

Corporate Raiding in Ukraine

Corporate raiding in Ukraine is a widely discussed and reported problem that severely damages investment and economic development, prospects for European integration, and the welfare of ordinary people. Yet the phenomenon of raiding itself is only poorly understood, often either dismissed as inseparable from the country's broader problem of endemic corruption, or imputed to powerful and shadowy raiders thought to be immune from defensive measures by private businesses. The author's field research in Ukraine has provided ample evidence that while the causes and methodologies of raiding are complex, the problem is not unsolvable. Both preventive and reactive defenses are available to private business owners threatened by corporate raiders, while some reforms already underway are likely to constrain raiding, and there are other promising avenues for future reform.

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Matthew Rojansky
Kennan Institute

Woodrow Wilson
International
Center for Scholars

Research Country:
Ukraine

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IREX 2121 K STREET, NW, SUITE 700, WASHINGTON, DC 20037

T +1 202 628 8188 F +1 202 628 8189 WWW.IREX.ORG

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RESEARCH IN CONTEXT

U.S. Ambassador to Ukraine John Tefft is fond of reminding Ukrainians of their country's great potential: its large size, location at a strategic crossroads, diverse resource base, and its large, well-educated, entrepreneurial population, to name just a few of Ukraine's advantages. Yet the Ambassador is also quick to point out that this potential remains very much unfulfilled, stymied by deeply entrenched problems of corruption, democratic backsliding, and growing apathy among ordinary citizens.¹ Nowhere is the deficit of Ukraine's potential versus reality more glaring than in the realm of business development, investment and economic growth.

Endowed with vast natural agricultural resources, considerable energy reserves, advanced industrial capacity, and considerable human resources, all within easy access to major global markets, Ukraine should be an investment success story. Yet total FDI remains anemic at less than 2% of GDP,² and domestic investment is still well below rates in most fast growing developing and developed economies. The reasons for such low rates of investment in Ukraine are complex, but many are attributable to the overarching problem of insecurity of investors' property rights.

Corporate raiding is one manifestation of Ukraine's weak property rights regime that has received significant attention from policymakers, the media and the general public. Yet despite this attention, and despite wide recognition of the problem by Ukrainians and outsiders as an obstacle to investment and economic growth, the phenomenon itself is not well understood. In public discourse, the term is seldom explained beyond generally vague implications that raiders are connected to oligarchic interests, powerful politicians, and the general culture of corruption in business. So what, exactly, is corporate raiding?

A handful of scholarly and business publications attempt to answer this question, however most scholarship to date has focused on raiding in Russia, with comparatively little attention paid to Ukraine, where the problem is arguably now far more acute. Still, some foundational concepts apply in both countries. According to Gans-Morse, for

For a fee, some private notaries will help raiders forge corporate or court papers.



example, "While the term ["raiding"] is taken from the American usage, it involves far more than buying up a company's shares in order to change management."³ In his seminal article on the subject, Tom Firestone explains that, "reiderstvo is not just simple thuggery.... Russian "reideri" rely on court orders, resolutions of shareholders and boards of directors, lawsuits, bankruptcy proceedings, and other ostensibly "legal" means as a cover for their criminal activity."⁴ Meanwhile, in the popular press, raiding has been described as everything from "modern-day feudalism,"⁵ to "a euphemism for the illegal and corrupt manipulation of Ukraine's patchy legislation and ramshackle institutions to seize control of unsuspecting companies."⁶

Each of the above definitions is both accurate in some respects, yet not entirely adequate. I propose a definition of corporate raiding in Ukraine that is broader but also more precise: Raiding is the illegal or improper transfer of valuable assets, or substantially all of the value generated from those assets, generally involving some improper coercive role of state authorities. It is equally important to distinguish what raiding is from what it is not: Raiding is not merely a business dispute, official graft, or corrupt privatization, though a corporate raid may include any or all of these elements.

RESEARCH PROCESS AND RESULTS

With the above definition of corporate raiding in mind, the purpose of my research was to illuminate the methods by which raiders achieve their objectives, including which vulnerabilities of firms raiders seek to exploit, as well as what defenses have been successfully deployed before and during past raids, and which defenses could succeed in the future. In addition, I offer some recommendations for Ukrainian policymakers concerned with reducing corporate raiding and enhancing the security of private property. Finally, I provide suggestions for more effective U.S. and Western engagement with Ukraine on the problem of corporate raiding, in light of its negative impact on growth and investment, high-level political relations, and Ukraine's prospects for European integration.

