

THE PROBLEMS OF DEVELOPMENT OF CORPORATE GOVERNANCE IN RUSSIA: COMPARISON WITH CENTRAL EUROPE AND CHINA

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Introduction

The present paper attempts to compare the development of corporate governance in Central Europe, Russia and China. All these countries share a common feature of having a legacy of planned economy and are now in the process of transition to a market economy. They all understand the importance of good corporate governance for the success of the economic reforms. However, the development of corporate governance in these three regions has achieved different degrees of success with Russia having the worst performance. The focus of this paper is directed at the problems of development of corporate governance in Russia. The paper first addresses the significance of establishing sound corporate governance practices for transition economies. Then it examines the development of corporate governance in the three locations, with the emphasis on Russia's corporate issues. Next, it turns to analysis of what factors caused Russia's corporate governance problems, and concludes that comparison with the experience of China and Central Europe in building proper corporate governance mechanism helps to identify the sources of Russia's poor corporate performance.

The Importance of Corporate Governance

In a market economy, corporations are the main form of organisation through which business activity is performed. They are 'the quintessential institutions of modern capitalism.'¹ A well-run and profitable corporation is a means through which a country provides 'employment, wealth, and satisfaction,'² that is not only material but also social welfare. Success of a corporation depends on the way it is governed, in other words, it depends on corporate governance. Corporate governance 'refers to control of corporations and to systems of accountability by

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1 Thomas Owen, 'Autocracy and the Rule of Law' in Jeffrey Sachs and Katharina Pistor (eds), *The Rule of Law and Economic Reform in Russia* (1997) 30.

2 Jonathan Charkham, *Keeping Good Company: a Study of Corporate Governance in Five Countries* (1994) 1.

those in control.³ It is the system by which companies are directed and controlled,⁴ which include legal rules as well as systems of self-regulation.⁵ As a rule, a company is built according to the principle of separation of ownership and control and has outside capital suppliers, such as external shareholders. Corporate governance determines the relationship between shareholders, directors and management of a company and helps to solve the agency problem between outside owners and inside managers. Good corporate governance makes a company attractive for external investors and ensures the inflow of outside finance.

The desire to attract foreign investments is one of the reasons why transition economies find good corporate governance so important. Another significant role which corporate governance plays in transition economies is expressed through its function of 'a key determinant of enterprise restructuring'.⁶ Through the scope and depth of enterprise restructuring, the quality of corporate governance is reflected in a company's profitability and productivity.⁷ Good corporate governance can help to discipline corporate insiders 'in the way they allocate and especially in the way they use, or waste, the sizeable real resources they control'.⁸ Through performance of a company, successful corporate governance contributes to general welfare of a country and influences national economic performance. It helps to achieve a developed capitalist economy.⁹ All countries in transition to market economies realise the interrelation between improved corporate governance and better economic performance and pay serious attention to the problems of corporate development.

3 John Farrar, *Corporate Governance in Australia and New Zealand* (2001) 3.

4 Charkham, above n 2.

5 Farrar, above n 3.

6 Joseph Blasi and Andrei Shleifer, 'Corporate Governance in Russia: An Initial Look' in Roman Frydman, Cheryl Gray and Andrzej Rapaczynski (eds), *Corporate Governance in Central Europe and Russia* (1996) vol 2, 78.

7 Wladimir Andreff, 'Beyond the Principal-Agent Model' in Eckerhard Rosenbaum, Frank Bönker and Hans-Jürgen Wagener (eds), *Privatization, Corporate Governance and the Emergence of Markets* (2000) 127.

8 Charles Oman, 'Corporate Governance and National Development' (Technical Papers No 180, EBRD 2001) <http://www.rid.ru/db.php?db_id=455&l=en> 27, at 17 December 2002.

9 Merritt Fox & Michael Heller, 'Lessons from Fiascos in Russian Corporate Governance' (1999), <http://papers.ssrn.com/paper.taf?abstract_id=203368> 6, at 16 December 2002.

Corporate Governance in Russia

Historical Background

In Russia, the establishing of first organisations in the corporate form began in the eighteenth century during the reign of Peter I, when the experience of Western Europe was actively introduced to the country. The first commercial-industrial joint-stock company was Russian-American Company, which was founded in 1799.¹⁰ In the end of the nineteenth century and the beginning of the twentieth century joint-stock companies were rapidly developing. In 1892, there existed 614 corporations in Russia.¹¹ During 1906-13, about 200 new companies were established per year and by 1914, their number reached 2,167.¹²

According to Thomas Owen,¹³ corporate law and the evolution of corporations in late Imperial Russia were determined by hostility of the tsarist government to capitalist enterprise, which was formed in the environment of 'the strong ideological traditions of autocracy and xenophobia.'¹⁴ Although Russia did manage to achieve some incredible progress in economy in the second half of the nineteenth century and the beginning of the twentieth century, its outdated commercial legislation seriously impeded industrial development. During almost a century Russian company law remained unchanged and ceased to exist when the Bolsheviks came to power.

The first company legislation appeared in Russia in 1807, which was a manifest governing partnerships. It was followed by the law on joint-stock companies adopted in 1836, which continued to be in force until 1917. The legislation had many unclear issues; 'allowed no investment except in the form of cash; failed to require a specification of "the share of participation by each partner in profits and losses"; and left unclear the procedures of liquidation.'¹⁵ Twice attempts have been made to reform the company law but both times, they were unsuccessful.

The first plan for corporate law reform, 'which would have introduced the principle of incorporation by registration, adopted by Great Britain in 1844, France in 1867, and the North German Confederation in 1870',¹⁶ was abandoned after the economic crisis in Europe and Russia in 1874. It was feared that a freely expanding corporate system could lead to the economic turmoil.¹⁷ The second

10 Introduction into Russian Company Law (in Russian), *Russian Educational Portal* <http://www.distance.ru/4stud/umk/ak_pr/ak_pr09.html> at 17 December 2002.

11 Owen, above n 1, 31.

12 Ibid 33.

13 Ibid 23.

14 Ibid.

15 Ibid 30.

16 Ibid 27.

17 Ibid 32.

reform plan was cancelled in 1899 and incorporation by registration never displaced incorporation by imperial concession. To establish a company, one had to obtain a corporate charter, which had to be confirmed by the tsar. Very often corporate charters conflicted with the corporate law of 1836, thus making it irrelevant. In such a situation, it was evident that 'no general system of corporate law really existed.'¹⁸

One of the reasons why a foundation for firm corporate capitalism was never established in Russia was the expansive involvement of the state in commercial and industrial affairs. For example, the largest construction project of the nineteenth century in Russia to build Trans-Siberian railroad was in the hands of the state. Whereas the construction of railroads in the United States at the same time promoted the development of a corporation, in Russia 'the state continued to exercise tutelage and, in frustration, resorted to the familiar pattern of direct administration.'¹⁹ The attempts to reform legislation to accommodate emerging capitalist economy failed because they contradicted the determination of the state to preserve its autocratic rule.²⁰

When the Communists came to power, the corporate activity was aborted. Although there were some attempts to reintroduce the form of joint-stock companies, they never really managed to gain any significance in the environment of state-owned enterprises, which were the main form of ownership. Only with the fall of communism, the true revival of corporate entrepreneurship became possible.

Development of Corporate Governance After the Collapse of Communism

Privatisation

In 1992 Russia stepped on the path of reforms towards a market economy. Privatisation was one of the major steps 'from plan to market.'²¹ It was aimed at introduction of hard budget constraints and creation of 'demand for stronger property rights and institution of corporate governance.'²² The country followed Western advice which 'called for "shock therapy"—rapid decontrol of prices,

18 Ibid 31.

19 Ibid 28.

20 Michael Newcity, 'Russian Legal Tradition and the Rule of Law' in Jeffrey Sachs and Katharina Pistor (eds), *The Rule of Law and Economic Reform in Russia* (1997), 50.

21 The World Bank Report, *Transition – The First Ten Years: Analysis and Lessons for Eastern Europe and the Former Soviet Union* (2002) 71 <http://www-wds.worldbank.org/servlet/WDS_IBank_Servlet?pcont=details&eid=000094946_02012504134954> at 19 December 2002.

