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Ownership and corporate governance in Russian industry: a survey

Carsten Sprenger

Abstract

The protection of property rights is more and more recognised as a core issue for improvement of the investment climate in Russia. In many post-privatisation Russian enterprises, shareholder rights have been severely disregarded by self-dealing transactions of the management, share dilution, exclusion of outside shareholders from the Board of Directors and even from shareholder meetings. A more recent development is the abuse of the bankruptcy procedure for the arbitrary redistribution of property. This article reviews the results of the privatisation process and concentrates then on the current structure of ownership and control in the Russian industry and on corporate governance mechanisms in the enterprises. It reviews the legal foundations of corporate governance and gives a detailed view of the state and the institutions of law enforcement. Special attention is paid to the connection between corporate governance and restructuring of enterprises and improved performance.

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Address for correspondence: Carsten Sprenger, Ph.D candidate, Graduate Programme in Economics and Management of the Universitat Pompeu Fabra, Ramon Trias Fargas, 25-27, 08005 Barcelona, Spain. E-mail: carsten.sprenger@econ.upf.es

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1. INTRODUCTION

The recent long-term plan of the Russian government for economic development until the year 2010 and numerous press articles on the most urgent problems of the Russian economy have focused on protection of property rights as a core issue for improvement of the investment climate in Russia. Since privatisation, corporate governance mechanisms have evolved that can impede economic development in general and the restructuring of industrial enterprises in particular.

The present paper concentrates on the current structure of ownership and control in the Russian industry and corporate governance mechanisms in the enterprises. The mass privatisation programme of 1992-94 led to dominance of Russian firms by insiders. Most shares were given to workers and managers, and the managers usually took effective control. We shall review briefly the privatisation results, the distribution and concentration of ownership among different types of owners in Section 2.

In the following section, we look at the role of some groups of insider owners (managers and workers) and outsider owners (investment funds and banks) and the state. Managers are the most powerful group of corporate owners in Russia. This is due not only to their ownership stake (around 15 per cent) but also to weak legal enforcement, which allows managers to run firms as they wish without risk of sanction from law enforcers and other shareholders. Workers' participation in the decision-making at firm level turns out to be limited despite of their large shareholdings. There is a further dimension wherever management is linked to large stakeholders, as it is true in many of the large oil companies. In such cases the joint power of managers and the large stakeholder is often used to expropriate minority shareholders. These facts show that the huge problems of corporate governance are tied to the extent of insider ownership. Investment funds and banks – the most typical outside owners – turn out to play a negligible role in corporate control in Russia. This warping of corporate control, caused by the nature of the privatisation process and encouraged by the legal and political environment, now threatens to stabilise into a unique model of corporate governance.

In this paper, we shall consider how Russian mechanisms of corporate governance affect creditors, minority shareholders and strategic majority shareholders. We will look at the different forms of violation of shareholder rights (Section 4.1), review the legal foundations of corporate governance (Section 4.2) and give a more detailed view of the state and the institutions of law enforcement (Section 4.3). On the firm level, minority shareholders and creditors can take into consideration some indicators of good governance (Section 4.4) and try to place independent directors, improve financial disclosure and press for the commitment to corporate governance standards and its certification in the company charter (Section 4.5).

The huge problems in enforcing rights of shareholders and creditors could lead to a corporate governance model oriented towards strategic investors and financial-industrial groups and limiting the scope for dispersed ownership and related financing (see Sections 4.6 and 4.8). Problems with corporate governance in Russia are most frequent in larger firms, and the conflicts that arise are usually between minority shareholders and controlling shareholders. This indicates that, in sketching the corporate governance problem in Russia, we have to look beyond the classical questions of agency between shareholders and managers. Shareholders with a majority stake can control the firm's decisions via their majority at general meetings and via the persons they appoint as managers. The parties who are discriminated against are minority shareholders. Therefore, in reviewing legal and practical ways of influencing corporate policy, we pay particular attention to the situation of minority shareholders.

The picture would not be complete without some hints on social-cultural traditions that influence the behaviour of managers and workers and perceptions of the ongoing redistribution of ownership in Russia (Section 4.7).

Are insider ownership and corporate governance really a problem? McKinsey (1999) maintain that the ongoing state intervention via preferred treatment of large and unproductive enterprises in taxes, effective energy prices and red tape distorts the market forces and is mainly responsible for low productivity, growth and investment. The development of institutions and corporate governance are said to be of secondary importance. While neither this claim nor the opposite is proved, we can give some indications on the connection between ownership on the one hand and some enterprise performance measures and restructuring activities on the other hand (see Section 5). It seems that managers perceive the gains from restructuring as uncertain and therefore put quick personal gains before long-term restructuring. Research in this field does not provide clear-cut results on the interaction of different control forces that lead to better performance of management and the whole company: the internal control system and legal constraints (as we refer to corporate governance) on the one hand, or the degree of competition on the factor and product markets and the softness of the budget constraint on the other hand. However, bad corporate governance blocks badly needed access to external finance to undertake restructuring of the privatised enterprises. In larger Russian firms (with more than 200 employees), only 5 per cent of funds were raised from banks and 1 per cent from equity finance according to an EBRD/World Bank enterprise survey from 1999.

In the final Section 6 we conclude with some policy recommendations and comment on the parts about security of property rights and corporate governance in the new long-term plan of the Russian government for the economic development.

2. THE CURRENT DISTRIBUTION OF OWNERSHIP

2.1 THE PRIVATISATION RESULTS

The Russian mass privatisation programme (MPP) carried out between late 1992 and 1994 had two distinguishing features: the distribution of vouchers to the public, and the great preference given to company insiders, where the latter is by far the more important one. The firms could choose between several options of privatisation. In option 1, 25 per cent of non-voting shares were transferred for free and 10 per cent of voting shares were sold to the employees. It limited the insider influence and was more frequent among very large enterprises where insiders could not purchase controlling blocks of shares (Kouznetsov and Muravyov, 2000). In most of the cases, employees chose the second privatisation option, which gave them 51 per cent of the shares at highly preferential conditions.¹ Only 29 per cent of the capital of privatised companies was sold at auctions where shares could be paid with vouchers. Employees and managers could increase their combined shareholdings up to 65 per cent in 1994 (Blasi et al., 1997). Insiders, especially the managers, used their ample scope of discretion in this process: they mostly determined the book value of assets, and for the acquisition of vouchers and additional shares in auctions they frequently used funds from the enterprises or state organisations (Ustyuzhanina, 2000). At voucher and share auctions, illegal methods frequently were applied in order to exclude outside bidders. Nevertheless, investment funds could collect some of the vouchers and obtained 5.7 per cent of the shares of privatised enterprises (Frydman et al., 1996). During the following years, the shares that remained with the state were partly sold to outside blockholders or management-affiliated companies in auctions. Here, another effective authority of the company directors became important: they were practically assigned to put up the privatisation plan containing specific investment requirements with which only an affiliated company could comply.

Another privatisation method, apart from the MPP, was the lease-buyout. It accounted for 25 per cent of the completed privatisations between 1993 and 1995 (Earle and Estrin, 1997). The firm's assets were originally leased in 1990-92 and later acquired by the employees at book value. The resulting insider ownership from this privatisation method² was even higher than for the three MPP options.

The privatisation strategy reflected the increased power of enterprise directors/managers in the *perestroika* period when the branch ministries' control ceased. The great extent of employee majority ownership can be viewed as an instrument to shield enterprises from outside influence.

The available survey data on ownership in Russian enterprises widely correspond in its prevalence of insider ownership and the greatly diminished shareholding of the state (see Table 1). Note that outsiders might be affiliated individuals or enterprises (within financial-industrial groups, for example). The most recent survey undertaken by the Moscow Bureau of Economic Analysis refers only to privatised enterprises.