My research methodology was straightforward and qualitative: Over a two-month period, I conducted over 50 in-depth interviews with individuals familiar with the problem from a wide range of perspectives. My interview subjects included Western diplomats, current and former Ukrainian officials, Ukrainian and international bankers, including representatives of International Financial Institutions (IFIs), Ukrainian businesspeople, foreign investors, representatives of business associations, lawyers, NGO experts, and journalists, among others. The final product of my work will most likely be a journal article. While I intend to include citations to interviews among my sources, in many cases I am bound by agreement with my interviewees to protect their anonymity, or to refrain from direct quotation.

According to my sources, raiding had its origins in the late Soviet-era "bazaar" system of privately-owned market stalls. Raiding on a relatively small scale flourished in this context, in which practically every small trader was forced to buy protection ("krysha") from organized crime groups, who in turn bribed or threatened officials to protect their own immunity from prosecution. Raids took place not only when gangsters decided to seize traders' assets, but when traders invoked the assistance of criminal kryshy or corrupt officials to take over or destroy a flourishing rival's business.

With the collapse of the Soviet system and the first wave of post-1991 privatization, came the emergence of what was known as "black" or "bandit" raids. These were straightforwardly criminal acts, made possible by the breakdown of social order, desperate economic conditions, and general lawlessness of the time. In the simplest

form, criminal groups would send armed men to seize the premises of a business, typically a former state enterprise, and physically remove all valuable assets and materials from it, ranging from cash, to computers and machinery—even antiquated Soviet equipment was seized and sold for scrap.

By the late 1990's and early 2000's, raiding entered what one of my contacts labeled the "gray" phase. The parties at interest may have been officials, wealthy businessmen, or Soviet-era "red directors" seeking to gain ownership over industries they already managed. In many cases the real parties at interest in a raid were unknown. Methods, too, became far more complex, with the involvement of a wide range of state ministries and private middlemen, including foreigners, and usually invoking decisions of a purported shareholders meeting or court orders to transfer assets for the raider's benefit. It was by such raids that many of today's oligarchs in Ukraine began to assemble their vast vertical monopolies in sectors such as energy, mining, telecommunications, or food and agriculture.

The 2004-05 Orange Revolution brought a temporary halt to raiding since the new government was formally committed to fighting corruption and protecting property rights, but the dysfunction of the Orange coalition quickly resulted in a huge uptick in raids by the latter part of the last decade. My interviewees noted that while the existence of competing political power centers in the Presidency, the Government and the Rada—plus local and regional governments—allowed business owners to secure at least some kind of political krysha, endless battles over privatization and re-privatization had the effect of increasing uncertainty and encouraging raiders to ply their trade.

Since the arrival of the Yanukovich Administration in 2010, raiding has evolved yet again, but it has not necessarily declined. One contact called this the period of "white raiding," meaning that raiders achieve the same ends as before but often do not appear to be raiders in the traditional sense. Another interviewee countered that, "what's happening today in Ukraine is like in markets in the 1990's—it's Mafia extortion, but by the state, and you cannot win or protect yourself."⁷ One reason for the continuation of raiding under the new Administration may be the increasing concentration of the financial benefits of political power around the so-called "Family" of

President Yanukovich himself (both actual family, like the President's son Oleksandr, and close associates), leaving even many loyal Regions Party officials out in the cold. These officials, accustomed to living well off of corrupt payments, now must raid successful businesses to acquire wealth, or must solicit payments from others for facilitating raids.

Another theory is simply that there is a new large-scale realignment of business ownership underway, in which those closest to the President are systematically stripping lucrative assets away from their previous owners, and they are doing so by means of corporate raids. Either way, the consolidation of political power around the Presidential Administration in Kyiv has meant that there are few if any reliable kryshy to be had, and so businesses must think differently if they hope to defend themselves.

