be in the form of assistance with the early privatization of selected individual enterprises or sectors.

Mr. Kalnins indicated three Ministries in which we should start our work -- the Ministries of Industry, the Sea and Construction. We will work closely with their staff, both to assist us in our work and so that we can pass on expertise and skills to Latvian officials.

During December we will discuss with the Government of Latvia the subsequent stages of our work. We will then set out our proposed program for the remainder of the assignment for USAID and the Latvian Government.

#### Timing of Phase 2

Phase 2 commenced on December 1. The Phase 2 team for the December field visit includes me, David Stafford, Stewart Robertson (Coopers & Lybrand-London), Gustav Plato, David Lane (Coopers & Lybrand-Washington, D.C.), Jonathan Cahn, Jodie Shopland (Coopers & Lybrand-London), and Maija Blaubergs.

The timing of the team members arrival and departure in Riga is as follows:

Mr. Mark H. Karns  
December 6, 1991  
Page 4

<u>Name</u>	<u>Arrival</u>	<u>Departure</u>
Michael Graham*	December 11	December 14
David Stafford*	December 10	December 14
Stewart Robertson	December 4	December 20
Gustav Plato	December 1	December 20
David Lane	December 4	December 20
Jodie Shopland	December 4	December 20
Maija Blaubergs**		

- \* To schedule a third trip in January.
- \*\* On site in Riga.

In addition, we will involve our environmental subcontractor firm to prepare an environmental due diligence checklist for the team participants. The consultant from this firm will not be travelling to Riga. The future involvement of Steptoe & Johnson (the law firm on this project) will be determined at the end of the December field visit.

#### Summary

Phase 1 was important in order to assess the situation in Latvia and to plan for Phase 2. We were greatly assisted in this process by Mr. Richard Peters, the USAID representative in Latvia. We worked closely with him and met on almost a daily basis to ensure that the project would have a good working foundation. I am sending a copy of this letter by fax to Mr. Peters and will deliver (in person) a copy of the written report when we arrive in Riga.

I look forward to USAID's comments on our approach to Phase 2 and on the written report. I would appreciate it if you would coordinate getting the comments from the various USAID departments and sending them to me. Please do not hesitate to call me at (415) 957-3209 or send me a fax at (415) 957-3394.

Sincerely,

*Michael D. Graham/cl*

Michael D. Graham

MDG:cl

cc: Richard Peters  
A.I.D. Baltics Desk: Dagnija Kreslins/Gale Rozell  
Ray Solem

**LATVIAN PRIVATIZATION PROJECT**  
**Phase 1**

---

**Table of Contents**

<b><u>Section</u></b>	<b><u>Page</u></b>
<b>1.0 CURRENT SITUATION</b>	<b>1</b>
<b>1.1 Current Stage of Privatization Process</b>	<b>1</b>
<b>1.2 Present Institutional Framework</b>	<b>2</b>
<b>1.3 Financial Resources</b>	<b>3</b>
<b>1.4 Individual/Private Sector (Restitution)</b>	<b>3</b>
<b>1.5 Constraints</b>	<b>4</b>
1.5.1 Political	4
1.5.2 Institutional	4
1.5.3 Economic	5
<b>2.0 PRIVATIZATION OBJECTIVES AND OPTIONS</b>	<b>6</b>
<b>2.1 Introduction</b>	<b>6</b>
<b>2.2 Objectives</b>	<b>6</b>
<b>2.3 Methods of Privatization</b>	<b>7</b>
2.3.1 The Public	8
2.3.2 Domestic Corporate Buyers	9
2.3.3 Foreign Corporate Buyers	9
2.3.4 Management and Employees	10
2.3.5 Combinations of Methods	11
<b>2.4 Progress So Far</b>	<b>11</b>
<b>2.5 Institutional Options</b>	<b>13</b>

**LATVIAN PRIVATIZATION PROJECT**  
**Phase 1**

---

**Table of Contents**  
**(Continued)**

<b><u>Section</u></b>	<b><u>Page</u></b>
<b>3.0 SECTOR AND ENTERPRISE SCREENING CRITERIA</b>	<b>14</b>
<b>3.1 Need for Screening Criteria</b>	<b>15</b>
<b>3.1.1 Screening Criteria for Early Privatization Candidates</b>	<b>16</b>
<b>3.1.1.1 Economic</b>	<b>16</b>
<b>3.1.1.2 Financial</b>	<b>17</b>
<b>3.1.1.3 Other Criteria</b>	<b>17</b>
<b>3.2 Summary</b>	<b>18</b>
 <b>APPENDIX A</b>	
<b>Legal Environment</b>	<b>A-1</b>
 <b>APPENDIX B</b>	
<b>Financial/Capital Market Overview</b>	<b>B-1</b>

## 1.0 CURRENT SITUATION

### 1.1 Current Stage of Privatization Process

Latvia is now in the initial stages of the privatization process. As a result, Latvia can greatly enhance its ability to implement privatization by drawing upon the collective experience of the privatization and economic restructuring efforts in East Germany, Hungary, Czechoslovakia, Poland, Yugoslavia, and Romania. Each of these countries has utilized varied approaches towards the privatization process.

The ingredients for privatization are shown in the following matrix. Each country in Eastern Europe has developed its own privatization program. Programs for housing, agrarian reform, small business, and large enterprises have differed in their depth and scope. Latvia will define and refine its approach to privatization based on privatization objectives and a strategy for achieving those objectives, as well as on the tactical program/projects which will result upon implementing privatization.

#### Privatization Matrix

<u>Ownership:</u>	Government	Mixed	Private
<u>Management:</u>	Regulated	Semi-autonomous	Autonomous
<u>Finance:</u>	Government	Access to private Markets	Private Capital
<u>Markets:</u>	Monopoly	Deregulation	Competition

## **1.2 Present Institutional Framework**

The Latvian government has been autonomous from the former Soviet Union since August, 1991. The government is made up of the Council of Ministers (Similar to U.S. cabinet positions) and the Supreme Council (a legislative body elected by the people). At the time of the Coopers & Lybrand team's arrival in Latvia for Phase 1, the government consisted of 23 ministries, which had 23 ministers and over 2500 employees. The supreme council consisted of 201 deputies who were elected by popular vote.

During the course of our visit, Latvia's Prime Minister, Ivars Godmanis, requested that the ministries be consolidated to 16. The parliament finally approved 16 ministries and 17 ministers. Several of the ministers, including Janis Aboltins (Minister of Economics), Uldis Gundars (Minister of Social Services), Auseklis Lazdins (Minister of Energy), Armands Plaudis (Minister of Trade) were replaced or their ministries were liquidated. In addition, the Deputy Prime Minister, Mr. Arnis Kalnins, was transferred to the newly formed Ministry of Economic Reform. This ministry will be our primary point of contact from the council of ministers during the next phase of this project.

