This teaching note is prepared as a basis for class discussion rather than to illustrate either effective or ineffective handling of a business situation. Support for this teaching note was provided by the U.S. Agency for International Development (USAID) through the Eurasia Foundation in Washington, D.C. for which we are very grateful. We would like to express our gratitude to Ms. Yulia Botvich, graduate student at Texas A&M University for her assistance in the analysis of the case.

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I. Example 1: **Bankruptcy and the Leningrad Metal Works Corporation (LMZ)**

It can be said that Interros pretty clearly won the battle for control of LMZ. The planned new share issuance where by debt was swapped for new shares went forward and thereby Interros gained control of LMZ. EMK contested the legality of this share issuance in various courts, but on December 19, 2000 the Supreme Arbitration Court of the Russian Federation ruled in favor of the new share issuance. Backed by this high court opinion, Interros was easily able to get a positive decision by the regional (St. Petersburg and Leningard Oblast) arbitration court with respect to ending external management at LMZ. On February 7, 2001 the arbitration court approved the LMZ external manager’s report on the completion of external management and adopted a decision to grant the company a six month period for the settlement with creditors. By August 7, 2001, LMZ had paid all its debts and external management of the company was formally ended. Today, LMZ is a publicly – traded company majority – owned (about 58 percent) by Interros. Siemens today owns about 4.8 percent of LMZ’s shares, while about 10.4 percent is owned by the Russian utility company Lenenergo (which was also a large creditor of LMZ’s).

The reasons why Interros was ultimately virtually completely successful are many. First, EMK had engendered considerable antagonism at LMZ as it attempted to centralize and consolidate its control over that company. As a result, there wasn’t a ton of local “goodwill” for EMK when its battle with Interros escalated. In contrast, Interros was (and is) extremely well politically connected. Its “maestro”, Vladimir Potanin, served as Deputy Prime Minister of Russia, and is one of Russia’s highly successful billionaire “oligarchs”. (Sale of the Century) Potanin’s positive connections with Anatoly Chubais may also have played a role in the final outcome. Chubais, also a former Deputy Russian Prime Minister, is now the chief executive officer of the major Russian utility company United Energy Systems (“UES”). UES has publicly announced its intention to spend billions of dollars in the coming years upgrading its utility power generation infrastructure, and one potential supplier of a good amount of the needed equipment is LMZ. Consequently, Siemens as a major continuing shareholder of LMZ (and of other St. Petersburg energy engineering companies like Electrosila – which is now also under Interro’s control) may have felt that its long-term interests were best served by “playing ball” with a very well-connected (to Chubais etc.) Interros rather than with a less politically potent EMK. Clearly Siemens’ decision in January, 2000 to sell its debt to Interros was perhaps the major event in the whole drama (and the German conglomerate with about $70 billion in sales and $7 billion in profit that year was likely not under any serious financial imperative to monetize the relatively very small amount of LMZ debt it held). Interro’s political prowess also probably didn’t affect it negatively in its battles with EMK in the Russian court system.

In the battle between Interros and EMK, Interros was the winner. This, though, was simply a battle between two Russian businesses, with the more politically powerful of the two winning. The scenario, however, may be somewhat different when the battle is between a powerful Russian company and a Siemens – like international business behemoth – which in example 2 is the British Petroleum Company.
II. Example 2: Chernogorneft

A wide variety of issues held up a final resolution of the dispute over Chernogorneft for over two years. At the heart of various tentative settlements was the return of the Chernogorneft properties by TNK to Sidanco in return for a major stake in Sidanco.