Raiders' methods vary widely, not only from "black" to "white" as described above, but across a diverse set of legal, economic and political instruments and contexts. While a case can be found in Ukraine to illustrate nearly every possible variation, the majority of cases fall into a handful of typologies: Forced bankruptcies or business crises, in which the raider takes advantage of the weakness imposed on the business to seize control; Corporate or minority shareholder attacks, in which the raider typically acquires a minority interest in the target company, and by means of a corrupt court decision, forged document, or other pressure, converts that interest into majority ownership and control of the company; Civil litigation, relying on corrupt courts to deliver judgments favorable to raiders, who then seek to collect on the judgment by taking control of the company; and Extortion, by way of anything from endless fines, inspections or other administrative pressure, to denial of a critical license or permit, to so-called "made to order" criminal cases ("zakaznye dela"), to outright physical threats or physical pressure. In most actual raids, elements of more than one methodology come into play, and raiders may also switch tactics during the course of an attack.

There is no rule without exceptions but certain sectors tend to be less vulnerable to raiding than others. Information technology (IT), for example, is relatively safer, simply because an IT company is less likely to have "assets" which are of any value without employees' full cooperation. If software engineers don't want to work for new owners, they can simply cease doing so, or go elsewhere. Some have argued that agriculture is less appealing to

raiders, because it is risky, depends on unpredictable weather, requires experience and expertise, and demands expensive capital investment in equipment and seeds, often on an annual basis.⁸ Major raiders tend to target businesses with expensive physical assets, like valuable land, machinery, and buildings, solid cash flow, and enough scale to make their efforts worthwhile. For them, ideal targets include extractive industries, large factories, and successful retail outlets, restaurants, or hotels, especially chains—in short, businesses with a large and steady cash flow. But recall that raiding had its start among small-scale bazaar merchants, and there are plenty of reported cases of raiders going to great lengths to steal modest individual apartments, small local cafes, or even intellectual property like a trademarked brand.

Other than the type of business, what makes particular firms vulnerable to raiders? Through lawsuits and administrative pressure, raiders will exploit any past legally or morally dubious privatization, past payment of a bribe, or any case when the business owners or their predecessors missed even a small legal technicality in the course of doing business. In other words, nearly every business in Ukraine will develop some vulnerability to raider attacks once it starts actually doing business in the country's complex and impossibly opaque regulatory environment. As one of my interviewees explained, "Raids don't just happen. You must have some weak points where you are in violation of the law, for example you gave a bribe ten years ago, the government changes, and now you must pay again."⁹ Even worse, many Ukrainians are still deeply dissatisfied with the consequences of post-Soviet privatization and resigned to pervasive corruption, so they tend not to see much moral difference between raiders attacking a businessman, and the businessman himself, whom they assume succeeded in the first place thanks to some kind of corruption. The surprising result is that despite alarmist media coverage, not much shame attaches to raiding and raiders in Ukrainian society.

At the same time, a major misconception is that corporate raiding can be dealt with only by finally eliminating corruption, especially in the judiciary, and that therefore only the government can solve the problem. While my interviewees

generally agreed that, “without corruption there would be no raiding,”¹⁰ it was clear from discussions with business owners, investors, journalists, and other experts that private defenses against raiders can be successful. In fact, the biggest problems for Ukrainian business owners are widespread indifference to the problem, the belief that, “it can happen to the other guy but not to me,” and the instinct that raider attacks should be dealt with quietly rather than fought loudly and in public.

The best defense, of course, is prevention. While some firms are more likely to be raided than others, my research indicates that any business can take steps to make itself more secure against raiders. These include: ensuring ownership is physically present and fully engaged with management; building a corporate ownership structure that provides “layered defense” of business assets; seeking foreign investment, especially by governments and IFIs; maintaining other kinds of relevant leverage, including prominent community involvement; building alliances with stakeholders such as labor unions and other businesses; retaining expert local and international counsel to advise on laws and regulations and conduct due diligence on all prospective partners and transactions; ensuring one’s own full compliance with all relevant laws; and undertaking regular internal audits to remedy any legal shortcomings due to past flawed privatizations or other regulatory imperfections.