¹ Option 1 was chosen by 35/25% of the firms participating in the MPP. Option 2 was used by 60/73%. Numbers are from Earle and Estrin (1997) and Blasi et al. (1997), respectively. There was also a third option that proposed the sale of 20% of the enterprise to employees upon completion of a restructuring plan, but it was used only by a small number of firms.

² 90 per cent in the World Bank sample (Earle and Estrin 1997).

Table 1 Ownership structure in the Russian industry from different survey data

Unweighted, in per cent

Survey / Date Owner	Bureau of Economic Analysis (2000) ^a	Russian Economic Barometer ^b (1999)	Blasi ^c (1996)	Nottingham Sample ^d (1995/96)	World Bank Sample ^e (1994)
Insiders	62.3	46.2	58	59.6	66.1
Managers	17.7	14.7	18	14.0	19.6
Workers	34.5	31.5	40	45.6	46.2
State	5.7	7.1	9	9.3	15.0
Outsiders	32.0	42.4	32.1	31.3	18.9
Individuals	N.A.	18.5	6	6.5	5.9
Non-financial firms	N.A.	13.5	15.3	10.3	6.7
Banks	N.A.	1.0	1.6	1.5	1.0
Investment funds	N.A.	3.9	5	4.6	4.5
Foreigners	N.A.	2.0	1.6	1.0	0.4
Holdings/Investment companies	N.A.	3.5	2.6	5.4	0.0
Others	0.0	4.3	0.9	1.7	0.0
Sample size	364	139	357	314	235

Data sources: ^aKuznetsov et al. (2001), survey among privatised enterprises, ^bKapelyushnikov (2000), ^cBlasi et al. (1997), ^dFilatotchev et al. (1999), ^eEarle and Estrin (1997)

An EBRD/World Bank enterprise survey from 1999³ gives the opportunity for a comparison of ownership structures across transition countries (see Table 2), although the definition of the ownership categories is slightly different and less detailed. The category Individuals/Families could contain insiders or affiliated persons. Note that the question here is for the largest stakeholder in the company.

Table 2 Dominant owners of companies in selected transition countries

Unweighted, in per cent

No. of companies	Czech Republic	Hungary	Poland	Romania	Russia	Ukraine
<i>Insiders</i>	3	11	10	15	40	45
State	51	53	26	46	8	21
Outsiders	46	29	55	39	45	28
Individuals / Families	6	8	31	20	40	22
Institutional outsiders	40	21	24	20	5	6
Others / no answer	0	7	9	0	7	6
Number of enterprises	35	38	84	41	214	87

Source: EBRD/World Bank Business Environment Survey 1999. Only medium-sized and larger companies with more than 100 employees are included here.

³ Survey on Business Environment and Enterprise Performance carried out in 1999 by the EBRD in collaboration with the World Bank. It includes over 3,000 enterprises in central and eastern Europe and central Asia, among them over 500 in Russia.

The privatisation of the oil, utility and telecommunications sectors followed a different path than in the remaining industries. The individual production companies were partly included in voucher privatisation schemes. The government, still in possession of controlling stakes, bundled them into holding companies (Lukoil, Yukos, Sidanko, United Energy Systems, Svyasinvest and others) which were privatised in 1995-97.⁴ The concentrated control on the top of these pyramid structures was often used to dilute the minority stakes at the bottom (e.g. in the process of swap for shares of the new holding). It also gave opportunities to the new controlling shareholder to siphon off wealth from the companies (Black, Kraakman and Tarassova, 1999).

In the military-industrial complex, the state retained a great influence. In November 1998, state-run enterprises accounted for 41 per cent, joint-stock companies with state capital for 34 per cent and private companies devoid of state capital for 25 per cent of all enterprises in the sector.⁵

These developments are reflected in a somewhat different ownership structure in the 100 largest Russian enterprises. Calculating ownership stakes by categories is a difficult undertaking in Russia, because insider ownership is often hidden in offshore investment and holding companies where the actual holders of control are not identified. For example, the direct management share is in most cases under 1 per cent in 1999. However, we can be quite sure about the average ownership of the state and foreign investors in the largest Russian enterprises: 14 and 13 per cent, respectively.⁶ That means that the state retained larger ownership stakes in the large companies, especially in the natural resource industries. Also, foreign shareholdings tend to be greater in the bigger companies than on average. Investment and holding companies account for 16 per cent in our calculations. All small shareholders (under 5 per cent), including workers and outside individuals and presumably some institutional outsiders, account for 32 per cent indicating that worker ownership is smaller in large enterprises.

2.2 HOW DID OWNERSHIP CHANGE?

From comparisons between three surveys of the Russian Economic Barometer in 1995, 1997 and 1999 (Aukutsionek et al., 1998; Kapelyushnikov, 2000) one can conclude that shifts in the ownership distribution have led to a gain in the outsider's share, while workers and the state have lost (see Table 3). Only a part of the sample firms are the same in the three surveys, but an analysis of the overlapping part of the sample in Kapelyushnikov (2000) confirms these movements in share ownership.

⁴ Five of the largest oil companies, Norilsk Nickel and two metallurgy plants were sold as part of the loans-for-shares scheme. The shares were transferred to commercial banks (among them Oneksim, Menatep and SBS-Agro Bank) in 1995 as collateral for loans to the state budget. As the government defaulted on the loans, the same banks or their affiliates purchased the shares in 1996-97 in widely criticised, non-transparent and poorly contested auctions. Afterwards they could increase their shareholdings (see Russian Economic Trends 1998.4, p.44 and Johnson, 1997, p.352).

⁵ Source: Ministry of Economics, cited in Profile No. 42 (1999) and RIA Novosti Daily Review 19.11.99. The forecasted numbers for 2000 are 42, 42 and 16 per cent, meaning in fact a re-nationalisation of some private enterprises.

⁶ The 100 largest Russian enterprises by sales in 1999 were taken from the Expert Journal, ownership information was gathered from the Disclosure Database of the Federal Commission for the Securities Market (FCSM) and supplemented with the Brunswick Warburg Equity Guide 1999/2000 for 75 enterprises. The FCSM database reports only ownership stakes greater than 5%. Calculations by Maria Goltsman and the author.

Table 3 Ownership change in the Russian industry

Unweighted, in per cent

Date Owner	1995	1997	1999
Insiders	54.8	52.1	46.2
Managers	11.2	15.1	14.7
Workers	43.6	37.0	31.5
State	9.1	7.4	7.1
Outsiders	35.2	38.9	42.4
Individuals	10.9	13.9	18.5
Non-financial firms	15.0	14.6	13.5
Financial firms, holdings, foreign investors	9.3	10.3	10.4
Others	0.9	1.6	4.3
Sample size	136	135	156

Source: Russian Economic Barometer, in: Kapelyushnikov (2000).

Two interesting observations shall be added. First, the share of financial outsiders, primarily banks and investment funds, which the designers of the privatisation programme saw as the future “effective” owners, did not increase. Second, although the direct stake of managers did not rise, they could have protected their influence by affiliated persons, which count for the outside individual shareholders. (Note the significant increase in this category in 1999.)

2.3 CONCENTRATION OF OWNERSHIP

Dispersed ownership as the result of the Mass Privatisation Programme created a collective action problem for shareholders wishing to monitor a particular firm. Can we observe an increased concentration of ownership in the data?

In the 1999 survey of the Russian Economic Barometer (Kapelyushnikov, 2000) the single largest stake in a company amounted to 32 per cent, on average. This shows that the ownership structure in the Russian industry is quite concentrated. Outsider and state shares are much more concentrated in the hand of one large shareholder of these categories in comparison to insiders.⁷

Following the EBRD/World Bank Survey, only in 9 per cent of Russian non-agricultural firms with more than 100 employees is majority ownership held by one shareholder and in another 9 per cent by two or three owners. That means that, in most cases, there is not a single controlling shareholder, but more than three in 82 per cent of firms. In 12 per cent of the enterprises the major stakeholder had changed in the last three years.

