Informal Corporate Governance Practices in Russia in the 1990s: The Cases of Yukos Oil, Siberian (Russian) Aluminium, and Norilsk Nickel

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March 2005
Abstract

During the 1990s businesses in Russia routinely relied on practices not entirely compatible with the formal rules. In the area of corporate governance, such extra-legal or informal practices as share dilution, asset stripping, transfer pricing, limiting shareholders’ access to votes, and using bankruptcy as a takeover instrument reportedly became pervasive in the running of joint-stock companies. This study aims at identifying the operational specifics of these informal corporate governance practices (ICGPs) and understanding their unique nature and role in post-Soviet Russia. Through the case studies of the Yukos Oil Company, Siberian (Russian) Aluminium, and Norilsk Nickel, this thesis presents an analysis of how ICGPs worked, why they were used, and what kinds of functions they performed in the context of the post-Communist transformation.

This thesis demonstrates the ambiguity of ICGPs. ICGPs were destructive in the sense that they undermined the foundations of good corporate governance, and their use constrained improvement to Russia’s investment climate. They were widely acknowledged as corporate governance abuses by investors, policymakers, and scholars as they violated shareholders’ rights, the protection of which is a cornerstone of globally accepted standards of good corporate governance.

However, it is important to recognise that they also played a constructive role in the context of the disintegration of the Soviet economic system and of underdeveloped market-supporting institutions. Post-Soviet enterprises, if they were to survive, grow, and compete in a new market-oriented environment, were required to encompass the resources and capabilities necessary to become a coherent business unit. The study demonstrates that ICGPs were constructive in the sense that they aided the reconstitution of post-Soviet enterprises into business firms, able to engage in commercial activities in the market-based economy. They were utilised to address the fundamental tasks of reorganisation that confronted enterprises, namely, establishing administrative control, integrating business functions, and reconstructing the production chain, in the context of the breakdown of the Soviet economic hierarchy and of institutional weaknesses.
I am grateful for those individuals who positively contributed to making the process of thesis writing fruitful. First of all I would like to thank my supervisor Alena Ledeneva, who guided me with her insightful advice throughout my PhD years. She continuously provided me with much encouragement, and I am most grateful to her. I also wish to especially thank Slavo Radosevic, who followed my research very closely. His valuable supervision and enlightening comments on draft chapters sharpened my view and helped improve the thesis. Also I would like to thank Tomasz Mickiewicz for his helpful comments on sections of the research.

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Finally, I would like to express my warmest thanks to my mother and my sister for their unwavering support.
Notes on Transliteration

Throughout the text, the author basically uses the system of Russian transliteration developed by United States Library of Congress. However, exceptions are made in some cases of names commonly rendered differently in English (e.g. Yeltsin rather than El’tsin, Yukos rather than Iukos). When citing English language sources, the transliteration from the original source is preserved.
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<tr>
<td>ADR</td>
<td>American Depositary Receipt</td>
</tr>
<tr>
<td>ASIP</td>
<td>Association for Shareholders Interests Protection</td>
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<tr>
<td>AO</td>
<td>Joint Stock Company</td>
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<td>BAZ</td>
<td>Bogoslovsk Aluminium Plant</td>
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<td>AGK</td>
<td>Achinsk Alumina Combine</td>
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<td>BrAZ</td>
<td>Bratsk Aluminium Plant</td>
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<tr>
<td>CEFIR</td>
<td>Centre for Economic and Financial Research</td>
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<tr>
<td>CIS</td>
<td>Commonwealth of Independent States</td>
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<tr>
<td>CMEA</td>
<td>Council of Mutual Economic Assistance</td>
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<tr>
<td>CPSU</td>
<td>Communist Party of the Soviet Union</td>
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<tr>
<td>DOZAKL</td>
<td>Dmitrov Rolling Mill</td>
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<td>EBRD</td>
<td>European Bank of Reconstruction and Development</td>
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<td>FCSM</td>
<td>Federal Commission for the Securities Market</td>
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<td>FSFO</td>
<td>Financial Service Recovery Agency</td>
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<tr>
<td>GAAP</td>
<td>Generally Accepted Accounting Principles</td>
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<tr>
<td>Glavk</td>
<td>Ministerial chief department</td>
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<tr>
<td>GKI</td>
<td>State Property Committee</td>
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<td>GKO</td>
<td>State short-term obligations or treasury bills</td>
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<td>Gosplan</td>
<td>State Planning Committee</td>
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<tr>
<td>Gosbank</td>
<td>State Bank</td>
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<tr>
<td>Goskomtsen</td>
<td>State Committee for Pricing</td>
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<tr>
<td>Gossnab</td>
<td>State Committee for Material-Technical Supply</td>
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<tr>
<td>GULAG</td>
<td>Main Directorate of Camps</td>
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<tr>
<td>ICGPs</td>
<td>Informal Corporate Governance Practices</td>
</tr>
<tr>
<td>ICLG</td>
<td>Institute of Corporate Law and Governance</td>
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<tr>
<td>IET (IEPP)</td>
<td>Institute for Economies in Transition (Institut Ekonomiki Perekhodnogo Perioda)</td>
</tr>
<tr>
<td>IFC</td>
<td>International Finance Corporation</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>IPA</td>
<td>Investor Protection Association</td>
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<td>IrkAZ</td>
<td>Irkutsk Aluminium Plant</td>
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<tr>
<td>ISMM</td>
<td>Russian Institute for the Stock Market and Management</td>
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<td>JSC Law</td>
<td>The Law on Joint Stock Company Law</td>
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<tr>
<td>KGMK</td>
<td>Kola Mining Company (a part of Norilsk Nickel)</td>
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<tr>
<td>KMK</td>
<td>Kuznetsk Metal Combine</td>
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<tr>
<td>Abbreviation</td>
<td>Full Name</td>
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<tr>
<td>KraMZ</td>
<td>Krasnoiarsk Metal Plant</td>
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<td>KrAZ</td>
<td>Krasnoiarsk Aluminium Plant</td>
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<tr>
<td>LME</td>
<td>London Metals Exchange</td>
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<tr>
<td>MIKOM</td>
<td>Metal Investment Company (Metallovicheskaia Investitsionnaia Kompaniia)</td>
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<tr>
<td>Minneftekhimprom</td>
<td>Ministry of Petrochemical Industry</td>
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<tr>
<td>Minfin</td>
<td>Ministry of Finance</td>
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<tr>
<td>Mingo</td>
<td>Ministry of Geology</td>
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<tr>
<td>Mingazprom</td>
<td>Ministry of Gas Industry</td>
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<tr>
<td>MMK</td>
<td>Magnitagorsk Metal Combine</td>
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<tr>
<td>MNGS</td>
<td>Ministry for Construction of Oil and Gas Enterprises</td>
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<tr>
<td>MNP or Minnefteprom</td>
<td>Ministry of Oil Industry</td>
</tr>
<tr>
<td>NAUFOR</td>
<td>National Association of Professional Participants of Securities Market</td>
</tr>
<tr>
<td>NGDU</td>
<td>Oil and gas production unit (Neftegazodobyvaitsehie upravleniia)</td>
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<tr>
<td>NGK</td>
<td>Norilsk Metal Company (to be later renamed as GMK Norilsk Nickel)</td>
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<tr>
<td>NGMK</td>
<td>Norilsk Combine</td>
</tr>
<tr>
<td>NGZ</td>
<td>Nikolaevsk Alumina Plant (Ukraine)</td>
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<tr>
<td>NkAZ</td>
<td>Novokuznetsk Aluminium Plant</td>
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<tr>
<td>NKVD</td>
<td>People’s Commissariat of Internal Affairs</td>
</tr>
<tr>
<td>NLMK</td>
<td>Novolipetsk Metal Combine</td>
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<tr>
<td>OAO</td>
<td>Open-type Joint-Stock Company</td>
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<tr>
<td>OECD</td>
<td>Organisation of Economic Cooperation and Development</td>
</tr>
<tr>
<td>OMRI</td>
<td>Open Media Research Institute</td>
</tr>
<tr>
<td>PARTAD</td>
<td>Professional Association of Registers, Transfer-Agents and Depositories</td>
</tr>
<tr>
<td>PAZ</td>
<td>Pavlodarsk Aluminium Plant (Kazakhstan),</td>
</tr>
<tr>
<td>PGM</td>
<td>Platinum Group Metal</td>
</tr>
<tr>
<td>PO</td>
<td>Production associations (proizvodstvennoe ob’edinienie)</td>
</tr>
<tr>
<td>RAO Norilsk Nickel</td>
<td>Russian Joint Stock Company Norilsk Nickel</td>
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<tr>
<td>RFE/RL</td>
<td>Radio Free Europe/ Radio Liberty</td>
</tr>
<tr>
<td>RFFI</td>
<td>Russian State Property Fund</td>
</tr>
<tr>
<td>RID</td>
<td>Russian Institute of Directors</td>
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<tr>
<td>RSPP (RUIE)</td>
<td>Russian Union of Industrialists and Entrepreneurs</td>
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<tr>
<td>RusAl</td>
<td>Russian Aluminium (Russkii Aliuminii)</td>
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<tr>
<td>SaAZ</td>
<td>Saimansk Aluminium Plant</td>
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<td>SAMEKO</td>
<td>Samara Metal Company</td>
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<td>Abbreviation</td>
<td>Full Name</td>
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<tr>
<td>SibAl</td>
<td>Siberian Aluminium (Sibir’skii Aliiuminii)</td>
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<td>SMZ</td>
<td>Samara Metallurgical Plant</td>
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<tr>
<td>Sovkhoz</td>
<td>State farm</td>
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<td>Sovmin</td>
<td>Council of Ministers</td>
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<td>S&amp;P</td>
<td>Standard and Poor’s</td>
</tr>
<tr>
<td>TadAZ</td>
<td>Tadzhik Aluminium Plant</td>
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<tr>
<td>TCC</td>
<td>Trans-CIS Commodities</td>
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<tr>
<td>TWG</td>
<td>Trans-World Group/ Trans-World</td>
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<tr>
<td>UES</td>
<td>Unified Energy Systems</td>
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<tr>
<td>UkrAl</td>
<td>Ukraine aluminium (Ukrainskii Aliiuminii)</td>
</tr>
<tr>
<td>USSR</td>
<td>Union of Soviet Socialist Republics</td>
</tr>
<tr>
<td>VAMI</td>
<td>All-Union Aluminium and Magnesium Institute</td>
</tr>
<tr>
<td>VTsIOM</td>
<td>All-Russian Centre for the Study of Public Opinion</td>
</tr>
<tr>
<td>Yukos E&amp;P</td>
<td>Yukos Exploration &amp; Production</td>
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<td>Yukos Refining &amp; Marketing</td>
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CHAPTER 1. Introduction

1.1 Objective

During the 1990s businesses in Russia routinely relied on practices not entirely compatible with the formal rules. Phenomena such as capital flight, barter, tax evasion, and non-transparent corporate governance have all been associated with informal, extra-legal practices. Unwritten codes of behaviour and informal practices have penetrated formal institutions, reducing the effect of Russia’s economic reform.

In the area of corporate governance, several practices have reportedly become widespread in the managing of joint-stock companies in Russia: selling the products of the company at below-market price to entities controlled by insiders; designing a convoluted ownership structure using a network of offshore entities; withholding information about the timing and venue of shareholders’ meetings and barring shareholders from exercising their voting rights at meetings; increasing charter capital and offering newly issued shares only to insiders; and executing hostile takeovers.

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3 Any designing of institutional change has to take into account both the interaction and the consistency between the informal and formal ‘rules of the game’ and their enforcement mechanisms. See Douglass North, Institutions, Institutional Change and Economic Performance (Cambridge: Cambridge University Press, 1990). For the effect of social capital in the context of Russia’s economic change toward sustained growth, Philip Hanson, ‘Barriers to Long-run Growth in Russia’, Economy and Society, 31, 1, 2002, pp.62-84.
This thesis aims at identifying the operational specifics of informal corporate governance practices, such as share dilution, asset stripping, transfer pricing, limiting shareholders' voting rights, and 'bankruptcy to order', and understanding their role in post-Soviet Russia. I use the term 'informal corporate governance practices' or ICGPs to refer to these practices collectively. ICGPs are informal in the sense that they represent informal ways of 'getting things done'. They are not entirely compatible with the behaviours that are envisaged by the formal rules, they often rely on the instrumental use of law, and they are based on unwritten agreements that are non-transparent to outsiders. Through the case studies of three of the largest Russian companies – the Yukos Oil Company, Siberian (Russian) Aluminium, and Norilsk Nickel – this research demonstrates how ICGPs worked, why they were used, and what kinds of functions they performed in the context of the post-Communist transformation.

1.2 Background

Economic and political instability

Against the particular background in which companies emerged and operated, Russian businesses during the 1990s resorted to informal practices. Following the collapse of

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Communism and the break-up of the Soviet Union, the 1990s was a decade of economic instability. For most of the decade, enterprises operated in an adverse economic environment. Continuous negative growth from 1992 led to a fall of 40 per cent in the official estimate of GDP per capita by the end of 1998.\(^5\) Inflation, which was reduced to double digits in 1996, generally remained high.\(^6\) The country experienced a serious fall in industrial production, investment and output: Explanations for the post-Communist output fall have been based on the range of issues including falls in aggregate demand, price liberalisation beginning in 1992, breakdown of CMEA (Council of Mutual Economic Assistance), break-up of the rouble currency area, and disruptions in production chain referred to as disorganization.\(^7\) On the official data, Russia’s industrial output in 1998 stood at less than half the 1990 level, and investment in most industrial sectors in 1997 was at 10-30 per cent of 1989 levels.\(^8\)

Industrial enterprises were plunged into a difficult financial situation, and faced a severe shortage of liquidity and capital.\(^9\) Several enterprise surveys pointed to the severity of liquidity problems across industrial firms.\(^10\) Liquidity and credit problems affecting enterprises were a primary reason for the proliferation of non-monetary transactions in

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\(^6\) Ibid., p.13.

\(^7\) There is a large literature on the causes of the post-Communist output fall. See, for example, Gerald Roland, *Transition and Economics: Politics, Markets and Firms* (Cambridge MA: MIT Press, 2000), Chapter 7 for overview. Disorganization, put forward by Oliver Blanchard and Michael Kremer ('Disorganization', *Quarterly Journal of Economics*, 112, 4, 1997, pp.1091-1126), is explored extensively later in the dissertation.


\(^9\) Simon Commander, Irina Dolinskaya and Christian Mumssen, 'Determinants of Barter in Russia: An Empirical Analysis', IMF Working Paper No.155, 2000, p. 11-12. Although producers of internationally tradable commodities such as oils and non-ferrous metals always have had an option to generate cash revenues, the Russian economy as a whole suffered a serious liquidity and credit crunch.

\(^10\) According to a series of surveys by Auktsionek and Bataeva, respondents from industrial enterprises indicated that the liquidity problem was the main reason for not investing. S.P.Aukutsionek and A.E. Bataeva, *Rossiiskie predpriiatia v rynochnoi ekonomike* (Moscow: Nauka, 2000), p.95.
the Russian economy.\footnote{Commander et al, ‘Determinants of Barter in Russia’, p.7. Woodruff reports that industry collected as much as 70 per cent of its receipts in non-monetary forms in 1998, leaving many firms short of cash. David Woodruff, Money Unmade: Barter and the Fate of Russian Capitalism (Cornell: Cornell University Press, 1999), p.xi.} As the International Monetary Fund (IMF) reported, the state tolerated an increase in non-monetary transactions through noncash tax payments or so-called ‘tax offsets’, which “amounted to a significant infusion of implicit subsidies which became the key reason for the growth of barter and arrears until 1998”.\footnote{IMF, World Economic Outlook 2000 (Washington: IMF, 2000), p.98.}

The dysfunctional financial system exacerbated the financial situation of enterprises. Russian banks did not conduct normal banking business, i.e., did not function as an intermediary between savings and investment.\footnote{William Tompson, ‘Old Habits Die Hard: Fiscal Imperatives, State Regulation and the Role Of Russia’s Banks’, Europe-Asia Studies, 49,7,1997, pp.1159-1185.} A volatile macroeconomic situation, particularly hyperinflation, discouraged long-term credit arrangements.\footnote{Ibid., p.1176.} For banks, rather than engaging in long-term lending, investing in treasury bills (GKOs) was much more profitable in the period before the Russian financial crisis of 1998.\footnote{The treasury bill market grew dramatically, as the stock of outstanding treasury bills increased from 1.2 per cent of GDP at the end of 1994 to over 12 per cent of GDP at the end of 1997. IMF, Recent Economic Developments, pp.73-77.} In addition, the underdeveloped and illiquid capital market was an irrelevant source of financing.\footnote{For an account of the weakness of capital market in Russia’s emerging capitalist order, see Philip Hanson, ‘What Sort of Capitalism is Developing in Russia?’, Communist Economies & Economic Transformation, 9, 1, 1997, pp. 27-42.} Enterprises had to rely on their own funds, including retained earnings.

Confronted with economic difficulties in real and financial fronts and uncertainty of the future, enterprises had no room to pursue long-term development and instead developed strategies oriented towards short-term survival.\footnote{T. Dolgopyatova and I. Evseyeva (Boeva), ‘Behaviour of Russian Industrial Enterprises under Transformation’, Communist Economies and Economic Transformation, 7, 3, 1995, p.320.} Political instability was another major contributor to this ‘short-termism’. Yeltsin-era governments failed to create an effective
central administration, and local governments were acting independently. 18

Parliamentary resistance to liberal economic reform persisted, and market confidence in the government’s ability to implement a reform agenda was weak.19

Economic and political instability negatively influences firms’ confidence to invest.20

Given political and economic uncertainty, combined with weak property protection, enterprise managers discounted future cash flows and concentrated on short-term gains. Under such circumstances, an array of practices such as asset stripping and cash flow diversion became the pervasive responses of managers.21

*State weakness and the business–state relationship*

The Russian state during the course of the 1990s lacked administrative capacity – that is, the ability to formulate and implement policy effectively.22 This weak public administration was particularly manifest in the state’s inability to collect taxes.23 Moreover, the state was unable to establish a stable ‘private property rights regime’ through a credible legal system to provide security of property rights.24 The World Bank emphasises that the role of the state is crucial in protecting property rights and contract rights.25 According to the World Bank, variation in the security of property

18 For the political uncertainty of the 1990s, see for example, Neil Robinson, *Russia: a State of Uncertainty* (London: Routledge, 2002).
23 Hanson, ‘What Sort of Capitalism is Developing in Russia?’, pp.29-32.
25 World Bank, *Transition – the First Ten Years: Analysis and Lessons for Eastern Europe and the
rights in the former socialist economies is wide. For example, more than 70 per cent of enterprises in Russia lack confidence in the security of their property rights, compared with fewer than 30 per cent in Croatia, Estonia, and Poland.26

In addition to lack of administrative capacity, lack of state autonomy contributed to the weakness of the state.27 The non-autonomous state has fallen prey to ‘state capture’, where special interest groups, such as powerful businesses and oligarchs, have been able to shape the laws, rules and regulations to their own advantage in an illicit way.28 As a result, business has engaged in efforts to forge a close integration with state structures, and to have representatives on government or legislative bodies that support particular business interests.29 A notable feature of state–business relations under this weak regime is the “conflation of state and business”,30 with the boundary between the private and the public blurred.31 State institutions have become too closely involved with business, and vice versa.32

26 Ibid.
27 The issue of ‘state strength’ has been conceptualised both in terms of state capacity – the ability of the state to undertake its goals, and state autonomy – the autonomy of the state from a particular social groups. See for example, Theda Skocpol, ‘Bringing the State Back In: Strategies of Analysis in Current Research’ and Peter Evans, Dietrich Rueschemeyr and Theda Skocpol, ‘On the Road toward a More Adequate Understanding of the State’, both in Peter Evans, Dietrich Rueschemeyer and Theda Skocpol (eds), *Bringing the State Back In* (Cambridge: Cambridge University Press, 1985). For a discussion on the weakness of the Russian state, see McFaul, ‘When Capitalism and Democracy Collide in Transition: Russia’s “Weak” State as an Impediment to Democratic Consolidation’; Robinson, *Russia: a State of Uncertainty*; William Tompson, ‘Putin’s Challenge’, *Europe-Asia Studies*, 54, 6, 2002, pp.933-957.
31 McFaul, ‘When Capitalism and Democracy Collide in Transition: Russia’s “Weak” State as an Impediment to Democratic Consolidation’.
While the Russian state has been non-autonomous and ‘captured’, it has exerted a potent ‘grabbing hand’, “empowered to impose on business a variety of predatory regulations”. Through excessive red tape or prohibitive tax rates, for example, state officials were able to reap benefit from firms that were seeking preferential treatment from the state in the form of tax exemptions, etc. As Tompson points out, Russia has a weak state but strong officials, where “The patronage dispensed by individual officials [...] has been enormous, while the weakness of the administrative machinery has made it easy for them to use its power for private gain at state expense”.

Emphasising the interpenetrative, two-way process of interaction between state and business, Rutland argues that the pattern of interaction is nevertheless more top-down, because it is the state that creates and maintains big businesses. In fact, the initial development of Russia’s big businesses, which came under the control of business tycoons known colloquially as oligarchs, owes much to the fact that these tycoons were ‘authorised’ by the state to be rich. By the mid 1990s oligarchs were able to accumulate wealth as heads of ‘authorised banks’, which were given exclusive privileges to handle the finances of various government agencies. Moreover, the loans-for-shares privatisation programme, by which the state handed over the most profitable enterprises to a select few who were politically well-connected, can be

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considered as another ‘authorisation’ process. In the words of Peter Aven, former Minister of Foreign and Economic Relations and head of Alfa bank, in Russia “you are appointed a millionaire”.

What emerged in Russia during the Yeltsin period was a particular type of interaction between the state and business. Volkov notes that the relationship between the state and big business was based on an intricate system characterised by unwritten agreements and exchanges: the Yeltsin administration aided the rise, and protected the expansion, of big business, including the Yukos Oil Company and Russian Aluminium, and the presidential administration could be seen as the Kremlin’s ‘roof’ (krysha, or protection) protecting the oligarch’s business interests. In return, oligarchs provided the resources that helped the administration to maintain power in the government.

When business depends on special relations with the state, close ties with the state are crucial in providing ad hoc security for the pursuit of business interests. However, such a situation is at odds with providing certainty in the longer term, and the state’s role could be destabilising for business. For example, a condition of what Ledeneva terms ‘suspended punishment’ contributes to the potentially destabilising role of the state. Because of the pervasiveness of informal practices that are in some violation of the formal rules, business actors are continually under threat of reprisals; actual punishment is suspended but might be enforced at any time. The authorities can selectively apply

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and enforce the formal rules as they see fit.\textsuperscript{41} The implication is that there is complicity or condonation on the part of the state for the running of business according to unwritten rules. At the same time, a condition of ‘suspended punishment’ and the possibility of selective enforcement increase the insecurity of property rights for businesses. Weak protection of property rights, in turn, motivates businesses to move their assets offshore.

**Weak legal institutions and weak rule of law**

Russian companies have operated under weak legal institutions and weak rule of law. The rule of law requires good laws, demand for those laws, and effective means for their enforcement.\textsuperscript{42} These are the critical institutions of the market economy.\textsuperscript{43} In Russia, however, the laws themselves have weaknesses, an exploitative attitude toward the law seems deep seated, and law enforcement mechanisms, in particular the judicial system, have been ineffective.

It has been pointed out that significant gaps have existed in Russian laws, which have often contradicted other legal acts.\textsuperscript{44} Their vagueness has permitted arbitrary action by judges and state officials.\textsuperscript{45} In terms of the quality of the formal laws pertaining to corporate governance, the initial assessment was generally positive, although they embody certain weaknesses that are exploitable. Specialists point out that from the technical point of view, the Law on Joint-Stock Company (the JSC Law), the main legislative act regulating corporate governance in Russia effective from 1996 until the

\textsuperscript{41} Alena V. Ledeneva, *Russia’s Economy of Favours* (Cambridge: Cambridge University Press, 1998), and *Unwritten Rules*, p.13.


\textsuperscript{43} Ibid.

\textsuperscript{44} Berglof et al. (eds), *The New Political Economy of Russia*, p.87; Ethan S. Burger, ‘Corruption in the Russian Arbitrazh Courts: Will there be significant progress in the near term?’, *International Lawyer*, 38,1, Spring 2004.

\textsuperscript{45} Ibid.
end of 2001, was considered to be comprehensive in the area of protection of shareholders rights. The 1998 bankruptcy law, which came to be regarded as "the worst law in Russia", was initially considered to be an "adequate legal framework" representing, when it came into force, a substantial improvement on the previous law.

While the extensiveness of coverage and clarity of legislation can enhance the evaluation of written laws in comparison to international standards, what matters is the extent of receptiveness to and observance of these laws by the population. As Thomas Jefferson put it, "[T]he will of the nation that makes the law obligatory". Historically, compliance with the law grew based on the legitimacy of the rule and the active participation by business actors in the legal development, rather than by its top-down imposition by the state. Hendley points out that much legislation related to economic development has been demanded not by Russian businessmen, but by international organizations, and in some cases the laws has resulted from the fact that receiving Technical Assistance for much-needed reform has required Russia to indiscriminately adopt a Western framework for these reforms, rather than allowing previous practice to dictate the shape of future institutions. The JSC Law, according to Hendley, is a good example of where a law was written with the comprehensive

46 The amended JSC Law came into effect in 2002. The discussion on the JSC Law in this thesis is based on the JSC Law that was in force from 1996 until the end of 2001, unless otherwise indicated.


49 IMF, Recent Economic Development, p.128.


51 Quoted in Leon Aaron 'Russia Reinvents the Rule of Law', AEI Russian Outlook, Spring 2002.


53 Ibid., p.237.
involvement of Western experts on corporate law, funded by USAID. Pistor, Raiser and Gelfer note that this Russian company law is a legal ‘transplant’ of a modified Anglo-American model of corporate law, that was drafted by Western advisers and was adopted by Russian legislatures without major change. They argue that “where new laws were forced upon a judicial system unfamiliar with the underlying legal tradition and were not adapted to fit the specific local context, the effectiveness of the law suffered”. 

Pistor and Xu emphasise that law is intrinsically incomplete, because it is impossible to design a law that would specify all future contingencies. They point out that the incompleteness of law has significant implications for transplanting law from one system to another. In particular, the effectiveness of transplanted law and its enforcement depend on how the law will be understood, interpreted, and applied by institutions in the transplant country.

In the Russian business community, laws have often been interpreted and observed manipulatively, and used as an instrument to pursue business interests. In fact, the degree of instrumental use of the law seems to be high. Russian companies have been legally conscious, in a sense that they “have been very careful to adhere to laws, but [...] the laws themselves are sometimes incomplete or imperfect; management who wished to have always been able to find ways to avoid the spirit of the law while

54 Ibid.
56 Ibid.
58 Ibid.
59 ‘Instrumental use of law’ here is meant to refer to manipulative (often ‘dodgy’) use of law.
remaining inside its strict interpretation”.60 Thus, where there is a will, a way can be found to follow the letter of the law while contradicting its spirit. Oda observes that “it may well be the case that neglect of law is not inherent in the Russian legal consciousness as is often contended, but rather, a different perception of law, an extreme legal instrumentalism, has prevailed in Russia”.61 With the instrumental-use-of-law mentality, law has been used as ammunition in Russia’s corporate life.62

Such instrumental use of law in business is facilitated by the disrespectful and cynical attitude towards the law in general. Murrell points out that “The experience of seventy years of communism did little to enhance the understanding of private property or to promote the firmness of law”.63 During the Soviet period, law was perceived as an instrument to be used by the state to achieve policy goals.64 Instrumental use of law by the state discredited the legitimacy of the law and led to cynicism. Newcity emphasises the general disrespect for the law and the legal authorities that historically has been ingrained in the Russian population.65

Furthermore, the enforcement infrastructure has been defective. Black, Kraakman and Tarassova point out that “Russia’s core problem today is less lack of decent laws than lack of the infrastructure and political will to enforce them”.66 The European Bank of Reconstruction and Development (EBRD), in its discussion on Russian company law, also note that “changes in formal rules may be largely ineffective unless matched by

60 Troika Dialog, ‘Russian Corporate Governance’, p. 1/4
64 Hendley, ‘Legal Development in Post-Soviet Russia’.
65 Michael Newcity, ‘Legal Tradition and the Rule of Law’, in Sachs et al. (eds), The Rule of Law and Economic Reform in Russia, pp. 41-54.
66 Black et al., ‘Russian Privatisation and Corporate Governance: What Went Wrong?’ , p.1755.
similar improvement in enforcement". 67 For rule enforcement to be effective, the court system must have the power and capacity to arrive at objective decisions and to enforce judgement. 68 In other words, the competence and independence of judges must be ensured for effective enforcement of the law.

The Russian judicial system is said to be lacking in well trained personnel with expertise in business matters. 69 Many of the judges operating in the arbitration courts were inexperienced in handling complex commercial issues. 70 The judiciary has excessive discretion in carrying out its duties, which has often been used as a device to extort bribes. 71 Although judicial reform under Yeltsin focused on overcoming the Soviet legacy of judicial dependence on political influence, Solomon notes that “local politicians and their wealthy friends could still exercise improper influence over judges, and the chairs of courts had too much leverage over their subordinates”. 72 The lack of independence of the judiciary is in part the result of inadequate financing from the federal government, which has led to the ‘sponsorship’ of courts by regional and local governments and private firms, and by financial packages for individual judges that included perquisites, arranged by the chairmen of courts and local government. 73

According to a survey of 500 firms conducted in 2000 by VTsIOM, the All-Russian Centre for the Study of Public Opinion, it is the governors, the regional and federal bureaucracies, and influential businesspeople that are most likely to pressure the arbitration-court judges over their decisions. 74

68 Cheryl W. Gray and Kathryn Hendley, ‘Developing Commercial Law in Transition Economies: Examples from Hungary and Russia’ in Sachs et al. (eds), The Rule of Law and Economic Reform in Russia, p.142.
69 Burger, ‘Corruption in the Russian Arbitrazh Courts’.
70 Ibid.
71 Berglof et al., The New Political Economy of Russia, pp.69-97.
73 Ibid.
74 500 firms from eight cities in Russia: Moscow, Nizhnii Novgorod, Novgorod, Smolensk, Tula,
The judiciary's lack of independence and its susceptibility to outside influence lead to a selective application and enforcement of rules. Through unwritten arrangements with judges, courts, and/or state security organs, for example, enforcement apparatus can be mobilised for this purpose.\textsuperscript{75} There has been a lack of confidence among businesses in the legal system for enforcing contracts, obtaining impartial judgements, and protecting property rights. As a result, private enforcement mechanisms have emerged.\textsuperscript{76} The weakness of the state is partly responsible for this, as it is the role of state to develop legal institutions with sufficient authority, impartiality and legitimacy to enforce the law.\textsuperscript{77}

It should be added that when laws are flawed, the attitude toward law is exploitative, and enforcement is ineffective, extra-legal practices can be seen as both the symptom and the cause of the weak rule of law. In other words, while the pervasiveness of such practices contributes to the weak rule of law, they are enabled, or made possible, because the law contains 'loopholes', the instrumental-use-of-law mentality seems influential and enforcement of the law is weak.

In sum, Russian businesses in the 1990s operated under conditions of economic and political instability, combined with state weaknesses and a weak legal system, all of which created an environment of uncertainty. Market supporting institutions, such as a legal framework ensuring the protection of property rights, a well-regulated banking

\textsuperscript{75} Ledeneva, Unwritten Rules: How Russia Really Works.

\textsuperscript{76} For an account of private enforcement, see Vadim Volkov, 'Between the Economy and the State: Private Security and Rule Enforcement in Russia', Politics and Society, 28, 4, 2000.

\textsuperscript{77} Gray et al., 'Developing Commercial Law in Transition Economies', pp. 139, 142-143.
system, efficient and liquid capital markets, and bankruptcy law, were all underdeveloped. It was against this general background that informal business practices became prevalent in Russia.

1.3 The Outline of the Empirical Analyses

In order to understand these informal practices from the participant’s perspective – what firms or managers do under given circumstances, and what they perceive as being their ‘survival strategies’ or ‘coping strategies’ – one could adopt Ledeneva’s approach. She focuses on understanding how things actually work from the participant’s perspective. Through the analysis of informal practices, she points out that they “compensate for the deficiencies in formal institutions and ‘help’ business activities” while at the same time they “undermine formal institutions and slow down their effective workings”. I would argue further and show that the ICGPs could play both constructive and destructive roles for the economy. This thesis investigates the nature of ICGPs and examines the following hypothesis. ICGPs are ambiguous in nature: although they were destructive in the sense that they undermined the foundations of good corporate governance, they also had a constructive aspect in relation to the specific tasks that confronted post-Soviet enterprises in reconstituting themselves into business firms.

ICGPs were destructive in the sense that they undermined the foundations of good corporate governance, and thus had an adverse impact on Russia’s investment climate.

79 Ledeneva, *Unwritten Rules: How Russia Really Works*, and ‘Underground Financing in Russia’, in J. Kornai, B. Rothstein, and S. Rose-Ackerman (eds), *Creating Social Trust in Post-Socialist Transition* (New York: Palgrave, 2004), pp.71-90. As she points out, “Although one has to agree that fraudulent and largely corrupt practices are one of the main obstacles to economic development, it would be wrong to engage in anticorruption policy making without an in-depth understanding of the genesis of these practices, of their functions in the economy, and the best ways of affecting them”. p.72.
80 Ibid., p. 89.
They were widely acknowledged as corporate governance abuses by investors, policymakers, and scholars as these practices worked against shareholders’ rights, the protection of which is a cornerstone of globally accepted standards of good corporate governance.

However, it is important to recognise that ICGPs also had a constructive aspect in relation to the reorganisation of post-Soviet enterprises into business firms in the context of the disintegration of the Soviet economic system and of institutional weaknesses. In Russia, the restructuring of post-Soviet enterprises entailed their reconstitution into business units, able to survive, compete and grow in a new market oriented environment. Former Soviet industrial enterprises, whose activities had been controlled and coordinated under the central planning system, had functioned as ‘production units’ working within the framework of the countrywide economic hierarchy. Several of the business functions, which were performed by individual firms in the West, were not organised within the framework of the individual enterprise under the Soviet system. In the theoretical context of the resource-based view of the firm, according to which a firm is conceptualised as a collection of resources that render various business functions organised within an administrative framework, Soviet enterprises were not really ‘firms’ comparable with those operating under a capitalist system. In other words, the resources and capabilities necessary to engage in commercial activities in the market were not integrated and organised within a single individual enterprise, the lowest unit of the Soviet economic hierarchy.

As these enterprises progressed through the post-communist transformation of the economic system, they faced a new challenge. To perform in a new market-oriented environment as ‘business units’, they were confronted with several fundamental tasks of
reorganisation: First, the management had to establish effective administrative control over the administrative framework within which industrial activities were coordinated. Secondly, enterprises were required to bring together the various resources that render business functions, such as financing, marketing, raw materials procurement, R&D, that under the Soviet system were distributed across the countrywide economic hierarchy. Thirdly, the production chain that linked successive stages of production had to be reconstructed. This production chain had been disrupted with the collapse of the Soviet economic system, and the task of reconstructing the production chain also involved the decision about which of the successive stages of production should be brought within the framework of the firm, which implied adjustments to the boundary of the firm. In short, the main agenda for management, if their enterprises were to survive, grow and become competitive in a market-based economy, was to reconstitute them into self-contained business units. Furthermore, these three tasks had to be accomplished in a context where market-supporting institutions were weak.

The method of analysis used in this research to analyse the role of ICGPs is case studies of companies. Case studies enable a thorough contextual analysis, which is appropriate for the objective of this research, because ICGPs need to be understood in association with the specific tasks that companies were faced with. I selected three Russian major companies – Yukos Oil Company, Siberian (Russian) Aluminium and Norilsk Nickel – as the subjects for case studies, in order to analyse the context in which ICGPs were used. In these case studies, the use of ICGPs is investigated in relation to the three tasks described above that these companies had to perform as they reorganised from enterprises of the Soviet-type economy and re-established themselves as business firms in post-Soviet Russia.
The Yukos Oil Company, which in 2003 was Russia’s largest oil company before it experienced dismemberment in 2004, was chosen for two main reasons. First, during the 1990s, ICGPs in the form of corporate governance abuses, were omnipresent in Yukos, as has been illustrated in a large number of studies by academics, international organisations, and analysts from investment banks, as well as various press reports. Secondly, in terms of the tasks, Yukos initially suffered from disintegration in corporate management. Although established as a vertically integrated oil company, Yukos was vertically integrated in name only. Yukos lacked internal cohesion as a result of the way privatisation took place. The use of ICGPs is examined particularly from the point of view of disintegrated corporate management, the establishment of effective administrative control, and the consolidation of vertically integrated structure.

Siberian (Russian) Aluminium – SibAl/RusAl – was selected because Russia’s aluminium sector, which underwent a redistribution of the ownership of aluminium assets, and highly visible ICGPs, suffered from a disintegration particularly of the production chain as a result of the collapse of the USSR. Many enterprises in the sector that went through the process of privatisation, were faced with the task of restoring a disrupted production chain linking related enterprises. The Saiansk Aluminium Plant (SaAZ), on which SibAl was founded, integrated vertically as well as horizontally as it reconstructed its production linkages. The analysis presented in this thesis focuses on the activities of SibAl up to a point where assets in the aluminium industry owned by SibAl were merged with other assets, to co-establish Russian Aluminium (RusAl), Russia’s largest and the world’s third largest producer of aluminium. The use of ICGPs is examined from the perspective of the reconstitution of aluminium plant into a major vertically integrated company, encompassing a chain of production from upstream to downstream.
The main reason for choosing Norilsk Nickel to be the subject of the third case study is that in contrast to the other two companies, reported cases of ICGPs in Norilsk Nickel were fewer during the 1990s. However, Norilsk Nickel’s ICGPs became the focus of criticism in 2000, at the time when awareness of the need to improve corporate governance practices was increasing in Russia. In the 1990s, Norilsk Nickel did not suffer a lack of internal cohesion as a result of privatisation, nor a disruption in its production chain as a result of the collapse of the Soviet economic system. In these respects, Norilsk Nickel seems to have been better placed as a business unit. ICGPs are considered against this characteristic feature of Norilsk Nickel, which is one of the major nickel and platinum group metal (PGM) producers of the world.

The empirical analyses of these three cases rely extensively on Russian sources, particularly reports in leading newspapers and journals.\(^\text{81}\) Materials made available from the companies themselves are also analysed. During my fieldwork in Moscow from September 2002 to March 2003, July 2003, and October 2003 to November 2003, I collected information, views and comments from seven company representatives, four Russian business representatives, twelve corporate governance specialists, twelve oil and gas consultants and metal specialists, nine investors, fourteen analysts from financial institutions and research institutes, eleven academics, and eight journalists relating to corporate governance in Russia and the developments of these companies (see Appendix 1). For many of the comments that were particularly useful for the analysis, I was able to find written reports in Russian newspapers and journals that confirmed the respondents’ comments, which was very helpful in linking up a cluster of

\(^{81}\) For the analysis of press reports, I consciously attempted to select newspapers and journals that are considered to be less subjective and are well-respected. However, there is no 100 per cent guarantee that the press reports are error-free; I used multiple sources wherever possible to corroborate evidence.
what was otherwise isolated information. In this thesis, I mostly refer to published
sources, given the sensitive nature of the subject and to maintain the confidentiality of
the interviewees. In some cases, respondents themselves recommended sources. Since
the three companies studied are major companies in Russia, it was generally possible,
with some degree of persistence, to find documentation relating to evidence given by
respondents. It should be noted that this thesis does not draw any definitive conclusions
about Russia’s corporate governance or Russian industrial enterprises on the basis of
these three case studies. Rather, the research aimed to capture the overall development
against which ICGPs were used by the companies in question, and to demonstrate the
ambiguous nature of ICGPs.

1.4 The Structure of the Thesis
This thesis is organised as follows. Chapter 2 discusses destructive aspect of ICGPs, i.e.,
ICGPs as corporate governance abuses. It reviews the theoretical literature on corporate
governance, focusing on the theoretical foundation as to why protection of shareholder
rights became central to good corporate governance. It then shows the substantial gap
between the principles of good corporate governance and Russia’s corporate governance
in practice. By demonstrating the use of ICGPs as corporate governance abuses, the
chapter describes the operational specifics of ICGPs – i.e., how they work and the
factors that make them workable. It focuses on the workings of the practices that rely on
the instrumental use of law, often based on unwritten agreements that are
non-transparent to outsiders. The chapter discusses the adverse impact of ICGPs on
Russia’s investment climate.

Chapter 3 provides an analytical framework within which to analyse the constructive
role of ICGPs in the case studies. Based on the resource-based view of the firm, the
chapter argues that post-Soviet enterprises had to be reorganised as business units in order for them to operate in a market oriented environment. The chapter identifies the three fundamental tasks of reorganisation that Russian companies faced in reconstituting enterprises as business units: 1) establishment of an effective administrative control; 2) integration of business functions; and 3) reconstruction of the production chain. This chapter suggests that understanding ICGPs in the context of fulfilling these tasks from the resource-based view of the firm sheds light on the constructive role of ICGPs.

The next three chapters consist of the case studies. Chapter 4 investigates the ambiguity of ICGPs based on the case of the Yukos Oil Company. It focuses on the role of ICGPs during the 1990s, when the major challenge for the management of Yukos was to establish effective control and to build a coherent company, which was to become the largest oil producer in Russia by 2003. The chapter argues that ICGPs, which were detrimental to minority shareholders, in fact addressed the tasks management faced in order to reconstitute the company as a functioning business unit. The focus is on why Yukos suffered from a lack of effective administrative coordination and control, which adversely affected the other tasks it needed to accomplish. The chapter demonstrates how ICGPs were utilised to establish corporate control and create an operating, vertically integrated oil company.

Chapter 5 analyses the ambiguity of ICGPs by examining the case of Siberian Aluminium (Sibir'skii Aliuminii) or SibAl. It focuses on the role of ICGPs during the 1990s, when an aluminium smelter, the Saiansk Aluminium Plant (SaAZ), developed into SibAl, up to the point where SibAl grew into Russian Aluminium (Russkii Aliuminii) or RusAl. This chapter analyses ICGPs in the light of their functions in contributing to the reconstitution of enterprises as business units. It focuses on how
ICGPs were used by Russian managers at SaAZ to achieve independence from the intermediary trader and to establish corporate control. It then discusses the use of ICGPs to adjust the boundary of the firm and to establish a vertically integrated company, which served to integrate various business functions and to reconstruct a production chain from the production of alumina and primary metals, to semi-fabricated and fabricated products.

Chapter 6 investigates ICGPs in the case of Norilsk Nickel. It analyses why the reported cases of ICGPs in Norilsk Nickel seem less prominent during the 1990s compared to the previous two cases. The reasons underlying this phenomenon are analysed by investigating the advantages that Norilsk Nickel had over the other two companies in terms of the three tasks these companies faced – establishing administrative control, integration of business functions and reconstruction of a production chain. However, Norilsk Nickel raised corporate governance concerns in 2000 during its major reorganisation. The chapter also examines the underlying logic behind the use of ICGPs, which came under criticism in 2000.

The concluding chapter, Chapter 7, summarises the main argument concerning the ambiguity of ICGPs under post-Communist transformation. It provides an analysis of ICGPs and their implications. Based on the findings from the case studies, the final chapter elaborates on the hypothesis about the ambiguity of ICGPs.
CHAPTER 2. ICGPs (Informal Corporate Governance Practices) and Corporate Governance Problems in Russia

2.1 Introduction

What is corporate governance, and in what way are Russia’s informal corporate governance practices problematic? What do ICGPs look like, and why do they matter? Over the past decade, there has been a surge in global interest in the subject of corporate governance, among academics, policymakers, and market participants alike. Corporate governance refers to “the system by which business corporations are directed and controlled”, and more specifically, the “structure of relationships and corresponding responsibilities among a core group consisting of shareholders, board members and managers designed to best foster the competitive performance required to achieve the corporation’s primary objective.” But what is meant by ‘good corporate governance’ and what are ‘corporate governance abuses’? The issue of corporate governance has been on the agenda for more than half a century, but the globalisation of the market and the increasingly international character of investment seem to have elevated the significance of the standard of corporate governance. The growing awareness of this subject is being felt not only in the advanced market economies, but also, and especially, in emerging and developing economies. It has been widely emphasised that good corporate governance would allow increased access to global financial markets, which play an important role in economic growth.

Against the background of increased concern over the standard of corporate governance,

corporate governance practices in Russia came under criticism in the 1990s. The ICGPs used in the running of Russian joint stock companies, such as share dilution, asset stripping, transfer pricing, limiting shareholders access to voting, non-transparent ownership, and hostile takeovers based on bankruptcy proceedings, became a subject of critique.

The objective of this chapter is to examine the destructive aspects of Russia’s ICGPs. This chapter firstly reviews the theoretical foundations of corporate governance. It seeks to understand why the empowering of shareholders has become central element in corporate governance. Secondly, the chapter investigates the substantial gap between the principles of good corporate governance and Russia’s corporate governance in practice by describing how ICGPs work and why they work, i.e., the operational specifics of ICGPs. It also demonstrates how ICGPs have constituted corporate governance abuses. Thirdly, this chapter discusses the adverse impacts of ICGPs.

2.2 What is Corporate Governance?

2.2.1 Corporate Governance and Agency Problems

Studies of corporate governance have predominantly been approached from the point of view of the principal–agent problem that emerges from the separation of ownership and control. The principal–agent problem refers to the problem of motivating one person to act on behalf of another. Jensen and Meckling define a principal–agency relationship as the type of relationship when “one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent”. According to a principal–agent

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approach, the essence of corporate governance has been, as Shleifer and Vishny put it, “how investors get the managers to give them back their money”.  

The agency problem emerges between shareholders and management as a result of the so-called separation of ownership and control. Berle and Means have recognised separation of ownership and control as the main characteristics of US corporations, and that this separation has produced a condition where the interests of the owner and those of the manager diverge. These divergences of interests between of managers and shareholders associated with the separation of ownership and control is a classic principal–agent problem.

In principal–agent analysis, information asymmetry – when different economic agents do not share the same sets of information – is central to understanding the issue of separation of ownership and control. In a corporation, shareholders do not possess full information on the manager’s actions, or the conditions surrounding those actions. When the manager’s efforts are unobservable and shareholders do not know how hard managers work, managers may shirk. In addition, managers have more scope to pursue their own interests, rather than those of their principal. According to Jensen and Meckling, an agency conflict between managers and shareholders could derive from the manager’s tendency to appropriate perquisites from the firm’s resources for personal consumption. Managers can use the profits of the firm for personal benefit, rather

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8 This is the hidden action or moral hazard problem associated with principal–agent relations.
than to increase shareholder value. The key issue becomes how to align the incentives of the agent in such a way that they will not act against the interests of the shareholder as principal.\footnote{A possible solution is to design an incentive scheme for managers such as a performance-based financial reward, or stock option and share ownership. Allocation of equities to managers could make them more interested in dividends than consuming perquisites, could encourage them to reduce slack, could increase the value of the firm, and thus encourage them to behave in the shareholders' interests. See Michael Jensen and Kevin Murphy, 'Performance Pay and Top-Management Incentives', \textit{Journal of Political Economy}, 98, 2, 1990, p.226; Shleifer and Vishny, 'A Survey of Corporate Governance', p.744.}

\subsection*{2.2.2 Corporate Governance and Protection of Shareholders}

Why, then, do shareholder rights matter in corporate governance from the principal–agent perspective of the firm? Jensen and Meckling, whose agency approach remains influential in the analysis of corporate governance, defined the firm as a "simply one form of legal fiction that serves as a nexus for contracting relationships".\footnote{Jensen and Meckling, 'The Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure', p.88. The conceptualisation of firm as a nexus of contract was first put forward by Alchian and Demsetz, who argue that a firm is a contractual structure characterised by the team production process, and raise the problem of shirking and monitoring of team production in the firm. Armen Alchian and Harold Demsetz, 'Production, Information Costs, and Economic Organization', \textit{The American Economic Review}, 62, 5, 1972, p. 778. Steven Cheung considers that it is misleading to draw a clear distinction between firms and markets. According to him, it is not quite correct to say that a 'firm' supersedes 'the market', as Ronald Coase has argued (see Footnote 19 below). Rather, Cheung argues that according to one's view a 'firm' may be as small as a contractual relationship between two input owners or, if the chain of contracts is allowed to spread, as big as the whole economy. See Steven Cheung, 'The Contractual Nature of the Firm', \textit{Journal of Law and Economics}, 26, 1, 1983, pp. 1-21, and Ronald H. Coase, 'The Nature of the Firm', \textit{Economica N.S.}, 1937, pp.386-405, reprinted in Oliver Williamson and Sidney Winter (eds), \textit{The Nature of the Firm: Origins, Evolutions, and Development} (Oxford: Oxford University Press, 1991), pp. 18-33. Luigi Zingales, 'In Search of New Foundations', \textit{The Journal of Finance}, LV, 4, 2000, p.1631.}

According to this view, the case for supremacy of shareholders' rights over the rights of other parties involved in the firm such as managers, employees, suppliers and customers, is based on the following reasoning. Zingales points out that a nexus of contract view of the firm deals with contracts that are explicit, and in the world of explicit contracts, the only residual claim is equity.\footnote{Luigi Zingales, 'In Search of New Foundations', \textit{The Journal of Finance}, LV, 4, 2000, p.1631.} In a framework of contractual relations each party is protected by a contract, with the exception of the shareholders, who accept a residual
payoff as residual claimants. Residual claimants are also residual risk bearers because the risks of the other parties are limited by the contractual conditions specifying either fixed, guaranteed payoffs or incentive payoffs.

In addition, shareholders face risks as a consequence of the principal–agent problem. As a result of an agency problem, shareholders cannot directly oversee the management of the company’s assets to ensure that they are being managed to maximise their value, or to check that the economic benefits are not misappropriated. Thus, it is generally accepted that shareholders need protection, and that they should be afforded protection through being allowed some rights to control a firm’s decisions, thereby maximising the incentives for value-enhancing investments while minimising inefficient power seeking. In addition, it is the shareholders who will benefit but also can stand to lose most from such decisions. Easterbrook and Fischel argue that it is the shareholders, as residual claimants, that are the group that have the appropriate incentives to make discretionary decisions.

