

SECTION 3  
PRACTITIONER'S  
CORNER



MINORITY SHAREHOLDERS VS. THE STATE: THE CASE OF JSC "UKRNEFT"

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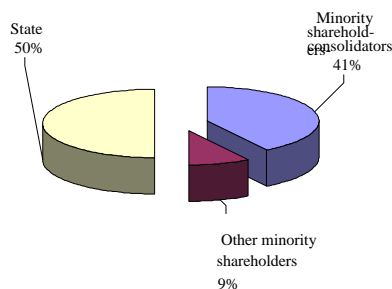
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**Introduction**

The joint-stock company "Ukrneft" is a good example for understanding the role of asymmetry of information in the corporate governance. Corporate ownership structure is characterized by high enough concentration. The state is the largest stockholder, owning 50%+1 company stock, i.e. controlling block. Besides the state, there are some large

shareholders in the structure of corporate ownership of the joint stock company "Ukrneft". They are represented by Pryvatbank, Ukrsybbank and Wotford Groups. The consolidated shareholding of these shareholders is 41 % of voting shares. The remaining 9 % of shareholder equity belong to the rest minority shareholders.



**Fig. 1.** Joint-stock company "Ukrneft" ownership structure

In general, about 35.800 individuals and 200 legal entities, of which about 50 are not residents, are the shareholders of the enterprise. Private shareholders aggregate 49% of shareholder equity. The JSC "Alpha-Capital Ukraine", incorporated bank

"Societe General' Ukraine", joint-stock bank "ING Bearing Ukraine", "Raznoeksport", companies "Oksydental Management Company Ltd", "Ukrainian Capital Management Ltd, "Optyma", "Synkom", "Zdobutok" and "Wood & Company Management" are the largest owners.

The reins of the corporate governance are at the hands of the state. This concerns not only the approving the strategic decisions at the shareholders' meeting, but also the implementing the control for its execution by the Supervisory Board. Before the next shareholders' meeting, which was planned on August 28, 2001, the state was represented in Supervisory Board by 9 members.

### **The first round of conflict**

A few questions, which became the reason of the agent conflict between the state and the consolidated shareholders, were included on the agenda of the shareholders' meeting, i.e.:

- reelections of the Supervisory Board and the Chairman of the Supervisory Board;
- question about the redistribution of the income, which the corporation has earned in 2000 and the dividend payment;
- the Board's report on the financial activity for the year 2000;
- some changes in the charter and internal corporate statements;
- establishing the new structural units, divisions, etc.

As a result of the enterprise activity for the year 2000, book income was generated at the volume of HRUA1 billion. It was planned to spend HRUA76 million to the dividend payments, i.e. about 7 %. On the assertion of the Supervisory Board and the Executive Board, the remaining amount was reinvested during the year. Thus, the minority shareholders confirm that neither the efficiency of the investment projects, nor its advantages for the shareholders of the company are obvious. In addition, the minority shareholders would like to get an answer at the question about the reason of the unprofitable gas sales by JSC "Ukrneft" to the national oil-gas joint-stock company "Neftegaz of Ukraine".

To find an answer to these questions, the minority shareholders consolidated their interests and suggested to an existent majority in the person of the state before the shareholders' meeting on August, 28, 2001, to discuss the possibility of the acceptance of some suggestions, which would protect the rights of the minority shareholders and were instrumental in the diminishment of the asymmetry of information between two groups of the shareholders - majority and minority shareholders.

The minority shareholders suggested to the majority shareholders to support the following suggestions at the shareholders' meeting:

- to increase the number of minority shareholders on the Supervisory Board from 2 to 5 persons;
- to approve some amendments and changes to the corporate charter. According to these amendments, the shareholders' meeting, instead of the Supervisory Board, should

elect the Chairman of the Supervisory Board.

The first suggestion of minority shareholders was aimed to getting an access to the control of the Board's activity. For the state, the suggestion of minority shareholders, who wanted to have 5 their members on the Supervisory Board, was unacceptable, because of the fact that the meetings of the Supervisory Board can be valid only for a seven members quorum. Thus, having five members on the Supervisory Board, the minority shareholders would get a good possibility to compel the majority shareholder – the state - to consider the minority interests.

Unfortunately, the majority shareholders did not accept the minority suggestion. As a result, the minority shareholders were not at the shareholders' meeting on August 28. Only 52,47% of the shareholders were registered at the shareholders' meeting (in accordance with Law of Ukraine "On Enterprises", a quorum at the shareholders' meeting is considered as attained, if no less than 60 % of shareholders are registered). Thus, the shareholders' meeting of JSC "Ukrneft", that was planned for August, 28, 2001, had not happened.