There is still no clear-cut evidence for an increasingly concentrated ownership structure, which could be an indication for a control-oriented model of corporate governance, discussed in Section 3.8. But with the change in ownership also patterns of concentration and control are changing.

⁷ The average stake owned by the largest shareholder is 36.3% if it is an outsider, 42.5% for the state, but only 16.2% if it is an insider, mostly a manager.

3. THE OWNERS

In this section several groups of owners and their characteristics shall be considered.

3.1 MANAGERS

Managers are the most powerful group among corporate owners because of their share ownership and their opportunities for unmonitored actions.

There are indications for considerable managerial entrenchment in the figures on managerial turnover. According to the EBRD/World Bank Survey, the general manager had been replaced in 26 per cent of the larger non-agricultural firms during the foregoing three years. But only in 20 per cent of the cases was this because of unsatisfactory performance. These numbers are comparable to those found in Poland or Hungary. Filatotchev et al. (1999) found from their survey results that the replacement of the general director was associated with greater outsider ownership. Following a recent study of managerial turnover in Russia (Goltsman, 2000), changes in the management team are insensitive to previous performance (measured as labour productivity, profitability and sales growth). However, ownership form matters, and the shareholdings of outside owners and the state affect managerial turnover positively. Also, the smaller the average blockholder share, the higher is the probability of a management change. The explanation could be that small blockholders and shares in the hands of outsiders contribute to ownership change, which in turn leads to managerial turnover. In sum, the threat of dismissal is not widely used as a disciplining device for managers in Russian firms.

In 31 per cent of firms with managerial turnover in the previous three years in the EBRD/World Bank Survey, the general manager was hired by another company. This indicates that there exists something like a managerial labour market, but it seems not to be very institutionalised yet.

Filatotchev et al. (1999) examined other indicators for managerial entrenchment, too. They reported a clear hostility of managers to any increase in outside ownership. Forty per cent of managers questioned intended to buy additional shares from employees. The motive behind these share purchases is clearly control, not an asset motive; no significant impact of performance variables, such as pre-tax profits, rate of return on capital or export sales, could be found on the decision to purchase employee's shares.

The problem of management entrenchment is even greater than in Western countries since the old management often lacks the necessary skills to run and restructure privatised firms.

In an environment of weak legal enforcement, risks of increased managerial ownership lie in self-interested decisions. As long as managers hold less than 100 per cent of the company's shares and are monitored weakly, they prefer private benefits to dividend payments. One could argue that managers have a short time horizon, which leads to a preference for gains from self-dealing against a long-term restructuring of the firm. More convincing, they perceive the gains from restructuring as uncertain and therefore prefer immediate gains from side-deals. These private benefits are also a main obstacle for further redistribution of shares and a more efficient distribution of shares to active shareholders.

If the management is linked to large stakeholders, such as in the large oil companies, their joint power is often used to expropriate minority shareholders (see Section 4.1).

3.2 WORKERS

Jones (1998) finds the overall influence of non-managerial employees on decision-making low, independent from the form of ownership. In a survey of 111 firms in the St Petersburg area managers and union leaders were interviewed. Workers had more control over work-related issues than over strategic matters such as new technologies or sales and production plans, but there was no joint decision-making. Hence, even if workers hold the majority of a firm, they do not necessarily control it.

Sometimes shares were given into collective trusts controlled by the management. More frequently, managers control proxy votes of the workers at shareholder meetings. Also, forced non-participation of workers and non-confidential voting with an implicit threat of dismissal were reported (Blasi and Shleifer, 1996).

Often, the management established barriers to the selling of shares by (implicitly) threatening workers with dismissal, wage cuts or restrictions on the use of social facilities such as kindergartens, housing or medical care. Independent registers and anonymous share trading could avoid a situation whereby managers and workers collude to hinder outsiders in purchasing the company's shares.

Workers are almost never represented at the board (Blasi and Shleifer, 1996). Their influence in profit allocation is only minor (Earle et al., 1995; Blasi and Shleifer, 1996).

Nevertheless, workers seem to have an effective veto on issues they are directly affected by, such as mass redundancies (Vlachoutsicos, 1998). The main reason for workers to keep on holding their shares seems to be the wish to secure employment and non-monetary benefits in the form of free or subsidised use of social facilities owned by the enterprise.

Earle and Estrin (1996) suggest that employee ownership could be a suitable institutional framework for large declining or loss-making enterprises, especially if a whole region depends on them. It could reduce social costs that would be very high in the case of liquidation. Workers would accept lower wages in order to secure their jobs. A normative evaluation of employee ownership must also consider the restructuring challenges the company faces (downsizing, the introduction of new technology, etc.). Decision-making in worker-controlled firms can be very costly if the employees are heterogeneous in skills, interests and age. On the other hand, worker ownership may encourage group and self-monitoring where external monitoring would be difficult. Higher wages in employee-owned firms were not observed.

3.3 THE STATE

The federal government disposed of shares in 3,896 privatised firms⁸ and cooperatives (mid-1999). As the objectives of the state in the company management are not clearly established, the representatives of the federal government seem to be often influenced by the company management. For example, they did not hold up massive dilution of the shares of the federal government (Radygin and Entov, 1999). The state representatives, mostly appointed by a branch ministry or a local authority, often are non-professionals in the management of firms. The procedures for the work of individual authorised representatives or trusts (juridical persons) are only beginning to develop (Radygin and Entov, 1999). Perevalov et al. (2000) find that firms where the state has a stake between 5 and 51 per cent perform even worse than

⁸ According to the Government of the RF (1999), the federal government has ownership stakes in 3,316 joint-stock companies, of which 863 with a stake smaller than 25%, 1,601 from 25 to 50%, 470 between 50 and 100%, 382 with 100% federal ownership.

corporatised firms with 100 per cent state ownership, because in these cases no new shareholders can monitor the management properly.

Regional governments as shareholders are often linked to the management of the local enterprises and take a position between insider and outsider. Their main interest could be described as the provision of public goods (e.g. social security) (Fox and Heller, 1999).

Apart from direct shareholding, the federal government has a special right to participate in the management in 580 enterprises, a so-called golden share.

Furthermore, over 13,000 firms are 100 per cent state-owned and have the legal form of unitary enterprises. The management of these enterprises by state representatives is largely inefficient. There is no database on the assets, liabilities and the financial results.

3.4 INVESTMENT FUNDS

Investment funds came up as privatisation intermediaries during the MPP. Their mean stake is below 7 per cent and they own very few large stakes greater than 25 per cent (Frydman et al., 1996). Voucher investment funds are restricted by law to a maximum of a 25 per cent share of an enterprise, but they can circumvent it using their group structure⁹ or colluding among different funds (Akamatsu, 1995).

Apart from wealthy individuals, non-financial firms and foreigners, investment funds are one candidate to take over the role of active outside investors in Russia. Their main task would be to discipline the incumbent management or to replace it if restructuring performance is low. But the minor scope of their shareholdings has so far been limiting their ability to do so. Since most Russian joint-stock companies (the legal form of approximately 90 per cent of all enterprises) do not pay dividends, and the funds were unable to attract public savings after several scandals of fraud, they are restricted in their refinancing possibilities to amplify their holdings. Moreover, they are hardly able to provide financial resources to enterprises where they have invested.

3.5 BANKS

Until the loan-for-shares transactions, Russian banks had been playing only a limited role in medium- and long-term lending to enterprises. The high real interest rates on state treasury bills (GKO) had been crowding out investment in the corporate sector.

