

# PROBLEMS OF CORPORATE GOVERNANCE IN COMPANIES WITH STATE PARTICIPATION OF THE POWER GRID

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*The past few years saw major legislative action aimed at increasing the effectiveness of corporate governance, for example, implementation of the astreinte mechanism, piercing the corporate veil, adoption of the Code of Corporate Governance (as enacted by Letter of the Bank of Russia No. 06-52/2463 dated April 10, 2014), expanding grounds for challenging interested-party and major transactions, as well as introduction of new amendments to the Law on Joint-Stock Companies designed to prevent dilution of rights to dividends and shares in the company's authorized capital, namely Federal Law No. 55 on Introduction of Amendments to Articles 40 and 75 of the Federal Law on Joint-Stock Companies dated April 15, 2019. One way or another, the current state of the electrical power market shows that, although companies are attracting external investments, the state reserves the majority stake in the companies, controls and supervises strategically important businesses and industries. Some energy companies of the electric power industry have a special legal status established by laws and regulatory legal acts. The state reserves full and comprehensive control over the energy sector while maintaining a high level of state support in the form of budget investments, as well as stable functioning of the said companies. When "external" investors are involved and company shares are sold at the stock exchange, potential shareholders are concerned about protection of their corporate rights and transparent, independent and effective corporate governance. The article examines whether implementation of tasks formulated by the state by the power grid companies via a corporate mechanism of subsidiary management can be deemed a potential conflict of interest.*

**Keywords:** energy law, corporate governance in state-owned energy companies, liability of management body members.

**A**t the moment, corporate governance in the Russian Federation undergoes significant changes. Current economic processes and global economic environment makes it necessary to consider the scheme and structure of management in companies with state participation. The most important strategic

economy sectors must be controlled, their development must be stimulated in the interests of the state, because well-being, safety, and other aspects of life of the population depend on functioning of energy companies.

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Some energy companies of the electric power industry have a special legal status established by laws and regulatory legal acts.

For instance, System Operator of the Unified Energy System, JSC (hereinafter referred to as JSC SO UES) develops process flow charts and development programs for the Russian Unified Energy System and submits them to the Ministry of Energy of Russia, controls the health of electric power facilities, and monitors the health of energy facilities.

Rosseti, PJSC, is the principal business entity due to its dominant participation in authorized capitals of subsidiaries or under the corporate agreement entered into by and between them, or otherwise controls its subsidiaries.

Rosseti, PJSC, can also use corporate mechanisms to influence subsidiaries of said companies.

If we take a look at the electrical power market, we will see that the largest players on the energy generation market are companies controlled by the state: RusHydro, PJSC, (the Russian Federation owns 61.2% of its authorized capital), OGC-2, PJSC, (controlled by Gazprom Energoholding, LLC, which, in its turn, is a wholly owned subsidiary of Gazprom, PJSC), Mosenergo, PJSC, (controlled by Gazprom Energoholding, LLC similarly to OGC-2, PJSC), TGC-1, PJSC, (controlled by Gazprom Energoholding, LLC), Rosenergoatom, JSC (controlled by Rosatom State Nuclear Energy Corporation), etc.

Network activities are mostly performed by a state holding, Rosseti, PJSC, (the Federal Agency for State Property Management (hereinafter referred to as Rosimushchestvo) owns 88.04 % of the authorized capital of Rosseti, PJSC), which includes the IDGC, PJSC, Group, as well as FGC UES, PJSC. The major shareholder of Rosseti, PJSC, and Rosimushchestvo have entered into an agreement for management and voting with shares of FGC UES, PJSC. Under this agreement, the extent of Rosimushchestvo's control (direct and indirect) is 80.72%. [1] Thus, the state reserves full and comprehensive control over the energy sector while maintaining a high level of state support in the form of budget investments, as well as stable functioning of the said companies.

At the same time, although the state owns a significant share in this industry, private investments are needed for further development and improvement of performance of the country's power grid.

When "external" investors are involved and company shares are traded at a stock exchange, potential shareholders are concerned about protection of their corporate rights and transparent, independent and effective corporate governance.

