



**CENTRE FOR THE STUDY  
OF ECONOMIC & SOCIAL  
CHANGE IN EUROPE**

**SCHOOL OF SLAVONIC & EAST  
EUROPEAN STUDIES**

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**Working Paper No. 33**  
*June 2003*  
**ISSN 1476-1734**

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# CORPORATE CONTROL AND GOVERNANCE PRACTICES IN RUSSIA<sup>1</sup>

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**May 2003**

## **ABSTRACT**

In Russia, the problem of corporate governance has become a frequent subject for discussion. Stories now abound about questionable corporate governance practices, such as share dilution, asset stripping, transfer pricing, complex ownership structures, limiting shareholders from attending the shareholders meetings. These practices, which have come to constitute corporate governance abuses to company shareholders, are considered to be factors adversely affecting the investment climate. At first glance, these non-transparent practices are a collection of independent cases of managerial malfeasance that are abusive to investors. However, there seems to be an internal logic in these widely used practices, as they have been functional for Russian corporates to navigate through circumstances characterised by an imperfect formal framework. The aim of this paper is to analyse such functionalities of the practices in light of an evolution of corporate Russia. Taking Yukos Oil Company as a case study, the paper demonstrates that resorting to these practices was instrumental in a process of ensuring corporate survival and strengthening market position by establishing a coherent corporate entity. This paper emphasises that these practices represent rational and logical responses by economic agents to the prevailing conditions shaped by policy choices, political and macroeconomic environment, and institutions.

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<sup>1</sup> The author is grateful to the Obuchi Fellowship of Japan for financial support of the research.

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## 1. INTRODUCTION

In Russia, corporate governance has become a frequent subject for discussion, and its problems are considered to be one of the serious obstacles in her effort at achieving deeper integration in the world economy. Russia's corporate governance practices such as share dilution, asset stripping, transfer pricing, and cashflow diversion have become known as abuses to company shareholders.<sup>3</sup> As Nestor and Jesover (1999) put it, "Well-publicised corporate governance abuses, which did not seem to matter in the buoyant equity boom of 1997, were perceived as a major impediment to investment." This was particularly so in the eyes of western investors.<sup>4</sup>

The aim of this paper is to analyse practices that have come to constitute corporate governance abuses in Russia, in an attempt to shed light on the functionality of these practices. It seeks to illustrate what has been abusive to investors may have been rational and logical from the perspective of corporate owner-managers in Russia.<sup>5</sup> Resorting to such practices was functional in order to ensure corporate survival and to build a coherent and viable corporate structure under the given conditions. By functionality of practices, it is to mean whether certain practices are instrumental for the growth of a company.<sup>6</sup> Throughout this paper, functionality is examined from a dynamic perspective of corporate growth, as opposed to a static view of financial efficiency. Corporate growth is understood in the spirit of Penrose (1959), whose theory of firm-growth is concerned with a dynamic process of development, which results in an increase in size or an improvement in quality of a growing object.

In this paper, corporate governance practices are analysed by taking the case of Yukos Oil Company. Because of the manner in which privatisation was carried out, the corporate structure of Yukos had been fragmented and lacked internal cohesion. The major challenge confronted by the owner-managers of Yukos was to establish effective corporate control. Under constraining environments in which corporate survival was at stake, establishing cashflow control and achieving wholly-owned vertical integration was particularly crucial. In order to achieve these objectives, questionable corporate governance practices, due to which the company became the most notorious among investors in the late 1990s, were utilised as tools. It is illustrated that abusive practices have been rational and functional for the owner-managers to achieve a coherent corporate structure and super-majority control, and ultimately delivered corporate growth.

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<sup>3</sup> See for example, Economist, July 24, 1999, "Hot shares, bothered investors."

<sup>4</sup> The following passage by Mobius and Filatov (2001: 65) captures the investor sentiment: "...the number and scope of corporate governance violations in Russia is appalling. Russia has certainly not been the safest market to invest based on economic and political criteria, but it has become infamous for the huge number of minority shareholder rights abuses perpetrated by the voracious and corrupted company managements and controlling shareholders."

<sup>5</sup> Unlike the Anglo-American system, the separation of ownership and control (or management) is not a characteristic feature of corporate governance in Russia. Owners and managers are usually not distinguishable (Dolgopyatova 2001), hence the term "owner-managers."

<sup>6</sup> This paper looks into functions from the perspective of growth of company, —whether particular corporate practices were instrumental to attain corporate survival and to establish robust corporate entity, rather than functions from the perspective of a firm as a statically-efficient "black box"(Aoki 2000:22).

This paper is organised as follows. The next section sets out an analytical framework for the case study in the subsequent sections. It is emphasised that the abusive corporate governance practices can be considered as rational responses by economic agents to the prevailing conditions, shaped by policy choices, political and macroeconomic environments, and institutional environments. The third section reviews privatisation initiatives in the oil industry. It is argued that the dual-level privatisations have become root causes of corporate governance problems, particularly for Yukos Oil Company. The section four examines the process of establishing cashflow control, by analysing the motivations and methods. The fifth section investigates the process of achieving wholly-owned vertical integration—an integration “from the well to the gas station.” It is highlighted that governance practices were used as a tool to achieve vertical integration and to resolve the problem caused by the conflict of interests with minority shareholders. It is also demonstrated that the institutional environments, particularly the legal and regulatory environment, have been conducive to such practices to be operational. Having established effective corporate control, two main initiatives undertaken by Yukos in its corporate development can be observed in the years after the financial crisis of 1998: First is a new focus on value maximisation. Another is an attempt to build a conglomerate across energy sectors. In section six, these recent developments, emerging against a background of post-1998 crisis turnaround, are reviewed, and their implications for the evolution of corporate Russia are examined.

## **2. ANALYTICAL FRAMEWORK TO APPROACH CORPORATE GOVERNANCE ABUSIVE PRACTICES**

By the end of the 1990s, Russia earned a notorious reputation for its corporate governance system as being opaque and non-transparent. The reason for this non-transparency is that it has been an economy where the benefit of being non-transparent exceeds that of being transparent; meaning that it pays to be non-transparent. The nature of non-transparency lies in business practices based on extra-legal or informal principles that are not always clear to outsiders. From the investors’ point of view, corporate behaviour has often been characterised as “devious.”<sup>7</sup> Consequently, abusive corporate governance practices have become one of the most serious problems adversely affecting the investment climate in Russia. Stories now abound about what have come to be known as abusive practices in corporate governance, because equal treatment of shareholders and protection of their rights are not provided as supposed to be. Corporate governance problems in Russia usually include: non-transparent ownership; transfer pricing; asset transfers (asset stripping); share dilution; limiting participation of unwanted shareholders; non-payment of dividends and hostile bankruptcy (See Table 1). These are included in the criteria used to measure corporate governance risks in Russia by rating agencies and investment houses assessing the quality of corporate governance (See Table 2).<sup>8</sup> The practices of tax evasion and capital flight are indeed a part of the same problem in

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<sup>7</sup> See for example, Moscow Times, June 1, 1999: “...devious practices such as transfer pricing and share issuance monkey business that are commonplace in post-Soviet Russia.”

<sup>8</sup> They include Brunswick UBS, Institute of Corporate Law and Governance (ICLG), Standard & Poor’s, and Troika Dialog.

governance, although they tend to be treated separately in academic studies: In fact, analysis generally refrains from incorporating various factors that motivate economic agents to employ particular practices. It is therefore necessary to scrutinise the how and why of these abusive practices, and put these into perspective by taking into account an environment where they take place.

**(Table 1): Corporate Governance Problems in Russia**

<b>Typical corporate governance abuses</b>	<b>What the practices look like</b>
Non-transparent ownership:	: Companies have intricate patterns of cross-ownership involving offshore affiliates, and company's structures are difficult to trace
Asset transfer (asset stripping):	: A company (A) transfers its good assets to another company controlled by insiders, and to leave the company (A) with bad loans, for example
Transfer pricing:	: Sales by insider controlled company (A) to another company (B) at a very low price. Proceeds from the transactions are transferred to an offshore company (C) controlled by insiders. Widely used to divert cashflows
Dilution of shares:	: Additional share issues take place in order to dilute stakes of a particular group of shareholders
Limiting 'unwanted' shareholders:	: Possible dissents-shareholders are denied from participating from governance procedures such as voting at annual shareholders meetings.
"Hostile" bankruptcy:	: A group of managers, investors or creditors put the target company into bankruptcy proceedings in order to takeover the company. Attackers buy debts of the target, put the target into bankruptcy by sending their own external managers
Non-payment of dividends:	: Dividends are not paid

**(Table 2): Rating Corporate Governance in Russia**

Organisation	Criteria
Standard and Poor's	<ul style="list-style-type: none"> <li>• Ownership structure and influence</li> <li>• Financial stakeholder rights and relations</li> <li>• Financial transparency and info disclosure</li> <li>• Board &amp; management structure and process</li> </ul>
ICLG	<ul style="list-style-type: none"> <li>• Information disclosure</li> <li>• Ownership structure</li> <li>• Board of directors and management structure (affiliatedness, remuneration etc)</li> <li>• Basic shareholder rights (rights for voting, participation, dividends etc)</li> <li>• Absence of expropriation risks (asset transfer, transfer pricing, dilution etc)</li> <li>• Corporate governance history</li> </ul>
Brunswick UBS	<ul style="list-style-type: none"> <li>• Low Transparency</li> <li>• Dilution</li> <li>• Asset transfers/transfer pricing</li> <li>• Mergers and restructuring</li> <li>• Bankruptcy</li> <li>• Ownership and voting restrictions</li> <li>• Corporate governance initiatives</li> <li>• Registrar quality</li> </ul>

Source: Based on Standard & Poor's, Institute of Corporate Law and Governance, Brunswick UBS

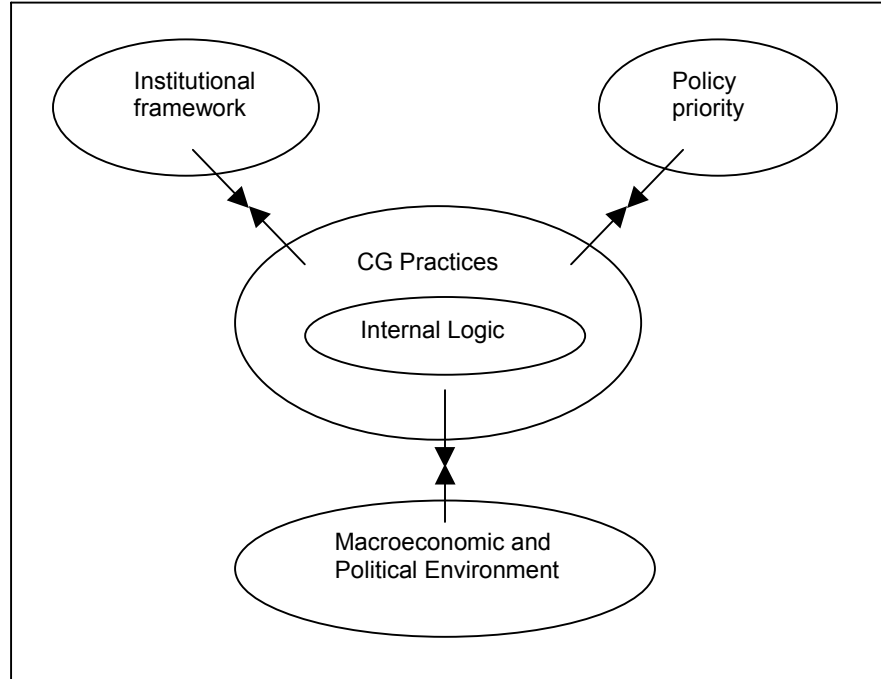
But what is corporate governance and what is meant by “abuses”? Since the beginning of the 1990s, the term ‘corporate governance’ has become a catchword for analysts, policymakers, and financial market participants alike. It has become a focus of debate along with the equity bubble in the U.S. and the increasing concern among investors as to how the company should be run. However, one of the problems of the corporate governance debate has been the absence of a consistent usage of the term based on the universally accepted definition (Keasey, Thopmson and Wright 1997:2). Nevertheless, the studies of corporate governance have dominantly been approached from a point of view of the ‘principal-agent problem’ that emerges from the separation of ownership and control. In this finance approach, the essence of the corporate governance problem has been “how investors get the managers to give them back their money” (Shleifer and Vishny 1997:738). The concept of corporate governance has developed with the notion that the shareholders are the owners of the corporation, and thus the corporations should serve the interests of shareholders above all. As such, the notion of corporate governance based on the standard approach carries a value judgement. It is a normative ‘shareholder-value’ based perspective (Aoki 2001). This concept is based on a situation where ownership of a company is widely dispersed among shareholders, with a presence of efficient institutions, such as effective legal protection of shareholders rights and competitive capital market, that makes such ownership pattern possible. When the capital market is developed and competitive, shareholders monitor the company’s activities and the market for corporate control becomes possible and workable. Seen from this

normative and static efficiency view on corporate governance, corporate governance practices in Russia are indeed abusive to investors.