### **The second round of conflict**

The next shareholders' meeting of JSC "Ukrneft" was appointed for November 15, 2001. The minority shareholders stayed on the steady positions concerning the redistribution of the seats on the Supervisory Board of the company. The subject of the confrontation between the "consolidators" and the main shareholder – national gas-oil JSC "Neftegaz of Ukraine" - remained unchanged. Mr. Galyev, vice-president of incorporated bank "Ukrnybbank", noticed that "questions of the redistribution of corporate control and access to insiders' information about company's activity between the state, as the owner of controlling block, and companies, that are owners of the consolidated block at 41 % of shares, still are not resolved". In this case, there is a question about the proportional representation on the Supervisory Board.

The requirement of the minority shareholders about the proportional distribution of seats on the Supervisory Board of JSC "Ukrneft" does not contradict with the current legislation of Ukraine, but also it is not ratified as obligatory.

According to the Galiev's statements, the minority shareholders can not protect their interests directly, i.e. in legal order, namely, to require appointing on the Supervisory Board five representatives, because of the current legislations. The principle of cumulative presentation on the Supervisory Board, which appeals to defend the minority rights, works in many countries of the world, but in Ukraine, unfortunately, is still absent.

In such situation, the owner of controlling block of shares receives a good possibility to

consolidate all information about the company's activity in his hands and limit the minority shareholders in getting it. It leads to the appearance of asymmetry of information and as a result, to the conflict of interests of the owners of the company, i.e. to the agent conflicts.

Obviously, the problem can be solved through the transparent reporting and communication policies to reflect current situation and the prospects of the company development at the market. The information about an economic activity of the joint-stock company, which is presented every year to all shareholders at the meeting, is rather common. So, before the meeting, the financial reports, that had the formal status and informed the owners, for example, about the profit which company has received at a size of HRUA1 billion was presented to the shareholders. As the minority shareholders noticed, this amount must be somewhere accumulated - at accounts or in highliquid assets, before shareholders' meeting makes a decision about its use. There was a far less amount of income at the company accounts before the moment of holding a meeting. The Board explains this fact by the realization of some actions, related to the renewal of fixed assets, new field development, etc. Minority shareholders find the majority shareholders guilty because they do not allow them to take part in developing of the company investment strategy, and only put them before the fact of the decisions accepted by the Supervisory Board. A. Dubylet, Chairman of incorporated bank "Pryvatbank" says: "It is strange, what the main point of this investment decision is, why a huge amount of money goes there, and there is no control from the side of the shareholders. There are many questions, connected with that fact that the company did not get a necessary income in 2000, in spite of such a serious jump of oil prices. May be, this is one of the most important questions".

The audit conclusion about the financial position of the company in 2000 was made about its stability, and coming from liquidity ratio, the company has a good position. But, the audit conclusion cannot contain the estimation of the loss of profit, as a result of the incorrect choice of investing.

Galyev on this occasion noticed that formally, documents, which are spreading at shareholders' meeting, must not contain the detailed information about the choice criteria of the objects of company's investing. So, they must not contain the statement of account, settlement account balance, etc. To get such information, it is necessary to be on the Supervisory Board. "If I were a member of Supervisory Board, - Galyev noticed, I would ask to explain, where the HRUA1 billion of income was. If it was not reinvested, it means that the money have been paid to the shareholders. If it was reinvested, the question is in what projects and what the return period. And in general, was this period calculated?"

In spite of the justified desire of shareholders to have five representatives on the Supervisory Board, the majority shareholders did not accept any suggestion of the minority. Only four seats on the Supervisory Board were offered to the minority shareholders. Having such number of seats, they would not be in a position to influence the investment decisions of the company. Besides this suggestion, majority shareholders did not offer concrete methods for solving the agent's conflict. V. Kopylov, Chairman of Management Board of joint-stock company «Neftegaz of Ukraine» who is the owner of the controlling block of shares of JSC «Ukrneft», explains that the private shareholders were not allowed to be on the Supervisory Board of the company because of their not large investments in comparison with the company value. A. Dubilet noticed that if U\$100 million investments mean nothing for the management and the welfare of the company, what it should say about the Ukrainian pensioners, whose stake in the company makes about UAH100, and whether it means, that they are not of interest for the state as co-owners of the Ukrainian enterprises.

The minority shareholders used a popular method of protest, i.e. ignoring shareholders' meeting, which had not happened on November, 15, 2001 again because of absence of the decision of the arising conflict. One of the minority shareholders, M. Wotford, Head of Wotford Groups, declared that the most painfully an agent conflict influences the market value of enterprise.