22 Ibid.

freeing of markets, and privatization of industry.²³ The main purpose of privatisation was to transfer the property of State-Owned Enterprises (SOEs) into private hands. It was believed that a private ownership would help enterprises to perform much better than state ownership.²⁴

In Russia, the chosen method of privatisation was implemented through the program of 'fairly rapid ownership transfer'.²⁵ The speed was important to make the privatisation process irreversible for those who opposed the reforms. Rapid privatisation was also perceived 'as a response to pretransition attempts at enterprise reform'²⁶ which took place in Russia in 1987-1991 and were known as "spontaneous" privatisation by managers. During that time there emerged cooperatives, leasing was allowed and managers obtained power, while 'the state had lost control over enterprises after the collapse of institutions during the dissolution of the Soviet Union.'²⁷

For the purpose of mass privatisation, a voucher scheme was adopted to enable the population to have 'purchasing power in a transparent and fair way'.²⁸ SOEs were corporatised by re-registration as joint stock companies through the Russian privatisation agency or its branches.²⁹ Vouchers were issued and distributed among citizens, which they could exchange for shares in privatised firms. But first, managers and employees of newly privatised enterprises received the offer of subsidised or free shareholding.³⁰ Due to the fact that vouchers were tradable in Russia, insiders could buy more vouchers and exchange them for more shares of their company. As a result, most of the companies became insider owned. After that, some amount of shares was sold through voucher auctions to the public.³¹ It is reported that as a result of the privatisation the typical ownership structure of enterprises consisted of 60-65% manager and employee ownership, about 20% ownership by individuals and voucher investment funds, and 15-20% state ownership.³² In summer 1994 voucher privatisation was completed in Russia. In eighteen months, the country privatised about 14,000 enterprises.³³

23 Bernard Black, Reinier Kraakman and Anna Tarassova, 'Russian Privatization and Corporate Governance: What Went Wrong?' (2000) 52 *Stanford Law Review* 1731, 1739. <http://papers.ssrn.com/paper.taf?abstract_id=181348> at 16 December, 2002.

24 *Ibid* 1797.

25 The World Bank Report, above n 21, 74.

26 *Ibid*.

27 *Ibid* 72.

28 *Ibid* 74.

29 Katharina Pistor, 'Company Law and Corporate Governance in Russia' in Jeffrey Sachs and Katharina Pistor (eds), *The Rule of Law and Economic Reform in Russia* (1997)169.

30 *Ibid*.

31 *Ibid*.

32 Black, Kraakman and Tarassova, above n 23, 1740.

33 Pistor, above n 29.

In 1995 the “loans-for-shares” program was announced which was the second privatisation wave. During that stage, a small number of enterprises were privatised, but those were very large and highly productive enterprises. The program stimulated the evolution of financial-industrial groups (FIGs) governed by powerful oligarchs. Merritt Fox and Michael Heller describe the “loans-for-share program in the following way:

the oligarchs gave relatively small loans to the government to plug the budget deficit and in exchange received as collateral security interests in shares of the most valuable Russian resource-extracting firms: oil, minerals, timber, and so on. When the government did not pay back the loans, the oligarchs conducted rigged auctions through which the collateral on the loans became controlling shareownership in these firms.³⁴

FIGs present huge conglomerates gathered around one of seven oligarchs and comprise ‘a captive bank, a holding company, and multiple privatised companies as subsidiaries.’³⁵ It is estimated that 40 percent of Russia’s economy is control by the oligarchs.³⁶

The mass privatisation program and subsequent ‘loans-for-shares’ auctions have shaped the basic features of corporate ownership in Russia which is characterised by insider control and diffuse ownership.³⁷ Such form of corporate ownership has produced highly negative results, such as asset stripping by managers and weak position of minority shareholders, which will be described in details later in this paper.³⁸

Legislation

Had the privatisation process been supplemented by adequate legal framework and constitutional constraints, its results could have been different. However, the first comprehensive company law in Russia, the *Law on Joint-Stock Companies*, was introduced only in 1996 - eighteen months after the end of the mass privatisation program.³⁹ Prior to it, the emerging corporate legislation had been drafted in the form of separate decrees. Such law-making method was quite typical under socialism⁴⁰ as well as in pre-revolutionary Russia⁴¹ and presented a

34 Fox and Heller, above n 9, 49.

35 Ibid.

36 Ibid.

37 The World Bank Report, above n 21, 74.

38 See below Part III C.

39 Pistor, above n 29, 170.

40 Cheryl Gray and Kathryn Hendley, ‘Developing Commercial Law in Transition Economies: Examples from Hungary and Russia’ in Jeffrey Sachs and Katharina Pistor (eds), *The Rule of Law and Economic Reform in Russia* (1997) 139.

41 Pistor, above n 29, 176.

piecemeal solution of issuing “special laws for special cases” and ‘case by case exemptions from general laws’.⁴²

The first legislative attempt to give enterprises more autonomy was embodied in the 1988 Law on State Enterprises.⁴³ By 1990 several statutes had been passed, both on the Soviet Union and on the Russian Federation levels, which recognised private organisations of different types, however they ‘were superficial and provided little if any guidance on organizational structure, fiduciary duty or shareholders’ rights’.⁴⁴ The statute on joint stock companies confirmed by Council of Ministers of RSFSR (Decree 601) adopted in 1990 contained some improvements, such as ‘guidelines on the rights and duties of shareholders and directors’.⁴⁵ Nevertheless, it still failed to address some very important issues, such as remedies and fiduciary duty, and it did not provide shareholders with mechanism to enforce their rights.⁴⁶

The Russian privatisation law was passed in 1991 to give the legal basis for the corporatisation of enterprises which were after that privatised.⁴⁷ The law was followed by Presidential Decree on Privatisation in 1992. During the privatisation process, several presidential decrees were issued which were mainly aimed at implementing the reform program and just touched upon some certain aspects of company law.⁴⁸ They would often contradict one other or be in conflict with underlying legislation.⁴⁹

The new Russian company law, the 1996 *Law on Joint-Stock Companies*, which develops relevant provisions of the new 1995 Civil Code, is recognised to be a well-drafted and comprehensive piece of legislation.⁵⁰ It contains detailed articles covering almost all standard elements of normal company law, such as procedural issues of the corporate relationships (provisions for the preparation of the shareholders’ meeting, election of members of management board, issue of new securities), requirement for information disclosure, provision on insider transaction etc.⁵¹ The law demonstrates significant improvement regarding protection of shareholders’ rights. Together with the definition of the rights, it contains a variety of procedural rights for shareholders, such as voting,

42 Ibid 170.

43 Gray and Hendley, above n 40, 151.

44 Ibid.

45 Ibid.

46 Ibid.

47 Pistor, above n 29, 170.

48 Gray and Hendley, above n 40, 151.

49 Pistor, above n 29, 175.

50 Ibid 177.

51 Alexander Radygin, *Privatisation in Russia: Hard Choice, First Results, New Targets* (1995) <<http://www.iet.ru/personal/radygin/book95.htm>> at 18 December 2002.

THE PROBLEMS OF DEVELOPMENT OF CORPORATE GOVERNANCE IN RUSSIA:
COMPARISON WITH CENTRAL EUROPE AND CHINA

information and redemption rights, and details of remedies that shareholders possess if their rights are violated.⁵²

Under the Russian Company Law the corporation consists of three organs: the shareholders' meeting, the board of directors (a supervisory body), and the executive board. The highest organ is the shareholders' meeting which gathers annually and has the power to appoint and dismiss company's directors to whom shareholders delegate general operating authority. The executive body, which can be formed by one person – the general director, is accountable to the board of directors and to the shareholders' meeting. General shareholders' meeting can dismiss executive board unless the power to form the executive board is given to the board of directors by the corporate code.

Since 1996, a number of other laws and regulatory documents have been passed aiming at creating legal framework for corporate activity, such as the 1996 *Securities Market Law*, the 1998 *Bankruptcy Law*, the 1999 *Law on Protection of Investors' Rights*, the 2001 *Investment Funds Law*. In 2001, there were adopted changes and amendment to the 1996 *Joint-Stock Companies Law*, which introduced further enhancements regarding protection of shareholders' rights. In drafting of many of these laws, Russia received assistance from foreign advisors, namely the American Aid Agency (USAID).⁵³ Such legislative activity and openness to outside help reflects current commitment of Russian government to introduce necessary measures to improve corporate governance in the country.

Current Trends

In the last couple of years, Russia has witnessed some definite signs of reformers' determination to improve national corporate governance performance. Along with the effort of the government to create a firm legal foundation for business activity of Russian corporations, a wide range of research work has been conducted by public, professional and academic organisations to develop programs for improvement of corporate governance. Besides, the corporate performance of Russian companies is measured by foreign and local organisations, and corporate governance ratings are published regularly to provide information for investors, as well as to promote competition among Russian companies and stimulate the improvement of corporate governance practices.

To assist Russia in bringing its corporate governance standards closer to global standards,⁵⁴ the Organisation for Economic Cooperation and Development (OECD)

52 Pistor, above n 20, 179.

53 Katharina Pistor, *Patterns of Legal Change: Shareholder and Creditor Rights in Transition Economies* (Working Paper No 49, EBRD 2000) 7
<<http://www.ebrd.com/pubs/find/alpha.htm>> at 30 December 2002.