The Supreme Council of the Republic of Latvia is the legislative body in Latvia from which all laws are passed. The Supreme Council has passed a law governing small enterprise privatization and is in the process of considering several other laws, including the following:

- a) National and Municipal Privatization Committees dated October 17, 1991.
- b) Formation of the Republic of Latvia's national privatization fund, its operations and rules of use dated November 7, 1991.

c) National and Municipal Enterprise Restructuring into Shareholder Corporations with limited liability dated October 17, 1991.

d) Latvian National Ownership Fund dated October 17, 1991.

The Supreme Council requested that the team visit their legislative body to discuss the privatization process. They indicated that they are interested in joining the efforts to coordinate the development of privatization objectives, strategy, and practical implementation.

### **1.3 Financial Resources**

Latvia is working to secure the capital necessary to finance privatization from sources such as the International Monetary Fund, World Bank, Nordic Investment Bank/Baltic Investment Bank, as well as other multi-lateral and bi-lateral agencies. In addition, Latvia has requested the return of its gold reserves, which have been held by the United States, France, and Great Britain since 1945.

Latvia's capital markets are under development. The foundation of this process will be the introduction of a stable money supply, a central banking system, and a commercial banking structure.

### **1.4 Individual/Private Sector (Restitution)**

Individuals within Latvia are taking initiatives by requesting the return of assets which were nationalized in 1940 and 1945. Requests are being submitted to "Izpild Komitejs", which are located throughout Latvia.

## **1.5 Constraints**

The constraints upon the privatization process in Latvia are political, institutional, and economic.

### **1.5.1 Political**

During the 1920's and 1930's Latvia prospered as an independent nation and as a member of the League of Nations. In 1940, following the signing of the Molotov-Ribbentropf pact (August 23, 1939) between Germany and the Soviet Union, Latvia was annexed by the Soviet Union. At the time of the annexation 62.3 percent of the Latvian population was employed in the agricultural sector. By 1989, only 25.4 percent of the gross national output could be attributed to agriculture.

The entire issue of restitution in Latvia is extremely complex. Not only were land, property, and other assets nationalized, but they were transferred for use to individuals of other nationalities.

Regardless of the nationality or citizenship issues, the government recognizes the need for a social "safety net" during transition. This is extremely difficult for Latvia because approximately 25 percent of its population is in retirement.

### **1.5.2 Institutional**

The extreme dominance of the public sector in Latvia as well as in the other Baltic Republics makes transitioning to the private sector more difficult. In Latvia, 89 percent of the population is employed in the state sector.

The major restructuring of the government in November 1991 appears to be the beginning of the transition from socialism to a system with a goal of promoting competitiveness.

Prime Minister Godmanis announced that privatization should be driven by the initiative of the individual ministries.

### 1.5.3 Economic

Economic constraints include:

- Lack of foreign exchange;
- Inflationary pressures and expectations;
- Control of the money supply (rubles) by the former Soviet Union;
- Severe budgetary constraints;
- Lack of savings and investment;
- High vertical integration and monopolization;
- High concentration of production rather than consumption goods;
- Distribution system problems;
- Lack of technological sophistication;
- Shortage of business skills;
- Dependence on the Soviet market.

## **2.0 PRIVATIZATION OBJECTIVES AND OPTIONS**

### **2.1 Introduction**

The scope of privatization in Latvia covers

- the sale of state owned enterprises (SOEs) which can be called large privatizations
- the sale of small businesses (e.g., shops) which can be called small privatizations
- the transfer of ownership of housing
- the transfer of ownership of land (e.g., the agrarian reform program)

We believe that our assignment should concentrate on large privatizations which will be handled by the national government. Small privatizations will be handled by the municipalities, and housing and the agrarian reform program are the subject of separate laws.

The remainder of this section discusses large privatizations under the following headings:

- objectives
- methods of privatization
- progress so far
- institutional options

### **2.2 Objectives**

On March 20, 1991 the Parliament issued a Decisior. on "State Property and the Fundamental Principles of its Conversion." The

objectives of privatization referred to in this Decision were of a general nature, including:

- to create the conditions for transition to a market economy
- to promote private initiative as the basis for economic development
- to remove the state monopoly from the economy
- to make structural changes in the national economy

In our meetings with Ministries and officials, these general objectives were confirmed as paramount. Other more specific objectives, such as wider share ownership and the development of capital markets, were not articulated explicitly but can be embraced by the broad objective of moving to a market economy.

There are however, two features of the privatization program which merit special mention, namely the intention

- to include a restitution program to compensate pre-1940 owners whose property was nationalized; and
- to pay the proceeds from privatization into a special fund rather than into the general budget. One of the purposes of this special fund will be to promote Small and Medium Enterprises (SMEs). This priority to SMEs was also voiced in our meetings and could become an important component of the privatization program.

### **2.3 Methods of Privatization**

The options for large privatizations can best be reviewed by considering to whom the enterprises, or proportions of the shares

of enterprises, will be sold. The potential buyers can be divided into the following categories:

- the public
- domestic corporate buyers
- foreign corporate buyers
- management and employees
- combinations of the above

### **2.3.1 The Public**

Sales of shares to the public are conventionally carried out through public offerings. This method is very suitable for promoting wide share ownership, but would be relatively demanding compared with other methods. For example,

- a detailed prospectus is usually produced
- some form of stock market is required for the trading of shares
- the offer needs to be carefully priced to reflect an appropriate balance between risk and reward for the investor, and
- the offer needs to be vigorously marketed in order to educate potential investors on share ownership, and then to attract their support

Public offerings will be difficult to do in Latvia in the next year or so - but not impossible. Poland has had approximately seven public offerings, including five which were made in December, 1990. Any candidates for public offerings should be very carefully selected. As far as possible, the companies should be financially solid and have

good prospects, so that the risk of failure and a subsequent loss of investor confidence are minimized. They should also be companies which appeal to a wide proportion of the population so that the risk of undersubscription is minimized.

Because public offerings are difficult, a number of East European countries (e.g., Czechoslovakia, Poland, Romania and Lithuania) have been developing mass privatization schemes, under which at least some of the shares of numerous state enterprises are sold (or given free) to large numbers of citizens. Such schemes do not offer easy solutions. For example, the Czechoslovak Government's scheme has been repeatedly delayed and postponed despite much time and effort; Poland is now reviewing whether their scheme will be cancelled. We understand that the Government of Latvia is not planning to introduce a mass privatization scheme.

### **2.3.2 Domestic Corporate Buyers**

A second group of potential buyers is the corporate sector in Latvia, which might be companies engaged in manufacturing or commerce, or financial institutions. At present, this is not a rich source of investors, as the number of substantial private companies in Latvia is small. But it should become a growing source of investors as the privatization process gathers pace.

### **2.3.3 Foreign Corporate Buyers**

In the absence of substantial private savings in Latvia to support a privatization program, the obvious alternative is to sell enterprises to foreign corporate buyers.