A Central Bank Regulation limits a bank's ownership of corporate shares depending on the extent of the bank's equity capital.¹⁰ More important are some remaining fundamental barriers for greater engagement of banks in the industrial sector: insiders' hostility towards outside investors, difficulties in accessing and evaluating financial statements of enterprises, and governance of the banks themselves.

During the crisis of 1998, banks were weakened in their ability to monitor enterprises. Many banks became insolvent and more than 200, especially small and medium-sized banks, lost their licences and went into bankruptcy proceedings. However, most of the large banks managed to influence the central bank not to withdraw their licences (which is the pre-condition for a court to declare bankruptcy; Schoors, 1999).

⁹ The group may include a holding, a fund management company, a broker and a bank.

¹⁰ The investment in shares of one company must not exceed 5% of the bank's equity capital; the sum of investments in shares above 5% in different companies must not exceed 25% of the bank's equity capital. However, this kind of regulation can be circumvented by establishing formally independent entities.

Since the crisis, bank restructuring is under way and, together with defaults on Eurobonds, has raised the issues of non-transparency of banks and poor regulation by the Central Bank of Russia. Numerous large banks transferred viable assets to so-called bridge banks leaving an empty shell to the creditors (Troika Dialog, 1999). Also, this behaviour gave these banks a strong initial position in the following debt restructuring negotiations (Schoors, 1999). The new Law on Insolvency of Credit Institutions still gives clear preference to the major bank's owners, not to creditors.

The role of outside blockholders was generally restricted because the management often-violated shareholder rights, as we shall discuss in the next section. Also foreign and domestic non-financial firms can act as major shareholders, the latter building up group structures (see Section 4.7).

4. CORPORATE GOVERNANCE

The term corporate governance is used here in a broad sense: "signifying the entire system of rewards, sanctions, co-ordination and conflict-resolution mechanisms used to order and arbitrate the economic interests of shareholders, lenders, managers and employees" (Goldberg and Desai, 1999, p.42).

4.1 METHODS OF VIOLATING SHAREHOLDER'S RIGHTS

A holder of a company share has asset rights, income rights (the payment of dividends) and control rights. In many post-privatisation Russian enterprises, these rights have been severely disregarded by self-dealing transactions of the management, share dilution, exclusion of outside shareholders from the Board of Directors and even from shareholder meetings. The most blatant forms of violating shareholder rights and corporate legislation, such as the manipulation of share registers and votes at shareholder meetings, were reported for the period 1993-96 (see Radygin, 1999) – a time when the basic regulations of corporate governance and capital markets were still lacking. It should be noted that these problems of corporate governance arise mostly in larger firms where ownership and control are separated.

The best-known violation techniques are as follows:

Asset stripping or transfer pricing. In the first case, company assets are transferred to management-owned holdings or affiliated firms. The value-stripped firm will go bankrupt if it is indebted. In transfer pricing, profits from sales are transferred to management-controlled trading companies applying low transfer prices for output products, or the company purchases input products from the trading company at artificially high prices. In many Russian enterprises the core company (the production facility) is surrounded by such (onshore or offshore) firms owned by the managers or their affiliates in order to skim off profits (Fox and Heller, 1999).

Share dilution. These cases occurred until recently, most visibly in some large oil companies such as Yukos, Sidanko and Sibneft. New shares on preferential conditions or convertible bonds were issued to managers, affiliated manager-controlled companies or employees in order to dilute outsiders' stakes, sometimes reducing those stakes below the blocking level of 25 per cent. In general, violation of minority shareholder rights prevailed in the natural resource sectors (oil, gas and metals). Share conversions during the formation of holding companies were frequently implemented on questionable terms.

Delayed dividend payments. Often, no dividends are paid and non-transparent investment programmes are proposed, instead. Already declared dividends are paid with large delays taking advantage of inflation and rouble devaluation (Troika Dialog, 2000).

Disinformation and outright deception. This category includes a whole range of stratagems by which minority investors are cut off from vital information. Troika Dialog (1999) gives an exhaustive list: "restricted access to shareholder meetings; barring outside investors from taking seats on the Board of Directors; failure to notify shareholders of important corporate events; voting irregularities; inadequate or misleading information in issue prospectuses; obstruction by registrars and depositories; violations of rules for conducting general meetings; adoption of inequitable charter provisions; failure to comply with laws regulating share issuance; violation of stipulated conditions on purchase of shares from a company; and untimely and incomplete information about company's operations and plans." (Troika Dialog, 1999, p.11).

Hostile bankruptcy: The very low bankruptcy threshold and other loopholes of the Bankruptcy Law (see Sections 4.2 and 4.3) are frequently used for the redistribution of

property. Unpaid energy bills or tax arrears as well as overdue debt can be used to initiate the bankruptcy procedure. A creditor together with a possibly bribed judge of the Arbitrazh Court and an external manager loyal to the creditor can easily remove the old management, find ways to omit other creditors from the registry and take over the assets of the company (Ustyuzhanina, 2000). Assets are usually sold to the creditors or to affiliated third persons. Even additional share issues by the external manager were used to accelerate the take-over and to water down shares of the old owners. The director of the Federal Service for Financial Recovery recently gave a probably very conservative estimate that 30 per cent of the 30,000 pending bankruptcy procedures are “commissioned” (“ordered”) in order to change ownership and not to re-establish financial solvency (Nesavisimaya Gaseta, 28 September 2001). It becomes reasonable when managers pay bribes to regional government in order to be protected from losing control over their enterprises. Also the withholding of information now appears in a different light.

4.2 LEGAL BASIS AND REGULATION

The legal environment for corporate governance in Russia is shaped mainly by three laws: the law ‘On Joint-Stock Companies’ (or Company Law, effective since 1 January 1996), the law ‘On the Securities Market’ (or Securities Market Law, effective since 25 April 1996), and, most recently, the law ‘On Protection of Investor Rights’ (or Investor Protection Law, effective since 11 March 1999).

The *Company Law* establishes a two-tier structure of corporate governance consisting of the management board and board of directors. However, the management board is not mandatory and can be replaced by a more informal body. The law provides, if honoured, a reasonable legal basis for effective corporate control (Sondhof, 1998).

The Company Law allows a minority at the board to block certain types of action that contradict their interests. Amendments to the corporate charter, authorised capital and major transactions ¹¹ need to be approved by a three-quarters majority. Transactions involving interested parties ¹² need to be approved by a majority of shareholders, who are not the interested party with respect to the particular transaction. The problem is that in a typical asset-stripping action, the value would be transferred to an affiliated entity circumventing the blocking option. It would be difficult to prove the affiliation to the interested party, especially if the affiliated entity is located abroad (Uvarov and Fenn, 1999). A bill on affiliated parties, which defines related entities and individuals and obliges enterprises to disclose information on them, has been debated in the Duma, the lower house of parliament, for several years without result. Amendments to the Company Law, enacted by the President on 7 August 2001, have brought some improvements in the protection of minority shareholders against capital dilution and have set a time limit for the payment of dividends, but have left out issues such as a tighter control of shareholders over the management, particular in respect of large transactions and transactions with interested parties.

¹¹ Major transactions are defined as transactions involving assets worth more than 25% of the book value of total assets or an issue of new shares exceeding 25% of existing shares. Transactions between 25% and 50% of book value can be approved by the board unanimously. A large degree of freedom in asset valuation under Russian accounting standards reduces the effectiveness of this rule (Troika Dialog, 1999).

¹² Interested parties are defined as shareholders owning 20% or more of the company's voting shares, as well as directors, other company officers and their affiliated parties.

The Company Law stipulates the voting procedures for general meetings, in particular cumulative voting for enterprises with more than 1,000 shareholders. This mechanism gives voting rights to each shareholder in the amount of his number of shares multiplied by the number of board members to be elected. Minority shareholders can concentrate their votes on one particular nominee to gain at least one board seat. But the decree was scarcely obeyed in 1994¹³ and since (Blasi and Shleifer, 1996; Troika Dialog, 1999).