54 OECD Roundtable, *Corporate Governance in Russia* <<http://www.corp.gov.org/projects/roundtable.php3>> at 21 December 2002.

launched the Russian Corporate Governance Roundtable in June 1999. In April 2002, a White Paper of Corporate Governance in Russia was presented in Moscow, which contains recommendation on enhancement of corporate governance performance.⁵⁵ The White Paper is the result of three years of debates and consultations, which were aimed at identifying the main areas for improvement of corporate governance practices in Russia.⁵⁶ The White Paper utilises the OECD Principle of Corporate Governance which were designed for OECD members, i.e. for countries with developed market economies, but which are also recommended for countries with developing markets. The Principles' task is to facilitate governments 'in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries.'⁵⁷ The White Paper of Corporate Governance in Russia was offered to specific institutions as a source for legislative change and reform implementation.⁵⁸

The OECD Principles of Corporate Governance have also been used to develop the principles of the Russian Code of Corporate Conduct,⁵⁹ a document which project was prepared by the Federal Commission for the Securities Market (FCSM), approved by the Government in April 2002, and was recommended for general use.⁶⁰ Along with the principles of corporate governance the Code contains provisions for general shareholders meeting, the board of directors, the executive board, information disclosure, recommends to introduce independent directors into the board, and to establish a position of a corporate secretary, etc. The Code is not legally binding on companies; its provisions are offered only as recommendations. However, once they are included into the bylaws of a company, they obtain obligatory character. Passing a document of such recommendatory nature is novel for Russia; never before has it adopted non-obligatory documents.⁶¹ The Code helps to address those issues, which have not yet been covered by legislation. It provides necessary guidance to Russian companies in drafting their corporate codes with a focus on protection of shareholders' rights. National companies are highly motivated to include the provisions of the Russian Code of Corporate Conduct into their own corporate code to attract attention of foreign investors. In November 2002, the FCSM introduced amendments into the trading regulations of

55 *The Russian Corporate Governance Roundtable, OECD*
<<http://www.oecd.org/oecd/pages/home/displaygeneral/0,3380,EN-document-28-nodirectorate-no-20-6814-28,00.html>> at 21 December 2002.

56 Ibid.

57 Foreign Best Practices Codes (2002), *Russian Institute of Directors*
<http://www.rid.ru/db.php?db_id=30&l=en> at 21 December 2002.

58 OECD Roundtable, above n 54.

59 The text of the Code < http://www.rid.ru/db.php?db_id=516&l=en> at 8 January 2003.

60 News Archives, *Corporate Governance in Russia*.
<http://www.corp-gov.org/news/news.php3?news_id=559> at 22 December 2002.

61 Alla Varlamova and Elena Kabatova, 'Russian Code of Corporate Conduct: a New Instrument for Protection Shareholders' Rights' (2002) *Russian Institute of Directors*
<http://www.rid.ru/db.php?db_id=538&l=ru> at 22 December 2002.

THE PROBLEMS OF DEVELOPMENT OF CORPORATE GOVERNANCE IN RUSSIA:
COMPARISON WITH CENTRAL EUROPE AND CHINA

Russia's major stock exchanges which oblige companies to implement the Code of Corporate Conduct or they could face delisting of their securities.⁶²

The Russian business community has recognised of the need to improve corporate governance practices. Local organisations are established to promote high professional standards and ethical norms among Russian corporations. With this purpose, the Russian Institute of Directors (RID) was founded by a group of the major Russian corporations.⁶³ The RID attempts to improve the board of directors' effectiveness; in order to do that it provides educational and training courses for corporate directors.⁶⁴ The RID believes that 'Russia's economic development depends to a large extent on ethics, competence, and entrepreneurial spirit of those who sit on boards of Russian companies, as well as on policy makers and government officials.'⁶⁵ At present, the institute is working on a code of rules for the board of directors called Professional Standard of Corporate Directors, which is meant to become a recommendatory document for companies to be used as a guide in building the board of directors in accordance with the highest professional requirements.⁶⁶

Another innovation in Russian business is the attempt to introduce methods of alternative dispute resolution. In December 2002, the Russian Union of Industrialists and Entrepreneurs (RUIE) formed a commission on corporate ethics.⁶⁷ The Commission will be dealing with out-of-court settlement of disputes, which will be determined according to the Charter of Corporate Ethics, adopted by the RUIE in October 2002. The Commission consists of 43 arbiters, ten of which are well-known oligarchs, the members of the RUIE Bureau.⁶⁸ According to the decision of the Commission on Corporate Ethics, during the first year of its work the ADR system will be utilised to settle a conflict only if both parties agree on it.⁶⁹ Later the ADR mechanism will be used even in the absence of the respondent.⁷⁰

62 News Archives, above n 60.

63 Mission and Key Avenues, *Russian Institute of Directors*, <http://www.rid.ru/db.php?db_id=27&l=en> at 22 December 2002.

64 Ibid.

65 Ibid.

66 Mikhail Samosudov, 'Professional Standards of Corporate Directors: Legal Requirement or Recommendation?' *Russian Institute of Directors* (2002) <http://www.rid.ru/db.php?db_id=606&l=en> at 8 January 2003.

67 'RUIE Creates Commission on Corporate Ethics', *Corporate Governance in Russia* <http://www.corp-gov.org/news/arch.php3?news_id=487> at 22 December 2002.

68 'Oligarchi budut miritsa s pomoshiyu ADR' (Oligarchs will make peace with the help of ADR), *Gazeta.ru* (Moscow Russia) 6 December 2002, <<http://www.gazeta.ru/2002/12/06/oligarhibudu.shtml>> at 6 December 2002.

69 Ibid.

70 Ibid.

The current trends in corporate governance activity signify a definite step forward in attempts of Russian business community to improve corporate governance performance. This goes in accord with the plan for economic development until the year 2010 adopted by the Russian government. The main goal of the plan is to create a favourable investment climate in the country and protect property rights. The issues of corporate governance receive even greater importance considering Russia's determination to become a WTO member. The fact that the country welcomes the introduction of internationally accepted standards of commercial transactions and is becoming more open to global community gives hope for significant enhancement of corporate governance mechanisms in Russia.

The Main Characteristics of Existing National Model of Corporate Governance

Ten years of reforms, during which Russia's economy has undergone historical transformations, have formed the main characteristics of the current national model of corporate governance. The privatisation program has fixed private property rights, established corporate ownership structure with insider control, and dispersed ownership.⁷¹ The speed of the program and lack of legal and regulatory framework to support it resulted in major corporate governance problems, which impede effective enterprise restructuring and successful economic development of the country. The World Bank confesses in its recent report that '[p]rivatization to diffuse owners and to enterprise workers and managers... has not been beneficial; indeed, privatisation to workers in the CIS [Commonwealth of Independent States] has been worse than state ownership for restructuring.'⁷²

According to Alexander Radygin,⁷³ corporate governance in Russia does not yet show a clear tendency in its development towards any of the existing corporate governance models (market-oriented or bank-oriented).⁷⁴ He argues that national corporate governance model presents a mixture of components characteristic for different models. For example, he points out at coexistence of such element as dispersed ownership with illiquid stock market, or weak institutional investors; or a firm tendency towards concentration of ownership and control with lack of adequate finance or effective monitoring devices; or presence of cross-shareholding elements and formation of complex corporate structures of different types but absence of preference of a definite type of such structures.⁷⁵

71 The World Bank Report, above n 21, 71.

72 Ibid.

73 Alexander Radygin is one of leading Russian economists, an OECD consultant on problems of privatisation, securities market development and corporate governance in Russia.

74 Ibid.

75 Ibid.

Alexander Radygin observes that the Russian corporate governance model is determined by the following features: permanent process of redistribution of corporate property; specific incentives of corporate insiders, engaged in self-dealing and asset-stripping; weak position of external mechanisms of corporate control (financial market, bankruptcy, takeovers); significant residual state ownership and subsequent problems of governance and control; intervention of regional authorities in establishing of corporate relations; and ineffective and selective enforcement of comparatively well-developed legislation regarding protection of shareholders' rights.⁷⁶ Some of these most striking features are examined in the next parts of this paper.

Lack of Institutional Mechanisms to Control Corporate Governance

Governance of a corporation, which is based on diffuse or insider ownership, cannot be effective in the absence of regulatory bodies of outsiders that could perform necessary control over corporate insiders.⁷⁷ The framework of such regulatory bodies, that support the establishment of strong corporate governance and allow dispersed owners to monitor enterprise managers, includes mechanisms enforcing rules to protect minority shareholders and rules against insider deals; adequate accounting, auditing, and disclosure standards; and enforcement of bankruptcy legislation.⁷⁸ Monitoring can also be performed by 'concentrated ownership blocks',⁷⁹ such as banks, investment and pension funds. Stock market is another mechanism to control corporate governance. It can enhance 'the quality of managerial decision-making'⁸⁰, which is reflected in the share price.

Russia experiences deficit in almost all of the above-named institutions. The existing banks, as well as insurance and pension funds, do not have sufficient capital to play the role of outside investors.⁸¹ The financial crisis of 1998 substantially weakened monitoring ability of the banks.⁸² Investment funds 'failed to evolve into active agents of corporate governance'⁸³ because of misuse of investors' rights during privatisation. The stock market remains small and

76 Alexander Radygin, 'Some Problems of Corporate Governance in Russia' (in Russian) <<http://www.iet.ru/personal/radygin/probkorpuprrus.htm>> at 22 December, 2002.

77 The World Bank Report, above n 21, 71.

78 Ibid.

79 Saul Estrin, 'Competition and Corporate Governance in Transition' (Working Paper No 431, William Davidson, 2001) 8, <<http://ideas.repec.org/p/wdi/papers/2001-431.html>> at 20 December 2002.

80 Ibid 7.

81 Radygin, 'Some Problems of Corporate Governance in Russia', above n 76.

82 Carsten Sprenger, 'Ownership and Corporate Governance in Russian Industry: the Survey' (2002) *EBRD Working Paper No. 70*, 9.