The main attractions of foreign investors are that they bring in hard currency, as well as management, marketing and other skills and expertise. There are, however, some difficulties:

- Latvia is in strong competition with other East European countries for foreign investment in state enterprises, and
- politically there can be opposition to "selling to foreigners"

#### **2.3.4 Management and Employees**

Selling shares to the management and employees is appealing, not only because many workers in the state enterprises usually want to have a share in the business, but also because workers are more likely to be positively motivated if they are going to benefit from a share in profits. Poland in particular is encouraging employee share ownership, by reserving 20 percent of the shares of privatized companies for sale to employees at a 50 percent discount to the offer price.

The main difficulty in selling shares to employees is the lack of savings to buy the shares. But various methods can be employed to mitigate this difficulty. In some countries another difficulty has been political opposition from those who argue that the sale of shares to employees on preferential terms discriminates in favor of small groups of workers.

### **2.3.5 Combinations of Methods**

In many privatizations in Eastern Europe, the sale has embraced a combination of the methods outlined above rather than a single method. The main reason has been that there are typically a number of objectives to be achieved in each privatization transaction, and the variety of objectives are best met by a combination of sale methods. For example, the management and employees of the enterprise may want to buy a substantial share of the business and bring in a foreign investor, while the government may be more concerned with spreading wide share ownership and the development of capital markets.

If an enterprise cannot be sold as a going concern, the final option is to liquidate it. Liquidation does not necessarily involve the closure of the whole business, but typically involves selling off parts of the business in the form of assets to the management and employees or other parties.

### **2.4 Progress So Far**

The Latvian Government has embarked on five pilot large privatizations. We visited one of the companies in this pilot scheme - Arta, which manufactures zips and other accessories.

Arta's assets had been leased to the management and employees about two years ago under one of the Soviet economic reform measures. Under this new arrangement the management and employees enjoyed greater freedom from central control, including the retention of any surplus profits after paying taxes and the lease payments. Over the two years surplus profits of 8 million rubles were made. These profits were not distributed to the workers, but instead the workers voted to buy shares in the

company. A further 1.8 million rubles of shares were offered for voluntary, share purchases by the workers to bring the management and employees total proportion of the share capital to 45 percent. In addition, 10 percent of the shares have been bought by a Russian supplier and 5 percent by an Italian company which has supplied Arta in the past with equipment. The remaining 40 percent of the shares remain with the Government.

This is an interesting example of a pragmatic and sensible approach to privatization. The earlier leasing arrangement had freed the company partially from state control and had greatly facilitated the sale of shares to the workers. The inclusion of the Russian and Italian suppliers in the sale was for commercial reasons, namely to secure some of the company's material supplies from Russia and to bring in a Western partner whom it is hoped will help in raising the quality of the products to a level which will permit the company to enter Western markets.

Further progress with large privatization (beyond the five pilot projects) is not planned until the new privatization law has been enacted. The major issue which is currently dominating the debate on the speed of privatization is whether there should be further sales before the introduction of the new Latvian currency. A further major issue which has a bearing on the privatization debate is the law on citizenship.

In parallel with the five pilot projects, there has been a rapid growth in recent years in cooperatives, some of which have formed shareholders societies. Such societies are a short step from a private company.

We visited a cooperative--Adazi, Inc., which is a large agro-firm. The business was valued and shares distributed to all managers and employees, on the basis of their past contribution to the cooperative. The enterprise is now thinking of forming a

holding company with subsidiaries established under the new company law. Adazi has already formed a large joint venture with Kelloggs and plans further ventures.

## **2.5 Institutional Options**

The institutional arrangements for privatization were changed at the end of our field visits, as part of the wider government reorganization. The present arrangements are not therefore known in detail.

There has been a variety of institutional models for privatization in Eastern Europe. In most cases the major objective has been to speed up the privatization process as part of a general move to a market economy.

In Hungary the first moves to privatize were the "spontaneous privatizations" prompted by the enterprises. This liberal approach resulted in a number of private lucrative arrangements between enterprise managers and foreign investors, and the State Property Agency was formed to take tighter control over the privatization process. But the new arrangements slowed down the process too much, and a more liberal approach is now being encouraged.

In Poland the program started with a small number of high profile public offerings. This absorbed considerable official and advisor energy for relatively modest results. A broader sectoral approach is now being pursued, which may be worth considering in Latvia.

Czechoslovakia, in contrast, is placing its major emphasis on mass privatization through a voucher scheme.

In the former East Germany the privatization process is being driven by the Treuhandanstalt. Romania may pursue a somewhat similar route through a State Ownership Fund, although the Romanian arrangements have been shaped largely by a previous commitment to a voucher system.

Drawing on our experience of these varied examples we believe that there are broadly two models for speedy privatization.

- the Treuhandanstalt model in which the process is driven powerfully from the "top down" by a large government organization
- a liberal model which encourages enterprises, ministries and potential investors to stimulate privatization transactions.

These models represent two extremes, but our understanding is that the Government of Latvia is leaning towards a relatively liberal approach. If this is the case it will be important to have a monitoring body which regulates the privatization process and ensures that there is cross-fertilization of ideas and experience.

### **3.0 SECTOR AND ENTERPRISE SCREENING CRITERIA**

This section gives our preliminary views on the criteria which might be used to screen priority sectors or enterprises. The section discusses:

- the need for screening criteria
- preliminary views on criteria for early privatization candidates

### **3.1 Need for Screening Criteria**

All East European countries starting on the privatization process have faced the question: Where should we start? The government has limited human and financial resources which it can devote to privatization and must decide on its priorities for the use of those resources. In addition, some enterprises are more suitable or better prepared for privatization than others. All Governments in Eastern Europe have therefore had to apply some form of screening process to decide on an order of priorities.

Screening criteria are typically used to classify enterprises into three categories (although in some cases the middle category may be further subdivided).

The three categories are those enterprises which:

- are suitable for early privatization
- require restructuring before privatization
- need to be liquidated because they are not viable

The screening process may be done in a sophisticated way by developing and applying specific criteria, or in an informal way which is based more on instinct. Our view is that a reasonably structured approach is sensible, as long as it does not delay the privatization process. We also believe that any screening process must be flexible so that it can be adapted to take account of new information and policies. It should not be used to reintroduce any form of central planning.

### **3.1.1 Screening Criteria for Early Privatization Candidates**

We give below our preliminary views on suitable criteria for selecting early privatization candidates. Other criteria can be developed for identifying other categories such as liquidation candidates.

The criteria can be divided into three groups:

- economic
- financial
- other

#### **3.1.1.1 Economic**

The economic criteria should address whether the enterprise is likely to be viable in the longer term, as prices and markets are liberalized and Latvia moves towards a market economy.

One test of longer term viability would be to examine the profitability of the enterprises if the outputs and main inputs are valued at world prices. We have developed (in other contexts) a methodology for such an approach and could readily adopt the methodology for use in Latvia. A number of ministries which we visited expressed great interest in such work.