The Company Law also requires an independent audit of financial statements. Furthermore, for companies with more than 50 shareholders, the share register has to be kept by an independent registrar.

The Company Law with its latest amendments, the Investor Protection Law and the Resolution on the Standards of Share Issues by the Federal Commission for the Securities Market,¹⁴ includes precautions against share dilution. Shares have to be issued at market value and private offerings require approval by a two-thirds majority of shareholders. Closed subscriptions have to be approved by shareholders. The same applies for open subscriptions if they exceed 25 per cent of outstanding shares; for smaller issues the board of directors can decide with unanimity. The Company Law now gives pre-emptive rights to all shareholders to buy into any new share issues.

The time limit for paying out announced dividends is two months, although the company charter or even the board of directors can define another payment schedule. However, there remains large scope of discretion for the firms in the way they calculate net profits and thus dividends.

The *Securities Market Law* is intended to make the exit option easier for shareholders. It sets out rules for traders, custodians and share registrars. However, the independence of many share registrars still is problematic: several registrars have been involved in share dilution or have refused to register legal share transactions (Troika Dialog, 1999).

The laws mentioned and rules imposed by the Federal Commission for the Securities Market (FCSM) require disclosure to the FCSM of information concerning the financial position of the firms (a quarterly report including the balance sheet and profit and loss account), and important corporate events (e.g. changes in the management, in the amount of equity capital, the list of shareholders and shares in other companies).

However, Russian corporate law is still no match for insider control over financial flows, and cannot deal adequately with transfer prices and asset stripping. A legal remedy could be the inclusion in the civil and criminal codes of sanctions against abusive self-serving by managers. This would also require a more detailed prescription for the personal liability of the management in the Company Law (OECD, 2000).

The main procedure, by which creditors can defend their legal rights, is bankruptcy. Until the adoption of a new law “On Bankruptcy” (Bankruptcy Law, effective since March 1998),¹⁵ extremely few enterprises had been declared bankrupt despite the widespread non-payment problems. The new law goes to the other extreme, making it very easy for any kind of creditor to initiate bankruptcy proceedings – a relatively small debt of 500 monthly minimum wages, overdue for more than three months, is sufficient grounds for bankruptcy proceedings. After a temporary manager has collected information on the claims of creditors at a creditors’

¹³ When regulation was by a presidential decree.

¹⁴ On the FCSM, see below.

¹⁵ The first bankruptcy law dated from 1992.

meeting, an arbitration court judge appoints an external manager or decides to liquidate the firm. The duties of the external manager are not determined precisely and the company assets do not necessarily have to be sold at competitive auctions (Ustyuzhanina, 2000). It is unclear whether the competence of the external manager extends to additional share issues. A licensing procedure for external managers is practically absent; often public servants of the Federal Service for Financial Recovery are appointed who do not bear any personal liability. Recent amendments propose a period of 20 days after the collection of claims to clear the debt and thus avoid bankruptcy. But also an increased role of the Federal Service for Financial Recovery is planned which does not look like an improvement.

A special category of enterprises are so-called unitary firms. These are enterprises that are 100 per cent owned by federal or municipal governments, having avoided privatisation due to low liquidity of their assets or because they are part of the military-industrial complex or fulfil social functions. The only legal basis for their administration is some very general paragraphs in the Civil Code.¹⁶ There is no clear procedure for the appointment of managers or directors; they have nearly unlimited authority for use of property and unchallenged control over financial flows,¹⁷ no personal liability for the outcome of their work (Government of the RF, 1999). Needless to say, that such a loose legal environment invites self-interested dealings by management and withholding of information on the operations of the enterprise. One step beyond unitary firms, institutions with responsibility for non-commercial functions of the state are also frequently used for illicit commercial purposes.

4.3 LAW ENFORCEMENT

Mechanisms for enforcement of the above-mentioned laws are of particular importance for minority shareholders, and the fact that shareholders rights violations are still rife proves that enforcement is inadequate. Under these conditions capital markets, a sound banking system, a labour market for managers, and corporate, bankruptcy and antitrust laws cannot develop or cannot perform the disciplining function that they should perform.

Apart from closing the mentioned legal loopholes, the crucial condition for making these institutions work is the enforcement of existing laws. While poor law enforcement in Russia is often criticised, this chapter will try to give a more detailed view of the operation of corporate and bankruptcy law by looking at the work of the arbitration courts and the FCSM as the main market regulator.

Shareholders can attempt to defend their rights in arbitration courts.¹⁸ According to the provision of the Law on Joint-Stock Companies, shareholders can file lawsuits in the following circumstances:¹⁹

1. to appeal against decisions of a general meeting or other executive bodies of a company
2. to oblige a joint-stock company to repurchase its shares from a shareholder if that shareholder did not vote for a reorganisation, major transaction or amendments to the company charter that limit the rights of shareholders

¹⁶ A promised law on state and municipal unitary enterprises is still lacking and will be superfluous if these enterprises are converted to the legal status of joint-stock-companies with the state as sole owner.

¹⁷ For instance, no regular audit is conducted.

¹⁸ There is a problem of dual legislation: If the claimant is an individual (not a legal entity), the case will be heard by a primary-jurisdiction court (not an arbitration court). This leads to conflicts of competence (Kozyr, 2000).

¹⁹ For some categories a minimum share is necessary.

3. to demand repayment for damage to the company caused by executive officers or a controlling company
4. to demand dividend payments from a joint-stock company once the decision to pay has been made at the general meeting
5. to demand invalidation of major transactions, which were made in violation of required procedures
6. to demand invalidation of transactions with interested parties
7. in case the right of shareholders to information was infringed (Kozyr, 2000).

The main problems are limited experience in interpretation of the law and a lack of guidelines from higher judicial authorities, which could reduce incoherent decisions by lower courts and resist corruption or pressure by local and regional authorities (OECD, 2000). Applications to courts for resale of shares to the company or for recovery of losses (Nos. 2 and 3 in the above list) are virtually unknown, partly due to the passivity of shareholders (Kozyr, 2000), and partly due to the difficulty of proving illegal behaviour of managers and of differentiating reasonable actions from extremely risky or illegal actions.

Moreover, some rulings by courts have to be seen as defeats for shareholder rights. For instance, appeals against decisions of a general meeting, where legal procedures were infringed, were sometimes upheld by courts if the shareholders in question would not have changed the result of the voting and did not suffer losses. This could turn procedures for calling and conducting a general meeting into merely optional ones (Kozyr, 2000).

Enforcement is made harder by a number of practical problems: documentary evidence for a lawsuit is difficult to obtain, the right of a shareholder to sell his/her shares to the company (No.2 in the above list) needs an independent appraisal mechanism ensuring a fair buy-back price, which is not yet available (OECD, 2000), and courts often lack the necessary resources to implement their rulings (Filatotchev et al., 1999).

The Federal Securities Commission (FCSM) is the main regulatory body in this field. It has considerable regulatory power, but few of its own legal and administrative enforcement tools. The main job of the FCSM is to set standards and assign licences for the operation of professional market participants and for share issues.

The FCSM can deny registration of share issues and convertible securities if prospectus information is incomplete or inaccurate. In addition, the Commission has to register a report by the company on the results of the issue, and this has become an effective tool for avoiding share dilutions (Radygin/Entov, 1999). If violations are discovered after registration of the report, only a court can declare the issue invalid.

The Investor Protection Law has improved the regulatory environment in different ways. Most importantly, it has given the FCSM the power to levy fines and sanctions for non-compliance with laws, such as failure of companies to provide required financial information (Troika Dialog, 1999). Nevertheless, requirements to provide full and accurate information are still poorly enforced (Radygin/Entov, 1999). The FCSM also received the right to file collective claims when rights of individual shareholders or of the state were violated.