The past few years saw major legislative actions aimed at increasing the effectiveness of corporate governance, for example, implementation of the *astreinte* mechanism, piercing the corporate veil, adoption of the Code of Corporate Governance (as enacted by Letter of the Bank of Russia No. 06-52/2463 dated April 10, 2014), expanding grounds for challenging interested-party and major transactions, as well as introduction of new amendments to the Law on Joint-Stock Companies designed to prevent dilution of rights to dividends and shares in the company's authorized capital, namely, Federal Law No. 55 on Introduction of Amendments to Articles 40 and 75 of the Federal Law on Joint-Stock Companies dated April 15, 2019.

Many problematic aspects of corporate governance in companies with state participation are targeted by scientific and research efforts, including international ones. [2] Legal studies are focused on topical issues of corporate governance in such companies. A recent monograph edited by V.V. Romanova titled *Topical Issues and Tasks of Corporate Law* [3] is of interest. It describes the current state and problems of legal regulation of corporate governance in state-owned companies in the Russian Federation and other countries, offers recommendations and suggestions on improvement of such regulation and also it is to necessary mention legal research of V.V. Romanova, dedicated to problems and tasks of legal regulation of corporate governance in companies with state participation in the sphere of energy. [4]

In this article, let us take a closer look at corporate disputes involving power grid companies.

Particular attention should be paid to a dispute (case No. A40-226105/2016 [5]) where minority shareholders of IDGC of Center, PJSC, (hereinafter also referred to as the Company) sought to recover damages from the board members of the Company and Rosseti, PJSC.

According to the case file, representatives of Prosvetaniye Holdings Limited, Lancranan Investments Limited, Genhold Limited, Jamica Limited, Prosperity Capital Management Sicav (hereinafter referred to as the plaintiffs), owners of 20.0957% of common voting shares of the authorized capital of IDGC of Center, PJSC, in total, filed a claim with the Commercial court of Moscow seeking to recover damages in the amount of RUB 872,265,526.78 jointly from the board members of IDGC of Center, PJSC, M.M. Saukh, O.V. Shatokhina, O.Yu. Isayev, and Rosseti, PJSC. This amount included RUB 808,058,534.88 of actual damages and RUB 64,206,991.90 of lost profit.

The plaintiffs provided the following grounds for their claim.

The issue of approving a service agreement for organization of functioning and development of the power grid between IDGC of Center, PJSC, and Rosseti, PJSC, as an interested-party transaction was brought up at the meeting of the board of directors of IDGC of Center, PJSC. The scope of the agreement included inspections of IDGC of Center, PJSC's readiness for autumn and winter operation, coordination of the investment policy, technical oversight of the distribution grid, arrangement and supervision of procurements, and other functions.

This was an interested-party transaction since Rosseti, PJSC, is the controlling entity in relation to IDGC of Center, PJSC, (Article 81 of the Law on Joint-Stock Companies), and, therefore, has to be approved as described in Article 83 Clause 3 of the Law on Joint-Stock Companies.

The plaintiffs believe that Rosseti, PJSC, pressured board members M.M. Saukh and O.V. Shatokhina, as well as the CEO, O.Yu. Isayev, to approve the transaction, because these people, while being members of the board of directors of IDGC of Center, PJSC, held key positions in the Rosseti, PJSC, management bodies, and the board members who voted in favor of O.Yu. Isayev being appointed at the CEO were nominated by IDGC Holding, OJSC (Rosseti, PJSC). Therefore, IDGC of Center, PJSC's willingness to enter into this agreement was created artificially, by using corporate mechanisms.

The plaintiffs believed there to be a conflict of interest, unreasonable and unscrupulous behavior on the part of the defendants.

Approval of an agreement disadvantageous for the Company became possible only when a new board of directors controlled by Rosseti, PJSC, was appointed.

As per Article 71, Clause 1, of the Law on Joint-Stock Companies, while exercising their rights and performing their obligations, the company's board members, sole executive body (CEO) are to act in the best interests of the company, exercise their rights and perform their obligations in regard to the company reasonably and in good faith.