83 Jeffrey Sachs and Katharina Pistor, 'Introduction' in Jeffrey Sachs and Katharina Pistor (eds), *The Rule of Law and Economic Reform in Russia* (1997) 13.

illiquid, with ten to fifteen participating securities issuers on average.⁸⁴ Besides, the exit mechanism in many companies simply does not work and shareholders have difficulties in selling their shares.⁸⁵

To conduct monitoring through evaluation of company information is very hard in Russia because of 'the lack of accounting principles that would establish standards for meaningful comparison.'⁸⁶ Russian enterprises are only beginning to introduce internationally recognised accounting standards.⁸⁷ Although Russian law requires from companies to publish financial reports at least once a year (for publicly traded companies the requirement is quarterly reports), the compliance with such regulations remains to be not very high.⁸⁸

The 1998 *Bankruptcy Law* contains substantial flaws as it 'gives great discretionary power to arbitration court judges and sets a very low bankruptcy threshold.'⁸⁹ It has been used by insiders to start bankruptcy procedures against viable companies to take hold of their assets.⁹⁰ It is said that '[t]he bankruptcy procedures became a tool for illegal enrichment of dishonest people ... due to the powerlessness of the law enforcement system in Russia.'⁹¹

Weak legal enforcement is another major problem hampering implementation of corporate control. It is reported that the main factors determining poor enforcement of laws in Russia 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'.⁹² This problem is exacerbated by existence of organised 'crime, corruption, and popular distrust of law and legal institutions'⁹³ in Russian society.

84 Alexander Radygin, 'Ownership and Control of the Russian Industry' (1999) *Institute for the Economy in Transition* <<http://www.iet.ru/special/oeed/owner/owner.html>> at 23 December 2002.

85 Ibid.

86 Pistor, 'Company Law and Corporate Governance in Russia', above n 29, 174.

87 'Banks Learn to Submit Accounting Reports' (2002), *Corporate Governance in Russia* <http://www.corp-gov.org/news/news.php3?news_id=587> at 24 December 2002.

88 Pistor, above n 29, 174.

89 Sprenger, above n 82, 16.

90 Ibid.

91 Glen Kolleeny, 'The Roller-Coasters of Russian Legislation' (2002), <www.salans.com/news/docs/GKolleeny.pdf> 7, at 23 December 2002.

92 Sprenger, above n 82, 15.

93 Newcity, above n 20, 41.

Specific Incentives of Insiders and Majority Shareholders

During Soviet times, the control over SOEs was performed by Ministries and the Party. After privatisation, many companies found themselves to be in 'a control vacuum'⁹⁴, which negatively influenced incentives of corporate managers. As Saul Estrin puts it:

Under communism, the monitoring of management and the incentives for efficiency were already weak. But with the collapse of central planning and the lack of any other external constraints, managers and insiders in transition economies gained almost total discretion to follow their own objectives.⁹⁵

Unfortunately, insiders' objectives did not include plans for effective enterprise restructuring or building of company's value. They preferred to pursue self-interests which resulted in large-scale asset stripping and was accompanied by disregard of shareholders' rights. Corporate managers, having almost unlimited control in their hands, had two ways of getting money: they could increase the company's value and consequently the value of their stake in the company; or they could loot the company.⁹⁶ While the first prospect was hard, risky and time-consuming; the other one was easy and fast. The latter was the preferred choice of corporate insider owners in Russia and took different forms of tunnelling, from 'outright looting of the firm – taking cash or assets belonging to the firm and effectively giving title to the insiders'⁹⁷ to engaging in 'sweetheart business deals'⁹⁸ with affiliated companies.

The incumbent management is the most powerful group of corporate owners. In 1999 the distribution of ownership had the following pattern: managers' ownership - about 15 percent, workers – 30 percent, the state – 7 percent, and the rest – outsiders.⁹⁹ Despite the fact that management ownership is relatively small, their actual influence is substantially higher. Thus, members of boards of directors are often appointed by managers,¹⁰⁰ and many of the outsiders are 'de facto insiders'.¹⁰¹ Corporate managers are known to make alliances with such outsider owners as company's key suppliers, leaders of a financial-industrial group,

94 Sachs and Pistor, above n 83, 14.

95 Estrin, above n 79, 9.

96 Black, Kraakman and Tarassova, above n 23, 1750.

97 Fox and Heller, above n 9, 21.

98 Ibid 22.

99 The Russian Economic Barometer survey as cited in Sprenger, above n 82, 6.

100 Andrei Shleifer and Dmitry Vasiliev, 'Management Ownership and Russian Privatization' in Roman Frydman, Cheryl Gray and Andrzej Rapaczynski (eds), *Corporate Governance in Central Europe and Russia* (1996) vol 2, 69.

101 Serguey Braguinsky and Grigory Yavlinsky, *Incentives and Institutions: the Transition to a Market Economy in Russia* (2000)121.

'[m]embers of regional and/or local government, as well as outright gangsters'.¹⁰² Together they enjoy their control over a company through expropriation of minority shareholders and rent-seeking.

As for another group of insiders, the workers, they 'in most cases have no say in managing the assets, and they often do not even receive their meagre salaries for months.'¹⁰³ Workers did not achieve any participation in control over the company; they are rarely represented in the board of directors.¹⁰⁴ They cannot freely sell their shares to outsiders because of the management's threat of subsequent dismissal or salary cut.¹⁰⁵ Very often the only possible way of exit for workers is to sell shares to the managers who, in their turn, are happy to enlarge their stake,¹⁰⁶ because they understand that 'the allocation of equity ... determine[s] the extent of their control.'¹⁰⁷

The problem is that powerful insider owners refuse to regard their shares as financial instruments.¹⁰⁸ Even such outside shareholders as leaders of financial-industrial groups, which sometimes are observed to resemble some features of Japanese keiretsu and Korean chabeol,¹⁰⁹ and are viewed as a potential solution for the problem of corporate control,¹¹⁰ are in some cases 'simply strip assets from more profitable member firms.'¹¹¹ Fox and Heller, for example, affirm that FIGs 'may seize control of firms, replace managers, and then also freeze out minority shareholders, including employees.'¹¹² They do not reinvest money in order to maximize their companies' profit; on the contrary, they transfer capital flow through their banks abroad to be safely kept there. For instance, Khodorkovsky, the head of the oil holding company Yukos, which he acquired during a rigged loans-for-share auction in 1995, was accused of stripping profits from subsidiaries.¹¹³ He would resell oil, bought from the subsidiaries at below-market prices, to foreign buyers at much higher prices. Such transaction constitutes 'a warped form of transfer pricing.'¹¹⁴ Instead of reinvesting in the oil fields, paying taxes and wages, Khodorkovsky kept the cash and destroyed 'the value of minority shares in Yukos and its production subsidiaries.'¹¹⁵

102 Ibid.

103 Ibid.

104 Sprenger, above n 82, 8.

105 Ibid.

106 Ibid, 7.

107 Shleifer and Vasiliev, above n 100, 69.

108 Fox and Heller, above n 9, 38.

109 Ibid 49.

110 Sprenger, above n 82, 18.

111 Ibid.

112 Fox and Heller, above n 9, 21.

113 Stephanie Baker-Said, 'Russia's Oil Czar Looks West', (2002) 7 *Bloomberg Markets* 43, 46 <www.bloomberg.com/marketsmagazine/ft2_0207.pdf> at 26 December 2002.

114 Ibid.

115 Black, Kraakman and Tarassova, above n 23, 1737.

Position of Minority Shareholders

From the beginning of the privatisation process, managers of Russian companies, engaged in self-dealing transaction, became notorious for disregard and blatant violation of shareholders' rights. The rights of shareholders include 'asset rights, income rights (the payment of dividends) and control rights.'¹¹⁶ Shareholders also have procedural rights: to vote, to entry and exit, and to have information about the company's activity.¹¹⁷ In Russia, shareholders have experienced violation of all of these rights.

The prevalent methods of violating shareholders' rights are share diluting by means of new share issues and by issue of corporate bonds convertible into shares,¹¹⁸ establishing barriers to shareholders' attendance of general meeting, in order to prevent them from participating in decision-making on important issues, through failure to adequately inform about the meeting, or rejecting to register shareholders, or not accepting proxy voting.¹¹⁹ Shareholders' right to vote is violated when the one-share-one-vote rule is substituted by one-shareholder-one-vote rule, thus diminishing the influence of large shareholders.¹²⁰ The right to freely sell one's shares is rejected through 'manipulation of share registers'¹²¹ when management refuses to register shares acquired by new owners.¹²² The list of such violations, which also includes non-payment or late payment of dividends, as well as disregard of information disclosure requirements, can easily be continued.

