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Corporate Governance Reform in Russia: The Effectiveness of the 1996 Russian Company Law

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CORPORATE GOVERNANCE REFORM IN RUSSIA: THE EFFECTIVENESS OF THE 1996 RUSSIAN COMPANY LAW

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Abstract: During Post-Soviet privatization, widespread abuses of power in Russian corporations contributed to the economic malaise in that country. These abuses are attributed to the domination of firms by senior management. In January 1996, the Russian Company Law went into effect with very strong protections for minority shareholders as a means to curb these abuses. This Comment analyzes the effectiveness of the Russian Company Law in this regard over the past three years. It concludes that the law has been moderately successful given the extremely hostile conditions at the time of enactment, and thus, it is a model for other transitional economies in need of corporate governance reform.

I. INTRODUCTION

In 1996, the Russian government enacted a statute designed to reform control over Russian joint stock companies.[1] The vast majority of these companies were state-owned firms that had undergone the privatization process.[2] Once privatization was nearly complete, senior management had gained control over most firms.[3] Unfortunately, senior management in most instances refused to share control with employees and outside minority shareholders.[4] This domination led to great abuses of power: gross mismanagement and even theft of corporate assets; a disregard for employee welfare; and the prevention of much needed outside investment in order to

[1] *See* Ob Aktsionernykh Obshchestvakh RF [Federal Law of the Russian Federation on Joint-Stock Companies], RF Federal Act No. 208-FZ, Dec. 26, 1995, *translated in* RUSSIAN ECONOMIC LAWS, *available in* LEXIS, Intlaw Library, Rflaw File [hereinafter Russian Company Law]. For a detailed and comprehensive discussion of the Russian Company Law see BERNARD BLACK ET AL., GUIDE TO THE RUSSIAN LAW ON JOINT STOCK COMPANIES (1998).

[2] The privatization process, which began in 1992, allowed Russian citizens to become partial owners in most of the formerly government owned enterprises. These privatized enterprises are now joint stock companies. Individuals and entities own a percentage of a company to the extent they possess a portion of a company's shares. *See* JOSEPH BLASI ET AL., KREMLIN CAPITALISM: THE PRIVATIZATION OF THE RUSSIAN ECONOMY 39-41 (1997).

[3] Most empirical studies in the mid-1990s found that management controlled about two-thirds of all privatized firms. *See infra* note 20 and accompanying text.

[4] If a majority of the stock in the company is owned by management and/or employees, the company is said to be "insider controlled." If an outside investor owns a small percentage of shares in an insider controlled company, the investor is a minority outsider. In fact, most of the Russian joint-stock companies were owned (as opposed to controlled) primarily by rank-and-file employees as opposed to management. *See infra* notes 20-43 and accompanying text.

retain control.[5] This irresponsible corporate governance delayed much needed enterprise restructuring.[6] In response to these abuses and concerns about the future, the Russian government promulgated the 1996 Joint-Stock Company Law ("Company Law" or "the law").[7]

The law, which was passed in December 1995, is a modified version of a proposed law designed by two American corporate law professors, Bernard Black and Reiner Kraakman.[8] The professors subsequently published an article explaining the novel approach of the law.[9] Their first claim is that "effective corporate law is context specific, even if the problems it must address are universal."[10] Mere transplantation of corporate law from developed economies to transition economies, they argue, will prove to be ineffective given the differing characteristics and roles of key participants in the corporate enterprise.[11] Their other claim is that certain cultural values and business practices must be considered when designing a country's corporate law.[12] Black and Kraakman identify these contextual factors within transition economies and advocate for the adoption of strong protections for minority shareholders as a means to promote the goals of corporate law in emerging market economies. The principal goal supported by these protections is "[t]he efficiency goal of maximizing the company's value to investors."[13]

The Russian Company Law offers many of the protections advocated in the Black and Kraakman article.[14] These protections include: 1) cumulative voting by shareholders to elect the board of directors; 2) extensive procedural protections for shareholders over the board; 3) a requirement for the use of independent registrars; 4) disclosure of a company's financial records and

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[5] *See infra* notes 21-38 and accompanying text.