To be able to claim damages, the person whose right was infringed must prove that all of the following occurred:

1. Violation of law provisions,
2. Occurrence and amount of losses,
3. A causal link between the losses and the defendant's behavior.

The plaintiffs believed Rosseti, PJSC, and the persons mentioned above to be in violation of provisions of Articles 71, 84 of the Law on Joint-Stock Companies, Articles 53, 53.1 of the Russian Civil Code, and the occurrence of losses to be proven by money being transferred to Rosseti, PJSC's account.

Commercial courts did not accept these arguments. [6]

The court rulings state that, according to Order of the Government of the Russian Federation No. 511-p on Approval of the Development Strategy of the Russian Power Grid dated April 3, 2013 [7] (hereinafter referred to as Order No. 511-p), Rosseti, PJSC, was responsible for "ensuring efficient and reliable functioning of the Russian distribution power grid facilities and sustainable development of the distribution power grid which are statutory objectives of the Company's activities, and implementation of the Power Grid Development Strategy as applied to the Company, including achievement of the power grid strategic priorities as applied to the Company are not possible without involvement of Rosseti, PJSC, the company responsible for strategic, coordination and control functions, as well as for solving institutional challenges facing the entire industry." [8]

The courts noted that "IDGC of Center, PJSC, as an integral part of the Russian power grid cannot function without receiving corresponding

services from Rosseti, PJSC.” The services rendered by IDGC of Center, PJSC, under the Agreement should help achieve IDGC of Center, PJSC’s corporate objectives, while the services necessary to ensure functioning and development of the distribution power grid can only be provided by Rosseti, PJSC.

At the same time, it should be noted that the plaintiffs’ arguments are not unreasonable. In this case, Rosseti, PJSC, became a “hostage” of its position as a company meeting the goals set forth by Order No. 511-p and exercising its authority to organize and manage activities of the power grid “subsidiaries”.

In accordance with Order No. 511-p, Rosseti, PJSC, is responsible for coordination, strategic, and control functions, which can only be implemented by using corporate mechanisms via subsidiaries.

This raises the first question: can implementation of these functions via the corporate mechanism of managing “subsidiaries” be deemed a potential conflict of interest?

For the purposes of this article, a conflict of interest means a situation when the company’s interests conflict with personal interests of a board member, the company’s collegial executive body or sole executive body. [9]

Rosseti, PJSC, can manage the power grid and control decision-making for the subsidiary using its controlling stake in the company’s authorized capital (for example, it holds 50.23% of the authorized capital of IDGC of Center, PJSC, 67.97% of the authorized capital of IDGC of Volga, PJSC, 57.84% of the authorized capital of IDGC of Siberia, PJSC).

According to the articles of association of Rosseti, PJSC, the main goals are profit-making and managing the power grid.

According to the then-effective articles of association of IDGC of Center, PJSC, approved by the resolution of the annual General Meeting of Shareholders of IDGC of Center, PJSC, dated 7/8/2015, the Company’s main goals are profit-making and ensuring effective and reliable functioning of the distribution grid facilities.

Thus, it can be said that IDGC of Center, PJSC’s mission is to serve the key national goal, which is to ensure reliable functioning of the power grid. Judges in the case described above came to the same conclusion stating that Rosseti, PJSC, accomplished the national, strategic goal to manage the power grid of the Russian Federation. Therefore, the interests of the parent company are consistent with those of its subsidiary and the state, thus eliminating the possibility of a conflict of interest.

However, since minority shareholders (mostly independent legal entities) also participate in the ownership of the Company, its mission and interests also include generating as much profit as possible on a regular basis. In my opinion, that’s where a conflict of interest may occur in theory, because the Company’s interests in profit-making inevitably conflict with its mission to serve national priorities.

Proceeding from the above, it must be stressed that such discrepancies may occur in the future since the “national” interest and the corporate goal to generate profit do not necessarily coincide. ■

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