The main question posed here in this paper is: how should one make sense out of the widespread use of these corporate governance practices in Russia? Have such abusive practices been dysfunctional for the system? At a first glance, these practices are a collection of shareholder violations and managerial malfeasance. However, there seems to be an internal logic in these widely used practices, as they may be functional under the given circumstances. In a static sense, these abusive practices are in no way optimal or efficient: However, in considering the role of these practices in a dynamic dimension, as opposed to static view, it could be argued that they have been needed and logical from a point of view of owner-managers in a process of avoiding corporate failure, ensuring corporate survival, and strengthening market position by establishing a robust corporate entity under the given conditions. Functionality, therefore, is considered here in a context of a dynamic growth perspective. From a standpoint of static efficiency, these can be examples of managerial malfeasance, opportunism, and shareholders rights infringement. However, from a point a view of process of corporate development, i.e, process of establishing durable organisational entity, these practices have been rational, and even may have been logical.

In this paper, it is demonstrated that so-called devious and abusive practices were in fact functional under the given circumstances in ensuring corporate survival. These practices represent rational responses by economic agents to the prevailing environment, created by a) policy choices, b) macroeconomic / political environment, and c) institutions (or lack thereof) (See Figure 1). For example, governance practices were utilised as a way to deal with the difficulty in corporate structures created by the privatisation policy initiatives at the level of holdings and their subsidiaries in the oil sector. The dire macroeconomic situation and continuous political instabilities have encouraged and necessitated entrepreneurial agents to resort to practices that secured cashflow control. The institutional environments, characterised by a gap in a formal framework and weak enforcement, have been conducive for particular practices to be operational. This way, there have been dynamic interactions among the prevailing conditions and corporate governance practices, which in effect has shaped the structure of corporate governance in Russia. This paper illustrates that the know-how embodied in these corporate governance practices has become crucial to navigate through highly constraining circumstances where conducting 'normal' business has been extremely difficult, in a sense that self-protective measures are constantly needed to defend or expand one's business. Consequently, corporate governance in Russia inevitably became closely associated with a struggle to establish corporate control, and these practices became instrumental for realising this objective.

**(Figure 1): Workings of corporate governance practices**



### **3. DUAL-LEVEL PRIVATISATION IN THE OIL SECTOR**

Corporate governance problems that became prominent particularly in the Russian oil sector had their roots in the privatisation policies that lacked coherence, i.e., the oil sector underwent dual-level privatisation<sup>9</sup>. The duality consisted of: the level of subsidiaries of the oil holding companies (daughter companies), and the level of holdings themselves (parent companies).<sup>10</sup> As it will be shown below, this dual privatisation led to a multilevel ownership and control structures with different shareholders with conflicting interests.

#### **3.1 Privatisation policy: Reorganisation of oil sector 1992-1995**

To understand why such dual-level privatisation took place, it is necessary to consider where this duality of ownership—holding and subsidiary—came from in the first place. The duality is due to 1) an establishment of a new level of ownership—a creation of vertically integrated oil holding companies, that included already exiting enterprises as subsidiaries, followed by 2) privatisation of subsidiaries and then of holdings. The establishment of holdings was promoted as part of a post-soviet reorganisation of the oil sector, which was necessitated in part as a policy priority in the midst of a chaotic economic situation and a weakened central control over the industry (Diens 1996:10, Moser and Oppenheimer 2001).

<sup>9</sup> The term “dual” is used to describe privatisation process in the oil industry in OECD (2001).

<sup>10</sup> Sources that point to this root causes include: interviews with specialists in the Russian oil sector, investment communities, and academia, conducted by author in Moscow (October 2002- January 2003).



## ***Background***

The Russian oil industry was increasingly decentralised as a result of Mikhail Gorbachev's economic reforms on the eve of the break up of the Soviet Union. A series of legislations, such as the Law on State Enterprises introduced in 1988, gave enterprise managers operational and financial autonomy. With the breakdown of the central administrative control, the various parts of the oil industry asserted their independence under the power vacuum. Enterprises and organs of local administration began to form independent companies, taking over assets in the oil industry. The management of the local companies were positioned to act in their own interest over production, refining and sales (Lane 1999:5). By arbitraging a difference between the world price and domestic price, which remained controlled in 1992, exporting oil became extremely profitable (Aslund 1995: 42). Besides, since the dismantling of the state monopoly over foreign trade in 1988, those who had access began to sell abroad practically anything exportable. "Anyone who could acquire oil, diamonds, or metals for rubles at controlled domestic prices, and then sell them abroad for dollars, was rich overnight" (Gustafson 1999: 27). As a result, large volumes of oil were illicitly exported (Moser and Oppenheimer 2001:305).

## ***What kind of policy?***

Following the break up of the Soviet Union, a fundamental reorganisation of the disintegrating Russian oil industry took place. The reform of the Russian oil industry began when President Yeltsin issued a decree<sup>11</sup> in November 1992, specifying the privatisation and the transformation of enterprises into corporate entities. Two points of the decree are especially important for our discussion. First is the establishment of "vertically integrated holdings" to create so-called vertically integrated oil companies (VIOCs). Second is the privatisation of subsidiaries.

### **1) Establishment of oil holdings**

First, the decree established vertically integrated oil companies (VIOCs). VIOCs were composed of holdings and subsidiaries. Each holding was made up of oil production subsidiaries and refining subsidiaries. The first three vertically integrated oil companies were Yukos, Lukoil and Surgut Holding (See table 3). Yukos, for example, was made up of about a dozen subsidiaries, including oil production companies such as Yuganskneftgaz. By mid 1995, Sidanco, Slavneft, VNK, Onaco, Rosneft, TNK, and Sibneft had been created as VIOCs. The share structure of the holding companies such as Lukoil, Surgut Holding and Yukos, initially looked as follows: 45 percent of the stock was to be owned by the federal government, 40 percent to be sold on investment tenders, and 15 percent to be tendered for privatisation cheques, and the shares owned by the federal government were initially to be owned for three years. Other shares were to be transferred to local authorities, and to management etc (Lane and Seifulmulukov 1999:25).

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<sup>11</sup> The decree became so well-known to be familiarised by its number—presidential decree number 1403 entitled "On Specifications for privatisation and reorganisation as joint stock companies or state enterprises, production, scientific-production associations in the oil and refining industries and in oil and petroleum supply."

**(Table 3): First three Vertically Integrated Oil Companies (VIOCs)**

Holding	Lukoil	Yukos	Surgutneftegaz
Oil Production	Kogalymneftegaz Langepasneftegaz Urayneftegaz Nizhnevolzhkneft	Yuganskneftegaz Samaraneftegaz	Surgutneftegaz
Oil Refining	Permnefteorgsintez Volgograd Refinery Novoufimsk Refinery	Kuibyshev Refinery Syzran Refinery Nobokubishev Refinery	Kirishinefteortsintez
Oil Products Distribution	Adygeisknefteprodukt Vologdanefteprodukt Volgogradnefteprodukt Chelyabinsknefteprodukt Chelyabinsknefteprodukt Permnefteprodukt	Bryansknefteprodukt Voronezhnefteprodukt Samaranefteprodukt Orelnefteprodukt Lipetsknefteprodukt Penzanefteprodukt Ulyanovsknefteprodukt	Karelnefteprodukt Novogorodnefteprodukt Pskovnefteprodukt Tvernefteprodukt Kaliningradnefteprodukt Peterburgnefteprodukt

Source: Based on RPI July/August 1994:16-18.

The establishment of VIOCs in 1992 were facilitated by the general directors of the former Soviet oil enterprises who wanted to keep their newly gained autonomy and control over their enterprises. They opposed a plan to create a unified state oil monopoly on the lines of Gazprom (Moser et al, 2001: 304-5). Given the disintegration and uncertainty of the sector, the creation of VIOCs was acceptable for the government, since with the restructuring of the Russian oil industry into several vertically integrated holdings it was hoped to eliminate the perverse discordance among entities dealing with oil exploration, development, and refining stages—a discordance that had plagued the Soviet oil industry when different ministries were responsible for each of these activities (Dienes, 1996:10). Also, since the oil industry was a strategic sector of the national economy, the government’s position was that some degree of state control was essential. The federal government intended to exert a large measure of influence over these companies through substantial ownership of stocks in the newly created holding companies. The state shares in separately privatised subsidiaries became charter capital of the holding, enabling the state to have a controlling interest in the holding.

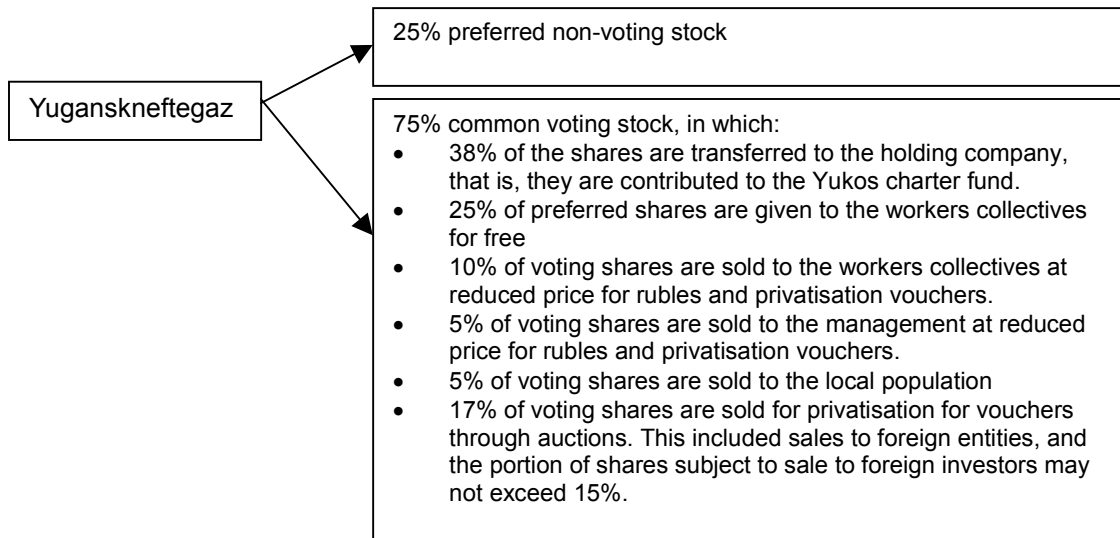
## 2) Privatisation of subsidiaries

The second pillar of the reorganisation policy was that all the formerly state owned enterprises, involved in oil production, refining, and marketing, were to be reorganised into open-type joint stock companies. The controlling interests in each enterprise would remain with the state for three years following the reorganisation. Oil production daughter companies of Yukos, such as Yuganskneftegaz and Samaraneftegaz, were corporatised into joint stock companies and went through the privatisation process.<sup>12</sup> In Yuganskneftegaz’s case, for example, shares were divided into the following manner: Stocks were divided into 25 percent preferred non-voting stock and 75 percent common voting stocks. Of the commons stocks, 38 percent of shares contributed to the Yukos

<sup>12</sup> Based on Presidential Decree number 1903 of 1992.

charter fund, 25 percent given to workers collectives, 10 percent sold to workers, 5 percent sold to management, 5 percent sold to local populations and 17 percent sold for privatisation vouchers through auctions.<sup>13</sup>

**(Figure 2): Share Structure of Yuganskneftegaz**



Source: Based on RPI, June 1993.

