

# AT THE HARRIMAN INSTITUTE

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## Russian Roulette: Is it Safe to Bet on Business?

“Foreign countries that are entering Russian markets understand that they have to act according to local rules,” Roman Shleynov, Director of the Investigative Department of *Novaya Gazeta* and the recipient of the annual Paul Klebnikov Prize for Excellence in Journalism, said to an audience at Columbia University on April 28, 2010. The problem is that the “local rules” in Russia are so inconsistent, it feels like there are no rules at all. “You can’t trust criminal cases, you can’t trust criminal investigations, and of course you can’t trust the rules,” asserted Shleynov, who was participating in a discussion chaired by former NPR Senior Correspondent Anne Garrels and co-sponsored by the Harriman Institute, the Paul Klebnikov Fund, and the Columbia University School of Journalism.

Garrels’ conversation with Shleynov made one thing clear—there is a vicious cycle driving business practices in Russia; in order to survive in the corrupt business environment that exists there, foreign companies have to close their eyes to (and participate in) corrupt practices. Companies risk a lot investing in Russia, but they are drawn to it because by side-stepping Western norms, they can make big money. They do not speak up about corrupt practices unless they find themselves in trouble. “Only after they get into really difficult circumstances do they start to discuss the situation,” Shleynov stressed. Because these noise-making incidents tend to be isolated, there is never enough momentum to change anything. Unless businesses in Russia can unite in the fight against corruption, the cycle will go on forever.

Emerging from a command economy in the 1990s, Russian business as we know it was founded on criminal activity. The understanding that businessmen have a criminal past gives the Russian government leverage against them and keeps corruption alive. “Every Russian oligarch or big businessman understands that if they act independently, if they don’t go to the President’s administration and ask for permission about this or that big deal, if they consider not donating money to this or that state-sponsored foundation, that the next day a Federal case can be initiated against them. Their past misdeeds can be easily remembered,” Shleynov explained. This unhealthy dynamic between business and state is another underlying force fueling business corruption in Russia.

“Businessmen in Russia, particularly foreign businessmen, need to understand that in order to protect themselves from undergoing criminal investigation, they need good contacts in law enforcement,” related Shleynov. Not only are business and the state linked too closely, but Russian laws that should protect businesses are murky and difficult to enforce—sometimes they are non-existent. “In Russia we have a lack of laws protecting private property and it is a real problem,” Shleynov said, reiterating a quote attributed to a top FSB official at a party. “We do not wish to take someone’s property, but we do not allow anybody to take what we consider to be ours, even if they own it.” Shleynov clarified that the official’s comment was meant as a joke, but it is certainly grounded in reality. “Russian businessmen don’t even act like property owners, but as if they were keeping it for just a while,” he remarked, noting that Oleg Deripaska, one of Russia’s top businessmen publicly announced that if the state demanded it, he would willingly give up all of his property, without consulting the shareholders. “I don’t know what the shareholders would think about this, but unfortunately this is the ideology of Russian businessmen,” Shleynov stated.

The irony is that Western companies enter Russia assuming that they can trust the state. Shleynov warned against this. “In Russia you can’t hope that the state will solve your problems even after juridical procedures.” In December 2008, several big investors (among them ING, Credit Suisse, UBS, Deutsche Bank) lost \$250 million after investing in the Finance Leasing Company (FLC), an aircraft carrier company that was a subsidiary of the United Aircraft Corporation, a state-owned Russian conglomerate. FLC declared bankruptcy. “In 2009 we made a joint investigation with the German magazine *Spiegel* and revealed a scheme—FLC had filtered the money from this corporation, through different companies, to absolutely different private businesses. It was invested in German shipyards.” FLC’s Deputy CEO, Andrey Burlakov, had changed the direction of business without consulting shareholders, and bought shipyards from corporations in Germany and Ukraine.

The investors appealed to the state, there was a criminal case, and the court sanctioned Burlakov’s arrest. That was the end of the matter. Though the

company was state owned, the court decided that the state was not responsible for “bad management.” The representatives of these foreign investors sent a letter explaining the situation to Prime Minister Putin, but received no response. “We had a talk with the representatives of different people close to these companies and they thought that the state would help them get their money back,” imparted Shleynov, calling this expectation “nonsense.”

Russia received a score of 143 out of 179 on the Index of Economic Freedom released by *The Wall Street Journal* and the Heritage Foundation in 2010, it was ranked 120 out of 183 countries in the World Bank Group’s “Doing Business” Index released in 2010, and 146 out of 180 on Transparency International’s 2009 Corruption Perception Index. Yet despite these red flags, foreign investors keep coming back. “During all the years I worked in Russia I had the impression that foreign companies were making so much offshore money and so many big deals that they would have been unable to make in their own countries. My foreign CEOs were telling me to keep my eyes closed because they were making so much of their money in Russia,” stated an anonymous audience member who had lived and worked in Russia from 1990 to 2005.