There are also other specific economic criteria which might be used to select early privatization candidates, such as:

- whether the enterprise exports some of its goods to hard currency markets

- whether the enterprise is heavily dependent on other sectors where prices are distorted
- whether the enterprise provides goods or services which are relatively protected from competition from imports (eg non-traded goods and services such as hotels, or goods like cement which are partially protected by high transport costs)
- whether the markets for enterprise's products are growing or declining and whether the enterprise produces products of adequate quality to meet increasing competition

#### 3.1.1.2 Financial

The financial criteria are aimed at assessing the financial situation of the enterprise, and might include:

- whether the enterprise is profitable
- the level of indebtedness of the enterprise
- the condition of the machinery and equipment (which will affect the need for new investment).

#### 3.1.1.3 Other Criteria

There will also be a number of other criteria which will determine whether an enterprise is suitable for early privatization. Such criteria might include:

- whether the enterprise is of national strategic importance

- the size of the enterprise: neither too large, nor too small
- the attitude of the management and employees to privatization

These criteria can be applied at the enterprise level or at the sectoral level. The most appropriate approach might be to

- identify a few suitable enterprises to demonstrate early progress
- identify a few sectors which can be studied as a whole. The advantages of a sectoral approach are that there are economies of scale (e.g., market information); individual enterprises can be reorganized or rationalized in the context of the overall sector; and "cherry picking" by foreign investors can be avoided.

During our December field trip, we will implement a sector screening model. As mentioned previously, the goal of this model is to identify those sectors suitable for early privatization, those which require restructuring before privatization, and those which need to be liquidated because they are not viable.

### 3.2 Summary

The privatization options could include a number of different combinations of classes of shareholders: the public, other domestic businesses, foreign businesses, management, and employees. We will lay the proper foundation for the privatization process by implementing a sector screening model.

After examining and analyzing the outputs of this model, we will then focus on a few specific enterprises (or sectors) in order to meet the Government's objectives of attaining specific privatization assistance.

## **Appendix A**

### **LEGAL ENVIRONMENT**

This appendix provides a preliminary assessment of those aspects of the Latvian legal environment which the Government of Latvia ("GOL") should consider reviewing in order to facilitate its privatization strategy. This appendix consists of a summary of the conclusions reached regarding the legal environment, followed by a report which selectively expands on certain of those conclusions.

### **SUMMARY OF CONCLUSIONS**

While in Latvia, Steptoe & Johnson attorneys had an opportunity to review various Republic of Latvia laws and to discuss legal matters pertinent to privatization with GOL attorneys, members of the Latvian judiciary, officials in various GOL ministries, Latvian private businessmen, and managers of state-owned enterprises ("SOEs"). The purpose of this effort was to identify the gaps in the Latvian legal system that required action in order to facilitate privatization. While this effort was initially impeded by difficulty in locating relevant Latvian laws, officials in the Supreme Court of Latvia, however, ultimately assembled much of the relevant legislation. Nonetheless, in light of the dynamic and fast changing situation in Latvia and the problems associated with reviewing the legal framework of such an environment, the following conclusions are subject to revision based on further inquiry.

#### **Privatization Statute**

The Government of Latvia has announced its intention to undertake a far-reaching privatization program. In this regard, the March 20, 1991 Declaration of the Supreme Council of the Republic of

Latvia sets the broad terms guiding the privatization process. With the exception of a law governing small enterprise privatization, none of the implementing legislation contemplated in the Declaration has been passed. Thus, fundamental questions relating to the process of privatization of major industry have not been addressed, including: (1) the scope of responsibility which specific governmental institutions have in the privatization process; (2) the governmental authority to privatize and transfer SOEs to private parties; and (3) the ownership status of enterprises and assets. Additionally, in order for broad-scale privatization to proceed efficiently, other issues require resolution. For example, privatization statutes in other countries typically address the process to be undertaken, priorities with respect to privatization, and the overall privatization strategy. These issues are discussed more fully in the body of this report.

#### **Agricultural Privatization**

Legislation reportedly exists which provides for agricultural privatization, but a copy could not be obtained prior to the team's departure. Assuming that this legislation does exist, it would seem difficult for significant privatization to occur in the absence of the legal infrastructure relative to land ownership, titling, and recordation. Furthermore, a number of Latvia's agricultural privatizations will involve agricultural industries (e.g. agricultural processing and packing). These privatizations may ultimately rely upon guidance as to industrial privatization as suggested above.

#### **Compensation/Restitution**

The March 20, 1991 Declaration appears to require restitution or compensation to former owners of nationalized property. No statutory authorization or procedure exists which would implement

the Declaration in this respect. It seems unlikely that Latvia has reserves to pay former owners "prompt, adequate and effective" compensation for property that is transferred to new owners. This issue needs to be considered in depth.

### **Citizenship**

Certain officials within the GOL have expressed the view that the right to purchase or receive ownership of formerly state-owned assets should be restricted to Latvian citizens. While this is aimed at the large ethnic Russian population residing in Latvia, it may pose serious problems for participation in the Latvian private sector by foreign equity capital. Further, discriminatory measures against ethnic Russians may impede privatization of otherwise successful SOEs currently managed by ethnic Russians. At the time of this writing, a law on citizenship has had its first reading before the legislature, but has not been finally adopted. While further analysis of this issue is not undertaken in the report, the draft statute should be scrutinized to determine its impact on the privatization process.

### **Sectoral Regulation**

The GOL will need to give attention to privatization's relationship to specific sector restructuring, as the process of privatization progresses. Where the state's role in a sector constitutes a monopoly (e.g., telecommunications, energy, ports), regulatory structures need to be developed to facilitate market entry and competition as part of the privatization process.

### **Commercial Code and Company Law**

The GOL has adopted a full complement of company laws permitting creation of shareholder corporations, closely held corporations,

and partnerships. The GOL, on the other hand, has not adopted a commercial code or other relevant legal provisions necessary for uniform and reliable private commercial activity.

### **Accounting Standards**

The GOL has not adopted a position on accounting standards. These play a role in a number of aspects of each privatization.

### **Bankruptcy Law**

Latvia's laws governing corporate dissolution do not address insolvency and, as such, are deficient in a number of respects. Once privatized, some formerly state-owned enterprises will fail. To facilitate the extension of credit during the privatization process, creditors and debtors need to be aware of their respective rights and obligations upon enterprise insolvency.

### **Tax Treaties**

Tax laws may have an effect on activity in the private sector, particularly domestic and foreign investment decisions. In this regard, the current absence of double-taxation treaties could prove a disincentive to foreign investment in the Latvian economy, including investment in state owned enterprises. Not addressed in the report, but deserving further scrutiny, are the limited availability of depreciation allowances and the absence of provisions for carry-forward of tax losses.

### **Labor Law**

Labor law obligations may affect privatization transactions, particularly during the restructuring stage. The GOL appears to have retained the Soviet Union Labor Code, modifying it to take into account a free market environment. In light of this

selective retention of the prior law, it is important to review the current amendments to ascertain whether these make Latvia's labor law fully compatible with a free market environment and the requirements of employers. Furthermore, review should be undertaken regarding the procedures for and ability of foreign investors to hire expatriate workers.