Because 38 percent is more than half of 75 percent of voting shares, a holding had controlling stakes (51 percent) of Yuganskneftegaz. In this manner, Yukos, as a holding company, obtained controlling stakes of its own subsidiaries

### 3.2 Privatisation at the level of holdings: Loans-for-shares programme

Privatisation of holdings took place from 1995<sup>14</sup> via investment tenders and loans-for-shares programme, as part of cash stage of privatisation following the voucher mass privatisation. The loans-for-shares programme, implemented from 1995-97, privatised substantial state industrial assets, a significant portion of which remained under the state control despite the implementation of a large-scale mass privatisation from 1992. Enterprises in the energy sectors that were categorised as strategically important for Russia's national interests remained unprivatised. This loans-for-shares scheme became the most notorious part of this monetary stage of privatisation. In exchange for bank loans, the government offered its shares of the most valuable enterprises to a small circle of well-connected entrepreneurs through a series of auctions. The loans-for-shares privatisation was another process of "authorisation," where the state authorised some of

<sup>13</sup> RPI, June 1993, 48-51.

<sup>14</sup> The 1995 presidential decree allowed the management to start new auctions to privatise the state-owned shares.

the appointed agents to promote governance of particular enterprises by concentrating the capital.<sup>15</sup> Many of the remaining state shares in the oil companies were privatised through this policy choice. The policy was introduced partly as a result of the government's pressing need for fiscal revenue. As the presidential election of 1996 was approaching, the need to prop up the cash-depleted government coffers increased. Also, at this time, the threat of re-nationalisation was serious.

Loans-for-shares privatisation was largely criticised as rigged auction, through which the shares were handed at a nominal price to predetermined buyers, connected to the organisers of auctions.<sup>16</sup> At the same time however, Pappé (2002) notes that from the point of view of corporate building, it could be argued that the loans-for-shares marked a full-fledged beginning of the development of large industrial business groups in Russia.

The background for loans-for-shares privatisation was that the interests of the state and business coincided. First, the state had to improve the situation of its ever-deteriorating budget deficit, and secondly, business was gradually shifting its emphasis from banking to industry. Winners of loans-for-shares auctions, i.e. the acquirers of the privatised holdings, were the newly emerged banks that had flourished during the immediate post-soviet period. Between 1992-95, Russia's commercial banking sector prospered; despite a steep decline in GDP for the Russian economy as a whole, GDP created in the financial industry grew by 57 percent from 1991 to 1994 (Johnson 2000: 99). During that time of hyperinflation, banking was extremely profitable. Banks made money through currency speculation and GKO investment, rather than by financial intermediation. By the end of 1995, more than 2500 commercial banks had been created—Russia had 2598 banks with 5580 branch offices (Bersnstam and Sitnikov 2001: 222). The most powerful of these new banks were known as the 'authorised banks' that were given exclusive privileges to handle the finances of various government agencies (Tompson 1997:1172). However, by the end of 1995, commercial banking business had become less attractive. Despite the high revenues obtained from the securities market, low inflation and a ruble corridor put an effective end to the easy gains by currency speculation that had been made between 1992 and 1994, and the high re-finance rates and high reserve requirements added burdens to commercial banks (Hedlund 1999: 206). Gradually, the center of attention was moving from the banking sector to the industrial sector.

Through loans-for-shares, new owners obtained majority ownership stakes in oil holdings. These new owners, as a result, became the controlling shareholders of their subsidiaries. However, they had yet to establish control over subsidiaries.<sup>17</sup> Because of the dual-level privatisation, subsidiaries had their own sets of shareholders, including the foreign portfolio investors. Shares of subsidiaries were being traded separately and consequently there were minority shareholders. As a result, the core owners of the holding and the minority shareholder of subsidiaries conflicted with one another. Among

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<sup>15</sup> The 'authorised class', according to Kryshantovskaya (1996), Kryshantovskaya and White (1996), refers to those with a privileged access to the market, and converted political power to property ownership by privatising the sections of the state for which they were themselves responsible.

<sup>16</sup> See for example, Freeland (2000).

<sup>17</sup> Moscow Times, September 23, 1997.

the holdings, particularly Yukos and Sindanko there was a lack of internal cohesion, as constituent subsidiaries enjoyed independence (Moe and Kryukov 1998: 600).

### **3.3 Acquisition of Yukos—birth of Integrated Business Group “Menatep-Rosprom-Yukos”**

In the period when banking business was very profitable, Bank Menatep, headed by Mikhail Khodorkovskii, grew as one of the leading Russian banks. Established in 1988, it was 26th largest bank in January 1993, became the 12th largest in January 1995 and was among the 10th largest by January 1997.<sup>18</sup> Menatep was regarded as the only Russian bank which expressed its industrial orientation from the very beginning, as it formed a large industrial group centered around the bank.<sup>19</sup> It aggressively acquired industrial assets, and according to Latynina (1999), more than a hundred industrial enterprises<sup>20</sup> came to be owned by Menatep during 1994-95. By 1995-96, Khodorkovskii and his team were moving its emphasis from banking to industrial sector. When they were acquiring Yukos, the company became the central part of their ‘empire’. In September 1995, the management company Rosprom, was established in order to manage shares of the industrial enterprises. In the beginning of 1997, core personnel were transferred from Menatep to Rosprom, indicating a clear shift of emphasis to the real sector (Pappe 2000).

#### ***Acquisition of larger portion of shares in the oil company***

From 1995, the Menatep-Rosprom group began to acquire shares of Yukos, via investment tenders and loans-for-shares privatisation programme. The cooperation<sup>21</sup> took place against the background in which holding companies required stronger banks for their operations (Kryukov and Moe, 1999). Besides this, the state was too weak and fragmented to be an effective owner.<sup>22</sup>

By the start of 1997, more than 85 percent of Yukos shares were owned by Menatep-Rosprom group. Menatep first acquired 33 percent of Yukos shares in December 1995, and won a loans-for-shares auction for a 45 percent state stock holding in the company. Menatep acquired 7.06 percent of Yukos in May 1996 at a cash auction (Lane and Seifulmulukov 1999: 30).<sup>23</sup> As a result, the composition of shareholders in Yukos as of 1 November 1996 looked as follows<sup>24</sup>:

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<sup>18</sup> *Natsional'naya Slujba Novostei*: <http://www.nns.ru>.

<sup>19</sup> *Ibid.*

<sup>20</sup> They included “Apatit”, “Voskresenkiy Mineral Fertilizer” (mineral fertiliser), “Uralsktromed” (copper), Central-Ural and Kirovgrad copper-smelting factories (copper), Ust-Ilmsk Kombinat (forestry), Krasnoyarsk Metal Plant (metal), Voljsk Pipe Plant, and also Avisma, the largest produce of titan sponge in Russia.

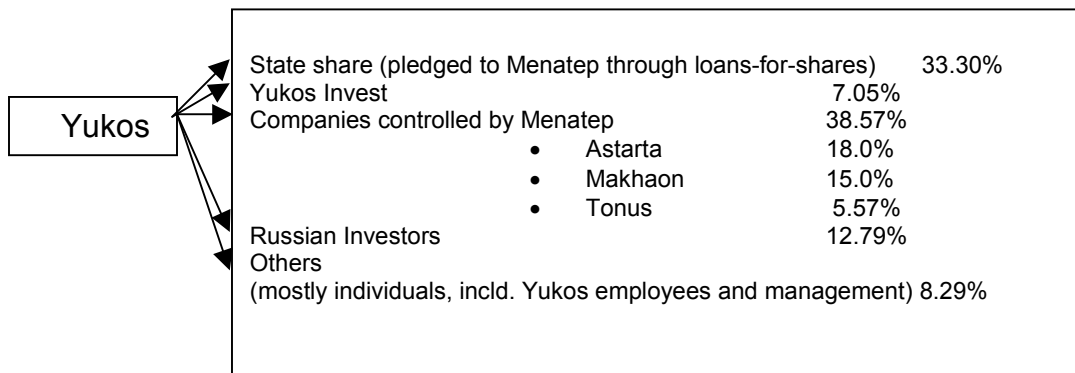
<sup>21</sup> The cooperation between Menatep bank and Yukos actually had started as early as 1992 (Krykov et al 1999).

<sup>22</sup> For a discussion on the state as a weak shareholder, see Kuznetsova and Kuznetsov (1999).

<sup>23</sup> Also [www.nefte.ru](http://www.nefte.ru).

<sup>24</sup> *Kommersant*, November 21, 1996, quoted in Lane et al. 1999:31.

**(Figure 3): Shareholders of Yukos Oil Company in 1996**



Source: *Kommersant*, November 21, 1996, in Lane et al. 1999:31.

### ***Strengthening position in the top management***

As the shareholdings in Yukos increased, representatives from Menatep came to occupy the top management at Yukos. In April 1996, at a session of the board of directors of Yukos, representatives of Menatep were included in the steering organs of the company. The position of first vice president of Yukos was filled by Khodorkovskii, the chairman of the management board of Rosprom as well as the board of directors of Menatep. He was given more power than other two first vice presidents. In addition, other Menatep representatives occupied leading position of the oil company. As a result, more than a hundred people were transferred to Yukos from Menatep, thus strengthening the bank's position in the top management of Yukos (Kryukov et al, 1999:64).

However, acquisition of shares and strengthening of top management positions were of secondary importance unless cashflow control was achieved in the company. The new owners had obtained Yukos' shares, and had occupied top management posts. However, they still had to establish control over cashflow. In what follows, the reason why cashflow control has been the essence of corporate control in Russia is demonstrated.

## **4. ESTABLISHING CASHFLOW CONTROL**

### **4.1 Why cashflow control was necessary**

Control over the cashflow has been the strongest driving force in managerial practices in Russia. In the Anglo-American system, efficient managers are considered to be the ones who increase the value of the firm—increase capitalisation and share price—in a static efficiency point of view. Since investors are the major source of capital, an effective managerial goal is to increase the share price of the company, hence the drive for profit maximisation. In Russia, particularly during the 1990s, the utmost motivation has been to take control over the financial flow of the company. To put it bluntly, profit is something to hide and divert, otherwise it would be taken away by the state as taxes, or profitable companies can become a target of takeover by rival companies. Effective managers are those who are able to know how to survive—such as by being able to hide profits.