Apart from the law enforcement by the state, self-commitment by enterprises and self-regulating bodies also can promote better corporate governance. The FCSM is drafting a Model Corporate Governance Charter to be completed in 2001. It will not be legally binding but companies that want to raise external capital will have an incentive to adopt its recommendations in order to convince the market of their good corporate governance

practices (Troika Dialog Market Weekly, 3 May 2000). A further positive development is the foundation in October 1999 of the Coordination Center for Protection of the Rights and Legal Interests of Investors. The main goals of this organisation, which was created by investors themselves, are to prevent violations of investor rights, to coordinate protective actions, to increase the transparency of the market and to make proposals for improvement of corporate legislation (Vasiliev, 2000).

As mentioned above, the Bankruptcy Law gives great discretionary power to arbitration court judges and sets a very low bankruptcy threshold. What was meant to take into account the variety of causes for insolvency has been turned into a source of widespread corruption. The law has given insiders or competitors the ability to initiate bankruptcy proceedings against viable companies in order to grab viable assets through receivership (Troika Dialog, 2000), and has made the whole bankruptcy procedure vulnerable to political capture by regional governments (Lambert-Mogiliansky et al., 2000).

4.4 INDICATORS FOR GOOD GOVERNANCE

There have been some positive examples where companies have made an effort to honour shareholder rights, probably driven by the need to access external finance. Companies have established investor relations departments or introduced corporate governance charters. Willer (1997) investigated firms' inclination to honour shareholder rights. Apart from the analysis of the legal framework, one can find indicators for the actual behaviour of management towards outside shareholders. Important criteria include use of independent and licensed shareholder registries, providing financial information to international accounting standards, and issuance of American Depository Receipts, traded at the New York Stock Exchange, or of related instruments. Empirical analysis shows that these control-related indicators tend to be matched by a greater commitment to shareholder rights. However, dividend payments (which affect the income rights of shareholders) are not an indicator for good governance according to Willer's study.

High potential returns from investment projects that have to be financed externally can force respect for shareholder rights by outweighing reduced disposal over the enterprise's assets and private benefits. However, it is difficult to measure the investment needs, which tip the scale (Willer 1997 uses industry dummies).

4.5 FORMAL AND INFORMAL MECHANISMS TO EXERCISE VOICE

Because capital markets in Russia are too tight, outside owners can get locked into their shareholdings. This, in turn, could raise their incentives to actively monitor managers (Earle and Estrin, 1997). How can outside owners take an active role in corporate governance and push the management towards honouring shareholder rights?

Wright et al. (1998) find that outside equity investors have a generally restricted role in formal board participation unless they obtain controlling or blocking equity stakes or seek both formal and informal mechanisms for dealing with incumbent management. The installation of an independent director is an important instrument to get access to information on the financial situation of the firm and influence on strategic decisions. Traditionally, and by virtue of the Company Law, the general director (the chief executive officer, sometimes also called the president) has extensive power at his disposal. In most enterprises, the board of directors has the right to appoint the General Director and, thus, can influence in some degree the company's day-to-day management (Uvarov and Fenn, 1999).

Outside investors generally face problems in influencing the management. If fundamental restructuring would affect the management personnel, representation on the board will often

not be sufficient to force its implementation. In some successful cases, former directors with specific technical knowledge were offered some form of consultancy contract. But managers have frequently asked the local, regional or even federal governments to intervene if outsiders challenged their position. The potential for progress is further undermined by the fact that some outsiders are loyal to the management and show a low level of shareholder activism.

Apart from legal obstacles to acquiring larger stakes, banks and investment funds face problems with getting access to share registers and assessing the enterprise's assets and liabilities on the basis of the available financial information (Wright et al., 1998). Russian Accounting Standards (RAS) became more consistent recently, but are difficult to apply in practice, and leave leeway for manipulation of financial statements, especially in the case of large and highly integrated companies. Financial statements are primarily geared to the information needs of tax and regulatory authorities, which makes them less useful for shareholders (Troika Dialog Market Weekly, 29 May 2000). The popularity of barter trading makes the problems worse.

Debt providers can use debt covenants, such as

- standard ratios
- restrictions on additional borrowing
- restrictions on significant acquisitions and investment expenditures
- requirements for the provision of information.

If the borrower defaults on the covenants, the bank can demand immediate repayment. But even then, the enforcement problem remains since bankruptcy legislation is still not properly enforced. Moreover, weak asset markets mean that the liquidation value of a company may be lower than the net present value of future revenues. Therefore, banks may prefer continuation of the business and obtaining of equity holdings. But they would then have to force the incumbents, mainly employees, to sell their shares, which may be difficult. Banks try to circumvent these enforcement problems by establishing close relationships with the management of a borrower enterprise.²⁰ By doing this, they can ensure information flows, commitment between parties and cooperation in resolving debt problems. These informal business networks sometimes crystallise in the organisational form of a financial-industrial group.

4.6 THE ROLE OF FINANCIAL-INDUSTRIAL GROUPS (FIGS)

Financial-industrial groups consist of a bank (or several banks) and a number of industrial enterprises. FIGs are often based on equity ownership, sometimes on cross-ownership and sometimes on mere personal ties (e.g. the same person may be board member of different companies of the FIG). Johnson (1997) distinguishes industry-led and bank-led FIGs. The former were established along traditional production chains with the inclusion of weak "pocket" banks. The bank-led FIGs built up their industrial holdings in the loans-for-shares transactions (see footnote 4) and later privatisation auctions. Far from all FIGs are registered in accordance with the Federal Law on FIGs from 1995. By October 1999, 87 FIGs were officially registered. In 1998 such FIGs accounted for 4.4 per cent of the gross domestic product and about 10 per cent of industrial production. They unite over 2,000 legal entities – production, scientific, financial and trade companies, employing over 4 million people. Of the registered FIGs, 60 per cent are regional, 25 per cent are inter-regional, 9 per cent carry out

²⁰ For instance, the bank can nominate the chief accountant of the enterprise.

their activities in other CIS states and 6 per cent are transitional (Ekonomika i zhisn, No. 48/1999, cited in RIA Novosti Daily Review, 2 December 1999).

FIGs are often compared to the Japanese system of corporate governance after the Second World War (*keiretsu*). The bank in the centre of the group structure has strong but not exclusive borrowing links. The bank has also a powerful position as an active monitor of management via the board of directors, informal meetings and by control over the firm's access to external funds (Dittus and Prowse, 1996).

Although the establishment of the industry-led FIGs was promoted by the state, which promised a wide range of concessions, it was the bank-led FIGs that accumulated the necessary political power to lobby successfully for special advantages (loans-for-shares, discrimination of foreign banks in the GKO market and in privatisation auctions).

The potential for improved corporate governance stems from better information of the affiliated banks about the financial situation of the group firms and better contract enforcement, especially in the more hierarchically organised FIGs. If outside investors secure the jobs of cooperative managers, mutual trust between both groups can develop (Filatotchev et al., 1999).

Perotti and Gelfer (1998) compare a sample of group-affiliated firms and a control set of firms with dispersed ownership or management/employee control, with regard to investment financing. In the independent firms, internal cash flows have an impact on investment; i.e. they are financially constrained. No such correlation can be found for FIG firms, which indicates financial reallocation within groups. In the sub-sample of bank-led groups there is a significant, negative correlation between internal cash flows and investment. This evidence of a more extensive financial reallocation inside FIGs might suggest that groups rely on internal capital markets for investment financing, or that they simply strip assets from more profitable member firms. While the latter hypothesis cannot be ruled out, the authors of this study find some indications of better capital allocation within bank-led groups (as the market-to-book-value of these firms tends to be higher). This may be due to the monitoring ability of FIG banks in bank-led groups.