### **Foreign Investment Law**

Latvia passed a foreign investment law just prior to the team's departure. Most important is that the law is generally receptive to foreign investment, and can be used to facilitate foreign investment in the privatization context. A number of issues, however, merit examination. First, scrutiny should be given to the purpose and structure of tax incentives provided under the act. Second, the act requires government approval of any foreign investment in a state-owned enterprise. Such approval of all foreign investment is generally disfavored in more developed nations as an impediment to free trade. It would be better to eliminate the approval process or limit it to strategic sectors such as telecommunications. Moreover, this approval process should be coordinated with any approval procedures required under the privatization law to avoid imposition of conflicting requirements for foreign investors seeking to invest in SOEs. Third, the law's assurances regarding compensation for expropriated property should employ the "modern traditional" standard of "prompt, adequate and effective" compensation. That familiar standard gives the potential foreign investor the measure of predictability that the "anti-expropriation" provisions in the law are intended to provide. Fourth, the "stand still" provision for benefits under Latvian law may unnecessarily discriminate against Latvian domestic enterprises.

## **Intellectual Property Protection**

The GOL has not adopted legal protections for copyrights, trademarks, or patents. Without such protections, foreign investors that might vitalize SOEs with modern technology will not do so. Similarly, newly privatized entities will be unable to avail themselves of such technology through licensing arrangements. And these protections may be important where intellectual property is an asset of the privatized enterprise or is a feature of the acquisition or operation of the enterprise.

## **Legal Information**

The GOL needs to establish a central repository where potential foreign investors can find all laws passed and declarations made by the GOL. Official translations of these laws into English or German would also be helpful to foreign investors.

## **PRELIMINARY ANALYSIS OF LEGAL ENVIRONMENT**

### **INTRODUCTION**

The GOL seeks to transfer state-owned assets and enterprises to private hands, or to "privatize" them. The legal issues which affect a privatization transaction vary depending on the specific transaction. This report, however attempts to identify those lacunae within the Latvian legal system that, if changed, would facilitate privatization transactions generally.<sup>1</sup> The analysis first addresses the need for a privatization statute. It then proceeds to a preliminary examination of other legal areas:

---

<sup>1</sup>This report also does not address the absence of a range of laws governing the conduct of private enterprise, such as environmental laws.

adoption of a commercial code, bankruptcy law, intellectual property law, and accounting standards.

#### **PRIVATIZATION STATUTE**

The March 20, 1991 Declaration of the Supreme Council of the Republic of Latvia "On State Property and the Fundamental Principles of its Conversion" (hereinafter referred to as the "Declaration") establishes the GOL's very broad intent to privatize certain state and municipal property. See Declaration, § 1. The Declaration, however, assumes that legislation will be adopted to implement its broad policy directives. Specifically, Section 8 of the Declaration requires that legislation be passed to regulate the process of state property conversion consistent with the Declaration's "fundamental principles." See *Id.*, § 8. In particular, the Declaration anticipates that the following issues will be addressed by implementing legislation:

- the state's ownership relationship to all state-owned property, Declaration, § 2, including the status of prior Soviet Union-owned property, Declaration §§ 2 and 3(3).
- a procedure for distributing certain state-owned property to municipalities. Declaration, § 2.
- determining the property rights of individuals "on the state property under privatization." Declaration, § 3(5)(2).
- governing compensation and return of property to prior owners of nationalized property. Declaration, § 3(5)(3).
- authorizing agricultural privatization. Declaration, § 3(5)(1).

The Declaration also contemplates that privatization will be undertaken under the supervision of the State Property Conversion Department. Declaration, § 7. However, prior to the team's departure, this Department was eliminated and its functions distributed to the respective ministries.

In summary, the Declaration is insufficient for the Government to undertake privatization of state-owned property. Implementing privatization legislation of the sort contemplated by the Declaration is found, for instance, in all Central and Eastern Europe ("CEE") countries which have undertaken comparable privatization strategies. The Coopers & Lybrand Team might assist in the formulation of a Latvian privatization law by providing to the GOL an assessment of these laws and those of other nations as they may pertain to the situation in Latvia. As a preliminary matter, we will review two types of issues commonly addressed in such statutes and alluded to in the Declaration: (1) ownership reform and (2) the process of privatization itself.

#### **Ownership Reform And Restitution**

Before the State can transfer ownership of an SOE, the State's ownership of assets must be clearly established. A buyer -- particularly one who is investing significant capital and effort -- will typically not assume the risk of purchasing an enterprise if the seller cannot warrant title to the property. In fact, each of the CEE countries currently undertaking privatization has attempted to unambiguously establish the central government's ownership rights to property as a precursor to the privatization process.<sup>2</sup>

---

<sup>2</sup>In Poland, the July 1990 legislation authorizing privatization of the industrial sector confirmed the state's ownership of property rights. See Act on the Privatization of State-Owned Enterprises, enacted July 13, 1990, Art. 8 ("A company emerging from the transformation of a state-owned .

The necessity of confirming the GOL's ownership is underscored by the inquiries made by the Coopers & Lybrand team. SOEs in Latvia are currently operating under their former management, with little supervision from the central government. In some instances, the enterprises are already asserting rights to profits and assets acquired after a given date. In other instances, both present and past workers at SOEs have expressed their sense of entitlement to shares in enterprises where they have worked. Unless these assertions are dealt with in a uniform way, and promptly, current managers may develop unrealistic expectations that will impede transfer to capital investors. Even among Latvian units of government, the issue of ownership is also not entirely clear. Various enterprises and assets have been shifted back and forth between ministries. In addition, municipalities have asserted ownership over certain enterprises and assets.

Ownership is also complicated by those claims which prior owners may assert to property previously nationalized by the Soviet Union, whose rights the Declaration acknowledges. If Latvia

---

enterprise, will remain company owned exclusively by the State Treasury until shares are disposed of to third parties.") In Hungary, the state asserted its rights of ownership in a series of laws passed in 1989 and 1990. See Act No. XIII of 1989 on the Transformation of Economic Organizations and Economic Associations, enacted on May 30, 1989, as amended ("Transformation Act"); see Act No. VII of 1990 on the Foundation of the State Property Agency With the Purpose of Managing and Utilizing State Property Belonging to the Agency, enacted on January 26, 1990, as amended ("On the basis of the present Law the following are pertaining to the Property Agency: . . . All those shares or quotas of the state companies transformed into economic companies, according to the Transformation Act, which have not become property of outside entrepreneurs.") The Czech and Slovak Federal Republic legislation also unambiguously established the republics' ownership rights through legislation. See, e.g., About the Transfer of State Ownership of Certain Properties to Other Legal Entities and Individuals, enacted on October 25, 1990.

recognizes rights to restitution, it must provide for paying such restitution with respect to assets that it privatizes. For instance, if Latvia sells a tract of land to which someone rightfully claims restitution, it must provide for the transfer of sale proceeds to that prior owner and assure that the sale is conducted under such circumstances as to generate the land's fair market value. And any preferences to current users of the land must be paid out of the proceeds from improvements that they made on the land or from the strapped public Treasury of Latvia.