### ***The main logic for cashflow control***

Especially before the 1998 crisis, rather than focusing on an increase in the value of assets, the business community in Russia attached great importance to cashflows generated by enterprises. The crucial point was to try to establish control over cashflows, and to divert these revenue streams. The logic was simple<sup>25</sup>: When there is a very high risk in a country, the discounted value of future cashflows decreases very quickly. The higher the country risk, the lower the value of next year's cashflow. This naturally precludes the long-term perspective: For example, it was much more worth focusing on the cashflow of the company today, rather than on the cashflow gain in three years time. And in Russia, the people who controlled the cashflow of the company 'today' were top management, usually owning majority stakes. The legal environment was characterised by weak rule of law and the property rights were poorly protected. The economic situation was uncertain and risky, and political stability was not in place. Control over cashflow was motivated by two clusters of factors: The first is the necessity to generate and maximize cashflow, and the second is the incentives for the diversion of cashflow.

### ***Why cashflows were necessary***

An urge to control cashflow has emerged against the background of negative macro-economic factors including severe shortage of available liquidity and capital.<sup>26</sup> Financial problems have come to the forefront for enterprises since the start of the systemic transformation of the economy. Continuous negative growth since 1992<sup>27</sup> led to the fall of as much as 40 percent of GDP per capita by the end of 1998. During the same period, business investment dropped by around 60 percent and was less than 13 percent of GDP (McKinsey 1999). The industrial sector suffered a liquidity and credit squeeze, prompted by falling demand, monetary tightening, cuts in direct subsidies and directed credit, and a decline in bank lending to enterprises (Commander and Mummsen 1998). Industrial enterprises have plunged into difficult financial situation, facing a severe shortage of funds for investment as well as a shortage for working capital. Several enterprise surveys point to the severity of liquidity problems across industrial firms.<sup>28</sup>

Liquidity and credit problems affecting enterprises was a primary reason that drove growth in nonmonetary transactions (Commander, Dolinskaya and Mummsen 2000). Enterprises were starved of liquidity, and the economy was increasingly demonetised. A share of barter in transactions of industrial enterprises reached 50 percent in 1998 (IMF

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<sup>25</sup> The following is based on interviews with investment research analysts based in Moscow (2002-2003).

<sup>26</sup> Producers of internationally tradable commodities such as oils and non-ferrous metals always have had an option to generate cash revenues. However, economy as a whole suffered a serious liquidity and credit crunch (Commander and Mummsen 1999).

<sup>27</sup> 1997 was the only exception: 0.9 percent increases from previous year (IMF 1999).

<sup>28</sup> According a survey by Commander and Mummsen (1999), liquidity problems were widespread across firms in their sample: over 70 percent of respondents report difficulty in obtaining bank credit, about 45 are loss-making, over 60 percent have overdue payables and /or receivable in excess of 30 percent sales and almost 90 percent suffer from at least one of the above. According to a series of surveys by Auktionsnek and Bataeva (2000), respondents from industrial enterprises indicated that liquidity problem has been the main reason for not investing.

1999: 142). Woodruff (1999:xi) reports that industry collected its receipts in nonmonetary forms by as much as 70 percent in 1998, leaving many firms short of cash.

The dysfunction of the financial system exacerbated the situation. Russian banks have not conducted normal banking business, i.e., have not functioned as an intermediary between savings and investment. A volatile macroeconomic situation, particularly with inflation, has discouraged long-term credit arrangements (Tompson, 1997:1176). Banks' disincentives to lend also stems from the difficulty in credit assessment of a borrower enterprise, as the reliability of available financial information is limited. Real lending rates were also high, which discouraged borrowing by viable firms. For banks, rather than engaging in long-term lending, investing in treasury bills (GKOs) was much more profitable in the period before the 1998 crash. The treasury bill market grew dramatically, as the stock of outstanding treasury bills increased from 1.2 percent of GDP at the end of 1994 to over 12 percent of GDP at the end of 1997 (IMF 1999: 73-77). Commercial bank credit to private sector to GDP has continuously declined, falling to below 10 percent of GDP even before the crisis in August 1998, as banks shifted their portfolios to financing the government deficit (Commander et al 1999). Moreover, the population does not trust the banking system, as the value of household savings in real terms significantly declined as a result of severe inflation in the early 1990s. A decisive blow to people's attitudes towards the country's banking system was done by the financial crisis of 1998. Savings have been largely kept "under the mattresses," rather than in the banks.

In addition to banks being an irrelevant source of finance for enterprises, the underdeveloped capital market made it extremely difficult for Russian companies to raise capital at the stock market. Under such a condition, enterprises needed to seek alternative means to secure financing. Enterprises had to rely on the use of their own resources, including retained earnings, or sought help from the state.

Confronted with economic difficulties in real and financial fronts, and with the uncertainty of the future, enterprises had no room to pursue a long-term development, but instead developed an orientation toward 'survival' (Dolgopyatova and Evseyeva 1995).

### ***Why diversion of cashflow was necessary***

#### **1) Tax reasons**

One of the strong motivations for cashflow control and its diversion has been to avoid taxes. Tax reform ever since 1991 has only led to a confusing and incoherent tax system. Many types of taxes have existed at the federal, regional and local levels, with overlapping tax bases (Shleifer and Treisman 2000:120). Most taxes are calculated from turnover or running cost, and not from profit. Aggregate tax rate was very high. The oil sector has been known as a heavily taxed sector<sup>29</sup>. Among the numerous taxes that producers have been required to pay are; excise tax, mineral rehabilitation tax, pension fund tax, property tax, road use tax, social security fund, social and accommodation tax,

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<sup>29</sup> The new Tax Code was introduced at the beginning of 2002, simplifying taxation by eliminating revenue-based excises, the mineral restoration tax and royalties, and were replaced by a single extraction tax.



profit tax, and value added tax. As many of these taxes are calculated on gross revenues rather than profits, taxes exceeded sales revenues for some producers (Considine and Kerr 2002). In 1997-98, additional tax burden was introduced in the sector. The tax system has been such that if you honestly pay all the necessary taxes, it may add up to more than 100 percent. In 1998, for example, the aggregate tax rate exceeded 100 percent, according to one calculation (Rotobo, 2001:21). It is no wonder, therefore, that the unpredictable tax system and exorbitant rates led to a deep-seated incentive by corporates to avoid taxes.

## **2) Investment reasons**

Investing in oil production in Russia in the 1990s was an unprofitable undertaking. VIOCs run by ‘financiers’ rather than ‘oil generals’<sup>30</sup> did not have a tendency to invest in oil holdings before 1998. The sharp contraction of the Russian economy led to the decrease in domestic demand for oil. There was a 30 percent fall in domestic demand since 1990, and oil production has fallen by half, from a peak of 12 million barrels per day in 1988 to a low of 6.1 in 1998 (McKinsey 1999:4). Also, because of the capacity limitation in the export pipeline system, there was no room for additional volumes for export (Hill and Fee, 2002:467). Under such circumstances, it made sense to focus on controlling cashflows and not investing back in oil production. Fear of potential renationalisation put a break on longer-term investment as well. In addition, the main agenda for new owners of VIOCs, like Yukos, was to make the governance structure more manageable and controllable via the centralisation of operations of subsidiaries.

## **3) To stop stealing**

For the parent company, cashflow control was necessary in part to stop stealing at the mid-level, or the level of daughter companies. Subsidiaries had their own rights to deliver or to export oil. One of the first tasks when Menatep acquired Yukos was to stop the “elementary theft” at the level of subsidiaries (Latynina 1999). As Latynina (1999) reports, at Nefteyugansk, where Yuganskneftegaz is the town-forming enterprise, crude has been stolen from the wells, and for the distribution of oil, there were about 20 intermediary firms, half of which belonged to a criminal authority, Otari Kvantrishvili. According to a former Menatep official, as quoted by Hoffman (2002: 445-446), when Khodorkovskii acquired Yukos, he dispatched three hundred of the best security personnel to Siberia to physically take over company’s wells and refineries: Khodorkovskii personally visited every single financial controller and head accountant in all the subsidiary daughter companies and made sure that he was the new owner.<sup>31</sup>

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<sup>30</sup> ‘Financiers’- led VIOCs were Yukos (Mikhail Khodorkovskii), Sidanko (Vladimir Potanin), Sibneft (Roman Abramovich), TNK (Mikhail Fridman), while ‘Oil generals’-led VIOCs were Lukoil and Surugutneftegaz, controlled by Vagit Alekperov and Vladimir Bogdanov respectively.

<sup>31</sup> The aim of any new owner of enterprise in Russia was to control flows of money and goods. This was particularly crucial for Yukos, as according to Krykov and Moe (1999: 56), the first three years of Yukos, from 1993 to 1995, were characterised by antagonistic relationship between the holding company Yukos and its main production subsidiary, Yuganskneftegaz. “Even though the general director of Yukos, Sergei Muravlenko, was the former general director of the production association, Yuganskneftegaz, the leadership of the holding company could not prevent resistance from Yuganskneftegaz to its policies; nor was the holding company able to control the main material and financial flows within the larger integrated organization” (Ibid).

## 4.2 How cashflow control was established

Cashflow control was established with the practice of transfer pricing. There are two kinds of transfer pricing. 'External' at the holding level, and 'internal' at the level of subsidiary.

### *'External' transfer pricing and schemes*

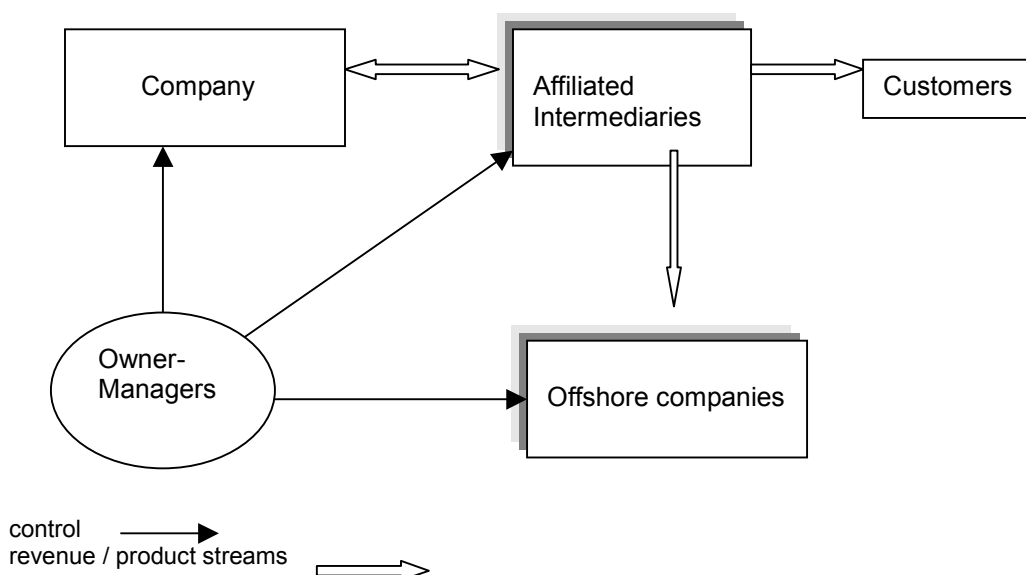
To establish control over cashflows, so-called financial scheming with transfer pricing practices became essential. In many cases, the quintessential part of corporate activity in Russia is to establish "*skhema*" or 'schemes', in which a core company is surrounded by a satellite of on- or offshore firms created by owner-manager-team for the purpose of transferring resources or diverting cash. Such a business scheme has been the operational and organisational principle of Russian business.