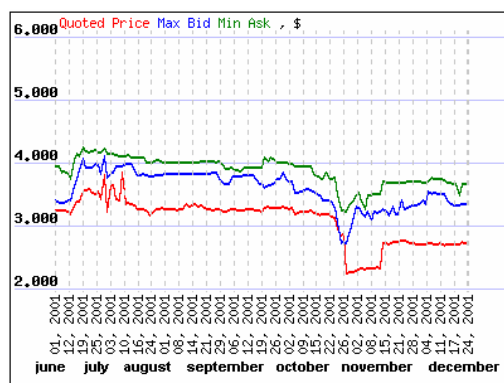


Fig. 2. Dynamics of share prices of JSC "Ukrneft"

As we can see at the figure, the share price of enterprise did not suffer sufficiently as a result of the agent conflict. A high price of "Ukrneft" shares is explained by the fact that a block of shares at 51%+1 share belongs to the state. That's why, the final owner has not been determined and fight for the company control is coming.

In addition, the reason of such stability is the statement, made by Mr. Galyev after the shareholders' meeting, which was to be undertaken on November 15, 2001. The Vice-president of incorporated bank "Ukrsybbank" declared that nobody of minority shareholders-consolidators is going to sell the company shares belonging to them.

Moreover, minority shareholders became more active to increase their share in the ownership structure. Obviously, increasing their participation in the shareholder equity, their requirement to get 5 seats in the Supervisory Board would be more and more convincing.

That is why, before the shareholders' meeting on November 15, 2001 there was an evidence of increasing the price of shares of "Ukrneft". A large transaction (25.000 shares) which took place on November, 7 on OTC market is a proof of this fact. This transaction went beyond the scopes of current market corridor (the bid quotations were HRUA22.66, the asked quotations were HRUA22.669). Analysts are sure that the protection strategy of minority shareholders rights is aimed to buy shares of those outsiders who own 9 % of the registered equity and who do not join the group of consolidators.

Probably, after that, minority shareholders would remind Mr. Kopylov, Chairman of the Supervisory Board, about his promise to give one seat in Supervisory Board to the owners of this 9 % block of shares. If they bought this block, shareholders -consolidators could require giving this seat to them. As a result, this seat and the other four seats, which the majority shareholders are ready to give to the minority shareholders, will give the possibility to the majority to influence the company work. This strategy would correspond to the principles of a honest fight for the corporate control.

The consolidated commercial banks just tried to purchase shares of JSC "Ukrneft" at the secondary market. The State responded quickly to deprive commercial banks of funds to finance purchases. The strategy was the following.

The State as a shareholder of JSC Ukrneft, decided to attack consolidants, represented by commercial banks. Thus, at the end of the year 2002, the Ukrainian government wanted to finance an activity of National JSC "Naftogas" through issuing corporate bonds. It was very strange initiative to allow a company with only HRUA 60 mln. assets, to issue corporate bonds at amount of HRUA 800 mln. The reason of such initiative was understood only by those, who knew how this issue of corporate bonds relates to commercial banks. The link was obvious,

i.e. commercial banks will have (forced by the Ukrainian government) to buy corporate bonds. In the case of success of this strategy, commercial banks would lost their liquid positions and they would have to get rid of a plan to purchase shares of JSC "Ukrneft" at the secondary market.

The National Bank of Ukraine, as a regulator of the banking sector in Ukraine, has not supported an initiative of the Ukrainian government (in Ukraine, the National bank is quite independent). The conflict between the Ukrainian government and the National Bank of Ukraine was settled at the Ukrainian parliament, where parliamentarians rejected the strategy, i.e. the issue of bonds was prohibited.

After this, local victory, minority shareholders chose another strategy, instead of purchasing shares of JSC "Ukrneft" at the secondary market. Instead of application of the corporate governance mechanisms, political blackmail became the key element of this strategy.

In 2002, the Ukrainian government decided to attract the investments of the Russian oil-extracting companies in the oil processing industry of Ukraine. Negotiations with Yukos, Sybneft, Lukoyl and TNK were initiated. The above mentioned Russian companies really wanted to come to Ukraine to invest huge funds. The prospects of these relations were examined by the Russian companies through the prism of the role in these relations of one of the largest Ukrainian financial and industrial groups – Privat-Invest<sup>1</sup> (see the figure below) and UkrSibBank, which are shareholders of JSC "Ukrneft".

For the moment of the beginning of negotiations, Privat-Invest actively co-operated with the Russian oil-extracting companies in the area of import of oil and petrol to Ukraine.