To date, these restitution issues have not been thought through. For example, in "agricultural privatization," individual farmers selected desirable plots of land without regard to whether they had owned the land prior to its nationalization, and without regard to whether the land would have to be returned to the former owners. As it became clear that enormous problems would ensue, agricultural privatization was put on hold. A number of different approaches to the problem of restitution have been undertaken in other countries. Hungary, Czechoslovakia, and Poland have all adopted strategies of one form or another. These models might be considered in developing a Latvian restitution strategy.

The GOL's ownership of assets is made even more complex due to a variety of international circumstances. With Latvia's independence, the GOL assumed control of enterprises and assets previously belonging to the Soviet Union. While Latvian government officials with whom this was discussed explained that title to property within the borders of Latvia was now vested in the Latvian state, a number of incidents suggest that Soviet authorities take a different view. For example, Soviet military authorities have, on several occasions, sold facilities within Latvia's territory to private parties.

A Latvian privatization law needs to establish GOL ownership over state assets. If appropriate, that law may provide for a percentage ownership by managers or employees or for preferential pricing of ownership interests to such persons. Assets as to which Soviet or local Latvian authorities have conflicting claims should be identified and title clarified. As to assets over which Latvia wishes to exercise dominion, arrangements may need to be established for adjudication of adverse claims and for restitution to the Soviet or local authorities in the event of a determination adverse to the GOL. The ultimate objective, however, is that GOL have clear and undisputed title to the assets it aims to privatize.

Finally, after establishing its right to the SOE's, the GOL should declare the legal procedures for transfer of title, the warrantability of that title, and the mechanism for public registration of title to assets transferred in the privatization process. These issues will be addressed within the concept of the "privatization process."

#### **The Privatization Process**

The Declaration anticipates that the privatization process will be coordinated by a governmental department.<sup>3</sup> Generally speaking, such an agency plays several of the following functions to one degree or another: conceptualizing the privatization strategy; initiating and supervising the privatization process; restructuring enterprises prior to their privatization; and managing enterprises prior to their privatization. These functions are important and should be addressed in the context of the law on privatization.

---

<sup>3</sup>Czechoslovakia, Hungary, Poland, Bulgaria, Romania, and the Yugoslavian republics have all established such supervisory administrative institutions.

**Distribution Approach.** The privatization statute should also address the various privatization approaches which the government intends to authorize. Approaches generally have differed given the size and sector of the enterprise involved. Small enterprises are often auctioned -- being sold or leased, with an option to purchase.<sup>4</sup> The privatization of more complex enterprises frequently entails more complex methods of transfer. Among these are concession financing, build-own-operate transactions, "trade sales," and various types of public offerings.

**Demonopolization and Break-up Of Certain SOEs.** The privatization statute or another related statute will also need to provide for breaking up and curbing the anticompetitive practices of certain enterprises. Interviews confirmed that a number of SOEs had been formed by combining related and sometimes unrelated business units. In a number of instances, enterprises enjoyed virtual monopoly status in their industrial subsector either as a result of being the exclusive producer of certain goods or as the result of informal, anticompetitive arrangements with other enterprises. In order to dispose of these enterprises, it may be necessary to break them up into their respective business units and to regulate the future conduct and status of these enterprises through prohibitions against monopolistic practices.

**Coordination with Sectoral Restructuring.** Where privatization involves a public utility or an industry where competition by other market entrants is difficult because of technological or other entry barriers, privatization necessarily involves adoption of regulatory institutions. Telecommunications, transportation,

---

<sup>4</sup>See, e.g., Law "On Privatization of Municipally-Owned Public Accommodations and Eateries", adopted November 5, 1991 (providing for sales to employees, auctions to the public, and other methods of selling small, municipally-owned enterprises).

and energy are examples of such sectors. Telecommunications is a sector which the GOL is now opening to private investment.

**Governance of State-owned Entities Pending Privatization.** A privatization statute should also address the legal structure and rules governing state-owned enterprises pending their privatization. There may also be instances in which the GOL will choose to retain an interest in certain enterprises. In these cases, the GOL will need to establish the reasons for and purposes to be pursued by continued government equity participation.

#### **COMMERCIAL CODE AND COMPANY LAW**

The GOL has adopted a series of company laws permitting the creation of shareholder corporations, closely held corporations, and partnerships. Upon preliminary examination, these laws appear to create a significant range of business entities. Rather, it is the absence of fundamental legislation in other commercial areas that creates problems in the privatization context.

**Enterprise Law.** The Law "On Entrepreneurial Activity" authorizes a variety of enterprise types, including general and limited partnerships, statutory associations, associations with limited liability, corporations, associations with additional liability, and joint ventures.<sup>5</sup> The rules governing the creation and legal implications of these various business forms are typically found in supplemental legislation. For example, the Law "On Limited Liability Companies,"<sup>6</sup> sets forth the rules governing

---

<sup>5</sup>Law "On Entrepreneurial Activity," adopted September 26, 1990.

<sup>6</sup>Law "On Limited Liability Companies," adopted January 23, 1991.

establishment of closely held corporations,<sup>7</sup> while the Law "On Shareholder Associations,"<sup>8</sup> establishes those rules for corporations with freely transferrable shares. Similarly, the Law "On Partnerships" governs the creation of general and limited partnerships.<sup>9</sup>

**Commercial Law.** In contrast with its relatively developed law on business entities, Latvia has yet to adopt a framework for a host of commercial transactions which are of great importance in a market dominated by private commercial actors. In essence, the private investor will wish to see a commercial environment in which newly privatized enterprises can conduct business predictably. Discussions with members of the Latvian judiciary confirmed that the pre-U.S.S.R. Latvian Civil Code and its framework for commercial law have been abandoned as outdated. Similarly, Soviet Law -- also abandoned in many respects -- is not sufficiently sophisticated to support the range of private transactions which are now contemplated.<sup>10</sup> Based on discussions with attorneys who have provided legal counsel regarding commercial transactions in Latvia, a great deal of legal uncertainty arises when undertaking transactions in the absence of a comprehensive legal framework. The following areas of concern were identified and should be addressed:

---

<sup>7</sup>The Latvian "closed corporation" resembles Germany's GmbH or Holland's B.V.

<sup>8</sup>Law "On Shareholder Associations," adopted [date not on copy provided].

<sup>9</sup>Law "On Partnerships," adopted February 5, 1991.

<sup>10</sup>See generally Farnsworth, E.A. and Mozolin, V.P., 1 Contract Law in the USSR and the United States (1987) 116-118 (many of the relevant commercial arrangements are not contemplated by Soviet civil law).