Financial schemes usually involve various commercial transactions among chains of affiliates, and commercial transactions involve transfer pricing, the understatement of export prices, fictitious contracts etc. The chain of offshore companies or affiliates, whose arrangement may consist of formally independent but informally connected structures, is often organised in a way so that the real owners and beneficiaries are not obvious from ownership registration (Radygin et al. 2000). They represent techniques that could divert payment and hide income from outsiders, enabling tax evasion and capital flight. Income had to be hidden from predatory tax officials, and money had to be put in more secure places outside Russia.

The creation and the extensive use of offshore networks has become a typical business practice in Russia. The nature of non-transparency of ownership structures is due to the fact that in Russia, a single company as a single legal entity barely constitutes a fully functioning economic unit. What this means is that, an economic unit is composed not of a single company, but of a collection of various forms of corporate entities. In other words, a basic operating system in the Russian economy is comprised of a unit made up of a collection of various firms (Rozinskii 2002).

A typical scheme used by larger companies to redirect revenue streams is to set up and use offshore intermediaries, as shown in Figure 4. For example, a Russian company sells products to its offshore intermediary created by its management team at below market price. Then, the top management team uses that offshore company to sell the goods onto the international market at world price. Since the Russian company does not make profit, profit tax can be avoided. Furthermore, revenues that accrue from the transactions remain offshore (Golubkov 1999). This scheme involves a chain of intermediaries, instead of single intermediary, and the transactions are made with legal contracts.

**(Figure 4): Typical business scheme**



### ***Internal transfer pricing***

Practices of internal transfer pricing were employed by the holding in order to establish cashflow control of the subsidiaries. ‘Internal’ or ‘intra-company’ transfer pricing refers to a situation where a product of a daughter subsidiary is sold to a parent company at deflated prices. A production subsidiary like Yuganskneftegaz, was an ordinary joint stock company, which could independently produce and sell oil. In order to centralise material and financial flows, the new owner-manager team at Yukos made sure that subsidiaries would not sell oil to whom they want, but only to the holding.<sup>32</sup> Then, the holding would distribute the oil to domestic as well as international markets. Only the holding would sell oil to its own traders, and this was hoped to stop side contracts (and hence internal theft) at the mid-management level: Thus, by making Yuganskneftegaz sell oil only to Yukos, the holding company would be able to integrate all financial flows of the subsidiary into the holding.<sup>33</sup> The question, however, was at which price Yukos would buy oil from the subsidiary.

In order to transfer oil cheaply from subsidiary to the holding, Yukos invented the term ‘liquid from the wells (*skvajina na jidkost*)’ (Latynina 1999). What the subsidiaries sold to the holding was not the ‘crude oil’, but instead, what is specially termed as the very cheap ‘liquid from the wells.’ On paper, ‘liquid from the wells’ is qualitatively different from ‘crude oil.’ Thus, Yukos would buy ‘liquid from the wells’ from its own subsidiaries at a so-called ‘intra corporate price’. The intra corporate price was 250 rubles per ton, when the domestic market price was 800 rubles per ton, and international market price was 73 dollars per ton (Ibid). Consequently, the holding was able to ‘economise’ or

<sup>32</sup> Interview with an oil analyst by the author, January 2003.

<sup>33</sup> Ibid.

lessen the amount of taxes levied at the site of oil production. As a result, the portion of raw material tax, which is levied from the sales price—which means 10 percent royalty and 6-16 percent for the reproduction of mineral-raw material base—is decreased from around 128 rubles to the level of 32 rubles per ton (Ibid). These taxes emerge at the site of oil production and are collected only from those who own licenses for oil extraction (Ibid).

By “paying less” to subsidiaries, Yukos was in effect making profit at the expense of subsidiaries via internal (intra-corporate) transfer pricing.<sup>34</sup> As the output of the daughter subsidiaries is sold to the parent holding company at below-market prices, operating costs and debt remain in subsidiaries and profits are transferred to a parent company. This has several implications. First, by making subsidiaries cost centres, the share value of subsidiaries would go down. The share price of Yuganskneftegaz fell by 30 percent, Samaraneftgaz by 47 percent, while Yukos shares rose by 185 percent, in the twelve-month period ending January 1998 (Moser and Oppenheimer 2001:316). Second, subsidiaries would end up becoming indebted, and when the holding purchased the debts to become the major creditor to the subsidiaries, the holding would gain more bargaining power. In early 1998, Yukos paid the federal government 1.3 billion rubles (\$216 million) in tax debt owed by its subsidiaries Yuganskneftegaz and Samaraneftgaz, giving it leverage over these subsidiaries as it underwent consolidation.<sup>35</sup> Thirdly, by registering no profit for Tyumen region to tax the regional subsidiary like Yuganskneftegaz, the holding could choose to pay taxes in Moscow, the location of Yukos head office, where there were more political and economic benefits for the holding (Shleifer and Treisman 2000:132-133).

It should be pointed out that these practices that increased the leverage of the holdings in order to establish cashflow control clearly had negative effects as far as the minority shareholders of the subsidiaries were concerned, as the value of their shares in subsidiaries was driven down. These transfer pricing practices in effect subjugated daughter companies to the parent holding, and undermined the subsidiary’s share value. As set out in section two, from the normative and static efficiency view, these practices were indeed detrimental to minority shareholders of subsidiaries. However, considering the functionalities from the dynamic growth perspective, they were a necessary evil in the process of establishing effective corporate control.

## **5. ESTABLISHING (COMPLETING) VERTICAL INTEGRATION**

Having established cashflow control, the next step was to achieve wholly-owned vertical integration, by further concentrating ownership and establishing a clearer ownership structure. In creating an effective vertically integrated organisational structure, Yukos

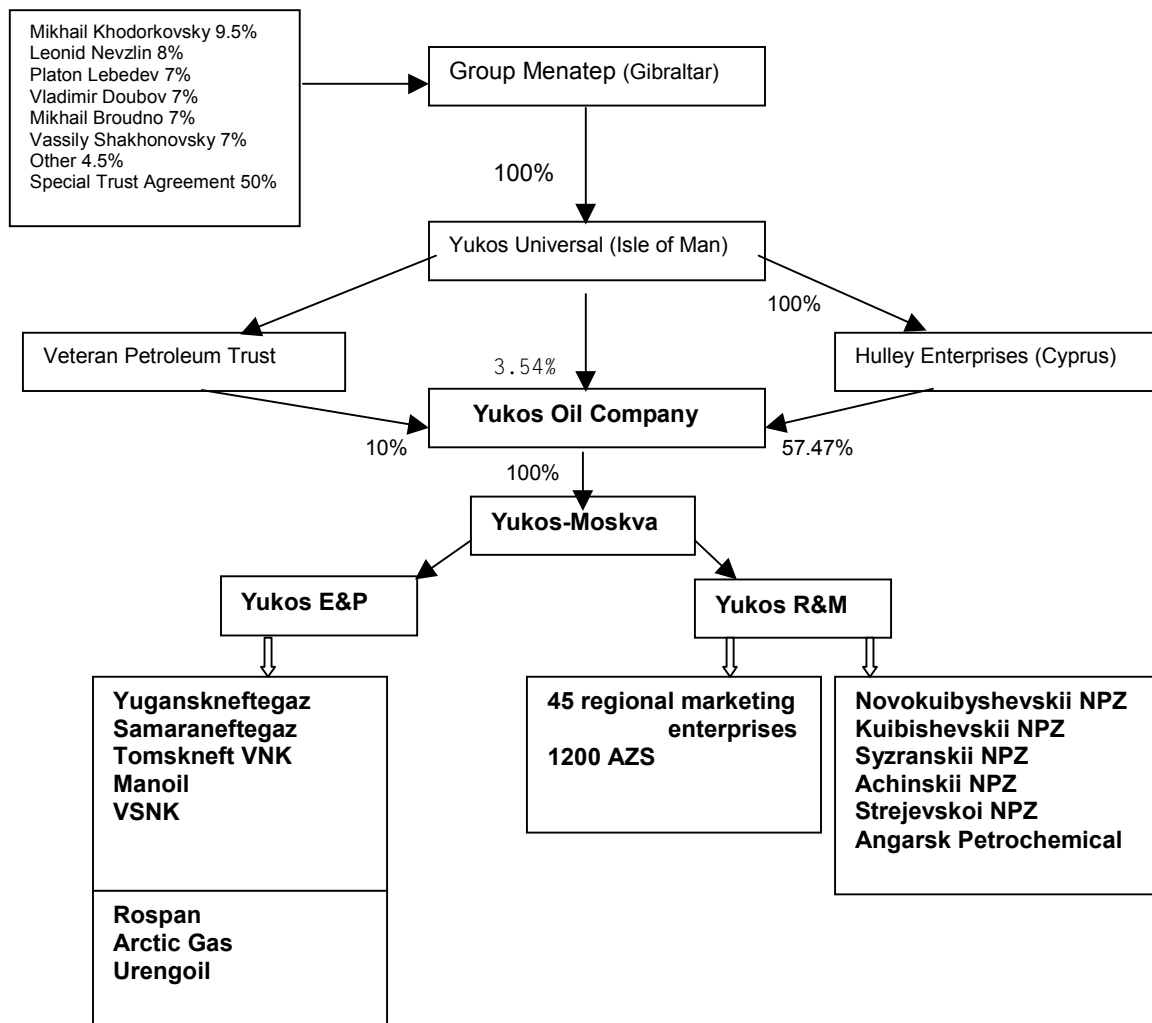
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<sup>34</sup> Moscow Times, February 17, 1998. Also, according to Yukos’ consolidating financial statement audited by Pricewaterhouse, Yukos holding recorded an after-tax profit of \$91.5 million in its consolidated accounts in 1996, while the subsidiary minority interests (Yuganskneftegaz and Samaraneftgaz) lost \$345 million (Moser and Oppenheimer 2001:316). The practice of intra corporate transfer pricing is also used by Sibneft and Sidanko (Ibid).

<sup>35</sup> Moscow Times, February 26, 1998.

reorganised its oil-producing and refining subsidiaries in mid 1998. A new company, Yukos Exploration & Production (E&P), was created to manage oil-extracting subsidiaries Yuganskneftegaz, Samaraneftgaz and Tomskneft. Another new company, Yukos Refining & Marketing (R&M), was to control the Kuibyshev, Novokuibyshev, Syzran and Achinsk oil refineries as well as a Yukos' sales network in eleven Russian regions. These two companies were to come under Yukos-Moskva, which would develop strategies and make principal decisions (See Figure 5).<sup>36</sup>

**(Figure 5): Corporate structure of Yukos**



Source: Based on Yukos, Group Menatep

<sup>36</sup> Moscow Times, September 3, 1998.

## 5.1 Constraints for full vertical integration

To achieve complete vertical integration, the main goal was to cancel separate listings of subsidiaries shares, and instead, the subsidiaries shares were to be swapped into holdings shares. This way, there would no longer be a situation where shareholders of subsidiaries and shareholders of the holdings coexisted within the framework of a single VIOC. However, the attempts for consolidation were hampered by the fact that Yukos could not get much cooperation from minority shareholders of Yukos subsidiaries. In particular, a conflict of interests between Yukos and minority shareholders led by investor Kenneth Dart became acute.<sup>37</sup> As has been shown, dual-level privatisation created a multilevel governance structure at the holding and subsidiary level, and created a different set of management and shareholders. This gave rise to a conflict between Yukos and minority shareholders. The minority shareholders of subsidiaries led by Dart were not strategic investors and hence had short-term speculative interests.<sup>38</sup> Minority shareholders were not at all keen on consolidation of the holding, as it effectively meant the 'takeover' by the holding of the subsidiaries.