Again in connection with agency problem, the need for shareholder protection was underlined by Oliver Williamson, who built on the transaction cost theory of the firm based on Ronald Coase’s argument. Williamson observed that

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16 Zingales, ‘Corporate Governance’, p.500.
17 Ibid.
19 In ‘The Nature of the Firm’, Nobel laureate Ronald Coase describes the existence of the firm in terms of transaction costs. Coase argues that the main reason for the establishment of the firm is that there are costs of using the price mechanism – such as the costs of discovering relevant prices, negotiating, drawing up contracts, making inspections, putting arrangements in place to settle disputes – which have come to be known as transaction costs. See Coase, ‘The Nature of the Firm’, and Coase, ‘1991 Nobel Lecture: The Institutional Structure of Production’, in Williamson and Winter (eds), *The Nature of the Firm: Origins, Evolutions, and Development*, p.230.
the suppliers of finance bear a unique relation to the firm: The whole of their investment in the firm is potentially placed at hazard. By contrast, the productive assets (plant and equipment; human capital) of suppliers of raw material, labour, intermediate product, electric power, and the like normally remain in the suppliers' possession. 20

Further, "Stockholders are the only voluntary constituency whose relation with the corporation does not come up for periodic renewal. [...] [They] invest for the life of the firm and their claims are located at the end of the queue should liquidation occur". 21 Thus, the contractual relationship between shareholders and the firm is more difficult to safeguard. 22 Hence, the need arises to create some form of protection for stockholders by inventing a means which "holders of equity recognize as a safeguard against expropriation and egregious mismanagement". 23 Safeguards can take the form of realignment of incentives and the creation of a specialised governance structure to resolve disputes through private ordering rather than litigation in the courts. 24 The board of directors is seen as a governance instrument, to safeguard the shareholders' investment. 25

Oliver Hart argues that corporate governance issues arise in an organisation whenever there is an agency problem, which cannot be dealt with through a comprehensive contract. 26 As Grossman and Hart emphasise, "It may be extremely costly to write a contract that specifies unambiguously the payments and actions of all parties in every

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21 Ibid., p. 1228.
observable state of nature". Complete contracts are not feasible because it is impossible to foresee all possible contingencies. The implication for incompleteness of contracts for the agency problem, therefore, is that it is not possible for the principals and agents to sign a complete contract specifying exactly what the agents must do in all possible circumstances.

In a world of incomplete contracts, where agency problems are also present, the corporate governance mechanism becomes necessary. Hart defines a corporate governance structure as a mechanism that "allocates residual rights of control over the firm's nonhuman assets; that is, the right to decide how these assets should be used, given that a usage has not been specified in an initial contract". Hart and Grossman, and Hart and Moore define a firm in terms of a collection of physical assets, and identify residual rights of control over assets with ownership. In other words, the firm's owners are the ones who have residual control rights.

In a large corporation, Hart observes that "the owners, that is, the shareholders, even though they typically have (ultimate) residual control rights in the form of votes, are too small and numerous to exercise this control on a day-to-day basis". Moreover, the shareholders are too dispersed to have incentive to monitor management. Since monitoring is costly, free-rider problems will arise: each shareholder will free ride, hoping that other shareholders will do the monitoring. However, when all shareholders

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29 Ibid. Emphasis in original.
31 Oliver Hart, Firms and Contracts and Financial Structure (Oxford: Clarendon Press, 1995), see particularly Chapter 2. This theory of the firm is known as the property right approach due to its emphasis on ownership.
adopt this behaviour, no monitoring will occur. Because of the separation of ownership and control, information asymmetry, and the absence of monitoring, there is a danger, the argument goes, that managers will pursue their own interests at the expense of those of the shareholders. Such opportunistic managerial behaviour includes: overpaying themselves, enjoying generous ‘perks’, conducting power-enhancing but unprofitable investment projects, and entrenching themselves, i.e. making their positions virtually invulnerable.33

In order to constrain such managerial opportunism, the need for corporate governance mechanisms arises. Typical mechanisms include the board of directors with fiduciary duties to the shareholders, and the ‘market for corporate control’, which disciplines managers’ actions.34 In addition, there are several other mechanisms, such as incentive pay for managers,35 the financial structure,36 monitoring by large shareholders,37 and

33 Ibid.
34 The market for corporate control functions as follows. Rights associated with corporate control include the right to claim the residual profit, to attend shareholders’ meetings, to cast votes, and to directly or indirectly appoint managers and sue the directors for breach of contractual duties. These rights can be bought and sold on the market. One way to obtain controlling rights is through a hostile takeover bid. As long as the market for corporate control functions effectively, managers, wanting to avoid a hostile takeover, have an incentive to run the company well and take heed of investors’ interests. In this connection, Henry Manne opined that “Only the takeover scheme provides some assurance of competitive efficiency among corporate managers and thereby affords strong protection to the interest of vast numbers of small non-controlling shareholders”. Henry Manne, ‘Mergers and the Market for Corporate Control’, Journal of Political Economy, 73,2, 1965, pp. 110-120, p.113.
36 A corporate financial structure, particularly the company’s choice of debt, is considered as one of the important sources of controlling managerial behaviour. According to this explanation, if a company borrows money, then this limits the scope of possible management activities, such as not spending too much on empire building, at least if the debt is to be repaid. Hart, ‘Corporate Governance: Some Theory and Implications’, pp.685-686.
37 Andrei Shleifer and Robert Vishny, ‘Large Shareholders and Corporate Control’, Journal of Political Economy, 94, 3, 1986, pp.461-488. They argue that the advantage of having large investors is that their presence provides a solution to the free-rider problem; In ‘A Survey of Corporate Governance’ they argue that when control rights are concentrated in the hands of a group of dominant investors (i.e., a small number of investors with a collectively large cash flow stake), concerted action by these investors is much easier than when control rights, such as votes, are split among many investors. This allows large shareholders to address the agency problem because they will be interested in profit maximisation, and also will have enough control over the assets of the firm to have their interests respected. In this case, the power of large investors depends on the degree of legal protection afforded to them because they govern by exercising their votes. p.754.
protection of minority rights and legal restriction on managers' behaviour. 38

Zingales points out that the property rights approach developed by Grossman, Hart and Moore has been interpreted to support the shareholder's value maximisation paradigm, as exemplified in the survey of corporate governance by Shleifer and Vishny, who argue that the shareholders should be protected through residual rights of control. 39 Taking an agency approach to corporate governance, Shleifer and Vishny focus on how residual control rights should be allocated under contract incompleteness. They argue that since insiders have a better bargaining position as a result of their power to quit or to entrench themselves, the shareholders, who have less protection from expropriation, should be protected against expropriation through the residual rights of control. Overall, they stress the legal protection of investor rights as an essential element of corporate governance. 40

Moreover, the argument that the residual rights of control should belong to shareholders is derived from the efficiency perspective. Viewing ownership as a system of control rights, 41 a distinction is made between ownership in the sense of possession of residual control rights, and ownership in the sense of entitlement to profit streams. 42 Following Grossman, Hart and Moore, two types of ownership rights are identified: control rights

and cash flow rights. Boycko, Shleifer and Vishny argue that “Generally, efficient ownership requires that control rights and cash flow rights over an asset be held in tandem by a decision maker whose interests are aligned with efficiency”, and that “since outside shareholders are only interested in maximizing profits, the ownership structure that gives them both cash flow and control rights is truly efficient”.

2.2.3 Shareholder-Sovereign Paradigm

Thus, the basic argument is that firms face an agency problem, which in its turn gives rise to corporate governance problems. Shareholders, who make a financial investment in a company, need protection against the risk of expropriation by opportunistic managers. Allocation of residual control rights can be seen as providing shareholders with such protection. Aoki argues that this shareholder-value paradigm is normative, which is “rationalised by the notion that the corporate firms are the property of the shareholders, while the agents supplying other resources, such as human assets and intermediate goods, can safeguard their interest through legally enforceable contracts”. In this context, the critical focus of corporate governance becomes the question of how to assure shareholders that they receive a return on their financial investment. More specifically, the major issue for corporate governance is how to protect shareholders’ rights and to design mechanisms to control management behaviour.

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44 Boycko et al., Privatizing Russia, pp.47 and 65.
It should be emphasised that the principal-agent approach to corporate governance generally envisages a situation where ownership of a company is widely dispersed among shareholders, in the presence of an effective legal protection of shareholders and a competitive equity market, which makes such an ownership pattern possible. When the capital market is developed and competitive, shareholders monitor the company’s activities and a market for corporate control, such as takeovers, become possible and workable. This paradigm, therefore, is characterised as market-based and shareholder-sovereign, associated with the Anglo-American model of corporate governance.48

One strand of debate stresses that the standard corporate governance paradigm with its exclusive focus on how to control managers by shareholders is unsatisfactory particularly when applied outside the Anglo-American economies, and therefore that the corporate governance paradigm should be broadened.49 The need for a broader paradigm arises out of the following inter-related concerns: the major premise of the standard approach based on dispersed shareholders is too specific; various stakeholders in addition to managers and shareholders should be considered; a standard approach is unable to capture the corporate governance problem in emerging and developing economies.

48 From a comparative perspective, three major models of corporate governance in developed economies are generally identified: the Anglo-American model, the German model, and the Japanese model. The Japanese and German models are characterised as relation-based, where banks play a significant monitoring role. The differences are reflected in the type of ownership in the respective models. In the Anglo-American model, the focus is on dispersed control, while a more concentrated ownership structure is observed in the German and Japanese models. See Jonathan Charkham, Keeping Good Company: A Study of Corporate Governance in Five Countries (Oxford: Oxford University Press, 1994); Mark Roe, ‘Some Differences in Corporate Structure in Germany, Japan, and the United States’, The Yale Law Journal, 102, 1993, pp. 1927-2003; Xavier Vives, ‘Corporate Governance: Does it Matter?’, in Xavier Vives (ed.) Corporate Governance (Cambridge: Cambridge University Press, 2000), pp.1-15.

economies, including Russia and other former socialist economies.  

Furthermore, questions have been raised about the usefulness of a principal–agent perspective for the firm as an explanatory framework for the analysis of corporate governance. For example, Allen and Gale argue that

the agency approach, broadly defined, is somewhat exaggerated and hard to reconcile with the successful performance (by some standards) of actual firms. [...] While there may be some conflict of interest between shareholders and managers, it appears to be the case that managers do regard the success of the firm, measured by earnings or growth, as part of their own objective function.  

In a similar vein, Coase raises concerns over the behavioural assumption of opportunism that has become dominant in the literature. He argues that “opportunistic behaviour of the type we are discussing would also normally be unprofitable and this argument has added force since a firm acting in this way will certainly be identified”.  

These criticisms suggest that for a firm to operate effectively, good corporate governance – in the sense that opportunistic managers are controlled, and the agency problem is resolved to the benefit of the shareholders as the owners of a corporation – is not enough.

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50 Ibid. Berglof and Thadden argue that although, legally speaking, the formal owners of the firms are the shareholders, the implicit argument that those who own should control is flawed because, in practice, other stakeholders are involved in controlling the firm, and this notion may not be equally reflected in corporate governance arrangements across the globe. The authors emphasise that the broader notion of corporate governance leads to a better understanding of economies, in particular those in development or transition, “where anonymous stock markets are unlikely to promote the necessary entrepreneurial activity and corporate restructuring”. p.6.


Nevertheless, the analysis of corporate governance based on the principal–agent view has predominantly been the approach adopted, which has had a strong influence on how the corporate governance problem is perceived in policy debates. Examples include the corporate governance framework defined by the World Bank, and the OECD Principles of Corporate Governance published by the Organisation for Economic Cooperation and Development (OECD). The World Bank emphasises the need of governance mechanism to address the principal–agent problem that grows out of the separation of ownership and control.\(^{53}\) The standard for good corporate governance published by the OECD focuses on the protection of the rights of shareholders as central to good corporate governance, as is described next.

2.2.4 OECD Principles of Corporate Governance

As the issue of corporate governance became a matter of global concern, an effort was made to formulate a global standard of good practice in corporate governance. In 1999, the OECD adopted a set of core principles on corporate governance as the result of a consultative process among OECD members, non-OECD countries, international organisations and the private sector, as well as various stakeholders.\(^{54}\) The G7 declared the need to strengthen corporate governance as part of establishing an enhanced global financial architecture,\(^{55}\) and in 1999 attached high priority to “the OECD’s

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\(^{53}\) To quote the World Bank’s Corporate Governance: A Framework for Implementation: What makes corporate governance necessary? Put simply, the interests of those who have effective control over a firm can differ from the interests of those who supply the firm with external finance. The problem, commonly referred to as a principal–agent problem, grows out of the separation of ownership and control and of corporate outsiders and insiders. In the absence of the protections that good governance supplies, asymmetries of information and difficulties of monitoring mean that capital providers who lack control over the corporation will find it risky and costly to protect themselves from the opportunistic behaviour of managers or controlling shareholders.


\(^{54}\) OECD Principles of Corporate Governance (Paris: OECD, 1999).

recently-approved core principles of corporate governance, and the World Bank's continuing work with the OECD and other international institutions to encourage their broadest possible adoption and implementation in emerging markets and industrial countries".  

The OECD Principles of Corporate Governance provides a set of good corporate governance practices and aims at developing a common international understanding of the components of good corporate governance. The OECD Principles focus on a set of relationships amongst shareholders, managers, the board of directors, and other stakeholders. They are designed to be applicable to listed companies, though they could be applied to improve corporate governance in non-traded companies. Although non-binding, they delineate a set of good practices in corporate governance, based on principles composed of: 1) the rights of shareholders; 2) the equitable treatment of shareholders; 3) the role of stakeholders; 4) disclosure and transparency; and 5) the responsibilities of the board.  

As mentioned in the preamble, the OECD Principles focus on the principal–agent problem, that is, corporate governance problems that result from the separation of ownership and control. The OECD Principles put particular emphasis on the rights and equitable treatment of shareholders. This emphasis reflects the observation that

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57 OECD Principles of Corporate Governance, p.11.
58 In 2004, a revised version of the Principles was published. In addition to the original five principles, "Ensuring the basis for an effective corporate governance framework" was added. This new entry states that the corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.
59 OECD Principles of Corporate Governance, p.12.
60 Berglof and Thadden, while appreciating the usefulness of the draft of the Principles, commented
common to all good corporate governance systems is the high degree of priority given to the interests of shareholders,\textsuperscript{61} while recognising there is no single model of good corporate governance in the world.\textsuperscript{62} In what follows, Russia’s ICGPs are discussed in the context of the \textit{OECD Principles}, in order to understand how and why corporate governance in Russia is seen as problematic.

### 2.3 Corporate Governance Problems in Russia

Russia’s corporate governance practices became a subject of critique in the 1990s. Facts abounded about informal practices, such as share dilution, asset stripping, transfer pricing, non-transparent ownership structures, cash flow diversion, limiting shareholders from attending the shareholders meetings, and using bankruptcy as a takeover tool, all of which have come to constitute corporate governance abuses.\textsuperscript{63} As the OECD reported,

\begin{quote}
Abuse of corporate governance remains a common problem in Russia. Investors have often seen their shares diluted by insiders and major shareholders. Companies have seen their assets stripped by various means of transfer pricing. The interests of creditors have not been adequately protected and the mobilisation of capital has been hampered.\textsuperscript{64}
\end{quote}

Corporate governance in Russia has been considered especially problematic or abusive
because of the discrepancy between the standard of good corporate governance and the Russia's corporate governance in practice. As McCarthy and Puffer put it, in Russia "most tenets of good corporate governance were badly abused". See from the point of view of good corporate governance as exemplified by the OECD Principles, the relevance of the corporate governance problem in Russia becomes acute. In particular, the basic rights of shareholders have not been well protected, and equitable treatment of shareholders has been lacking. In this section, ICGPs in Russia are examined using the taxonomy of the OECD Principles. This discussion has two objectives: to describe how ICGPs work, emphasising the instrumental use of law in executing ICGPs, and to show how principles of good practices are violated.

2.3.1 Barring Shareholders from Participation in Shareholders' Meetings and Voting

The OECD Principles emphasise the protection of shareholder rights, and the ability of shareholders to influence company’s decisions. Basic shareholder rights include the opportunity to participate effectively and vote at shareholders' meetings. In Russia, there have been cases where outsider shareholders have not given these basic rights to participate in shareholders’ meetings and exercise their right to vote.

Withholding information

One direct way used to restrict shareholders’ rights to vote is to bar a particular group of

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66 Nestor and Jesover 'OECD Principles of Corporate Governance on Shareholder Rights and Equitable Treatment: Their Relevance to the Russian Federation'.
67 OECD Principles, p.27.
shareholders from attending a meeting. Selecting a meeting venue and time that would likely be impossible for ‘undesirable’ shareholders, and failing to provide information regarding the time, venue, and agenda of general shareholder meetings have also been used by companies to limit shareholders’ access to general meetings, while staying within the letter of law. For example, a complete copy of War and Peace by Lev Tolstoy might be sent out to announce and give details of a general shareholder meeting, the exact details of time and venue being hidden somewhere inside the lengthy text.

In 1999, there was an instance where the shareholders in Tomskneft, a subsidiary of the Yukos Oil Company, arrived for a shareholders’ meeting to find a notice on the door that the meeting had been relocated to Mosalsk, several hours’ drive south of Moscow. The notice was posted at 9 am, which made it impossible for minority shareholders to reach the venue in time for the registration deadline of 11.45 am.

While such examples may seem like anecdotal evidence, the acuteness of the problem is reflected in the fact that in Russia’s Corporate Governance Code, developed by Russia’s Federal Commission for the Securities Market (FCSM), a whole chapter is dedicated to how best to conduct a general shareholders’ meeting. There is a clause in Chapter 2 of Russia’s Corporate Code stating that “It is recommended that easy and uncomplicated access for shareholders be the goal when the place, date and time for the general shareholders meeting are being selected (1.6)”, and that “it is recommended that the annual general shareholders meeting should commence not earlier than 9 am nor later than 10 pm local time (1.6.3)”.

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70 ‘Hot Shares, Bothered Investors’, The Economist, 24 July 1999, p.64.
71 Corporate Governance Code (Moscow: FCSM, 2002).
Inadequate proxies

Access of ‘undesirable’ shareholders to voting at shareholders meeting has been limited by declaring voting slips inaccurate, or proxies as unacceptable. A proxy vote requires certain passport information, and this requirement became a reason to bar the authorised representatives of ‘undesirable’ shareholders from participation in meetings. For instance, missing data from the passport, such as the details of blood type, or failure to provide a certified copy backing up certain data in the passport, such as information on an exchange of foreign currency six years earlier, were used as grounds for denying the representative from participating in a general shareholders’ meeting.

Obtaining court injunction

Restricting shareholders from voting has also been achieved through the instrument of a court injunction. A group of shareholders can obtain a court injunction which freezes the shares held by the ‘undesirable’ shareholders, and bars them from voting. According to the legal experts, obtaining such an injunction does not demand “as high a burden of proof as in a normal hearing”. A court injunction typically can be set in motion by a suit brought by a third party minority shareholder, but arranged by those who wish to restrict a particular group of shareholders from voting. As a means to protect shareholder rights, the Law on Joint Stock Company Law (JSC Law) contains a

72 Vasiliev, ‘Korporativnoe upravlenie’, p.44.
73 Vasiliev, ‘Corporate Governance in Russia’, p.6.
74 Drakina, ‘Masterklass dla perekhvatichkov’.
75 Ibid. Also, see Aleksandr Volkov and Dmitrii Sivakov, ‘Tekhnologii absolutnoi vlasti’, Ekspert, 21 June 1999, (http: //dlib.eastview.com/sources/article.jsp?id=2797739, accessed 13 January 2004). This so-called ‘passport technology’ has been systematically used, for example in the general meetings of Sakhalin Sea Shipping Line and Nakhodka Shipbuilding Plant, according to Ekspert.
77 Richard N. Dean, Barry Metzger, Derek A. Bloom and Kirill Ratnikov, ‘Abusive Corporate Takeovers in Russia: Proposals for Reform’, Courdert Brothers, 2003, p.3.
78 The JSC Law that came into effect in January 1996 was in force until the end of 2001. The amended JSC Law came into effect in 2002. Since this thesis is concerned with corporate governance practices in the 1990s, the following discussion on the JSC Law and its provisions is based on the original 1996 Law, unless otherwise indicated.
provision whereby a shareholder, including a private holder of even one share, is able to appeal to a court about a decision taken at a past general shareholders’ meeting, if the shareholder states his belief that the decision has incurred a damage to shareholder rights.  

The third party minority shareholder who files the suit can claim that some action taken by other shareholders has damaged his rights and, in accordance with the Arbitration Procedure Code, can ask for a provisional relief called ‘protective measures’ (‘obespechitel’nye mery’), which involves prohibition of those shareholders from casting their votes.

By means of these court injunctions, therefore, the judicial process can be used manipulatively. It is widely believed that in many cases corporate conflicts have motivated the instrumental use of lawsuits by a private shareholder to obtain a court injunction. For example, a court injunction was used to freeze the shares held by representatives of the metal company, OMK, in a conflict between OMK and a Russian business group, the MDM Group. In addition, through court injunctions and ‘protective measures’, a hostile takeover can be achieved quite effectively, when a corporate raider holds 30 percent or more of the shares. And, a company’s operations

80 Peter Clateman, ‘More Yukos’, from Johnson’s Russia List, 11 May 2004. According to Clateman, ‘The Russian Arbitration Procedure Code provides that a plaintiff may apply for and receive ‘preliminary protective measures’ (what would be called ‘injunctive relief’ in the US or UK) if not granting such measures would encumber or render impossible fulfilment of the final court judgment should the plaintiff win its claim’.
83 The scenario is as follows. When a corporate raider owns 30 per cent or more of the target company’s stock, the raider files a request to hold an extraordinary shareholders’ meeting. However, the extraordinary meeting lacks a quorum, because a raider had made sure that a court injunction prevents other shareholders from participating in the meeting. Subsequently, an adjourned meeting takes place with a reduced quorum of 30 per cent. According to the JSC law, if an extraordinary meeting did not take place due to the absence of a quorum, the adjourned meeting may have a
can be paralysed by a court injunction that grants provisional remedies through ‘protective measure’, as happened at Lukoil, a major Russian oil company.\textsuperscript{84}

This method became widely used because the practitioners found ways to avoid formal constraints in the legal and judicial system by exploiting their weaknesses. For example, a private shareholder was able to file a lawsuit with the court of general jurisdiction where the plaintiff resided, rather than with the arbitration court where the company involved was registered.\textsuperscript{85} In filing such a lawsuit, the shareholder thus was able to choose a jurisdiction where it was known there are ‘friendly judges’.\textsuperscript{86}

The problem was that prior to the adoption in late 2001 of the new code of procedure for arbitration courts, jurisdictions between arbitration courts and courts of general jurisdiction used to overlap. This meant that a single commercial dispute was contested


\textsuperscript{85} \textit{Vedomosti}, ‘Samaia tsennaia bumaga’. When initiating such judicial processes, the potential defendant’s place of registration (i.e. registered location of the company in this case) can be different from the place of residence of the plaintiff, the third party private shareholder who files a lawsuit to obtain a court injunction.

\textsuperscript{86} Golikova, ‘Oruzchie v zakone’, p.40.
in parallel in two courts, as a result of which contradictory rulings were given by each court.\textsuperscript{87} Due to the absence of ‘the court of last resort’ uniting both systems,\textsuperscript{88} it was not possible to determine which ruling should be enforced.\textsuperscript{89} In response to increasing numbers of the problems involving overlapping jurisdictions, Arkadii Vol’skii, President of the Russian Union of Industrialists and Entrepreneurs (RSPP), appealed to the Supreme Court in September 2001, requesting that the possibility of a private individual shareholder filing a lawsuit against a company with a court of general jurisdiction should be restricted. He also requested that the court of general jurisdiction should be prohibited from freezing company assets under the pretext of ‘protective measure’, and that arbitration courts should consider all commercial disputes.\textsuperscript{90}

The misuse of ‘protective measures’ stems also from other weaknesses in the arbitration procedure code. The code did not provide a comprehensive list of provisional remedies to be granted by ‘protective measure’, and therefore the court may grant any protective measure it considers reasonable.\textsuperscript{91} Russian law lacked certain criteria which help prevent the misuse of ‘protective measures’, such as a finding that the plaintiff’s case has some minimal degree of merit.\textsuperscript{92} Thus, legal and judicial system have enabled the instrumental use of court injunctions, which have been used to limit shareholder rights.


\textsuperscript{88} The arbitration courts are subordinate to Supereme Arbitration Court, while courts of general jurisdiction are subordinate to the Supreme Court. The Supreme Court has no authority over Supreme Arbitration Court. See \textit{OECD Economic Surveys: Russian Federation}, 2004, p.95, n.2.

\textsuperscript{89} Tompson, ‘Judicial Reform Moves Forward in Russia’, p. 195.


\textsuperscript{91} Bloom et al., ‘Russia’, p.6.

\textsuperscript{92} Clateman, ‘More Yukos’.
2.3.2 Share Dilution

The OECD Principles state that shareholders have the right to participate in, and to be informed about, decisions concerning fundamental issues such as amendments to the statutes, and the authorisation of additional shares.\(^\text{93}\) However, in Russia, these rights have frequently been infringed. This has resulted in the dilution of the shares of shareholders, which in turn, violates the basic rights of shareholders to some share in the profits.\(^\text{94}\) Share dilution appears to be very common in Russia. According to Dmitrii Vasiliev, the former chairman of the Federal Securities Commission (FCSM), “Violations of the rights of shareholders most frequently occur during share issues, which have resulted in most new issues almost always plagued with violations”.\(^\text{95}\)

Originally, the legislation provided only limited protection for shareholders against share dilution. Thus, there were exploitable ‘loopholes’ in the law. Although a new share issue required a three-quarters majority shareholder vote, after this, the board of directors was able to control the entire process: With a simple majority, the board of directors could make decisions about the actual issuing of the new shares.\(^\text{96}\) In addition, shareholders had no pre-emption rights in respect of shares placed through private offering or so-called closed subscription.\(^\text{97}\) As a result, there have been cases where shareholders were not consulted when the board was issuing additional shares to new

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\(^{93}\) Ibid., p.28.


\(^{95}\) Vasiliev, ‘Corporate Governance in Russia’, p.6.


\(^{97}\) Denis Uvarov and Iain Fenn, ‘Aspects of Corporate Governance in Russia’, Law in Transition, Autumn 1999, p.65.
investors or to a limited group of existing shareholders. Even where an offer purported to be a public offer, if the company required that payment be made in kind, which most existing shareholders were unable to do, the offer became de facto a closed offer.

The Law on Protection of Rights and Lawful Interests of Investors on the Securities Market (Investor Protection law) of 1999 sought to limit share dilution by requiring that any closed subscription should be approved by two-thirds of shareholders and also that shareholders be given the option of paying cash for their quota of a new issue. The Investor Protection Law also required the company to redeem the shares of those shareholders who voted against the resolution, or who abstained from voting. However, although this law sought to close gaps that enabled share dilution, its effect has been limited. This is because if shareholders are barred from exercising their rights to vote at shareholders meetings, and decisions about additional share issue are taken without their participation, their shares could still be diluted.

2.3.3 Self-Dealing

The OECD Principles stress that all shareholders, including minority and foreign shareholders, should be treated equitably by controlling shareholders, boards, and management. The OECD Principles call for prohibitions on insider trading and abusive self-dealing, which “occurs when persons having close relationships to the
company exploit these relationships to the detriment of the company and investors".\footnote{Ibid., p.33.} Such practices constitute a breach of good corporate governance because they violate the principle of equitable treatment of shareholders.\footnote{Ibid.} In Russia, self-dealing in the form of so-called transfer pricing and asset stripping, through which insiders gain at the company’s expense, often to the detriment of minority shareholders, has been considered as the most detrimental feature of Russian corporate governance.\footnote{Nestor and Jesover, ‘OECD Principles of Corporate Governance on Shareholder Rights and Equitable Treatment: Their relevance to the Russian Federation’, p.9.}

**Transfer Pricing Scheme**

In Russia, manipulation of transfer pricing has been practised to divert cash flow.\footnote{Rozinskii, ‘Mekhanizmy poluchenii dokhodov i korporativnoe upravlenie v rossiskoi ekonomike’, p.168.} A transfer pricing scheme was employed by Russian companies to redirect revenue streams with the use of offshore intermediaries.\footnote{Golubkov, Osobennosti korporativnogo upravleniya v Rossii, p.68.} For example, under a typical scheme a Russian company sells products to its offshore intermediary, created by its management team, at below the market price. The management team uses this offshore company to sell the goods on to the international market at the world price. The profit made by the Russian company is kept at the minimum to avoid profits tax, and the revenues that accrue from the transactions remain offshore.\footnote{Ibid., pp.68-70.} The scheme involves a chain of intermediaries, and the transactions are made under both official and unofficial contracts.\footnote{Ledeneva, *Unwritten Rules: How Russia Really Works*, p.23.} Such schemes have been essential ‘standard operating procedures’ for Russian business.\footnote{Rozinskii, ‘Mekhanizmy poluchenii dokhodov i korporativnoe upravlenie v rossiskoi ekonomike’, pp.168-170, 177-178. Financial schemes have been used as a way of avoiding taxes and achieving capital flight. See Iakovlev, ‘Pochemu v Rossii vozmožhen bezriskovyi ukhod ot nalogov?’.}
An example of a transfer pricing scheme is where the holding company makes a purchase at below the market price from one of its subsidiaries, leaving the subsidiary with operating costs and debts. The Yukos, Sibneft and Sidanco oil companies have engaged in this practice.\textsuperscript{112} According to a 2000 report by a Russian investment bank, a production subsidiary of the oil company Sibneft was selling oil at USD2.20 per barrel, while the average export price was USD13.50.\textsuperscript{113} In order to hide its income, the profits made from manipulating the transfer prices, were transferred to an intermediary company, Runicom, located in an offshore tax haven, to the detriment of the shareholders of the subsidiary.\textsuperscript{114} The transfer pricing practices of the oil companies have become problematic because by turning their subsidiaries into cost centres, the value of these subsidiaries has been transferred away from their shareholders.\textsuperscript{115}

**Asset Stripping**

In addition to transfer pricing schemes, so-called asset stripping has deprived shareholders of their dues. Asset stripping occurs when a company's assets are transferred to another company controlled by the insiders, which can shrink the value of the original company. Russian oil majors, such as Yukos and Sibneft, were accused of both asset stripping and transfer pricing.\textsuperscript{116} In the case of Gazprom, the Russian gas


\textsuperscript{114} Ibid.

\textsuperscript{115} Mobius and Filatov, ‘Corporate Governance in Russia: the Battle for Shareholders’ Rights’, pp. 66-67; Moser and Oppenheimer, ‘The Oil Industry: Structural Transformation and Corporate Governance’, p. 316; Lee S. Wolosky, ‘Putin’s Plutocrat Problem’, *Foreign Affairs*, 79, March-April 2000, (available at EBSCO database, http://search.epnet.com/direct.asp?an=2807959&db=aph accessed 1 April 2004). According to Wolosky, “in the first nine months of 1999, Yukos forced its three partially owned subsidiaries to sell it some 240 million barrels of oil at approximately $1.70 per barrel – at a time when the average market price was about $15. Yukos then exported nearly a quarter of that oil to world markets. And so Khodorkovsky’s Yukos managed to siphon off some $800 million during a span of approximately 36 weeks”.

\textsuperscript{116} Jeannie Whalen, ‘Sibneft Courting New Investors’, *Moscow Times*, 6 June 1998,
monopoly, its minority shareholders feared that a company called Itera was expanding as a result of asset-stripping by Gazprom.\textsuperscript{117} It was speculated that Itera was linked to Gazprom and enjoyed cheap access to its development licences and vast pipeline network.\textsuperscript{118} In another example, asset stripping occurs when valuable assets of a company under the bankruptcy receivership are transferred to another entity controlled by insiders, leaving the company an empty shell, as happened at Russia’s largest alumina refinery, Achinsk Alumina Combine (AGK).\textsuperscript{119} In addition, asset stripping can occur when company managers, under threat of a hostile takeover, transfer assets to another entity prior to the takeover in order to protect their assets.\textsuperscript{120}

The JSC Law, the main legislative act regulating corporate governance in Russia, has enabled shareholders to block certain types of actions, such as transfers of valuable assets from one company to a related entity that could result in asset stripping.\textsuperscript{121} The JSC Law requires the approval of the general shareholders’ meeting or the board of directors to effect transactions which qualify as ‘major transactions’ (\textit{krupnye sdelki}).\textsuperscript{122} Transactions that involve more than 25 per cent of the asset value of the company need the approval of the board, while transactions involving more than 50 per cent of the company’s assets require a 75 per cent shareholder vote.\textsuperscript{123} However, when the transfer


\textsuperscript{121} Sprenger, ‘Corporate Governance in Russia’, p.8.

\textsuperscript{122} Oda, \textit{Russian Commercial Law}, p.128.

\textsuperscript{123} The definition of a major transaction is given in article 78 of the JSC Law. A major transaction is defined as a transaction with a value above 25 per cent of the company’s book asset value or, in relation to the issue of new shares, an issue in excess of 25 per cent of the outstanding shares. Transactions with a value of between 25 and 50 per cent of the company’s book value of assets are
of key corporate assets takes place at very cheap price to entities affiliated or controlled by management, these transfers are often ‘subdivided’ to bypass these approval requirements. In addition, a large degree of freedom in asset valuation under Russian accounting standards is said to have reduced the effectiveness of this rule.

Legal provision for shareholder approval of so-called interested party transactions has also become prone to instrumental use by company managers to the detriment of minority shareholders. Examples of interested party transactions include transactions entered into by the company with shareholders owning 20 per cent or more of the company’s voting shares, directors, other officers and their affiliated parties. Most transactions of more than two per cent of the company’s book asset value with an interested party are subject to shareholder approval. An ‘interested party’ is any entity or person in a position to be able to influence the decision of the company that also stands to benefit from the transaction in question: such interested parties are prohibited from voting. However, generally such transactions do not come before the shareholders for approval because they have been structured within a non-transparent ownership arrangement such that the entity with whom the company is dealing does not fall within the statutory definition of an interested party. Lack of a clear definition of an interested party, together with the absence of credible sanctions for failure to disclose

125 Sprenger, 'Corporate Governance in Russia', p.8, n2, quoting information from Troika Dialog report from 1999.
126 Ibid., p.65. (Art 82).
127 Uvarov and Fenn, 'Aspects of Corporate Governance', p. 64. Interested party transactions are subject to approval by a majority vote of shareholders, who are not the interested party concerned in the particular transaction. Ibid., p.65.
128 Ibid.
interested party transactions, and lack of access for shareholders to information about company transactions, have all contributed to the problem of shareholder rights violation through interested party transactions conducted by insiders during the 1990s.\textsuperscript{129}

In relation to interested party transactions, the JSC Law referred to the definition of an 'affiliated person' of an interested party in the anti-monopoly legislation.\textsuperscript{130} However, the requirement that covers the definition of 'affiliated person' of an interested party is difficult to enforce, and in the case of affiliated entities incorporated outside Russia, it is almost impossible to enforce.\textsuperscript{131} In addition, affiliation is sometimes effected through individuals so that it is virtually untraceable, and consequently the requirements of the law become unenforceable.\textsuperscript{132} Thus, weaknesses in the legal provision, and the practicalities of enforcing the rules, combined with the exploitative attitude of business practitioners toward the law, have all contributed to making ICGPs such as asset stripping possible.

2.3.4 Non-Transparent Ownership

The corporate governance framework, as the OECD Principles emphasise, should ensure timely and accurate disclosure and transparency on all material matters regarding the company, such as its financial situation, company performance, major ownership structure and voting rights, members of the board and key executives, ownership, as well as governance structure and policies of the company.\textsuperscript{133}

\textsuperscript{129} White Paper on Corporate Governance in Russia, (Moscow: OECD, 2002), p.15.
\textsuperscript{130} A definition is provided in Article 4 of the Law on Competition and Limitation of Monopolistic Activity on Commodities Markets. See Uvarov and Fenn, 'Aspects of Corporate Governance', p. 65.
\textsuperscript{131} Ibid.
\textsuperscript{132} Ibid.
\textsuperscript{133} OECD Principles, pp.37-38.
In Russia, lack of transparency in the ownership patterns of companies has often been highlighted.\textsuperscript{134} In general, a company is controlled by an inner-circle consisting of several partners, and control is distributed among them through affiliated corporate satellites such as funds, offshore companies, nominal holders, individuals, etc. rendering the real owners difficult to trace.\textsuperscript{135} A particular owner of a company insulates himself by establishing ‘front’ companies that are organised in a multi-layered financial network.\textsuperscript{136} For example, Klebnikov shows how a sophisticated network of companies with opaque ownership structures was the quintessence of Boris Berezovskii’s empire.\textsuperscript{137}

An ownership structure composed of intricate interweavings of offshore networks seems to be managed on the basis of informal relations and personal trust. According to an investigative report by the \textit{Financial Times},\textsuperscript{138} Stephen Curtis, who reportedly had been one of the architects of “a dizzying array of shell companies in tax havens around the world” for Yukos Oil Company,\textsuperscript{139} and was personally managing profits through companies that were informally controlled by Yukos, explained that the basic principle

\textsuperscript{134} Dmitrii Ladygin, ‘Kto v Rossii Vsekh Prozrachei’, \textit{Kommersant}, 16 September 2002, p.13. According to Standard & Poor’s 2002 Russian Transparency and Disclosure Survey, which analyses the disclosure levels of 42 Russian companies, representing about 98 per cent of Russia’s total market capitalisation, average disclosure level for Russian companies based on ownership structure, financial information, board and management structure and investor relations, at 34 per cent fell short of the emerging Asian regions and was comparable only with levels in Latin America. ‘S&P Issues Russian Transparency and Disclosure Survey’, Information Release, 13 September 2002, Standard & Poor’s.


\textsuperscript{137} Paul Klebnikov, \textit{Godfather of the Kremlin: Boris Berezovsky and the Looting of Russia} (New York: Harcourt, 2000), p.89-90. Avtovaz, the leading car maker, had a financial relationship with Forus Services, established by Berezovskii and two other founders, which was owned by Forus Holding (Luxemburg), which in turn was owned by the holders of bearer shares including Anros SA, a shell company in Lausanne.


\textsuperscript{139} According to this FT report, Curtis managed offshore money for Arab clients, and Russian new riches, including Berezovskii.
of the financial structure was that "A huge amount of the structure was based on trust". Yurii Dubov, an entrepreneur and writer, points out that in the Russian business community, relations are governed not by formal rules or norms, but by a code of honour, loyalty and friendship, that is, 'poniatia' or 'understandings'.

The chain of offshore companies or affiliates is often arranged in such a way that the names of the real owners do not appear on the ownership registration. Real owners disguise their ownership by buying shares through one or more offshore shell companies that are not traceably connected to the beneficial owners. Therefore, although the JSC Law requires detailed disclosure of major shareholdings by a company when the threshold of 25 per cent of ownership is passed, the company can satisfy this rule without disclosing the beneficial owners. Requirements for disclosing ownership are contained with several different laws and regulatory acts, and sometimes can be contradictory. For example, some consider the percentage of authorised capital while others look at the percentage of votes. It should be noted also that in the face of such a non-transparent network of offshore entities (which other shareholders are not part of), circumvention of the aforementioned interested party rule would become possible. Russia lacks a strong disclosure regime, which would enhance shareholders' ability to monitor the company and exercise their voting rights, and would enable shareholders to have the necessary information to ensure their equitable treatment.

140 Catan, 'Before the Crash'.
142 Radygin and Sidrov, 'Sto let odinochestva', p.52.
143 Nestor and Jesover, 'OECD Principles of Corporate Governance on Shareholder Rights and Equitable Treatment', p.5.
144 Ibid.
146 Ibid.
147 Ibid., p.38.
2.3.5 Bankruptcy as a Takeover Instrument

The *OECD Principles* requires that the role of stakeholders should be recognised as being established by law, and the corporate governance framework should encourage active cooperation between corporations and stakeholders. Stakeholder rights as established by law, such as labour law, business law, and insolvency law, should be respected. Further, the *OECD Principles* state that the market for corporate control should be transparent such that shareholders understand their rights to recourse.

In Russia, creditors as stakeholders have generally been unable to involve in a corporate governance process. Moreover, the bankruptcy proceedings have not functioned as mechanisms for liquidating or rescuing distressed companies. Instead, the bankruptcy proceeding have become a widely used mechanism for hostile takeovers, or they have been used to stage 'fictitious bankruptcy' by a group of insiders trying to avoid paying creditors. Manipulation of bankruptcy proceedings for the purpose of a hostile takeover have become known as 'bankruptcy to order' (*zakaznoe bankrotstvo*), or 'contract' bankruptcy (in the sense of 'contract' killing). In one prominent case, BP Amoco, which held 10 per cent of the shares of the oil company Sidanco, claimed in 1999 that Chernogorneft, Sidanco's most valuable subsidiary, had been artificially bankrupted by TNK, another major Russian oil company. TNK, having acquired debts from creditors, took advantage of bankruptcy proceedings and obtained control over

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148 *OECD Principles*, p.35.
149 Ibid., pp.29-30.
150 Tompson, 'Reforming Russian Bankruptcy Law', pp. 154-162.
151 According to an internet poll conducted by Investor Protection Association of Russia in 2001, these two forms of staged (or opportunistic) bankruptcies ('fictitious bankruptcy' and 'bankruptcy to order') rated second highest percentage point (20 per cent) as the typical violation of shareholder rights in Russia. The first was asset stripping and transfer pricing (39 per cent), followed by share dilution (20 per cent). See http://www.corp-gov.org/index.php3, accessed January 20 2002.
Weaknesses in the Law on the Insolvency (Bankruptcy) of 1998\textsuperscript{153} have triggered the use of bankruptcy proceedings as a means for carrying out hostile takeovers. In 2001 Tat’iana Treifilova, the head of the Federal Service for Financial Rehabilitation (FSFO), which had been responsible for supervising bankruptcy proceedings before it was abolished by presidential decree in March 2004,\textsuperscript{154} claimed that in approximately 30 per cent of cases, creditors were more interested in bringing a change in ownership of a particular company than in recovering a debt.\textsuperscript{155} From the business people’s point of view, in the absence of a developed capital market and in the context of a weak rule of law, and hence a non-transparent market for corporate control, the use of bankruptcy law to initiate bankruptcy proceedings has become an inexpensive way to take over a company.\textsuperscript{156} In effect, the law has created a non-transparent ‘market’ for hostile takeovers in Russia.

Among the weaknesses of 1998 version of the bankruptcy law that facilitated such conditions are: 1) the debt threshold to file a bankruptcy suit was low; and 2) extensive power was granted to bankruptcy administrators that was not offset by stringent procedures of selection and appointment of administrators.\textsuperscript{157} First, a bankruptcy proceeding could be initiated against a company whose outstanding debts exceeded 500

\textsuperscript{153} The 1998 Law was replaced by a revised version of the Insolvency Law, which took effect in December 2002.
\textsuperscript{154} Some of the functions performed by FSFO was transferred to the new Federal Property Agency, others to the Ministry of Economic Development and Trade.
\textsuperscript{155} This was the result of the in-depth analysis of 100 cases of bankruptcy conducted by FSFO. At the time, FSFO was reviewing 27,000 bankruptcy cases. Interview with Tat’iana Treifilova by Vitalii Golovachev, \textit{Trud}-7, 23-29 August 2001, (http://bankr.ru/doc/75, accessed 30 September 2002).
\textsuperscript{156} Radygin, ‘Oсобенности интеграционных процессов в корпоративном секторе’, p.33.
times the minimum wage or about USD15,000 in 1999, and that failed to meet payment obligations within three months after the due date. In addition to overdue debts, tax arrears or unpaid energy bills were often used to initiate bankruptcy procedures. The 1998 law, however, was intended to correct for the defects in the previous bankruptcy law of 1992. The previous law allowed debtor companies to continue accumulating debts and unpaid bills. The revised 1998 law went to the other extreme: It set the threshold so low that not only truly insolvent companies, but also those capable of servicing debts could be forced into bankruptcy. The number of bankruptcy cases soared after the adoption of the new bankruptcy law from 4,200 bankruptcy cases in January 1998, to 15,200 in January 2000, and 52,500 in January 2002.

Secondly, the 1998 legislation made it possible for court-appointed administrators to exercise considerable power over the bankruptcy procedures. Therefore, for a creditor, who was launching a hostile takeover against a bankrupt debtor, a key to success was to obtain as much debt as possible, then to appoint the creditor's 'own' (svoi) person as the bankruptcy administrator. There are two types of court-appointed bankruptcy administrators: temporary and external administrators. After the court accepted an application for the recognition of a debtor as insolvent, the temporary administrator took charge of the debtor company placed under the observation procedure. The responsibility of the temporary administrator included assessing the

158 Ibid.
159 Sprenger, 'Corporate Governance in Russia', p.8.
161 Ibid.
162 Iurii Simachev, 'Institut nesostoiatel'nosti: osnovnye tendenntsii v primenenii i slozhivshaiasia "struktura sprosa"- vzgliad ekonomista', in Razvitie sprosa na pravovoe regulirovanie korporativnogo upravlenia v chastnom sektore (Moscow: Moskovskii obschestvennyi nauchnyi fond, 2003), p.127.
163 Volkov, 'The Selective Use of State Capacity', p.133.
financial state of the debtor.

However, the problem with the appointment of temporary administrators was that those creditors who filed the application for the initiation of the bankruptcy proceeding often exerted influence over the choice of the temporary administrator, who would be serving the interests of the particular creditors. Once the observation procedure started, the temporary administrator had the authority to give (or withhold) approval for many of the transactions to be effected by the incumbent managers, including the disposal of assets or taking out of loans. Temporary administrators were granted control over the registers of creditors, which enabled administrators to exclude or undervalue the claims of some legitimate creditors or to inflate the claims of others. Moreover, the temporary administrator was responsible for organising the first creditors meeting at which it was decided whether external administration should be introduced as the next step, or whether company liquidation and asset disposal should be initiated immediately. If the decision was to introduce external administration, the candidate for the external administrator must be decided at this meeting.

Upon introduction of external administration, the external administrator was granted substantial power. The external administrator took over the bankruptcy process, as the head of the debtor-organisation was removed from his position and the power of the incumbent management was terminated. External administrators, who were appointed by the court, received authority to make changes to the management and to dispose of assets and control the financial flow of the debtor company. Often, the

166 Ibid.
167 Tompson, ‘Reforming Russian Bankruptcy Law’, p.156.
168 Oda, *Russian Commercial Law*, p.154. This is according to Art. 66.
169 Ibid.
temporary administrator was appointed as the external administrator. Therefore, the creditor who had initiated the procedure could control the entire procedure through the same bankruptcy administrator.\textsuperscript{171} For a creditor who initiated hostile bankruptcy, the appointment of his ‘own’ person as a temporary administrator was particularly important because this temporary administrator could influence the appointment of external administrator by manipulating the minutes of the creditors’ meeting and colluding with the judges.\textsuperscript{172} It has been pointed out that once a creditor managed to appoint his ‘own’ administrator, the bankruptcy became a cheaper and sometimes more reliable way to take over a company than obtaining shares in the target company.\textsuperscript{173}

In order for a bankruptcy takeover to be successful, however, some alliance between the court-appointed bankruptcy administrator and the judges is generally required, as well as political intervention for its enforcement. The cooperation or at least non-interference from regional authorities has become particularly important in bankruptcy proceedings, since arbitration courts have been dependant on regional authorities.\textsuperscript{174} The regional authorities, in turn, often see bankruptcy proceedings as a way to enhance their power base in the region.\textsuperscript{175} By participating in alleged artificial bankruptcy cases, the regional authorities are able to keep abreast of the affairs of the target enterprise, in terms of, for instance how the financial flows will be organised after the takeover.

\textsuperscript{171} Oda, \textit{Russian Commercial Law}, p.155.
\textsuperscript{172} Volkov, Gurova and Titov, ‘Sanitary i marodery’. \textit{Ekspert} 1 March 1999, (http://dlib.eastview.com/sources/article.jsp?id=2797300, accessed 11 August 2003). For example, candidacy of external administrator is confirmed by arbitration court on the basis of the minutes of the first creditors’ meeting organised by the temporary administrator. The minutes are prepared by temporary administrator at the meeting, and cannot be amended once submitted to the court. But the actual preparation of the minutes is not monitored or controlled by anybody — the temporary administrator is solely responsible. Therefore, the temporary administrator can ignore a candidate for external administrator decided at the meeting and deliberately fail to put his/her name in the minutes. This allows the arbitration court to appoint practically any external administrator, regardless of the creditors’ opinions. If the creditor(s) who initiated the bankruptcy does not have his ‘own’ temporary administrator in place, the bankruptcy proceedings may not take place as the creditor desires. Ibid.
\textsuperscript{174} Simachev, ‘Institut nesostoiatel’nosti’, p. 117.
\textsuperscript{175} See ‘Sanitary i marodery’, pointing out Kemerov is the most prominent region in this respect.
Having information on the financial flows of the enterprise, which is usually kept confidential from outsiders, gives the regional authorities some degree of leverage over the enterprise.\textsuperscript{176} For example, it might become easier for the authorities to collect taxes from the enterprise, since they know how much the enterprise is earning. By improving tax collection, the authorities can increase the regional budget. Or they might rely on the enterprise for local employment, thus alleviating social problems. For regional governors or mayors, dealing with such issues as regional budgets or employment, such aspects are crucial in increasing their prospects of being successful in future elections.\textsuperscript{177}

When bankruptcy proceedings were being used to procure a takeover, various actors were involved, such as external administrators, courts, the regional governor, the regional representative of the FSFO,\textsuperscript{178} law enforcement agencies, private security agencies, etc.\textsuperscript{179} In order to proceed with the takeover, an initiating party had to coordinate and mobilise an informal network of these actors, many of whom formally belong to the state, with a view to advancing its economic interests. This informal network is known as the 'administrative resources' (administrativnye resursy), and the use of such administrative resources is crucial to the success of the takeover.\textsuperscript{180}

Thus, instrumental use of bankruptcy proceedings by exploiting the weakness of the law, and making use of political intervention, has made bankruptcy proceedings a mechanism for achieving a hostile takeover. Bankruptcy proceedings have created a non-transparent 'market' for corporate control in Russia, and have undermined

\textsuperscript{176} Izumi Sakaguchi, 'Mikro keizai no shiten kara mita rosia keizai no tokushisei', \textit{Rosiaichousageppou}, November 1999, p.44.
\textsuperscript{177} Ibid.
\textsuperscript{178} After the abolition of FSFO in March 2004, the role described here has been assigned to the Ministry of Economic Development and Trade.
\textsuperscript{179} Volkov, 'The Selective Use of State Capacity', pp.134-135.
\textsuperscript{180} Ibid.
2.3.6 Summary

As has been described, ICGPs are not in agreement with good corporate governance practices as prescribed in the *OECD Principles*. In particular, they go against the principles of the basic rights of shareholders, and equitable treatment of shareholders. In addition, the principles of stakeholder rights, and disclosure and transparency have not been observed. In short, they undermine the foundations of good corporate governance.

The operational specifics of these practices are that of the instrumental use of law through the bending of formal rules. The intention of the law is subverted and different goals are achieved by extra-legal practices. The requirements of the law were purposefully circumvented in Russian business based often on unwritten agreements within an inner circle that were non-transparent to outsiders. For example, the requirements of the JSC Law on major transactions and interested parties were circumvented by the use of a non-transparent ownership structure composed of entities not formally connected to the insiders. With those entities in place, asset stripping could be accomplished without strictly contradicting the letter of the law. In addition, shareholders’ meeting could be made inaccessible to outside minority shareholders with the instrumental use of the JSC Law. When outside shareholders are prevented from exercising their right to vote, insiders can make key decisions that in accordance with the JSC Law requires three quarters of the shareholder vote, while maintaining the appearance of legality. Moreover, resorting to a court injunction, used to freeze outsiders’ shares, can be based on a lawsuit from a formally independent private shareholder, though the plaintiff is often representing the interests of an insider. In the case of ‘bankruptcy to order’, the true intention of bankruptcy law is subverted and it
became a widespread means for corporate takeover. To make such takeovers successful, 
the practice involves exploiting the weaknesses in the legislation, such as the low 
threshold needed to initiate bankruptcy procedures, and the mobilisation of unwritten 
arrangements with actors such as bankruptcy administrators, regional administrations 
and local courts.