**Law Governing the Sale of Goods.** It is important in the context of both international and domestic transactions that Latvia adopt a modern regime covering the sale of goods. Obviously, the economic soundness of a private company's business frequently depends on the enforceability of purchase and sale obligations.

**Law Governing Credit Transactions.** A modern commercial regime requires a range of credit arrangements, from revolving credits and term loans to acceptance financing. Because the credit transactions used to support privatizations can be quite varied, Latvian law on credit and lending should be clearly established.

**Secured Transactions.** Similarly, the law of secured transactions establishes rules pertaining to possessory and non-possessory security interests. Without a law of secured transactions, many privatization transactions which would be supported by collateralized credit cannot be undertaken.

**Securities, Negotiable Instruments and Documents of Title.** The law pertaining to securities, negotiable instruments and documents of title are an important aspect of commercial transactions and in particular will play a role in privatizations, since these frequently involve the transfer of securities or transfer of assets as evidenced by documents of title.

**Law of Real Property.** Where real property is one of the assets of an enterprise being privatized, it becomes critical to have a system of real property law: recording title to land, encumbering the land (e.g., with a deed of trust, mortgage, or leasehold), and allocating real property interests are all real property transactions.

The process of legislating in the foregoing legal areas can be greatly facilitated by the partial or wholesale adoption of

existing models. Foremost among these is the United Nations Convention on Contracts for the International Sale of Goods, which has now been adopted in most developed commercial nations, including the United States.

#### **INSOLVENCY LAW**

Latvia does not have a bankruptcy law. Bankruptcy law defines the rights and obligations of creditors and debtors when a debtor enterprise cannot meet its financial obligations. In the absence of established creditor rights in bankruptcy, the remedies available to a creditor under credit agreements are of dubious value. Thus, deficiencies in the law on bankruptcy may hinder certain privatizations which involve the extension of secured or unsecured credit to an enterprise. The Latvian law pertaining to liquidation of companies needs to be reviewed with attention to the following:

- Those circumstances with respect to which a debtor is deemed insolvent both for individuals and going concerns.
- The mechanism by which creditors may place a debtor in bankruptcy.
- The mechanism permitting a debtor to elect voluntary bankruptcy.
- The description of circumstances which if proven by the creditor (e.g., fraudulent transfers, wasting of assets) would permit the court to take protective action (e.g., require security, authorize a receiver to take possession, etc.) or to turn assets subject to a security interest over to the creditor.

- The rights and obligations of the debtor.
- The rights and obligations of secured creditors, and priority of unsecured creditors.
- The appointment of a receiver and the receiver's powers and duties, e.g., meetings of creditors; determining rights of creditors to vote; discovering and assembling assets; collecting income due to the debtor; determining whether to liquidate or reorganize; and administrative fees for the receiver.
- Those circumstances under which creditors are authorized to take possession of the debtor's property.
- The factors for determining whether to liquidate some or all of the debtor's assets; and factors for determining whether to continue to operate the debtor's enterprise.

As with commercial law, a number of models exist for insolvency law, ranging from the debtor-friendly U.S. model to the relatively creditor-friendly German model.

#### **TAX LAWS**

The GOL has passed a number of laws relating to the taxation of income and assets.<sup>11</sup> Exemptions from taxes are also available

---

<sup>11</sup>See, e.g., Law "On Taxes and Duties in the Republic of Latvia," adopted December 28, 1990 and effective January 1, 1991; Law "On the Property Tax," adopted December 18, 1990 and effective January 1, 1991; Law "On profit tax," adopted December 20, 1991 and effective January 1, 1991; Law "On land tax," adopted December 20, 1990 and effective January 1, 1991; Law "On Natural Resource Tax," adopted December 12, 1990 and effective January 1, 1991; and Law "On Road Tax," adopted February 13, 1991

pursuant to other legislation, for example, the Law "On Foreign Investment." The GOL, however, has yet to negotiate tax treaties. Such treaties are designed to avoid double taxation and to prevent fiscal evasion. Because double taxation typically discourages investment, including investment in SOEs being privatized, the absence of double taxation treaties should be addressed.<sup>12</sup>

## **ACCOUNTING STANDARDS**

The GOL has not yet adopted a position on the nature of accounting standards applicable to Latvian enterprises. The absence of an official position can affect the privatization process in the following areas:

- **Valuation:** Valuation of enterprises is intimately linked to standard rules of accountancy.
- **Warranties and Representations:** Warranties and representations are frequently made in connection with the sale of an enterprise (e.g., in a stock purchase agreement), and typically rely upon analysis based on standard accounting principles.
- **Financing:** The underlying financing for a privatization transaction is typically based on a lender's evaluation of financial statements that comport with stated accounting standards.

---

and effective March 1, 1991.

<sup>12</sup>Tax treaties may govern a variety of subjects. For example, the United States is a party to income, estate, gift, and generation-skipping transfer tax treaties. The immediate concern, however, is with respect to income tax treaties, because these may have the greatest impact on foreign investment in the privatization process.

- **Requirements of Latvian Law:** Requirements of Latvia law, e.g, current company law, require the issuance of annual reports and audits. See Law on Entrepreneurial Activity, Article 12. Such reports contemplate the promulgation of accounting standards.

Discussions with Latvian businessmen in the private sector and with managers of state-owned enterprises, consistently underscored the lack of familiarity with accounting principles and the way in which economic events are described in connection with an enterprise functioning in a free market environment. The GOL needs to consider what model of accountancy should be adopted. Consideration should be given to an approach which makes Latvia's accountancy model consistent with that of its anticipated trading partners, and which is capable of administration in light of the radically changing economic context.

#### **INTELLECTUAL PROPERTY PROTECTION**

The law protects the rights which an author, inventor, or trademark holder has in a creative work, invention, or established reputation through the legal mechanisms of copyrights, patents, and trademarks. Privatization of certain state-owned enterprises will require that an intellectual property regime be in place, particularly where intellectual property is an important asset of the state-owned enterprise, or where privatization will depend on an investor contributing intellectual property.

Despite the GOL's expressed desire to secure access to foreign technology, the GOL has yet to pass legislation protecting intellectual property. Interviews of Latvian private sector enterprises underscored the need for such legislation. In one instance, a software developer could not sell or even disclose

software developed in Latvia because it was unprotected. The developer feared the software was subject to "pirating." In a second instance, a Latvian businessman admitted to pirating from an international firm all of the software upon which his business relied.

The scope and duration of protection which Latvia chooses to offer will partly depend on Latvia's evolving relationships with its trading partners and the nature of industry which Latvia wishes to encourage.<sup>13</sup> However, of equal importance to the issue of scope and duration are the remedies afforded under law, and the perception that the legal system actually enforces them. For investors, institutional and judicial commitment to protection of intellectual property must go hand in hand with the passage of laws. Assistance in connection with adoption of laws protecting intellectual property in Latvia must be coupled with assessment and prescription of an institutional strategy for their implementation.