The consolidation of Yukos was made difficult by financial factors. Minority shareholders were interested in higher buy-back rates of the shares, and the conflict with minority shareholders occurred in a background where Yukos was suffering from financial difficulties. The financial crisis of 1998 heavily weakened the banking arm of the Rosprom-Menatep-Yukos group. The majority of large private banks in Russia collapsed, and Bank Menatep was brought to the brink of bankruptcy.<sup>39</sup> It has lost control of the 31.9 percent stake in Yukos, the shares that were pledged to the three western banks in return for \$236 million loan, on which Menatep defaulted after the crisis.<sup>40</sup> The fall in world oil prices and economic downturn hit Yukos especially hard, which was heavily indebted.<sup>41</sup> Accumulated large debts made it difficult for the company to raise further financing, and the long-running disputes with shareholders and creditors made matters worse (Moscow Times July 1, 1999).

## 5.2 Methods of vertical integration

In order to overcome obstacles in achieving vertical integration, practices such as manipulating share capital, or limiting shareholder access to vote have flourished in Russia. These practices have been made possible by circumventing the formal rules and have been tolerated under the legal system where the formal framework of legislations contains ambiguities, enforcement is not in place, and judicial system is weak.

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<sup>37</sup> Moscow Times, June 1, 1999.

<sup>38</sup> Dart was often referred to as a greenmailer.

<sup>39</sup> Moscow Times, July 1, 1999.

<sup>40</sup> *Kommersant*, May 18, 1999. 31.9 percent stake in Yukos were acquired by foreign banks: Germany's West Merchant Bank received 16.5 percent, Japan's Daiwa Europe Limited Bank 13.9 percent and Standard Bank of South Africa 1.5 percent (Also Moscow Times, May 20, 1999)

<sup>41</sup> At the end of 1998, Yukos, together with its partly-owned subsidiary VNK, was expecting turnover to drop 12 percent to about \$4 billion for 1998 due to the fall in oil prices (Moscow Times Dec. 3, 1998). The company had already paid some \$800 million in the year 1998 in debt repayments, and faced another \$1.25 billion in the near term (Ibid). In 1998, production at Yukos declined 4 percent to 34.1 million tons of crude oil and refining was down 9 percent to 20.1 million tons processed, and the company's core oil business was left without needed working capital as a result of a major investment and acquisition program in 1996 and 1997 (Moscow Times, July. 1, 1999).

### **5.2.1 Operation of shares**

#### **1) Single share conversion**

Conversion into a single share was a basic method to complete wholly-owned vertical integration used by the majority of VIOCs, including Yukos, Sibneft, and TNK. The objective was to stop the separate listing of subsidiaries shares, and swap those shares into the shares of the holding. Single share conversion was initiated based on a presidential decree issued back in 1995.<sup>42</sup> The decree allowed VIOCs to issue additional shares to be exchanged with the shares of daughter subsidiaries, which would then become wholly owned subsidiaries of VIOC whose share represents the entire company (Moser et al 2001).

The main issue had become on which terms the share swap was to take place. This swap ratio became a source of conflict between holders of daughter companies' shares and the parent company. Yukos acted to swap the shares of subsidiaries into their own, as consolidation remained its immediate goal. However, Yukos could not agree on the swap rates with minority shareholders, led by Dart (Nechaev 1999). During the voucher privatisation, Dart obtained shares in the three subsidiaries of Yukos: Yuganskneftegaz, Samaraneftgaz, and Tomskneft.<sup>43</sup>

Shares of production subsidiaries were relatively liquid, and were readily available to brokers at a fairly high price.<sup>44</sup> The higher the market price of daughter companies, the worse off the parent company was to swap the shares, because it would be more costly for exchanging the shares: Therefore, for the holding company, it would be advantageous to minimise the value of subsidiary companies. If the market price of subsidiaries can be made lower, the holding can achieve better (i.e. cheaper) swap terms (Moser et al 2001). In order to achieve this, several means were used by the holding companies. As mentioned in the previous section, internal transfer pricing was used as a means to diminish the value of subsidiaries. Another practice used was an additional share issuance. As discussed below, this practice served to dilute minority shareholders stakes, and also creditors.

#### **2) New share issuance/ “share dilution”**

In Russia, an increase in the level of statutory capital through share emission is often carried out, not necessarily in order to raise capital, but rather to dilute outsiders' stakes. As Vasiliev (2001) argues, despite the economic crisis, in 1998-99, there was no significant decline in stock-issuing activity by joint stock companies. The former chairman of the Federal Securities Commission argues that this can be explained by the fact that the mechanism involving the placement of securities is employed not as a means of attracting needed investments, but as an instrument in the struggle for control of a company through the dilution of shares held by “undesirable” shareholders (Ibid). In

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<sup>42</sup> Decree no.327 of 1 April 1995.

<sup>43</sup> VNK was one of the VIOCs in its own right. Tomskneft was originally a subsidiary of holding company VNK, which held 51 percent stakes of Tomskneft. In 1997, Yukos acquired controlling stakes of VNK, which meant that Tomskneft had become subsidiary of Yukos.

<sup>44</sup> Moscow Times, September 23, 1997.

large oil companies such as Yukos, Sidanko and Sibneft, new shares were issued in order to dilute outsiders' stake, to reduce their blocking level of 25 percent (Sprenger 2000).

One of the ways by which outsiders' shares were diluted is as follows. A company decides to issue new shares, and those shares are to be distributed (sold) only to "insiders". "Insiders" establish offshore entities formally not affiliated with them. Newly issued shares are sold to these entities. Moreover, this transaction is approved by shareholders meeting. This way, outsiders' stake in the company can be 'legitimately' diluted.

This is possible despite the law stipulating otherwise, due to a skilful application of the law, combined with weak enforcement. The Joint Stock Company law has a regulation against what is known as "interested party transactions." Article 81 of the JSC law stipulates that any entity or person who is in the position to influence the decisions of the company and also stands to benefit from the transaction is an interested party, hence such transaction is an interested party transaction.<sup>45</sup>

Interested parties are prohibited from voting on approval of interested-party transactions.<sup>46</sup> If you are in a position to influence a decision to issue and sell shares, then you cannot participate in voting to decide to issue and sell that shares to a company affiliated with you. In other words, if it can be established that these offshore entities are connected with owners-managers who voted to transfer the newly issued shares to those entities, then the transactions are interested party transactions. Then, the transactions would be illegal under the law. In that case, registration of new shares can be denied by the Federal Securities Commission (FCSM), which registers newly issued shares when additional share issuance takes place.<sup>47</sup>

In Yukos case, it was believed that the offshore companies, to which newly issued shares were to be transferred, were formally not connected with Yukos, but were suspected to be affiliated with the core shareholders of Yukos (Fenkner 1999). At a series of shareholders meetings in March 1999, it was decided to increase the level of stock in Yukos subsidiaries.<sup>48</sup> According to Hoffman (2002:449), Yuganskneftegaz shares were to be

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<sup>45</sup> Interested party transactions include transactions with: shareholders owning 20 percent or more of the company's voting shares, directors, other officers and their affiliated parties.

<sup>46</sup> An interested party transaction requires the approval of a majority of members of the board of directors who are not interested parties of that transaction. Also, interested party transactions with a value above 2 percent of the company's book asset value, or entered in relation to the issue by the company of new shares in an amount exceeding 2 percent of the company's outstanding shares, are subject to approval by a majority vote of shareholders who are not the interested party in respect of the transactions (Uvarov and Fenn 1999).

<sup>47</sup> According to Vasiliev (2001) in 1998 alone the FSCM refused registration of stock issues in 2600 cases, and that the share dilution was not successful in a significant number of cases.

<sup>48</sup> More concretely, Yukos planned to issue

- 1) 77.8 million new shares in Yuganskneftegaz, to the existing 40 million.
- 2) 67.4 million new shares in Samaraneftgaz, to the existing 37.6 million.
- 3) 135 million new shares in Tomskneft, to the existing 45million (Hoffman 2002:448-449).

In addition, it was decided that the payments of newly issued shares were to be made in veksels or promissory notes (Ibid). According to the JSC law, payments for shares must be made to the company in



sold to four offshore entities—Asbury International Inc. of the Bahamas, Rennington International Associates Ltd. of Ireland, Thornton Services Ltd. of the Isle of Man, and Brahama Ltd. of the Isle of Man—which were suspected of being affiliated with the top management of Yukos. Dmitri Vasiliev, head of the Federal Securities Commission at that time, being convinced that objective of Yukos in issuing shares was a share dilution by transferring the shares to affiliated offshore companies, remarked: "If we managed to trace beneficiary property we could prove the fact of interested-party transactions and deny Yukos in registration of unfair offerings."<sup>49</sup> Although alleged, it was not possible to prove that the sales of additional shares to these offshore companies constituted interested party transactions. When the proposed share issuance of Samaraneftgaz was to be voted at the FCSM, because the transactions were all legal, the FCSM did not deny the registration, and consequently voted to approve the registration of the newly issued shares (Hoffman 2002:456).

Interested party transactions are difficult to enforce, hence it remains one of the most problematic aspects of corporate governance practices in Russia. This is because in practice, interested party transactions have been structured in a way as to circumvent the statutory definition of an interest party transaction (Uvarov and Fenn, 1999). That is, it has been made impossible to prove that the entity with which the company is having a transaction is an interested party in terms of this particular transaction. With respect to the definition of an interested party, the concept of an affiliated person has been particularly problematic. Even if the transactions involve affiliated entities, it is difficult to prove the “affiliated person” of interested parties. As Uvarov and Fenn (1999) argue, the definition of an affiliated person is provided by the anti-monopoly legislation, but it has been difficult to enforce. It is difficult to prove the affiliation in practice, particularly if affiliated entities are incorporated abroad. When affiliated persons are individuals, it becomes almost impossible to trace (Ibid).

### **3) Share consolidation**

The practice of share consolidation is aimed by owner-managers at achieving a maximum corporate control. Share consolidation specifically refers to a situation in which an original number of shares are consolidated or concentrated into a much smaller number. For example, at the Angarsk Petrochemical Company (Angarskaya Neftekhimicheskaya Kompaniya) acquired by Yukos, it was decided in September 2001 that 1.2 billion ordinary shares were to be consolidated into 4 shares, and 0.4 billion preferred shares were converted into three.<sup>50</sup> Considering the illiquidity of Angarsk shares, the terms of conversion were not specifically intended to bring damage to minority shareholders, although this share conversion became another telling example of shareholder rights violations.<sup>51</sup> This instrument was used to consolidate corporate control over a daughter

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full. However, by making payments by promissory notes, “while the obligation is formally satisfied, the company may still receive zero value in exchange for its shares” (Uvarov et al 1999).

<sup>49</sup> FCSM website: <http://www.fcsm.ru>

<sup>50</sup> *Finansovaya Rossiya*, September 26, 2001, quoted in Dolgopyatova (2002: 48-49).

<sup>51</sup> Ibid.

company, and was also applied to other daughter companies, such as ryansknefteprodukt, Novokuibyshevskii NPZ, Voronejneteprodukt, and Orelnegeprodukt (Radygin 2002).<sup>52</sup>

When such share consolidation takes place, so-called ‘fractional (*drobny*)’ shares emerge—shares that are not whole or integral, but only fractional. The amendment in the Joint Stock Company Law that came into force from January 2002 introduced this fractional share as a concept. Prior to that, the fractional shares could not be exited as such and had to be bought back. This meant that share consolidation was a useful means of eradicating minority shareholders from daughter companies “as a class.”<sup>53</sup> Since the existing subsidiary shares are consolidated into new securities with such a high par value, only the parent holding can receive shares that are non-fractional. The holding then buyback fractional shares formed at minority shareholders, according to the article 74 of JSC law.<sup>54</sup>

### **5.2.2 Limiting access of ‘unwanted’ shareholders**

The Joint Stock Company Law stipulates that the decision on new share issuance, major transactions, or the selection of CEO and board of directors, needs approval at the shareholders meeting. Thus, one of the most direct means of strengthening control has been to limit the access of “unwanted” shareholders to vote at shareholders meeting. This way, owner-managers would be able to ensure that certain decisions are made legitimately. There are numerous ways to do this within the framework of the letter of the law. Examples include proxies that were deemed unacceptable, voting slips that were inadequate, incomplete notification of the time and venue of the shareholders meeting, controlling share registers, and ‘arresting’ shares through court order.