In explaining the workings of ICGPs, the institutional environment in which ICGPs 
were used should be emphasised. In particular, ICGPs become operational particularly 
in the context of weak legal institutions. Under a judicial system that lacks 
independence and impartiality, ICGPs show that where there is a will, a way can be 
found to adhere to the letter of the law while contradicting its spirit. The weaknesses or 
loopholes in the law, the weak judicial system, and the practitioner’s exploitative 
attitude towards the law, combined with the weakness of the state, seem all to have 
resulted in the instrumental use of law in the area of corporate governance in Russia.

2.4 Impact of ICGPs

2.4.1 Russia’s Reputation for Corporate Governance Abuses

Given the substantial gap between the principles of good corporate governance and 
Russian corporate governance practices, these practices are acknowledged by 
international organisations, investors and scholars alike as abuses. The OECD, in its 
first Russian Roundtable on Corporate Governance, established in association with the 
World Bank in 1999 to improve corporate governance practices and guide future reform 
efforts,\(^\text{181}\) drew attention to the fact that “Minority shareholders in Russia have often 
faced a range of abuse, including asset stripping, transfer pricing, share dilution,

\(^{181}\) See the information on Round Table on Corporate Governance in Russia at OECD website, 
http://www.oecd.org/document/11/0,2340,en_2649_34813_2351179_1_1_1_1,00.html, accessed 3 
restricted access to shareholder meetings and barring outside investors from taking seats on the board of directors”. 182

The World Bank, in its Corporate Governance: A Framework for Implementation, citing an example of transfer pricing by Russian oil companies, referred to Russia as “A bad case” of corporate governance.183 In addition, the IMF reported that “Weak corporate governance structures have played a significant role in hampering restructuring and efficiency improvement in the enterprise sector. [...] Without effective oversight, managers [...] have reportedly engaged widely in illegitimate activities such as diversion of cash flow and asset-stripping”. 184

In their discussion of Russia’s ‘corporate governance failures’, Fox and Heller point out that the failure to make pro-rata distribution of the residuals the firm generates to the residual claimants through deviations such as share dilution, fictitious bankruptcies, diverting asset through transfer pricing arrangements, has been the most visible symptom of bad corporate governance in Russia.185 Black, Kraakman and Tarassova emphasise the extent of self-dealing by managers and controlling shareholders as Russia’s corporate governance ills.186

In sum, ICGPs – such as share dilution, asset stripping, transfer pricing, limiting shareholders access to votes, and using bankruptcy as a takeover instrument – have earned Russia notoriety for its corporate governance. It has been observed that “Russian

182 ‘Synthesis Note from 1st Russian Corporate Governance Roundtable’, 31 May – 2 June 1999, OECD website, http://www.oecd.org/document/7/0,2340,en_2649_34813_1854919_1_1_1_1,00.html, accessed 3 June 2004, p.3.
184 IMF, Recent Economic Developments, p.126.
corporates have developed probably the worst reputation in the world for abusing shareholder rights".  

2.4.2 Investment Climate as Evidence of ICGPs

ICGPs, being recognised as corporate governance abuses, have been particularly detrimental to Russia’s investment climate. Perhaps the following quote from Mark Mobius, a well-known international investor, captures an investor’s sentiments well:

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".  

According to a survey conducted by McKinsey, an international consulting company, investors are willing to pay a premium on the shares of companies with good corporate governance. The premium for Russia is among the highest, which is indicative of both an unfavourable investment climate and the potential attractiveness of Russian companies. In interviews with Western executives working in Russia, a chief strategist of a leading Russian private bank in reply to the question, “what do you think about Russian corporate governance?” said that:

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187 Nestor and Jesover, ‘OECD Principles of Corporate Governance on Shareholder Rights and Equitable Treatment’, p.3.


189 Mobius and Filatov, ‘Corporate Governance in Russia: the Battle for Shareholders’ Rights’, p.65.


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Poor corporate governance has become an absolutely extreme problem in Russia. It has drawn attention here more than anywhere else and became the strongest barrier to investment in the country. [...] Corporate governance in Russia must become much better than in other emerging markets just because it used to be so awful. 191

Accordingly, ICGPs, the main culprit of the corporate governance problems that have beset Russia, have became the main criteria used by rating agencies and investment houses measuring the corporate governance risks in Russia, against which to assess the quality of corporate governance. For example, Brunswick UBS measured corporate governance risks among Russian companies based on the criteria of low transparency; dilution; asset transfers/transfer pricing; mergers and restructuring; bankruptcy; ownership and voting restrictions; corporate governance initiatives; and registrar quality. The Institute of Corporate Law and Governance (ICLG), headed by the former chairman of the FCSM, Dmitrii Vasiliev, assesses corporate governance in Russian companies based upon ownership structure; board and management structure, focusing on affiliatedness and remuneration; basic shareholder rights, such as voting rights; expropriation risks such as asset transfers, transfer pricing, and dilution; and corporate governance history. 192

The magnitude of the problem is reflected in the increased awareness of the need to improve corporate governance among policy makers. Since the late 1990s, various

private and public institutions – both domestic and international – have made significant efforts to improve corporate governance in Russia. The FCSM published national Corporate Governance Code based on the OECD Principles, with the assistance of several international organisations.

The problem of corporate governance, and its damaging effect on the investment climate, is recognised as a serious obstacle to Russia's efforts to achieve deeper integration in the world community and to become a major player in the global arena. In the words of President Putin:

193 International organisations have been actively involved in corporate governance initiatives in Russia:
- The World Bank announced a technical assistance loan in 1996 to strengthen the institutional capacity of the Federal Commission on Securities Market (FCSM), the market regulator, to supervise and regulate the securities market and provide sound corporate governance. See White Paper On Corporate Governance In Russia, p.71.
- The World Economic Forum in 1999 launched a project called “Changing Corporate Governance in Russia” and created Russian Task Force. White Paper On Corporate Governance In Russia, p.72.

As for Russian authorities, besides FCSM, the Ministry of Economic Development and Trade of Russia’s Department on Business Regulation and Corporate Governance Development formulated and implemented state policy in the area of corporate governance. The State Duma established a Working Group on Improving Corporate Governance in 2001. Ibid. (Information is as of 2001).

Self-regulatory and non-profit organisations that are active include Investor Protection Association (IPA), Russian Institute of Directors (RID), Professional Association of Registers, Transfer-Agents and Depositories (PARTAD), National Association of Professional Participants of Securities Market (NAUFOR). Ibid. Information is as of 2001).

Private institutions include the ICLG, established to improve corporate governance, and its project include CORE’s-rating, the Corporate Governance Rating of Russian Companies. ICLG website, www.iclg.ru, last accessed 1 July 2004. Other institutions such as Troika Dialog, Standard & Poor’s also carry out extensive research on corporate governance. White Paper On Corporate Governance In Russia, pp.63-72.

Corporate Governance Code, p.5. The Code is developed as recommendations, and most of the provisions in the Code, according to the Code, have been reflected in the Russian legislation (p.5). The EBRD, in its effort to promote improved corporate governance in Russia, aiming at bringing standard in line with best international practice, helped the FCSM to develop the country's Corporate Governance Code, officially published in 2002. The code-drafting process is EBRD's single largest legal reform project. EBRD website, http://www.ebrd.com/new/pressrel/2001/01oct18x.htm, accessed 1 July 2004.
Russia has a strategic goal – to become a country that makes competitive goods and renders competitive services. All our efforts are committed to this goal. We understand we have to solve questions pertaining to the protection of owners’ rights and the improvement of corporate governance and financial transparency in business in order to be integrated into world capital markets.195

In fact, the government’s role in creating stable and secure investment climate is critical, as the World Bank study on investment climate indicates. This study shows that policy-related risks – such as policy uncertainty, macroeconomic instability, and arbitrary regulation – dominate investment climate concerns across developing countries.196

2.5 Conclusion

As this chapter has shown, ICGPs have been detrimental in various ways. These practices constitute abuses to shareholders that are not consistent with globally accepted good practice in corporate governance. A substantial gap exists between the principles of good corporate governance exemplified in the OECD Principles of Corporate Governance and ICGPs. In particular, they go against the basic rights of shareholders, and the principle of equitable treatment of shareholders. In addition, the principles of stakeholder rights, and disclosure and transparency have not been observed.

The operational specifics of these practices are that of instrumental use of law through bending of formal rules. The intention of the law is subverted by them and different


goals achieved. The requirements of the laws have been purposefully circumvented based often on unwritten agreements among an inner circle, that are non-transparent to outsiders. ICGPs have become particularly rife in the context of the institutional weaknesses of Russia. The weaknesses or loopholes in the law, the weak judicial system, and the practitioner’s exploitative attitude toward the law, combined with the absence of an autonomous or disinterested state, all combine to aid the instrumental use of law in the area of corporate governance in Russia.

The adverse consequences of ICGPs are that they have undermined the foundations of good governance, and have earned Russia notoriety for its corporate governance. ICGPs, being recognised as corporate governance abuses, have become particularly damaging to Russia’s investment climate. Once a pattern of such non-transparent behaviour which adversely affects minority shareholders becomes established, this further deters investors and depresses the development of a capital market. This, in turn, is not growth enhancing as improving the investment climate is an essential feature for economic growth.\textsuperscript{197}

Notwithstanding such destructive aspects of ICGPs, however, they exhibit constructive facets. There are two aspects to them – constructive and destructive – which coexist and are difficult to separate, and constitute the ambiguity of ICGPs. In what follows, the constructive role of ICGPs is analysed in the context of the tasks of enterprise reorganisation under the post-Communist transformation. Before the in-depth examination of the three case study companies, Yukos Oil Company, Siberian (Russian) Aluminium and Norilsk Nickel, Chapter 3 provides a framework within which to analyse the constructive role of ICGPs in the case studies.

\textsuperscript{197} Ibid.
CHAPTER 3. Reconstitution of Enterprises into Business Firms: Interpreted from the Resource-Based View of the Firm, and the Role of ICGPs

3.1 Introduction

The objective of this chapter is to provide an analytical framework within which to analyse an ambiguity of Russian ICGPs – their constructive and destructive aspects – through the three case studies. To this end, this chapter offers an interpretation of the transformation of post-Soviet Russian enterprises from the resource-based perspective of the firm. According to this theory, a firm is conceptualised as a collection of resources embedded in business functions that are all organised within an administrative framework. Based on this view of the firm, this chapter demonstrates that the restructuring of post-Soviet enterprises entailed their reconstitution into business units, able to engage in commercial activities and compete in a market oriented environment.

In order to show that post-Communist economic transformation of the corporate sector involved the reconstitution of post-Soviet enterprises into business units, Section 3.2 discusses the concept of the firm as a collection of resources organised in an administrative framework. Section 3.3 analyses how enterprises were organised under the Soviet economic system from the resource-based view. Section 3.4 identifies a set of fundamental tasks faced by Russian enterprises in reconstituting themselves as business units. These tasks included establishing an effective administrative hierarchy; integrating business functions under a single point of control; and reconstructing the production chain. The chapter concludes by suggesting that considering ICGPs in the context of fulfilling these tasks points to the constructive role of ICGPs in the face of disintegration of the Soviet economic system and institutional weaknesses.
3.2 The Firm as an ‘Administrative Organisation’ and a ‘Collection of Resources’:
The Resource-Based Perspective

In order for a firm to actually operate – to engage in the production and sale of goods and services in a market economy, it must have certain basic attributes. This point derives from Edith Penrose’s influential work, *The Theory of the Growth of the Firm*, which laid the intellectual foundation for the resource-based view of the firm.\(^1\) According to this view, a business firm is a collection of resources, both human and material, and the services or business functions those resources render.\(^2\) In short, a firm is a business entity that carries out certain business functions. Stating that the economic function of a firm “was assumed simply to be that of acquiring and organizing human and other resources in order profitably to supply goods and services to the market”,\(^3\) Penrose defined a firm “as a collection of resources bound together in an administrative

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framework, the boundaries of which are determined by the ‘area of administrative coordination’ and ‘authoritative communication’. She thus defined a firm based on two sets of attributes: 1) “a coherent administrative organization” and 2) “a collection of resources”.

First, an administrative coordination is an essential aspect of the firm, as one important component of the firm “involves its role as an autonomous administrative planning unit, the activities of which are interrelated and are co-ordinated by policies which are framed in the light of their effect on the enterprise as a whole”. Such an autonomous administrative planning unit has “some form of central managerial direction responsible for the general policies under which the firm’s administrative hierarchy operates”, and this central management (or ‘court of last resort’) must be accepted in practice as the highest authority within the administrative framework of the firm, and must be small enough to make more or less agreed decisions”. For an industrial firm to function, therefore, it must have effective administrative control over the administrative framework within which its industrial activities are coordinated.

The second aspect of the definition of the firm is that the firm is a pool of resources – “a firm is essentially a pool of resources the utilization of which is organized in an administrative framework”. Resources include tangibles as well as intangibles. The physical resources of a firm consist of tangibles such as plant, equipment, land and natural resources, raw materials, semi-finished goods, waste products and by-products, and unsold stocks of finished goods. There is also a variety of human resources

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4 Ibid.
5 Ibid.
6 Ibid., pp.15-16.
7 Ibid., p.16.
8 Ibid., p.149.
available in a firm, including unskilled and skilled labour, clerical, administrative, financial, legal, technical, and managerial staff. According to Penrose, the "full range of resources used in any firm of even moderate size" includes "various grades of management personnel, its engineers and other technical specialists, the minimum sales force needed to reach its market and sell its products, its financial specialists, and even its research personnel".

However, it should be pointed out that "it is never resources themselves that are the 'inputs' in the production process, but only the services that the resources can render". The services rendered by the resources are dependent on the way in which the resources are used. In other words, "Services [...] are the contributions these resources can make to the productive operations of the firm. A resource, then, can be viewed as a bundle of possible services". In addition, the services that the resources yield depend on the capacities of the people using them, and development of the capacities of these people is partly shaped by the resources that they are required to deal with. Resources and the capacities are the two factors that create the special productive opportunity of a firm, which eventually leads to the growth of the firm. With regard to the boundary of the firm, Penrose argues that "it is a firm's ability to maintain sufficient administrative

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9 Ibid., pp.24-25. Emphasis in original.  
10 Ibid., p.69.  
11 Ibid., p.23. Emphasis in original.  
12 Ibid., p.67.  
13 Ibid., pp.78-79. Eventually, some firm resources are developed into so-called 'organisational capabilities', which in turn contribute to the growth of the firm. The chain starts with the collecting of resources to become an actual collection of resources that render various business functions; from the collection of resources to firm's 'organisational capabilities'; and then from 'organisational capabilities' to firm growth. In this chapter, I focus on the resource parts of this chain only, i.e., the most basic attributes or the prerequisites for an organisation to become a 'firm', rather than the issue of how the resources develop into 'organisational capabilities' that lead to competitive advantage and growth of the firm. The concept of 'organisational capabilities' was introduced by Richardson, who elaborated Penrose's ideas. He argued that firm's activities are "carried out by organisations with appropriate capabilities, or in other words, with appropriate knowledge, experience and skills". (Emphasis in original). See G.B. Richardson, 'The Organisation of Industry', The Economic Journal, 82, 327, 1972, pp.883-896. For a recent empirical account of 'organisational capabilities', see Giovanni Dosi, Richard R. Nelson and Sidney G. Winter (eds), The Nature and Dynamics of Organizational Capabilities (Oxford: Oxford University Press, 2000).
co-ordination to satisfy the definition of an industrial firm which sets the limit to its size as an industrial firm". 14

What emerges from the foregoing is a picture of the firm as a collection of resources that are embedded in business functions. The resources of the firm render such functions, as production, procurement of raw materials, marketing, sales, financing, investment, research and development (R&D). Or to put it differently, and following Penrose, it is useful to conceptualise the firm’s resources as enabling the firm, as a business organisation, to perform its business functions. This, in practice, implies the presence of top management and other personnel with appropriate knowledge, skills and capabilities to carry out those business functions – that is, to procure raw materials, produce the actual goods, coordinate production, organise financing, marketing, distribution, research, and so on.

In addition to the resource aspect, there is an administrative aspect to the definition of a firm as emphasised above. In other words, how the business functions are organised is a crucial attribute of the firm, which relates to the question of an administrative control within an appropriate administrative framework. That is, in a firm, the resources that render certain business functions are organised and managed under a single administrative point of control. This conceptualisation of the firm based on resource and administrative aspects is depicted in Figure 3.1. The firm is represented within a triangular administrative framework, in which the collection of the various resources embedded in business functions is pooled. These resources, in turn, are organised within the firm by a top management.

14 Penrose, The Theory of the Growth of the Firm, pp.19-20. Penrose viewed the growth of the firm as the attempt by top managers to fully utilise excess resources.
In sum, varieties of resources are required for a firm to engage in its commercial or business activities in a market economy. As such, a firm can be considered as a collection of technical and organisational resources. The resources of the firm have business functions, such as production, procurement of raw material, marketing, sales, finance, investment, and R&D. In addition, evidence of an administrative hierarchy that can organise these business functions is crucial for the firm.

3.3 Soviet Enterprises from the Resource-Based View of the Firm

3.3.1 Firms under a Market Economy and the Socialist System

The resource-based view of the firm, and any other theories of the firm for that matter, have been advanced on the basis of the experience of Western firms operating under a capitalist system. However, the capitalist system and the socialist system assigned
different roles to firms. Firms operating under the market system and enterprises under the socialist system were different creatures because they served different purposes, and therefore had different features in order to fulfil those purposes.

However, the fact that Soviet enterprises were not really ‘firms’ in the sense of those operating under a capitalist system, may not have been obvious; Simon Clarke points out that the assumption made in Western analyses of Soviet enterprises is that Soviet enterprise were like any other capitalist firms, but had inappropriate incentives. Western analyses of Soviet enterprises have not taken account of the fact that capitalist firms and socialist enterprises had different objectives, served different functions, and thus inevitably were different types of organisations. Clarke emphasises that Soviet enterprises were not simply an imperfect realisation of capitalist firms, but were “social organisms at the heart of the local community”, that sought to expand production for their own benefit, which in turn benefited the social infrastructure of the local community.

In market economies, a firm is a business unit. The general purpose of the firm is to organise the use of resources for the production and sale of goods and services at a profit. In a system-to-system comparison, Janos Kornai shows that one of the main aims of competitive private firms under capitalism is to increase profits, while state-owned enterprises under socialism are primarily interested in gaining recognition from superior organisations for meeting performance criteria. Under the capitalist

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The systemic change from socialism to capitalism necessarily required the transformation and restructuring of Russian enterprises. Russia's economic reforms, centred on liberalisation and privatisation, sought to stimulate adjustments in incentives and to expose enterprises to a buyers' market, hard budget constraints, and competition, encouraging increased entry of new enterprises and the exit of unviable ones. 23 However, the resource-based view of the firm points to the basic prerequisites for a business firm to operate in a market economy. Hence, the resource-based view sheds additional light on the tasks Russian enterprises faced as they sought to transform from state-owned enterprises under the Soviet system to business firms in the market-oriented

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21 Peng points out that enterprises in post-socialist economies exhibit a number of differences from Western firms, such as "lack of complete discretion to acquire and allocate resources and little knowledge and experience to compete in a competitive, market-based economy". 22

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21 Ibid., p.264. Kornai argues that in general, the fundamental difference between the classical socialist system and the capitalist system is that the former is marked by a 'seller's market' – with some caveat in the use of the word 'market' – while the latter is a 'buyer's market' (pp.245-252). In this connection, Havrylyshyn and McGettigan point out that the workable 'model' of transformation from socialism to capitalism includes the following two key changes: First is the enforcing of the move from a sellers' to a buyers' market (through price liberalisation) and second is the imposition of a hard budget constraints (through privatisation and eliminating various government support mechanisms). See Oleh Havrylyshyn and Donal McGettigan, 'Privatization in Transition Countries: A Sampling of the Literature', IMF Working Paper, WP/99/6, January 1999, p.10.


system. To appreciate this task more, it is worth examining what former Soviet enterprises looked like, and in what ways they differed from Western firms from the resource-based view discussed above. In the context of the resource-based view of the firm, and more specifically, Penrose's definition of a firm as a collection of resources organised in an administrative framework, the following section discusses the general features of Soviet enterprises based on their administrative as well as their resource aspects.

3.3.2 Administrative Aspects: 'USSR Inc.'

Soviet enterprises were an integral part of the Soviet economic system, a system that was based on centralised planning, implemented administratively through commands and instructions. The Soviet economic system was characterised by the party bureaucracy as a single entity encompassing the whole of society. The core concept of the Soviet economy, at least until the mid 1980s, was that the economy as a whole must be run as an integrated, single complex on the basis of a system of commands. An individual Soviet enterprise, in such a system, was more appropriately a 'production unit', located at the lowest level of the economic hierarchy.

The hierarchical economic planning system of the Soviet Union was composed of all-union ministries and state committees. State committees included the State Planning Committee (Gosplan), the State Committee for Material-Technical Supply (Gossnab), and other committee for prices, labour, etc. The heads of those committees, and industrial ministers constituted the Council of Ministers, the chief executive body of the

Soviet government. The Communist Party of the Soviet Union (CPSU) stood at the top of the hierarchy, with the main economic policy makers belonging to the Central Committee of the CPSU.\(^27\)

Under the Soviet economic system, central planning and bureaucratic control dictated to the enterprises about product lines, procurement, and distribution.\(^28\) Relations between enterprises were also bureaucratically coordinated.\(^29\) The central planning system, via Gosplan, the top planning agency, administratively imposed production targets on each producer-enterprise. Gosplan dictated to enterprises what they should produce, and how much to produce, and allocated their production either for delivery to other domestic enterprises, or for export. Finances were also allocated according to established plans. Based on the quantity of products required from them, enterprises were provided with the resources needed and the items needed to maintain and replace equipment. Soviet enterprises, therefore, were production units whose responsibility was to meet the targets set by the central plan. Even large enterprises, despite their huge scales of production, were not autonomous entities with economic accountability. As Yudanov argues, “large Soviet industrial enterprises could be regarded not as independent entities, but as operating units within the framework of the countrywide superstructure”.\(^30\)

As operating units, or production units of the Soviet economic system, Soviet enterprises had limited decision-making managerial power. Each enterprise was ultimately subordinate to a branch ministry, the administrative body that supervised the


\(^29\) Kornai, *The Socialist System*, p.98.

particular sector of the economy. Branch ministries were responsible for selecting enterprise managers. They were charged with controlling planning targets, and managing resource availability, flows of capital, R&D, product introductions and the distribution of output by enterprises. They also coordinated vertical and horizontal relationships between enterprises.\textsuperscript{31} Ministries were divided into main administrations known as \textit{glavki}, which had different responsibilities within the ministry. Managers of enterprises had a degree of influence over decision making through various bargaining processes,\textsuperscript{32} but primarily in terms of trying to achieve looser plans, i.e., negotiating a lower target output assignment, or more generous input quotas.\textsuperscript{33} A vast majority of decisions, and particularly the more crucial ones, were made at higher up in the hierarchy.\textsuperscript{34}

The limited executive decision making authority within individual Soviet enterprises differentiates Soviet enterprises from Western firms. The basic responsibilities of top management in capitalist industrial firms include strategic planning and the allocation of resources necessary to implement the strategy: In a firm, it is the top management, or administration, that carries out executive action, gives orders, and makes decisions related to coordinating, appraising and planning the work of the firm.\textsuperscript{35} However, as Soviet enterprises were the lowest units working within the framework of the


\textsuperscript{32} Bruce Kogut and Andrew Spicer, ‘Capital Market Development and Mass Privatization are Logical Contradictions: Lessons from Russia and the Czech Republic’, \textit{Industrial and Corporate Change}, 11, 1, p.13.

\textsuperscript{33} Kornai explains the ‘plan bargaining’ that characterised the socialist economies. There was continuous vertical bargaining between superiors and subordinates, who regularly pushed for a looser plan. As the economy became more deregulated the subject of bargaining gave way to officially permitted prices, wages, taxes, subsidies, credit terms, import licenses and foreign exchange allowances. See Kornai, \textit{The Socialist System}, pp.122-123, 487-488.

\textsuperscript{34} Kornai, \textit{The Socialist System}, p.271.

countrywide administrative planning hierarchy, they did not perform these executive functions.

Given the narrow scope for managerial power vested in individual enterprises in the USSR, Yudanov points out that an ‘enterprise’ in the Russian meaning is synonymous with a ‘plant’ rather than a ‘firm’ in the Western sense of the word.\(^\text{36}\) In other words, a Soviet industrial enterprise was not a business firm in the Western sense of the word, but was more like a production unit within a single huge firm, as Hanson puts it, ‘USSR Inc.’\(^\text{37}\) From this viewpoint, ‘USSR Inc.’ was the largest firm in the world.\(^\text{38}\) This huge countrywide structure of economic hierarchy is illustrated in Figure 3.2. ‘Top management’ of the ‘USSR Inc’ was the state bureaucracy. CPSU developed the overall policies, Gosplan rendered the policy operational, and the ministries supervised the enterprises. Enterprises were the lowest production units within the administrative framework of ‘USSR Inc.’

\(^{36}\) Yudanov, ‘USSR: Large enterprises in the USSR’, p.405.


At the level immediately above enterprises, was the so-called production associations, under whose umbrella were several production units. Production associations were established as part of the 1973 reforms of industrial reorganisation, by amalgamating and integrating related enterprises. The establishment of production association merged enterprises to become a smaller number of larger units. In this way the reform sought to create more efficient and more controllable units.\(^{40}\) The 1973 industrial reorganisation also aimed at devolving some of the decision making function to the production associations, and drawing power away from the ministries. However, the state bureaucracy continued to be the ‘top management’ of ‘USSR Inc.’, and the production associations were really no more than “production units writ large”.\(^{41}\)


\(^{40}\) Hewett, *Reforming the Soviet Economy*, pp.248-249.

Subsequent developments did not fundamentally alter the administrative aspects of Soviet enterprises. At the time that Mikhail Gorbachev initiated a reform process in 1985, most of the managerial functions typically found within firms in market economies were not located either in the enterprises, or in the production associations. Instead, they were performed by one or more departments of the various branch ministries. In order to increase the economic autonomy of individual enterprises, Gorbachev promoted a policy designed to decentralise the decision making. For example, the 1987 Law on the State Enterprise gave enterprises more control over their finances, and allowed them to set their own production plans. However, the law did not change the position of enterprises in the economic hierarchy. They were still subordinate to a superior branch ministry, and Gosplan. Gosnab coordinated the flows of materials based on the processes of production and distribution. The enterprises’ own plans still had to be in line with branch objectives, guideline figures, and state orders for output from the central authorities.

3.3.3 Resource Aspect: ‘Outsourcing’ of Business Functions

As has been emphasised, the resource-based view defines a firm in a market economy in terms of a collection of resources that render business functions, such as finance, R&D, marketing, procurement, sales, etc. This suggests that these resources are the prerequisites for a firm to be a business unit. From the resource-based view, the enterprises under the Soviet economic system lacked various resources and were therefore not self-contained business units. In other words, as Radosevic points out,

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42 Joskow and Schmalensee, ‘Privatization in Russia: What should be a Firm?’ , p.93
43 Ibid.
44 Hewett, Reforming the Soviet Economy, pp. 322-323.
45 Hanson, The Rise and Fall of the Soviet Economy, pp.196-198.
46 Tat’iana G. DolgopiatoVa, Rossiiskie predpriiatia v perekhodnoi ekonomike: ekonomicheskie problemy i povedenie (Moscow: Delo, 1995), p.56.
47 Hanson, The Rise and Fall of the Soviet Economy, pp.196-198.
several of the business functions that were performed by individual firms in the West, were not organised as 'in-house' activities but were 'outsourced' to ministries and other organisations. Resources embedded in various business functions were scattered across a huge Soviet industrial framework of 'USSR Inc.' and enterprises, whose business functions were 'outsourced' to other organisations in the Soviet economic hierarchy, were not fully-fledged business firms.

Soviet enterprises did not internalise business functions within themselves in the following sense. For example, in the area of procurement, branch ministries were responsible for allocating supplies to their enterprises. The financing function was managed by various agencies, such as the Ministry of Finance and Gosbank (the State Bank). The Ministry of Finance provided a portion of the funds directly from the state budget. The Investment Bank, or Stroibank, was in charge of the actual disbursement of finance, while Gosbank provided funds for general repairs. In the area of R&D, there were technical or research institutes that served industry as a whole. The marketing of products abroad was the responsibility of the Ministry of Foreign Trade, which was subordinate to Gosplan and the Council of Ministers. Actual sales were conducted by the Foreign Trade Organisations. Thus, individual enterprises were production units that 'outsourced' their other business functions to various different organisations.

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49 Gregory and Stuart, Russian and Soviet Economic Performance and Structure, p.98. 
50 Ibid. The primary function of Gosbank was to grant credit to enterprises in whatever amount necessary to fulfil the plan for output and investment. From enterprise's point of view, capital was virtually a free good. IMF et al., A Study of the Soviet Economy, vol.1, p.10.
51 Ibid.
52 Radosevic emphasises that the operation of the Soviet economic system involved all the actors in the hierarchy, be they Gosplan, the branch ministries, or the production units/enterprises, who were linked through often complex hierarchical relationships. See Radosevic, 'Transformation of Science and Technology Systems into Systems of Innovation in Central and Eastern Europe', pp.290-292.
By the 1970s, the ‘outsourcing’ of various business functions across the system was recognised as a weakness of the Soviet economic system. Aleksei Kosygin, the then prime minister who initiated the 1965 reform, in 1970 wrote: “Standing alone, the plant finds it hard to identify demand, arrange supply and marketing, improve specialization and cooperation, centralize auxiliary operations, etc. These functions must be vested in the [production] associations”. As mentioned above, production associations were established as part of the 1973 reform. However, these production associations fell short of internalising such functions as distribution, marketing, purchasing and financing, that were found in an industrial firms in market economies.

Integration of business functions

The ‘outsourcing’ of business functions under socialism meant that individual enterprises were not acting as integrators of the various functions. That is, enterprises did not have the capability to bring together various business functions under one umbrella. However, in order to produce a product, different resources or business functions need to be integrated. For example, the R&D function has to be in place for the product to be developed. Financing has to be secured to fund the product. Sales and marketing functions are necessary to enable the product to be distributed and marketed. Moreover, production needs to be integrated or linked with all of these functions, and a management has to be in control of the whole process. In market economies, a firm is an integrator of resources in the sense that these various business functions are integrated within a single firm. Under the Soviet system, these individual business

54 Ibid., p.410.
functions were distributed across the hierarchy. Financing was carried out by Gosplan and the ministries. Marketing was located in the foreign trade organisations. Strategic decision making was managed by Gosplan, the branch ministries, and glavki. Thus, in the context of post-Soviet transformation of enterprises, these functions had to be brought together, i.e., to be integrated and self-contained, within each of the enterprises, in order that a marketable product could be produced by a single unit.

**Organising a production chain**

There is another layer to the resource and capabilities side of a firm. Production must be organised across several tiers of suppliers that are all involved in successive stages of production. However, Soviet enterprises did not have the capacity to organise successive stages of production by facilitating the linking of a network of related enterprises.\(^{56}\) For example, a multi-component product, for example a car, involves several components that are products in themselves, such as the engine. In order to produce a product that is comprised of several component products, a firm has to integrate or organise a network of first tier suppliers, second tier suppliers, and so on. While firms in market economies act as organisers of a production chain, in the Soviet system the centralised planning system took care of organising the production network and operated as organiser of the production chain.\(^{57}\)

**Soviet enterprises as a collection of resources?**

Although the Soviet enterprise can be viewed as a collection of resources, these resources were those suited and needed in the Soviet type economy.\(^{58}\) For example, to

\(^{56}\) Ibid. Radosevic terms this organisation of a network of related enterprises as *network integration at the firm level.*  
\(^{57}\) Ibid.  
\(^{58}\) Uhlenbruck et al., ‘Organizational Transformation in Transition Economies: Resource-Based and Organizational Learning Perspectives’.
survive under the shortage economy that was characteristic of the Soviet economy, certain managerial skills were required. They included bargaining skills in order to negotiate over performance targets, or to secure supplies. Particularly crucial was the ability to mobilise informal networks, using blat. Although Soviet enterprises possessed the resources needed to function as production units of the Soviet economic hierarchy, they were not endowed with the technical, financial and organisational resources typical of firms in market economies. Individual enterprises did not integrate various business functions under a single control, or did not organise the production chain. Nevertheless, as pointed out earlier, Soviet enterprises performed significant social functions, such as provision of welfare services to the local community.

3.4 Reconstitution of Post-Soviet Enterprises into Business Unit: Tasks Confronting Management

Based on the foregoing discussion, the most basic attributes of a business firm in a market economy can be identified from the resource-based view of the firm. The most important is evidence of effective administrative coordination and control, which defines the framework of a business firm. This requires clear administrative control, and top management able to take on the responsibility of coordinating and appraising and plan. Secondly, the firm must integrate the technical and organisational resources embedded in various business functions such as production, raw materials procurement, financing, marketing, R&D, etc. In other words, these various business functions must be brought together under a single control within the administrative framework of the

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60 Ledeneva, *Russia’s Economy of Favours*.
firm. Third, a business firm organises an input-output chain of production – a network of several tiers of related enterprises involved in production. These three attributes are summarised in Table 3.1.

**Table 3.1: Firm as Business Unit**

<table>
<thead>
<tr>
<th>Administrative Coordination and Control</th>
</tr>
</thead>
<tbody>
<tr>
<td>▶ Evidence of clear administrative control</td>
</tr>
<tr>
<td>▶ Top management responsible for strategic decision-making, for coordinating, appraising, and planning</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Integrator of Various Business Functions</th>
</tr>
</thead>
<tbody>
<tr>
<td>▶ Production / raw material procurement / financing / marketing / R&amp;D / investment etc. are brought together under a single point of control</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Organiser of the Production Chain</th>
</tr>
</thead>
<tbody>
<tr>
<td>▶ Coordination of input-output links of production: a firm organises successive stages of production</td>
</tr>
</tbody>
</table>

Analysis of Soviet enterprises from a resource-based view of the firm suggests that because the notion of a business firm was not applicable to the Soviet economic system, the former Soviet enterprises had to be reconstituted as business firms for them to be able to function in a new market environment. That is, a redefinition of enterprise was bound to take place with the transformation of economic system.63 Specifically, enterprises, whose activities had hitherto been controlled and coordinated under the Soviet central planning system, were faced with several fundamental tasks of reorganisation in order to fulfil the criteria of a business firm. First, administrative coordination needed to be established. Second, integration of business functions was necessary. Third, the production chain had to be reconstructed.

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3.4.1 Integrating Business Functions under Single Control

In the wake of the disintegration of the Soviet economic system, enterprises, which previously had operated as production units, faced the task of integrating various business functions if they were to survive and compete as business firms in the market economy. The main challenges were to rectify the lack of resources and to bring together various business functions, which up to that time had been 'outsourced' across the Soviet economic structure, and to integrate them under a single administrative framework.

After the collapse of the Soviet Union, the privatisation of former Soviet enterprises became a central part of Russia's economic reform, along with the liberalisation of prices, the reduction of government expenditure, and trade liberalisation. As these former Soviet enterprises went through the process of corporatisation and privatisation, they were only endowed with resources and capabilities geared toward serving the needs of a centrally planned economy. However, privatisation of state owned enterprises did not automatically transform these enterprises into business firms. In fact, the main objective of privatisation in Russia was depoliticisation – to get rid of political influence over economic life by removing the control rights of former state enterprises from the hands of politicians.

The basic principle of privatisation in Russia was the assigning of private property, namely, the transfer of state owned enterprises into private ownership. The idea was that privatisation would help to establish a secure property rights system through the

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64 Hitt et al., ‘Organizational Transformation in Transition Economies: Resource-Based and Organizational Learning Perspectives’.
creation of an efficient structure of ownership rights. In fact, the primary concern of privatisation appeared to be the rapid reallocation of ownership rights, with little focus on the resources and business functions that needed to be integrated within a single administrative control, for these former enterprises to restructure as business units. Thus, it is likely that privatisation in Russia was not primarily directed towards the fact that a firm in a market economy is an integrator of various business functions.

While it is often argued that privatisation of state owned enterprises will lead to improved economic performance, solely because ownership will provide the proper incentives, it seems unlikely that a change in ownership alone will be sufficient. Also important in a post-socialist context is the reconstitution of enterprises into business entities. In other words, if these former state owned enterprises were to survive and compete in a market environment after privatisation, equal attention needed to be given to the resources that they must possess and develop, and the organisation of these resources and business functions within an appropriate administrative structure.

It should be added that conversion from a post-Soviet ex-state enterprises to a business firm may require disintegration as well as integration of some activities: For example, it may involve the discarding of non-core activities like provision of social functions such as nurseries, as well as in-house, small-scale production of components and equipment developed in the Soviet era solely to insulate the enterprise from the vagaries of the input-supply system.

66 Boycko et al., *Privatising Russia*; Shleifer, ‘Establishing Property Rights’.
3.4.2 Reconstructing the Production Chain

The breakdown of the Soviet economic system posed enterprises with the problem of reconstructing the production chain linking downstream and upstream production. The collapse of centralised planning resulted in a break-up of a production chain, a phenomenon described as 'disorganisation'. Disorganisation refers to a disruption in the production chain, particularly in the provision of materials and intermediate inputs, resulting from the collapse of central planning, which led to the dismantling of the Soviet structure that was characterised by a complex set of highly specific relations between enterprises. The Soviet industrial hierarchy was made up of interrelated enterprises, production associations and branch ministries, and the collapse of the Soviet economic system triggered an overhaul of the industrial structure, leading to a break-up of pre-existing networks of related enterprises for production.

In addition, privatisation brought about the deconcentration of Russian industry, as privatisation in principle took place at the level of the individual enterprise, the lowest unit in the Soviet industrial hierarchy. The reason that this fragmentation of the

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69 Disorganisation explains the reason for the collapse of output after the disintegration of the USSR, and the notion of disorganisation does not assume that the chain that existed under the Soviet system was efficient, or that its destruction would lead to an efficient outcome. See Blanchard, The Economics of Post-Communist Transition. See also Hanson, ‘The Russian Economic Crisis and the Future of Russian Economic Reform’, p. 1164. Other literature on disorganisation includes: Gerald Roland and Thierry Verdier, ‘Transition and the output fall’, Economics of Transition, 7, 1, 1999; Jozef Konings and Patrick Paul Walsh, ‘Disorganization in the process of transition: Firm-level evidence from Ukraine’, Economics of Transition, 7, 1, 1999; and Alan Bevan, Saul Estrin, Paul Hare and Jon Stern, ‘Extending the economics of disorganization’, Economics of Transition, 9, 1, 2001, pp.105-114.

70 Joskow and Schmalensee, ‘Privatization in Russia: What should be a Firm?’

71 Posing the question "what should be the boundaries of the firm [that is] to be privatised?" Joskow and Schmalensee criticise the Russian privatisation programme from the point of view of industrial structure: "The Russian privatisation programme effectively involved substantial deconcentration compared with programmes that might have been based on other aggregates within the existing industrial hierarchies and that could, arguably, have been viewed as more closely resembling firms in developed market economies". Further, they note that the decision to privatise existing enterprises at the lowest level of the industrial hierarchy was not based on detailed analysis of the best way to reform the industrial structure. In fact, privatisation at the existing production unit level was seen as
industrial hierarchy was favoured was that "The huge Soviet industrial hierarchies contained the lumbering bureaucracies that were at the heart of the failure of the central planning system". At the same time, it was argued that this fragmentation of the industrial hierarchy through privatisation would lead to a disruption in the chains of vertical and horizontal relationships. These production chains were supported by relation specific human and physical capital that were important for maintaining production. Some scholars have argued that privatisation in fact brought disorder to the industrial structure, which led to the dissolution of many potentially effective production associations (ob’edineniia) and concerns (kontserny), and that privatisation led to a destruction of the production chain, while others point out that the collapse of the Soviet economic system contributed more to the disruption in the production chain than did privatisation.

It should be noted that the task of reconstructing the production chain should also be considered from the perspective of transaction costs. While the resource-based view highlights the competence of the firm as the organiser of several stages of production, the transaction cost view focuses on whether a production chain should be organised inside or outside a single firm. In view of economising on transaction costs, firms generally have to decide whether to organise transactions along the production chain being the most convenient way to achieve speedy privatisation. See Joskow and Schmalensee, 'Privatization in Russia: What should be a Firm?', pp.110-111.

Ibid., p.103. Fortescue argues that the branch ministries had long been criticised as the example of the defects in the planned economy, particularly the ministries' vedomstvennost' or departmentalism, which led to protection of their own narrow interests at all costs. Stephen Fortescue, Policy-Making for Russian Industry (London: Macmillan, 1997), p.77. Ministries avoided cooperating with other ministries, and this led to a ministerial autarky (self sufficiency for inputs as well as consumer goods), which compromised scale economies. See Hewett, Reforming the Soviet Economy, p.176.

Joskow and Schmalensee, 'Privatization in Russia: What Should be a Firm?', p.103.


inside the firm by vertically integrating with their suppliers and/or buyers, or to arrange transactions in the market. According to this theory, given the incompleteness of contracts, vertical integration, where related assets are organised under a common ownership, can curb opportunism and deal with uncertainty in the context of recurring transactions that involve specific assets.\textsuperscript{76} In other words, vertical integration becomes likely and more attractive way of organising transactions when the assets used in production are most valuable in a specific relationship, and when transactions are frequent.\textsuperscript{77} In the situation of Russia, where market-supporting institutions were underdeveloped, the higher costs of organising transactions through the market seem to strengthen the case for vertical integration. Vertical integration reduces the risk of uncertainties in the market, such as uncertainty over price movements, reliability of supply, and access to markets. Undeveloped product, labour and financial markets would make transactions in the market difficult. Besides contracting costs, in Russia the costs of contract enforcement are high due to the weak legal system and weak enforcement mechanism. Moreover, particularly for industries where a successive production process involves relation specific assets, including oil, aluminium, nickel, steel and copper industries, the cases for vertical integration arguably become stronger.\textsuperscript{78}


Therefore, the task of reconstructing the production chain implied the adjustments to the boundaries of the firm, i.e., deciding on which successive stages of production should be brought within the firm. As noted above, the transaction cost theory explains vertical integration in terms of so-called ‘make-or-buy’ decisions aimed at economising on the transaction costs. The resource-based view complements the rationale for vertical integration by explaining vertical and horizontal integration in terms of what Teece et al. call ‘corporate coherence’. As they put it, “Firms are coherent to the extent that their constituent businesses are related to one other. In the language of economics, businesses are related if there are economies to their joint operation and/or ownership”. They argue that lateral and vertical integration stem from the growth/diversification motives of the firm, because “firms over time add activities that relate to some aspect of existing activities”. Thus, firms diversify and grow through lateral and vertical integration by arranging their complementary assets coherently. In order to make the meaning of the word ‘coherence’ more articulate here, it would be perhaps useful to differentiate administrative coherence – what Penrose terms ‘coherent administrative organisation’, and resource coherence – what Teece et al. term ‘corporate coherence’. From this point of view, a ‘coherent company’ has both administrative coherence and resource coherence.

3.4.3 Establishing Effective Administrative Coordination

The previous two tasks – integrating business functions and reconstructing production...
chain – must be accompanied by the task of establishing effective administrative coordination and control. The three tasks go together, i.e., business functions have to be integrated under a single control and the production chain has to be under the control of the top management. However, the breakdown of the Soviet central planning authorities removed the ‘top management’ of ‘USSR Inc.’ Individual enterprises had increased autonomy through the process of spontaneous privatisation, and the programme of mass privatisation that followed, but this was not necessarily accompanied the transfer of management responsibility – i.e., coordinating, appraising and planning the operation of the enterprise – to the new owners. 82

As has been emphasised, a firm is an administrative framework within which central management coordinates and controls the industrial activities. The nature of administrative coordination within a firm, however, can differ depending on the type of internal organisational structure of firm. For example, in the so-called U (unitary) form organisational structure, the top management is responsible for both for the firm’s day-to-day administration, coordination of business activities, and the formulation of business strategy. In the M (multi-divisional) organisation, the firm is organised into separate divisions, with divisional managers responsible for the day-to-day management, while top management (chief executive) concentrates on formulating overall strategic planning. The U-form has a high degree of centralisation whereas the M-form organisation is internally-decentralised, in which divisional managers have an enhanced level of control. 83 In terms of the evolution of the organisational form, the shift towards the M-form structure often was motivated by an expansion of the product line or

82 Clarke and Kabalina emphasise that the basis of Russia’s privatisation process was the ‘destatisation’ of property in the absence of a strong state, which “left the enterprise directorate in control of the means of production, with all rights but none of the responsibilities of ownership”. See Simon Clarke and Veronika Kabalina, ‘Privatisation and the Struggle for Control of the Enterprise’, in David Lane (ed.), Russia in Transition: Politics, Privatisation and Inequality (London: Longman, 1995), p143.
geographic expansion of a firm.  

Although a firm may adopt a different type of internal organisational form, the point to be emphasised here is that in the post-Soviet context, establishing effective administrative coordination within a firm in the very first instance required the establishment of management control over the firm’s overall operations. Moreover, in Russia, in order to establish management control over a company, obtaining control of the cash flows and assets was essential. Further, in the Russian context, establishing management control necessitated concentration of ownership as discussed below.

Initially, the government’s privatisation programme resulted in a dispersed ownership.  

At the same time, the privatisation programme had expectations that the initial allocation of ownership would ultimately lead to an improvement in management.  

Although the initial pattern of dispersed ownership posed a principal–agent problem, it was expected that the secondary market trading of shares would lead to the development of an effective system of corporate governance which would improve enterprise

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85 The voucher privatisation programme, through which the country’s population was allocated vouchers with which to buy company shares, usually led to dispersed patterns of ownership structure. In the early period of privatisation, a survey of enterprises in 1994 reported that management on average held 9 percent of shares, while employees held 50 per cent. The remaining 41 per cent was held by the government or minority shareholders who bought their stakes in auctions. Peter Boone and Denis Rodionov, ‘Rent seeking in Russia and the CIS’, Paper prepared for the EBRD tenth anniversary conference, 2001. p. 10, citing a survey by Joseph Blasi in 1994.

86 Boycko et al., *Privatising Russia*, pp.94-95; Frydman et al., ‘Investing in Insider-Dominated Firms: A Study of Russian Voucher Privatization Funds’, in Frydman et al. (eds), *Corporate Governance in Central Europe and Russia: Banks, Funds, and Foreign Investors*, p.189. The privatisation programme based on the free distribution of vouchers to the population sought to bring about fair and equitable distribution of assets, in part to win wider support for privatisation. Although the method of privatisation became a subject of contention, the gap between the domestic supply of savings and the potential market value of the company to be privatised made privatisation based on asset sales difficult. Frydman and Rapaczynski, *Privatization in Eastern Europe: Is the State Withering Away?*, pp.16-17. It should be emphasised that politically, speed was considered the priority, and the official privatisation programme aimed to stop the spontaneous privatisation process. Alexander Radygin, *Privatisation in Russia: Hard Choice, First Results and New Target* (London: CRCE, 1995), p.32.
performance.\textsuperscript{87} It was hoped that outside owners, including foreign investors, would accumulate equity stakes large enough to allow them to control or to offer a degree of monitoring to prevent managerial opportunism, and to allow the influx of capital to the enterprise.\textsuperscript{88} In fact, Russian reformers seemed to be aware that a secondary reallocation would be needed to transform the initial ownership pattern into an economically more efficient one, putting enterprises into the hands of owners who would be able to restructure them.\textsuperscript{89}

What happened in Russia was that ownership became concentrated in the hands of those who owned and managed the companies.\textsuperscript{90} Many scholars have reported the trend in the concentration of shareholdings in Russia.\textsuperscript{91} Radygin and Starovoitov point out that the redistribution of property after privatisation resulted in the concentration of ownership.\textsuperscript{92} This is in line with other observations that dominant shareholders have emerged. Dolgopiatova found that in one of every five enterprises at the end of 1998, there were large shareholders with controlling packets of shares (more than 50 per cent), and forecasted further concentration of corporate ownership.\textsuperscript{93} Aukutsionek et al. reported that managers were the dominant shareholders.\textsuperscript{94} Dolgopiatova points to the

\begin{footnotesize}
\textsuperscript{90} See for example, Boone and Rodionov, ‘Rent seeking in Russia and the CIS’.
\textsuperscript{91} Here, concentration of ownership refers to the concentration of shareholding at the level of the individual company. For Russia’s industrial concentration, see for example, World Bank, ‘From Transition to Development: A Country Economic Memorandum for the Russian Federation’, Draft, World Bank, 2004.
\textsuperscript{94} Aukutsionek et al, ‘Dominant Shareholders, Restructuring and Performance of Privatised
\end{footnotesize}
problems of quantitatively illustrating this fact, but argues that the composition of the growing concentration of corporate ownership with large numbers of shares remaining in the hands of insiders, indirectly indicates that the managers are concentrating their ownership.\textsuperscript{95} Further, she also emphasises that the characteristic feature of the emerging ownership structure is that the owners and managers are usually indistinguishable, i.e., they are same group of people.\textsuperscript{96}

From the managers' perspectives, concentration of shareholding was of prime importance for the managing of the company, given a legal environment which had weak protection of property rights. Ownership concentration above all lessened the risk of hostile takeover in an environment where struggles over the redistribution of property were rife. As described in Chapter 2, relating to the instrumental use of law, the law has been used as ammunition in Russian businesses. In some cases, legal manoeuvres enabled a 30 per cent shareholder to take control away from the management.\textsuperscript{97} Generally, control over a company was contingent on a shareholding of 75 per cent plus one voting share. That is, owning 75 per cent plus one voting share in a company was considered to be a secure threshold from which to exercise managerial control. With a holding more than 75 per cent plus one, the possibility of key decisions being blocked was eliminated as, in accordance with the JSC Law, this required a shareholding of 25 per cent. In addition, super majority control provided owner-managers with the security to manage the assets more productively, because control rights and cash flow rights were both in their hands.\textsuperscript{98} Therefore, owner-managers sought to increase their equity

\begin{footnotes}
\item Companies in Russia: An Analysis and Some Policy Implications', pp.501-2.
\item Dolgopiatova, 'Modeli i mekhanizmy korporativnogo kontroliia v rossiiskoi promyshlennosti', p. 48.
\item Ibid. She describes this as 'a blending (sovmeshenie) of owners and managers in one person (v odnom liise)'.
\item See Chapter 2, particularly Footnote 83.
\item Boone and Rodionov, 'Rent seeking in Russia and the CIS', p.15.
\end{footnotes}
holdings to the super majority level range of 70-100 per cent. In Russia, concentration of ownership by owner-managers has become the means to establish stable administrative control over the operations of enterprises.

3.5 Conclusion

From the resource-based view of the firm, post-Communist economic transformation of the corporate sector involved the reconstitution of enterprises into business units. As has been discussed, since the notion of the firm as a business unit was not relevant in the Soviet context from a resource-based view, former Soviet enterprises had to be reconstituted as business units in order for them to survive and compete in a market oriented environment. Specifically, three fundamental tasks were involved for the

99 Boone and Rodionov show that after a group of owner-managers achieved 70-100 per cent control of their companies, the productivity of these companies increased, and they argue that “Our general conclusion from these observations is that dispersed ownership was not an equilibrium outcome for Russian companies”. Ibid., p.15.