To illustrate these violations, it would be enough to highlight the activity of already mentioned oligarch Khodorkovsky. The transfer pricing transactions with Yukos' subsidiaries never received approval of their minority shareholders, which was 'a flagrant violation of the company law'.¹²³ However, in 1999 Khodorkovsky did manage to get shareholder approval for transfer of Yukos' stakes in the production subsidiaries to offshore companies, as well as for a massive new share issuance.¹²⁴ But the means to get the approval were indeed flagrant. Yukos' leader needed 75% of the votes of those who participated in shareholders meeting. In order to reach his goals, Khodorkovsky made a judge disqualify all unwanted shareholders from voting on the ground of acting in violation of the Antimonopoly

116 Sprenger, above n 82, 11.

117 Pistor, 'Company Law and Corporate Governance in Russia', above n 29, 174.

118 Igor Belikov, 'Ot "tayochnogo" k tsivilizovannomu' (From "taiga"-style to civilised) (2000) 10 *Journal for Shareholders* < http://www.rid.ru/db.php?db_id=225&l=ru > at 20 December 2002.

119 Ibid.

120 Pistor, 'Company Law and Corporate Governance in Russia', above n 29, 172.

121 Sprenger, above n 78, 11.

122 Pistor, 'Company Law and Corporate Governance in Russia', above n 29, 173.

123 Black, Kraakman and Tarassova, above n 23, 1769.

124 Baker-Said, above n 113, 46.

Law.¹²⁵ Armed guards blocked minority shareholders from attending the meeting on the basis of the court order.¹²⁶

The position of minority shareholders in Russian corporations is beginning to improve as a result of recent changes brought about by commitment of reformers to enhance the image of the Russian market and create a favourable investment climate. The same Yukos company is 'reportedly making an effort to improve shareholder relations'¹²⁷ and is now a role model for other Russian firms. In the last two years Khodorkovsky started to publish the company's accounts according to international standards, introduced five foreign directors into the board, and paid \$500 million in dividends in 2001.¹²⁸ Besides, investor protection organisations are emerging in Russia who aim at making minority shareholders more pro-active in defending their rights.¹²⁹ More and more companies are becoming aware that violating shareholders rights is one of the major problems that have to be eliminated in order to get access to foreign capital.

There is a hope that Russian companies will finally 'turn the page on their past corporate governance abuses'¹³⁰ and the need for external capital will 'open critical opportunities for the development of corporate governance.'¹³¹

Development of Corporate Governance in Central Europe

In Central Europe the initial conditions for development of corporate governance were much more favourable than those in Russia, and are mainly determined by openness to the influence of Western Europe. The Czech Republic, Slovakia, southern Poland, Hungary and Slovenia used to form a part of the Austro-Hungarian Empire and share German civil law tradition, which they obtained from Austria or borrowed from Germany during the inter-war period.¹³² The development of capitalism was interrupted in these countries after the World War II when they were turned into Socialist states. When the Communist Block ceased to exist, Central European countries began a transition to market economy and return to capitalism. The first step in this path was the transfer of ownership from the state to private sector by means of privatisation.

125 Black, Kraakman and Tarassova, above n 23, 1771.

126 Ibid.

127 OECD, *'On Shareholder Rights and Equitable Treatment'* (Synthesis Report for the 2nd Meeting of the Corporate Governance Roundtable for Russia, Moscow, 24-25 February 2000) 8.

128 Baker-Said, above n 113, 44.

129 For example, the Investor Protection Association
<<http://www.corp-gov.org/association/association.php3>> at 24 December 2002.

130 OECD, above n 127.

131 Shleifer and Vasiliev, above n 100 76.

132 Pistor, 'Patterns of Legal Change', above n 53, 6.

THE PROBLEMS OF DEVELOPMENT OF CORPORATE GOVERNANCE IN RUSSIA:
COMPARISON WITH CENTRAL EUROPE AND CHINA

In the 1990s different approaches were used by different countries in Central Europe to implement privatisation. According to the 2002 World Bank Report,¹³³ the voucher program was the primary method of privatisation only in the Czech Republic; while Slovakia used it as the secondary method and direct sales the primary one. Hungary and Poland preferred direct sales to strategic investors as their primary privatisation method and management-employee buyouts as secondary. The latter was used as the primary method in Slovenia, where voucher program was the secondary method. Hungary, Poland and Slovenia chose a gradual and cautious approach to privatisation, employing more traditional case-by-case privatisation technique, in which companies are sold to large strategic investors.¹³⁴ However, the Czech and Slovak republics embarked on rapid mass privatisation.

The Czech Republic was a pioneer of mass privatisation: it started the program in 1991 and by 1994 had privatised more than 1,600 firms.¹³⁵ In 1996 the Czech Republic was performing very well: new companies were emerging, economy was rapidly developing, and stock markets were functioning well. The Czech experience with privatisation was called 'a success story'.¹³⁶ But in 1997 the situation on the Czech market deteriorated and the country went into recession. The cause of the problem was widespread tunnelling: many privatised companies had been looted by insiders and voucher investment funds.¹³⁷

The privatisation in the Czech Republic was conducted through investment funds which initial number was over 500; in 1991-1992 they received over 60 percent of the total available assets.¹³⁸ Reformers hoped that investment funds would provide necessary monitoring of enterprise restructuring; but it turned out that the funds preferred tunnelling to restructuring.¹³⁹ Many investment funds were controlled by unreformed state-dominated commercial banks which combined the functions of lenders to companies and owners to the funds.¹⁴⁰ The banks did not evolve into effective monitors, and a bank-based corporate governance model similar to the German one, to the disappointment of some reformers, failed to

133 The World Bank Report, above n 21, 75.

134 Gerhard Pohl *et al*, 'Privatization and Restructuring in Central and Eastern Europe: Evidence and Policy Options' (Technical Paper No 368, The World Bank, 1997) 11 <<http://ideas.repec.org/p/ftth/wobate/368.html>> at 27 December 2002.

135 *Ibid* 12.

136 John Coffee, 'Institutional Investors in Transitional Economies: Lessons from the Czech Experience' in Roman Frydman, Cheryl Gray and Andrzej Rapaczynski (eds), *Corporate Governance in Central Europe and Russia* (1996) vol 1, 111.

137 Black, Kraakman and Tarassova, above n 23, 1790.

138 Ralph Heinrich, 'Corporate Governance: a Systemic Approach with an Application to Eastern Europe' in Eckerhard Rosenbaum, Frank Bönker and Hans-Jürgen Wagener (eds), *Privatization, Corporate Governance and the Emergence of Markets* (2000) 93.

139 Black, Kraakman and Tarassova, above n 23, 1791.

140 Heinrich, above n 138, 94.

emerge.¹⁴¹ In the absence of sound bankruptcy procedures, bank and fund relationships resulted in disregard of shareholders' interest.¹⁴² Commenting on the results of mass privatisation in the Czech Republic, the World Bank report states: 'the lack of appropriate accompanying institutional policies and lagging banking sector reform made mass privatization unnecessarily costly in equity, transparency, and microeconomic efficiency.'¹⁴³

Comparing to the Czech approach to privatisation, which bore rather a spontaneous character, Polish privatisation experience was a result of careful and planned calculations.¹⁴⁴ Poland did not follow 'the Washington consensus of shock therapy',¹⁴⁵ which pressed for rapid privatisation, but concentrated first on building legal and institutional framework, necessary to ensure healthy functioning of market economy. The voucher privatisation program, that was planned to be launched as early as 1990, was postponed until 1995, took five years to implement and was accompanied by the government control over the ownership structure.¹⁴⁶ In addition to voucher program, Poland also employed other forms of privatisation, such as "privatisation through liquidation", in which assets and selected liabilities of over 1000 enterprises were sold through instalment sales,¹⁴⁷ as well as share floatations and direct sales.¹⁴⁸ Such cautious implementation of privatisation helped Poland to avoid 'the risks of market failure and political corruption that may result when control seekers are tempted to bribe and seduce the judicial and regulatory systems to achieve the private benefit of control'.¹⁴⁹

Polish and Czech experiences with privatisation exemplify two opposing views of reform planners on how privatisation should be conducted. Proponents of rapid mass privatisation program argue that it allows establishing 'new owners who would support further market reforms.'¹⁵⁰ Their opponents, however, stress that 'the quality of privatization should not be sacrificed for the speed of privatization.'¹⁵¹ John Coffee, for instance, speaks in favour of 'a prudent course of phased privatization'¹⁵² and asserts that Poland's success in privatisation relates

141 Pistor, 'Patterns of Legal Change', above n 53, 21.

142 Heinrich, above n 138, 95.

143 The World Bank Report, above n 21, 77.

144 John Coffee, '*Privatisation and Corporate Governance: Lessons from Securities Market Failure*' (1999) Transition Newsletter, The World Bank Group
<<http://www.worldbank.org/transitionnewsletter/novdec99/WDIPrivCor.htm>> at 29 December 2002.

145 Joseph Doggett, '*Privatization and Central and Eastern Europe*'
<<http://cog.kent.edu/lib/doggett1.htm>> at 29 December 2002.

146 Pohl *et al*, above n 134, 12.

147 The World Bank Report, above n 21, 78.

148 *Ibid*.