According to Volchkova (2000), the theoretical setting in which Perotti and Gelfer conducted their study – the Q model of James Tobin – has some problems while applied to transition countries because the assumption of efficient stock markets is not realistic. Therefore, the market value of firms does not reflect the present value of returns from their investment projects. The theoretical alternative suggested is the accelerator model of investment. Using a different datasheet for estimation and assuming a negligible role of external finance, Volchkova comes to the opposite conclusion that fixed investment in unofficial, i.e. bank-led, groups are even more dependent on internal cash flow of the firm. If we consider two firms of similar size and investment opportunities (approximated by the changes in sales), of which one is independent and the other a group firm, the latter firm would invest a greater share of its cash flow. The interpretation of this result, however, is similar to that of Perotti and Gelfer: banks in unregistered FIGs can monitor the management of the affiliated firms more effectively. Reduced managerial discretion over retained earnings means that more of them are used for new investment projects.

However, the period 1997-98, during which FIGs consolidated their formative acquisitions, was too short to properly assess the ability of FIGs for effective restructuring. Many banks at the centre of FIGs were severely damaged by the 1998 financial crisis. Those with a high GKO share in their assets were particularly hard-hit. This led to major changes in the shape of the largest Russian FIGs, which are still in progress.

The overall conclusion, though, must be that FIGs are not the solution of the corporate governance problem, but a part of that problem. They do not mitigate problems for minority shareholders. Their huge political influence, resulting from their media outlets, political campaign finance and their own representatives in government, “underscores a worrisome concern that constraints are fixed for minority investors and movable for well-connected majority ones” (Troika Dialog, 1999, p.27).

4.7 SOCIAL-CULTURAL BACKGROUND

The development of institutions is path-dependent. For the Russian context we have to refer to some cultural, social and economic traditions that favour communitarian values and informal networks. Also FIGS are most probably based in these traditions. In addition to the legal instruments, reputational mechanisms, often called the social capital of a society, provide for contract enforcement and the prevention of short-sighted self-dealing of enterprise insiders. In the end, the evolution of good corporate governance practices must include some cultural change.

Following Vlachoutsicos (1998), we can observe an astonishing continuity in communitarian values (such as equivalence and entitlement) and a decision-making process which consists of strong centralism (one-man-leadership, paternalistic relations towards subordinates) and collective participation (based on consensus, not majority). These values can be traced back to the medieval village commune (*mir, obshchina* – see also Ehlers, 1997), and survived in the USSR in the form of socialist worker councils, collective farms (*kolchozy*) and the Communist Party’s democratic centralism. Today these values live on in privatised enterprises, where the management is resistant to job cuts. Exclusion of outsiders and retention of information are common features in all these organisational structures.

Persistent shortage was among the key factors leading to the distinctive features of communitarian values: under the old system, informal networks were widely used to obtain goods and services in a form of non-monetary exchange known as *blat* (Ledeneva, 1998), which roughly translates as “pull” or “influence”.

The process of redistribution of state property, beginning in 1988 with the first profit-making cooperatives within existing socialist firms, has led to an extreme inequality in the distribution of wealth, along with rising poverty rates and overall decline of incomes. These developments are in direct contradiction with communitarian values such as egalitarianism and collectivism, and it is easy to understand why the existing distribution of property rights is perceived as illegitimate by a vast majority of Russians.

4.8 CORPORATE GOVERNANCE MODEL FOR RUSSIA?

Berglöf (1995) distinguishes two different models of corporate governance and finance. The first, the Anglo-American model of mostly dispersed ownership, is based on liquidity and transparency of the stock market. In the case of equity finance, arm’s-length finance relies on the take-over threat exerted by the market for corporate control. For debt finance, the basic institutions are collateral and a sound bankruptcy procedure. In the second, the European model, external finance has to be combined with monitoring and control exerted by the creditor or shareholder over the investment decisions.

Looking at the present economic system in Russia (and most of the transition countries), we can quickly exclude the first model. Several factors render it inapplicable: the illiquidity of asset markets, the ambiguity of property rights and the prohibitions against transfers of certain assets such as land, and the inefficient and discretionary enforcement of bankruptcy law.

Thus, the equity and bond markets will not play an important role for resource allocation and financing of enterprises in the near future.

However, the main components of the European model of corporate governance – strong banks as shareholders and strategic investors as providers of outside finance – are available in Russia (Radygin and Entov, 1999). The scene is instead dominated by the initial outcome of privatisation – widespread insider ownership and group structures.

But still, monitoring and control are important features of Russian corporate governance. The importance of control rights is also revealed by large price premiums of ordinary shares over preferred shares (Willer, 1997). This gives scope for strategic majority owners. They are much less dependent on court solutions and legal enforcement than minority shareholders. Hence, the weakness of law enforcement could favour the concentration of ownership.

5. OWNERSHIP, RESTRUCTURING AND COMPANY PERFORMANCE

5.1 EMPIRICAL EVIDENCE ON THE IMPACT OF OWNERSHIP ON RESTRUCTURING AND PERFORMANCE

As we have shown in Section 3, different types of owners vary in their objective functions and their ability to control the management. We could expect that outsider-owned firms have better access to external finance (e.g. for restructuring) than have manager- or worker-owned firms. Foreign owners also could provide Russian enterprises with management know-how. Whether this leads to better performance of these enterprises is first of all an empirical question, but results on the impact of ownership on restructuring and efficiency are not always clear cut. Analysis faces problems of finding suitable indicators of performance and coping with a selection bias in the privatisation process.

Defining efficiency in an environment of tax evasion, barter and the shadow economy turns out to be difficult. In most of the studies, labour productivity is chosen as the less-distorted indicator of performance. However, it measures technical efficiency only. Opportunistic behaviour of managers should affect only financial results and share prices, but not technical efficiency. Alternatively, measuring performance in terms of profitability, revenue growth or Tobin's Q (as approximated by market-to-book value of equity; Perotti and Gelfer, 1998), is difficult because of the lack of a liquid stock market and reliable financial data. There is not one standardised accounting system. Tax evasion, arbitrary pricing for barter operations and inflation make the numbers highly inconsistent across time and different enterprises. Alternatively, one could also take restructuring actions into consideration. But here, restructuring does not necessarily mean good or successful restructuring.

Earle and Estrin (1997) and Earle (1998) investigated the influence of ownership structure on performance right after the Mass Privatisation Programme. For measuring performance they used labour productivity and indices of restructuring actions undertaken. They found manager ownership and ownership of investment funds to have a positive impact on performance. Possibly, this result could be biased by a simultaneous influence of performance on the inclusion of a particular company into the privatisation programme and the resulting private share. The authors accounted for this selection bias using instrumental variables and found the previous results confirmed. In addition, concentrated institutional outsider ownership turned out to have a positive impact on performance. This suggests that these outsiders, like banks and non-financial firms, have relatively fewer shares in companies with better opportunities for restructuring and productivity improvements. One could argue that the data of these studies were collected too early to reflect the effects of new ownership forms on performance. Nonetheless, Kapelyushnikov (2000), working with recent data, also finds managers and, to a minor degree, financial outsiders as dominant shareholders more effective than others in different dimensions: order-book level, capacity and labour utilisation rates or percentage of enterprises in bad financial condition. But for other indicators there are no significant differences to worker-owned firms (e.g. capacity and employment reduction, share of barter in sales).

Perevalov et al. (2000) examined a sample of 198 industrial firms in the Sverdlovsk region. They find no clear performance improvements from the mere fact of privatisation. This may be partly due to a negative selection bias, with worse-performing firms more likely to be privatised. However, there is some significant variation in performance for different options of privatisation (see footnote 1): option 1 on the one hand and option 2 and lease-buyout on

the other hand.²¹ The latter ones are associated with a higher ownership share of managers and lead to better performance indicators.