100 A notable aspect of ownership concentration in Russia from a principal–agent view was that the concentration brought about the unification of ownership and control. To use the concept of the agency chain argued by Stiglitz, ownership concentration resulted in shortening the agency chain by unifying principal and agent. Stigliz and Ellerman argue that implicit in the voucher privatisation scheme was the imposition of long, multistage chains of agency relationships that are only feasible in developed market economies. See Joseph E. Stiglitz, ‘Whither reform? Ten Years of the Transition’, in Annual World Bank Conference on Development Economics 1999 (Washington: World Bank, 2000), pp.38-40, and David Ellerman, “Why Shock Therapy is Wrong”, Challenge, 46, 3, May-June 2003, pp.11-13. They point out that stable and developed market economies are based on long agency chains. (For example, workers are agents for managers, who are agents for shareholders, such as mutual funds, whose shares are held by pension funds, which act as agents for their beneficiaries, which include workers.) The long chain of agency relations is supported by an array of institutions that grow only incrementally, including the legal system to enforce shareholder rights, liquid capital markets, competition policy, the monitoring system and accounting and auditing. In the absence of institutions that support a multilayer of agency chain, it would be best to shorten the agency chain to a manageable level. (For example, “instead of A trying to get B to get C to do something for A, A could try to get B to do something for A. The most dramatic and self-enforcing arrangement is the unification of principal and agent so that A is directly helping A”. Stiglitz, ‘Whither Reform?’, pp.38-39.)

Thus, one way to interpret the concentration of ownership in Russia was that ownership concentration virtually removed the separation of ownership and control. As a consequence of the unification of ownership and control, the agency problem was alleviated in the absence of institutions that could support long agency relationships. In the long term, unified managers-owners would pose a problem of ‘who monitors the monitors’, but in the early stages of corporate development, shorter agency chains make sense, given the underdeveloped institutional framework. In addition, it should be added that the unification of owners and managers was realistic in Russia because reliance on the retained earning was substantial, particularly in export-oriented natural resources industry.
reconstitution of enterprises into business firms (see Table 3.2). The first was in the area of establishing effective administrative control and coordination. Individual enterprises during the Soviet period were production units, working under the direction of the state bureaucracy of ‘USSR Inc.’ Therefore, to be in charge of a business firm, the management of post-Soviet Russian enterprises had to become responsible for executive actions and orders, through coordination, appraisal and planning of their activities.

The second task involved the reconstruction of the production chain to allow enterprises to become the organisers of production linkages. Under the Soviet economic system socialist enterprises did not act as organisers of production chain. Moreover, the collapse of the Soviet Union disrupted the downstream–upstream chains of production and, in addition, privatisation was carried out at the level of the production unit in order to deconcentrate the industry into small pieces. Further, organising the network of production implied the adjustment to the boundaries of the firm through decisions about which successive stages of production should be brought within the firm. The task of reconstructing the chain of production by organising a network of related firms has to be seen in the context of all these factors.

Thirdly, the task of enterprise reconstitution entailed the integration of various business functions within the single framework of a firm. Originally, Soviet enterprises were not endowed with the technical and organisational resources that render various business functions; they were distributed across the Soviet economic hierarchy. Further, corporatisation and privatisation often created joint stock companies that were not self-contained business firms. They were not full-fledged business entities in that they were without the resources and capabilities necessary to carry out the various business functions on their own.
Russian enterprises were faced with these tasks against a background where market-supporting institutions were insufficiently developed. In particular, Russia’s emerging market order suffered from an underdeveloped financial system, such as capital market and banking sector, and from a weak legal and judicial system. In addition to lack of an adequate legal infrastructure, the weakened capacity and autonomy of the state made rigorous enforcement of law difficult. Moreover, the overall political and economic environment was uncertain and volatile. During the most of the 1990s political stability was not ensured and the decade was a period of macroeconomic instability and output decline. The three tasks were challenging particularly in the context of the disintegration of Soviet economic system and accompanying institutional weaknesses.

Table 3.2 Tasks of Reconstituting Enterprises as Business Units

<table>
<thead>
<tr>
<th>Tasks of Russian companies in Reconstituting enterprises as Business Units</th>
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</thead>
<tbody>
<tr>
<td>1. Establishing effective administrative coordination and control</td>
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<tr>
<td>(i.e., to establish management control to put administrative hierarchy in place)</td>
</tr>
<tr>
<td>2. Integrating various resources embedded in business functions under single control</td>
</tr>
<tr>
<td>(i.e., to become an integrator of business functions)</td>
</tr>
<tr>
<td>3. Reconstructing a production chain and redefine boundaries of the firm</td>
</tr>
<tr>
<td>(i.e., to become an organiser of production linkage)</td>
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</tbody>
</table>
What, then, is the relevance of this discussion to ICGPs? A framework of analysis derived from this chapter allows us to argue that ICGPs performed important functions from the perspective of reconstitution of enterprises into business units, and therefore to demonstrate that the nature of ICGPs is ambiguous. Russia’s ICGPs, which became widely publicised as corporate governance abuses, are destructive in that they undermine investor confidence and the foundations of good corporate governance. However, understanding the firm from a resource-based view sheds light on the ambiguity of these practices.

Figure 3.3 depicts an analytical framework within which to examine the role of ICGPs in the context of the three tasks described in this chapter. In order to reconstitute enterprises into business firms that could survive, compete and grow in a market-oriented economy, it was necessary to establish administrative control, integrate business functions, and reconstruct the production chain. The arrows in Figure 3.3 indicate the role of ICGPs in this process. These arrows capture the destructive and constructive aspects of ICGPs that came into play. The dotted background in the figure signifies the context in which ICGPs were used – i.e., the context of the disintegration of the Soviet economic hierarchy and Russia’s institutional weaknesses.
An ambiguity of ICGPs is that although these practices have been abusive and detrimental to investors, they acted as 'coping strategies' from the perspective of owner-managers, who had the task of reconstituting business entities in the face of institutional weaknesses and disintegration of the Soviet economic system. In examining the cases of the Yukos Oil Company, Siberian (Russian) Aluminium and Norilsk Nickel, the following chapters investigate the ambiguous nature of ICGPs.

The assumption here is that owner-managers have a stake in the survival and eventual growth of their companies as going concerns. It can be argued that this assumption does not contradict the view that managers are opportunistic actors in the sense that if companies cease to function, opportunistic owner-managers will lose their vehicle to act opportunistically.
CHAPTER 4. ICGPs and Yukos Oil Company

4.1 Introduction

In an article entitled “Yukos’s Fall from Grace”, the Financial Times reported in November 2004:

Q: What is Yukos? A: Just more than a year ago, Yukos was Russia’s largest and most profitable oil company. [...] For much of the 1990s, Yukos was associated with the worst abuses of minority shareholder rights in Russia. However, the company subsequently evolved into one of the country’s most highly regarded companies with foreign management and internationally audited accounts. At its peak Yukos had a market capitalisation of more than $30bn, making it the biggest stock in Russia.

Q: What has happened to it? A: [...] It faces back tax claims of up to $25bn; its two shareholders, Mr Khodorkovsky and business associate Platon Lebedev, are in prison on charges of fraud and tax evasion; [...] and its main production asset - Yuganskneftegaz - is being sold at half its minimum fair value at a forced auction. The company’s market capitalisation has fallen to just $2bn.¹

Based on the case of the Yukos Oil Company, this chapter analyses the ambiguity of ICGPs. It focuses on the role played by ICGPs during the 1990s, when the major challenge confronting the management of Yukos Oil was to establish effective administrative control and to build a company with the potential to become the largest oil producer in Russia.

Due to the way ICGPs violated shareholders’ rights, the company was referred to as “a

veritable centrefold of corporate governance abuse" in 1999.\(^2\) At the same time, however, it is argued in this chapter that Russia’s ICGPs fulfilled functions from the resource-based view of the firm outlined in Chapter 3: As argued there, a combination of the three tasks – establishing an effective administrative control, integration of business functions, and the reconstruction of the production chain – confronted management in the effort of reconstituting enterprises into business firms following the disintegration of the Soviet economic system. This chapter illustrates that ICGPs, which were abusive to shareholders, in fact addressed these tasks confronting Yukos in reorganising Yukos into a coherent business unit.

In order to understand the tasks confronting Yukos, this chapter first describes the background to the development of the Yukos Oil Company, emphasising privatisation in the Russian oil sector which was the source of Yukos’s corporate governance problems. Secondly, the chapter examines the three tasks that Yukos’s management needed to perform in order to reconstitute into a functioning business unit. A focus is directed to why Yukos suffered from the lack of an effective administrative hierarchy, an aspect that adversely affected the other two tasks. Thirdly, the chapter shows how ICGPs were utilised in the fulfilment of the three tasks.

4.2 Reorganisation of the Oil Sector and Yukos Oil Company

4.2.1 Creation of Vertically Integrated Oil Companies (VIOCs)

With the disintegration of Soviet Union and the breakdown of central administrative control, the various segments of the oil industry asserted their independence.\(^3\)

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\(^2\) 'Bulletin on Corporate Governance Actions’, No. 50, Troika Dialog, September, 1999, p.1. The report provides its clients with an analysis of corporate governance, including reported and potential violation of shareholder rights, and this 50th issue of the Bulletin since its launch in 1998, highlighted Yukos (and its subsidiaries) as being a major contributor to the Bulletin.

\(^3\) David Lane and Iskander Seifulmulukov; 'Structure and Ownership', in David Lane (ed.), *The Political Economy of Russian Oil* (Maryland: Rowman & Littlefield Publishers, 1999), p.17.
Enterprises and organs of the local administration began to form independent companies, taking over various of the oil industry’s assets, and the managements of local companies were able to act in their own individual interests over production, refining and sales.\(^4\) By arbitraging the difference between the world price and the domestic price, which was still controlled in 1992, oil exports became extremely profitable.\(^5\) Following the dismantling of the state monopoly over foreign trade in 1988, those who had access to exportable goods began to sell them abroad: “Anyone who could acquire oil, diamonds, or metals for rubles at controlled domestic prices, and then sell them abroad for dollars, was rich overnight”.\(^6\) As a result, large volumes of oil were often illicitly exported.\(^7\)

Reorganisation of the disintegrating Russian oil industry took place following the break up of the USSR. In November 1992, President Boris Yeltsin issued decree 1403, detailing specifications for the corporatisation and privatisation of oil enterprises.\(^8\) The first pillar of the reorganisation policy was the establishment of holding companies to create ten to twelve vertically integrated oil companies (VIOCs) in Russia. The establishment of VIOCs was done in an effort to restructure the Russian oil industry. Vertically integrated companies were designed to encompass an entire production linkage ‘from the well to the gas station’.\(^9\) Such a vertically integrated structure was in

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4. Ibid.
part modelled on the vertically integrated Western oil majors. ¹⁰

Decree 1403 established VIOCs comprising holding companies, under the umbrella of which the existing enterprises were organised as subsidiaries. In other words, each oil holding company was made up of subsidiary operating companies, i.e., oil production subsidiaries, refining subsidiaries, and the enterprises that dealt with the distribution of oil products. The first three vertically integrated oil companies to be, established under decree 1403, were the Yukos Oil Company, Lukoil and Surgut Holding. The original constituent enterprises of these three VIOCs can be seen in Table 4.1. Yukos Oil, for example, was made up of a dozen subsidiaries, including oil production enterprises such as Yuganskneftegaz, Samaraneftegaz, and refineries such as Kuibyshevnefteorgsintez.¹¹

The name of the company Yukos was derived from Yuganskneftegaz and Kuibyshevnefteorgsintez.

| Table 4.1: First Three Vertically Integrated Oil Companies (VIOCs) ¹² |
|---------------------------------|-----------------|-----------------|-----------------|

<table>
<thead>
<tr>
<th>Holding Companies</th>
<th>Yukos</th>
<th>Lukoil</th>
<th>Surgut</th>
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<td>Oil Production Subsidiaries</td>
<td>Yuganskneftegaz</td>
<td>Kogalymneftegaz</td>
<td>Surgutneftegaz</td>
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<td>Oil Refining Subsidiaries</td>
<td>Kuibyshev Refinery</td>
<td>Permnefteorgsintez</td>
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<td>Nobokuibyshev Refinery</td>
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<td>Oil Product Distribution Subsidiaries</td>
<td>Briansknefteprodukt</td>
<td>Adygeisknefteprodukt</td>
<td>Karelnefteprodukt</td>
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<td>Ulianovsknefteprodukt</td>
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¹² Compiled by author from Russian Petroleum Investor (RPI), July/August 1994, pp.16-18.
The establishment of VIOCs in 1992 was facilitated by the general directors of former Soviet oil enterprises who wanted to maintain the newly gained autonomy and control over their enterprises. They opposed a plan to create a unified state oil monopoly on the lines of Gazprom, the gas monopoly. The general directors of the enterprises therefore actively promoted the creation of VIOCs: Vagit Alekperov, former First Deputy Oil Minister in the Soviet government, played a pivotal role in these endeavours and ultimately became president of Lukoil.

The creation of VIOCs was in part a policy priority in the face of a chaotic economic situation and weakened central control over the oil industry. Since the oil industry was a strategic sector in the national economy, the government's position was that some degree of state control of it was essential. The federal government intended to exert a large measure of influence over these VIOCs through substantial share ownership in the newly created holding companies. The state shares in separately privatised subsidiaries became the charter capital of the holding companies, enabling the state to have a controlling interest in them.

Given the disintegration and uncertainty in the sector, the creation of VIOCs was acceptable to government, as the restructuring of the Russian oil industry into several vertically integrated holdings would eliminate the discord among the existing entities in charge of oil exploration, development, and refining – a discord that had plagued the

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13 Moser and Oppenheimer, 'The Oil Industry: Structural Transformation and Corporate Governance', pp.304-305.
14 Ibid.
15 Diens, 'Corporate Russia: Privatisation and Prospects in the Oil and Gas Sector', p.10; Moser and Oppenheimer, 'The Oil Industry: Structural Transformation and Corporate Governance', pp.304-305.
16 Presidential Decree No.1403.
17 Diens, 'Corporate Russia: Privatisation and Prospects in the Oil and Gas Sector', p.10.
18 Lane and Seifulmulukov, 'Structure and Ownership', pp.17-18.
Soviet oil industry when different ministries were responsible for each of these activities. In fact, the various business functions involved in oil production, such as extraction, refining, and distribution, appeared to be incoherently organised across the Soviet economic system. For example, under the Soviet system the Ministry of Oil Industry (MNP, or Minnefteprom) was responsible for extraction, while the Ministry of Petrochemical Industry (Minneftekhimprom) controlled refining. Gossnab was in charge of distribution, and Soyuzneft export, a division of the Ministry of Foreign Trade, controlled export. The Ministry of Geology (Mingeo) was responsible for the preliminary stages of exploration, and Minnefteprom and the Ministry of Gas Industry (Mingazprom) were both responsible for exploration. In addition, the Ministry for Construction of Oil and Gas Enterprises (MNGS) was in charge of building facilities. The result was a perverse blend of collaboration and tension among these ministries, leading to jurisdictional instability in the sector.

4.2.2 Privatisation of Subsidiaries

The second pillar of the reorganisation policy was corporatisation and privatisation of enterprises engaging in oil production, refining, and marketing. They became open-type joint stock companies and were organised as subsidiaries. The controlling interest in each subsidiary was to remain with the state for the first three years of reorganisation. In the case of Yukos, its oil production subsidiaries, such as Yuganskneftegaz and Samaraneftegaz, were corporatised into joint stock companies and went through the

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19 Diens, 'Corporate Russia: Privatisation and Prospects in the Oil and Gas Sector', p.10.
20 Lane and Seifulmulukov, 'Structure and Ownership', pp. 15-16.
21 Ibid.
23 Lane and Seifulmulukov, 'Structure and Ownership', p. 16.
privatisation process.\textsuperscript{26} This meant that shares were issued both at the subsidiary and the holding company level. For example, Yuganskneftegaz, which acquired the status of an independent enterprise in 1991,\textsuperscript{27} became an open type joint stock company in June 1993.\textsuperscript{28} Its shares were divided into 25 per cent of preferred non-voting stock and 75 per cent of common voting stocks. Of the common stock, 38 per cent of shares contributed to the Yukos charter fund.\textsuperscript{29}

Because 38 per cent was more than half of the 75 per cent of voting shares, the holding company had the controlling stake (51 per cent) of Yuganskneftegaz. Thus, Yukos, as the holding company, obtained controlling stakes in its separately incorporated subsidiaries.

4.2.3 Further Privatisation of Holding Companies

A further privatisation of the oil holding companies began in 1995 via the investment tenders and loans-for-shares programme, representing a second phase in Russia’s privatisation policy, the first phase having consisted of voucher privatisation. The loans-for-shares programme, implemented in 1995, reflected the shift in government priority from rapid mass-scale privatisation to a more selective selling off of the largest and most profitable enterprises to maximise state budget revenue.\textsuperscript{30} In exchange for

\textsuperscript{26} The process was based on Presidential Decree No. 1903 of 1992. See \textit{Russian Petroleum Investor (RPI)}, June 1994, p.50.
\textsuperscript{27} Yuganskneftegaz was organised as a production association in 1977, and operated under Gavlitsmenneftegaz, until the latter was abolished in 1991. See ‘Memorandum ob AO Yuganskneftegaz’, Yuganskneftegaz, April 1994, p.3.
\textsuperscript{28} Ibid.
\textsuperscript{29} RPI, June 1993, pp 48-51. The remaining shares were distributed as follows: 25 per cent went to workers’ collectives, 10 per cent were sold to workers, 5 per cent were sold to management, 5 per cent were sold in the local population and 17 per cent were sold by auction as privatisation vouchers.
\textsuperscript{30} Gustafson, \textit{Capitalism Russian-Style}, p.43. For a detailed account of the loans-for-shares, see Allan, ‘Banks and the Loans-for-Shares Auctions’, pp.137-159, and Freeland, \textit{Sale of the Century} Chapter 8. Allan emphasises the government’s need to raise revenue for the budget, while Freeland emphasises the exchange of property for political support ahead of the presidential election in 1996 as the main explanation of this scheme. The revenue from the loan-for-shares auction turned out not to be substantial, and Pappe argues that what was achieved at the time through the loans-for-shares
bank loans, the government offered its shares of the valuable enterprises in the oil and metal sectors through a series of auctions. In the oil sector, companies such as Yukos, Surgut Holding, Lukoil, Sidanco and Sibneft were privatised through this policy action. The loans-for-shares programme was largely criticised as being a series of rigged auctions, through which the shares were handed over, at a fraction of their potential market value, to a selected small circle of politically well-connected buyers.

**Acquisition of Yukos by Menatep**

As a result of the loans-for-shares programme, the Menatep group became the new owner of the holding company, and thereby the controlling shareholder of Yukos' subsidiaries. In December 1995, Menatep acquired 33 per cent of Yukos's shares in an investment tender, and through a loans-for-shares auction acquired a 45 per cent state shareholding in the company. This loans-for-shares auction was run by Menatep itself, and by excluding outside bidders from participating based on a technicality, involved only two bidders, both proxy companies founded by Menatep.

In the period when the banking business had been very profitable, Bank Menatep, an 'authorised bank' headed by Mikhail Khodorkovskii, had become one of the leading Russian banks. Menatep was regarded as being the only Russian bank that from the outset had had an industrial orientation. It aggressively acquired industrial assets, and

scheme, was a) the formation of strong ties between the banking sector and industry; b) the emergence of domestic 'strategic' owners with longer-term interests in companies; and c) the securing of a political alliance between the government and business. Iakov Pappe, *Oligarkhi: Ekonomichsiaia khronika 1992-2000* (Moscow: HSE, 2000), p.34.

31 See Chapter 6, Section 6.4.1 of this thesis for the mechanics of the loans-for-shares.


33 For a scandal associated with the Yukos auction, see Allan, 'Banks and the Loans-for-Shares Auctions', pp.152-153; Freeland, *Sale of the Century*, pp.175-177.

34 'Authorised banks' received special privileges to handle the finances of various government agencies. Tompson, 'Old Habits Die Hard', p.1172. See also Chapter 1.

by 1994-95 more than a hundred industrial enterprises were owned by Menatep.\textsuperscript{36} In September 1995, the management company Rosprom was established in order to manage the shares of the industrial enterprises.\textsuperscript{37} At the beginning of 1997, core personnel were transferred from Menatep to Rosprom, indicating a clear shift of emphasis from banking to the industrial sector.\textsuperscript{38} The Menatep-Rosprom group began to acquire shares in Yukos Oil in 1995, through investment tenders and the loans-for-shares programme. Prior to becoming a controlling shareholder, Menatep had had a relationship of cooperation with Yukos Oil, which was nurtured against a background where holding companies required strong banks to support their operations.\textsuperscript{39} In general, the state as a shareholder was too weak to be effective.\textsuperscript{40} By the beginning of 1997, more than 85 per cent of Yukos shares were owned by the Menatep-Rosprom group. As the shareholdings in Yukos increased, the top management of Yukos came to be dominated by representatives of Menatep. In April 1996, Khodorkovskii was made first vice president and chairman of the board of directors of Yukos. Other Menatep representatives occupied leading positions in the oil company.\textsuperscript{41}

Thus, the new owners had obtained a controlling stake in the Yukos Oil Company and occupied the top management posts. However, the new owners had still to establish

\textsuperscript{36} They included Apatit, Voskresenkii Mineral Fertilizer (mineral fertiliser), Uralektromed (copper), Central-Ural and Kirovgrad copper-smelting factories (copper), Ust-Ilimsk Kombinat (forestry), Krasnoyarsk Metal Plant (metal), Volzhsk Pipe Plant, and also Avisma, the largest produce of titan sponge in Russia. Yulia Latynina, ‘Mikhail Khodorkovskii: Khimiia i Zhizn”, Sovsekretno, 8, August 1999 (http://www.sovsekretno.ru/1999/08/1.html accessed 2 December 2003).
\textsuperscript{37} By the end of 1995, commercial banking, which had prospered since 1992, had become less profitable, and the attention of business was moving to the industrial sector. Valery Kryukov and Arild Moe, ‘Banks and the Financial Sector’ in David Lane (ed.), The Political Economy of Russian Oil, p.62.
\textsuperscript{38} Pappe, Oligarkhi, p.134.
\textsuperscript{39} The cooperation between Menatep and Yukos actually had started as early as 1992. See Kryukov and Moe, ‘Banks and the Financial Sector’, pp.56-57.
\textsuperscript{41} Valery Kryukov and Arild Moe, The Changing Role of Banks in the Russian Oil Sector (London: Royal Institute of International Affairs, 1998), p.28-29. For example, Leonid Nevzlin became the vice president of public relations.
corporate control over Yukos Oil as a whole. In other words, Menatep needed effective administrative control over all of the constituent subsidiaries of Yukos, and although Menatep had obtained majority shareholdings in these constituent subsidiaries, it did not control them.\textsuperscript{42}

4.3 Tasks Yukos Faced: Yukos without Effective Administrative Framework

4.3.1 Lack of Administrative Cohesion

As discussed in Chapter 3, evidence of an effective administrative framework, in which administrative coordination and control are exercised by management, constitutes a basic attribute of a business firm. However, since its establishment, Yukos Oil had suffered from a lack of internal cohesion and organisational integrity. Therefore, the most immediate task for Yukos from the perspective of its reconstitution into a business unit lay in the sphere of its administrative coordination.

The lack of internal cohesion between the holding company and Yukos's constituent enterprises was in part due to how the privatisation occurred. Corporatisation and privatisation took place at the holding and the subsidiary levels. Yukos, as well as its subsidiaries, were organised as joint stock companies. In other words, the constituent subsidiaries were corporatised and privatised as independent units. This two-tiered privatisation created a multilevel governance structure at both holding and subsidiary level, and created different groups of management and shareholders, including minority shareholders. The two-tiered scheme resulted in a situation where even though the holding company had a director and board members, its subsidiaries, being independent legal entities, could choose not to recognise them.\textsuperscript{43}


\textsuperscript{43} Moser, 'The Privatization of the Russian Oil Industry', p.28.
The subsidiaries effectively maintained their operational independence which the management of Yukos could not penetrate. For example, since the privatisation of the subsidiaries and the creation of the holding company, Yukos did not exert administrative control over its main subsidiary Yuganskneftegaz.\textsuperscript{44} Yuganskneftegaz had its own company charter, management, and board of directors, and continued independent operation.\textsuperscript{45} Although the first general director of Yukos Sergei Muravlenko, was also the general director of Yuganskneftegaz, Yukos was unable to control resource and financial flows of Yuganskneftegaz; Yukos management eventually sought state intervention to resolve this lack of internal cohesion.\textsuperscript{46} Another subsidiary, Novokuibyshev Refinery, also did not want to give up its autonomy to Yukos. The Novokuibyshev Refinery, against the will of Yukos’s general director, planned to independently strike a deal with a Canadian bank to obtain investment.\textsuperscript{47}

Clearly, the operative administrative hierarchy essential for the Yukos Oil Company to “make [the] operations of the whole enterprise more than the sum of its operating unit”, to use the words of Alfred Chandler,\textsuperscript{48} did not exist. Therefore, the first task for Yukos was to resolve the lack of administrative cohesion and to establish an effective administrative framework, in which all activities were organised and controlled by the management.

As argued in Chapter 3, the reconstitution of enterprises into business units involved the

\textsuperscript{44} Kryukov and Moe, \textit{The Changing Role of Banks in the Russian Oil Sector}, p.13.
\textsuperscript{45} ‘Memorandum ob AO “Yuganskneftegaz”’, pp.12 and 22. As an example of independent activity, Yuganskneftegaz became the main founder of the then leading bank Tokobank, and became a 20 percent shareholder. Kryukov and Moe, \textit{The Changing Role of Banks in the Russian Oil Sector}, p.13.
\textsuperscript{46} Kryukov and Moe, \textit{The Changing Role of Banks in the Russian Oil Sector}, p.13.
\textsuperscript{47} ‘Look before you leap’, \textit{RPI}, October 1993, pp. 55-56.
establishment of an administrative control within the administrative framework of the firm, the integration of business functions, and the reconstruction of the production chain. In the case of Yukos Oil, the establishment of an effective administrative control was particularly critical to the fulfilment of the other two tasks.

4.3.2 Integration of Business Functions

In considering to what extent the Yukos Oil Company was a pool of resources that rendered various business functions, Yukos was better placed than an individual Soviet production unit, the lowest unit in the Soviet economic hierarchy. Yukos had a better set up in the sense that it was more than a production unit, because it was comprised of several subsidiaries, which themselves were composed of several production units. In other words, to a degree Yukos was a collection of resources able to render certain business functions including oil production, refining, distribution, and R&D, while a production unit was not. Yuganskneftegaz, for example, was a former production association (PO- proizvodstvenoe ob'edinenie), itself composed of several oil and gas production units (NGDU – Neftegazodobyvaiuschie upravleniia) such as Yuganskneft' and Pravdinskneft'.\footnote{Memorandum ob “AO Yuganskneftegaz”, Yuganskneftegaz, April 1994, p.3.} In addition to these units that performed oil producing functions, refining and distributing were pooled under the umbrella of Yukos Oil, as the company included such subsidiaries as the Novokubyshev refinery, and several distributors of oil products. The holding company also included the R&D function, i.e., it encompassed research institution and design bureaux serving the enterprises that belonged to the holding.\footnote{Leonid Gokhberg, Russia: a Science and Technology Profile, British Council 1999, p.48.} Thus, several entities responsible for business functions such as production, refinery, exploration and distribution were assembled under Yukos’s umbrella when the VIOC was established.
However, the resources of a firm must be bound together in an administrative framework, and the administrative hierarchy must be able to integrate and organise these resources. In other words, business functions rendered by resources have to be linked to one another and integrated under a single administrative control. Yukos had no effective administrative framework within which the business functions under its umbrella were organised. The operational independence that was maintained by Yukos subsidiaries led to a disintegrated corporate management within Yukos as a whole, and the absence of a proper administrative hierarchy and resultant lack of administrative control over the subsidiaries made the integration of business functions within Yukos very difficult.

4.3.3 Reconstruction of the Production Chain

Yukos’s lack of administrative control over subsidiaries adversely affected its ability to organise the production chain. As mentioned above, Yukos was established as a vertically integrated oil company which envisaged the integration of entire production linkage ‘from the well to the gas station’, i.e., the production chain linking crude oil production to refining, and refining to distribution.\textsuperscript{51} In a vertically integrated company, management must be in control of the whole process of organising a network of related enterprises dealing with extraction, production, refining and distribution, in order to be the organiser of the production chain.

However, despite the fact that Yukos had been established as a vertically integrated company, it was vertically integrated in name only. The production chain from the well to the gas station was not linked closely within the structure of Yukos. The constituent

\textsuperscript{51} Major international oil companies have vertically integrated – i.e., have expanded operations from oil extraction into oil refining, petrochemicals, and sale of refined oil products in order to be competitive.
subsidiaries of Yukos were independent legal entities which also operated outside Yukos. For example, refineries that belong to Yukos were buying oil from other companies, and refusing to restrict their purchases within the framework of the holding company.  

According to Yulia Latynina, at Nefteyugansk, the town that became established around Yuganskneftegaz, crude oil was being stolen from the wells, and the distribution of oil involved about twenty intermediary firms, half of which belonged to a recognised criminal, Otari Kvantrishvili. Thus, there were production chains that operated outside of Yukos. As one observer noted, “To declare vertically integrated companies and to actually have them working are two very different things”. Although Yukos did not have to establish the boundaries of the firm completely, in the sense that the boundary that encompassed successive stages of production was already in place, they had to make this production chain work.

To make production linkages effective in order to be a truly vertically integrated oil company, successive stages of industrial process had to be brought together within the administrative framework. Therefore, the task for the management was to reconstruct and bring the production chain within the boundaries of Yukos. In order to achieve this, the company required an effective administrative hierarchy controlled by a single management. Because of this need to establish single management control over the subsidiaries in order to reconstruct the production chain, the tasks of organising business functions and of reconstructing the production chain overlapped.

4.4 Reconstituting Yukos as a Functioning Business Unit: Use of ICGPs

The government recognised that there was a lack of organisational integrity and lack of

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53 Latynina, ‘Khimia i Zhizn’.
internal cohesion amongst holding companies and their subsidiaries as a result of the
two-tiered privatisation.\textsuperscript{55} Presidential decree 327, issued in 1995, was intended to
complete the first stage of privatisation and reorganisation of the Russian industry.\textsuperscript{56}
The decree allowed the oil holding companies to issue additional shares in order to
enable them to transform their constituent subsidiaries from independent joint stock
companies into wholly owned subsidiaries of the holding companies. Thus, all holding
companies were permitted to consolidate the shares of their subsidiaries into a single
stock issue representing the entire company.\textsuperscript{57} By this means it was hoped that the
problems resulting from an ineffective administrative framework and disintegrated
administrative coordination between holding companies and subsidiaries would be
overcome. Moreover, in effect, this Presidential degree enabled the holding company to
construct an effective administrative hierarchy with which the resources and business
functions of subsidiaries could be integrated. The decree allowed the holding company
to become consolidated through its sole ownership of subsidiaries, which was also
important in facilitating the reconstruction of the production chain within the company,
and consequently in allowing vertical integration both in name and in substance.

However, although Yukos management announced its intentions to make subsidiaries
wholly owned, the actual process of consolidation was arduous. To be able to convert
the shares of a subsidiary into a single share, it was first necessary for Menatep to take
firm control of what were often clearly independent subsidiaries. Because these
subsidiaries were operating independently, Menatep had to establish control over their
revenue streams in order to centralise cash flows within the holding company, which

\textsuperscript{55} Ibid.

\textsuperscript{56} Presidential Decree 327: Ukaz Prezidenta RF ot 1 aprelia 1995g. N327 'O pervoochere

was not straightforward.

### 4.4.1 Depriving Operational Independence of Subsidiaries

From the perspective of reconstituting into business units, the most immediate task for Yukos Oil was the strengthening of a single controlling administrative framework. An effective administrative hierarchy was needed to be built within which to organise business functions and reconstruct the production chain within Yukos. In order to establish administrative control, the first item on the agenda for management was to centralise cash flows, so that all product and revenue streams were under direct control of Yukos management, rather than the managements of the individual subsidiaries.

**a) Establishing Control of Cash Flow: Transfer Pricing**

As a first step, management sought to limit independent transactions by the subsidiaries who were selling and buying oil outside of the Yukos umbrella. It should be remembered that production subsidiaries, such as Yuganskneftegaz, were joint stock companies, which could independently produce and sell their oil. In order to centralise material and financial flows, the new owner-management team at Yukos first ensured that subsidiaries would not be allowed to deliver oil to anywhere but the holding company. The holding company was then responsible for distribution to both domestic and international markets. Only the holding company was allowed to sell oil to its own traders, which it was hoped would stop side contracts being entered into at the level of subsidiaries. Thus, making Yuganskneftegaz deliver its oil exclusively to the holding

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58 Author interview with a Russian oil analyst at an oil consultancy firm in Moscow, January 2003. Hoffman cites an account of a former Menatep official, who said that 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 chief accountant in all the subsidiary daughter companies and made sure that it was known and accepted that he was the new owner. David Hoffman, *The Oligarchs: Wealth and Power in the New Russia* (Oxford: Public Affairs, 2002), pp.445-446.

59 Author interview with a Russian oil consultant, January 2003. In this connection, Moser points out
company allowed the holding company to integrate all the financial flows of the subsidiary. In doing so, the question of the price at which Yukos would buy oil from the subsidiary was important. Forcing subsidiaries to sell at a very low price meant that the subsidiaries were even more subjugated to the holding.

In order to transfer oil cheaply from the subsidiary to the holding, Yukos classified what they were buying from the subsidiaries as ‘liquid from the wells’ (skvazhinaia zhidkost’). What the subsidiaries sold to the holding was not ‘crude oil’, but a much less expensive product on paper. Thus, Yukos was able to set an ‘intra corporate price’ for ‘liquid from the wells’ from its own subsidiaries. This intra corporate price was set at 250 rubles (USD10.2) per ton, while the domestic market price was 800 rubles (USD32.6) per ton, and the international market price was USD73.0 per ton. It should be noted, though, that a direct effect of this manipulation of transfer pricing was a reduction in tax burden of the holding company.

The result of the output of the ‘daughter’ subsidiaries being sold to the ‘parent’ holding company at below-market prices, was that the operating costs and debt remained with the subsidiaries while the profits accrued to the parent company. Subsidiaries eventually became indebted, and by purchasing their debts and becoming their major that transfer pricing can actually serve as a rather useful device for top management to enforce a hard budget constraint at the production level, in order to keep costs under control. See Nat Moser, ‘Transfer Pricing and Calculating Russian GDP’, Moscow Times, 10 June 2004, p.9.

For example, the portion of raw material tax, which had been levied from the sales price decreased from around 128 rubles to 32 rubles per ton as a result of intra-corporate transfer pricing. Ibid. In addition, by reducing the profits made by subsidiaries through the transfer pricing scheme, and by decreasing the amount of profit for regional authorities to tax subsidiaries located in the region like Yuganskneftegaz, the holding company could choose to pay taxes in Moscow, the location of Yukos head office, where more political and economic benefits were available for the holding company. Andrei Shleifer and Daniel Treisman, Without a Map: Political Tactics and Economic Reform in Russia (Cambridge MA: MIT Press, 2000), pp.132-133.

creditor, the holding company gained even more bargaining power over them. In early 1998, Yukos paid the federal government 1.3 billion rubles (USD216 million) to cover tax owed by its subsidiaries, Yuganskneftegaz and Samaraneftegaz, which gave it even more leverage over these subsidiaries in the process of consolidation. 64

Through intra-corporate transfer pricing between the holding company and its constituent subsidiaries, Yukos was in effect making a profit at the expense of subsidiaries. 65 According to Yukos’s financial statement audited by Pricewaterhouse, in 1996 the holding company recorded an after-tax profit of USD91.5 million, while the subsidiary minority interests (Yuganskneftegaz and Samaraneftegaz) recorded a combined loss of USD345 million. 66 Yuganskneftegaz in 1996 lost an estimated USD195 million through transfer pricing. 67 Manipulation of transfer prices by insiders, therefore, was being practised to the detriment of the shareholders in Yukos’s subsidiaries: by transferring profits to the holding, Yukos took away the rights of shareholders to participate in profits.

Moreover, due to transfer pricing practices, which forced subsidiaries to be subjugated to the holding company, minority shareholders in the subsidiaries saw the value of their holding rapidly diminish. For example, in the twelve-month period ending January 1998, the share price of Yuganskneftegaz fell by 30 per cent, and that of another subsidiary Samaraneftegaz dropped by 47 per cent, while Yukos’s share price rose by 185 per cent. 68

67 Ibid.
68 Ibid.
4.4.2 Consolidation of Yukos (via Single Share Conversion)

After establishing cash flow control over the subsidiaries, Yukos’s management proceeded with the plan to make subsidiaries wholly owned by Yukos through cancellation of the separate listings of subsidiaries’ shares. Consolidation envisaged a single share conversion, i.e., a swap of subsidiaries’ shares for a holding company. This would ensure that there would no longer be a situation where shareholders of subsidiaries and shareholders of the holding company coexisted within the framework of a single VIOC. Consolidation thus aimed at resolving the task of establishing effective administrative control within the framework of Yukos Oil.

a) Constraints

However, the attempts to accomplish this single share conversion were hampered by the fact that Yukos was receiving little cooperation from the minority shareholders in its subsidiaries. As has been noted, the two-tiered privatisation process had created a multilevel governance structure at holding company and subsidiary company levels, and created different sets of management and shareholders. The two-tiered scheme gave rise to a conflict of interest between the management of Yukos and subsidiaries’ minority shareholders who owned separately listed subsidiary stocks. In particular, the conflict of interests between Yukos and one minority shareholder group led by an investor Kenneth Dart became acute.69

Dart had obtained shares in the subsidiaries following voucher privatisations.70 Through his various investment entities, his group reportedly held some 12 to 14 per cent of

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70 Ibid.
shares in each of the three production subsidiaries of Yukos: Yuganskneftegaz, Samaraneftegaz, and Tomskneft. The investments of Dart’s group were not considered ‘strategic’ with long-term interest, but rather were seen as short-term speculative investments. Dart had reportedly approached Khodorkovskii in 1997 at the time of Russian stock market boom and offered a buy back of subsidiaries’ shares.

However, neither side could agree about terms for the buy back, and this served to intensify the conflict. In early 1998 Dart’s group demanded an audit of the Yukos subsidiary Yuganskneftegaz. The group accused Yukos of asset stripping via manipulation of transfer prices with subsidiaries. As mentioned above, making subsidiaries cost centres drove down their share value. Dart’s group was losing on its investment and was making a stand about shareholder’s rights.

From the perspective of minority shareholders of subsidiaries, transfer pricing practices were detrimental to share values. At the same time the management of Yukos was keen to proceed with consolidation of a vertically integrated company by making subsidiaries wholly owned, and maximising the value of subsidiaries, which was in the interests of minority shareholders, did not fit with this plan. The interests of both parties were not at all aligned. From the perspective of owner-managers of Yukos, the minority

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74 Ibid.


76 John Kenyon, ‘Who is Kenneth Dart?’
shareholders of subsidiaries were hindering the process of consolidation.

At an extraordinary shareholder meeting of Tomskneft in January 1999, a Dart-controlled group that owned 13.9 per cent of Tomskneft proposed a change in a composition of the board of directors controlled by Yukos management, and elected a new board. It attempted to change the Tomskneft charter, which conferred on Yukos the right to manage Tomskneft, and also sought to freeze the 51 per cent of shares in Tomskneft that were held by Yukos. This effectively blocked the attempts of Yukos's management to pursue the task of establishing an effective administrative hierarchy, essential for a well functioning vertically integrated company.

To the management of Yukos, it seemed imperative that minority shareholders be rendered powerless if Yukos were to be able to proceed with the planned restructuring of the company. In the given situation, it appeared to be impossible to establish internal cohesion and build a truly vertically integrated firm, and also protect the interests of minority shareholders simultaneously. However, abusive treatment of minority shareholders risked the cost of losing some of the sources of firm's equity financing. Good corporate governance, which gives strong protection of shareholder rights, reduces agency costs: reduction in agency costs is important for obtaining financing from shareholders. However, during the 1990s, particularly before the financial crisis of 1998, Russian businesses were not reliant on equity finance. As Nash points out, "Equity investment in the sense of oversight and company valuation simply had no

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78 RPI, March 1999, p.57.
79 Fedor Svarovskii, 'Opasnost' dlia investorov'.
impact on firm behaviour". In addition, market-supporting institutions were underdeveloped. Rather than attracting financing from shareholders, managers strove to establish cash flow control, which enabled them to obtain cash that was generated from assets. Obtaining cash flow control was more important than adding value to the assets at the time, given the political and economic uncertainty. In the context of weak property rights protection, controlling the cash flow enabled managers to divert cash offshore.

In addition, for the Yukos management, establishing administrative control by installing an effective management structure and controlling the production chain, appeared to be of greater priority than increasing in market capitalisation, at that time. The cost that would be incurred from violating shareholders' rights seemed to be less significant than the benefits to be derived from removing the influence of minority shareholders in the priorities of Yukos's management. By eliminating minority shareholders' influence and concentrating ownership management hoped to establish strong administrative control. It should be borne in mind however that if expropriation of minority shareholders' rights becomes frequent, the investor confidence is damaged and the investment climate suffers.

81 For a newly added incentive to maximise share value, which emerged around 2000, see Chapter 6, Footnote 116, p.235.
82 Yukos's focus shifted more towards increasing market capitalisation after gaining complete corporate control. Its improvement in corporate governance after around 2000 is beyond the scope of this study, but Yukos's drive to increase transparency and to boost capitalisation included the introduction of corporate governance charter of the company in 2000, and the appointment of independent directors and foreigners as 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, and disclosed core shareholders of the company in June 2002 (see Figure 4.1).
b) Transfer Pricing as a Precondition (of Single Share Conversion)

Given the plan to cancel the separate listing of subsidiaries' shares, the transfer pricing scheme became a precondition for single share conversion. As noted above, by making subsidiaries cost centres, the share value of subsidiaries went down. The shares of production subsidiaries were relatively liquid, and were readily available to brokers generally at fairly high prices. Of course, the higher the market price of subsidiaries, the more costly it was for the holding company to do the share exchange. Therefore, it was advantageous to the holding company to minimise the value of the subsidiaries. If the market price of subsidiaries could be reduced, the holding could achieve better (i.e. cheaper) terms for the share exchange. Transfer pricing was the means used to reduce the value of the subsidiaries, and thus became a precondition for the share conversion.

c) Share Dilution at Subsidiaries

To facilitate the consolidation of Yukos, share dilution practices were used to eliminate minority shareholder influence, including that of the Dart group. In March 1999, extraordinary general shareholder meetings were held at Tomskneft, Samaraneftegaz and Yuganskneftegaz. Minority shareholders were not invited to attend the meetings as will be described below. Each meeting adopted a decision to increase the number of shares in order to dilute the shares held by minority shareholders. Moreover, a proposal was passed to authorise an issue of new shares available through closed subscription only to certain offshore companies believed to be affiliated to Yukos, and therefore out of reach of existing minority shareholders. For example, the new share issue in

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84 Moser and Oppenheimer, “The Oil Industry”, p.315.
85 More concretely, Yukos planned to issue:
1) 77.8 million new shares in Yuganskneftegaz, in addition to the existing 40 million.
2) 67.4 million new shares in Samaraneftegaz, in addition to the existing 37.6 million.
3) 135 million new shares in Tomskneft, in addition to the existing 45 million.

See Hoffman, The Oligarchs, pp.448-449. As he points out, it was a part of a plan to “wrest Yukos out of the grip of its creditors and minority shareholders, [...] to move the oil company offshore,
Yuganskneftegaz shares was to be sold to four offshore entities — Asbury International Inc. in the Bahamas, Rennington International Associates Ltd. in Ireland, and Thornton Services Ltd. and Brahma Ltd. both registered in the Isle of Man — all of which it was suspected were affiliated to the top management of Yukos. According to Black, Kraakman and Tarassova, a proposal was passed at each of the three meetings for “a massive new share issuance to obscure offshore companies, at dirt-cheap prices that valued the companies at 1% or less of their true value, and perhaps 10% of their depressed trading prices”.

In addition, these new shares were to be purchased through bills of exchange issued by the oil-producing subsidiaries themselves, and had a maturity date in 2003, meaning that the subsidiaries would not receive any payment from the new shares. The other decision that was made at these meetings was to transfer unspecified company assets to more than a hundred new unnamed and obscure companies during the period of 1997 to 2001. These actions — share dilution combined with asset stripping — were cases of abusive self-dealing that went against the principle of equitable treatment for shareholders. Accordingly, these resolutions passed at the three March 1999 shareholders meetings became well-publicised examples of corporate governance abuses.

The resolutions on new share issues were passed at a time when the conflict between

leaving minority shareholders and creditors with an empty shell”.

86 Ibid., p.449.
88 Hoffman, The Oligarchs, pp.448-449. According to the JSC law, payments for shares must be made to the company in 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 and Fenn, ‘Aspect of Corporate Governance’, p.66.
90 Oleg Fedorov, ‘Three Cases of Abusive Self-Dealing’, paper presented at the OECD 2nd Round Table on Corporate Governance in Russia, Moscow, 2000.
Yukos and Dart was intensifying. Yukos reportedly made it explicit that the aim was to dilute the stake held by Dart’s companies to smooth the process of single share conversion.\textsuperscript{91} For example, the new issue would reduce the proportion of Dart’s shareholding in Yuganskneftegaz to less than five per cent.\textsuperscript{92}

The practice of share dilution was enabled by limiting shareholders’ voting rights. The meetings approved these share issues aimed at dilution without the participation of minority shareholders who could have blocked the decision by their votes.\textsuperscript{93} Minority shareholders of subsidiaries were barred from voting at the shareholders meeting on the basis of court injunction allegedly arranged through “a compliant judge”.\textsuperscript{94} (Prior to the meeting date, a regional judge in the town of Mosalsk froze the shares that were able to block the passage of resolutions.\textsuperscript{95}) The court injunction froze the shares owned by four offshore entities managed by minority shareholders on the grounds that these companies had failed to register properly with Russia’s Antitrust Ministry.\textsuperscript{96} This court ruling was issued under Russian legislation that required special registration if affiliated entities owned more than a 20 per cent in a company.\textsuperscript{97} The four companies excluded together owned more than the 25 per cent plus one share required for a blocking vote. One of them, the Arrowhead Enterprise, an investment vehicle of Dart which owned 12 per cent in Samaraneftegaz, disputed Yukos’ claims, saying the four companies were not affiliated, and thus were not acting in concert.\textsuperscript{98} The court ruling was made after an individual shareholder had filed a suit in a district court in the Kaluga region, claiming

\textsuperscript{91} Ibid.
\textsuperscript{92} Ibid.
\textsuperscript{94} Black et al., ‘Russian Privatisation and Corporate Governance: What Went Wrong?’, p. 1771.
\textsuperscript{97} Fremya MN, 1 April 1999; Semenenko, ‘Yukos Locks Investors Out of Meeting’.
\textsuperscript{98} Semenenko, ‘Yukos Locks Investors Out of Meeting’.
that companies owned by Dart were hindering the operating activities of the oil holding. 99 Yukos maintained that their actions were based on this court injunction and thus had the backing of the law. 100

The weak judicial system in Russia contributed to the use of ICGPs. Some minority shareholders tried to challenge the Mosalsk judge’s ruling, as they believed that there had been several violations of the legislation by this judge. For example, according to Oleg Fedorov, a representative of NAUFOR (National Association of Professional Participants of Securities Market), the judge was not competent to consider the case; and when he levied a freezing of the shares, this ruling was in violation of the law of procedure and that of the enforcement proceedings. 101 Minority shareholders lodged an appeal against the ruling with the General Prosecutor’s Office and filed a complaint against the judge’s actions with the Grievances Commission and a higher-level regional court. However, all these protests either went unheeded or were sent to the judge against whom the complaints had been made. 102 As a result, Fedorov concluded that “None of the legal Russian instruments for appealing against a judge’s unlawful actions proved to be of any effect”, 103 indicating the flaws in the judicial system that made ICGPs workable.

The minority shareholders attempted to prevent the Federal Securities Commission (FCSM), which was responsible for registering newly issued shares, from registering Yukos Oil’s new share issue. As noted above, the offshore entities chosen to receive the new shares, although not connected formally with Yukos, were suspected of being

99 Ibid. See Chapter 2 for a general discussion of the instrumental use of court injunction in Russia.
100 Ibid.
102 Ibid.
103 Ibid.
affiliated to the core owner-managers of Yukos.\textsuperscript{104} Therefore, if it could be established that these offshore entities were connected with owners-managers of Yukos who had participated in the vote to transfer the newly issued shares to those entities, then the transactions would be interested party transactions and this would allow FCSM to refuse to register these new share issues.\textsuperscript{105}

However, circumvention of the interested party rule was generally possible by the setting up a non-transparent network of offshore entities in which other shareholders did not participate. Vasiliev, the head of the FCSM at that time, was convinced that the objective of Yukos in issuing the shares was to transfer them to affiliated offshore companies.\textsuperscript{106} However, it proved impossible to show that the sales of the additional shares to these offshore companies constituted interested party transactions. Noting that the Yukos share dilution case involved multiple offshore jurisdictions, Vasiliev stressed the need for a mechanism that would help FCSM to establish the identities of the real individuals behind offshore companies in order to prevent transactions involving interested parties. In Russia, the real owners often disguise their ownership by buying shares through one or more offshore shell-companies that cannot be traced back to them.\textsuperscript{107} Chains of offshore companies or affiliates are often arranged in such a way that the real owners do not appear on the ownership registration.\textsuperscript{108}

Moreover, the role of the state did not live up to the expectations of minority shareholders in relation to the protection of their rights. Although the FCSM attempted

\textsuperscript{104} Fenkner, ‘How to Steal an Oil Company’.
\textsuperscript{105} Vasiliev, ‘Korporativnoe upravlenie v Rossii’. According to Vasiliev, in 1998, the FCSM refused registration of stock issues in 2,600 cases, and share dilution was not successful in a significant number of cases.
\textsuperscript{107} Nestor and Jesover, ‘OECD Principles of Corporate Governance on Shareholder Rights and Equitable Treatment’, p.5.
\textsuperscript{108} Radygin and Sidrov, ‘Rossiiskaia Korporativnaia Ekonomika: Sto let odinochestva’, p.52.
to investigate the legitimacy of the share issue at Yukos's subsidiaries, it did not have sufficient investigative power. Other Russian government agencies refused to provide FCSM with information they held that might assist the investigation: For example, the Fuel and Energy Ministry and the State Tax Service ignored requests from FCSM for assistance. 109 In fact, it appears that the state authorities ultimately had taken no action to prevent the investments of minority shareholders from being diluted. To try to block the issue of new shares, a group of minority shareholders sought help from the state authorities. They filed claims with the General Prosecutor’s Office, and sent a collective letter, which was made public, to the government. However, the government did not answer this; the Prosecutor’s Office was silent, and apart from the FCSM no other government agencies would give assistance to minority shareholders. 110

Thus, despite the efforts of minority shareholders, share dilution took place. 111 Because the transactions were all considered to be legal, the FCSM could not refuse registration of the newly issued shares. 112 Vasiliev 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". 113 By November 1999 Yukos had reportedly succeeded in the dilution of Yuganskneftegaz and Samaraneftegaz shares, and in transferring the greater part of its own shareholding in its operating subsidiaries to offshore entities. In December 1999 Dart’s group agreed to sell its shares to Yukos. 114

109 Hoffman, Oligarch, p.455.
110 Fedorov, 'Three Cases of Abusive Self-Dealing'.
111 According to the Harvard Study, after the Yukos action in March, minority shareholders saw their stakes in the subsidiaries reduced from 37-49 per cent to 14-17 per cent. According to Fedorov’s sources, before the operation Yukos managers had a 40 per cent stake in Yukos and negligible stakes in its subsidiaries; and after the distribution of the new issue they obtained control over 80 to 90 per cent of the vote in every oil-producing subsidiary. See Ibid; ‘OAO Yukos Oil Company’, Harvard Business School.
112 Hoffman, Oligarchs, p.456.
114 Moser and Oppenheimer, ‘The Oil Industry: Structural Transformation and Corporate Governance’. 
d) Share Consolidation

The term ‘share consolidation’ refers specifically to a situation in which the original number of a company’s shares is concentrated or consolidated into a much smaller numbers with higher par value. Under share consolidation, what was originally one share in a subsidiary thus became only a fraction of the newly consolidated share.