Ultimately, on January 9, 2002, TNK transferred the Chernogorneft properties to Sidanco in return for a 25 per cent plus one share “blocking” stake in Sidanco. By the time this deal was completed TNK had also been able to buy large amounts of Sidanco stock from other Sidanco holders, including an August 3, 2001 purchase of 44 percent of Sidanco from (of all people!) Interros for $640 million. Thus, upon the completion of the transfer of the Chernogorneft properties on January 9, 2002, TNK (and its parent holding company Alfa Group) controlled about 84 percent of Sidanco’s stock. After all these transactions BP (its name changed back to this from the former BP Amoco) continued to hold its 10 percent stake in Sidanco, and about 6 percent of Sidanco stock continued to float publicly. Consequently, after all has been said and done, TNK today controls Sidanco (and the Chernogorneft properties which are important parts of the company as reconstituted).

Unlike EMK, however, which suffered essentially a total loss in the LMZ bankruptcy proceeding, BP was able to salvage a decent amount of assets in the Chernogorneft situation. BP’s 10 percent of a now-whole Sidanco is worth at least $150 million (based on the August 3, 2001 price TNK paid for Interro’s Sidanco stock) and probably more. Moreover, as part of the January 9, 2002 TNK-Chernogorneft – Sidanco share exchange, BP was named as the operational manager of Sidanco (and TNK and BP have entered into other joint venture arrangements and appear to currently have quite cordial relations). Nevertheless, it should be remembered that BP did indeed pay $571 million in November, 1999 for its 10 percent in Sidanco and has, due in good measure to the Chernogorneft bankruptcy episode, clearly lost at least $200 million of this amount in less than three years.

III. Example 1 versus Example 2

Example 1 involved two Russian companies, and the less politically potent company lost. Example 2, however, added a very powerful international oil company to the bankruptcy drama mix, a company that was able to “cry wolf” and be heard at the highest level of international politics. BP’s international political clout, and the strong interest of the Russian government (and even TNK) in maintaining positive relations with the major international oil companies, helped it emerge from the Chernogorneft scenario losing only about half of its initial investment.

One lesson from the above discussion for international investing in Russian businesses is that absent absolutely superior knowledge of given local Russian companies, it’s probably safest to invest in Russia via holdings in major non-Russian companies that are doing business in that country. Even so, however, there is still clearly risk (BP did indeed lose a lot of money), and obviously investing in a company like BP does not give one a “pure play” on Russia. Another obvious lesson from the two examples is the need for reform of the 1998 Russian bankruptcy law, and indeed such reform is currently in motion.
IV. Russian Bankruptcy Law Reform

A new bankruptcy law was proposed to the Russian Parliament in January 2002. The new law is supposed to put an end to the business of making money by forcing companies into bankruptcy. It is designed to encourage “civilized bankruptcy procedures”. It will try to balance the interests of creditors, shareholders and management. The main changes in the new law are the following:

1. Under the 1998 bankruptcy law any creditor who holds even a small amount of outstanding debt (around $5000 U.S. dollars), which is at least three months overdue, can file for bankruptcy of the firm. Under the new law, instead of filing for bankruptcy of the firm, the creditor will have to go to court and claim the outstanding debt that is overdue. After that the firm will have 20 days to repay the debt and avoid the bankruptcy. This way the law will protect the firms from creditors with bad intentions.

2. External managers will be subjected to criminal sanctions for inappropriate handling of bankruptcy procedures. Their activities will be monitored by regulatory agencies.

3. External managers will have to get 450 hours of special training, pass qualifying exams, and get one year of practical training before they apply for the external manager license.

4. The direct sale of the assets will be prohibited. Assets will be able to be sold only through an open auction. This will protect the shareholders from sale of the assets by external managers and the firm itself during the bankruptcy procedures.

5. Under the news law courts will closely look at the intent of the party filing for bankruptcy.

Finally, the new law will attempt to better coordinate the activities of federal agencies, tax authorities and courts in an effort to monitor the situation in a troubled firm and jointly make a decision about its future behavior. Every attempt will be made under the new law to protect companies from unscrupulous bankruptcy proceeding behavior (Bekker).
References


4. “BP Amoco threatens to pull out of Russia if Chernogorneft is sold,” Interfax, November 5, 1999.