Moreover, Privat-Invest was successful in establishing a vertically-integrated structure in the oil sector. Therefore, Russian oil companies considered Privat-Invest as a serious partner at the market. It is interesting, that the commercial bank "Privatbank" is the financial kernel of the Privat-Invest group. In this situation the state had to choose between saving of corporate control in JSC "Ukrneft" and realization of investment projects in oil industry of Ukraine.

<sup>1</sup> One of the largest financial and industrial groups of Ukraine. The book value of assets of the companies owned by Privat-Invest is HRUA11,5 bln. (USD 2,18 bil.) The largest FIG is «Industrial Soyuz Donbass» (USD 12,5 bil.). Mr. Tigibko is the former CEO of «Privatbank». He is the leader of the former President of Ukraine L. Kuchma fraction «Trydovay Ukraina». On December 2002 he was elected on the post of Chairman of National Bank of Ukraine, at the end of November, 2004 he left the position.

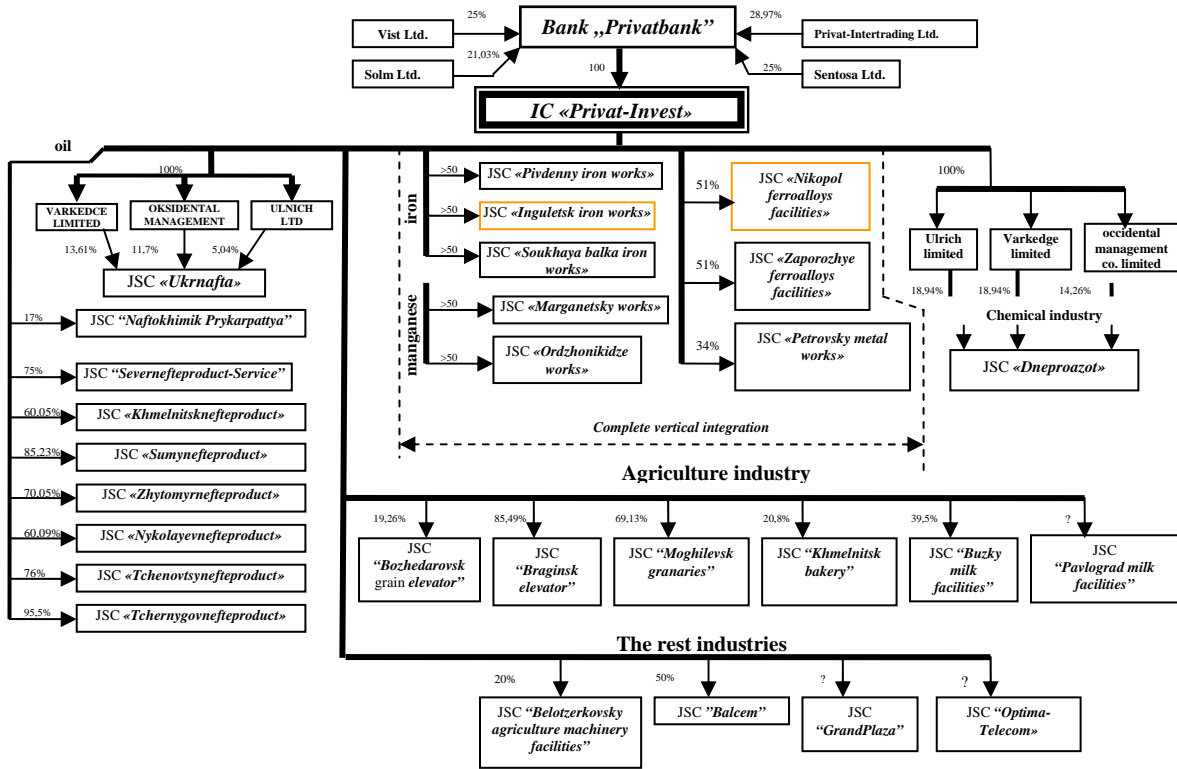


Fig. 3. Financial-industrial group "Privat-Invest"