Share consolidation was utilised to facilitate the conversion of subsidiaries’ shares. When this share consolidation took place, so-called fractional (drobnye) shares resulted. The amendment in the JSC Law that came into force from January 2002 introduced the concept of a fractional share. Prior to this, fractional shares did not exist, and thus holders of fractions of original shares were in principle left with three choices: to sell them back to the subsidiary, to sell them on the market, or to exchange them for holding company shares. Since the existing subsidiary shares were usually consolidated into a much smaller quantity of shares with a very high par value, only the holding company was able to afford to obtain shares that were non-fractional. The holding company could then buy back those subsidiaries’ fractional shares from the minority shareholders of the subsidiary, according to the article 74 of the JSC Law. This meant that share consolidation was a useful means of eliminating minority shareholdings in subsidiaries, and of facilitating the holding company to convert subsidiaries’ shares into a single share representing the holding company. According to Vladimir Statyn, the General Director of ASIP (Association for Shareholders Interests Protection), adoption of amendments to the JSC Law was delayed for more than a year

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118 Tutushkin, ‘Golovnaia bol’ neftianika’.
as a result of opposition from some companies, which allowed these companies to complete their share consolidation process.  

For example, share consolidation facilitated the conversion of subsidiaries’ shares into a single Yukos share. Share consolidation in Samaraneftegaz took place in two steps. First, its shares were exchanged for shares in Yukos (one ordinary share in Samaraneftegaz became four shares in Yukos): shareholders of Samaraneftegaz exchanged their shares for Yukos shares between March 2000 and February 2001. As a result, the main shareholders of Yukos, to whom ownership of the exchanged Samaraneftegaz shares was granted, accumulated more than 95 per cent of Samaraneftegaz shares. In the next step, the total number of Samaraneftegaz shares was consolidated into a much smaller number; 50 ordinary and 15 privileged shares, with high par value. Thus one original share in Samaraneftegaz became only a fraction of a new consolidated share. Those minority shareholders of Samaraneftegaz who did not exchange their shares for Yukos shares were now left with fractional shares. These fractional shares had to be sold and the holders of fractional shares were offered 251 rubles for ordinary shares and 125 rubles for preferred shares. By this means Samaraneftegaz shares were converted to Yukos shares, and minority shareholders of Samaraneftegaz were “eradicated as a class”.

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121 Tutushin and Lange, ‘Yukos stal mishen’iu’; Tutushkin, ‘Golovnaia bol’neftianika’. There was a conflict between Yukos and minority shareholders, who were dissatisfied with the share consolidation of Samaraneftegaz, and thus initiated legal actions against the company. Similarly, at the Angarsk Petrochemical Company (Angarskaia Neftekhimicheskai Kompania) acquired by Yukos, it was decided that 1.2 billion ordinary shares should be consolidated into 4 shares, and 0.4 billion preferred shares were converted into three. 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. See Dolgopiatova, Rossiskaiapromyshlennost’, pp. 48-49. This instrument was used to consolidate corporate control over a subsidiary, and was also applied to other subsidiaries of Yukos. See Alexandr Radygin, ‘O nekotorykh problemakh korporativnogo upravleniya v Rossii’, mimeo, 2002.
4.4.3 The Outcome

Through the use of ICGPs, as has been shown, the Yukos management strengthened its administrative control over subsidiaries by eliminating minority shareholders’ influence and concentrating ownership. As a result, Yukos established a workable administrative framework, or became what Penrose called an “autonomous administrative planning unit” with “managerial direction responsible for the general policies under which the firm’s administrative hierarchy operates”.122 The management was able to bring the operations of its subsidiaries under its control, which enabled management to integrate and organise business functions, and make the production chain operational.

By June 2000, Yukos had control of over 90 per cent of the stock in its Yuganskneftegaz, Samaraneftegaz and Tomskneft subsidiaries.123 During 2001, Yukos Oil announced that it had “substantially completed its plan to acquire 100 per cent of the voting stock in its key production, refining and marketing subsidiaries”.124 Yukos, in turn, was owned by a group of core owner-managers, who had built up an equity stake since the loans-for-shares auction.125 They owned Group Menatep, which, through one of their entities called Yukos Universal (see Figure 4.1), owned Yukos. The core shareholders, as of early 2001, held nearly 70 per cent of Yukos shares, which, when combined with the company’s treasury stock and a pool of shares set aside for retiring employees, left an effective free float of less than 16 per cent.126 By this time, if not ownership per se, owner-managers had de facto control of more than 80 per cent of Yukos shares.127

126 ‘OAO Yukos Oil Company’, Harvard Business School, p.12. In June 2002, the company publicly disclosed that 61 per cent of Yukos was owned by Group Menatep.
127 Takov Pappe, ‘Rossiskii krupnyi biznes kak ekonomicheskii fenomen 1992-2001 gg:'
The acquisition of more than 90 per cent shares in its subsidiaries enabled Yukos to effectively manage upstream operations within a single Yukos framework. Yukos Exploration & Production (E&P), a wholly-owned subsidiary of Yukos originally established in 1998, was finally in control of the oil extracting subsidiaries, Yuganskneftegaz, Samaraneftegaz and Tomskneft, which allowed it to manage the upstream chain of production operations. Similarly, Yukos Refining & Marketing (R&M), created as a wholly owned subsidiary of Yukos, had control of the Kuibyshev, Novokuibyshev, Syzran and Achinsk oil refineries and Yukos’s sales network, which covered eleven regions of Russia. Yukos E&P and Yukos R&M were under the management of Yukos-Moskva, which was responsible for developing strategy and for decision making on major strategic issues (see Figure 4.1). Thus, the company had achieved to establish an effective administrative hierarchy, with the activities of subsidiaries being brought together under a single management within the framework of Yukos as a whole. In short, Yukos was now a vertically integrated oil company both in name and in substance.
4.5 Conclusion

The analysis of the role of ICGPs in Yukos’s corporate development during the 1990s reveals the ambiguity in these practices. As has been shown, Yukos used a series of ICGPs, which went against the principles of good corporate governance. Their abusive nature had adverse consequences for investors and investment climate as they violated shareholders rights. As a result, the minority shareholders in Yukos subsidiaries condemned corporate governance abuses by the Yukos management and initiated a

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public relations campaign against Yukos in 1999.\textsuperscript{133} The share valuation of Yukos plummeted as a consequence.\textsuperscript{134} Yukos's company image was severely damaged. The company was branded a “corporate governance disaster”.\textsuperscript{135}

However, it is important to recognise that ICGPs performed constructive functions in the context of the reorganisation of the oil sector and institutional weaknesses. ICGPs were used to build a business entity within which the operations of subsidiaries were brought under the control of the framework of VIOC. They became tools to resolve the tasks the company faced in reconstituting itself into an effective business unit. Specifically, as this chapter has demonstrated, ICGPs addressed the lack of administrative cohesion and helped establish management control. Establishment of administrative control was, in turn, necessary to integrate business functions and to organise successive stages of oil production under a single management.

This chapter has shown that Yukos suffered from disintegration in its corporate management as a result of the two-tiered privatisation. Although established as a vertically integrated oil company, it was vertically integrated in name only and lacked organisational integrity. Due to the lack of an effective administrative hierarchy, Yukos had difficulties in integrating business functions and linking the production chain. In order to alleviate the problems produced by the lack of internal cohesion between the holding company and subsidiaries, the management first sought to establish control over


\textsuperscript{134} In June 1999, Yukos shares were trading at 15 cents, down a per cent from the high of USD 6 two years earlier. Ibid.

\textsuperscript{135} One analyst noted that Yukos “will need the mother of all public-relations efforts to rescue their reputation”. Gary Peach, ‘Yukos Seeks to Move Stakes Offshore’, \textit{Moscow Times}, March 12 1999.
the cash flow of subsidiaries. As summarised in Table 4.2, ICGPs, particularly transfer pricing practices, were utilised to this end. Having established cash flow control, the next step was to consolidate Yukos as a VIOC. To do this, the company attempted to cancel the separate listings of subsidiaries’ shares and transfer them into single Yukos shares. However, the process was complicated by the presence of minority shareholders in these subsidiaries. The two-tiered structure gave rise to a sharp conflict of interests between the management of Yukos and the shareholders of subsidiaries. To consolidate Yukos as vertically integrated company, ICGPs such as share dilution, and limiting shareholder’s voting rights, were used. They were utilised to assist Yukos management to concentrate its ownership, strengthen its management control and reconstitute the company into a functioning business unit that would be competitive in the world market.

As has been demonstrated, the use of ICGPs was facilitated by the presence of certain institutional factors. Russia’s institutional environment contained several weaknesses that made these practices possible. More concretely, ICGPs worked because of the imperfections of laws themselves, the instrumental-use-of-law mentality, and weak enforcement mechanism, including lack of independence in the judicial system. In addition, although minority shareholders appealed to the state over the violation of their rights, the authorities generally did not act. Therefore, it appears that the state authorities at the time tolerated the use of ICGPs.
Table 4.2 Tasks Yukos Faced and ICGPs

<table>
<thead>
<tr>
<th>Tasks faced by the company</th>
<th>ICGP as Tools</th>
<th>Type of ICGP</th>
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<tbody>
<tr>
<td>Establishment of administrative control</td>
<td>▶ To deprive subsidiaries of operational independence</td>
<td>Transfer pricing</td>
</tr>
<tr>
<td>▶ to alleviate lack of internal cohesion between Yukos and its subsidiaries - as a result of two-tiered privatisation, Yukos, as well as its subsidiaries, were each organised as JSC. Subsidiaries had operational independence, with their own company stock, with different shareholders, management and boards of directors. ▶ to alleviate a lack of ability to maintain effective administrative coordination within a framework of Yukos as a VIOC. Management control was needed for 1) organising business functions located within VIOC; and 2) making the production chain that was nominally integrated within Yukos actually work.</td>
<td>▶ to establish cash flow control over subsidiaries</td>
<td></td>
</tr>
<tr>
<td>▶ To establish wholly owned vertically integrated company by canceling separate stock issue of subsidiaries, and swapping subsidiary shares for a holding share, thus converting to a single share issue.</td>
<td>▶ to minimise value of subsidiaries; achieve better share swap/conversion terms of subsidiaries shares and Yukos shares</td>
<td>▶ to establish cash flow control over subsidiaries</td>
</tr>
<tr>
<td>Share dilution</td>
<td>▶ to dilute the holdings of subsidiaries’ shareholders to less than the blocking level, through new share issues</td>
<td>▶ to dilute the holdings of subsidiaries’ shareholders to less than the blocking level, through new share issues</td>
</tr>
<tr>
<td>▶ to distribute additional shares to entities informally affiliated with Yukos’s management - circumventing the interested party transactions rule.</td>
<td>▶ to distribute additional shares to entities informally affiliated with Yukos’s management - circumventing the interested party transactions rule.</td>
<td>▶ to distribute additional shares to entities informally affiliated with Yukos’s management - circumventing the interested party transactions rule.</td>
</tr>
<tr>
<td>Limiting shareholders access to vote</td>
<td>▶ to facilitate decision to issue new shares by excluding ‘undesirable’ shareholders (minority shareholders of subsidiaries): incomplete notification for the time and venue of shareholder meeting, freezing shares through court injunction</td>
<td>▶ to facilitate decision to issue new shares by excluding ‘undesirable’ shareholders (minority shareholders of subsidiaries): incomplete notification for the time and venue of shareholder meeting, freezing shares through court injunction</td>
</tr>
<tr>
<td>Share consolidation</td>
<td>▶ concentrating subsidiary shares to create fractional shares for advantageous buyback by management affiliated entities</td>
<td>▶ concentrating subsidiary shares to create fractional shares for advantageous buyback by management affiliated entities</td>
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It should be noted here that although the two-tiered privatisation led to the disintegrated administrative structure of Yukos as a VIOC, not all VIOCs were similarly affected by
privatisation. Lukoil is a case in point: this company seemed to be able to avoid the disintegration of its corporate management despite the two-tiered privatisation. This may have been in part due to the fact that the plan to reorganise the Russian oil industry through the creation and privatisation of several VIOCs was spearheaded by the president of Lukoil, Vagit Alekperov, former deputy oil and gas minister of the Soviet Union. In fact, Lukoil as a vertically integrated unit was already in the making at the end of 1990, and Lukoil was officially established as the first and only state oil concern in November 1991. Subsequently, when VIOCs were established and privatised, the top management of Lukoil was from the outset conscious of the need to establish strong administrative control, and maintain internal cohesion among the holding company and the oil producers, refineries and distributors which were to become its subsidiaries. Thus, it appears that when privatising Lukoil, the issue of organisational requirements – the need to put an effective administrative hierarchy in place to integrate various business functions and organise a successive stage of oil production under single point of control – was already being addressed by this company.


137 Ibid., pp.96-97.

138 Kryukov and Moe, The Changing Role of Banks in the Russian Oil Sector, pp.12-13. They point out that the “holding company was clearly superior to the subsidiaries in both personnel and competence”.

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CHAPTER 5. ICGPs and Siberian (Russian) Aluminium

5.1 Introduction

Chapter 5 continues examination of the ambiguity of ICGPs based on the case of Siberian Aluminium (SibAl). It focuses on the role of ICGPs during the 1990s, when the aluminium smelter, Saiansk Aluminium Plant (SaAZ) was developed into SibAl, which ultimately in 2000 became Russian Aluminium (RusAl), Russia’s largest and the world’s second largest aluminium producer at the time.

Use of ICGPs is examined in the context of the tasks of reorganisation faced by SaAZ in the wake of the disintegration of the Soviet economic system and institutional weakness. SaAZ, which had functioned as a production unit under the Soviet economic hierarchy, had to remedy its lack of technical and organisational resources in order to reconstitute itself into a business unit. This chapter illustrates that ICGPs, which were abusive to outsider shareholders and creditors, and were detrimental to the investment climate, did in fact contribute to the tasks of reorganisation and performed certain functions for the reconstitution of enterprises as business units.

In order to understand the tasks involved, this chapter first describes the background to developments in the Russian aluminium industry, including the problems that emerged with the collapse of the Soviet economic system, and the services provided by intermediary traders through a mechanism known as tolling. Secondly, the challenges that the management of SaAZ/SibAl faced in the task of reconstituting the aluminium plant are examined, focusing on the problems arising from the fact that SaAZ was a production unit with limited resources from the resource-based view of the firm. Thirdly, the chapter discusses the various measures taken to reconstitute the plant into a business
firm. In particular, it examines how the aluminium plant was developed into a vertically integrated aluminium company, and how ICGPs were used in the process.

5.2 Disintegration of the Soviet Economic System and Aluminium Enterprises

5.2.1 Problems that Emerged with the Disintegration of the System

Under the Soviet economic system, production was under the state's administrative control, which was exercised through a country-wide industrial hierarchy: from the policy makers at the top who decided what should be produced and in what quantities, to the production units at the bottom which carried out the processes according to instructions. 1 The production of aluminium was controlled by the Ministry of Non-Ferrous Metallurgy. 2 The Ministry, together with Gosplan, the State Planning Committee, was responsible for formulating plans on production and investment in the aluminium sector. 3 Marketing and overseas sales were managed by foreign trade organisations. The research function was performed by an industry-wide technical institute, VAMI (All-Union Aluminium and Magnesium Institute). Individual aluminium enterprises did not have to be concerned with pricing, as the price of goods was fixed by Goskomtsen. 4 Soviet aluminium enterprises functioned as production units whose primary concern was to fulfil and to exceed the production target set by the state. They were at the bottom layer of an economic hierarchy in which executive management functions such as strategic planning, or financing and marketing functions were performed by the top organs in the Soviet economic system.

Production of aluminium involves more than one stage in which bauxite is refined to

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1 Hanson, *The Rise and Fall of the Soviet Economy*, p.9.
3 Ibid.
produce alumina and alumina is smelted to produce primary aluminium. The USSR was the second largest aluminium producer in the world. There were several alumina refineries in the Soviet Union, including Pavlodarsk Aluminium Plant (PAZ) in Kazakhstan, Bogoslovsk Aluminium Plant (BAZ) and Achinsk Alumina Plant (AGK) in Russia, and Nikolaevsk Alumina Plant (NGZ) in the Ukraine. The five largest aluminium smelters in Russia were Bratsk Aluminium Plant (BrAZ), Krasnoiarsk Aluminium Plant (KrAZ), Novokuznetsk Aluminium Plant (NkAZ), Irukutsk Aluminium Plant (IrkAZ), and Saisansk Aluminium Plant (SaAZ). The downstream stage of production involved plants, such as Krasnoiarsk Metal Plant (KraMZ) and Samara Metal Combine (SAMEKO) in Russia, that produced rolled aluminium and semi-fabricated products (see Figure 5.1).\(^5\) Under the Soviet system, the smelters that produced primary aluminium were supervised by the Ministry of Ferrous Metallurgy, while KraMZ, which produced rolled aluminium, was under the jurisdiction of the Ministry of Aviation Industry.\(^6\)

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Over the last years of the Soviet Union, the structure of state administrative control over the aluminium industry was characterised by instability. As a result of decentralisation, the authority of branch ministries was diminished, and the autonomy of individual enterprises increased. Although previously there had been separate Ministries for Ferrous and Non-Ferrous Metallurgy, with thousands of personnel in each, these ministries were merged into a single Ministry of Metallurgy as part of Gorbachev’s economic reform, which involved cutting back the state bureaucracy, particularly that part with industrial branch responsibilities. Decentralisation culminated in total privatisation of the aluminium sector. Corporatisation and privatisation took place at the

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8 Stephen Fortescue, ‘Russian Mining and Metals Sector: Integration or Disintegration?’, in Vladimir Tikhomirov (ed.), *Anatomy of the 1998 Russian Crisis* (Melbourne: Contemporary Europe Research Centre, University of Melbourne, 1999), pp.206-207. According to Fortescue, with the collapse of the Soviet Union, the Ministry of Metallurgy ceased to exist, and it was replaced by the Department of Metallurgy, which came under the Ministry of Industry. The Committee for Metallurgy was created in September 1992 as an independent state agency representing the aluminium sector. The staff numbers of this committee did not exceed 250. Thus, the state agency in charge of aluminium was not stable, and was continuously shrinking.
lowest level of the industrial hierarchy, at the production unit level. This 'atomising privatisation', Fortescue points out, was designed to finally destroy the integrated administrative structure of the Soviet economy.\(^9\)

Against a background where the whole administrative-planned Soviet economic system was disintegrating, the state withdrew from the functions of providing financing and supplying raw materials to aluminium smelters, and coordinating distribution.\(^10\) The aluminium enterprises, i.e., the plants, that had operated as production units, faced the problem of obtaining working capital, procuring raw materials, and marketing their production.

The first need was for working capital. The withdrawal of the state from economic activities meant that the state was no longer a reliable source of finance.\(^11\) Bank loans were not a realistic proposition, as interest rates were prohibitive – up to 200 per cent or higher per year for bank credit.\(^12\) The time from the purchase of raw materials to the receipt of payment for the metal produced was three to four months.\(^13\) This meant that the plants (smelters) had to seek means of financing themselves during this period.

The macroeconomic situations were exacerbating the problems. Hyperinflation was hitting the country, eroding the value of working capital. An overall lack of liquidity in the economy led to the rise of non-monetary transactions such as barter and a use of veksels in industrial sectors. The aluminium plants rarely received what was termed 'live money', or real cash. In addition, as will be described below, domestic demand for metal dropped sharply due to the drastic cut in defence spending. In addition to the

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\(^10\) Zander et al., 'Novye formy rynochnykh otnoshenii v aliuminievoi promyshlennosti', p.107.
\(^11\) Ibid.
\(^12\) Ibid., p.105.
\(^13\) Ibid.
enterprises not having sufficient finance to manage operations, energy and transportation costs had risen, and they had to find money to pay the wages of employees and to pay taxes to the authorities.\textsuperscript{14}

Secondly, there was the problem of procuring alumina. To begin with, the Soviet Union was traditionally not richly endowed with alumina. Sixty per cent of demand was met by suppliers within the USSR, but the Soviet Union had bought in the remainder from Guinea, Jamaica, Yugoslavia, Greece, Australia and other countries.\textsuperscript{15} During Soviet times, the largest domestic suppliers of alumina were Pavlodarsk Aluminium Plant (PAZ) and Nikolaevsk Alumina Plant (NGK) located in Kazakhstan and Ukraine, respectively. When these former Soviet republics became independent states, traditional economic links that supplied alumina to the Russian smelter were disrupted. Moreover, lack of working capital made it difficult for Russia's aluminium smelters to attempt to purchase alumina.

In addition, the Russian aluminium industry faced a drastic fall in domestic demand. In the USSR, the main consumers of the produced aluminium were the defence, aircraft and space industries.\textsuperscript{16} After the collapse of the USSR at the end of 1991, domestic demand for aluminium fell sharply, due in part to Russia's defence spending being reduced by 80 per cent the following year.\textsuperscript{17} Domestic consumption was 1.9 million tons (out of total production of 2.916 million tons) in 1990, but this figure plummeted after 1992, and in 1996 was only 434,000 tons (out of a total production of 2.870

\textsuperscript{14} For the costs of transportation and energy tariffs, see V. M. Sokolov and M.A. Iagol'nitser, 'Tollingovoi platsdarm rossiiskogo aluminia', \textit{EKO}, 8, 1997, p.84.
\textsuperscript{16} Izumi Sakaguchi, 'Rosiano hitetsusangyou no genjou ni tsuite', \textit{Roshia chousa geppou}, 2000, p.60.
\textsuperscript{17} 'King of the Castle?', \textit{The Economist}, 21 January 1995, p.62.
million tons). A fall in the volume of production in the civil machine-building sector also had an effect.

Following this greatly reduced demand from the domestic defence sector, Russia's way forward was to export aluminium to the West. However, the aluminium smelters had insufficient expertise in marketing and sales in the international market. During Soviet times, foreign trade in aluminium was handled by specialised organisations of the Ministry of Foreign Economic Relations, such as Raznoexport. Raznoexport managed exports according to state orders. The enterprises delivered the metals as per instructions from above and did not handle export sales directly. They had no sales channels abroad, and lacked experience in world markets, and in conducting contracts and other commercial practices.

During the Soviet period, the major export markets were the CMEA (Council for Mutual Economic Assistance) countries. Exports of aluminium did not exceed 0.5 million tons per year. Hungary, which had large bauxite and alumina production, but little capacity for smelting, was the largest trading partner. Therefore, through a barter arrangement, the USSR received alumina from Hungary and in return shipped refined metal to Hungary. The Soviet Union exported aluminium to the Czech and Slovak Federal Republics, Poland, and Bulgaria. However, the patterns of trade were changing as a result of the end of the Cold War, and Russia needed to look for export markets

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19 Zander et al., ‘Novye formy rynochnykh otnoshenii v aluminievoi promyshlennosti’, p.103.
21 Ibid.
22 Interview with aluminium specialists at a Japanese trading company in Moscow conducted by the author, July 2003. Fortescue also notes that even enterprises with a long history of export, though not many, had no direct experience of trading in the world market. Fortescue, ‘Russian Mining and Metals Sector’, p.218.
24 Ibid., p.243.
beyond these traditional trade links with the CMEA countries.\textsuperscript{25}

\subsection*{5.2.2 Tolling and Traders–Intermediaries}

Despite these wide-ranging problems, Russian aluminium smelters continued operations. They continued to produce primary aluminium and their production levels did not fall.\textsuperscript{26} A system called tolling helped maintain stable aluminium production in Russia despite the sharp fall in overall industrial production after the collapse of USSR. Tolling, or originally known as \textit{daval’cheskaia pererabotka}, is a system of production based on raw materials provided to the producer, who processes the material on commission.\textsuperscript{27} The tolling system was put into operation by foreign traders, who acted as intermediaries.\textsuperscript{28} They not only took charge of the supply of the inputs (alumina) for aluminium smelters, but also the sale of the outputs (primary aluminium) that these smelters produced. The aluminium smelters received processing fees for the aluminium produced using the material provided by traders.\textsuperscript{29} This tolling system gave the traders involved great control over the Russian aluminium industry because they provided the smelters with alumina and capital, which allowed smelters to continue operations.

\textbf{Mechanism of Tolling}

The first tolling operation in Russia reportedly began in 1991 when the Swiss-based

\begin{center}
\begin{tabular}{|c|c|c|c|c|c|c|c|c|}
\hline
\hline
Production of Primary Aluminium (in 1,000t) & 2,916 & 2,735 & 2,745 & 2,818 & 2,669 & 2,728 & 2,870 & 2,906 & 3,005 \\
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\end{tabular}
\end{center}


\textsuperscript{27} \textit{Daval’cheskaia pererabotka} is used in other Russian industries such as food and textiles. See Svetlana B. Avdasheva, \textit{Khoziaistvennye Sviazi v Rossiskoi Promyshlennosti: problemy i tendentsii poslednego deiatelitii} (Moscow: HSE, 2000). Also, this type of arrangement, known as OPT, or Outward Processing Traffic, is used in other emerging economies of Central and Eastern Europe.

\textsuperscript{28} The main foreign traders included a Swiss company Marc Rich, Glencore, the UK-based Trans-World, and the US-based AIOC. See below for the further discussion on Trans-World, the most influential of the traders. This chapter focuses on activities of Trans-World.

\textsuperscript{29} The raw materials provided to producer for commissioned production are called \textit{daval’cheskoe syr’e}.  

\textsuperscript{25} Ibid.

\textsuperscript{26} Production of Primary Aluminium (in 1,000t)
trader Marc Rich introduced it at Krasnoiarsk Aluminium Plant (KrAZ). In 1992, Trans-World, a UK-based trader, was the first to officially conclude tolling contracts with Russian smelters in Siberia, namely with Bratsk Aluminium Plant (BrAZ).

Alumina needed for aluminium smelting, which was extracted from bauxite, was imported and provided to Russian smelters by Trans-World, who then exported the primary aluminium produced abroad. Traders obtained alumina from countries outside of Russia, including Ukraine and Kazakhstan, for aluminium plants in Russia. Alumina and the processed primary aluminium produced were the property of the trader, who acted as an intermediary. The Russian smelters received fees from the trader for the production or processing work. Thus, they did not have to be concerned with finding alumina suppliers or customers for the aluminium produced. In other words, the trader acted as the organiser of the production chain.

Tolling operations were officially approved by a State Customs Committee order ‘On the procedure of bringing in imported goods for processing’ in 1992, which legalised the scheme. The tolling arrangement was endorsed by the government as a temporary provision to help the aluminium smelters that were suffering from lack of working capitals and supplies of alumina. The Customs Committee order was followed by a regulation issued by the Ministry of Economy ‘On bringing in imported raw material for processing (daval’cheskoe syr’e dlia pererabotki)’ in July 1992. Oleg Soskovets, 30

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32 Kuleshov, Aliuminievaiia promyshlennost’ Rossii v rynochnykh usloviakh, pp. 59-60; Mirontseva and Petrovich, ‘Aliuminievye koroli i “kapusta”’.
35 Polozheniia ministerstva ekonomiki RF “O vvoze importnogo daval’cheskogo syr’ia dlia
Deputy Prime Minister, who represented the interests of the metal industry at the time, helped promote the official approval of the tolling system in Russia. The tolling system quickly became widespread: By 1994, 1.8 million tons, or more than 50 per cent of total production, was dependent on tolling.

For the intermediary traders, tolling deals were lucrative due to tax exemptions and to the high profit margins. Alumina supplies were traditionally insufficient to supply the smelting industry, so it had to be imported. Primary aluminium had a stable international demand. Under the tolling system, alumina imports and finished aluminium exports were exempt from customs duties. No VAT was levied on products made from imported alumina. In addition, due to the difference between the domestic aluminium price and the world price, profit margins were high. In 1992, the domestic aluminium price in Russia ranged from USD 300 to USD 600 a ton, while the world price was about USD 1200. As Helmer points out, these tolling schemes maximised the cost of inputs to aluminium production plants, and then minimised the selling price of the metals at the plant. The tolling system was a type of transfer pricing scheme: it was “the way in which the shareholders of Russian metal combines removed the capital pererabotki”. See Aleksei Makarkin, ‘Otravlennye aliuminiem’, Segodnia, 18 November 1999, (http: //dlib.eastview.com/sources/article.jsp?id=2072813 accessed 20 August 2003).

Oleg Soskovets was a ‘patron’ of the metal industry. In other words, he was the politician in charge of the metal industry, which, according to Kryshtanovskaya, was one of ‘authorised sectors’ in the early 1990s. Chernomyrdin was in charge of the heat and power complex, while Geraschenko was in the finance sector. See Olga Kryshtanovskaya, ‘The Financial Oligarchy in Russia’, CDPSP, XLVIII, 4, 21 February 1996, p.3.

of the industry and invested it offshore".40

**Trans-World (TWG)**

Trans-World, an enterprise launched by the Reuben brothers, David and Simon, was the most active and successful of these traders.41 David Reuben had been the chairman of Trans-World Metals, a London-based metal trading company that had been buying aluminium from the Soviet Union since the late 1970s.42 Prior to the start of economic reform in Russia, including trade liberalisation, Reuben had cooperated with a state organisation in charge of the trade of Soviet aluminium.43 After the break-up of the Soviet Union, he tried to deal directly with Russian smelters, but they were unable to produce aluminium due mostly to the lack of working capital and alumina.44 Trans-World then adopted the tolling system, to enable the production of aluminium in Russia as well as sales of metals in the world market. The Russian end of Reuben’s operation was handled by the Chernoi brothers, Lev and Mikhail. In 1992 Reuben formed Trans-CIS Commodities (TCC), a Monte Carlo based company, to be headed by Lev Chernoi; TCC, in combination with their other companies, came to be known as the Trans-World Group (TWG).45 The group owned a web of more than 100 corporate entities, including trading companies and banks.46

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40 Ibid.
44 ‘King of the Castle?’, *The Economist*.
45 Satter, *Darkness at Dawn*, p.184. In the following, the terms Trans-World Group, TWG, and Trans-World are used interchangeably.
46 Simon Pirani. ‘Siberia’s Great Smelting Pot’, *The Observer*, 18 February 2001, (http://www.guardian.co.uk/Archive/Article/0,4273,4137782,00.html, accessed 21 April 2002); Behar, ‘Capitalism in a Cold Climate’. According to Behar, “Shells within shells within shells – constantly shifting, many with similar names – in places like Cyprus, the Bahamas, the Cayman Islands, the Isle of Man”.

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Privatisation of Russia’s aluminium enterprises led to the strengthening of TWG’s control over the enterprises with which it did business. At the time that tolling deals were becoming widespread, the process of privatisation started in the Russian industry.\(^{47}\) As a result of privatisation, Trans-World’s power and influence increased even more through the acquisition of shareholdings in aluminium and alumina assets in Russia and other CIS (Commonwealth of Independent States) countries. Share ownership allowed TWG to entrench the tolling deals, and to keep away possible competitors.\(^{48}\) By the time the first stage of mass privatisation ended in 1994, Trans-CIS Commodities and its associated companies controlled 20 per cent of KrAZ, around 50 per cent of BrAZ and more than 60 per cent of SaAZ.\(^{49}\) This share ownership combined with the tolling arrangements, meant that Trans-World controlled approximately two-thirds of Russia’s aluminium output.\(^{50}\) Thus, in a short time, TWG had gained an influential position in three of the five largest smelters in Russia, making it the third largest aluminium producer in the world by 1996 after Alcoa and Alcan in terms of production volume.\(^{51}\)

At SaAZ, which was located in Khakasiia, the process of privatisation started in December 1992 with voucher privatisation.\(^{52}\) Khakasiia was one of the few regions that proceeded quickly with organising voucher privatisation.\(^{53}\) Privatisation was conducted according to so-called ‘option two’, by which 51 per cent of the shares were offered to

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\(^{47}\) Privatisation of enterprises in the aluminium industry was carried out according to the general privatization programme that was accepted by the Russian parliament in June 1992, which subsequently was signed into law by President Yeltsin. Butrin, ‘Komu pereznadzhit Rossiia: Tsvetnaia metallurgiia’, p.60.

\(^{48}\) Behar, ‘Capitalism in a Cold Climate’.

\(^{49}\) ‘King of the Castle?’, The Economist.

\(^{50}\) Ibid.

\(^{51}\) Behar, ‘Capitalism in a Cold Climate’.

\(^{52}\) Butrin, ‘Komu pereznadzhit Rossiia’.

managers and workers. In 1994, after the investment tenders for state shares at SaAZ, two entities, Russkii Kapital and Aliuminprodukt, became the largest shareholders in SaAZ. Russkii Kapital was an investment company directly controlled by Trans-World. Aliuminprodukt was controlled by Oleg Deripaska, who initially was closely associated with Trans-World. By November 1994, these Trans-World led consortia, as they were known at the time, were the largest shareholders, controlling more than 60 per cent of the shares. On an initiative from Trans-World, Oleg Deripaska was appointed general director of the plant, at the shareholders meeting held in November 1994. However, as will be shown below, conflict of interests began to emerge between the management, led by Deripaska, and the trader, Trans-World.

5.3 Tasks SaAZ Faced: Aluminium Plant with Limited Resources

5.3.1 Integration of Business Functions

When SaAZ became a privatised joint stock company, it was not the full fledged business firm conceptualised in Chapter 3. It was an aluminium production unit with

58 Gotova and Mirontseva, ‘Novye khoziaeva zavoda prishli v uzhas ot uvidennogo’.
59 Iana Mirontseva, ‘Pervye aktsionery zavoda vybrali sovsom svoego direktora’, Kommersant, 19 November 1994, (http://www.kommersant.ru, accessed 7 June 2003); Vladimir Lisin, then a vice president of Trans-CIS Commodities, initially became the chairman of the board of directors at SaAZ. Butrin, ‘Komu prenadlezhit Rossia’; Pappe, Oligarkhi, p.191.
limited resources, in the sense that various business functions were not self-contained ‘in-house’ activities. After the disintegration of the Soviet economic system, the most immediate functions required for Russia’s aluminium smelters included raising finance, procuring raw materials and marketing products on the international market. However, the plants lacked the necessary resources to carry out those functions.

As discussed in section 5.2, aluminium enterprises in Russia lacked working capital. Previous users of its products, the defence sector, no longer needed aluminium as defence spending had plummeted. This exacerbated the cash flow problems of aluminium enterprises. In addition, the financial system was not sufficiently developed to provide enterprises with credits. Without capital, these aluminium enterprises (the aluminium smelters) could not buy the raw material (alumina) needed to produce aluminium. In addition to the procurement of raw materials, aluminium smelters needed to perform other functions: to export their products, domestic demand for aluminium having collapsed. However, selling in the international market required skills and knowledge that the privatised former production units did not possess. They had no direct experience of trading aluminium in the international market because the sales and marketing functions had been ‘outsourced’ to foreign trade organisations during the Soviet period.

These business functions were taken on by intermediary traders through the system of tolling. Through tolling arrangements, intermediary traders brought raw materials to the Russian aluminium smelters and took the produced metals for sale on the world market. Enterprises received fees from the traders for processing the metals, using the raw materials that were supplied by traders. Thus these traders took on some of the previously ‘outsourced’ functions, by providing finance, procuring raw materials, and
marketing products abroad. In this sense, the aluminium plant was not a self-contained business unit integrating business functions. It did not have to raise finance, raw material procurement was ensured, and the end product was marketed abroad by the trader. Therefore, in order to reconstitute itself as a business firm, SaAZ had to overcome these shortcomings and integrate the various functions as ‘in-house’ activities.

5.3.2 Reconstruction of the Production Chain

The ‘atomising privatisation’ involved the break up of the old structure, and the collapse of the Soviet economic system generated ‘disorganisation’, where a network of related firms, in particular, the input-output chains of production were disrupted. This disruption in the vertical chains that linked downstream and upstream production – often referred to as the ‘technological chain’ (tekhnologicheskaia tsep’) in Russian – posed difficulties for aluminium smelters. As pointed out above, after the collapse of USSR the major sources of alumina, the raw material for aluminium production, were located outside the national borders, the Ukraine and Kazakhstan, for example. Bauxite, the raw material for alumina production, had been imported from Guinea, but the network of suppliers disintegrated with the break down of the Soviet centralised system. Thus, Russia’s aluminium enterprises urgently needed to organise a network of suppliers of raw materials and reconstruct the chain of production.

However, instead traders took over the organisation of the input-output chain of Russia’s aluminium production. Traders acted as organisers of the production chain. They organised tiers of suppliers to secure the raw materials necessary for the aluminium plants to process the metal. The processed metal was then sold on the international market by traders.
As discussed in Chapter 3, reconstruction of the production chain implied adjustments to the boundaries of the firm, i.e., deciding on which successive stages of production should be brought within the firm, and arranging the production's complementary assets coherently. For SaAZ, the task of reconstructing the production chain implied that its boundary had to be adjusted. In other words, an appropriate framework of a firm which entailed successive stages of production requiring complementary assets such as aluminium production, would be expected to be larger than the current SaAZ, which was effectively a production unit, that was a part of an entire aluminium production chain linked by complementary assets. Indeed, the top management of SaAZ, led by Deripaska, sought to adjust the firm’s boundaries through the establishment of SibAl, which vertically integrated SaAZ, as will be described in detail below.

5.3.3 Establishment of Administrative Control

With the disintegration of the Soviet economic system, the state no longer supplied the planning and coordinating mechanism that controlled the activities of the Soviet enterprises. However, individual enterprises or production units were not able then to perform the executive administrative functions that the state had provided. These conditions gave intermediary traders the opportunity to take on this administrative role through the tolling system. Given the extent of this role, it was frequently observed that the traders operating in the aluminium industry in the immediate post-Soviet period, had merely replaced the Soviet central planners. The traders, as Vladimir Lisin puts it, “in essence, replaced former Gosplan, Minfin and Sovmin”.

Again as pointed out in Chapter 3, evidence of effective administrative coordination and

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60 Kuleshov, Aliuminievaia promyshlennost' Rossii v rynochnykh usloviakh, p. 61.
control is a defining attribute of a business firm. From the point of view of a firm as a “coherent administrative organisation”, it can be seen that SaAZ, with the organisation of a former Soviet production unit, was not equipped with an established administrative framework or with an independent top management to make executive decisions about coordinating, appraising and planning the work of the organisation and allocating its resources.

5.4 Reconstituting SaAZ as Business Unit: Use of ICGPs

From the resource-based view of the firm, as long as a trader was fulfilling the role of central planner, integrator of business functions and organiser of the production chain through tolling arrangements, it was impossible for SaAZ to become a self-contained business unit. If the plant were to break free from the still de facto status of a production unit, and survive and grow as a firm in a market environment, it had to be reconstituted into a business unit. In practice, this meant addressing the three issues discussed above, namely, having an effective administration, becoming an integrator of various business functions, and organising a chain of production. As has been already discussed, the trader was especially influential in providing services in some of the core business functions, and by acting as the organiser of suppliers and buyers. Therefore, reconstitution of the plant required it to take over the role of the trader, and its first and most important item on the agenda was to gain independence from the trader.

5.4.1 Gaining Independence from the Trader

a) Conflict of Interests: Corporate Growth vs. Status Quo

Over time, the importance of the role played by Trans-World declined for several reasons. Relationships were being established between the smelters and suppliers and customers. There were other possibilities for obtaining financing apart from through the
trader. Russian managers in charge of the plants had become more experienced. In addition to this reduced value of the services provided by TWG, a conflict of interest emerged between managers and the traders, who had been influential as a shareholder. The managers of Russian plants were becoming more interested in the long-term growth of firms through expansion and diversification of production activities, while traders were interested in short-term profits, and maintaining the status quo by keeping tolling arrangements intact. As a result, Russian managers of metal plants sought to break their commercial relations with TWG in an attempt to obtain independence. Deripaska, who started out as a trader before being chosen as CEO of SaAZ, was one of those managers.

The conflicting interests incentivised SaAZ's managers, led by Deripaska, to strive for complete independence from Trans-World, which had control over cash flows and material flows, and over the management of various aluminium enterprises that it became owners of. Managers needed to establish more control over their activities so that export revenues could be allocated for what they considered to be productive use, such as reinvestment, modernisation, payment of regional taxes, etc. However, they lacked the power to implement their strategic plans and to use financial resources for the development of their productive activities. Through the use of ICGPs, they got the power to establish corporate control.

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62 Interviews with a former banker who dealt with Russian metal industry, and a journalist covering aluminium issues in Russia conducted by author, July 2003.
64 In fact, it was Vladimir Lisin, the head of Novolipetsk Metal Plant (NLMK), a former vice president of Trans-CIS Commodities, and a former chairman of the board of directors at SaAZ when Deripaska was appointed as CEO, who initiated the so-called “managers' revolt" against TWG in 1997, which was regarded as the united efforts of Russian managers’ to gain independence from TWG. See footnote 101 below.
65 Popelov, ‘Russian Aluminum Industry’.
The long-term strategies of Russian managers involved such factors as increasing profitability by producing value added products, cutting costs, and making long-term investments for corporate growth. However, such strategies went completely against the interests of the trader. The trader, who was also a shareholder, was primarily interested in maintaining control of the production of primary metal for the purpose of export by maintaining tolling deals. Conflicts of interest manifested themselves in four main areas: 1) securing raw materials supply; 2) developing downstream production to produce value added products; 3) making long-term investments such as reinvesting in the plant and carrying out modernisation; and 4) ensuring 'corporate social responsibility.'

1) Securing Supplies of Raw Materials

First, Russian managers of aluminium smelters started to seek ways to obtain supplies of alumina, other than those supplied by TWG. Because of the short-term nature of the contracts concluded between aluminium producers and the trader under tolling deals, smelters did not have assured, long-term supplies of alumina. Therefore, the smelters tried to bypass TWG in order to secure stable supplies of alumina, thereby giving them more control over material flows, and eventually overall production process. However, controlling the flow of alumina to Russian plants seemed to be one of TWG’s most powerful levers. According to Borisov, attempts by Russian smelters to act

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66 Ibid.
67 For example, SaAZ and other plants made a separate agreement with Ukraine’s NGZ in the spring of 1997. When Russian smelters made these agreements with NGZ on their own initiative, TWG, boycotted NGZ's product and curtailed their regular alumina supply to the aluminium smelters that had been under their control. The traders did this because they did not wish the smelters to have independent alumina supplies, and did not want to give up the influence they had over the smelter through their service of supplying alumina. As a result, according to Borisov, Russian smelters had to pay more for their alumina, resulting in a total loss of USD60-80 million a year. See Borisov, 'Aliuminievaia Saga', Sliianiia i Pogloscheniia, pp.78-79. This action by TWG was called “alumina pressure” on the plants, i.e., TWG exerted pressure by creating a situation where aluminium smelters would become short of alumina. See Institute of Economics of Transition, Russian Economy in 2000, Trend and Outlooks, Issue 22 (Moscow: IET, 2001), (www.iet.ru/trend/2000/4_2.htm, accessed 19 August 2003).
independently of Trans-World were continually suppressed.\(^{68}\)

Nevertheless, in November 1997, SaAZ managed to establish direct supply of alumina from Nikolaevsk Alumina Plant (NGZ) in Ukraine and Tadzhik Aluminium Plant (TadAZ) in Tadjikistan. SaAZ aimed to obtain a long-term supply of alumina, independent of any outside intermediaries.\(^{69}\) Moreover, SaAZ entered into a project with NGZ to reconstruct the Dnepr-Bugsk sea port in the Ukraine, which enabled NGZ to process an additional 1.5 million tons of bauxite per year into alumina. The project also included the development of NGZ’s bauxite base in Guinea.\(^{70}\)

2) Producing Value Added Products

Conflicts of interest emerged as managers sought to increase profitability by producing value added products. Despite being one of the world’s largest exporters of primary aluminium, Russia imported aluminium products, mostly finished products.\(^{71}\) The import ratio in domestic aluminium consumption was around 20 per cent during the decade from 1991-2001, and the more the value added of the product, the higher the import ratio.\(^{72}\) For example, in foil and foil-based packing materials, the share was twice as high (41.8 per cent) as the average import ratio of 20.5 per cent.\(^{73}\)

However, Russia’s dependence on imports of finished aluminium products did not mean that it had no capacity to produce finished products itself. Rather, because most of the


\(^{71}\) Sakaguchi, ‘Rosiano hitetsusangyou no genjou ni tsuite’, p.63.


\(^{73}\) Ibid.
primary aluminium was oriented toward export, domestic producers of finished products suffered from a shortage of primary aluminium from which to manufacture finished products. This structurally idiosyncratic phenomenon was one of the consequences of the tolling system. Zander, Sokolov and Iagol’nitser argue that the export orientation of primary aluminium producers as a result of tolling provoked a decline in enterprises producing secondary products. For example, although the Krasnoiarsk Metal Plant (KraMZ), which produced rolled aluminium, was located opposite to the Krasnoiarsk smelter (KrAZ), KraMZ had to buy metal from elsewhere, including from abroad, because KrAZ’s primary aluminium output was oriented towards export.

When the rising cost of Russia’s aluminium production became critical, Oleg Deripaska, the general director of SaAZ, expressed his preference to invest in the domestic market. In 1996, due to the strong export orientation, no more than

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74 Sakaguchi, ‘Rosiano hitetsusangyou no genjou ni tsuite’, p.63.
76 Borisov, ‘Aluminiumvaia Saga’, p.79.
77 Sokolov and Iagol’nitser report that toward the mid 1990s the cost of Russia’s aluminium production was increasing, which affected the profitability of enterprises. In 1995, the effectiveness of export operations fell compared with 1994, which led to a fall in profitability in most of the factories. Profitability fell despite the rise in average prices on the London Metal Exchange (LME) from USD1477 to USD1805 per ton. What happened was that the cost of producing primary aluminium in Russia for export was becoming higher than the international level. The cost of producing 1 ton of aluminium in 1995 was USD1495 in Russia, while in the West it was USD1291 on average. In 1994, the average cost in Russia was still USD1006 per ton. See Sokolov and Iagol’nitser, ‘Tollingovoi platsdarm rossiiskogo aluminia’, pp.82-83. According to Segodnia, in mid 1996, the average production cost in Russian aluminium plants rose to USD1700 per ton, an almost 70% increase from 1994. If in 1994, profit from production of metal was about USD471 per ton, then in 1996, 1 ton of aluminium brought about a loss of about USD25. Natal’ia Gotova, ‘Proizvoditel aluminii obratili vzor na vnunrenii rynok’, Segodnia, 6 July 1997, (http://dlib.eastview.com/sources/article.jsp?id=2007936 accessed 20 August 2003). One of the main reasons why the cost of aluminium production at the Russian smelters exceeded that in the West was higher cost of alumina. The cost of alumina used in Russia was high because factories mostly used imported alumina. Domestic alumina did not receive any tax exemption until mid 1995 when ‘internal tolling’ was introduced (see Footnote 196 below), and therefore demand for domestic alumina fell, which led to the collapse of domestic alumina enterprises in Russia. See Zander et al., ‘Novye formy rynochnykh otoshennii v aluminievoi promyshlennosti’, p.103. According to Tarasov, “Russian suppliers of alumina, that were unable to operate under the tolling scheme, like the processor of primary metal who could not receive the metal, were nearly dead”. Tarasov, ‘Aluminievyi shantazh’.
160,000-170,000 tons of aluminium remained within Russia, although the domestic market could have absorbed up to 500,000 tons. Deripaska argued that SaAZ had done all it could to lower the cost of aluminium production, and revenues from export were now dependent on the price fluctuations on the London Metals Exchange (LME). In addition, an increase in the volume of exports would have driven down the price of aluminium at LME, and further increase of Russian aluminium in the international market would not have been welcomed by the world’s other aluminium producers. In 1994, a precedent was set whereby Western producers made a production-cut agreement to curb Russia’s soaring production to prevent a decrease in the price of metal. In addition, value added products attracted a higher price than primary metal, which added motivation to produce value added products for the domestic market.

From the view point of TWG, any investment made to increase the value added of products was diametrically opposed to their interests. Expansion in the production of semi-finished or finished products would reduce the volume of exportable aluminium, as a result of the increasing share of primary aluminium that would be needed to produce those secondary products. Reduced exports would result in less profit for the trader. Therefore, an increase in production of value added products was not in their business interest. It was also pointed out that even if those value added products could

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78 Gotova, ‘Proizvoditeli aliuminiia obratili vzor na vnutrennii rynok’.
79 Ibid.
80 Since Russia’s industrial collapse, the aluminium production was redirected from domestic consumption into exports. When Russia’s aluminium supply to the world market soared, the market was saturated with Russian metals. International prices of aluminium fell along with the profits of western producers. Fearing Russia’s output would increase, but not wanting to proceed with antidumping measures on Russia, western producers and Russia made an agreement in 1994 to cut worldwide production. For the background to this development, see Erle Norton and Martin du Bois, ‘Foiled Competition: Don’t Call it a Cartel, But World Aluminium Has Forged New Order’, Wall Street Journal, 9 June 1994 and also ‘Aluminium: Smelt a Rat’, The Economist, 23 July 1994.
be exported, the trading of secondary products was handled by different kinds of traders, and not those specialised in primary aluminium.\textsuperscript{83}

3) Reinvestment and Investment into Modernisation

Tolling deals with TWG had become a routine exercise rather than an emergency measure.\textsuperscript{84} Smelters were receiving only fees for processing, and not the direct proceeds from the export sales of their metal.\textsuperscript{85} It was claimed that the amount of the fees the smelters received from TWG was not enough to allow reinvestment in production or modernisation. The fees covered only the production expenses and costs of routine maintenance and running repairs.\textsuperscript{86} This was a situation in which plants could continue working, but could not develop.\textsuperscript{87}

According to Guschin, the proposal by managers to reinvest part of the profit into the modernisation of plants, and to stimulate domestic market was turned down by Trans-World, which, from their view seemed completely logical.\textsuperscript{88} The trader was “satisfied with their business based on over exploitation of fixed assets”.\textsuperscript{89} However, Russian aluminium plants were seriously in need of large investments to modernise their production units to increase efficiency.\textsuperscript{90} Also, modernisation was needed in order to improve their environmental standards, as Soviet (Russian) smelters were major polluters.\textsuperscript{91}

\textsuperscript{83} Zander et al., ‘Novye formy rynochnykh otnoshenii v aliuminievoi promyshlennosti’, p.109.
\textsuperscript{84} Mirontseva and Petrovich, ‘Aliuminievye koroli i “kapustai”’
\textsuperscript{86} In the words of Behar, “In truth, Trans World systematically starved one of the ex-Soviet region’s few viable industries, breathing just enough oxygen into the plants to keep its own tolling racket alive, while the aging facilities were largely left to wither”. Behar, ‘Capitalism in a Cold Climate’.
\textsuperscript{87} Borisov, ‘Aliuminevaia saga’; Kommersant, ‘Partnerstvo prevratiolos’ v obuzu’.
\textsuperscript{88} Guschin, ‘Zakat siiuminutnykh investitsii’.
\textsuperscript{89} Popelev, ‘Russian aluminium industry’.
\textsuperscript{90} IMF et al., A Study of the Soviet Economy Vol.3.
TWG was not keen on making any long-term investment in the plants. According to a Russian leading business journal *Ekspert*, despite TWG’s announcing its intentions to invest, no concrete cases of such investments were known. The Ministry of Economy did not find any examples of long-term investments into enterprises such as SaAZ, KrAZ, and the Novolipetsk Metal Plant (NLMK) between 1993 and 1997. Yeatman at the end of 1995 remarked that Trans-World’s investment had a short-term risk profile and that it had undertaken virtually no long-term investment in Russia or other CIS countries. He argued that the litmus test of whether TWG would make the transition from trader to producer was whether it used any of its own funds to make a long-term investment.