For instance, “arresting shares” means that by invoking a court order, a party can ‘freeze’ or suspend (hence ‘arrest’) the share held by opponents—be they corporate competitors or unwanted shareholders. When the shares of the opponents are arrested or frozen, they are prevented from using their rights enjoyed by holding those shares, such as voting at the shareholders meeting. Shares can be arrested on various grounds, and it is the weakness in the judicial system that can make the share arresting measures operational. For example, in the case of Yukos’ three subsidiaries—Yuganskneftegaz, Samaraneftgaz and Tomskneftgaz, the decisions to increase the statutory capital via additional share issuance and transfer them to offshore entities were approved at shareholders meetings, as required by the law. This decision was passed at the emergency shareholders meetings at which minority shareholders who would have blocked this plan

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<sup>52</sup> For example, share consolidation of Samaraneftgaz took place in two steps (*Vedomosti*, September, 19 2001): 1) From March 2000 until Feb 2001, its shares were exchanged into the shares of Yukos (One ordinary share of Samaraneftgaz to four shares of Yukos). As a result, main shareholders of Yukos accumulated more than 95 percent of Samaraneftgaz shares. 2) Then, conversion of Samaraneftgaz shares into 50 ordinary and 15 privileged with high par value. Minority shareholders now possess fractional shares, which must be bought up according to the law, and was offered 251 ruble for ordinary shares and 125 ruble for preferred shares. There was a conflict between minority shareholders and Yukos with regard to the share consolidation of Samaraneftgaz, where minority shareholders initiated legal actions against the company.

<sup>53</sup> *Vedomosti*, October 8, 2001.

<sup>54</sup> *Ibid.*

were not allowed into the meeting.<sup>55</sup> Prior to the meeting dates, a regional judge in the town of Mosalsk put an arrest to share packages that were able to block the passage of resolutions (Fedorov 2000; Fenkner 1999).

The limiting of participation and arresting shares was achieved through a court order, a means which has gained wide currency in Russia. At a Samaraneftgaz extraordinary shareholders meeting, representatives of minority investors were locked out of the meeting as the court bailiff barred them from the meeting<sup>56</sup>. Yukos obtained a court order that arrested the shares owned by four offshore entities representing foreign shareholders on the grounds that these companies had failed register properly with Russia's Antitrust Ministry. The court ruling was issued under Russian legislation requiring special registration if affiliated companies own more than 20 percent in one company<sup>57</sup>: The four companies excluded together own more than the 25 percent plus one share required for a blocking vote. The court ruling was served after an individual shareholder filed a suit in a district court in the Kaluga region, claiming that companies owned by Dart hindered the operating activities of the oil holding. Yukos said their actions were based on a court order and thus had a backing of court. A representatives of the Arrowhead enterprise, a investment vehicle of Dart, owning 12 percent in Samaraneftgaz, however, disputed Yukos' claims, saying those four companies were not affiliated.<sup>58</sup>

This instance had exposed a sign of weakness in the judicial system in Russia. As mentioned above, a group of shareholders were effectively prevented from voting at shareholders meetings in the three Yukos subsidiaries called to approve the issuance of additional shares for subsequent sale to offshore entities (Black et al. 2000; Fedorov 2000). This was made possible, because a judge in the town of Mosalsk put an arrest to the shares that would have blocked the resolution. According to Fedorov (2000), minority shareholders tried to challenge the Mosalsk judge's ruling, as they believed that this judge had made several violations of the effective legislation. For example, the judge was not competent to consider the case; and when he took it on and levied arrest on the shares, the ruling was made in violation of the law of procedure and that of enforcement proceedings. There were no grounds for arresting the shares. Also, they tried to appeal against the ruling at General Prosecutor's Office and to file a complaint against the judge's actions with a Grievances Commission and a higher-level Oblast Court. However, all complaints were either left unheeded or were sent to the very same judge the shareholders had complained against. As a result, Fedorov (2000) concluded that "None of the legal Russian instrument for appealing against a judge's unlawful actions proved to be of any effect."

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<sup>55</sup> See also Black et al (2000).

<sup>56</sup> Moscow Times, March 24 1999. The following account of the shareholder meeting is based on this article ("Yukos locks investors out of meeting" by Igor Semenenko).

<sup>57</sup> *Vremya MN*, April 1, 1999.

<sup>58</sup> Moscow Times, March 24, 1999.

### 5.3 Soft legal constraints

These practices, summarised in Table 4, were tolerated under the legal system where 1) legislations contain ‘loopholes’, 2) enforcement of rule is not strong, and 3) the judicial system is weak. Those methods examined are extra-legal in nature, meaning that they rely on legal instrumentalism. Capitalising on the imperfections in the legal system, the practices represent what Radaev (2001) terms as “informalisation” of the formal rules. Informalisation of the rules, according to Radaev, is a continuous transformation of institutions when formal rules are largely built into the sophisticated system of informal arrangements and widely used as an umbrella for flexible strategies. The problem for Russia, the author points out, is that neither the lack of formal rules nor their abundance, but rather the structure of these rules and the way they are introduced into the economy.

From owner-managers’ perspective, a planned share issuance and its transfer to non-transparent offshore entities were protective measures against any ‘enemy’ such as minority shareholders standing in a way for the company, first of all to survive, and secondly to consolidate as a wholly owned vertically integrated oil company. The plan to hide and ‘protect’ assets from minority shareholders and creditors was well publicised as a telling example of the terrible state of corporate governance in Russia. At the same time, however, the developments showed how non-transparency of ownership relations and corporate governance practices turned out to be functional as a strategic and ‘protective’ reaction to the given situation. These practices reflected the extent of legal instrumentalism, and informalisation of rules that has become tendentious in Russia’s corporate behaviour against the backdrop of a weak regulatory and judicial system. Skilful application of the law using “*lazeika*” –a gap or loophole—, while satisfying formal procedures, became crucial. In an interview with *Forbes*, Khodorkovskii recalled the Yeltsin years: “In those days everyone in Russia was engaged in the primary accumulation of capital... Even when laws existed, they were not very rigorously followed. If you conducted yourself too much in a Western manner, you were simply torn to pieces and forgotten” (Klebnikov 2002). The survival game experienced by Yukos can be considered as an account of how to play the game in order not to get “torn to pieces.”

In an environment where everybody wants the control, and everybody tries to outwit the opponent by skilful use of extra-legal informal practices, it is increasingly becoming important to defend your business by limiting outsiders or neutralizing opponents. Under such circumstances, the attitude toward the usefulness of the law acquires a different meaning. Legal instrumentalism came to protect your business interest better. True, inconvenient rules are avoided and legal loopholes are sought everywhere in the world. However, in Russia, the phenomenon has become systematic and law has become indispensable ammunition in corporate life.<sup>59</sup>

With the continuation of economic reforms, new rules are being introduced, but enforcement continues to be problematic. Laws allow multiple interpretations, and clear and enforceable bylaws are necessary to actually enforce the law. Furthermore, the capacity of administrative as well as judicial bodies in Russia is such that enforcement is conducted on an uneven, discriminate basis. Although the desire to be ‘not illegal’ seems

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<sup>59</sup> For example, *Kommersant-Dengi*, December 19, 2001.

to be very strong, the laws themselves and their enforcement have not been strong. While refraining from being strictly illegal by carefully observing the letter of the law, the spirit of the law can be circumvented. Indeed, as reported by Troika Dialog (2001), Russian companies have been very careful to adhere to laws, but the laws themselves are sometimes incomplete and the management have always been able to find ways to avoid the spirit of the law while remaining inside its strict interpretation if so wished. In this environment, practices that flexibly apply the rules are widely observed. Know-how of a certain rule-informalising conduct became accumulated and came to constitute ‘unwritten rules’ of practices.<sup>60</sup> In addition, general attitudes toward the law in Russia, characterised by the lack of respect toward the law, can facilitate this tendency.

It should be pointed out that these issues relate to not only the tendency to circumvent the rules, which undermines the rule of law, but also to the implementation of the laws themselves. Some laws are intentionally not implemented quickly enough due to the vested interest. For example, the adoption of amendments to the Joint Stock Company Law was delayed for over a year due to the opposition of some companies.<sup>61</sup>

There is an argument that the legal development in Russia has been characterised by the lack of demand of the law, as opposed to the laws supplied from the West, and by the lack of acknowledgment of the usefulness of the law by economic actors (Hendley 1997). While this is truly the case, it is also curious to observe that the demand for the law, understood here as the demand to *resort* to the law in order to neutralise opponents, is very much on the rise. Also this demand comes from the desire of economic agents to at least formally abide by the formal rules. This increasing demand for the use of law has manifested itself in the legal instrumentalism described above.

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<sup>60</sup> On how Russian economy works according to ‘unwritten rules’, see Ledeneva (2001)

<sup>61</sup> Interview with Vladimir Statyin, the General Director of ASIP (Association for Shareholders Interests Protection), at [www.corp-gov.ru](http://www.corp-gov.ru). October 2001.

**(Table 4): Practices to achieve Cashflow Control and Vertical Integration**

Practices	Functionalities
Obfuscating ownership structure	<ul style="list-style-type: none"> <li>Operational principles for financial schemes for cashflow control</li> </ul>
Asset transfers	<ul style="list-style-type: none"> <li>Hide assets from the “enemy”</li> <li>Protect from potential takeover</li> <li>Drive down value of subsidiaries to create favorable swap terms for the parent holding</li> </ul>
Transfer pricing <ul style="list-style-type: none"> <li>Internal</li> <li>External</li> </ul>	<ul style="list-style-type: none"> <li>Tax optimisation</li> <li>Control subsidiaries-- Create advantageous merger terms for holding</li> <li>Generate, maximise and divert cashflow</li> <li>Tax optimisation</li> <li>Hide profit</li> </ul>
Single share conversion	<ul style="list-style-type: none"> <li>Make affiliates wholly owned subsidiaries of a parent holding company, with single stock representing the entire company</li> </ul>
New placement of shares	<ul style="list-style-type: none"> <li>“Dilute” shareholding of “unwanted” outsiders</li> </ul>
Share consolidation	<ul style="list-style-type: none"> <li>Concentrate and consolidate ownership</li> </ul>
Limiting access to Shareholder meeting via <ul style="list-style-type: none"> <li>Arresting shares through court order</li> <li>Controlling share registry</li> <li>Proxies that were deemed unacceptable,</li> <li>Incomplete notification of the time and venue of the shareholders meeting</li> </ul>	<ul style="list-style-type: none"> <li>Eliminate dissenting forces</li> <li>Prevent certain shareholders from voting</li> <li>“Legitimatised” decision taken at shareholders meeting</li> </ul>

## 6. NEXT STAGE: VALUE MAXIMISATION AND RE-EMERGENCE OF INDUSTRIAL GROUPS

In Russia, concentration of ownership and consolidation has taken place across companies and industries. Concentration and control of assets is of prime significance in an institutional environment where protection for assets is not well provided. As a rule, owning 75 percent plus one share in a company is generally considered as a secure threshold, as it can eliminate the possibility of blocking minorities, who, with their 25 percent shares, could take action in corporate control. (Dolgopyatova 2001). Yukos also achieved super-majority control by core owners—more than 90 percent of shares in its subsidiaries.<sup>62</sup> Having achieved effective corporate control by establishing cashflow control and vertical integration, two main initiatives undertaken by Yukos in its corporate development became apparent. First is a new focus on value maximisation. Second is an attempt to build a conglomerate across the energy sectors. These recent developments have emerged against a background of post-1998 crisis economic and political turnaround.