A common scenario that causes foreign businessmen to close their eyes to corruption often transpires while these businessmen make their way through a web of complicated bureaucratic regulations (tax, safety, licensing, etc.). The regulations for opening a business tend to be confusing and inconsistent, and owners must undergo numerous inspections (health, fire, environmental). Whether they pass these inspections depends on the whims of local officials—these officials tend to overlook regulations by charging a fee. If businesses refuse to pay, they keep failing inspections. Sometimes refusal to pay bribes can lead to a criminal investigation against the refusing company.

Shleynov described a case involving the Swedish company Lundin Petroleum, which had a license for oil exploration in the Caspian region, and a subsidiary company called Petro-Resource in Russia. “The conflict started in 2007, when someone decided that the subsidiary company was breaking ecological rules.” First the state tried to pressure Lundin Petroleum to give up the license for its subsidiary, and then it tried to strike various deals, asking Lundin to sell part of its subsidiary to a Gazprom structure—Lundin refused both.

In August 2009 the local prosecutor’s office initiated a criminal case against the general director of Petro-Resource. By that fall, 30% of the subsidiary company was sold to a company owned by a friend of Prime Minister Putin. “Now there are no longer any ecological violations,” commented Shleynov. “They solved the problem, and the discussion is over. You will never find someone from foreign companies

commenting on the situation if they don’t have any problems.”

The Swedish company Ikea, one of Russia’s largest foreign investors, has been the loudest Western corporate enterprise against corruption. Starting with the opening of its first Russian branch in 2000, the corporation refused to pay a bribe to the employees of a local utility company, who threatened to cut electricity for the grand opening. Instead of complying, Ikea rented diesel generators to power its store, and continued this practice for the rest of its branches.

In June 2009, after a year-long fight to open its twelfth location in Samara, the director of Ikea in Eastern Europe, Per Kaufmann, announced Ikea’s decision to suspend future investment in Russia “due to the unpredictability of the administrative processes in some regions.” Ikea postponed plans to open approximately 30 additional stores. Though it was obvious that Ikea was referring to corruption, the company did not outwardly mention it, but attributed the decision to its frustration with Russia’s hefty bureaucracy. But, even Ikea’s executives fell into the Russian corruption trap—in February 2010, Per Kaufmann, along with another executive, was fired for agreeing to pay a bribe to an electrical company official.

In 2009 the Russian Federation received over \$81 billion in foreign investment. Foreigners often invest in Russia under the impression that they face less business risk than Russian businessmen do. “Practice shows that Russian courts are not friendly to foreign investors,” Shleynov lamented. “There is a lot of danger for those who are working in Russian markets, even those who have worked in the Russian markets for many years.”

Shleynov recalled the case of Hermitage Capital Management, a UK-based investment fund that became the largest foreign portfolio investor in Russia. In 2007, officers from Russia’s Interior Ministry raided the Hermitage Moscow office and its law firm Firestone Duncan, as part of a tax evasion investigation and, according to Hermitage, seized corporate records, using these sensitive documents to embezzle \$230 million. James Firestone, co-founder and partner of Firestone Duncan, was in the audience and recounted his experience, “A bunch of NVD officers raided my office and beat my lawyers, with express purposes of taking documents from one of my clients. When we exposed them they took my partner, beat him, and then denied him medical care, so he died.”

Firestone’s partner, Sergei Magnitsky was jailed in a pre-trial detention center for 11 months—a month shy of the maximum time one can be held in Russia without trial—and died of an easily treatable condition in November 2009. Magnitsky’s death attracted international attention. “But even after this, no one was really punished. A few people were fired, but there was no proper institution of a criminal case,” recounted Shleynov. Firestone, who had been working in Russia

since 1991, recently fled the country due to threats on his life.

Shleynov and his colleagues try to make a difference by reporting on the corruption, but unfortunately their reports go largely unnoticed. “One thing that certainly surprises me is that you’ve done these series of articles about the people around Putin, and all of the benefits that they have accrued because of their association with Putin, and you say that you are not afraid of writing about it. Why would you not be penalized if you embarrass them or raise questions about their business deals?” Garrels asked Shleynov, who responded that *Novaya Gazeta* is not a threat to the government. “The circulation is small, less than 500,000 issues in Russia, which is nothing compared to state-controlled television. It is nothing to be afraid of because the day after we publish an article criticizing the Kremlin or this or that practice, it will be entirely forgotten.”

Unless businesses join forces to contest corruption, the cycle will go on. Shleynov related that there have been some efforts for businessmen to unite. “I know that some associations are attempting to put up a fight against corruption. At least that is what we hear, but unfortunately even these meetings are closed to the press. Even if the right words are pronounced, words are not enough. State agencies, law enforcement, special services, federal services, are all very strong, and they are highly involved in business in Russia.”

Shleynov hopes that the corruption chain will weaken as the children of the current oligarchs inherit their businesses. “They are studying in Europe and the US; they have no obligations, no criminal activity in their past. They will inherit these businesses and will have more freedom to act. Maybe they will change Russian society.”

*Reported by: Masha Udensiva-Brenner*