4) Ensuring ‘Corporate Social Responsibility’

Another source of conflict between management and the trader was consideration for the region in which the aluminium plants were operating. Aluminium smelters in Russia generally were known as city-forming enterprises (*gradoobrazuiushchee predpriatie*), in that the enterprise contributed most to the regional budget, and was the largest employer in the region. SaAZ was one such enterprise, employing more than 8,000 people, providing 95 per cent of Saianogorsk’s city budget and about 60 per cent of the income of the Khakas Republic.

Deripaska in an interview emphasised that the ‘social factor’ was a critical aspect of the

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92 Sivakov, ‘Vysokii peredel’.
plant’s well-being. Since the Khakasia region in the Russian Urals had always had difficulties in supplying its population with sufficient foodstuffs, SaAZ converted the sovkhoz (state farm) into a vigorous supplementary farm (plant’s podkhoz: podsobnoe khoziaistvo), which enabled collectives and other population to have an assured and improved food supply. SaAZ invested in the construction of roads, schools, housing, and storage facilities, and also financed the purchase of agricultural machinery and forage. The smelter always paid wages to employees on time, and not only did it have no tax arrears, it made advance payments to the national budget. The smelter was also reportedly meeting environmental standards. Deripaska emphasised that SaAZ was the first plant in the country to pay the local utilities in full and with ‘live money’, or actual cash.

The importance of the ‘social factor’ was also emphasised by Vladimir Lisin, the head of NLMK and a former vice president of Trans-CIS Commodities. He claimed that “Working in the region at the factory, you are forced/obliged to bring social responsibility as well, otherwise, you are ‘variag (alien)’, who is going to be forced out”.

He confirmed that the essence of his conflict with TWG was the difference in their mutual understanding of this very aspect. When the task of cutting production cost

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97 Ibid.
99 Vishnepol’skii, ‘Aliuminievyie skandaly plodiatstia i mnozhatsia’.
101 Interview with Vladimir Lisin, by Elena Evgrafova, ‘Smena partnerov – ne izmena’, Vedomosti, 28 October 1999. It was Lisin who initiated the ‘managers’ revolt’ against TWG in 1997 when NMLK cut off metal supply to the trader. By the end of 1997, according to Kommersant, “almost all” Russian plant managers had broken their commercial relations with TWG. In December 1997,
arose, TWG, based outside of Russia, suggested cutting expenses for social infrastructures such as kindergartens, according to Lisin. In his view, the reduction in the social burden – [is] not the only and basic source of cutting the cost; it is possible to economise on electricity, gas, transportation costs, or to cut cost by technological advancement. And all these Russian resources, with Russian domestic price, are the things that give competitive advantage before Western firms.\textsuperscript{102}

In a similar vein, a former SibAl employee told me that:

‘Social-ness’ (\textit{Sotsial’nost’}) is the key to the success. The company has to be a part of the society and a part of the region, to be accepted in order to work successfully. The company has to make some contribution to the society to become a part of the society. TWG was not keen on this aspect, and I know other foreign companies right now that are not so successful due to this lack of ‘social-ness’.\textsuperscript{103}
b) ICGPs as Tools

From the perspective of reconstitution into a business unit, SaAZ could not achieve this as long as the trader acted as central planner, integrator of business functions and organiser of the production chain, as noted above. The SaAZ management took steps to establish administrative control over the plant in order to obtain complete independence from the trader. First it sought to increase its equity holdings in the enterprise. In Russia, concentration and control of assets have been of prime significance in an environment where protection for assets is not well provided for.¹⁰⁴ As a rule, owning 75 per cent plus one share in a company is generally considered as a secure threshold, as it eliminates the possibility of minorities, with their 25 per cent shares, blocking votes and taking part in corporate control.¹⁰⁵ Thus, as long as top management had not achieved supermajority ownership, the motivation to achieve more than 75 plus one per cent remained.

By 1997, the Deripaska-led management at SaAZ had increased its influence over the plant as owner-managers,¹⁰⁶ who held shares through SibAl, established by Deripaska. SaAZ became the core constituent of SibAl. Deripaska was in a process of developing SibAl by increasing its shareholdings in SaAZ.¹⁰⁷ However, the blocking share of more than 25 per cent of SaAZ remained with TWG and this gave the owner-manager team of SaAZ/SibAl the incentive to take over supermajority ownership in order to achieve a safe threshold position to manage the company. In a bid to gain complete independence

¹⁰⁴ See Boone and Rodionov, ‘Rent Seeking in Russia and the CIS’ and Nash, ‘Corporate Consolidation’.
¹⁰⁶ With the decrease in influence of TWG over SaAZ, according to the ISMM report, the plant achieved a fivefold increase in its profits, in added value by 1.5 times, working capital by 4 times, and reducing commercial expenses by 2.6 times in 1997. Popelev, ‘Russian Aluminium Industry’.
¹⁰⁷ Sibal’s founding partner was Mikhail Chernoi, who had already distanced himself from TWG by 1997. It was believed that the patronage of Mikhail Chernoi, who distanced himself from TWG, allowed Deripaska to openly go against TWG. See Titova and Sidorov, ‘Rynki’.
from TWG and to consolidate administrative control, various ICGPs such as share dilution were used.

**Share Dilution**

Increase in Charter Capital followed by Share Issue: At the extraordinary shareholders meeting of SaAZ held on March 1998, changes were made to the statute of the joint stock company, which increased the maximum number of the plant’s shares. It was decided to increase the statutory capital by 50 per cent. The increase in charter capital, according to Dmitrii Vasiliev, has generally been considered as a prelude to share dilution in Russia. As expected, following this change in the statute, the board of directors of SaAZ adopted a decision to issue additional shares. The newly issued shares were to be distributed in an open subscription.

As a result of the additional issue of shares, TWG’s shares in SaAZ dropped below the blocking level: from 37.8 to 14.7 per cent. TWG did not purchase any of the newly issued shares, and their shareholding was diluted. They claimed not to have known about the open subscription of additional share issuance. However, a notice was published in the paper *Trud* and it was also covered by the *Reuters* news agency, according to *Kommersant*. There were reports at the time that the SaAZ management ‘forgot’ to send notification of the shareholders’ meeting to some ‘undesirable’ shareholders, or that such notification was never received due to the ‘defective mail system’ in Russia.

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111 Rozhkova, ‘Anglichane khotiat v Khakasiiu’.
112 Ibid.
113 For a possibly deliberate ‘forgetfulness’, Andrei Dmitrienko, ‘Saianskii aluminievyi: inostrantsy
All the additional shares were bought by companies affiliated with SaAZ/SibAl.  

These newly issued shares were bought extremely quickly, by Aliuminprodukt and Pervyi Investor, the entities connected with the owner-management of SaAZ/SibAl.

As a result of the share purchase, the SibAl group’s shareholding increased from 40 per cent to 70 per cent. Thus the use of this IGCP had strengthened SibAl’s control over SaAZ, though another step was needed to reach the 75 per cent level.

The Role of the State: The issue of additional shares was made possible through the involvement of another group of shareholders – the state. This new issue diluted the state’s share in SaAZ, as well as that of TWG. Because the Russian State Property Fund (RFFI) did not participate in the open subscription, the state share was reduced from 15 per cent to 6.15 per cent. However, the share issue had been supported by the Khakas Regional Property Fund, in charge of managing the state shares of SaAZ for the RFFI, which voted in favour of the proposal.

In fact, the plant was acting with a backing of and with the involvement of the state authorities. SaAZ signed a protocol with RFFI to maintain the state’s original level of state shares, and after the dilution, the plant made the relevant transfer of shares to the state free of charge. According to the protocol signed by representatives of RFFI


Dmitrienko, ‘Saianskii aliuminevyi: inostrantsy ne sdaiut’.

Rozhkov, ‘Anglichane khotiat v Khakasiu’.

Sinitskii, ‘Sibirskii aliuminii’ dogovorilsia s mestnoi vlast’iu’.


Ibid.

Ibid
and SaAZ, the state, as a federal holder of state shares in the plant, confirmed that it would not make any stand against an additional share issue.\textsuperscript{121} This share issuance of spring 1998 was seen as an example of “coordinated state participation” in a corporate conflict between non-state shareholders, in this case, between SaAZ management and TWG.\textsuperscript{122}

Furthermore, SibAl’s shares in SaAZ increased as a result of an investment auction of state shares. In September of 1998, an investment auction of 6.5 per cent of the 15 per cent of state shares took place. The winner of the auction was Aliuminprodukt, a company controlled by SibAl’s top management. Now SibAl had control over more than 75 per cent shares in SaAZ.\textsuperscript{123}

It should be added that the money raised from the additional shares issue was invested in production. The plant obtained USD30 million as a result of this issue. The capital was used to build new electronodes which enhanced the smelting capacity of the plant.\textsuperscript{124}

**Legal Actions:** In response to its ever declining influence over SaAZ, TWG was behind more than 20 lawsuits, in various places such as Moscow, St Petersburg, Krasnoiarsk, Khakasiia, Irkutsk and Kemerovo.\textsuperscript{125} Basically, Trans-World challenged the legality of two events: 1) the additional issue of SaAZ shares in the spring of 1998; and 2) the

\textsuperscript{122} IET, Russian Economy in 1998: Trends and Perspectives.
\textsuperscript{124} Rozhкова, ‘Anglichane khotiat v Khakasiiu’; AK&M, ‘Saianskii Aliuminevyi Zavod’.
investment tender of state shares in the autumn of 1998. For example, a private shareholder, suspected to be representing TWG, filed a suit in a Kemerovo court, claimed the upcoming auction illegitimate, and asking for a ban on the auction as a protective measure.\textsuperscript{126} Three offshore companies, informally connected with TWG, asked the arbitration court of Khakasiia to deem the additional share issue as unlawful, and they initiated a legal action claiming that the investment auction of state shares was illegal.\textsuperscript{127}

However, Trans-World did not receive favourable final rulings. In May 1999, the Moscow arbitration court confirmed the legality of SaAZ’s additional share issue, and also acknowledged the results of the investment tender. In fact, this decision followed a confirmation from the Ministry of Economy, which officially recognised the legality of both the additional share issue and the investment tender, and thus concluded that there were no grounds for ordering SaAZ to return the shares to the state.\textsuperscript{128}

The legal manoeuvres of Trans-World were unsuccessful, partly as a result of the state’s role and actions. When TWG initiated these lawsuits, one of the central arguments was that these incidents (share dilution and investment tender) had damaged the interests of a particular group of shareholders, namely, the state.\textsuperscript{129} (According to a Trans-World representative, the law on privatisation, and several ordinances (postanovlenie) of the RFFI did not allow an increase in charter capital until the state shares had been sold.\textsuperscript{130}) Trans-World was attempting to argue that they were bringing these lawsuits in the

\textsuperscript{126} See Chapter 2 for the discussion of ‘protective measures’.
\textsuperscript{127} Davydov, ‘Idet za volnoiu volna. Kto gonit ikh?’.
\textsuperscript{128} Ibid.
interests of the state. However, the state authorities were not sympathetic to TWG. The share issue had been conducted by SaAZ with the endorsement of the state, and as mentioned above the state’s shareholding was restored free of charge. The court proceedings being initiated by TWG, therefore, were of no benefit to the state.\

**Interests of the State**

As has been illustrated, dilution of TWG shares, and the consequent increase in SibAl’s control over SaAZ were made possible with the cooperation from the state. Even though there may not have been active support, there was at least a tacit endorsement of their actions. What, then, was the general position of the state as a stakeholder? While interests diverged between the trader and managers, it was also becoming increasingly apparent that the business interests of TWG represented were also not compatible with those of the state. TWG became the subject of various accusations emanating from state quarters. The state was seen to dissatisfied on various counts. First was that privatisation had allowed foreign traders like TWG, who were seen as monopolising the Russian aluminium market, to take control. Second, the way traders operated their business based on tolling, brought: a) no contribution to state budgets in the form of tax due to tolling’s tax exemption, and b) no contribution to long-term investment for the development of the Russian aluminium industry.\

In 1996, the deputy chair of the State Committee on Metallurgy, Vsevolod Generalov, made the accusation that foreign traders had bought up blocks of shares (for example, in SaAZ and BrAZ) in order to control their lucrative exports, and that the privatisation of Russia’s metals had not led to the influx of investment that was urgently needed.\

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132 According to Aleksei Makarkin, citing tax officials, the state budget was losing approximately USD300 million per year due to the tax exemption accorded to the tolling scheme. Makarkin, ‘Otravlennye aliuminiem’.
Generalov urged the Russian enterprises to issue new shares to raise new capital, even
even though it would dilute the value of the existing shares of investors.\textsuperscript{133}

In a speech to the State Duma, the lower house of parliament, in early 1997, First
Deputy Prime Minister Anatolii Kulikov, strongly urged that measures should be taken
to restructure the Russian aluminium industry. In addition to criticising the overall
criminalisation of the industry, Kulikov called for the establishment of a state
commission to investigate violations in the privatisation of metallurgical enterprises.\textsuperscript{134}

In March 1997, there was an open confrontation between the Deputy Prime Minister
and TWG in an exchange of open letters that were published in major newspapers.\textsuperscript{135} In
a full-page open letter, entitled “Foreign Investment in Russia in Peril”, TWG’s founder,
David Reuben, claimed that Russia’s Ministry of Internal Affairs and the commercial
banks were plotting to “reprivatise” aluminium enterprises and thus “steal” his
company.\textsuperscript{136} Kulikov claimed that the tax advantages enjoyed by foreign traders on the
Russian market, such as 20 per cent VAT exemption on alumina imports, “condemn tens
of thousands of Russian citizens involved in alumina production to poverty and
dehdration”, in a situation where, as he put it, “mafia-like structures are monopolizing
and destroying the market”.\textsuperscript{137}

By the time this exchange of open letters took place, the power of TWG was on the

\textsuperscript{135} OMRI reports that Kulikov published an open letter on 10 March in which he replied to charges
levelled by David Reuben, chairman of Trans-World, in an open letter carried by Western
Kulikov of using corruption charges and a media smear campaign to try to renationalise aluminium
plants which had partial foreign ownership. Kulikov said that he was neither opposed to foreign
ownership nor private property, but was investigating accusations of money laundering and other
possible crimes in cooperation with Interpol and other law enforcement agencies. OMRI, 11 March
\textsuperscript{136} Mark Whitehouse, “Kulikov Challenges Trans-World Allegations”, Moscow Times, 12 March
\textsuperscript{137} OMRI 11 March 1997.
decline. Trans-World appeared to have lost what had been described as its political 'krysha (roof)', or the political ties that protected its business. It was viewed that part of Trans-World's problems was the result of a change in political configuration that resulted in the ousting of Deputy Prime Minister Oleg Soskovets from the government in June 1996.138

'Triangular Forces'

Iakov Pappe argues that apart from the formal owners, there are two forces that hold de facto property rights in Russian enterprises. One group consists of insiders (not only management, but also other influential groupings). The other is the authorities (ispolnitel'naia vlast'), be they municipal, regional, or federal. Only by establishing the balance among these 'triangular forces', the author argues, is it possible for the owner of a business group to establish robust and effective corporate control, and to secure the opportunity for growth. When a corporate conflict emerges, any one of these sides alone, generally loses out against the coalition of other two forces.139

At the height of TWG's might, all three forces – TWG being both formal owner and insider, the management of the plant as insiders, who valued the service provided by the trader, and the support of the Deputy Premier Soskovets at the federal level being the three forces – seemed to have struck a balance. However, the managers became independent from the trader, and Soskovets left the political arena in 1996. Managers who were physically based in the region cultivated relationships with the regional authorities, whose budget as well as their region's employment depended on the enterprises. As the triangle began to break down, a new coalition – the enterprise

139 Pappe, Oligarkhi, p.49.
managers and the regional authorities – began to take shape. In such circumstances, it was inevitable that the lone force, the trader, lost out against the coalition of other two forces.

5.4.2 Creating a Vertically Integrated Company

As the previous section has discussed, complete independence from the trader, and consolidation of control over SaAZ were achieved by the management of SaAZ/SibAl with the help of ICGPs. The ultimate objective of gaining control by the management, however, seemed to be the creation of a vertically integrated aluminium corporation, i.e., to become an organiser of production chain and bring together entire production stages from mining, to metal fabrication and distribution of output. This in part would reconstruct the production chain that had been disrupted by the collapse of the Soviet Union and the breakdown of central planning.

In general, vertical integration a of a chain of production under the control of a single firm is considered applicable to a type of industry like aluminium, where successive stages of production are technically complementary and thus capital costs associated with substitutions tend to be high. 140 Indeed, in the international aluminium industry, a vertical integrated corporation encompassing a chain of production is the prevalent form of organisation. 141

140 Stuckey, Vertical Integration and Joint Ventures in the Aluminum Industry, p.64. Stuckey shows that upstream integration (mining and refining, refining and smelting) helps in part to alleviate a hold up problem and the risk that arises from complementary technical relationships between pairs of small groups of vertically related plants (technical specificity). Downstream integration (primary aluminium and fabrication) is the answer to avoiding hold up problems and particularly uncertainty of price and demand. When smelting and fabrication are integrated within one firm, the authority and control of the internal organization coordinates the two stages of production. When final demand unexpectedly rises or falls, the central office ensures the transmission of this information and orders that adjustments be made to production and shipment schedules, inventory levels, etc. pp.251-252.
141 Such as Alcan and Alcoa.
a) Integration and Restructuring of SAMEKO

With a view to establishing a globally competitive integrated aluminium company, a vertical integration process started in SaAZ, on the basis of which SibAl was created. To achieve this objective, ICGPs were utilised by SibAl. An initial element of SibAl's vertical integration was to establish a link between SaAZ, the primary producer on the one hand, and Samara Metallurgical Company (SAMEKO), an enterprise dealing with the later stages of production on the other. SibAl acquired SAMEKO in 1998, the largest enterprise in Europe for the output of rolled and semi-finished products and alloys. The purchase of SAMEKO was made to carry out a forward vertical integration: SaAZ produced primary metal, and SAMEKO produced rolled aluminium from the metal produced by SaAZ.

However, SAMEKO had to be financially revitalised to be able to exploit its productive capacity. Although SAMEKO was the largest producer of rolled aluminium in Europe, the purchase of SAMEKO by SibAl was viewed by outsiders with a certain amount of reservation because SAMEKO was a hugely loss-making company with mounting debts. SibAl found the situation to be worse than it had expected. In March 1998, SibAl acquired controlling stakes in SAMEKO from Inkombank. When Inkombank obtained control over SAMEKO (controlling 52 per cent of shares) in 1995, SAMEKO, the producer of semi fabricated aluminium products, was isolated from the suppliers of primary aluminium. It suffered from disruption to the production chain. As a result, SAMEKO was in deep financial difficulties. When SibAl acquired

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143 Sivakov, ‘Vysokii peredel’.
SAMEKO, the enterprise owed its creditors more than 1 billion rubles (USD164 million).\textsuperscript{146}

\textit{`Revitalising Bankruptcy’}

SibAl set out to financially revitalise SAMEKO. First, the company’s 1 billion ruble debts had to be somehow restructured, which SibAl’s management intended to manage through the use of bankruptcy procedures after acquisition of SAMEKO. ICGPs, namely, the combination of asset transfers (asset stripping) and bankruptcy procedure helped revitalise the plant.

Creating 12 ‘Daughters’: First, the managers of SibAl established 12 subsidiaries of SAMEKO. They included: 1) Samara Metallurgical Plant (SMZ), the largest and the most important among the newly established subsidiaries; 2) Aliuminievye Stroiteln’yye Konstruktsii; 3) Aliuminievye Bytovye Tovary; and 4) Aliuminevye Izdeliia. The number of shares held by the main shareholders in SMZ was about at the safe threshold level of 75 per cent.\textsuperscript{147}

Asset Transfers (Asset Stripping): Next, asset transfers from SAMEKO to those 12 newly established subsidiaries took place. By the end of summer 1998, the most valuable production assets of SAMEKO, including ownership rights to vital equipment, had been transferred to the subsidiaries, and the main output of rolled aluminium production was being assigned to the newly created SMZ.\textsuperscript{148} Any assets that were not worth much, such as equipment for manufacturing military-industrial products and

\textsuperscript{146} Fedorov and Rozhkova, ‘V Samare bankrotiat kompaniiu-prizrak’.
\textsuperscript{148} Fedorov and Rozhkova, ‘V Samare bankrotiat kompaniiu-prizrak’.
social infrastructure, remained with SAMEKO along with all the debt. This meant that once bankruptcy procedures started, SAMEKO’s creditors could only make claims on the part of the assets that remained with SAMEKO, whose value at disposal was just enough to settle the outstanding debts. The assets that had been distributed across a number of separate subsidiaries were inaccessible to and safe from outsiders, including outside creditors.

Initiation of Bankruptcy: Once any assets of value had been transferred from SAMEKO to SMZ, bankruptcy procedures were initiated. In October 1998, one debtor, Maddox, an offshore entity registered in Cyprus, filed for bankruptcy of SAMEKO with the Samara Arbitration court. It was believed that Maddox had some, informal, affiliation with SibAl. This triggered the meeting of the creditors to be held. As described in Chapter 2, the Insolvency Law (bankruptcy law) of 1998 stipulated that at the first creditors meeting, creditors should discuss whether to 1) apply to the court for the company to be managed by an external administration, or 2) apply for liquidation. In other words, at this meeting it should be decided either to take measures to rescue the company, or to liquidate it and distribute the proceeds of the sale of the assets. When such a meeting was held by the creditors of SAMEKO, the recommendation was that liquidation should begin immediately. SibAl was SAMEKO’s main creditor, with 70 per cent of the debt, and therefore had the most influence in the creditors meeting. Although outsider creditors were convinced that the claim of bankruptcy was fictitious, the Samara regional arbitration court declared SAMEKO to be bankrupt.

149 Sur'ianinov, "Ostatki SAMEKO poidut s molotka".
150 Sivakov, 'Vysokii peredel'. These assets were called 'untouchable assets (neprikosnovenny aktivy)' for outsiders
151 Fedorov and Rozhkova, 'V Samare bankrotiat kompaniiu-prizrak'; Sakaguchi, 'Mikurokeizai no shiten kara mita rosiakeizai no tokushusei', Rosiachousageppou April 1999, pp.21-82.
152 Oda, Russian Commercial Law, p.154.
153 Fedorov and Rozhkova, 'V Samare bankrotiat kompaniiu-prizrak'.
154 Ibid.
and that its assets should be sold off to repay the creditors.\textsuperscript{155}

\textbf{Interests of the Region}: Thus, after its most valuable assets were transferred to SMZ, SAMKO was liquidated. This whole process of 'reincarnating' SAMEKO as SMZ took place under the supervision of the Samara regional administration.\textsuperscript{156} The local electricity utility lowered the tariff for SMZ, with the agreement of regional administration, in order to contribute to its rehabilitation.\textsuperscript{157} Samara was one of the biggest industrial cities in Russia, governed by Konstantin Titov, who was known to be keen to attract investment.\textsuperscript{158} In an interview, Titov emphasised the importance of 'agreement' or 'understanding' between the region and business to promote the prosperity of both sides by making conditions mutually attractive. Titov stressed that providing favourable conditions to help to improve the enterprises in the region, would also reap benefits for the region. He noted,

Before Deripaska came to SAMEKO, the plant produced 16,000 tons of rolled aluminium per year, when the capacity was 600,000 tons. SibAl presented me with a business plan, and showed that with this much tax and electricity tariffs, they could produce 280,000 tons. And they achieved that figure after three years. This was fine by me. And when I learned that SibAl had concluded a social partnership with the labour collective, I welcomed it.\textsuperscript{159}

\textsuperscript{156} Gleb P'ianykh, 'Vesna oligarkha', Kommersant-Vlast', 19 October 1999, (http://dlib.eastview.com/sources/article.jsp?id=3205344 accessed 20 August 2003); Pappe, Oligarkhi, p.192; Sivakov, 'Vysokii peredel'.
\textsuperscript{157} Sivakov, 'Vysokii peredel'.
\textsuperscript{159} Ibid. At the time, SibAl was in the process of re-registering its business from Khakasiia to Samara.
It was reported that almost immediately after SibAl took control of SAMEKO's assets, the performance of the plant improved, doubling the level of production.  

With the integration of SMZ (i.e. former SAMEKO) and the arrangement of other related assets, SibAl was on the way to becoming the organiser of the production chain (see Figure 5.2). By 1999, various assets involved in downstream production were placed under the ownership of SibAl. More specifically, SibAl, or Ob'edinennaia Kompaniia ‘Sibirskii aliuminii (OKSA SibAl)’, was the owner of SaAZ, SMZ (SAMEKO), and other companies such as Saiansk Foil Mill (Saianskaia Fol’ga), the largest producer in the CIS of aluminium foil including super thin foil, and foil-based packing materials; Abakanvagonmash, a producer of heavy-load containers, universal platforms, and special goods vans; DOZAKL (Dmitrov Rolling Mill), a producer of flat rolled products, and Rostar, the leading Russian producer of aluminium tins for beverages. In the upstream part of the chain, SibAl increased its control over its raw material base at NGZ in Ukraine. In order to ensure a stable supply of alumina, SibAl had already forged a ‘strategic alliance’ with NGZ, as mentioned above, and SibAl subsequently obtained 36 per cent stake in NGZ. However, SibAl and TWG clashed again over the control of NGZ. When the Ukrainian government auctioned off its 30 per cent shareholding in NGZ however, these shares were obtained by Ukrainskii Aliuminii (UkrAl), a daughter company of SibAl. Thus, at the beginning of 2000 SibAl controlled around 66 per cent of NGZ.  

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b) Establishing Control over NkAZ

To exploit fully the benefits of vertical integration, it was important also for SibAl to integrate horizontally in order to achieve scale economies as well as increased market share. In this sense, vertical integration and horizontal integration went hand in hand as a longer term growth strategy. In the pursuit of growth, a firm generally seeks to

increase capacity and market share through internal and external expansion, by three potential routes: vertical integration, horizontal expansion, and diversification.¹⁶³

SibAl again used bankruptcy procedures to take over the Novokuznetsk Aluminium Plant (NkAZ). Establishing control over NkAZ, SibAl believed, would enable it to achieve economies of scale, and to win increased market share. The smelting capacity of NkAZ was greater than SaAZ, although the production volume of SaAZ was 40 per cent higher than that of NkAZ.¹⁶⁴ However, the capacity of SaAZ is smaller than some other smelters such as KrAZ and BrAZ, i.e., SaAZ were fairly small compared with the largest smelters in Russia, KrAZ and BrAZ. In terms of the volume of aluminium production, SaAZ level was 2.5 times less than that of KrAZ and BrAZ, which were controlled by Trans-World.¹⁶⁵ In getting control of NkAZ, SibAl could achieve a larger smelting capacity.

In addition, by establishing control over NkAZ, SibAl was surviving the conflicts for ownership redistribution.¹⁶⁶ Increased market share through vertical and horizontal integration would ensure survival, which in turn was necessary for the company to achieve growth. Throughout the 1990s, the Russian aluminium sector was characterised by intense redistribution of aluminium assets, as privatisation of aluminium enterprises unleashed all-out struggles for control over assets in the industry.¹⁶⁷ This phenomenon


¹⁶⁶ Ibid.

¹⁶⁷ See Butrin, ‘Komu Prenadlezhit Rossiia: Tsvetniia Metallurgiia’.
was dubbed the ‘aluminium wars’, a term that reflects the severity of the conflicts for ownership of aluminium assets. In such an environment, the accumulation of assets by way of expansion was a means to proactively survive in the industry. Moreover, the weak protection rights property made an increase in the equity holdings of aluminium enterprise essential for survival and competitiveness.

**Initiation of Bankruptcy at NkAZ**

To achieve horizontal integration, bankruptcy was used as a takeover instrument. As discussed in Chapter 2, so-called ‘administrative resources’, particularly cooperation from the regional authorities, proved helpful in launching takeover through bankruptcy. In January 2000, the bankruptcy of NkAZ was formally initiated by Kuzbassenergo, the local electric utility, for overdue payments for electricity. Kuzbassenergo filed for insolvency of NkAZ a couple of days after the court bailiffs froze NkAZ’s account at Sberbank.\(^{168}\) Already in the autumn of 1999, a lawsuit had been brought by the regional prosecutor’s office to collect money from NkAZ for debts owing to Kuzbassenergo. This had resulted in acknowledgement by the court of the 789 million rouble (USD 30 million) indebtedness of NkAZ against Kuzbassenergo.\(^{169}\)

NkAZ was at the time controlled by MIKOM (Metallurgicheskaia Investitsionnaia Kompaniia), an investment company owned by Mikhail Zhivilo. MIKOM had once been a dominant industry player in the Kemerovo region. In addition to NkAZ, it once controlled Kuznetsk Metal Combine (KMK), a leading producer of rails, and a coal

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company called Chernigovets. Ironcally, MIKOM had been a beneficiary of bankruptcy proceedings against KMK, since MIKOM had been able to put in an external administrator who represented its interests, and strengthened its control over KMK. However, in 1999, MIKOM was in the process of being forced out of Kemerovo, primarily as a result of a conflict with the governor, Tuleev. The effort to oust MIKOM from Kemerovo was endorsed at the federal level by President Putin. With MIKOM being ousted from the region, SibAl-connected forces were becoming increasingly dominant in the Kemerovo region.

Temporary and External Administrator

In January 2000, the court appointed Sergei Chernyshev as temporary bankruptcy administrator at NkAZ. Chernyshev was known to be representing the interests of SibAl, although both Chernyshev and SibAl denied any connections. As explained in Chapter 2, a hostile takeover through bankruptcy proceedings was made possible by the weak legislation, which conferred substantial power on temporary bankruptcy administrators. During the period of receivership, the bankruptcy administrator took several measures that assisted SibAl in taking control over NkAZ:

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Replacing Top Management: The arbitration court of Kemerovo removed MIKOM, the owner of the controlling 66 per cent of NkAZ, from the management of NkAZ in February 2000. This was in reply to a request from the three main actors: the temporary administrator, Kuzbassenergo, the electricity company, and the regional prosecutor. The removal of MIKOM from the management meant that new managers could be appointed who could take control of the material flows of the plant. The new director of NkAZ was Viktor Geitse, from SibAl.

Creating New Creditors: At the creditors meeting held at the beginning of March 2000, a vote for the appointment of an external administration was passed by a majority of 81 per cent of votes. The creditors appointed Chernyshev as the external administrator. The deciding votes among the creditors belonged to the newly emerged entities, including Energopromservis and Azial, whose claims on NkAZ amounted to 1.6 billion rubles (USD56 million). These were the previously unknown new creditors who claimed for newly emerged debts during the first three weeks of the temporary administration. These new debts had emerged because, in the February, the temporary administrator of NkAZ had concluded a series of contracts with daughter companies of SibAl, as a result of which the NkAZ had become indebted to these companies.

Eliminating ‘Undesirable’ Creditors: In addition to the creation of new creditors,

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178 ‘Vektor: Torgovlia bankrotami’.
180 Galin, ‘NkAZ ushel ot “LogoVAZa”’.
181 Ibid.
bankruptcy procedures involved the elimination of 'undesirable' creditors. An external administration at NKAZ was introduced in March, and the first responsibility of the external administration manager was to organise a creditors meeting to vote on the external management plan. Prior to this meeting, which was eventually held in June, Chernyshev challenged Kuzbassenergo’s claim against NkAZ in the court, despite the fact that it was this debt that had triggered the bankruptcy procedure.\textsuperscript{182} He also challenged the claims of MIKOM. The court decided in favour of Chernyshev, which meant that he was able to wipe out the debts to Kuzbassenergo and MIKOM from the creditor register.\textsuperscript{183} Kuzbassenergo’s claim was for 738 million rubles (USD25.9 million), while MIKOM’s was some 500 million rubles (USD17.5 million).\textsuperscript{184}

**Consolidating Debts:** The largest proportion of NkAZ’s debts, about 85 per cent of 3 billion rubles, was owed to three obscure entities, believed to be closely connected to SibAl.\textsuperscript{185} At the June creditors meeting representatives of these entities including Azial, Medal and Energopromservis, were elected to the board of creditors. Also, the external management’s plan was approved.\textsuperscript{186} Although the controlling shares were still in the hands of MIKOM at this point, once bankruptcy procedures had begun under the initiative of SibAl-connected bankruptcy administration, MIKOM’s authority over NkAZ was sure to be diminished to SibAl’s advantage, giving the latter the power to manage NkAZ according to its own business strategy.\textsuperscript{187}

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\textsuperscript{183} Ibid.


\textsuperscript{185} Galin, ‘NkAZ podelili na troikh’.


\textsuperscript{187} Galin, ‘Energetikov otklyuchili ot NkAZa’.
With the instrumental use of bankruptcy procedure, SibAl had achieved de facto control over NkAZ by the spring of 2000. The use of ‘administrative resources’, and close ties with regional authorities, contributed to the success of this hostile bankruptcy, as described above. These factors were essential particularly because regional courts were considered to be subordinate to regional governors, and court decisions were carrying increasing weight as more and more business actors resorted to legal means (rather than actual violence) in settling corporate conflicts.\(^\text{188}\) For SibAl to obtain formal share ownership of NkAZ, it took a little while since the establishment of RusAl was in process at the same time.\(^\text{189}\)

c) Establishment of RusAl

Based on the foundation of SaAZ, SibAl’s development in the aluminium industry produced RusAl, Russia’s largest vertically integrated aluminium company and the world’s second largest aluminium corporation. There had been an unexpected turn of the events in February 2000, when the ‘shareholders of Sibneft’ led by Roman Abramovich acquired majority shares of BrAZ, KrAZ and AGK (Achinsk Alumina Combine) from Lev Chernoi of TWG. They were reportedly planning to acquire NkAZ also.\(^\text{190}\) These events represented for SibAl a huge competitive force. Yet another round of “aluminium


\(^{189}\) While bankruptcy proceedings at NkAZ were in process, SibAl reportedly tried to purchase shares from MIKOM, but the parties could not agree terms. Logovaz, the car maker, was considered a potential buyer at the time. In the end MIKOM sold its shares to a well-known businessman Luchaevskii, who acted as intermediary and eventually re-sold 66 per cent of NkAZ shares to RusAl. But the story did not end there. In December 2000, a 2.7 billion dollar lawsuit was brought in a US district court in New York. It was a case brought under the US Racketeering-Influenced and Corrupt Organizations (RICO) Act, filed by three offshore metal companies, Base Metal Trading SA, Base Metal Trading Ltd. and Alucoal Ltd. They accused RusAl, its chief executive Oleg Deripaska and his business partner Mikhail Chernoi of taking over and monopolising Russia’s aluminium industry. The plaintiffs in the RICO suit protested against takeover of NkAZ. However, the US court rejected the case, suggesting that the United States was not the appropriate place to examine it. See ‘Siberian Aluminum Counters U.S. Suit’, \textit{Moscow Times}, 28 May 2001, p.7; Lyuba Pronina, ‘U.S. Rejects $3Bln Suit Against RusAl’, \textit{Moscow Times}, 1 April 2003, p.5.

\(^{190}\) Butrin, ‘Komu prenadlezhit Rossii’. 
wars" over redistribution of ownership seemed imminent. However, the new owners of BrAZ, KrAZ, and AGK decided to merge their aluminium assets with those of SibAl, leading to the establishment of RusAl, announced in the spring of 2000. It was considered to be a pragmatic decision of the new owners from Sibneft not to confront SibAl for the various reasons which are indicative that SibAl had been reconstituting itself into effective business units.

First, SibAl was the organiser of the production chain. KrAZ’s main supplier of alumina was NGZ, the largest producer of alumina in the CIS, which was under the control of SibAl. As mentioned above, SibAl and its affiliate UkrAl owned 67 per cent of NGZ. Furthermore, the management of AGK, another supplier of alumina to KrAZ, had changed. KrAZ had lost influence over AGK, and by the end of 1999, the Alfa group, an ally of SibAl in this particular context, took over management of this alumina refinery. This meant that, without the cooperation of SibAl, the new owners of BrAZ and KrAZ, would have difficulties in organising the upstream chain of production to procure alumina,

Second, SibAl was better placed in terms of raw material procurement than BrAZ and

KrAZ. From 2000, abolition of so-called internal tolling\textsuperscript{197} took effect, posing serious problems for KrAZ and BrAZ. Internal tolling, introduced in 1995 to protect domestic alumina production, worked in basically the same way as the tolling mechanisms explained above, except in terms of the origin of the alumina that was used for aluminium production. Under internal tolling, the smelters use domestic alumina for the processing of metal, rather than imported alumina. KrAZ and BrAZ, which processed domestic alumina, had been major beneficiaries of the internal tolling system. Therefore, its abolition deprived KrAZ and BrAZ of certain tax advantages. On the other hand, SibAl’s Saiansk smelter was using imported alumina, so the abolition of internal tolling did not have any damaging effect. In fact, it was reported that SibAl had lobbied for the abolition of internal tolling.\textsuperscript{198}

Thirdly, the newly acquired assets had to be managed professionally, and it was more effective to delegate that responsibility to SibAl, which was considered to have managed its aluminium enterprises reasonably well.\textsuperscript{199} In other words, the managerial

\textsuperscript{197} Internal tolling is when a trader brings domestic alumina to a smelter, then takes back the aluminium produced to sell it abroad. The difference from original tolling, or external tolling as it later came to be called to differentiate it from internal tolling, lay in the origin of the alumina — that is, whether the alumina was imported or not. Under internal tolling, no VAT or custom duties are levied. Internal tolling was approved in 1995 as a measure to protect the domestic alumina industry. Due to the tax advantages on the processing of imported alumina under external tolling, the demand for domestic alumina fell sharply, leading to the collapse of domestic alumina enterprises in Russia. By providing a level playing field for the processing of domestic alumina, internal tolling aimed in part to alleviate the collapsing domestic alumina production. This internal tolling measure was initially introduced to be effective for a one year period. The system had been the subject of controversy since its inception, but its abolition kept being postponed year after year, until the end of 1999. See ‘Otnena tollinga’, Vedomosti, 31 December 1999, (http://www.vedomosti.ru/stories/1999/12/31-42-06.html, accessed 20 August 2003); Mariia Rozhkov a and Sergei Rybak, ‘Voina plakatov’, Vedomosti, 6 October 1999, (http://www.vedomosti.ru/stories/1999/10/06-01-01.html, accessed 20 August 2003); Vadim Bardin and Aleksandr Vol’nets, ‘Metallurgi primeriayt tolling, neftianiki meriaiut eksport nefti kreditami’, Kommersant, 9 February 1995, (http://www.kommersant.ru, accessed 29 July 2003); Viktor Smirnov, ‘Aluminiyevye zavody groziatsia prekratit’ rabotu i vsvyatiat o pomoschi k Borisu El’tsinu’, Kommersant, 4 June 1997, p.10; Vadim Bardin and Aleksandr Vol’innets, ‘Tamozhnia vmeshivaetsia v igry s tollingom, importery zhe ostaiutsia na zapasnom puti’, Kommersant, 1 September 1994, p.1.


\textsuperscript{199} Kasulinskii, ‘Kak aliuminii stal “Russkim”’. 
function of SibAl in organising firm resources was in place. As Sergei Generalov, vice chairman of the Duma committee on economic policy put it in an interview, “For the owners of Sibneft, the management crisis was absolutely clear to me – where to find a team of managers who can professionally manage aluminium business, and moreover, ideally, not steal? It is quite a serious problem”.200

Fourth, it should be pointed out that SibAl’s alliance with RAO UES, the electricity monopoly, at the time was too powerful to ignore.201 The planned establishment of EMO (Energometallurgicheskii ob’edinenie) Saian was taking shape at the time. This was a project that would unite SibAl with Saiano-Shushensk Hydropower Station under a close cooperation with RAO UES.202 Since electricity accounts for up to 30 per cent of the overall cost of aluminium production, this project would have given SibAl a competitive edge over electricity supply. Moreover, an alliance with RAO UES would give SibAl another advantage against competitors in an environment where the threat of hostile bankruptcy was rife. At the time, NkAZ was in the throes of its bankruptcy procedure and it was a local utility under the control of RAO UES that had initiated the bankruptcy suit. Since most aluminium plants were in debt to electricity companies, this meant that they could be easily bankrupted if a corporate rival was so inclined.203

The new company, RusAl, assumed ownership of assets previously held by two groups of investors (that is, SibAl and Sibneft), and control of RusAl was shared equally between the two groups.204 Deripaska became the CEO. Russia’s antitrust ministry

201 Ibid. Deripaska and Chubais, head of RAO UES, reportedly maintained good relations at the time.
202 However, the project did not materialise. Kasulinskii, ‘Kak aliuminin stal “Russkim”’.
203 Rozhko, ‘Aliuminii razdelil oligarkhov’.  
204 Valeria Korchagina, Kirill Koriukin and Alla Starceva, ‘The New Face of Russia’s Oligopoly’, 1 November 2001, p.1; Robert Cottrell and Andrew Jack, ‘Russian Aluminium given green light’,

199
approved the formation of RusAl in 2001 and the world’s second largest aluminium producer was established in Russia.\textsuperscript{205}

5.5 Conclusion

Russia’s aluminium sector had long been characterised by intense redistribution of ownership of aluminium assets, the phenomenon described as ‘aluminium wars’. ‘Atomising privatisation’ initially created a dispersed ownership base, which unleashed all-out struggles for control over assets in the industry. The highly controversial character of the industry and evidence of ICGPs discouraged foreign investment.\textsuperscript{206}

Paul O’Neil, a former US commerce secretary, who had been chairman of Alcoa, the world’s largest aluminium company, commented in replying to the question as to why Alcoa has not invested in Russia: “God bless anybody who wants to do it. How would you like to be in charge of a company whose economics were dependent on screwing the people? That’s just crazy”.\textsuperscript{207}

At the same time, as this chapter has shown, ICGPs were also instrumental in reconstituting the aluminium enterprise into a business firm. The tasks faced by SaAZ/SibAl and the use of ICGPs to address them are summarised in Table 5.1. In the aluminium sector, mass privatisation resulted in privatisation of former Soviet production units, which were not able then to function independently as self-contained business units in a new market-oriented environment. With the collapse of the Soviet economic system, SaAZ, which had functioned as a production unit in the Soviet

\begin{flushleft}
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industrial hierarchy, had insufficient technical or organisational resources. Moreover, the production chain that linked upstream and downstream production had been disrupted. The tolling arrangement, introduced by the intermediary trader, served to replace the function fulfilled by the central planning system, and enabled the continuation of aluminium production in the initially dire economic period of post-Soviet Russia. Through tolling, business functions such as raw materials supply, financing, sales and marketing, were provided by the trader. Privatisation, together with tolling, had enhanced the influence of traders, who had been the major shareholders. However, the importance of the role played by traders diminished over time, and conflicts of interest between the trader and managers of aluminium plant increased.

Against this background, ICGPs were used by Russian managers at SaAZ/SibAl to obtain independence from the trader and to establish administrative control. Share dilution was used in order to concentrate ownership, i.e., to eliminate the influence of the trader, which enabled SaAZ/SibAl to integrate business functions independent of the trader. In addition, fictitious bankruptcy and ‘bankruptcy to order’ were utilised to revitalise SAMEKO, which advanced downstream vertical integration, and to take over NkAZ, which added smelting capacity and advanced lateral integration. Thus, ICGPs were used to adjust the boundary of the firm and to establish a vertically integrated aluminium company, which served to integrate various business functions and to reconstruct the production chain from production of alumina, and primary metals, to semi-fabricated and fabricated products. In short, ICGPs became the tools used to resolve the three tasks of reconstituting the enterprise into a more coherent business firm.
Table 5.1 Tasks SaAZ/SibAl Faced and Use of ICGPs

<table>
<thead>
<tr>
<th>Tasks faced by the company</th>
<th>ICGP as Tools</th>
<th>Type of ICGPs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Establishment of administrative control</td>
<td>• To break free from being a production unit and to grow as a firm in a market environment, it needed to gain independence from the trader and to establish control, which enabled:</td>
<td>Share dilution</td>
</tr>
<tr>
<td>• Administrative coordination provided under the Soviet system was gone, and the trader replaced the central planner</td>
<td>• to take full control over the industrial activities;</td>
<td>• to dilute the shareholding of the trader by increase in charter capital, followed by additional share issue</td>
</tr>
<tr>
<td>Integration of various business functions</td>
<td>• to take on business functions performed by the trader;</td>
<td>• to consolidate control by management by concentrating more than 75 plus one share</td>
</tr>
<tr>
<td>• Business functions such as financing, raw material procurement, marketing/sales could not be fulfilled by the plant due to lack of resources of its own. Instead, these services were provided by the intermediary trader</td>
<td>• to restore the disrupted production chain, and create a vertically integrated aluminium company which encompasses the production chain under one umbrella</td>
<td>• &quot;cooperative&quot; involvement of the authorities with regard to share dilution</td>
</tr>
<tr>
<td>Reconstruction of the production chain</td>
<td>• The plant was required to adjust the boundaries of the firm.</td>
<td>• limiting shareholder access to open subscription of new issues</td>
</tr>
<tr>
<td>• Downstream-upstream production chain was disrupted as a result of the breakdown of central control, collapse of USSR, and privatisation at the production unit level, but the trader took on the role of organiser of the production chain.</td>
<td>• To survive and grow, it needed to increase market share</td>
<td>Revitalising bankruptcy</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• to financially revitalise a downstream company, to create a dozen daughter companies, transfer valuable assets to them from the company, then initiate bankruptcy of the company</td>
</tr>
<tr>
<td></td>
<td></td>
<td>'Bankruptcy to Order' (Takeover bankruptcy)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• to further the integration process, to increase economies of scale, and to proactively survive “aluminium wars” in the industry, bankruptcy procedure were used as takeover tool: initiate bankruptcy for overdue local utility payment, create new creditors while eliminate original creditors, consolidate debts to control bankruptcy processes</td>
</tr>
</tbody>
</table>

SaAZ / SibAl (RusAl)
Use of ICGPs became possible in the context of weak legal institutions and state weakness. They worked because the weak legislation, particularly in relation to the bankruptcy law, allowed the instrumental use of law, and this exploitative attitude towards the law facilitated subversion of the intentions of the formal rules. As this has chapter illustrated, the role of the state was also crucial in making ICGPs possible. It was likely that share dilution, fictitious bankruptcy, or 'bankruptcy to order' would not have been possible if there had not been 'cooperation' between the state and business. Therefore, close alliance with the state, particularly the regional authorities, influenced the 'success' of ICGPs.
CHAPTER 6. ICGPs and Norilsk Nickel

6.1. Introduction

This chapter analyses ICGPs of Norilsk Nickel, the world's leading nickel and platinum group metal (PGM) producer. The reason for choosing Norilsk Nickel as the subject of the third case study was that the instances of its use of ICGPs during the 1990s appeared less prominent compared with Yukos and SibAl, which were examined in Chapters 4 and 5. The reason for this appears to the degree to which Norilsk Nickel was an integrated entity; this chapter analyses how this affected the Norilsk Nickel's task of reconstitution into a business unit. The analysis in the chapter demonstrates that Norilsk Nickel was originally established as an association of related enterprises, and was united under a single decision-making structure with internal administrative cohesion. In addition, Norilsk Nickel's constituent enterprises were united under a common input-output chain of production and from its establishment, a mixture of important resources were integrated under its umbrella. Throughout the collapse of the Soviet Union, and the ensuing period of corporatisation and privatisation, Norilsk Nickel was able to maintain its corporate management structure, its production chain and its pool of resources.

However, while ICGPs in Norilsk Nickel were less prominent during the 1990s, its use of them in 2000 has attracted much attention. In 2000, Norilsk Nickel encountered some corporate governance problems that were associated with its complex process of reconstitution.

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1 The smaller number of reported cases of ICGPs during the 1990s is corroborated by the weekly corporate governance report 'Bulletin on Corporate Governance Actions' produced by Troika Dialog. From 1998, the reports, on a weekly basis, documented incidences of corporate governance violations and potential violations that involved abuse of shareholders' rights which, in general, accompanied the use of ICGPs. Many cases of corporate governance violations were documented in the reports on the Yukos Oil Company and on enterprises in the aluminium industry, including SaAZ and SibAl, while until 2000 there were very few reported for Norilsk Nickel. After 2000, information on corporate governance violations by Norilsk Nickel started to appear in connection with abuses that were associated with the restructuring that started in that year.
corporate reorganisation. This chapter analyses the logic that produced this phenomenon and suggests that ICGPs were in part used to insure against the political risk, or so-called deprivatisation risk, i.e., the possibility that the result of loans-for-shares programme would be annulled, and that the company would be renationalised.

The chapter is organised as follows. First, section 6.2 demonstrates that Norilsk Nickel was quite well integrated from its creation and continued to be so. Section 6.3 examines how much better placed Norilsk Nickel was from the perspective of the reconstitution of enterprises into business firms in the context of the collapse of the Soviet economic system, i.e., in the light of the three essential tasks facing enterprises – establishing an effective administrative hierarchy, integration of business functions, and reconstruction of the production chain. The lesser prominence of ICGPs during the 1990s is analysed from this perspective. Section 6.4 examines the underlying rationale for Norilsk Nickel's use of ICGPs, which attracted much scrutiny and criticism, particularly on the part of investors, in 2000.