### 6.1 Newly emerging focus on value maximisation

Up until now, the focus was placed on corporate growth, i.e, in terms of expansion of assets, as opposed to the efficiency of assets. Then, the previous focus became

<sup>62</sup> See Boone and Rodionov (2001).

supplemented by the new one—which is, to increase value of assets. As Nash (2001:109) points out, the ownership of 75 percent plus one share in a company “provides both the security and the incentive to manage those assets more sensibly and therefore profitably.” In addition, a change in the surrounding environment prompted a longer-term perspective. The macroeconomic environment improved, and the oil prices have risen. The devaluation of the ruble after the 1998 crisis boosted particularly raw material industry. Moreover, compared with the Yeltsin years, the political stability increased as Putin came to power. As a result, more room for longer-term thinking emerged for those industries that benefited from the devaluation and high commodity prices. The owner of the assets became interested in increasing the value of assets, rather than how much cash the assets can generate. It was a triple coincidence—an economic turnaround triggered by the devalued rubles, the political stability brought under Putin, and the owner-managers’ demand for stability and order—that have prepared a ground from which a change in incentives emerged.

In this respect, the best known example is Yukos. After gaining absolute supermajority control, the owners started to focus on an increase in capitalisation. The financial position of the company improved and was ready for more business expansion. Production bottomed out in 1998, but has since enjoyed growth, and the company’s profitability has also risen dramatically. Capital investment increased, and at the same time, there emerged a need to raise more capital from abroad. When there is a motivation to raise capital at the international market, non-transparency becomes less operational. In order to increase transparency and improve the corporate reputation, badly tainted by corporate governance problems, Yukos reportedly spent approximately 300 million dollars in two years to improve its corporate image.<sup>63</sup> Corporate governance charter of the company was introduced in 2000, and independent directors were included in the board, including foreign board members. Since 2001 the company started to issue regular quarterly US GAAP. The company launched a Level 1 ADR (American Depositary Receipt) programme, in March 2001. The highlight of increasing transparency of Yukos occurred in June 2002 when the company disclosed core shareholders of the company (see Figure 5), even the beneficiary owners as well, though it is not required by the Russian legislation. This was done in an effort to be listed on the New York Stock Exchange, which requires stricter corporate disclosure.<sup>64</sup>

The disclosure also indicated that the core owners found new safety measures to hang on to what they now own. The increase in capitalisation would create a favorable condition if the core owners of Yukos decide to sell stakes, especially to foreigner strategic investors. If foreign strategic investors participate in the share capital, the argument goes, the company can protect themselves from a sudden and selective ‘raid’ from the state, for example (Nedogonov 2001). Thus, just as non-transparent corporate practices served as protective measures, transparency can also be a safety measure against the background where property protection at home is still in doubt.

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<sup>63</sup> *Ekspert*, February 18, 2002.

<sup>64</sup> *Vedomosti*, June 20, 2002.

## 6.2. The re-emergence of Industrial Groupings (or Conglomeration)

This newly emerging focus on value maximisation does not mean that the focus on growth is abandoned. Particularly after the 1998 crisis, corporate growth is taking the form of a re-emergence of business groupings, or Integrated Business Groups (IBG). In the mid 1990s, there was an emergence of Financial Industrial Groups, or FIGs, in Russia. Post-1998 crisis, the re-emergence of business groups has been observed, but the groupings are formed around the industrial sector, rather than financial sector, and the term Integrated Business Groups (IBG) is used in this context (Pappe 2000, 2002, Dynkin and Sokolov 2001). This development is closely linked with the concentration of ownership and control, as a substantial portion of Russian industry was consolidated into a handful of core owner-managers.<sup>65</sup> The devaluation after the 1998 crisis, and high commodity prices have increased purchasing power of Russian companies, who have been buying back the shares that foreigners had bought earnestly between 1996-98. Besides, Russian shares are valued low (i.e. cheap), which facilitate intra- and inter-industry consolidation. Moreover, despite low equity valuation, risk premium is added to Russian companies. However, Russian owner-managers, enjoying super majority ownership, could do away with the risk factor as they consolidated their control over the companies (Nash 2001). The concentration of ownership, and the attendant emergence of a strong propertied business elite, Boone and Rodionov (2002) argue, are the important factors that explain Russia's strong productivity growth since 1998.

There are around eight to ten IBGs in Russia (See Table 5).<sup>66</sup> As for Yukos, it is a central component of one of the largest IBGs in Russia: the Yukos-Menatep Group. The group is in a process of establishing an energy conglomerate, seeking to expand into the natural gas and domestic power generation market. For example, Yukos has accelerated new acquisitions since 2000. Recent acquisitions of Rospan, Urengoil, Arctigas—the license holders of gas reserves in Western Siberia—indicate Yukos' expansion in natural gas market. In addition, the company acquired stakes in local energos such as Belgorodenergo, Kubanenergo, Tomskenergo as opportunities for power generation market.<sup>67</sup>

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<sup>65</sup> The process of conglomeration in which a large part of Russian industry was concentrated into the hands of several groups, is sometimes referred to as “chaebolisation” of Russian economy. One of the main differences between South Korea's *chaebols* from Russia's groups, as Yakov Pappe noted, however, is that the very core of a business group was comprised of a family in Korea, while in Russia, the core was *'komanda'*, or a team of a very small number of key actors.

<sup>66</sup> According to a survey of 64 medium and large enterprises by Boone and Rodionov (2002), eight groups (1) Menatep (Yukos), 2) Interros, 3) Millhouse (Sibneft)/Russian Aluminium, 4) Sistema, 5) Alfa Group, 6) Lukoil, 7) Surgutneftegaz, and 8) Avtovaz ) control roughly 86 percent of the revenues of privatised companies. A study by Dynkin and Sokolov (2001) shows that there are eight Integrated Business Groups” who dominate in the Russian economy. These are 1) Lukoil, 2) Yukos, 3) Interros, 4) Surgutneftegaz, 5) Alfa group-Renova, 6) Russian Aluminium-Sibneft, 7) Severstal, 8) Systema.

<sup>67</sup> [www.yukos.ru](http://www.yukos.ru)



**(Table 5): Major IBGs (Integrated Business Groups) in Russia**

Group	Core business	Other components include:	Group's key figures
Lukoil	Lukoil (Oil)	KomiTEK (Oil), Arkhangelskteolgobycha (Extraction), Imperial (Bank), Bank of Moscow, Nikoil (Investment) Lukoil-Garant (Insurance)	Vagit Alekperov
Yukos-Menatep	Yukos (Oil)	Menatep SPb (Bank), DIB (Trust and Investment Bank), Progress (Insurance), VSNK (Oil and Gas), ANKhK (Petrochemical), Volgotanker (Transport), Transpetrol (Pipe), Arcticgas (Gas),	Mikhail Khodorkovskii
Interros	Norilsk Nickel (Metals) Sidanko (Oil)	Silovye Mashiny (Machine), NLMK (Metal), Perm Motors (Auto), Severnaya Verf, Severo-Zapadnoe Parakhodstvo (Shipbuilding), Rosbank (Bank), Agros (Agro-industrial complex)	Vladimir Potanin
Basel-Sibneft (Millhouse Capital)	Rusal (Aluminium) Sibneft (Oil)	Ruspromavto (GAZ, PAZ—auto) Aviakor (Aircraft plant), Soyuzmetalresurs, Ingostrakhsoyuzbank (Bank) Ingosstrakh (insurance)	Roman Abramovich Oleg Deripaska
Severstal	Severstal (Steel)	Cherepovetsky (Metal), UAZ (Auto), ZMZ (Auto), Severstaltrans (Transport), Kolomensky Machinebuilding, Mekombank (Bank), Vyksa (Pipe)	Aleksei Mordashev
Alfa-Renova	TNK (Oil) SUAL (Aluminium)	Alfa Bank, Onako (Oil), Perekryostok, Vimpelcom, Golden Telecom	Mikhail Fridman Viktor Vekselberg
Surgutneftegaz	Surgutneftegaz(Oil)	Surgutneftegazbank, Insurance Society Surgutneftegaz	Vladimir Bogdanov
Sistema	Sistema telecom	Rosno (Insurance) MGTS MTS MTU Nauchny Tsentri (Scientific center), Sistema Neft	
MDM Group	MDM Bank	Baikal-Ugol (Coal), Eurochem (Chemical), Rinako (Investment), TMK (Pipe)	Andrei Melnichenko

Source: based on Dynkin et al. (2001), Interfax, Pappé(2000, 2002).

At the center of the IBG lies enterprises in the real sector, generally either oil or metals (with the exception of Sistema). As Dynkin and Sokolov (2001) argue, in every industrial group, there are commercial banks that serve the group as their own credit organization: They act as a center of accounts, a channel to transfer resources abroad, ‘accumulator’ of financial resources of the group, depositaries for securities, and also as share registers. Besides industrial enterprises and banks, there are trading companies, insurance companies, financial companies, investment companies, leasing companies, transportation companies, securities companies, medical recreational organisation, construction companies etc (Ibid).

There are ‘institutional’ reasons for explaining the rise of such integrated business groups.

- To reduce transaction costs.
- To compensate the lack of functioning banking system.
- To protect themselves under the weak protection of assets.
- To ‘cushion’ the adverse consequence of economic transformation.

In the absence of market institutions observed in the developed economies, Russian businesses have learned to operate by their own devices, by forming a business group structure that can compensate for institutional constraints. When formal market mechanisms do not work as they are supposed to, informal mechanisms have continued to influence corporate behaviour.

## **7. CONCLUSION**

In this paper, corporate governance practices and their functionalities were analysed in light of an evolving process of corporate development. First, the way privatisation was carried out in the oil sector has caused a fragmented coexistence of holding companies and their daughter companies. This has created a difficulty for a corporate to achieve robust and viable corporate structure. At the second stage, owner-managers of newly privatised enterprises have prioritised to establish cashflow control as a way to achieve corporate control. It was an asset-accumulating period where the national economy was in dire straits, property protection was not properly provided, the financial system was dysfunctioning, tax policies were incoherent, and an overall environment was of high degree of uncertainty. Having established cashflow control, the next stage was to achieve a full-fledged vertical integration. Corporate conflicts became especially acute during this stage. Concentration of ownership and control were fought for, often by ‘informalisation’ of formal rules and skilful application of the legal and regulatory system. It was followed by the stage at which the re-emergence of industrial grouping has become the dominant feature in the evolution of corporate Russia. After obtaining super-controlling stakes, consolidation of ownership and control has provided an impetus for some of the owner-managers to have a new focus on an increase in the return on capital. The improvements in the overall external environments have also facilitated a change in the incentive structure.

As the analysis presented here indicates, conditions that incentivise an entrepreneurial agent are crucial, as they shape the structure of corporate governance practices. At the same time, non-transparent corporate practices, which have been “devious” and “abusive” particularly to foreign investors, in fact have compensated the imperfections of the formal framework, in the context of the weakness of the institutional foundations that are intrinsic to the most advanced market economies.

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