

Worst Corporate Governance Case Since Yukos

By [Liam Halligan](#)

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A week ago during the VTB investment conference titled “Russia Calling!” our colleague Alexander Branis questioned Prime Minister Vladimir Putin about a corporate governance dispute that is arguably the most serious since the Yukos affair. The answer he received was encouraging but ultimately indecisive.

This is a test case on the maturity of Russia’s legal system, the outcome of which will show whether Russia has fair and consistent investment rules and whether Moscow is truly ready to become an international financial center.

The dispute being referred to is highly technical, but a great deal is at stake for the future investment climate in Russia. That is why we’re campaigning hard to resolve this serious injustice.

In March 2008, Federation Council Senator Leonid Lebedev’s Kores group bought a

controlling stake in TKG-2, one of the generation companies spun off during the wholesale privatization and restructuring of the country's power sector. As such, Kores was legally required to offer to buy out TKG-2 minority shareholders at the same price at which they took majority control. Prosperity Capital Management, or PCM, tendered its shares, along with other Russian and international minorities. But by the time the proceeds were due, share prices had fallen. For over two years now, Kores has created legal diversions to avoid paying what it owes TKG-2 minorities — about \$350 million.

Kores initially obtained a court injunction, effectively by suing itself, which blocked the previously agreed buyback. PCM's appeals against this ridiculous ruling were repeatedly adjourned — often for months at a time — on flimsy technicalities. Last week, though, PCM finally met with some success when the courts decided that this injunction should be lifted. This was a significant victory for PCM and other TKG-2 minorities.

Lebedev, however, has built other legal obstructions. TKG-2 minorities in theory benefit from a guarantee that Sberbank will meet the buyout liabilities if Kores fails to do so. But payment by Sberbank would amount to official recognition of Kores' default. So Lebedev obtained another injunction that has prevented Sberbank from paying.

More important, Kores argues that its buyout obligation is invalid under Russia's strategic investment law given that TKG-2 is involved with the treatment of radioactive material, albeit only on a minimal basis. Because the group has affiliated companies based offshore, Kores says it should never have been allowed to take majority control of TKG-2 in the first place, reasoning that "foreign entities" need prior state permission for "strategic" transactions.

This is farcical. At the time of the buyback, Russia's power-generation companies were specifically excluded from the strategic investment law in order to attract foreign investment. In any event, Kores is domiciled in Russia and controlled by a Russia citizen — Lebedev. In addition, Kores' offshore affiliates had no involvement in buying the TKG-2 stake and exert no control over the company.

For the past two years, PCM and other minorities have worked to overturn these legal subversions in the Moscow Arbitration Court and several courts of appeal. In four separate cases, the courts have backed Kores.

This is why PCM is now leading an application to appeal against these pro-Kores rulings to the Supreme Arbitration Court on behalf of a large group of TKG-2 minorities. In late July, PCM's request to appeal was rejected, a development that made headlines in Russia. At that point, having gone all the way to the highest commercial court in the land, we began to feel that all may be lost and this blatant injustice would never be corrected.

In late August, though, the Federal Anti-Monopoly Service issued an updated ruling on the aborted mandatory buyout at TKG-2. We were happy to learn that the anti-monopoly service now rules unequivocally that the company doesn't fall under the auspices of the strategic investment law. Therefore, Lebedev's justification for not meeting his obligations has now collapsed. The Supreme Arbitration Court is being directly contradicted by the anti-monopoly service, Russia's most important commercial regulatory authority and the body directly responsible for implementation of the strategic investment law.

The implications of the Supreme Arbitration Court's indefensible position goes way beyond the plight of TKG-2 minorities. Many leading companies — including Gazprom, Rosneft and Novotek — have offshore affiliates. Yet they are clearly seen as “domestic” for the purposes of the strategic investment law. So if the Supreme Arbitration Court fails to overturn successive pro-Kores rulings, numerous Russia commercial entities are, in effect, in legal breach. Some of the most significant transactions in this country's recent history could be challenged in the courts and rendered null and void, causing commercial chaos.

After the Federal Anti-Monopoly Service judgment became public, an expanded group of TKG-2 minorities lodged a renewed appeal request to the Supreme Arbitration Court. Recently, we learned that the anti-monopoly service had made a point of highlighting its latest ruling on the strategic investment law to the Government Commission on Monitoring Foreign Investment, which is chaired by Putin.

That is why Branis, PCM's chief investment officer, decided to question Putin on this issue at the VTB conference, emphasizing the dangers to both domestic and foreign investors in Russia given the current confused position. We were pleased to hear that Putin, who championed the wholesale privatization and restructuring of Russia's power sector, fully understands this complex situation and shares PCM's concerns. It is also significant that he disclosed that the government will soon issue a statement on how it intends the strategic investment law to be interpreted, making the official position clear.

Russia's business environment has certainly improved significantly over the past 20 years. But serious risks remain. While this TKG-2 dispute is complicated, the outcome matters. Around the world, professional and institutional investors are watching this case very closely. Correcting the blatant legal abuses related to this TKG-2 buyback and forcing Lebedev to pay would have a considerable positive effect on the investment climate in this country, which would help stabilize and strengthen Russia's economy.

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Editor's note: This comment has been amended to reflect the following change: "Recently, we learned that the anti-monopoly service had made a point of highlighting its latest ruling on the strategic investment law to the Government Commission on Monitoring Foreign Investment, which is chaired by Putin." The previous version incorrectly referred to the commission as the Foreign Investment Advisory Council, or FIAC.

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