6.2 Norilsk Nickel as an Integrated Unit

6.2.1 The State Concern: Norilsk Nickel

Norilsk Nickel was formally organised as an official state enterprise – 'The State Concern for Non-Ferrous Metals Production Norilsk Nickel' by a resolution adopted by the Council of Ministers of the USSR on 4 November, 1989.² The Soviet Union was the world's largest producer of refined nickel; it is estimated that production in 1989 was 251,000 metric tons, or nearly 30 per cent of world production.³ Within the Soviet Union, the State Concern Norilsk Nickel accounted for more than 80 per cent of Soviet

² Postanovlenie Soveta Ministrov SSR, No. 947, 4 November 1989, 'On the Establishment of the State Concern for Non-Ferrous Metals Production Norilsk Nickel'.
nickel production.\textsuperscript{4}

The metal complex based at Norilsk, located on the Taimyr Peninsula in an isolated zone in the Arctic, had historically occupied a key position in the Soviet nickel industry. The region contained more than a third of the world's nickel reserves and two-fifths of the platinum-group metals. It also had significant reserves of cobalt and copper.\textsuperscript{5} Dating back to the Stalinist period, the development of vast nickel-copper ore deposits of Norilsk and the establishment of a huge metal complex based at Norilsk, or Norilsk Combine (NGMK), was the major base metal mining and smelting project undertaken in the USSR.\textsuperscript{6} Under the GULAG labour camp system, between 1935 and 1956 the prisoners in Norilsk extracted the raw materials, built the factories, and built the city of Norilsk.\textsuperscript{7}

The establishment of the State Concern Norilsk Nickel is set against the background of the economic reforms introduced by Mikhail Gorbachev. In the late 1980s, ministerial reorganisation aimed at devolving the power of industrial ministries, since the huge bureaucratic apparatus of the ministries had been criticised for undermining the economic efficiency of Soviet industry. In 1987, ministerial staff numbers were reduced by as much as 50 per cent, and the number of ministries also shrank as a result of a series of abolitions and mergers of ministries.\textsuperscript{8} The aim, according to Prime Minister Nikolai Ryzhkov, was to reduce the number of ministries by 40 per cent.\textsuperscript{9} Thus, the

\textsuperscript{4} Ibid.
\textsuperscript{9} A report by N.I. Ryzhkov on a session of the USSR Supreme Soviet, \textit{Current Digest of the Soviet
power and capacity of the industrial ministries declined during the time of Gorbachev’s rule.\textsuperscript{10}

Prior to Gorbachev’s industrial reforms, the Norilsk Combine (NGMK) and other would-be constituent enterprises of the Concern were subordinate to the Ministry of Non-Ferrous Metallurgy, which controlled all Soviet enterprises in the non-ferrous metal sector. At the time of reform in 1989, the Ministries of Ferrous Metallurgy and Non-Ferrous Metallurgy were merged into a single body named the Ministry of Metallurgy. However, this rendered Norilsk Nickel independent of ministerial control as it did not come under the newly formed Ministry of Metallurgy.\textsuperscript{11} Instead, the State Concern Norilsk Nickel was created as a new legally autonomous entity.\textsuperscript{12} Norilsk Nickel was an independent metal concern, which reported directly to the Council of Ministers.

The State Concern was established through the formal unification of several enterprises that de facto were already operating as a vertically integrated production complex.\textsuperscript{13} The formal arrangement brought together six enterprises: 1) Norilsk Combine (NGMK) – the Norilsk metal complex based on the Taimyr Peninsula, which was the leading enterprise of the Concern;\textsuperscript{14} 2) Pechenganickel Combine, and 3) Severonickel Combine, both producers of nickel and copper located at Kola Peninsula at Murmansk Oblast; 4) Olenegorsk Mechanical Works, whose operations included mining and metallurgical

\textsuperscript{10} Fortescue, ‘The Industrial Ministries’, p.155.
\textsuperscript{11} IMF et al., \textit{A Study of the Soviet Economy Vol.3}, p.233.
\textsuperscript{12} \textit{Postanovlenie Soveta Ministrov SSR}, No. 947, ‘On the Establishment of the State Concern for Non-Ferrous Metals Production Norilsk Nickel’.
\textsuperscript{14} The leading status of NGMK in the State Concern is said to be reflected in the name “Norilsk Nickel.” Aleksei Komarov and Iuliia Gavrilina ‘RAO “Noril’skii nikel”’: Rost kursa aktsii predopredelen’, \textit{Rynok Tsennykh Bumag}, 1996, p.32.
machine building and equipment repair; 5) Krasnoiarsk Non-ferrous Metal Processing Works, a producer of platinum, palladium, rhodium, osmium, and ruthenium from PGM concentrates supplied by NGMK; and 6) the Gipronickel Institute, a research institute in St Petersburg conducting design and scientific-technical research (see Figure 6.1).

Figure 6.1: Composition of the State Concern Norilsk Nickel

When the State Concern was created, Norilsk Nickel maintained its internal cohesion in terms of corporate management. When Norilsk Nickel was freed from ministerial control and supervision, constituent enterprises were brought together within a common decision-making structure under the leadership of NGMK, which had already acquired the status of a glavk during 1970s. Glavki were the administrative units of the central ministerial apparatus that were most directly responsible for providing Soviet production units with operational orders. Given that the glavk was in actual control of the day-to-day operations of Soviet production units, the glavk status seemed to have endowed Norilsk Combine with responsibility for administrative functions that enabled it to play a lead role in managing related enterprises under a single unit, i.e., the State

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15 Ibid.
17 During the reform of industrial ministries, there was also an effort to abolish or reorganise the glavki, that were under the control of the ministries. Fortescue, ‘The Industrial Ministry’, p.153.
Concern Norilsk Nickel. Moreover, the fact that NGMK was the quintessential component of Norilsk Nickel as a producer and supplier of material to other constituent enterprises enabled NGMK to play a lead role in this state Concern.

6.2.2 How Norilsk Nickel Managed to Remain Integrated

a) Economic Significance of Norilsk Nickel

That Norilsk Nickel became independent of the ministerial control in part reflects Norilsk Nickel’s economic importance both for the country and the world market. It produced a range of rare metals and accounted for large shares of world and national mine production. As noted above, Norilsk Nickel produced more than 80 per cent of the nickel produced in the USSR, which was the largest producer of refined nickel in the world, representing 30 per cent of world production in 1989 when the state Concern was formed.\(^{18}\) Norilsk Nickel contributed almost all the output of platinum, palladium and other platinum group metals in the USSR, as well as a large proportion of the copper, cobalt and other by-products of the copper-nickel deposits produced.\(^{19}\)

Reliable data are available for the late 1990s, which show the position Norilsk Nickel occupied in Russia and in the world: Norilsk Nickel contributed 1) copper: 3 to 5 per cent of the world total and between 60 and 70 per cent of the Russian total; 2) nickel: 19 per cent of the world total and 85 per cent of the Russian total; 3) cobalt: 17 per cent of the world total; 4) platinum: roughly one-fifth of the world total and 95 per cent of the Russian total; 5) palladium: one-half to two-thirds of the world total and virtually 100 per cent of the Russian total; 6) other platinum-group metals: rhodium (20 per cent of world total), osmium, iridium, and ruthenium; and 7) some gold and silver.\(^{20}\)

\(^{19}\) Ibid., p.235.
Norilsk Nickel was valued for its ability to generate foreign currency through export. The removal of ministerial control over the Concern was to enable funds to be channelled into this major generator of foreign exchange.\textsuperscript{21} Norilsk Nickel was already an important metals exporter and its export volume was growing in the 1980s. During the latter half of the 1980s, nickel exports to Western markets increased from 26,000 metric tons in 1985 to around 80,000 metric tons in 1989.\textsuperscript{22} Norilsk was exporting not only very large volumes of nickel, but also large quantities of platinum and palladium, as indicated above.

Because of its economic importance, Norilsk Nickel enjoyed a special status. Its independence from the Ministry of Ferrous Metallurgy and reporting directly to the Council of Ministers meant that Norilsk Nickel was granted the status as an organisation at the same level as an industrial ministry, and much greater independence than any other base metal production enterprise in the Soviet Union.\textsuperscript{23} The Concern was assigned a separate line/heading in its own right in the national economic plan.\textsuperscript{24} This meant that Gossnab and Gosplan assigned material-technical resources and consumer goods to the Concern in accordance with the separate heading, which reflected this special treatment given to Norilsk Nickel.\textsuperscript{25}

The Concern received a number of privileges. In the area of foreign economic activities, the government extended Norilsk Nickel the equivalent rights and functions in the area of external economic activities that the central organs which managed industrial sectors

\textsuperscript{21} IMF et al., \textit{A Study of the Soviet Economy Vol. 3}, p.267.
\textsuperscript{22} Ibid., p.265.
\textsuperscript{23} Ibid.
\textsuperscript{24} "RAO Noril'skii nikel", http://www.referat.su/refs_new/1056/ref_part_0.shtml, accessed 23 December 2003. Also, personal communication with Norilsk Nickel staff on 31 October 2003.
\textsuperscript{25} Ibid.
enjoyed. For instance, Norilsk Nickel was able to organise the export of its products, bypassing the Ministry of Foreign Economic Relations, and to keep foreign currency proceeds. It was also able to conduct an independent import policy. An IMF/World Bank/OECD/EBRD study on the Soviet economy reported in early 1992 that Norilsk Nickel had been highly profitable in Soviet accounting terms and appeared to have privileged access to foreign currency.

The economic significance of Norilsk Nickel had historically been reflected in the volume of resources allocated to it by the state to expand metal production capacity. Norilsk’s metal production had received large investments since the 1970s, principally designed to maintain nickel production by exploring new ore reserves. In the 1970s, the Soviet planners put extensive effort into the development of Talnakh, 25 km northeast of Norilsk on the Taimyr Peninsula, where there were vast ore deposits. The funds that were allocated during the early 1970s for the expansion of mining at Talnakh were massive, and similar in scale to the funding allotted to the construction of the dam and hydroelectric station at Bratsk, which was a major Soviet project during the late 1950s and 1960s.

The continued investment that Norilsk Nickel had received had contributed to its efficiency. The overall operation of Norilsk Nickel was positively assessed by international organisations, which regarded it as one of the most efficient producers of metal in the country. Norilsk Nickel had a significant proportion of modern mining, smelting and refining plant and equipment. Thus, although lack of investment was a

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26 Ibid.
29 Ibid.
31 IMF et al., A Study of the Soviet Economy, p.268. However, it is important to emphasise that Norilsk Nickel is responsible for serious pollution.
typical problem in most of the Soviet base metal industry due to the critical state of the Soviet economy, Norilsk Nickel did not suffer from lack of funds. The efficiency of its mining and smelting operations was due to a reasonable condition of the underground mining operations at Norilsk. The mine ventilation systems were effective and production efficiency was said to compare well with that of Western mines. The equipment in use at Norilsk was appropriate, for example, large scoop trucks, large underground haul trucks and jumbo drills for multiple blast-hole drilling.\textsuperscript{32}

There are other indicators of the economic importance to the country of Norilsk's metal complex. Norilsk's significance in the Soviet economy was reflected in the political sphere. Bond argues that the importance of Norilsk's metal operations was reflected in special political administrative arrangements that applied to the city of Norilsk where NGMK was based.\textsuperscript{33} Instead of being governed by Taimyr Autonomous Okrug, where Norilsk was physically located, the city came under the larger administrative unit, Krasnoiarsk Krai.\textsuperscript{34} But, such was the importance to the country of NGMK, that almost 90 out of 100 matters that related to the Norilsk Combine were considered and decided in Moscow, bypassing the Krasnoiarsk regional administration.\textsuperscript{35}

The special status of Norilsk can be seen in its personnel policy. The post of the general director of the NGMK was usually occupied by someone who was seen as eventually occupying a senior political position. Former directors of the Norilsk Combine subsequently were given high-ranking posts, such as Deputy Director of the NKVD (precursor to KGB), or Central Committee Secretary for Heavy Industry of the

\textsuperscript{32} Ibid, p.266.
\textsuperscript{33} Bond, 'Economic Development at Noril'sk', pp. 362-363.
\textsuperscript{34} Ibid.
Communist Party. As a rule, the general director of NGMK was a member of or candidate for membership of the Central Committee of Communist Party.

b) General Director of NGMK

At the time of its establishment, Norilsk Nickel had a strong general director, Anatolii Filatov, who apparently had played a crucial role in the creation of the State Concern by bringing together the six enterprises under a single umbrella. Popularly known as ‘the King of Nickel’ or the ‘Tsar of Norilsk’, Filatov enjoyed almost unlimited authority in Norilsk. Filatov assembled Severonickel Combine, Pechenganickel Combine and Krasnoiarsk plant under the patronage of Norilsk Combine upon the creation of the State Concern, with the power he gained as he “broke free from ministerial tutelage and control” at the end of the 1980s. Nikolai Abramov, chief engineer of NGMK, referred to this development as the “Norilsk rebellion,” suggesting that there was some political struggle involved in the establishment of the Concern.

Being in control of Norilsk metal, a significant hard currency earner, combined with the political skills and authority he acquired as general director of Norilsk appear to have helped Filatov in his bid for Norilsk’s independence from the ministerial governance at the time that the Gorbachev reform was reorganising industry by reducing the power of the industrial ministries. Furthermore, it seems that Filatov contributed to the corporate integrity of the State Concern being preserved. When Filatov left Norilsk Nickel in 1996, Abramov remarked that it was to Filatov’s credit that the Concern had remained in its...

40 Tarasov, ‘Ukhodit Filatov, Nikelevyi korol”.
41 Ibid.
entirety, and in working condition, and had continued to increase the production of metals.\(^{42}\)

c) 'Technological Chain'

The constituent enterprises of Norilsk Nickel were integrated by the common 'technological chain', as it is termed in Russia. This technological chain can be understood as a production chain or linkage, supported by cooperative ties among enterprises, which ensure effective use of production capacity. The constituent enterprises of Norilsk Nickel were a unified production complex for the production and processing of sulphide copper nickel ore, and were linked by cooperation.\(^{43}\)

The production chain, which had for a long time existed among the three combines, constituted the nucleus of a vertically integrated Norilsk Nickel. Norilsk Combine, or NGMK was the main raw material base for Norilsk Nickel and the main supplier of raw materials for other enterprises within the Concern. It had one of the largest nickel ore bodies in the world, and ore grades generally higher than those of its competitors.\(^{44}\)

Large quantities of nickel in the form of ore and high-grade matte were transported from NGMK to the Kola Peninsula for processing at Severonickel Combine and Pechenganickel Combine. This linkage between the Norilsk Combine and these other two combines had been in existence since the late 1960s.\(^{45}\)

The Soviet government was committed to securing a stable transportation route between enterprises on the two Arctic Peninsulas in order to maintain the production linkage. Ore and matte were transported from NGMK on the Taimyr Peninsula to

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\(^{42}\) Ibid.

\(^{43}\) 'RAO “Noril’skii nikel”’: problemy i perspectivy’, EKO, 1988, p.47.

\(^{44}\) Brunswick UBS Warburg, Russian Equity Guide 2002/03, pp.146-147.

\(^{45}\) Bond, 'Economic Development at Noril’sk', pp.362, 323.
Pechenganickel and Severonickel Combines on the Kola Peninsula via the Northern Sea Route. In order to extend the winter navigation period, both conventional and nuclear-powered icebreakers are used, which keep shipping lanes open almost the year round. By 1980, the use of these icebreakers had achieved an eleven month navigation period. The success of these efforts to ensure navigable waters enabled an increase in the overall tonnages of freight via the Northern Sea Route.\textsuperscript{46} In this connection, Bond argues that the government’s commitment to maintaining a nearly year long sea connection between the two Peninsulas can be seen as a good indication of the national importance of Norilsk metal production.\textsuperscript{47}

Upstream in the vertical chain, Pechenganickel Combine processed rich copper-nickel ore received from NGMK. It also was responsible for mining and enrichment of local copper-nickel sulphide deposits, producing converter matte, containing nickel and copper, and supplying matte to Severonickel Combine for further processing. Severonickel produced finished nickel and copper from the processing of rich ores and converter matte transported from NGMK, and processed matte from Pechenganickel. NGMK also produced finished products as well as being the main supplier of raw materials. NGMK is the only enterprise in the Concern that produces nickel, copper and cobalt in a complete cycle — from concentrates to the marketable product, and not based on semi-finished products from other sources.\textsuperscript{48}

**6.2.3 Creation of RAO Norilsk Nickel**

At the time of its corporatisation and privatisation, Norilsk Nickel was a single association of related enterprises in the sector organised as a State Concern. It was an

\textsuperscript{46} Ibid., p.362.
\textsuperscript{47} Ibid., p.361.
\textsuperscript{48} Komarov and Gavrilina ‘RAO “Noril’skii nikel’”, p.32.
independent, integrated unit in its own right. When Norilsk Nickel was corporatised and privatised it is significant to point out that the structural composition and organisational integrity of Norilsk Nickel remained unchanged.

Government policy, through this process of corporatisation and privatisation, ensured that the State Concern Norilsk Nickel continued as a single unit. In accordance with a presidential decree, the State Concern was corporatised into RAO Norilsk Nickel, or ‘the Russian Joint Stock Company (RAO-Rossiiskaia Aktsionernoe Obschestvo) Norilsk Nickel for Production of Non-Ferrous and Precious Metals’. This recognition of Norilsk Nickel as an integrated single entity was reflected in the presidential decree which recognised Norilsk Nickel as an association of enterprises that comprised a single unit both in property terms and in terms of its economic activities. Norilsk Nickel participated in the development of the policy for corporatisation of the Concern as its entirety, composed of enterprises constituting a unified association. The basis of this close association, as shown above, was the common production chain that vertically linked the components of the metals complex.

RAO Norilsk Nickel was thus simply the legal successor (pravopriemnik) of the State Concern Norilsk Nickel. The novelty of RAO Norilsk Nickel was that it was established as a holding company, with the constituent enterprises being wholly owned subsidiaries of RAO Norilsk Nickel (see Figure 6.2). The constituent enterprises became joint-stock companies (AO), which were 100 per cent owned by RAO Norilsk Nickel.

50 Ibid.
51 ‘RAO Noril’skii nikel’.
52 The company was registered in accordance with the postanovlenii no 692, 27 April 1994 of the
Nickel’s change to becoming a joint stock company RAO, did not involve any substantial changes in its basic operational structure: the production chain remained as it had been under the State Concern Norilsk Nickel. Main business functions for production activities were integrated, although the marketing mechanism was still to be developed, as mentioned below. In terms of the structural composition of Norilsk Nickel, there was no change: Norilsk Nickel was comprised of NGMK, Severonickel Combine, Pechenganickel Combine, Olenegorsk mechanical works, Krasnoiarsk Plant and the Gipronickel Institute. The holding company RAO Norilsk Nickel was designed to serve as a managing structure encompassing the constituent subsidiaries that were already connected operationally. In the first few years, the RAO was in practice, just a ‘symbolic’ organisation, the key enterprise continuing to be NGMK. In fact, the general director of the combine and that of the RAO was the same person, Anatolii Filatov, the general director of NGMK.

Figure 6.2: Original Composition and Structure of RAO Norilsk Nickel

It should be emphasised that the organisational and operational integrity of Norilsk city administration, Krasnoiarsk Krai. Telephone inquiry to Norilsk Nickel from author, Corporate department, October 2003.

53 The plant was sold to the Krasnoiarsk regional administration in order to make up for overdue tax payment in 1997.
55 Ibid.
Nickel remained intact during the privatisation processes. Norilsk Nickel went through programme of mass privatisation in 1994, followed in 1995 by a loans-for-shares programme, which resulted in Norilsk Nickel being owned and managed by the Interros group, headed by Vladimir Potanin. Unlike what had occurred in the oil sector, there was no two-tiered privatisation in the case of Norilsk Nickel. Hence, there were no problems of the owners of the holding company being different from the owners of the subsidiaries, as had happened in the privatisation of the Yukos Oil Company. Existing production linkages among enterprises were maintained in Norilsk Nickel, and the collapse of the Soviet Union did not result in disruption to the production chain. Norilsk Nickel had from the start been a vertically integrated company, encompassing successive stages of production. It did not encounter the problems suffered by the aluminium sector of the production chain falling into the hands of different sets of shareholders.

In this connection, Batchikov (from the Interros group) and Petrov argued in 1995 that “perhaps the most important thing is: the fate of the privatised Norilsk Nickel was a rare fortunate case in a sense that in the process of corporatisation, the Concern was able to preserve itself as a single production entity/organism”. However, the phrase “a rare fortunate case” should not be taken to mean that this development was a pure accident. As mentioned above, Filatov had been able to bring together related enterprises into a single Concern. The implication of the establishment and preservation of Norilsk Nickel as a single commercial entity is that the management matters. However, although it was

56 'Privatiziruemuiu promyshlennost' spasut banki i FPG', Rossiiskii Ekonomicheskii Zhurnal, No. 7, 1995, p.14. It is important to note that they also referred to the relatively favourable situation of RAO Norilsk Nickel in a following manner: Unlike RAO Gazprom, Russia’s Gas monopoly, for example, Norilsk Nickel was not obliged to supply its product at a symbolic low price to the domestic consumers or to Ukraine, who already was indebted by billions of dollars. Unlike RAO UES, the electricity monopoly, for example, Norilsk Nickel did not have to work with consumers who were incapable of paying for their services. Unlike the coal industry, Norilsk Nickel produced expensive products, whose price was not influenced much by the rise in railroad tariffs. Unlike the machine-building industry, Norilsk Nickel produced competitive products.
in part due to Filatov’s skills that Norilsk Nickel continued to be an integrated unit, the following evidence suggests that different skills mattered for the management of Norilsk Nickel under a new, more market-oriented environment.

By the time Interros took control of the metal complex in 1996, Norilsk Nickel’s finances were in a shambles. Reports of financial negligence abounded, and mismanagement by the former administration headed by Filatov was believed to be one of the main reasons for its mounting debts. When the new management team from Interros took over, the company’s debt was over 2 billion dollars. Former managers and members of their families, had set up their own companies, with finance from Norilsk Nickel, or based on loans guaranteed by RAO and NGMK, none of which was ever repaid, while the creditors were demanding payment from the guarantors. NGMK received a 25 billion ruble credit (USD5.5 million) from Sberbank in November 1995 for the purpose of paying the workers wages. However, the workers received no wages from November 1995 and the money was used to finance the various family companies, and to repay the loans. As a result, the Prosecutor’s office at Norilsk brought a criminal case against the management of RAO Norilsk Nickel.

In the one-company city of Norilsk, Norilsk Nickel as a city-forming enterprise (gradoobrazuishee predpriiatie) encountered other serious problems. It had the problem of an excessive workforce and had to bear the heavy costs of supporting the

58 Maksim Stepenin, ‘Nikelevyi monopolist pogriaz v dolgakh’, Kommersant, 16 April 1996, p.14; Leonid Skabichevskii, ‘Kholodnaia zima grozit “Noril’skomu nikeliu” uzhe v mae’, Kommersant, 25 May 1996, p.9. One of the most urgent problems at the time was that in 1996, the so-called “severnyi zavoz” – delivery of goods prior to and in preparation for the winter, was unable to start as planned due to lack of funds.
60 Stepenin, ‘Nikelevyi monopolist pogriaz v dolgakh.’
city of Norilsk’s social infrastructure, upon which the 300,000 population depended.62 In Norilsk Nickel, production accounted for less than half the workforce, most being employed in auxiliary functions and in providing for the social sphere.63 Of the 120,000 people employed by Norilsk Nickel, 40,000 were involved in production and 80,000 worked in supplementary areas.64 Moreover, the costs of maintaining the social infrastructure were heavy: Norilsk Nickel assumed much of the responsibility for the hospitals, schools and pre-school institutions, housing and road maintenance. The cost of operating municipal organisations and for procuring necessary supplies was shared between Norilsk Nickel and Oneksimbank.65 Some 40 per cent of Norilsk Nickel’s revenues went towards supporting 45,000 pensioners, and the infrastructure of an entire town.66 Norilsk Nickel was burdened with having to pay taxes while supporting the social sector, in a situation where curtailing these social payments would be catastrophic both for the city and for the company.67 In addition to certain cutbacks, the company therefore decided to create a separate joint stock company involving the municipal authorities, which would assume responsibility for these social and infrastructural tasks so that the burden of maintaining the social services could be shifted to the regional government.68 Such problems were not unique to Norilsk Nickel however. According to Vedomosti, the amount of social spending by Russian industrial enterprises in 2002 was 97 billion rubles (USD3.4 billion), equivalent to almost 1 per cent of GDP.69

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62 The bill for caring for all these people in 1996 reportedly exceeded some 1.3 trillion rubles (USD230 million). Larsen, ‘Miners’ Threats Loom Over Norilsk Reform’.
63 Ibid.
65 Ibid.
67 Larsen, ‘Miners’ Threats Loom Over Norilsk Reform’.
68 Ibid. According to Hill and Gaddy’s data, the city of Norilsk is aiming to reduce its population by 160,000 by 2010 under the terms of the World Bank’s Northern Restructuring Project, and other initiatives. The World Bank approved loans of USD80 million to Russia in 2001 to facilitate the relocation from three northern regions, including Norilsk. However, according to Meier, “By 2002 the bank program had still not moved a single person”. Hill and Gaddy, The Siberian Curse, pp. 148-149, Andrew Meier, Black Earth: Russia After the Fall, (London: HarperCollins, 2003), p.229.
69 Boris Grozovskii, Svetlana Ivanova and Ol’ga Proskurina, ‘Dobrovol’noe bremia’, Vedomosti, 3
Interros appointed three key people to the top management team that helped deal with the situation. First was Aleksandr Khloponin, the young president of MFK, the bank established by Interros, who was appointed head of RAO Norilsk Nickel. The second person, Dzhonson Khagazheev was from the older generation, and had been made head of NGMK. Khloponin’s financial background helped in tackling the financial mess at Norilsk Nickel, while Khagazheev, who was a production expert, took on responsibility for the production side of Norilsk Nickel’s operations. This balance of a young financier with diplomatic skills, and an old engineer, somewhat of a father figure, seemed to have worked well; the company finances and production capacity improved, and the tensions surrounding the social aspects were eased. The deep-seated suspicion of Norilsk’s population towards outsider ‘aggressors’ from Moscow (i.e., Interros) began to dissipate as Khloponin brought order to the city by establishing control over the company’s expenditure and exports, and by improving the public services. Social tensions in the city of Norilsk eased, and relations with the regional Kranoiarsk administration improved.

The third person appointed by Interros to this new management team was Iurii Kotliar who had close ties with the external trade operations. This enabled Potanin’s Interros, which already had a strong external trade background, to enhance the marketing
abilities of Norilsk Nickel. It is fairly clear that although Norilsk Nickel did not have serious problems in connection with production, because it had an assured supply of raw materials, and the production chain had remained intact throughout the collapse of the USSR, it needed to make improvements in the area of marketing. Norilsk Nickel's competitors were western companies. Competition from overseas companies, for instance the Canadian company Inco, was threatening the international market share of Norilsk Nickel;\textsuperscript{76} it was important for Interros to strengthen its marketing function to sell nickel internationally.

6.3 Tasks Norilsk Nickel Faced – Better Placed in Terms of Reconstitution into Business Unit

6.3.1 Administrative Control

The above discussion suggests that Norilsk Nickel was well placed in terms of three challenges for becoming a coherent business firm – establishing effective administrative control, integrating various resources embedded in business functions, and organising the production chain. First, the administrative coordination – effective administrative control within the framework of Norilsk Nickel – was maintained during the initial privatisation process. This contrasts sharply with the situation in Yukos, where a two-tiered privatisation led to the lack of internal cohesion in corporate management. For Norilsk Nickel, the process of corporatisation and privatisation was basically a nominal conversion of the existing State Concern. The State Concern, in turn, had its roots in \textit{glavk}, a ministerial chief department in the Soviet administrative hierarchy. Norilsk Combine, the very central part of Norilsk Nickel, was given the status of a ministerial \textit{glavk} in the 1970s.\textsuperscript{77} Moreover, when Norilsk Nickel was privatised, its subsidiaries were already wholly owned entities of the holding company, RAO Norilsk

\textsuperscript{76} V. M. Sokolov, 'Mirovoi Rynok Nikelia', \textit{EKO}, 7, 8, 1996, p.185.

Nickel. In other words, the constituent subsidiaries of Norilsk Nickel were already wholly owned when Norilsk Nickel became a holding company upon privatisation. Subsidiaries were centrally managed and did not have operational independence. Unlike Yukos, Norilsk Nickel had from its inception been a vertically integrated company both in name and substance.

In addition, Norilsk Nickel’s existence as a going concern was not threatened by sharp conflicts of interest between managers and shareholders. The two-tiered privatisation in Yukos had led to the emergence of shareholders in the subsidiaries with different interests from those of the owner-managers of the holding company. In the case of the aluminium industry, a reliance on intermediary traders enhanced the power of these traders who strengthened their control over aluminium plants even further by becoming shareholders. These conflicts of interests among the different competing parties, lay at the root of the problems which were attacked by the use of ICGP against ‘undesirable’ shareholders in the process of reconstitution of Yukos and SaAZ/SibAl into business units. In contrast, Norilsk Nickel was fairly immune to such problems, which in part was due to the fact that Norilsk Nickel remained integrated, allowing less room for property redistribution.

6.3.2 Integration of Business Functions

Norilsk Nickel also had the advantage that it encompassed a collection of resources that rendered the various business functions. Norilsk Nickel had its own raw material base in Norilsk, and did not have to rely on other organisations for its raw materials. In this

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78 As noted by Mirontseva, “Norilsk Nickel was almost the only Russian enterprise which was able to avoid the emergence of large outside shareholders in the process of privatisation”. Iana Mirontseva, ‘Spokoinoe meropriiatie vsbudorazhilo mirovoi rynok nikelia’, Kommersant, 25 May 1995, (http://www.kommersant.ru/archive/archive-text.html).

79 It is indicative that there were ‘oil wars’ and ‘aluminium wars’ in the Russian industry, denoting the intense conflicts among those who struggled to control the companies, but no ‘nickel wars’ occurred. See Tarasov, ‘Ukhodit Filatov, Nikelevyi korol’.”
sense, raw material procurement was already an ‘in-house’ function within the framework of Norilsk Nickel. Further, Norilsk Nickel, which had achieved glavk status in the 1970s and the ministerial status in the late 1980s, had privileged access to foreign currency and had sufficient capital to fund its investment projects. As noted above Norilsk Nickel also performed its own export and import activities. In addition, the research function was integrated under Norilsk Nickel. That all these functions were being performed within the framework of Norilsk Nickel indicates that Norilsk Nickel embraced a mixture of the resources that are embedded in basic business activities. This does not mean that no additional resources were needed, but rather that Norilsk Nickel had a better collection of the resources that rendered business functions at the start of the post-Communist transformation than enterprises that were in the lowest layer in the Soviet economic system. Aluminium smelters, for example, were not endowed with the resources to carry out raw materials procurement, financing, or export of metals: these services were provided by traders. However, in Norilsk Nickel, these functions were already self-contained, and protected Norilsk Nickel from the degree of resource deficiency suffered by the aluminium smelters.

6.3.3 Reconstruction of Production Chain

As described above, Norilsk Nickel’s immediate predecessor was the State Concern, which also was an amalgamation of related enterprises linked by an input-output chain, which had existed since the 1960s. The entire production chain was integrated within the framework of the newly established Norilsk Nickel, and thus the company was already organising the network of upstream–downstream entities. Furthermore, the fact that RAO Norilsk Nickel was able to maintain its existing structure throughout the collapse of Soviet economic system and the ensuing privatisation process meant that the

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'technological chain' was not disrupted. Therefore, in stark contrast with the aluminium sector, Norilsk Nickel did not need to make radical adjustments to the firm boundary and bring the production linkages within the framework of the firm.

Thus, compared with Yukos or SaAZ/SibAl, Norilsk Nickel was much better placed to reconstitute into a business unit in the first stage of privatisation. Firstly, administrative coordination was maintained in Norilsk Nickel. And although there was a major change in top management following the loans-for-shares auction, there was no lack of administrative cohesion amongst the constituent enterprises, which were united under a single decision-making structure. Secondly, Norilsk Nickel had a mix of important resources that rendered various basic business functions already integrated under its umbrella. Finally, the chain of production, which had been functioning since the late 1960s, was also already organised under the umbrella of Norilsk Nickel. In short, Norilsk Nickel was an integrated unit at the start of the post-Communist transformation, and it was able to maintain its organisational and operational integrity during the period of transformation.

Therefore, it can be argued that these factors explain why in the 1990s Norilsk Nickel had less need to resort to ICGPs. The smaller number and reduced visibility of cases of ICGPs in the 1990s seem to be inextricably linked to the advantageous position of Norilsk Nickel in terms of the three tasks – establishing administrative control, integration of business functions and reconstruction of the production chain. From the resource-based view of the firm, therefore, it can be argued that the less prominent use of ICGPs reflected Norilsk Nickel's better position from the perspective of reconstitution of enterprises into business entities.
6.4 Reorganisation of Norilsk Nickel: Use of ICGPs

However, in the year 2000 Norilsk Nickel's use of ICGPs as abuses of corporate governance has attracted much attention.\(^{81}\) In 2000, Norilsk Nickel’s corporate governance problems came to be associated with its complex corporate reorganisation. This section examines the logic behind the use of ICGPs in Norilsk Nickel’s overhaul of its corporate structure. The analysis suggests that ICGPs were used during the reorganisation process in part to insure Norilsk Nickel against a political risk – the so-called deprivatisation risk, which emerged as a result of the loans-for-shares privatisation of Norilsk Nickel.

6.4.1 Deprivatisation Risk

Although much has been written about the mechanics of the loans-for-shares auctions, it is helpful for the ensuing discussion to briefly describe what is entailed.\(^{82}\) In substance, the loans-for-shares scheme allowed some of the most valuable enterprises in Russia to be sold at a fraction of their potential market value to politically well-connected entrepreneurs, who became known as ‘oligarchs’. The loans-for-shares programme was envisaged as comprising two rounds of auctions. First, investors, primarily banks, offered loans to the government. In exchange for the loans, the government allowed these banks to manage the shares, which served as collateral. The right to manage the state’s shares was auctioned off: this first round of the loans-for-shares programme took

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place in 1995. In the second stage, the government had two choices: it could choose to repay the loans to the lenders and take the shares back from them, or it could decide to divest itself of the shares were being used as collateral. If this latter course was decided on the state authorised the lenders to arrange the sale of those shares that they had been managing. In 1997 the government sold off shares that had been used as collateral enabling the winners of the first round to continue owning and managing them.

From the time that Interros took control of Norilsk Nickel as a result of winning the loans-for-shares auction, the deprivatisation risk existed: There was always the possibility that the result of loans-for-shares privatisation would be annulled, and that the company would be renationalised. 83

This risk was shaped by at least three interrelated factors. First, and foremost, was the procedures involved in the loans-for-shares scheme, which were known to be rather 'shady'. 84 This left Interros open to attacks from various quarters about the legitimacy of the loans-for-shares auction, and demands for the reversal of privatisation of Norilsk Nickel. The loans-for-shares auction of Norilsk Nickel in 1995 was the highlight of the scheme, due to its potential value as the world's leading producer of nickel and PGM. 85 Oneksimbank, controlled by Potanin, head of the Interros group, was the official representative of the State Property Committee (GKI), the state agency in charge of Russia's privatisation programme. It was Potanin who had originally put forward to the government the idea of loans-for-shares, and Anatolii Chubais, first deputy prime minister in charge of the privatisation programme. 86

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83 Former Economic Minister Evgenii Iasin, in response to a lawsuit by prosecutors against Norilsk Nickel (see below), argued in defence of Potanin that deprivatisation could have made some sense if the company was on the verge of bankruptcy due to mismanagement. 'Priamaia rech' Komsomol'skaia pravda, 22 June 2000, (http://dlib.eastview.com/sources/article.jsp?id=3224162, accessed 5 July 2003).
Onekismbank was responsible for receiving the bids in the loans-for-shares auctions and GKI entrusted it with organizing the Norilsk Nickel auction. However, Onekismbank was also a bidder. The starting price for the 38 per cent of shares in Norilsk Nickel was USD170 million. There were originally four bidders – three of whom were connected with Potanin’s Oneksim-Interros. MFK, a sister bank of Onekismbank, and Reola, an affiliate of MFK, both put in bids at exactly USD170 million while Oneksimbank put in a bid of USD170.1 million, a mere 0.1 million above the starting price and was declared to be the winner. Another bid of USD355 million was mounted by Kont, an affiliate of Rossiskii Kredit, but this rival participant was disqualified. Supported by Alfred Kokh, the deputy head of GKI, the auction committee rejected this bid claiming that the amount involved exceeded Rossiiskii Kredit’s charter capital, which allegedly breached the Central Bank’s regulations.

The legitimacy of the loans-for-shares auction of Norilsk Nickel was called into question on two counts in particular: that the bid price was too low, and that the winner of the auction was also the organiser of the auction. The grounds for challenges to the loans-for-shares auction of Norilsk Nickel are well documented in the Audit Chamber report published in 1998. For example, the report states that the extremely low starting price, and only fractional difference in the winning bid price, “attests to the practical absence of an auction of RAO Norilsk Nickel”. The Audit Chamber also dismissed the collateral auction by which 38 per cent of RAO shares was auctioned off saying “in
essence it was a sham”, and that there had been collusion among the three bidders: Oneksimbank, the winner and the organiser of the auction, MFK, the guarantor of Oneksimbank, which in turn acted as a guarantor of MFK, and Reola, an affiliate of MFK. The report claimed that these three entities had been able to agree on and coordinate their actions beforehand for the object of keeping the selling price of the shares as low as possible. The Audit Chamber concluded that the Russian government and its plenipotentiary representative GKI were “guided not by the requirements of the presidential decree 889 of August 31, 1995, but by the interests of Onekismbank. Such a neglect of state interest and federal budget for the benefit of a commercial bank’s interest should have been the subject of investigation by law enforcement organs”. 

The second factor that added to the risk of deprivatisation was that the loans-for-shares auction had ultimately been a de facto hostile takeover. The transfer of power over Norilsk Nickel from the incumbent management to the new owner inherent in the loans-for-shares in Norilsk Nickel, and failure to arrive at a compromise prior to the auction, gave rise to a protracted confrontation between the management incumbent at the time of the auction and Interros. The first attempt to obtain deprivatisation, which was followed by a series of similar attempts by various other parties, was initiated against Interros by the management headed by Anatolii Filatov through appeals in both legal and political arenas. Although Filatov and Interros had originally had a close working relationship, relations deteriorated as the plan to transfer the state shares in RAO Norilsk Nickel to Interros via loans-for-shares became more concrete. After the

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89 Ibid.
90 Ibid., p.28.
91 Presidential decree No. 889 ‘On the Procedure of Transfer of Shares of Federal Ownership for Pledge (zalog) in 1995.’
93 See also Tompson, ‘Privatisation in Russia: Scope, Methods and Impact’, p.7.
94 For example, loans-for-shares of Lukoil and Surgut were a management buyout.
95 Oleg Krotov ‘Konflikt ONEKSIMbanka i RAO “Noril’skii nikel”’ razvivaetsia po vsem pravilam
shares were auctioned off to Interros, Filatov filed lawsuits in the Moscow Arbitration court against Interros, contesting the result of the auction. In addition, Filatov, who was well connected in both government and opposition circles, approached the then Communist-dominated Duma to seek assistance in his struggle with Interros. The hostility between Filatov and Interros contrasts greatly with the atmosphere surrounding Menatep's acquisition of Yukos through loans-for-shares. The former head of Yukos, Sergei Muravlenko, had developed and maintained a good relationship with Khodorkovskii, which made the acquisition of Yukos by Menatep “a friendly takeover”.  

Thirdly, the deprivatisation risk was sustained by the forces – mainly political – that were continually seeking greater state control or/and less ‘oligarchic’ control. In the aftermath of the various loans-for-shares auctions, the results were repeatedly attacked and examined by the courts at various levels: the General Prosecutor’s Office, the Audit Chamber, Duma special committees, etc. Even after the Audit Chamber’s report

97 Larsen, ‘Government Fires Norilsk Nickel Chief’.
published in 2000, which declared nothing to be wrong with the loans-for-shares auctions of Norilsk Nickel, the Moscow Prosecutors’ office in June 2000 filed a lawsuit over the sale of RAO Norilsk Nickel. At the beginning of July the General Prosecutors’ office sent a letter to Potanin, ordering to pay the government USD140 million compensation for the damages to the state resulting from the loans-for-shares programme.

Although Interros won all the lawsuits, these attempts to re-examine the privatisation process were motivation enough for Interros to make moves to safeguard their assets in Norilsk Nickel. As will be discussed below, as long as RAO Norilsk Nickel remained in its present form, it was always going to be exposed to the risk of deprivatisation. Therefore, Interros decided to safeguard its assets through a reorganisation of Norilsk Nickel’s corporate structure, which reduced the visibility of RAO Norilsk Nickel, and which was achieved through the use of ICGPs.

6.4.2 Reverse Takeover

Norilsk Nickel launched their overhaul of the corporate structure in 2000. It was

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103 Gregory Feifer, ‘Prosecutors: Sale Of Norilsk Fixed’, Moscow Times, 12 July 2000, (http://www.themoscowtimes.ru/stories/2000/07/12/001.html accessed 20 July 2003). The Prosecutor General’s Office said the auction was rigged under an agreement between Potanin and Kokh. In the letter, First Deputy Prosecutor General Yuri Biriukov claimed that Norilsk Nickel’s privatisation brought damage against the state, and said, “In the event of voluntary compensation for the damage in the sum of USD140 million, there will be no legal demands against you”. According to Biriukov, Oneximbank should have paid USD310 million, not USD170 million, for the 38 per cent stake of Norilsk Nickel – hence the demand for USD140 million. See Ibid. In protest against the letter from Biriukov, Potanin published an open letter. However, according to Segodnia (‘Taina, pokrytaiia nikelem’, 3 October 2000), rumour had it that Potanin paid the money.
criticised for its use of ICGPs to bring about a simplified corporate structure in a very complex manner. The thrust of the streamlining consisted of a so-called ‘reverse takeover’, by which the holding company became a subsidiary of what was previously one of its own subsidiaries.

RAO Norilsk Nickel became the holding company for the six subsidiaries at the time of corporatisation and privatisation. The most valuable subsidiary was NGMK, which owned important assets, notably licences for mining and exploration: RAO Norilsk Nickel as the holding company owned 100 per cent of the shares of NGMK. RAO itself had no other assets than its ownership interests in the subsidiaries. This situation is reminiscent of the Yukos case where the holding company was a shell with a stake in the subsidiaries, in which the real value lay. Interros, the owner-manager of Norilsk Nickel, wanted to own shares in the company that owned mining licences and actually produced things, rather than in the holding company whose only assets were its shares in the subsidiaries. Since NGMK was heavily indebted, Interros created a new subsidiary, NGK (Norilsk Mining Company), and transferred NGMK’s most valuable assets to this daughter company. Then, by swapping the RAO Norilsk Nickel shares into NGK shares, the owner-manager made this subsidiary the parent company. NGK was renamed GMK Norilsk Nickel, which then became a publicly held company traded on the stock exchange, while RAO Norilsk Nickel was delisted. In Yukos’s case, the holding company swallowed up the daughter subsidiaries. In Norilsk Nickel, the reverse happened, as shown in Figures 6.3 and 6.4. The holding company RAO (M – mother company) was taken over by one of its subsidiaries, NGK (D – daughter company).

According to the owner-manager, this reverse takeover was designed to protect Norilsk Nickel from deprivatisation, i.e., to ensure the irreversibility of privatisation and protect the company from attempts by various government agencies to contest the results of the
privatisation of Norilsk Nickel. The new entity (D), which had exchanged places with RAO Norilsk Nickel (M), was a legally different entity, and therefore was in theory not the same Norilsk Nickel that had been attracting the attention of prosecutors and other government agencies. The reorganisation effectively erased RAO Norilsk Nickel from the market, because in the place of RAO Norilsk Nickel, NGK, later renamed GMK Norilsk Nickel, became the publicly held and traded company while RAO Norilsk Nickel ceased to be an independent, publicly traded entity. As can be seen from Figure 6.4, even if RAO Norilsk Nickel were to be liquidated, deprivatised, or taken over, this would not penalise the shareholders, as all the valuable assets now belonged to NGK. In this reorganised structure, RAO Norilsk Nickel, including the enterprises under RAO, that is, NGMK, Pechenganickel and Severonickel, were simply shells with little economic value. Furthermore, the reorganisation process entailed a variety of transactions, involving multiple jurisdictions, to “complicate traces” of share capital, which practically meant the erecting of multi-level barriers or roadblocks against attempts to deprivatise Norilsk Nickel through court or other legal means.

Norilsk’s management acknowledged that the reorganisation was intended to reduce the political risk. The new entity was designed to reduce the grounds for any investigation into the legality of the loans-for-shares privatisation of Norilsk Nickel. Khloponin, the general director of RAO Norilsk Nickel at the time, said that the reason

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111 In fact, the reduction of political risk through a Norilsk Nickel-type reorganisation was also considered by TNK-BP in an attempt to avoid a potential state law enforcement agency investigation. See Aleksandr Bekker, Iuliia Bushueva, Vladimir Karpov, ‘Sniat’ politicheskie riski’, Vedomosti, 28 January 2004, p.1.

112 Kashulinskii, “Nornikel’” ischeznet’.
for restructuring was to avoid political risks; that is, to avoid problems with attempts to re-examine the results of privatisation. However, he admitted that whatever restructuring was carried out within the company, if the political will to deprivatise or nationalise Norilsk Nickel existed, nothing could protect it.

The restructuring also aimed at simplifying and rationalising the corporate structure by shifting the group’s capitalisation centre from RAO Norilsk Nickel to NGK (GMK Norilsk Nickel). Since NGK had all the necessary licences, and accounted for most of the profit, the shareholders would obtain direct ownership of the valuable assets by this moving of the centre of capitalisation. In addition, monitoring costs would decrease, as shareholders would be better able to monitor the financial flow of the company. Moreover, the new company structure with a single centre of capitalisation eliminated double taxation on dividend payments. In the original structure (see Figure 6.3), profits made by subsidiaries could only be transferred to the holding level (RAO Norilsk Nickel) through dividends, which incurred profit tax on the part of RAO as well. The principal contributor of revenue was NGK, and the new structure allowed NGK to pay dividends directly to the shareholders instead of first having to transfer them to the holding company. Thus, the reverse-takeover helped to create a more transparent and

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113 Ol’ga Romanova, ‘My uvodim “Nornikel” ot politicheskikh riskov’ — Interview with Aleksandr Khloponin, Vedomosti, 4 October 2000, (http://www.vedomosti.ru/stories/2000/10/04-37-01.html), and Bulat Stoliarov, ‘Deprivatizatsiia uzhe nevozmozhna’ — Interview with Aleksandr Khloponin, Novaia Gazeta, 4 December 2000, (http://2000.novayagazeta.ru/nomer/2000/69n/69n-s10.shtml). A press release issued by Norilsk Nickel mentioned also that reducing the political risk was one of the reasons for reorganisation. Kashulinskii, ‘“Nornikel”’icheznet’. In addition, it was reported that Norilsk Nickel’s competitors showed interest in obtaining Norilsk Nickel’s assets, which may have caused the action by the prosecutor’s office to attempt to deprivatise Norilsk Nickel. Feifer, ‘Prosecutors: Sale of Norilsk Fixed’. Khloponin said he did not believe the incident was related to corporate conflicts among business people, and indicated that it was political. Romanova, ‘My uvodim “Nornikel”’ ot politicheskikh riskov’.

114 Stoliarov, ‘Deprivatizatsiia uzhe nevozmozhna’ — Interview with Khloponin.

115 Norilsk Nickel Annual Report 2000, p.34.

116 Also, because subsidiaries like Severonikel were loss making, it suggests that under the original structure the profits made by the NGK were diluted by loss-making subsidiaries when the accounts were consolidated.
manageable structure, which it was expected would lead to an increase in corporate value.\textsuperscript{117}

The reverse takeover – the swapping of RAO Norilsk Nickel shares into NGK shares – did in fact simplify the corporate structure by making NGK a single centre of capitalisation. However, a couple of questions remain. If the aim were to simplify the corporate structure by making a single profit centre, would it not have been simpler to make RAO the capitalisation centre? If the problem was that it was NGK, and not RAO who owned the licences and thus generated most of the profits, why not transfer ownership of these assets to RAO?\textsuperscript{118} This would have allowed the shareholders to own the company that owned the assets, without going through a complex swap. In response to such questions, Iurii Kotliar, the chairman of the board of directors of RAO Norilsk Nickel, replied that the protection of company assets from the state was a consideration. He stated in an interview that “In such a case, we would have to re-register the licences for the exploitation of deposits from NGK to RAO, and you would never know how the state would behave in that situation”.\textsuperscript{119} Apparently, he was very aware that the state could deprive Norilsk Nickel of its main asset, such as the licences.\textsuperscript{120}

\textsuperscript{117} Emphasis on enhancing corporate value is a trend that emerged around 2000. After the financial crisis of 1998, the combination of the devaluation, which increased the purchasing power of Russian companies, together with the low valuation of Russian shares, facilitated concentration of ownership, as a result of which a substantial portion of Russian industry was consolidated into a handful of core owner-managers. Having owned substantial assets, owner-managers became more aware of the value of assets. In addition, the macroeconomic environment improved, and compared with the Yeltsin years, political stability seems to have increased during the first years of Putin’s rule. From the owners’ perspective, ownership concentration motivated them to achieve higher share value. Apparently, there was a realisation, and hence a new incentive that came with the ownership consolidation: adding value to assets was also very lucrative for the core owners, as they became richer with a rise in share prices, and also could prepare possible exit strategies. See for example, Boone and Rodionov, ‘Rent seeking in Russia and the CIS’, Nash, ‘Corporate Consolidation: Russia’s Latest Lurch towards Capitalism’.


\textsuperscript{119} Ibid.

\textsuperscript{120} Ibid.
Secretive Acquisition of Norimet

Before the actual swap of RAO shares into NGK shares took place, two steps, which were controversial in terms of the protection of shareholders rights, were taken. First, Norilsk Nickel secretly acquired Norimet. Second there was an issue of additional shares at NGK.

Norimet was a UK based marketing arm of Norilsk Nickel. With the purchase of Norimet, a foreign trading-marketing network was incorporated into the Norilsk group. The rationale for incorporating Norimet within Norilsk Nickel's fully owned entity was that it would improve base-metal sales and trading operations, and make the company more competitive internationally.\(^{121}\) The acquisition took place without any notification to outside shareholders, although technically it seemed there was no legal requirement to obtain the approval of shareholders for this acquisition because of the way it was structured.\(^ {122}\) It transpired that Norilsk Nickel actually acquired 100 per cent of the shares in an affiliated entity called Interrosprom, which in turn owned Norimet.\(^ {123}\) Thus,

\(^{121}\) Matveev, ‘Norilsk Nickel’, pp.8-9. By integrating its own trading structure, Norilsk Nickel would not need to pay commission fees to the trading company. See Maria Rozhko, ‘Tainyi proekt “Norikelia”’, Vedomosti, 19 June 2000, (http://www.vedomosti.ru/stories/2000/06/19-42-02.html). Moreover, by making Norimet a wholly owned subsidiary of the Norilsk Nickel group, Norilsk Nickel’s trading operations would be centralised and would become more transparent. Also, Norilsk Nickel argued that the alternative of establishing a new trading arm had been made more difficult due to the Central Bank of Russia’s intervention in the company’s attempt to buy a stake in AlmazUSA, which was the government’s PGM trading company in the US. See Christopher Granville and Mikhail Seleznev, ‘Norilsk Nickel: Restructuring Update’, United Financial Group, September 2000, p.2.

\(^{122}\) Norilsk Nickel acquired Norimet through intermediary companies at 83.9 million rubles (USD 2.9 million). Approval at company’s shareholder meeting would have been required by the JSC Law if the transaction fell into the category of major transaction. The JSC Law stipulates (Art 78) that transactions that exceed 20 per cent of company’s book value are major transactions, which require the approval from general shareholder meetings. However, by using intermediaries and making the underlying contract of the transaction at 83.9 million rubles, the deal was allegedly structured so that it did not fall into the definition of a major transaction. Norilsk Nickel claimed that given the company’s book value of 12 billion rubles, the value of the deal (i.e., 83.9 million rubles), was less than 1 per cent of the book value — therefore, the value of the contracts would not be a major transaction and hence did not require approval at a general meeting. See ‘FCSM to appeal against Moscow court’s denial’, Prime TASS, April 5, 2001.