Even if preventive measures have not been taken or have proven inadequate, it is still possible to mount a defense once a raider attack is underway. Reactive defensive strategies depend on two key premises: acting quickly, and imposing unacceptably high costs on the raiders. Tactics may include: maximizing negative publicity about the raid and the raiders as quickly as possible; immediately filing suits and counter-suits, not only to resist the attack by legal means, but to force the raiders into revealing the true parties at interest and other details of the attack; reaching as high as possible up the political ladder to seek protective intervention, though only with adequate preparation and knowledge of the risks; engaging foreign allies to apply pressure to Ukrainian officials; and, as a last resort, “fighting fire with fire,” by engaging asset recovery experts who can apply all kinds of pressure against raiders, including launching attacks on their own businesses and personal assets.

RELEVANCE TO POLICY COMMUNITY

In a recent article, First Deputy Prime Minister of Ukraine Serhiy Arbuzov, who chairs the state anti-raiding commission, summarized the importance of addressing this issue for the future of Ukraine: “In recent years, the phenomenon of illegal company takeovers has unfortunately reached a significant scale in Ukraine, greatly hindering the government’s efforts to implement reforms designed to strengthen the economy and increase the flow of foreign investment.”¹¹ In addition to scaring off investors and blocking economic development, corporate raiding does damage to ordinary Ukrainians by destroying enterprises that provide badly needed jobs and complicating the prospects for Ukraine’s economic integration with the European Union, which would vastly enhance Ukrainians’ well-being in the long run. All of these are urgent priorities for the U.S.-Ukraine strategic partnership.

On the basis of my research, I can offer some preliminary observations regarding prospective reforms designed to combat corporate raiding:

Corporate Law Reform: Reforms recently enacted and proposed by the government should help narrow the opportunity for raiders to abuse corporate ownership structures. Of particular note are simplified procedures for registering corporations, such as requiring that all registrars use a single national database, and clarifications of the procedure for corporate dispute resolution, including notice requirements and limiting jurisdiction for lawsuits to the region where the defendant firm is registered. In the future, the government should be urged to implement simpler, more transparent procedures for registering businesses and granting necessary permits and licenses, such as e-government web portals, and the “one window” systems successfully pioneered in the Republic of Georgia and Vynnytsia Oblast’.

Judicial and Prosecutorial Reform: Corruption in the judiciary may be the single biggest facilitator of corporate raiding. The judicial reform launched in 2010 is still underway, however some early results are promising, including reforming the system for judicial appointments and oversight, requiring timely and full publication of judicial decisions online, and enhancing punishment for corruption. Judges must also see that fairness and independence are rewarded in their career development, and must feel insulated from political pressure both within the judiciary and from other government structures.

Most notable in this respect is the urgent need to reform the General Prosecutor's Office, which can exercise "general supervisory authority" over any regulatory issue, and may intervene in any pending court case to assert a state interest which judges seldom contradict. The new criminal procedure code, implemented in 2012, also contains several relevant provisions, and should significantly reduce pressure exerted via "zakaznye dela" by explicitly forbidding pre-trial detention for alleged economic crimes.

Administrative Reform: Officials at all levels are often key facilitators of raids, if not the ultimate parties at interest. To reduce official facilitation of corporate raiding, it is essential not only to enhance oversight and accountability for officials, but to buoy the development of professional pride and standards of conduct in both the private and public sectors. Since lower level officials sometimes do not even realize they are participating in a raid when they follow directives from corrupt superiors, the government should consider implementing an education campaign across all local, regional and central government ministries, with explicit protections for whistleblowers and rewards for those who uncover waste, fraud or abuse. These practices could be mirrored in the private sector by business associations, which could offer a "gold seal" for those businesses that undertake thorough self-audits, commit to corporate codes of conduct, and refuse to do business with raiders.

Interested parties have also backed a wide variety of ad-hoc solutions to the problem of raiding. Since at least 2005, there has been a formal state commission on raiding (now the "Interdepartmental Commission on Counteracting Illegal Takeovers and Raids," headed by First Deputy Prime Minister Arbuzov), whose purpose is to investigate alleged raids and take any necessary remedial action. Some have recently proposed the appointment of an additional high-level Ombudsman from outside the government to address raids and threats to property rights, by bringing these cases to the attention of senior government officials. Still others have suggested the need for mixed Ukrainian and international courts of commercial arbitration, as a stop-gap measure to ensure impartial adjudication of business disputes while Ukraine's judicial and corporate law reforms are implemented. While any of these measures may help resolve individual cases in the short term, it is clear that progress on the broader reform agendas mentioned above is essential to reducing corporate raiding and securing stable property rights in the long term, with all the attendant benefits for Ukraine's economic growth, political stability, and European integration.