149 Coffee, 'Privatisation and Corporate Governance', above n 144.

150 The World Bank Report, above n 21, 74.

151 Pohl *et al*, above n 134, 11.

152 Coffee 'Privatisation and Corporate Governance', above n 144.

to its serious approach to securities regulation. Coffee speculates that despite the fact that company laws of both the Czech Republic and Poland are based on German law and lack provisions for strong protection of shareholders, Poland did manage to develop good securities law. The law prohibits insider trading, has transparency requirements, adopted from the US legislation, and imposes takeover regulation, borrowed from the UK.¹⁵³ Besides, the activity of the Polish National Investment Funds (NIFs), holding controlling stakes, prevented the expropriation of minority shareholders' investments in companies by abusive entrepreneurs.¹⁵⁴ The introduction of similar regulations allowed the Czech Republic to curb 'the frantic scramble for control'.¹⁵⁵

Successful performance of developing corporate governance is not predetermined by the selected privatisation method; rather it depends on the combination of privatisation strategies with creation of legal and regulatory framework.¹⁵⁶ Nevertheless, there is a certain correlation between the method of privatisation and the subsequently developing corporate governance model.¹⁵⁷ For example, a mass privatisation program is expected to result in dispersed shareholder ownership and is associated with market-based model of corporate governance, whereas methods of direct sales to strategic investors are linked to a bank-oriented model.¹⁵⁸ However, in the absence of strong minority shareholder protection rules mass privatisation technique has produced concentrated ownership structure, which would have fewer chances to undermine rights of minority shareholders in the environment of efficient stock market. The Czech experience has shown that illiquid and non-transparent stock market and absence of necessary security regulations can create agency problems between investment funds and individual investors.¹⁵⁹ Other Central European countries, such as Poland and Hungary, that introduced economic reforms more gradually, after the important legal and institutional changes, were able to avoid negative side effects of radical reforms.

The reform of legal system in Central European countries is heavily influence by the requirement of the European Union (EU) to harmonise their laws with European standards in order to become the EU members. The desire of accession to the EU is a very powerful incentive for the countries of Central Europe to succeed in their reforms. Apart from the Czech misfortune with mass privatisation, these countries do not exhibit severe problems with corporate governance or corporate performance. However, even the Czech republic was not trapped in the pitfall of radical reforms externalities. After taking financial and

153 Ibid.

154 Ibid.

155 Ibid.

156 Heinrich, above n 138, 92.

157 Pistor, 'Patterns of Legal Change', above n 53, 22.

158 Ibid.

159 Heinrich, above n 138, 93.

enterprise reforms with the help of foreign direct investments, the Czech economy resumed its growth in 2000.¹⁶⁰ The Czech accession to the EU is expected in 2004.¹⁶¹

According to the Merit Research Corporate Governance Risk Survey,¹⁶² the countries of Central Europe show similar weak and strong points in corporate governance. Thus, the law enforcement is their weakest point, while regulatory framework is the strongest. Slowness of courts, inefficiency of arbitrage, as well as influence on court's decision and evasion of the final verdict are the most commonly observed problems. At the same time, it is admitted that regulatory institutions are independent and well functioning. In Hungary and Poland, the quality of the regulatory framework is defined as approaching the standards of economically developed countries. Company laws in all these countries are of good quality as regards shareholder rights, but creditor rights and laws dealing with bankruptcies, quality of contracts and conflicts of interests remain less pronounced. Overall, the business climate in the Central European countries with advanced transition economies is described as neither violent nor dominated by organized crime; however, there are concerns expressed about opaqueness of public tenders and existence of corruption.

When the law enforcement is weak, it is important that companies develop internal regulatory mechanisms for better corporate performance. In order to do that local corporate codes are being developed and adopted in Central European countries. This is an example of various activities carried out in these countries in the area of corporate governance in their preparation to become the EU members. For the countries of Central Europe the anticipated accession to the EU is a powerful incentive for bringing their corporate governance practices in accordance with highest international standards.

160 Czech Republic Country Brief, the *World Bank Group*
<[http://lnweb18.worldbank.org/ECA/eca.nsf/Countries/
Czech+Republic/48C9B2358C09BFAF85256C2500542125?OpenDocument](http://lnweb18.worldbank.org/ECA/eca.nsf/Countries/Czech+Republic/48C9B2358C09BFAF85256C2500542125?OpenDocument)>
at 30 December 2002.

161 *Ibid.*

162 The Merit Research <<http://www.merit-research.cz/cgr/>> at 31 December 2002.

Development of Corporate Governance in China

China differs from all other countries with transition economies in the fact that it never ceased to be a Communist state. Nevertheless, it did not prevent China from embarking on economic reforms with the purpose of building a “socialist” market economy. But before China adopted communist ideas, certain steps had been taken in attempt to found a corporate capitalism.

The first companies appeared in China as a result of the penetration of Western capitalists into the Asian country after 1840.¹⁶³ Prior to 1866, when a first private commercial company was established, Chinese companies were heavily influenced by the state.¹⁶⁴ To regulate the corporate activity of developing and emerging companies in 1904 the first Chinese *Company Law* was adopted. The law was drafted on the basis of the UK and Japanese legislation. The 1904 Company law comprised the main principles of corporate organisation and designated four different types of companies, including joint stock companies of limited and unlimited liability.¹⁶⁵ However, the law was not very successful; it failed to facilitate entrepreneurial activity in the corporate form. In 1914 the law was substituted by the Company Regulations which were developed on German law and was more detailed.¹⁶⁶ The state control over Chinese companies increased once again during nationalist regime.¹⁶⁷ Public enterprises owned by the state were preferred over private ones; this led to the foundation of state monopoly and deterioration of the private sector. The new Company Law enacted in 1929 further strengthened intervention of the government into companies’ affairs.¹⁶⁸

Another Company Law, which was adopted in 1946 and was aimed at regulating company activities in the post-war period, was invalidated when the Communist came to power. The corporate form had remained in disgrace for quite a while and was brought back after China decided to introduce deep economic reforms and enterprise restructuring.

China chose a phased strategy to implement the reforms: the first step was to liberalise agriculture and non-state industry; the second one was to transform a command economy into a market economy.¹⁶⁹ It is said that ‘[t]he key characteristic of China’s gradual approach to transition is not that it is slow, but that it develops elements of the new system, such as the private sector and market pricing, while keeping the old system, such as SOEs and state banks, in place for a

163 Yuwa Wei, ‘The historical development of the corporation and corporate law in China’ (2002) 14 *Australian Journal of Corporate Law* 240, 243.

164 Ibid.

165 Ibid 244.

166 Ibid 245.

167 Ibid 247.

168 Ibid 248.

169 The World Bank Report, above n 21, 35.

while.¹⁷⁰ Such gradual approach proved to be very fruitful: '[f]rom 1978 to 1995 GDP per capita in China grew at 8 percent a year and lifted 200 million people out of absolute poverty.'¹⁷¹

During the first phase in the rural areas 'a contractual responsibility system'¹⁷² was introduced, and the agricultural reform allowed farmers to sell any above-quota surplus on the open market; this led to a substantial growth of productivity and accumulation of private capital.¹⁷³ Some of household savings were directed to cover losses from SOEs and some were used as investments in new non-state enterprises.¹⁷⁴ Conditions were created for development and growth of township and village enterprises which, 'despite unclear property rights, functioned as private enterprises in almost every way.'¹⁷⁵ In the coastal area, the industry was growing rapidly due to openness of the market to direct foreign investments. The first foreign subsidiaries and joint venture enterprises started to emerge in Beijing, Shanghai, Tianjing and Shenyang after 1979, when the law was enacted enabling activity of such companies.¹⁷⁶

In the 1980s, attempts were made to restructure SOEs, which were given greater autonomy by means of transferring 'leadership and management powers from the Party committee to the general manager.'¹⁷⁷ However, such strategy did not have a positive outcome as '[m]anagerial autonomy had resulted in waste and depletion of State assets and resources.'¹⁷⁸ Other endeavours of enterprise restructuring were equally unsuccessful. The idea of employing corporatisation to reform SOEs was gaining greater recognition.¹⁷⁹ In 1984-85 in some cities it was tried to establish shareholding companies, 'but these were simply SOEs raising loans from their employees.'¹⁸⁰ Later some SOEs were transformed into limited liability corporations and joint stock companies. The number of share companies was increasing in the early 1990s, which signified the need for stock market, and in

170 Fan Gang, 'Progress in Ownership Changes and Hidden Risks in China's Transition' (2002) Transition Newsletter, The World Bank Group
<<http://www.worldbank.org/transitionnewsletter/mayjune2002/pgs1-5.htm>>
at 2 January 2003.

171 Ibid.

172 Guanghua Yu, 'The Relevance of Comparative Corporate Governance Studies for China' (1997) 8 Australian Journal of Corporate Law 49.

173 Lan Cao, 'Chinese privatisation: Between Plan and Market' (2000) 13 Law and Contemporary Problems.

174 The World Bank Report, above n 21, 35.

175 Ibid.

176 Yuwa Wei, above n 163, 255.

177 Tan Lay Hong, 'Corporate Law Reform in the People's Republic of China' (1999) 10 *Australian Journal of Corporate Law* 238, 244.