\(^{123}\) The FCSM claimed that Norilsk’s directors failed to comply with the JSC Law when they decided on the transaction without seeking approval at the shareholder meeting. Because Norimet was valued as USD234 million by an auditor, Interrosprom, which owned Norimet 100 per cent,
the actual acquisition was structured rather differently from the way RAO initially explained it to its shareholders: RAO Norilsk Nickel did not acquire Norimet directly, but through Interrosprom.\(^{124}\)

**Additional Issue of NGK**

Following its acquisition of Norimet, NGK issued additional shares in a closed subscription. Because NGK was the company with the valuable assets, which would become the mother company at the end of the restructuring, the more NGK shares the core owners had, the more control they would have over the newly restructured Norilsk Nickel. The aim of issuing additional NGK shares through a closed subscription, therefore, was to increase the equity stakes of Interros in NGK.\(^{125}\) This increase in Interros's shareholding in NGK came at the expense of minority shareholders whose holding was diluted. As a result of the closed subscription, all the additional NGK shares were bought by some "unknown shareholders of NGK", but who were associated with Interros.\(^{126}\) RAO Norilsk Nickel itself did not participate in the purchase of additional NGK shares and minority shareholders of RAO Norilsk Nickel did not have the opportunity to acquire additional NGK shares. Therefore, RAO's shareholding in NGK was further diluted from 62.1 to 36.4 per cent (RAO's holding in NGK was first decreased from 100 to 62.1 after the acquisition of Norimet\(^{127}\)) and Interros increased its

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\(^{126}\) Ibid.; Granville and Seleznev, ‘Norilsk Nickel: Restructuring Update’. This was because RAO Norilsk Nickel paid with its NGK shares when it acquired Norimet.

Thus, it can be seen that the closed subscription was designed to ensure that the core owners consolidated control over the newly restructured Norilsk Nickel. In other words, the restructuring was designed to increase control by core shareholders over the company that was being restructured. The restructuring involved the practice of share dilution by the core owners to increase their control over the new and supposedly better (i.e. more transparent) company. As mentioned in previous chapters, increasing ownership stake was important for owner-managers in Russia in establishing control over a company. Since the controlling stake of a 51 per cent shareholding was not usually enough to allow complete control over the enterprise, owner-managers strove to increase their stake to 70-100 per cent. This threshold partly reflects the stipulation of the JSC Law, which required 75 plus one per cent of the votes to change key provisions in the charter. Core shareholders in Interros reportedly owned a 58 per cent stake in RAO Norilsk Nickel before restructuring, which meant that they would own 63 per cent of the newly restructured Norilsk Nickel. However, according to Renaissance Capital, one of the leading Russian investment banks, since these figures are based on 1999 data, the core shareholders might already have owned close to 70 per cent at the time that restructuring started. This means that core shareholders possibly ended up controlling more than 70 per cent after the restructuring.

This closed subscription also had an aspect of protection of assets by the core owners.

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128 Sivakov, 'Mutatsiia “Noril’skogo nikelia”', p.29.
129 Boone and Rodionov, 'Rent seeking in Russia and the CIS', p.15.
130 Ibid.
133 According to Boone and Rodionov, core shareholders achieved more than 70 per cent control of Norilsk Nickel. Boone and Rodionov, 'Rent seeking in Russia and the CIS', p.15.
The closed subscription enabled shareholders associated with Interros to convert part of their holding of RAO Norilsk Nickel shares into NGK shares. In so doing, core shareholders were able to obtain shares in the company that owned the valuable assets, such as ores and licences. Because Interros now directly owned these assets, this reportedly made it more difficult for the state to divert the major assets of Norilsk Nickel away from Interros.\(^{134}\) In addition, protecting their assets appeared to be among the reasons of the core owners for publicly announcing the subsequent stages of the restructuring plan only after the first stages had been completed. The initial steps in the restructuring process, that is, acquisition of Norimet in April of 2000 and the closed subscription issue of NGK shares in August, were carried out without any prior announcement. Interros tried to justify their secrecy over the closed subscription by fear that the state would possibly attempt to hinder the process.\(^{135}\)

The timing of the restructuring seemed to have added the credibility to the asset-protection argument.\(^{136}\) The major restructuring was launched soon after the resumption of the drive to challenge the legality of Norilsk Nickel privatisation when the Prosecutors office filed a lawsuit in June. In addition, it was suspected that Russian corporate rivals were behind the action of the Prosecutors Office.\(^{137}\) Then a letter from the first deputy general prosecutor was sent to Potanin and almost immediately, the closed subscription of NGK shares was approved at an extraordinary shareholders meeting in July.

**Actual Swap of RAO and NGK**

After the closed subscription of NGK shares, several steps were taken to actually

\(^{135}\) Ibid.
\(^{136}\) Ibid; Rodionov and Skaletsky, ‘Corporate Governance Analyzer’, p.9.
\(^{137}\) See Footnote 112 above.
formalise the reverse takeover.\footnote{138} NGK was renamed OAO GMK Norilsk Nickel in February 2001.\footnote{139} By the end of 2001, all the key production assets that had formerly belonged to RAO Norilsk Nickel were transferred to GMK Norilsk Nickel (see Figure 6.4). GMK bought from RAO 100 per cent of the shares in KGMK, Olenegorsk mechanical works, Gipronickel institute, Norimetimpeks (former Interrosimpex), which dealt with the registration of the export deals of Norilsk Nickel, and Norilskinvest (former Interrosprom), through which GMK owned the UK company Norimet. Thus, Interros, achieved the aims of the restructuring of the company.\footnote{140}

6.5 Conclusion

Reported cases of the use of ICGPs in Norilsk Nickel were not prominent during the 1990s. This chapter has analysed the reasons for this phenomenon by investigating the advantages that Norilsk Nickel had in terms of the three tasks associated with the reconstitution of enterprises into business units in the post-Communist transformation of firms, i.e., establishing administrative control, integration of business functions and reconstruction of a production chain.

This chapter has demonstrated that Norilsk Nickel, since its creation, was relatively well organised from the perspective of becoming a coherent business unit.\footnote{141} First, Norilsk

\footnote{138} These were technical steps to facilitate the share swap. After the official announcement of the restructuring in September, the number of NGK shares was increased in December 2000 by an additional share issue in preparation for the actual swap of RAO shares and NGK shares. It was simply a technicality to make the price of NGK equal to that of RAO shares without having to change the shareholder structure. Sivakov, ‘Mutatsiia “Noril’skogo nikelia”’, p.29; see also Norilsk Nickel Annual Report 2000, p.34.

\footnote{139} According to Sivakov, this was done so that the name of the future mother company would be familiar to investors and others. Also it would erase the name NGK, which would be associated with the restructuring of Norilsk Nickel. Next, GMK Norilsk Nickel shares were listed in the Russian Trading Systems.


\footnote{141} It should be reminded that a business unit is considered coherent in the sense that it has both ‘administrative coherence’ and ‘resource coherence’. See Chapter 3.
Nickel was originally established as an association of related enterprises, whose activities were organised under a single point of control. Norilsk Nickel did not suffer a lack of internal administrative cohesion. Secondly, from its establishment Norilsk Nickel had a pool of resources that rendered basic business functions under its umbrella. Thirdly, the constituent enterprises of Norilsk Nickel had been united via the production chain which had been in place since the 1960s, and which was organised within the framework of Norilsk Nickel. Further, throughout the collapse of the Soviet Union, and the ensuing corporatisation and privatisation, Norilsk Nickel maintained its structure of administrative coordination, its production chain and its pool of resources. In other words, Norilsk Nickel had been an integrated unit since its inception, and it continued to maintain its organisational and operational integrity. Therefore, an exigency to use ICGPs to achieve the reconstitution to a business unit was less pronounced, a situation that contrasted with the cases of Yukos and SibAl/RusAl cases, where ICGPs were employed in the 1990s to achieve this end.

However, in the 2000s Norilsk Nickel came under criticism for its corporate governance abuses through the use of ICGPs, when it launched a reorganisation of its corporate structure. The logic behind the reverse takeover that it conducted, and the use of ICGPs included an attempt by core owners to protect their assets from the threat of deprivatisation, which was shaped by the loans-for-shares privatisation that had taken place. Although the collapse of the Soviet economic system, and privatisation, did not induce disintegration in Norilsk Nickel, in the way that they did in Yukos and SaAZ/SibAl, the way that the loans-for-shares auctions were conducted did leave Norilsk Nickel vulnerable to attack. The continuous attempts to deprivatise Norilsk Nickel, that came from various quarters including state agencies, became one of the motivations for the owner-managers to overhaul the corporate structure in a bid to
safeguard their assets. Although, it seems that ultimately, all the shareholders stood to gain from the new corporate structure, in part designed to enhance corporate value, ICGPs employed in the restructuring process did lead to the violation of minority shareholders’ rights. The restructuring plan was drawn up, and key decisions were taken without consultation with minority shareholders, whose stakes in Norilsk Nickel were diluted. Furthermore, it is important to emphasise that the way the restructuring was carried out enabled the core owners to consolidate their control over the newly structured Norilsk Nickel.
CHAPTER 7. Concluding Remarks: ICGPs and Their Implications

7.1. Informal Corporate Governance Practices in Russia during the 1990s

Russian businesses routinely relied on practices that were non-transparent, and were extra-legal, or informal during the course of the 1990s. The decade was a period of economic and political instability. It was for the most part characterised by an adverse macroeconomic environment. The state was 'weak' in that it lacked the capacity to deliver policies effectively and lacked the autonomy to be independent of particular interests. The rule of law — good laws, popular demand for those laws, and their effective enforcement — was weak. Market supporting institutions, such as a legal framework ensuring the protection of property rights, a well-regulated banking system, and an efficient and liquid capital market were underdeveloped. All of these factors created a condition of uncertainty, and it was against this general background that informal business practices became prevalent in Russia.

In the managing of Russia's joint stock companies, a number of informal corporate governance practices reportedly became pervasive in the 1990s: selling the products or assets of the company at below market price to entities controlled by insiders; designing a convoluted ownership structure using a network of offshore entities; barring shareholders from exercising their voting rights at shareholders meetings; restricting newly issued shares to insiders; and executing hostile takeovers through bankruptcy proceedings.

The aim of this thesis has been to identify the operational specifics of such practices as share dilution, asset stripping, transfer pricing, limiting shareholders' voting rights, and using bankruptcy as a takeover instrument, and to understand their role in post-Soviet
Russia. I have used the term ‘informal corporate governance practices’ or ICGPs to refer to these practices collectively. These governance practices were informal in the sense that they represented informal ways of ‘getting things done’. They were not entirely compatible with the behaviours that are envisaged by the formal rules; they often relied on the instrumental use of law; and were based on unwritten agreements that were non-transparent to outsiders. Through the case studies of the Yukos Oil Company, Siberian (Russian) Aluminium, and Norilsk Nickel, this research has demonstrated how ICGPs worked, why they were used, and what kinds of functions they performed in the context of post-Communist transformation of firms in the 1990s.

7.2. Ambiguity of ICGPs

The nature of ICGPs has been demonstrated through examination of the following hypothesis. ICGPs are ambiguous in nature: although they were destructive in the sense that they undermined the foundations of good corporate governance, they had a constructive aspect in relation to the specific tasks that confronted post-Soviet enterprises in reconstituting themselves into business firms.

ICGPs were destructive and detrimental in various ways. They impaired the existing principles of good corporate governance. They were inconsistent with globally accepted good practice, and there was a substantial gap between ICGPs and the principles of good corporate governance laid out in the OECD Principles of Corporate Governance. In particular, ICGPs worked against the basic rights of shareholders, and the principle of equitable treatment of shareholders. Principles of stakeholder rights, and disclosure and transparency were not observed. In short, ICGPs undermined the foundations of good corporate governance.
The use of ICGPs exacerbated the state of Russia’s investment climate. They earned Russia a reputation for poor corporate governance. ICGPs, being recognised as corporate governance abuses, were particularly damaging to investor sentiment. Once such a pattern of non-transparent behaviour which adversely affected minority shareholders became established, this further deterred investors, constraining improvement to Russia’s investment climate.

ICGPs exploit and penetrate formal institutions, and in effect distort the consolidation of the rule of law. ICGPs were based in instrumental use of law and the bending of formal rules. They subverted the intention of the law and different goals were achieved in a non-transparent manner. The requirements of the laws were often purposely circumvented through unwritten agreements within ‘an inner circle’. ICGPs were enabled in the context of the institutional weaknesses in Russia. A combination of the defects in the legal framework, the exploitative attitude toward the formal rules, and the weak enforcement infrastructure in a condition of state weaknesses, all aided the use of ICGPs in Russia.

Notwithstanding such destructive aspects of ICGPs, it is important to recognise a constructive role played by the ICGPs in the context of the disintegration of the Soviet economic system and of the weak market-supporting institutions. This thesis has examined ICGPs in the Yukos Oil Company, Siberian (Russian) Aluminium and Norilsk Nickel during the 1990s, and has argued that ICGPs were constructive in the sense that they helped enterprises in the fundamental task of reorganisation, which was necessary for their reconstitution into business firms that could survive, grow and compete in a market-oriented economy. Thus, the ambiguity of ICGPs is that although they were often abusive and detrimental to shareholders, they can also be seen as the ‘coping
strategies' of owner-managers, who were faced with the task of reconstituting post-Soviet ex-state enterprises into business entities in a context of institutional weaknesses and disintegration of the Soviet economic system.

7.3. Reconstitution of Enterprises into Business Units

This thesis presented an analysis of ICGPs from the perspective of reconstitution of post-socialist enterprises into business firms. The post-Soviet transformation of Russia’s industrial sector necessitated the reconstitution of enterprises into business firms, capable of becoming key agents in a market-oriented economy. This was because Soviet industrial enterprises were not ‘firms’ comparable with those operating under a capitalist system in the theoretical context of the resource-based view of the firm. The resources and capabilities necessary to engage in commercial activities were not brought together within the single framework of an individual enterprise. Instead, they were distributed countrywide across the Soviet economic system, which operated like a huge ‘USSR Inc.’, with the state bureaucracy being the ‘top management’.

In order for a firm to engage in commercial activities in a market economy, it must have certain very basic attributes. According to the resource-based view, a firm is a collection of resources organised within an administrative framework. A business firm is a pool of resources that render various business functions such as production, procurement, marketing, financing, investment, research and development (R&D); It is an administrative organisation with effective administrative control. Moreover, it has the capacity to organise a network of successive stages of production. From the perspective of the reconstitution of former Soviet enterprises into business firms, three types of fundamental task confronted the post-Soviet enterprises: First the establishment of effective administrative control; second the integration of various business functions.
under a single administrative entity; third the organisation of the production chain.

7.3.1. Integration of Business Functions

Under the Soviet economic system, individual enterprises functioned as its production units: the various business functions were not collectively managed within individual units. When these enterprises were privatised, a main objective was the reallocation of ownership rights away from bureaucratic state control. Relatively little attention was given to the question of resources and capabilities, and business functions of individual enterprises that were being privatised. In other words, privatisation was not primarily directed towards the basic attributes that enable firms to effectively function as business organisations in a market-oriented environment. Therefore, in the wake of the disintegration of the Soviet economic system and following privatisation, the enterprises, that previously had operated as production units, faced the task of integrating various business functions if they were to survive and compete as business firms in the market economy. The main challenge was to rectify their lack of resources and capabilities, and to bring together within one administrative structure the various business functions such as financing, marketing, procurement of materials, and R&D, which up to that time had been spread across the countrywide Soviet economic hierarchy.

7.3.2. Reconstruction of the Production Chain

The collapse of the Soviet economic system posed a problem for enterprises in terms of reconstructing the downstream–upstream chains of production. Under the Soviet economic system the centralised planning system had been responsible for organising the production network. However, the breakdown of centralised planning resulted in disruption in the network of the various tiers of suppliers involved in successive stages of production. Moreover, privatisation was carried out at the level of the production unit,
the lowest unit in the Soviet industrial hierarchy, in order to break down the industry into small units. As a result individual enterprises faced the problem of reorganising an interrupted network of related enterprises involved in production. Further, this task must be seen in the context that the reconstruction of the production chain implied adjustments to the boundaries of individual enterprises, i.e., the decision about which of the successive stages of production should be brought within the framework of the firm.

7.3.3. Establishment of Administrative Control

The third task comprised the establishment of an effective administrative control. During the Soviet period individual enterprises worked to the direction of the state bureaucracy. To manage a business firm, the management had to become responsible for executive actions and orders, through coordination, appraisal and planning of their activities. This task of establishing effective administrative control was inseparable from the first two tasks because effective administrative coordination was necessary for the integration of firm resources and the reconstruction of the production chain. Furthermore, in the Russian context, particularly in a condition of institutional weaknesses and the resultant insecurity in relation to property rights, concentration of ownership was extremely important for establishment of effective control over the enterprises.

7.4. Case Studies

Taking SaAZ/SibAl, the Yukos Oil Company, and Norilsk Nickel as case studies, this research has demonstrated that ICGPs became the tools used during the 1990s to achieve these three tasks. Table 7.1 outlines the position of each company in terms of the three tasks.
### Table 7.1 Three Cases in Terms of the Three Tasks

<table>
<thead>
<tr>
<th>Tasks</th>
<th>Establishment of Administrative Control</th>
<th>Integration of Business Functions</th>
<th>Reconstruction of Production Chain</th>
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<td>Cases</td>
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<tr>
<td>SaAZ (SibAl / RusAl)</td>
<td>The trader was playing influential role – it was referred to as 'central planner' in the immediate post-Soviet Russia</td>
<td>Business functions were distributed between the trader (financing, procurement, marketing &amp; sales) and enterprise (production unit)</td>
<td>The trader acted as organiser of the production chain</td>
</tr>
<tr>
<td>YUKOS</td>
<td>No effective administrative hierarchy existed: Lack of cohesion between Yukos and its constituent subsidiaries</td>
<td>Business functions were nominally assembled within Yukos but no effective administrative control to organise them</td>
<td>The chain from 'well to the gas station' was located within Yukos, as it was established as VIOC, but the production chain was not working due to lack of effective administrative control</td>
</tr>
<tr>
<td>Norilsk Nickel</td>
<td>Norilsk Nickel (State concern since 1989) had an administrative control over constituent enterprises.</td>
<td>Basic functions were already performed mainly within Norilsk Nickel</td>
<td>Norilsk Nickel was the organiser of production chain – the production chain that existed since the 1960s was maintained throughout</td>
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#### 7.4.1. SaAZ/SibAl and ICGPs

**Tasks Confronting SaAZ/SibAl**

1) Integration of Business Functions

When Saiansk Aluminium Plant (SaAZ) became a privatised joint stock company, it was still not a full fledged business firm: it was an aluminium production unit with limited resources, whose various business functions were not self-contained within the framework of the plant. In the wake of the disintegration of the Soviet economic system, aluminium plants in Russia lacked the resources to carry out such functions as raising
finance, procuring raw materials and marketing products in the international market. To start with, their working capital was inadequate. Previous primary users of their products, the defence sector, no longer needed aluminium, defence spending having plummeted. This exacerbated the cash flow problems of aluminium enterprises. In addition, the financial system was not sufficiently developed to provide enterprises with credit. Without capital, aluminium enterprises could not buy the raw material needed to produce aluminium. Moreover, these aluminium smelters needed to selling metals abroad the domestic demand for aluminium having virtually collapsed. However, selling in the international market required skills and knowledge that the privatised former production units did not initially possess.

These business functions were taken on by intermediary traders through the system known as tolling, and this enabled the continuation of Russia’s aluminium production. Through the tolling system, the traders brought the raw material to the Russian aluminium smelters and took the metals produced to sell them on the world market. The enterprises were paid only a fee for processing the metals, using the raw materials supplied by the traders. The traders took on the important business functions, providing finance, procuring raw materials, and marketing the products abroad. At SaAZ, therefore, the trader acted as the integrator of business functions.

2) Reconstruction of Production Chain
The ‘atomising privatisation’ process involved the break up of the aluminium industry into small pieces, and the collapse of the Soviet economic system generated a disruption in the input-output chains of production. This disruption in the vertical chains that linked downstream and upstream production posed difficulties for the aluminium smelters. After the collapse of USSR the major sources of alumina, the raw material
needed for aluminium production, were outside the national borders, mostly in the Ukraine and Kazakhstan. Thus, in order to continue to produce aluminium, Russia’s aluminium enterprises now needed to organise a network of suppliers of raw materials.

Instead, traders stepped in to take on this role and at SaAZ. The trader acted as the organiser of the production chain – it organised the tiers of suppliers of raw materials for the aluminium plant, and itself sold the processed metal produced on the international market.

3) Establishment of Administrative Control

With the disintegration of the Soviet economic system, the activities of the enterprises were no longer under the planning and coordination of the state. However, these individual enterprises were not yet in a position to perform the executive administrative functions that the state had provided. Once again, the trader, through the tolling system and through equity ownership, exercised control over the enterprises. Due to the substantial role played by the trader in the aluminium industry during the immediate post-Soviet period, it was often said that the traders had replaced the Soviet central planners.

Reconstituting SaAZ as Business Unit: Use of ICGPs

From the resource-based view of the firm, as long as the trader was fulfilling the triple role of central planner, integrator of business functions, and organiser of the production chain through tolling arrangements, SaAZ could not become a self-contained business unit. If the plant were to break away from its still de facto status of a production unit, and survive and grow as a firm in a market environment, it needed to be reconstituted into a business unit which, in practice, involved addressing the three issues discussed
above: having an effective administrative control, becoming an integrator of various business functions, and organising a chain of production. This reconstitution of the enterprise necessitated putting in place an aluminium enterprise to take on the role of the trader, which could not be achieved without the enterprise first gaining independence from the trader.

The SaAZ management, who held the plant’s stake through Siberian Aluminium (SibAl), became increasingly interested in the long term growth of the company, through further expansion and diversification of activities. However, the trader was keen to maintain the status quo, and also was more interested in short-term gains. Thus there was a continuing conflict of interests. Eventually, the value of the trader’s services as the provider of business functions diminished, but the trader remained influential as a shareholder. Thus, the management needed to establish effective corporate control over the plant by securing complete independence from the trader. To achieve this, management sought to increase its equity holding in the enterprise.

Concentration of ownership was critical to assuring control over an enterprise. In Russia, the threshold of 75 per cent plus one share ownership in a company was generally considered necessary to enable owner-managers to secure control. A shareholding of 25 per cent was sufficient for outsider shareholders to block key decisions at shareholders’ meetings. Also an increased shareholding by the owner-managers should shield the company against a hostile takeover in Russia where laws had been applied as ammunition in corporate conflicts.

Elimination of the trader’s influence, and consolidation of control over SaAZ were achieved with the help of ICGPs. As a result of an additional share issue at SaAZ, the
equity holding of the trader dropped below the blocking level, to less than 15 per cent. The trader claimed at the time that it had not been properly notified of the subscription of additional shares. Nevertheless, the trader’s shareholding was diluted and the additional shares were bought by entities affiliated with SaAZ/SibAl. The trader brought numerous lawsuits, but the findings were not in favour of the trader.

The state in the form of the Russian State Property Fund (RFFI) was involved in this share dilution. RFFI allowed its equity holdings in SaAZ also to be diluted (from 15 to 6.15 per cent), so that SaAZ management could increase its stake vis a vis the trader. Afterwards, however, SaAZ transferred shares across to RFFI to restore its original holding level, free of charge. This was in accordance with an agreement signed between the plant and RFFI prior to the issue of additional shares that resulted in the dilution. In addition, an investment auction of state shares was held which allowed the owner-managers to increase their stake in SaAZ to over 75 per cent. In this way, the owner-managers of SaAZ/SibAl consolidated their control over the plant.

The ultimate objective of gaining control was to create a vertically integrated aluminium corporation – to organise a network of related enterprises and to integrate the successive stages of production linkage under one umbrella. In general, vertical integration of the chain of production under the control of the single firm is considered appropriate to such an industry as aluminium, where successive stages of production use technically complementary assets. Vertical integration would restore the production linkages that had been disrupted with the collapse of Soviet economic system, and arrange related assets under a common ownership. To this end, SibAl embarked on integration from SaAZ, which was SibAl’s core enterprise.
The SaAZ/SibAl management was oriented toward enlarging the boundaries of the firm in order to contain the production chain under one umbrella, and pursued a growth oriented strategy through expansion. Expansion through vertical and lateral integration was also seen as a way to ensure survival in the Russian aluminium sector, which had long been characterised by continuous redistribution of ownership of aluminium assets. This process became known as the ‘aluminium wars’, reflecting the severity of the conflicts it involved. Since an increase in the ownership stake of the aluminium enterprises was essential to allow control, the accumulation of assets by way of expansion was a means to proactively ensure survival in the industry.

In order to establish a vertically integrated aluminium company ICGPs were utilised by SibAl. A first and critical element of SibAl’s vertical integration was to establish a link between SaAZ, the primary producer, on the one hand, and SAMEKO, an enterprise dealing with the later stages of production, on the other. However, to accomplish this downstream integration, the heavily indebted SAMEKO needed to be restructured. Twelve subsidiaries were created, to which the main assets of SAMEKO were transferred. Of these, the most valuable and productive were concentrated in the Samara Metallurgical Plant (SMZ), one of the new entities. SAMEKO was left with non-productive assets and the debts. Then bankruptcy proceedings were initiated at SAMEKO, with the endorsement of the Samara regional authority. In effect bankruptcy procedures were used to revitalise a company in a downstream chain of production. While SibAl was furthering downstream vertical integration, it also gained control over a raw material supplier, an alumina plant in Ukraine, thus linking the upstream production chain as well.

To fully exploit the benefits of vertical integration, it was important for SibAl to
integrate horizontally to achieve scale economies as well as increased market share. In this sense, vertical integration and horizontal integration can be seen as going hand in hand towards a longer term growth strategy. To proceed with lateral expansion, the bankruptcy law was used as a corporate take-over tool. Since the 1998 Bankruptcy Law came into force, bankruptcy procedures had been increasingly used to take over companies in Russia. Two factors, the low threshold needed to initiate bankruptcy and the extensive powers conferred on bankruptcy administrators, facilitated such instrumental use of the law. Bankruptcy proceedings were initiated by a local utility company against NkAZ, one of the largest aluminium smelters, for overdue electricity payments. The court-appointed bankruptcy administrator, who was in reality representing the interests of SibAl, introduced measures to enable SibAl to accomplish de facto control over the NkAZ. These measures included the replacement of top management at NkAZ, creation of new creditors, elimination of ‘undesirable’ creditors, and consolidation of the debt. Gaining control over NkAZ furthered SibAl’s integration process, and culminated in the creation of RusAl, one of the world’s largest vertical integrated aluminium companies.

It should be emphasised that ICGPs became operational and were tolerated under a legal system in which the formal legislative framework contained weaknesses, and neither the judicial system nor the system of enforcement was strong. In addition, the role of the state was critical in facilitating the use of ICGPs. That is, ICGPs were usually accompanied by either explicit or implicit cooperation from the state authorities, which enabled ICGPs to achieve the desired results.
7.4.2. Yukos Oil and ICGPs

Tasks Confronting Yukos

1) Establishment of Administrative Control

Since its establishment as Russia’s vertically integrated oil company composed of the holding company and its subsidiaries, Yukos Oil Company has suffered from a lack of internal cohesion and organisational integrity. The lack of internal cohesion between the holding company and Yukos’s constituent subsidiaries was in part due to the manner in which privatisation was conducted. Corporatisation and privatisation took place both at the holding and the subsidiary levels, which meant that the constituent subsidiaries were privatised as independent units, each with its own lock of shares. This two-tiered privatisation created a multilevel governance structure at both holding and subsidiary level, and created different groups of management and shareholders, including minority shareholders. The subsidiaries effectively maintained their operational independence and Yukos management was unable to control them.

There was no operative administrative hierarchy in place – essential if the Yukos Oil Company was to be able to organise and control its activities as an integrated whole. Therefore, the crucial task for Yukos was to resolve the lack of administrative cohesion and to establish an effective administrative framework, in which all activities were organised and controlled by the management. In other words, the most immediate task for Yukos from the perspective of its reconstitution into a business unit lay in the sphere of its administrative coordination.

2) Integration of Business Functions

To the extent that the Yukos Oil Company was a pool of resources that rendered various business functions, Yukos was better placed than an individual Soviet production unit in
the sense that it had been established as a vertically integrated company, consisting of several subsidiaries, which themselves were composed of several production units. Business functions such as production, refining, exploration and distribution were all assembled under Yukos’s umbrella when the VIOC was established. Yukos was, at least nominally, a collection of resources that could in theory render certain business functions including oil production, refining, distribution, and R&D as a single integrated unit, while individual Soviet production units were not.

However, the resources of a firm must be bound together within an administrative framework, and the administrative hierarchy must be able to integrate and organise these resources. In other words, the business functions rendered by resources must be linked to one another and integrated under a single administrative control. The problem with Yukos was that the operational independence of its subsidiaries led to a disintegrated corporate management within Yukos as a whole, and the absence of an effective single administrative control over the subsidiaries made the integration of business functions under the umbrella of Yukos very difficult.

3) Reconstruction of the Production Chain

Yukos’s lack of administrative control over its subsidiaries adversely affected its ability to organise the production chain. Yukos was established as a vertically integrated oil company which envisaged integration of the entire production linkage ‘from the well to the gas station’, i.e., the production chain linking crude oil production to refining, and refining to distribution. In a vertically integrated company, management must be in control of the whole process of organising a network of related enterprises dealing with extraction, production, refining and distribution, in order to be the organiser of the production chain. However, despite the fact that Yukos had been established as a
vertically integrated company, it was vertically integrated in name only. The production chain from the well to the gas station was not linked closely within the structure of Yukos. The constituent subsidiaries of Yukos were independent legal entities, which also operated outside the Yukos boundaries.

To make the production chain work within the boundary of a VIOC, successive stages of the industrial process had to be coordinated and brought together. In order to achieve this, the company required an effective administrative hierarchy controlled by a single management. Because of this need to establish a single management control over the subsidiaries, the tasks of organising business functions and of reconstructing the production chain overlapped.

_How Yukos was Reconstituted into a Coherent Entity: Use of ICGPs_

From the perspective of constructing coherent business units, the most immediate task for Yukos Oil was the strengthening of a single administrative control. In the case of Yukos Oil, the establishment of an effective administrative framework was indispensable to the fulfilment of the other two tasks, i.e., to integrate business functions and organise a well functioning production chain. In order to establish administrative control, the priority for management was to centralise cash flows, so that all product and revenue streams were under direct control of Yukos management, rather than the managements of the individual subsidiaries. Management sought to limit independent transactions by subsidiaries. In addition to making the subsidiaries deliver their oil exclusively to the holding company, a transfer pricing scheme was used to force subsidiaries to sell at a very low price, as a result of which the independence of the subsidiaries was further constrained.
Yukos's management then proceeded with the plan to make subsidiaries wholly owned by Yukos through cancellation of the separate listings of the subsidiaries' shares, and the transformation of these shares into single Yukos shares representing all constituents. The process of consolidation of Yukos was envisaged as a single share conversion, i.e., a swap of subsidiaries' shares for a holding company share. This was designed to ensure that there would no longer be a situation where subsidiaries' shareholders and holding company shareholders coexisted within the framework of a single VIOC. The consolidation thus aimed at resolving the problem of establishing effective administrative control within the framework of Yukos Oil.

However, this process was complicated by the presence of minority shareholders in the subsidiaries. Due to the two-tiered privatisation, not only did subsidiaries have separate managements, but also there were shareholders who owned subsidiaries' shares. This two-tiered scheme gave rise to a sharp conflict of interest between the management of Yukos and the shareholders in the subsidiaries. The management of Yukos was keen to proceed with consolidation by making subsidiaries wholly owned. However, a minority group of subsidiary shareholders, in a bid to get higher buy-back rates, attempted to hinder the process. For Yukos management, therefore, it was necessary to render this group powerless, in order to proceed with the planned restructuring of the company. To achieve this, ICGPs such as share dilution, limiting shareholder access to voting, and transfer pricing were utilised.

Share dilution reduced the proportion of subsidiaries' equities held by minority holders, thus weakening their voting power. Through instrumental use of the law, combined with weak enforcement of formal rules, the management succeeded in excluding minority shareholders of subsidiaries from attending the shareholders' meeting where the
decision to issue additional shares was taken. At this same meeting a decision was made to distribute the additional to entities which allegedly had some affiliation with the management, thus bypassing the rules on interested party transactions. Further, under the transfer pricing schemes, the output of the subsidiaries was sold at a below-the-market price to the holding company or one of its affiliates. Operating costs and debts remained with the subsidiaries while the profits were transferred to the holding company. In this way, the share value of subsidiaries was driven down, to the detriment of shareholders. The lower the market price of the subsidiaries, the better the deal that the holding company could conclude over the share swap.

In effect, ICGPs were utilised to assist Yukos management to concentrate its ownership, strengthen its management control and reconstitute the company into a coherent business unit that could become competitive in the world market. It should be emphasised that the ICGPs were enabled through instrumental use of the law with the exploitation of lazeika – a gap or loophole. ICGPs capitalised on the imperfections in the legal system, the weak legislation, uneven enforcement of rules, and the weak judicial system. In addition, when minority shareholders appealed to the state over the violation of their rights, the authorities generally took no action. Therefore, it appears that the state tolerated the use of ICGPs generally, and particularly in the case of Yukos during the 1990s.

7.4.3. Norilsk Nickel and ICGPs

Tasks Confronting Norilsk Nickel

Apart from their use in 2000 as part of a bid to safeguard assets, the use of ICGPs appeared less pronounced in the case of Norilsk Nickel during the 1990s. The reasons for this phenomenon were investigated by focusing on the degree to which Norilsk
Nickel was a business entity. This study has shown that Norilsk Nickel was well positioned in terms of the three challenges faced in reconstituting to a business firm—establishing effective administrative control, integrating various resources embedded in business functions, and organising the production chain.

1) Establishment of Administrative Control

When Norilsk Nickel was established as an association of related enterprises, it was united under a single decision-making structure with internal administrative cohesion. Moreover, administrative coordination within the framework of Norilsk Nickel was maintained during the privatisation process. This contrasts sharply with the situation in Yukos, where two-tiered privatisation led to the lack of internal cohesion in corporate management. For Norilsk Nickel, the process of corporatisation and privatisation was basically a nominal conversion of the existing State Concern. The State Concern, in turn, had its roots in glavk, a ministerial chief department within the Soviet administrative hierarchy. Furthermore, when Norilsk Nickel was privatised, the subsidiaries were already wholly owned entities of the holding company, RAO Norilsk Nickel. In addition, Norilsk Nickel did not suffer from the sharp conflicts of interest between management and outsider shareholders, which were serious obstacles to the reconstitution of SibAl and Yukos into business firms.

2) Reconstruction of the Production Chain

Since its inception, Norilsk Nickel’s constituent enterprises were united under a common input–output chain of production. Norilsk Nickel’s immediate predecessor, the State Concern Norilsk Nickel, was an amalgamation of related enterprises linked by a network of upstream–downstream entities that had existed since the 1960s. The fact that RAO Norilsk Nickel maintained this pre-existing structure throughout the privatisation
process meant that the ‘technological chain’ was not disrupted, as it had been in the aluminium industry resulting in the increasing dependence of the aluminium plants on the services provided by intermediary traders through tolling.

Furthermore, the production chain was already integrated under the organisation of Norilsk Nickel, which indicated that a relatively stable boundary of the firm existed. Norilsk Nickel, had no need to adjust the firm boundary by going through a process of ‘patching up’ to produce an integrated structure, which had been the process adopted in the aluminium industry.

3) Integration of Business Functions

Norilsk Nickel also had the advantage that it encompassed, to a degree, a collection of resources that are embedded in the basic business functions. In particular, raw materials procurement, and export and import functions were internalised. Although this is not to imply that Norilsk Nickel needed no additional resource and capabilities, it had a functioning pool of the resources that rendered business functions at the start of the post-Communist transformation, and a much better set up than enterprises that were in the lowest unit of the Soviet economic hierarchy. Aluminium smelters, for example, suffered from the lack of resources necessary to carry out raw materials procurement or export of metals, as a result of which they were dependent on traders for these services. However, in Norilsk Nickel, these functions were already being performed within the framework of Norilsk Nickel.

Well Placed in Terms of Reconstitution into Business Unit

From the perspective of reconstitution of enterprises into business units in the post-Soviet context, therefore, Norilsk Nickel was much better positioned. Throughout
the collapse of the Soviet Union, and the ensuing period of corporatisation and
privatisation, Norilsk Nickel was able to maintain its production chain, and it benefited
from a pool of resources that rendered business functions. Furthermore, Norilsk Nickel
continued to have a centripetal administrative structure with a single point of control
directing the activities of Norilsk Nickel as a whole.

Therefore, it can be argued that it is these factors that explain why in the 1990s Norilsk
Nickel had less need to resort to ICGPs, i.e., the less prominent use of ICGPs is
reflected by Norilsk Nickel’s better position from the perspective of reconstitution of
their enterprises into business entities. In other words, the smaller number and reduced
visibility of cases of ICGPs in the 1990s seem to be inextricably linked to the
advantageous position of Norilsk Nickel in terms of the three tasks.

7.5. The Correlation between ICGPs and the Tasks

Based on the findings from the case studies, the role of ICGPs in association with the
three tasks from the resource-based view can be outlined as follows: In a nutshell, it can
be argued that the extent of use of ICGPs tends to depend on the degree to which the
enterprise was analogous to a production unit, or the degree to which it was already
constituted as a business unit. This general conclusion is summarised in the following
three ways, broken down in to three tasks:

1) Integration of Business Functions and ICGPs

The extent of the use of ICGPs tends to depend on the degree to which resources
embedded in business functions were integrated under an effective administrative
framework. As mentioned above, the tasks faced by enterprises were to bring together
technical and organisational resources embedded in business functions under a single
framework of a firm. From this point of view, the exigency for ICGPs appears to be influenced by the extent to which resources are integrated, and accordingly business functions are organised within an administrative framework.

For example, SaAZ was required to pool various resources and become a collection of resources in order to reconstitute itself into a business firm. ICGPs were used by SaAZ/SibAl to help integrate business functions such as raw material procurement, financing, and marketing that were taken over by the intermediary trader as the Soviet economic system disintegrated and the aluminium sector underwent privatisation at the production unit level, which fragmented the industry. In contrast, when Norilsk Nickel underwent the privatisation process, it was better placed as an integrator of various resources, in the sense that it was performing multiple business functions within the framework of Norilsk Nickel. The less prominent use of ICGPs by Norilsk Nickel during the 1990s can be explained by the Norilsk Nickel's better position as a pool of resources that rendered business functions.

2) Establishment of Administrative Control and ICGPs

The extent of the use of ICGPs tends to be dependent upon the degree to which there is effective administrative control by top management. It appears that the use of ICGPs tends to depend on internal administrative cohesion between the holding company and its constituent subsidiaries. That is, the more disintegrated the corporate management, the more prominent the use of ICGPs. This observation is particularly exemplified in the case of Yukos, which demonstrates the significance of operative administrative control as an essential attribute of a firm. For the functioning of an industrial firm, there must be evidence of administrative coordination with central management controlling the operations of the whole company. Yukos suffered from a lack of administrative control,
while Norilsk Nickel maintained its operative administrative hierarchy, which was crucial for it to manage business functions and organise the production chain under a single point of control. It should be emphasised again that in the Russian context, establishment of effective management control over the company was contingent on the concentration of ownership. Therefore, the role of ICGPs in addressing the task of establishing administrative control can also be formulated as follows: the extent of the use of ICGPs tends to be dependent upon the degree of ownership concentration.

In Russia, an initial allocation of shares through privatisation gave rise to a diverse class of shareholders. However, ownership was then concentrated into the hands of managers who became the controlling shareholders. From the managers’ perspective, concentration of shareholding was important for the managing of the company given the legal environment where protection of property rights was not well provided for. Ownership concentration by management substantially diminished conflicts of interest between managers and shareholders. It also lessened the risk of hostile takeover in a context where struggles over redistribution of property were rife.

As pointed out throughout the thesis, control over a company was generally contingent on controlling a shareholding of at least 75 per cent plus one share. With more than 75 per cent plus one, the owner-manager could eliminate the possibility of shareholders blocking a vote: in accordance with the JSC Law, 25 per cent was needed for minority shareholders to vote block and stop decisions from being implemented. In addition, super-majority control provided owner-managers with the security to manage assets more productively, because control rights and cash flow rights were in their hands. Thus, owner-managers sought to increase their equity holding to super-majority level. It follows that the less ownership is concentrated, the more room there is for the use of
ICGPs. Indeed, operating in a condition of uncertainty, the concentration of ownership was important for the running of joint stock companies.

In this connection, the case studies demonstrated that the use of ICGPs seems to be inversely related to the degree of ownership concentration. ICGPs were used to concentrate ownership, in order to accumulate shareholding close to or at a super majority level. In SaAZ and Yukos in particular, the use of ICGPs for the purpose of achieving a high level of concentration of ownership was prominent. Further, ICGPs by Norilsk Nickel of the year 2000 can be explained from this perspective: ICGPs were used as a means of owner-managers to further concentrate ownership.

3) Reconstruction of the Production Chain and ICGPs

The extent of the use of ICGPs tends to depend on the degree to which the production chain linking successive stages of production had disintegrated, and to the extent to which firm boundaries had to be adjusted. In terms of the task of reconstructing the production chain, the need for ICGPs appears to be influenced by the extent to which a company acts as organiser of production chain and has a clear firm boundary encompassing the production chain.

For example, Norilsk Nickel had a better set up as a vertically integrated company in name and substance from the beginning. Unlike Yukos, which was a vertically integrated company only in name, where subsidiaries enjoyed operational independence and successive stages of oil production were not organised within the framework of Yukos, Norilsk Nickel’s constituent subsidiaries were wholly owned and its successive stages of production was well linked. The production chain, which had existed from the 1960s, was integrated within the boundary of Norilsk Nickel. Moreover, the production
linkage was not disrupted by the collapse of Soviet economic system or by privatisation. Therefore, while SaAZ/SibAl had to build a vertically integrated structure almost from scratch, encompassing the successive stages of aluminium production, from mining to metal fabrication and to distribution of output, Norilsk Nickel had an integrated chain within an integrated structure. Norilsk Nickel was an organiser of network of upstream-downstream entities from its inception, while Yukos and SaAZ were not.

7.6. Two-fold Ambiguities of ICGPs

The analysis of ICGPs presented in this thesis suggests a tendency that the more daunting the tasks, the more prominent the use of ICGPs. Due to the constructive aspect of ICGPs in helping to resolve these tasks, the more likely logic would be that the more difficult the tasks, the more constructive was the use of ICGPs. However, it would be wrong to suggest that the link between the tasks and the constructiveness of ICGPs rules out their destructive (or abusive) influence. ICGPs are ambiguous in the sense that they are constructive and destructive at the same time, i.e., the constructiveness and destructiveness coexist. In other words, constructiveness does not imply an absence of destructiveness: it is likely that the greater the use of ICGPs the greater were the corporate governance abuses. Thus, constructive and destructive aspects are not mutually exclusive or ‘zero-sum’. And, where there is greater scope for the ICGPs to play a constructive role, the scope for them having a destructive effect is also increased. Therefore, it can be said that the nature of ICGPs is ambiguous in two senses. Not only is the role of ICGPs ambiguous in that they were simultaneously destructive and constructive, but there is ambiguity in that more constructive their role for the firm involved, the more the likelihood of their effects being destructive in other directions.
7.7. Institutional Weakness and ICGPs

In examining the nature of ICGPs, the factors that made ICGPs work were also analysed. Focusing on the operational specifics of ICGPs, it can be concluded that it was *institutional weaknesses that created the room for the use of ICGPs*. The relationship between ICGPs and institutional weaknesses can be looked at in more than one way. On the one hand, ICGPs were used by management facing the fundamental tasks of reorganisation when the market-supporting institutions were underdeveloped. In a situation where the financial system was underdeveloped, legal institutions were weak and protection of assets was not properly provided for, ICGPs became the tools to enable coping strategies to manage the tasks. From this point of view, ICGPs helped navigate the condition of institutional weakness, and aided the reconstitution of enterprises into business firms under that condition.

On the other hand, however, ICGPs and institutional weakness are symbiotic in the sense that the use of ICGPs was possible because institutional weaknesses were exploitable. In particular, ICGPs became workable because the legislation contained imperfections, manipulative attitude towards the law was dominant, enforcement of the law was problematic and the judicial system was not strong. ICGPs thrived because of these institutional weaknesses, which enabled systematic exploitation of the defects in the institutional framework. In addition, ICGPs became operational in the absence of a strong, impartial state, as has been demonstrated. Thus, the institutional framework and the weakness of the state invited and enabled the use of ICGPs. ICGPs would not have been possible if the formal and informal aspects of the 'rules of the game' were consistent and congruent. ICGPs exploit and penetrate formal institutions, and in so doing, ICGPs further entrenched these institutional weaknesses. Furthermore, such an infiltration of informal practices into formal institutions was not conducive to making
the Russian business environment transparent and predictable.

7.8. Policy Implications

The analysis of ICGPs has policy implications for the course of Russia’s reform. First, the evidence of ICGPs testifies to the continuous penetration of informal practices into formal institutions, a phenomenon that has implications for the prospective building of institutions for markets. As the World Bank emphasised, "Building bridges between existing formal and informal institutions is an effective means of enhancing the success of formal institutions".\(^1\) Any designing of institutional change must take into account the consistency between the informal and formal ‘rules of the game’ and their enforcement mechanisms.\(^2\) Therefore, policies which aim at institution building must take informal practices into consideration.

In view of the interaction between the formal and informal, Russia’s problem is not the disregard of the formal institutions, but rather the penetration of informal practices into the formal institutions: informal practices that exploit the formal rules through the conscious use of formal institutions by practitioners, to their advantage. This tendency distorts the role of law, and makes it difficult for the rule of law – the critical market institution – to take root. Furthermore, what makes institution building challenging is the role of the state: Not only does it lack the capacity and autonomy to uphold the consolidation of legal institutions, but also, and more particularly, the state actors behave no differently from private actors, in that they exploit the formal institutions instrumentally to pursue their interests.\(^3\)

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\(^3\) Barnes points out that even in cases where the Russian state can act independently of large business groups, it is not necessarily acting differently from them. See Andrew Barnes, ‘Russia’s
Secondly, the analysis of the ambiguity of ICGPs has implication for enterprise restructuring and the fostering of Russia’s corporate sector. For example, in designing privatisation policies or policies for the break-up of enterprises, which aim at enhancing their efficiency and performance, it will unlikely be sufficient to make the reallocation of ownership rights *per se* the sole objective. Without consideration of the resources and capabilities side of firms, policies for privatisation or other forms of ownership reallocation will likely have limited economic significance. It is essential that such policies take into account the pool of resources and capabilities that are organised in an effective administrative framework of a firm, in order to avoid the disintegration of a corporate entity, which has been shown by the findings of this research to be a risk. The elaboration of successful strategy for the further development of Russian corporates should therefore involve consideration over endowment of the firm’s resources, knowledge and skills which could eventually grow into its competitive advantage.

As discussed in this thesis, the corporate governance literature views a firm as a contractual entity and emphasises the alignment of incentives between principals and agents. However, as this thesis has shown, in addition to the principal–agent problem, a firm does face resource and capabilities constraints from the resource-based view of the firm. It has been recognised by scholars that there is a separation in the literature between the two approaches to the theory of the firm – the governance approach and the resource-based approach to the firm – with less attention being paid to the latter. Managing the firm’s resources and development of competencies, however, should be an important aspect of the governance of corporations, which affects the performance of

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4 See, for example, Foss, 'Introduction: The Emerging Competence Perspective' in Foss, and Knudsen (eds), *Towards a Competence Theory of the Firm*. 

firms. Bringing the governance and the resource-based perspectives together is important for the theory of the firm because both are complementary and mutually reinforcing.

To conclude, I would like to suggest some possible future research agendas related to this thesis. This thesis has focused on the role of ICGPs during the 1990s. That is, ICGPs were considered constructive only in how they behaved as 'coping strategies', which helped enterprises survive and be able to develop in a new market based environment during the period of uncertainty in the wake of the disintegration of the Soviet economic system. The primary focus in this thesis has been ICGPs in the 1990s until the end of 2001, before the amendment of the JSC Law took effect in January 2002. Future research could focus on the possible change in ICGPs once the context has improved. It could examine whether corporate governance practices have changed following the reconstitution of enterprises into coherent business firms, or whether the implementation of the Corporate Governance Code in 2002 or the amendments in the JSC Law and the new bankruptcy law that took effect in December 2002 have had a visible impact on the use of ICGPs. Also, since this thesis was based on three companies that are all capital intensive and natural resource based, future research could investigate companies in different types of industries and analyse the differences or similarities in their use of ICGPs.

This thesis studied companies where the state was not the major shareholder. Future research could investigate companies with major state shareholdings, such as Russia's gas monopoly Gazprom, which might be even less transparent in terms of their corporate governance. It might be that Gazprom's ICGPs were solely a case of unproductive rent-seeking. At the same time, there is an argument that its alleged asset
stripping to the US-based company Itera, was Gazprom’s solution to having Russian gas delivered to Europe via Ukraine by another entity, i.e. Itera, which could enforce payment without risking retaliation from the Ukraine.\textsuperscript{5} By incorporating the analysis of the state as the major shareholder, future research could use Gazprom as a case study.

Finally, as this thesis analysed three companies that each constitutes the core of Russia’s major business group, future research could extend the analysis to the organisation of business groups. Business groups have become key agents in the economic and political transformation in Russia. In this connection, by examining the role of business groups, as well as the nature of the relationship between the state and business groups on governance, Russia’s emerging system of corporate governance could be analysed in future research.

### Appendix 1: List of Respondents

<table>
<thead>
<tr>
<th>Classification of Interviewees</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company Representatives</td>
<td>7</td>
</tr>
<tr>
<td>(of which)</td>
<td></td>
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<tr>
<td>Yukos Oil Company</td>
<td>3</td>
</tr>
<tr>
<td>RusAl</td>
<td>2</td>
</tr>
<tr>
<td>Norilsk Nickel</td>
<td>2</td>
</tr>
<tr>
<td>Press Correspondents</td>
<td>8</td>
</tr>
<tr>
<td>Corporate Governance Specialists (in Rating Agencies, Audit Institutions, Consultancies,</td>
<td>12</td>
</tr>
<tr>
<td>Fund Managements, Corporate Governance Associations, Law Firms/ Legal Departments of</td>
<td></td>
</tr>
<tr>
<td>Companies, etc.)</td>
<td></td>
</tr>
<tr>
<td>Analysts from Financial &amp; Research Institutions</td>
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<tr>
<td>Investors</td>
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</tr>
<tr>
<td>Business Representatives</td>
<td>4</td>
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<tr>
<td>Academics</td>
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</tr>
<tr>
<td>Oil &amp; Gas Consultants</td>
<td>8</td>
</tr>
<tr>
<td>Metal Specialists</td>
<td>4</td>
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