ENDNOTES

¹ "The Importance of Economic Reform to Ukraine," Speech by Ambassador John Tefft at Kyiv National Economics University, April 23, 2013.

² Auyezhov, Olzhas. "Selective justice keeps foreign investment out of Ukraine," Reuters, June 10, 2013. Available at: <http://uk.reuters.com/article/2013/06/10/uk-ukraine-investment-idUKBRE95904L20130610?feedType=RSS&feedName=worldNews> (Discounting investment by Ukrainian oligarchs and businesses via Cyprus and other offshores, Ukraine had just over \$2 billion in real FDI in 2012).

³ Gans-Morse, Jordan. "Threats to Property Rights in Russia: From Private Coercion to State Aggression," *Post-Soviet Affairs*, 2012, 28, No. 3, pp. 263-295, 281.

⁴ Firestone, Thomas. "Criminal Corporate Raiding in Russia," *The International Lawyer* 42. 4 (Winter 2008): 1207-1229, 1207.

⁵ Matthews, O., & Nemsova, A. "The new feudalism; forget corruption. in putin's russia, the nexus of payoffs and patronage is almost medieval, touching every aspect of life." *Newsweek*, October 23, 2006.

⁶ Stack, Graham. "Ukraine's corporate raiders take time out - but for how long?," *Business New Europe*, February 10, 2010. Available at: <http://www.bne.eu/story1954>.

⁷ Author's interview with Ukrainian financial journalist, May 2013.

⁸ Author's interview with Western corporate lawyer working in Ukraine, May 2013. N.B. Notwithstanding the challenges for potential raiders, in recent years there have been several raids on large agribusinesses.

⁹ Author's interview with Ukrainian investigative reporter and TV producer, May 2013.

¹⁰ Author's interview with European business representative in Ukraine, May 2013.

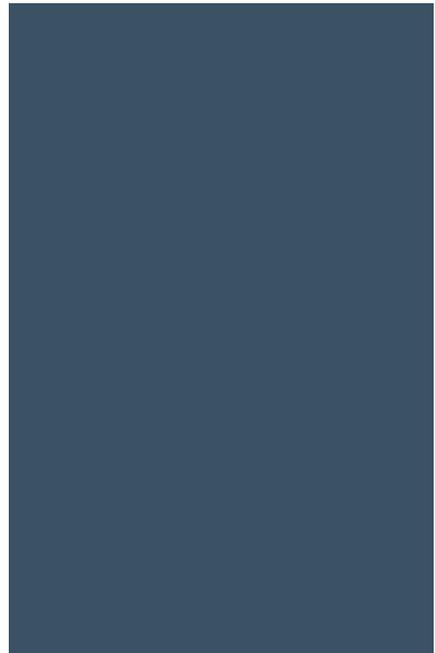
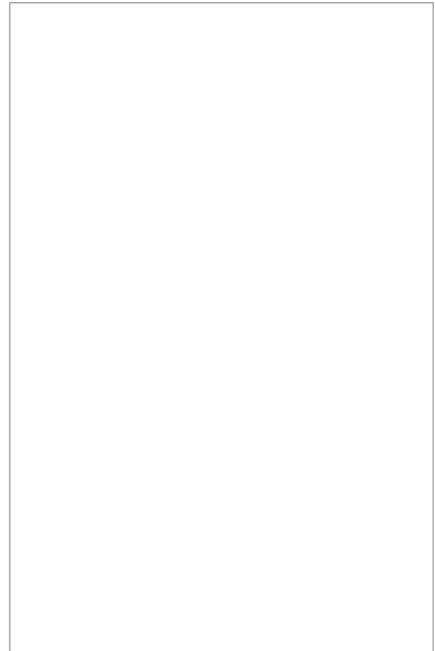
¹¹ Arbuzov, Serhiy. "Ukraine will fight illegal takeovers," *Kyiv Post*, June 13, 2013. Available at: <http://www.kyivpost.com/opinion/op-ed/ukraine-will-fight-illegal-takeovers-325613.html>

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