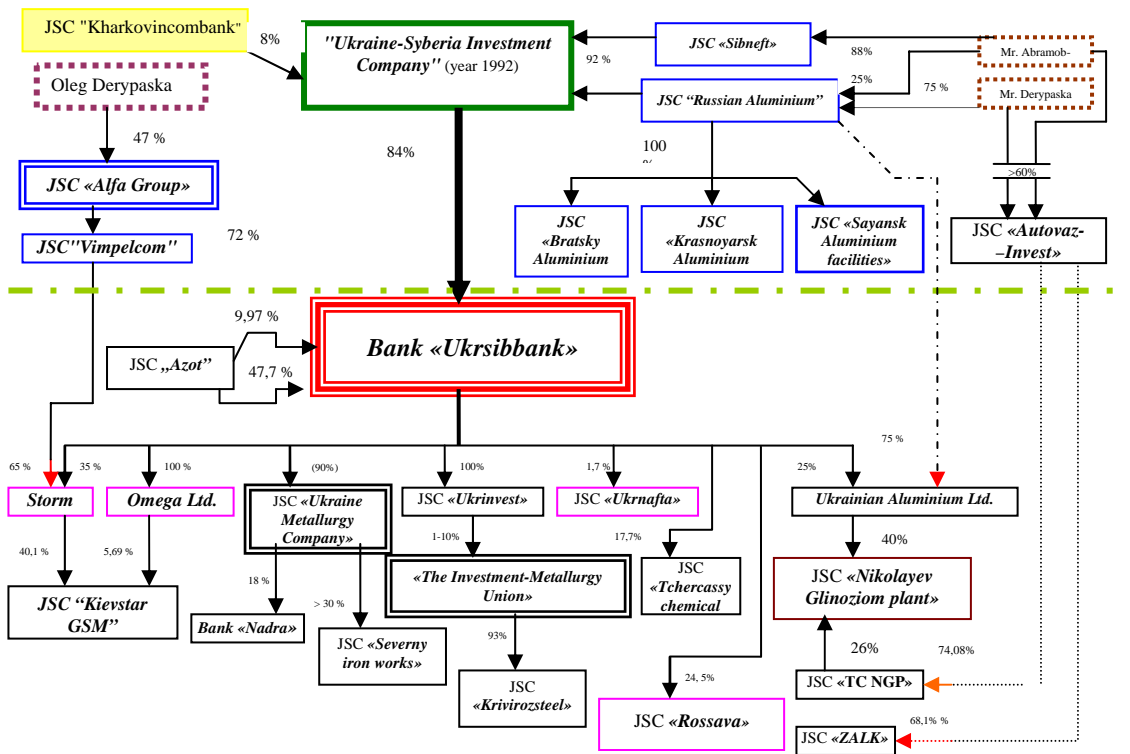


Fig. 4. Financial-industrial group "UkrSibbank"

UkrSibBank represents interests of Mr. 'Sibneft' (see the figure above). Therefore, JSC Abramowich who is an owner of Russian JSC "Sibneft" will come to Ukraine to invest only if the

Ukrainian government gives a guarantee that the rights of UkrSibBank as shareholder of JSC "Ukrneft" are protected.

As a result of numerous negotiations the decision was accepted. First, the state, as a shareholder, gives the position of a Chairman of the Management Board of JSC "Ukrneft" to the representative of Privat-Invest<sup>2</sup>. Secondly, the state promises in the near future to sell a part of the shares of JSC "Ukrneft", i.e. to lose the corporate control. Thus, the circle of participants of shares tender sale is already defined - the Russian oil-extracting companies and financial and industrial groups "Privat-Invest" and UkrSibBank. Interestingly, interests of other consolidators are not taken into account.

Thus, as the result of the fight for corporate control at JSC «Ukrneft» - the leading corporation at the market for oil and gas in Ukraine, the State is going to give corporate control to other large investors who behave in not transparent manner. Rights of minority shareholders, under such circumstances, are an excellent target to violate. Probably, the State prefers to find a mutually advantageous way out with participation of a small number of large shareholders to keep the process of transfer of corporate control under shadow. The state men suppose that it is much easier to find a compromise with a narrowed circle of discusants than try to find the best decision for all minority shareholders – consolidants.

Such kind of perspective for the market for corporate control development is a step back from the principles of corporate governance, i.e. principle of transparency and accountability.

P.S. After the inauguration of the new President of Ukraine Mr. Yuschenko, the President of Ukraine placed a lot of emphasize to such issue as transparency and accountability of corporations. He underlined that the State will do its utmost to create a system of incentives to drive owners toward the best principles of corporate governance. This is not an issue of regulation. This is an issue of liberalization, when the State takes a position of guarantee of rights of minority shareholders. Besides this, the President will pay attention to development of external mechanisms of corporate governance, i.e. stock market, credit market and so on.

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<sup>2</sup> On January, 30, 2002 a representative of "Privat-Invest" was elected on the post of Head of the Management Board JSC «Ukrneft». Before that he hold a position of the Head of the Management Board of JSC «Galichina».The controlling block of shares belongs to FIG "Privat-Invest".