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INDEPENDENT NEWS FROM RUSSIA

Selective Justice Keeps Foreign Investment Out of Ukraine

By The Moscow Times

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KIEV — Four years after British financier Neil Smith bought one of Ukraine's largest local vodka producers, it was listed by Forbes as one of the country's fastest-growing firms, with annual sales of $600 million. Then, a local court ruling nearly shut it down.

Such cases are one reason why Ukraine performs so poorly in attracting foreign investment, drawing just over $6 billion in FDI last year compared to over $10 billion each for its EU neighbors Poland and Czech Republic.

Of that sum, $3.9 billion came from Cyprus, which many Ukrainian businessmen used — until this year's banking crisis — as an offshore tax haven. Investors also took out $1.3 billion in profits and wrote off $629 million in losses, leaving very little in genuine foreign investment.

‘Where there is a dispute with the government, the court sides with the government’

Chief Executive

A Ukrainian Food Firm

Although President Viktor Yanukovich's government has made business climate improvement one of its top goals, figures and high-profile cases show that the former Soviet republic is still a long way from becoming an investor-friendly location.

Smith says a court in the southern Crimea region froze all the assets, including bank accounts, of his Crimean Vodka Company, or KVK), in April under a lawsuit from a Ukrainian firm chasing debts owed by the bankrupt former owner of the assets.

The court's ruling was based on allegations that KVK had put assets up for sale on the local equivalent of the craigslist or eBay websites. Smith says the ads were planted fakes.

It lifted the ruling within a few days after Smith turned to the Crimean government, Western diplomats and the media, averting a shutdown that could have bankrupted KVK.

But Smith says he fears KVK's assets could be frozen again during the court case, which does not dispute the takeover itself, achieved by Smith buying most of the bankrupt producer's collateralized debt for a sum he did not wish to disclose.

"The impact of us not achieving a resolution to this situation promises to be absolutely destructive for the investment climate in this country," he said.

Empire, the company suing KVK, could not be reached for comment. It bought its collateralized debt in the bankrupt vodka producer from Alfa Bank Ukraine, one of the top ten lenders in the former Soviet republic. The bank declined to comment.

Lawyers say Smith's experience is not an isolated incident.

"We encounter such cases very often," said Olga Vorozhbyt, a lawyer at law firm Chadbourne & Parke LLP Ukraine.

"If the ultimate goal is forcing the opponent into some kind of deal, usually on unfavorable terms, such strong measures [freezing assets] are one of the ways to achieve it," she said.

Raiding

While Smith says the case against his company appears to be only about money, such tactics are also used for what Ukrainians call "corporate raiding".

In the West the term refers to hostile takeovers, but here, as elsewhere in the former Soviet Union, it implies taking over a business without paying.

In its annual report on Ukraine's investment climate, the U.S. State Department said local courts "allow and sometimes protect corporate raiding," one reason foreign direct investment has been anemic in recent years.

Last week, First Deputy Prime Minister Serhiy Arbuzov pledged to "jointly address foreign investors' complaints about the shameful incidents of raider takeovers" with foreign ambassadors, without saying which incidents he had in mind.

The most recent, high profile case of alleged "raiding" was the takeover of TVi, which used to be the only Ukrainian television station to air frequent criticism of the government.

In April, Alexander Altman, a Ukrainian-born U.S. businessman who has in the past advised Ukraine's government, took over the station from Konstantin Kagalovsky, a former executive of the defunct Russian oil giant Yukos.

Altman said he had received a power-of-attorney letter from a director of its Cyprus-based holding company authorizing the takeover. Kagalovsky says the document was a fake but state registrars have recognized the transfer of ownership.

Although TVi has never been profitable, according to Kagalovsky, it can, along with other large media outlets, influence the outcome of the 2015 presidential election in which Yanukovich is widely expected to seek a second term.

In May, Kagalovsky, who is now a British citizen, said he had filed a lawsuit with London's High Court to regain control over TVi.

The Luxury of Justice

Even the rich and powerful of Ukraine prefer to settle their disputes in London courts rather than in local ones.

In March, Ukrainian billionaire industrialist Viktor Pinchuk sued two of his compatriots at the same London court, saying they failed to hand over an iron ore business for which he paid $143 million.

According to Pinchuk's claim, at the time of the deal, he and the defendants — billionaires Gennady Bogolyubov and Igor Kolomoisky — agreed to settle all potential disputes in an English court.

But most businessmen working in Ukraine cannot afford such luxury and have to deal with the local judiciary that is known for often coming down in favor of the government.

Lawyers say this has become a big issue since last year when the government sought to boost tax collection in order to finance increased public spending ahead of a parliamentary election while the economy slipped into recession.

Speaking on condition of anonymity, a Ukrainian chief executive of a local food company owned by a large Western firm said that when taxmen came to his office, they told him they had been ordered to issue a claim or lose their jobs.

"Tax inspectors are asking me: 'If we refuse to file claims as ordered, will you hire us?" the businessman said.

His company, which employs 170 people, paid more than $1 million in taxes last year and has, at the request of tax authorities, paid income tax in advance for a period up to 2015.

However, taxmen have accused the firm of dodging $200,000 in taxes, a claim it is challenging in court, and the businessman himself has been informed he could face criminal charges over the alleged offenses, together with his chief accountant.

The businessman has also been told that he could resolve the issue with an informal payment. But he says company policies and personal beliefs stop him from doing that.

"Our only 'flaw' is that we do not pay bribes," he said, adding that he had little hope of winning a court appeal against the tax authorities. "Where there is a dispute with the government, the courts side with the government."

Lawyers say challenging such claims in courts usually requires going through several trials.

"In a recent case, tax authorities stated that 'the state budget needed money' to justify their demands" said Vorozhbyt from Chadbourne & Park.

Such practices are familiar across the former Soviet Union, but have a greater impact in resource-poor Ukraine than in its huge neighbor Russia, where foreign direct investment per capita since the Soviet collapse is almost three times higher.

Local brokerage Concorde Capital said Ukraine badly needed high quality investment to improve its competitiveness.

"However, due to poor property right protections, selective law enforcement and a weak judicial system, investors do not consider Ukraine very attractive, especially in view of many alternatives like Turkey in the region."

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