## CONCLUSION

There remain a number of lawmaking priorities for the GOL: it must adopt a privatization law and other laws that facilitate ownership reform. In addition, a legal framework to support the commercial aspects of privatization transactions must be adopted. Finally, attention must be given to those legal areas which facilitate foreign investment, assuming that it is the GOL's objective to promote foreign direct investment in certain SOEs.

---

<sup>13</sup>Intellectual property rights and the schemes for their protection are primarily creatures of national law. The leading international agreements involving intellectual property are the Universal Copyright Convention, the Berne Convention for the Protection of Literary and Artistic Works, and the Paris Convention for the Protection of Industrial Policy.

**Appendix B**  
**Financial/Capital Market Overview**

**FINANCIAL INSTITUTIONS**

**The Bank of Latvia (BOL)**

The Bank of Latvia (BOL) is the central bank for the country. The (BOL) has assumed supervisory and ownership responsibility for the five Soviet banks that are operating in the Republic of Latvia:

<u>Bank Name</u>	<u>Number of Branches</u>	<u>Employees</u>	<u>Asset Size</u>
Agriculture	30	900	6 million rubles
Industry & Construction	8	N/A	6 million rubles
Social & Housing	9	N/A	6 million rubles
Foreign Trade	N/A	N/A	N/A
Gosbank	N/A	N/A	N/A

Technically a major percentage of the assets of the various banks are collateralized. However, in the absence of Soviet law the enforceability of the collateral is unknown.

**ISSUES**

- These banks continue to operate autonomously under the supervision of the BOL--i.e., they continue to make loans. The banks' future source of ongoing liquidity should be identified.
- The BOL has set up hard currency accounts. It is using Barclays in the UK as one of its correspondent banks. It also has banking relationships in Sweden and Germany.

- There is no deposit insurance scheme or one proposed at present.
- The BOL uses a committee system to establish its interest rates.
- The BOL has a staff of 170 persons.
- There is a proposal to restrict foreign ownership of banks to 40 percent.
- The BOL indicates that it has limits on "insider" lending. The BOL's ability to be able to monitor this at the present time is doubtful. There is no specific information at the present time as to the prescribed limit.
- No statutes for commercial bank capitalization exist.
- The obligation to repay the loans made by the previous Soviet banks is uncertain.
- The BOL is reviewing Western models for accounting standards.

#### **RECOMMENDATIONS**

- The BOL needs to evaluate the acquired portfolio from Soviet Banks.
- The BOL needs to organize an audit program for itself.

## **PRIVATIZATION OBJECTIVES**

- The BOL indicated that privatization of those banks operating under BOL's supervision might occur under the following time table:

	<u>Bank</u>	<u>Timeframe</u>
•	Agriculture	Long-term
•	Industry & Construction	Medium-term
•	Trade	Immediate

## **BOL SUMMARY**

The BOL has yet to make its decision to proceed with a two tier banking system which formally separates the central bank from the commercial and savings banks. The BOL can be a source of information as to the behavior of the commercial banks, savings banks and their own captive banks in identifying mechanisms for jump-starting the saving function in Latvia.

Opportunities for bank privatization within the BOL itself exist. The BOL informally indicated an interest in exploring this option in the near term.

## **COMMERCIAL BANKS**

The BOL has registered twelve (12) commercial banks whose market mandate is corporate/commercial and "high-net worth" lending as well as the related financial services.

- State owned enterprises (SOE) are among the chief investors in the commercial banks. In the case of Riga Komerc Banka the SOE's own 50 percent of the bank among the fourteen (14) initial investors.

- In the absence of a stock market in Latvia (at the present time) commercial banks are investing a portion of their funds on an equity basis in Latvian enterprises. Therefore, these banks are meeting borrower needs on a short-term basis with loans, and on a long-term basis with equity investments. However, the tendency will be to lend and invest in larger enterprises, including SOE's. Smaller enterprises and more entrepreneurial start-ups may receive less credit and capital funding from these institutions.
- While formalization of the restriction of foreign branch operation is expected in the near future, the commercial banks are actively seeking minority investments in their banks by foreign investors, including foreign banks.
- Most commercial banks are in the process of establishing correspondent banking relationships with foreign banks in the surrounding nations of Germany, Finland, Sweden and Denmark.
- Commercial banks have set up foreign exchange operations and are taking deposits in hard currencies.
- Visa, Mastercard and American Express are all setting up relations with the major commercial banks.

The newly established banks are concerned with what they perceive as undue competition from foreign banks and specially subsidized state banks.

#### **SAVINGS BANKS**

The saving banks of Latvia (krajbanka) are a hold-over from the Soviet style banking system. The savings bank has become effectively a retail bank. It has a large network of branches

and has small minimum deposits for hard currency. It lends to individuals for consumer purposes, housing and small businesses.

The Latvia State Savings Bank (LSSB), the largest krajbanka, employs over 2,500 persons in its headquarters and 500 branches. This branch network gives it a significant retail banking opportunity.

Like the commercial banks, LSSB takes hard currency deposits, with a minimum of US\$15, compared to the commercial banks' US\$300 minimum. Also, it is establishing correspondent relationships with foreign banks as well as setting up a Visa, MasterCard and American Express clearing capability.

#### **SUMMARY: COMMERCIAL AND SAVINGS BANKS**

Both types of institutions have been operating either with direct supervision from the BOL with nominal control or under corporate bylaws of each of the institutions. Legal recourse with regard to loans made by these banks is unclear.

#### **FOREIGN BANKS**

##### Baltic Investment Bank

The Nordic Investment Bank (NIB) has been providing assistance to the Baltic Republics for the development of a Baltic Investment Bank (BIB). The NIB will provide the technical and executive resources to the BIB. The initial capital subscription is projected to be ECU 330MM. At the present time the Scandinavian countries and the Baltic Republics are reviewing specific proposals. The NIB's conditions for establishment of the BIB are: 1) sufficient demand for loans with project proposals, 2) access to long-term capital, 3) clear and effective laws pertaining to banking and commerce and 4) trained staff.

The initial areas for BIB financing would be 1) new enterprises in the private sector, 2) joint ventures and other export oriented projects with hard currency earning capability.

The European Bank for Reconstruction and Development (EBRD)

This organization is beginning its assessment of financing needs for the Baltic Republics, including the Republic of Latvia. It will coordinate with the BIB to ascertain mechanisms for the financing of projects.

**SUMMARY**

The financial institutions in Latvia do not have a developed infrastructure at the present time. The future of the Latvian banking system will depend on how the Bank of Latvia, commercial banks, and savings banks define their respective roles. In addition, the assistance from the Nordic Investment Bank and the European Bank for Reconstruction and Development will assist the development of a more market oriented banking system.

There are several unresolved issues affecting the Latvian banks. These include the obligation of enterprises to repay loans, the ability of the banks to seize collateral if loans are not repaid, the clearing of deposits in the former Soviet Union, and insider lending practices. As the Latvian banks address these issues, they should make progress in their development.