178 Yuwa Wei, above n 163, 255.

179 Ibid.

180 John Farrar, 'Developing Corporate Governance in Greater China' (2002) 25(2) *UNSW Law Journal*, 6.

THE PROBLEMS OF DEVELOPMENT OF CORPORATE GOVERNANCE IN RUSSIA:
COMPARISON WITH CENTRAL EUROPE AND CHINA

1990 and 1991 two stock exchanges were opened in China.¹⁸¹ The progressing corporate activity was also in need of legal regulations and in 1994 the *Company Law* was enacted.

The Company Law has some elements of Anglo-American and German corporate laws transplanted into Chinese soil. The law distinguishes three types of companies: state-owned companies, stock companies and limited companies. The Company Law provides for two-tier board system, adopted from Germany. However, contrary to the German model, the supervisory board does not take part in decision-making, but only supervises the board of directors and operations of the company. Under the Chinese Company Law, the highest corporate organ in a Chinese corporation is the shareholders' meeting which has the power to appoint both directors and supervisors, as well as a number of other powers. The board of directors act as the executive body of the shareholders' meeting and is accountable to it. The major drawbacks of the Company Law are absence of minority shareholders' remedies¹⁸² and lack of definition of directors' duties.¹⁸³

The 1994 Company Law became a legal foundation for the restructuring of SOEs into corporations.¹⁸⁴ This is a long-expected and complex task for China as its SOEs remain to be 'the Achilles heel of China's otherwise remarkable economic performance';¹⁸⁵ besides, there is an apprehension that they can drag down the whole economy of the country.¹⁸⁶ Profits of industrial SOEs continued to decline in spite of all reform attempts, '[y]et according to conservative estimates three-quarters of all bank lending ended up in the SOEs' coffers.'¹⁸⁷ In 1997 the Chinese Government initiated the 'big bang' enterprise reform which is aimed at rapid corporatisation of large and medium-sized SOEs.¹⁸⁸ In the light of these events the issue of corporate governance has become of major importance in China since the mid-1990s.

To improve performance of SOEs and to build a strong modern corporate sector, China turned to the experience and practices of other countries in corporate governance issues. As reflected in the Chinese *Company Law*, the Anglo-American system of corporate governance is taken as a model which provides the basic guidance for reformers in China. However, it is pointed out that '[t]he actual practices and behaviour of the key participants in the corporate governance

181 Yuwa Wei, above n 163, 256.

182 Farrar, 'Developing Corporate Governance in Greater China', above n 180, 7.

183 Yuwa Wei, above n 163, 263.

184 Ibid.

185 Farrar, 'Developing Corporate Governance in Greater China', above n 180, 5.

186 Fan Gang, above n 170.

187 Ibid.

188 Yuwa Wei, above n 164, 264.

process ... are not always consistent with the principles underlying this external market-based framework.¹⁸⁹

What China has managed to establish, as regards corporate governance, is hidden behind a façade of Anglo-American form of a corporation. With the state as the largest block shareholder of Chinese enterprises, it is hard to break the ties that connected factory directors with government officials before the reform.¹⁹⁰ This is apparent as managers are usually appointed by government officials, who also sit in the company's board of directors.¹⁹¹ The actual control of a company is performed by executive managers who 'are generally not subject to effective monitoring and review by the boards of directors and supervisors.'¹⁹² In fact, despite its cautious and gradual approach to reforms China has not turned out to be immune to the disease of insider control problem of other countries with transition economies, and suffers from corruption, 'insider dealing, managerial excesses and inefficiency.'¹⁹³ Neither has China managed to avoid an issue of minority shareholder rights, and exhibits a common disregard of minority shareholder rights, which cannot be protected by the existing legal system. For example, 'the Supreme People's Court recently banned a class-action shareholder lawsuit against a company because of its possible political implications.'¹⁹⁴

Another corporate governance problem that China shares with other transition economies is the lack of regulatory institutions necessary for effective work of a market-based corporate governance model. The banks cannot perform the role of corporate monitors, because they are controlled by the government that does not give up the policy of soft-budget constraints. Banks are directed to issue policy loans to SOEs which are 'seldom if ever repaid.'¹⁹⁵ Besides the inefficiency of bankruptcy mechanisms does not allow banks to have the power to control the debtors. The capital market in China is also a bad monitor of corporate governance. The stocks are volatile; they present interest for short-term speculations only and do not reflect the quality of corporate management.¹⁹⁶ It is observed that 'Shanghai and Shenzhen's casino-like stock exchanges are poorly regulated and demand little discipline from listed companies.'¹⁹⁷

189 On Kit Tam, 'The Development of Corporate Governance in China' (1999) 77.

190 Ibid 89.

191 Ibid.

192 Ibid.

193 Tan Lay Hong, above n 172, 260.

194 Richard Ewing, 'Corporate Governance Can Drive China's Reforms' (2002) *The Asian Wall Street Journal*

<<http://www.nixoncenter.org/Articles%202002/Ewing%20Nov%202002.htm>>

at 4 January 2003.

195 Tan Lay Hong, above n 177, 263.

196 Ibid 266.

197 Ewing, above n 194.

The source of major corporate governance problems in China is the involvement of the state in corporate affairs. The government requires from corporate managers to become efficient economic competitors, yet it sets political goals that are often incompatible with such demand.¹⁹⁸ Foreign advisers underline how important it is to keep a balance and not to undermine the key elements of a market system: 'it is important not to sacrifice financial stability and efficiency in order to mitigate the social costs of restructuring by shielding companies from market discipline and pressure.'¹⁹⁹ With the accession of China into WTO, such requirements have become more pressing.

Recently, the Chinese Securities Regulatory Commission (CSRC) has been taking active measures to improve corporate governance mechanisms in China. In August 2001 it introduced the guidelines on independent directors, and in January 2002 – the *Code of Corporate Governance for Listed Companies*. The Code promoted the corporate practices of international standards and sets principles of the proper conduct of the board of directors, specifies rules for shareholders' meeting and rules of controlling shareholders' behaviour, covers issues of the supervisory board, as well as information disclosure, etc. Along with tougher standards, the CSRC promises to introduce higher listing requirements and strengthened market discipline. In addition to that the Commission aims at training the management cadres and educating investors.

Why Corporate Governance in Russia is Worse than in Central Europe and China

The countries of Central Europe, Russia and China have much in common: they all have been involved in the two major economic events of the twentieth century: the communist experiment with a command economy, and the subsequent transition from plan to market.²⁰⁰ The latter still continues, and has yielded different results in different countries. For example, between 1990 and 1999, GDP in Poland grew by more than 40 percent, while in Russia it fell by 40 percent.²⁰¹ In China, during the 25 years of reforms GDP grew steadily at the rate of 9

198 Ibid.

199 James Wolfensohn, '*Corporate Governance and the Challenge of Development*' (Speech delivered at the International Conference on Building the Institutions for a Modern Market Economy: Corporate Governance Reform in Post-WTO China, Beijing, China, May 26 2002) <<http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:20049690~menuPK:34472~pagePK:34370~piPK:34424~theSitePK:4607,00.html>> at 4 January 2003.

200 Joseph Stiglitz, '*Quis Custodiet Ipsos Custodes? Corporate Governance Failures in the Transition*' (Paper presented at the Annual Bank Conference on Development Economics-Europe, Paris, June 21-23, 1999) 2.

201 The World Bank Report, above n 21, xiii.

percent and lifted 1.3 billion people out of poverty,²⁰² whereas in Russia in 1998 one in five people lived below a standard poverty line, compared to one in 25 people ten years before.²⁰³ The awareness of the interrelation between the success of reforms and the quality of corporate governance brought forward the issue of corporate governance improvement.

In the last decade transition economies have been developing their corporate sector and have encountered similar problems in the governance of their companies. However, they were not equally successful in managing these problems. Of all these countries Russia has performed the worst, mainly due to the failure to cope with two major corporate governance problems: the lack of efficient monitoring mechanisms and the absence of incentives for corporate managers to increase the company's wealth.

The reasons for poor corporate governance in Russia are numerous and depend not only on the chosen reform strategies but also on the initial conditions and the characteristics of the country. Moreover, Jonathan Charkham calls corporate governance 'a mirror to society in general';²⁰⁴ he affirms that as any other system, corporate governance is imprisoned by the social, political, and economic history of the society in which it was developed.²⁰⁵ Therefore, to understand why corporate governance in Russia is poor, as compared to other countries with transition economies, it is important to have a look at how different Russian initial conditions were at the beginning of transition period, and why social, political and economic factors in Russia did not facilitate the development of an efficient corporate governance system in the country.

The Burden of Initial Conditions

In the early 1990s, when Russia embarked on economic reforms, the initial conditions for building a market economy in the country were the least favourable as compared to initial condition in other transition economies.²⁰⁶ First of all, the central planning was much more entrenched in Russia than in China or Central European countries; in Russia it was much more rigid and extensive.²⁰⁷ For example, in the 1970s the allocation of different commodities by central government agencies through the plan in the Soviet Union was 60,000; whereas in

202 Richard Hirschler, 'China's Experience with Transition: What is Behind Its Stunning Economic Success?' (2000) Transition Newsletter, The World Bank Group <<http://www.worldbank.org/transitionnewsletter/mayjune2002/pgs5-9.htm>> at 2 January 2003.