Kouznetsov and Mouravyov (2000) study the ownership-performance link in 103 of the biggest Russian enterprises that are traded at the stock exchange (for their different ownership structure see Section 1.1). There are no consistent effects of the categories of owners on performance (measured as labour productivity, profitability and market-to-book-value of equity). What matters is the concentration of ownership in the hand of private owners. Enterprises with a share of the three largest private blockholders between 26 per cent and 43 per cent perform best.²²

Lambert-Mogiliansky et al. (2000) shows theoretically that only a bankruptcy procedure with an independent judge leads to restructuring of the firm and a more efficient use of assets. Regional alliances of company insiders and regional governments influencing arbitration court decisions leave outside creditors and even federal tax collectors unpaid; i.e. the bankruptcy procedure is no credible threat for an inefficient management. The empirical analysis reveals that it is not the worse-performing firms that are put under external management, and that previous successful restructuring efforts do not significantly affect the probability of a firm to come under external management.²³ Although the analysis does not capture the performance after the introduction of external management, it becomes clear that it provides little incentives for active restructuring.

5.2 HOW TO PROMOTE ENTERPRISE RESTRUCTURING

One recent proposal aims at the transformation of ownership of insider-dominated firms with high amounts of tax arrears (Desai and Goldberg, 2000). The tax arrears should be converted into equity and this equity will be resold immediately through competitive auctions. Regional governments should make a credible commitment to resell the converted shares and not to intervene in the firm's decisions, so that enterprises would be protected from the expropriation of restructuring gains. However, most of the tax arrears are with the federal government, which would touch the often-difficult fiscal relationships. The proposed mechanism would create a purchase opportunity to strategic investors and circumvent a lengthy bankruptcy procedure, which would have to rely on the court system and entail collective decision problems between creditors.

Ownership and management change and improved corporate governance are surely not the only measures enhancing enterprise restructuring. Introducing competition by regulation and improvements in the investment climate to support the entry and growth of new private enterprises will be just as important. Earle and Brown (2000) found clear empirical evidence for the disciplining force of competition on enterprises in Russia. Especially, regional competition in the product markets, but also import competition and local labour market competition, have a strong positive impact on the growth of total factor productivity. This last point indicates that reducing barriers to labour mobility would be beneficial for restructuring. Other measures include reforms of the social safety net to make social security more independent from employment in one particular company, reducing in-kind payments, offsets

²¹ See Section 1.1 and footnote 1 for the privatisation options.

²² The authors get this result taking into account the selection bias and using instrumental variables technique.

²³ Nevertheless, successful restructuring decreases the probability of a firm to be liquidated. Firms in liquidation are significantly smaller and in worse financial situation, and can thus provide less private benefits for the management and regional politicians.

and arrears to the tax authorities and utility companies in order to harden the budget constraint of firms.²⁴

We do not have clear cut empirical results on the interaction of different control forces that lead to better performance of management and the whole company: the internal control system and legal constraints (as we refer to as corporate governance) or the degree of competition on the factor and product markets and the softness of the budget constraint.

²⁴ See the EBRD *Transition Report* 1999, Chapter 9 (EBRD 1999a), for more details on these policy guidelines.

6. POLICY CONCLUSIONS

In the Russian policy debate on the privatisation and ownership change, the need for efficient owners is often stressed. After three waves of redistribution of property, as Ustyuzhanina (2000) has put it – privatisation, expropriation of minority shareholders and hostile bankruptcies – policy should be focused on the security of property rights and favourable conditions for investment instead of new, arbitrary redistributions of property or even re-nationalisation. The new strategy for the long-term development of the Russian Federation, indeed, focuses in its sections on the protection of property rights on a well-defined legal field for property redistributions and for the current owners. This strategy was adopted by the Russian Government, but it is still unclear if it will be realised in its rather detailed proposals and with its interdependencies between the parts for microeconomic, macroeconomic and social policy.

The strategy proposes changes in the corporate law that should:

- broaden the fields of monitoring over management actions by the Board of Directors and small shareholders;
- define exactly the concepts of affiliated persons, major transactions and *bona fide* purchasers (a person who often has taken part in illegal transfers of property);
- broaden the demands for information disclosure and the content of this information;
- harden the principles of personal liability of managers and large shareholders for damage to the company or particular shareholders.

It also proposes that:

- all shareholders should have equal rights in reorganisations of the firm, such as split-ups and spin-offs;
- a shareholder meeting must approve closed subscriptions;
- payment for shares by specific assets should be forbidden.

Contradictions between the Law on Joint Stock Companies and the Labour Codex (e.g. concerning the dismissal of a general director) should be eliminated. Also, the need of laws for real estate property and the protection of intellectual property are addressed. Share registrars should be independent of emitting companies and large shareholders.

All these proposals offer some improvements for the protection of shareholder rights we mentioned earlier. As for the improvement of the bankruptcy procedure, however, it seems to be difficult to find a balance between the rights of creditors, on the one hand, and the protection of the company from simplified procedures for hostile take-overs of control. Personal liability of temporary managers, the improvement of their professional qualifications and removing limitations for settlements out of the court are good, but not enough for making bankruptcy a device of market exit of non-viable firms. We face not only a legal problem here, but the efficiency of the bankruptcy procedure is connected with the widespread non-payments, the share of loss-making but socially important firms, problems in valuating assets properly, and extensive corruption in receivership.

Concerning the remaining state enterprises, it is envisaged to incorporate quickly all unitary firms into joint-stock companies with 100 per cent state ownership. Only then, after strengthening the control over these enterprises, should privatisation be envisaged. The state representatives in joint-stock companies, mostly appointed by a branch ministry or a local authority, often lack professional skills for the management of firms. The procedures for the

work of individual authorised representatives or trusts (juridical persons) have to be developed (Radygin and Entov, 1999).

There are good signs for the further development of corporate legislation, such as the above-mentioned Government Programme and the creation of a Duma Commission for Investor Rights Protection.

To improve law enforcement, a great institution-building effort for the courts will be necessary, especially Arbitrazh Courts, including more and higher-paid judges and full publicity of decisions and written opinions (OECD, 2000). The government strategy also proposes the creation of private arbitration institutions for corporate conflicts similar to the *treteyskiye sudy* for the enforcement of trade contracts. Precise procedures for the enforcement of their rulings have to be established. The institution of collective claims would be helpful in protecting shareholder/investor rights.

In the end, it will be the urgent need for external finance that will change the behaviour of managers and even ownership structures. In larger Russian firms (with more than 200 employees), only 5 per cent of funds were raised from banks and 1 per cent from equity finance, according to the EBRD/World Bank enterprise survey from 1999. The anticipated inflow of capital to the real sector, be it domestic savings, repatriated capital or foreign investment, needs improved laws and law enforcement to come true.

In the presence of frequent state intervention (subsidies, arrears, and specific advantages to influential firms and lobbies), ownership change does not lead to better governance (EBRD, 1999a). Therefore, privatisation should be followed by improvements in corporate governance and by other control forces over enterprises: hardening of the budget constraint and fostering competition by lowering bureaucratic barriers to market entry. The unavailability of external finance is in itself a barrier to market entry. New firms do not have any retained earnings by which they could finance their start-up investments.

The lack of legitimacy of the new distribution of property will affect the security of these property rights. But a new redistribution round would be arbitrary and influenced by particular interest groups again. Buitter (2000), p.6: "Probably the best one can hope for is that a combination of sustained growth, efficient and equitable government tax and expenditure programmes and economic reform aimed at eliminating monopoly rents throughout the economy will gradually diminish the significance of the initial distribution of property rights." The opportunity for these reforms, which appeared with the improved macroeconomic situation, should be used to promote investment, deep restructuring of the old industrial enterprises and further economic growth in Russia.

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