203 The World Bank Report, above n 21, xiii.

204 Charkham, above n 2, 174.

205 Ibid 1.

206 Estrin, above n 79, 6.

207 Ibid.

THE PROBLEMS OF DEVELOPMENT OF CORPORATE GOVERNANCE IN RUSSIA:
COMPARISON WITH CENTRAL EUROPE AND CHINA

China the number was 600.²⁰⁸ Some of the former socialist countries of Central Europe had a lighter version of a command economy. In Hungary and Poland, for example, enterprises had some autonomy regarding questions of employment, production, sales, and investment.²⁰⁹ Hungary adopted a lighter form of economic planning in 1968, Poland in the early 1980s, and China started reforms in 1978. Whereas Russia tried partial liberalisation only in 1987, which ended by “spontaneous privatisation”.

The planned economy in Russia was not only the most deeply entrenched in comparison with other socialist countries; it also lasted there for the longest period of seventy five years, i.e. thirty years longer than in Central Europe and forty years longer than in China. This means that in China and Central European countries ‘market memory’ was not lost: they ‘could draw on their market experience before the Soviet period in the design of an institutional-legal framework supporting markets at the start of the transition.’²¹⁰ In Russia such memory was absent after seventy five years of distortions in the economy, which characterized by severe repressed inflation, overindustrialisation, and absence of sound pretransition policy reforms.²¹¹

Neither was Russia’s economy as open to international trade and western influenced in general as were the economies of other countries in question. For example, in Czechoslovakia, Poland, Slovenia and Hungary over 50 percent of export went to western countries, whereas Russian mostly traded within the Soviet block.²¹² Consequently, the level of exposure to market-oriented business practices through international trade in Russia was substantially lower. In China, such exposure became possible in the late 1970s through the work of foreign subsidiaries and joint venture enterprises in the coastal regions of the country. The degree of interconnectedness with western economies depends to some extent on the location of the country; in addition to that, the country’s geographical characteristics can influence its commitment to reforms. Thus, countries rich in natural resources, which economies depend largely on energy export, show tendencies to delay reform. Russia is a bright example of such countries with its heavy reliance of energy sector and long neglect of the need to implement reform policies.

Another important contributor to the unfavourable nature of initial conditions for economic reforms in Russia was the unstable political situation in the country at the start of transition. The situation was characterised by the ongoing struggles for power and was of such gravity that the transition from plan to market could have never taken place in the former Soviet Union. After the coup attempt in 1991

208 The World Bank Report, above n 21, 36.

209 Estrin, above n 79, 5.

210 The World Bank Report, above n 21, 12.

211 Ibid 11.

212 Estrin, above n 79, 6.

and the dissolution of the Soviet Union in December 1991 the political situation was very shaky and there was a fear that communist regime could come back.²¹³

All of the above-mentioned initial conditions were the main determinants in the choice of reform strategies. The program of rapid mass privatisation was believed to be the only alternative for Russia considering its political situation. To make the reform process irreversible, economic reforms were pushed forward; thus, leaving constitutional and legal reforms to lag behind.²¹⁴ However, with the lack of institutional and regulatory framework such strategy resulted in control vacuum for corporate activity and improper incentives for corporate managers. The new laws, which followed the privatisation, were hard to interpret and implement 'in an environment that remains unreceptive to Western notions of corporate governance'.²¹⁵ The reason for such aversion of western legal and corporate ideas lies in the historically determined traditions of Russian society.

Socio-Historical Tradition

The most relevant feature in the history of Russia for the development of corporate governance is the lack of a rule of law tradition. Autocracy has been the only known form of ruling in the country for centuries: in medieval Muscovy, the Russian Empire, and the Soviet Union, the autocratic government enjoyed absolute power unrestrained by anything.²¹⁶ The law in the form of numerous codes, statutes and decrees 'functioned as an administrative device, not as a set of rules to be obeyed by state officials.'²¹⁷ Russia was the last of the European states to adopt constitution and to create a parliament; however, that did not produce a positive effect as the tsar and state bureaucracy kept almost all of their autocratic powers.²¹⁸

In western countries, the rule of law was born during medieval times in the 'struggle between Church and State over sovereign authority, natural law, and political legitimacy.'²¹⁹ In Russia, the tsar was both the head of the state and the head of the church; thus, nothing prevented 'the concentration of power in the hands of a single ruler.'²²⁰ The rule of law was also difficult to import from western countries because of the problems in creating links with those countries due to geographical features of Russia. Vast territory, bad roads, lack of access to Europe

213 Sachs and Pistor, above n 83, 2.

214 Ibid 1.

215 Katharina Pistor, Martin Raiser and Stanislav Gelfer, 'Law and Finance in Transition Economies' (Working Paper No 48, EBRD 2000) 23, <<http://www.ebrd.com/pubs/find/alpha.htm>> at 30 December 2002.

216 Owen, above n 1, 24.

217 Ibid 25.

218 Sachs and Pistor, above n 83, 5.

219 Ibid 4.

220 Ibid.

by rivers highly limited involvement of Russia in international trade with the consequence of being excluded from integration 'into the emerging European market economic system.'²²¹

For centuries, the majority of Russian self-contained society had lived without any civil rights. Prior to the 1861 emancipation of the serfs, peasants relied on the grace of their lord and could seek no protection from anybody else: '[t]he rural aristocracy, rather than a state bureaucracy, effectively governed Russia in its vast rural areas where the overwhelming majority of the Russian population lived.'²²² But even after the emancipation peasants did not become really free. They continued to live in village communes, did not acquire property rights or land titling, and their fate depended on the decisions of the communal organisation.²²³ Later, in Soviet times such communes were turned into collective farms.

The commune-based structure generated a weak civil society in which individual rights of an ordinary person have never been respected. Respect, fear and awe are paid to the strong leader. Law is ignored in such society simply because people do not believe that law can protect them. Distrust of law is common among all members of Russian society, be it ordinary people, state officials, police or judiciary.²²⁴ Even nowadays, many people in Russia doubt that they will ever live in a *Rechtsstaat*, while older people say that Russia needs another Stalin to cure the situation.

Comparison

The combination of economic, political, historical and social factors in Russia created many obstacles along the path of reforms from plan to market. It is said that '[t]he ability of these reforms to improve corporate performance appears highly sensitive to the institutional environment and initial conditions in which the policies were introduced, along with the specific nature of the policies enacted.'²²⁵ This can be confirmed by the results of comparison of initial conditions in different countries and the impact of implemented policies on the outcome performance.

Thus, the lack of rule of law tradition makes Russia and China alike. For example, according to a recent study of the World Bank Institute,²²⁶ the rule of law indicator in Russia is -0.87, in China it is -0.19, whereas in Poland it is 0.55, 0.64 in the

221 Ibid 5.

222 Ibid.

223 Ibid 6.

224 Newcity, above n 20, 43.

225 Estrin, above n 79, 3.

226 The results of the study are available at
<<http://www.worldbank.org/wbi/governance/wp-governance.htm>> at 6 January 2003.

Czech Republic, and 0.76 in Hungary.²²⁷ Notwithstanding the similarity of these factors between Russia and China, the latter presents a striking antipode to Russia in the success of reforms. The explanation to this is the fact that in the process of reforms China, in contrast with Russia, retained strong political control over corporatisation and thus prevented blatant asset-stripping, which did so much damage to Russia.

The lack of regulatory institutions at the start of reforms prior to privatisation process in Russia was similar to the situation in the Czech Republic. In the former Czechoslovakia, just like in Russia, there was a fear of a possible return to communism. Thus, the political situation prompted the choice of reforms in favour of rapid mass privatisation, which produced similar results in both countries. However, in the Czech Republic the civil society proved to be stronger than in Russia as it was able to change the government that refused to fight corruption. The other government managed to implement necessary reforms and as a result tunneling was curbed in the country.

The fact that unites Central European countries and China and distinguishes them from Russia is the reform policy of creation of friendly business climate for small and medium enterprises and joint ventures with foreigners. This made accumulation of investment capital possible and introduced competition between corporations, which is an important factor for stimulating good corporate governance.²²⁸

Conclusion

The comparison of development of corporate governance in Russia with that of China and Central Europe helps to reveal the factors that influence its poor performance. Although in the process of reforms all those countries have encountered similar problems, such as insider-dealing, violation of shareholders' rights, residual state property in enterprises and others, it seems that the initial conditions in a country as well as its characteristics and implemented policy reforms play a key role in shaping the performance of a national system of corporate governance.

The importance of developing good corporate governance mechanisms cannot be overestimated in the world that is getting more and more globalised. Globalisation opens exciting opportunities for transition economies, but at the same time, it places the burden of huge responsibility on them. When more and more countries become members of the global community, each participating country has to realise that its economic performance and the quality of corporate governance are

227 Higher values correspond to better results, on a scale from -2.5 to 2.5.

228 Stiglitz, above n 200, 16.

THE PROBLEMS OF DEVELOPMENT OF CORPORATE GOVERNANCE IN RUSSIA:
COMPARISON WITH CENTRAL EUROPE AND CHINA

now vitally important not only for that very country, but for the whole world. The interconnectedness of economies all over the globe makes them very powerful, yet vulnerable at the same time, just like the world itself.