[6] BLASI ET AL., *supra* note 2, at 147. Corporate governance refers to the mechanisms and processes by which companies are governed. THE INTERNATIONAL TASK FORCE ON CORPORATE GOVERNANCE OF THE INTERNATIONAL CAPITAL MARKETS GROUP, INTERNATIONAL CORPORATE GOVERNANCE: WHO HOLDS THE REIGNS? 1 (1995). The authors state: "If the companies in which wealth is accumulated are poorly governed, if their resources are inefficiently used, if their managements are inept or if the power of their management becomes channeled in a way which conflicts with the company's interests, all stakeholders [viz., shareholders with relatively large, though not necessarily controlling, shareholdings] and society suffer, not just the owners of the enterprise. It is therefore important that within every company there are means of ensuring that resources are used efficiently and in a manner that ensures the achievement of the company's objectives and its ability to contribute to the common good." *Id.*

[7] BLASI ET AL., *supra* note 2, at 98. *See also* Russian Company Law.

[8] Bernard Black & Reiner Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1914 n.2 (1996).

[9] *Id.*

[10] *Id.* at 1914.

[11] *Id.*

[12] *Id.*

[13] *Id.* at 1921.

[14] *See infra* notes 61-85 and accompanying text.

other relevant information; and 5) mandatory board and shareholder oversight over classes of large-scale and self-interested transactions.[15] Given its primary emphasis on strong minority protections, the Russian Company Law reflects a definite commitment to corporate governance reform within the context of emerging market economies.[16]

Not surprisingly, the primary difficulties, which these protections have had to overcome, are those same abuses of power that the Company Law sought to reform. In fact, those who control certain companies demonstrate a general disregard for laws that compromise their own interests.[17] Black and Kraakman argue that their legal model is "self-enforcing" so that key participants in the corporate enterprise, including those in control, will voluntarily accept the law as the reasonable standard of corporate governance.[18] Those participants who egregiously violate the law will be subject to harsh, and possibly violent, extra-judicial repercussions from, paradoxically, the law-abiding participants.[19] The Company Law was therefore novel in that it was designed primarily as a model for reasonable corporate behavior and not as a tool for judicial enforcement.

The purpose of this Comment is to analyze the effectiveness of the recently promulgated Russian Company Law on Russian business practices. Effectiveness will generally be measured by an increase in the recognition for, and the implementation of, minority shareholder rights. Part II of this Comment assesses the extent to which minority shareholder rights were recognized in Russia just prior to the enactment of the Company Law. Part III examines the protections within the Company Law's provisions with explanations and arguments supplemented from the Black and Kraakman article. It then analyzes the extent to which minority shareholder protections have been recognized and respected since the law was passed and the factors that would tend to explain the extent of post-promulgation recognition and respect.

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[15] Black & Kraakman, *supra* note 8 at 1933-36. Large-scale transactions are company purchases or dispositions involving a large portion of the company's assets. Self-interested transactions are company purchases or dispositions with another entity or individual controlled by or related to one or more of the company's directors or officers. *See* Russian Company Law arts. 78-79 & 81-83.

[16] Although other emerging economies have company laws that seek to promote corporate governance, the 1996 Russian Company Law earned the highest marks for setting extensive legal standards for corporate governance. *See* John L. Taylor & Françoise April, *Fostering Investment Law in Transitional Economies: A Case for Refocusing Institutional Reform*, 4 PARKER SCH. J. E. EUR. L. 1, 23-24 (1997).

[17] *See infra* notes 61-85 and accompanying text.

[18] Black & Kraakman, *supra* note 8, at 1915.

[19] *Id.* at 1940-41.

II. BACKGROUND TO THE ENACTMENT OF THE 1996 RUSSIAN FEDERATION JOINT-STOCK COMPANY LAW

Prior to the enactment of the Russian Company Law, managerial control over the majority of firms was the major reason for a general disregard for minority shareholder rights. This insider ownership of the majority of Russian firms was a direct consequence of the Russian privatization process.[20] Most managers were able to gain control in the governing structure in these firms,[21] which in turn allowed managers to neatly align the goals of the firms with their own interests.[22] Many of these managers were more concerned with stability and job security than the dictates of the market.[23] Without the necessary outsider input and oversight, irresponsible corporate governance burgeoned in a country where there was little experience to accommodate basic market forces.[24]

A. *Insider Control*

The Russian privatization program led directly to insider ownership over the majority of shares in almost all privatized firms.[25] It offered several buy-out options to employees (both rank-and-file workers as well as managers) of suitable enterprises.[26] The most common method known as Option Two involved employees purchasing, during a period of extreme

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[20] Most of the surveys conducted on the ownership results from the privatization process estimated insider shareholdings as a percentage of all shareholdings in privatized firms to be between 65% and 70%. *See* Joseph Blasi & Andrei Shleifer, *Corporate Governance in Russia*, *in* 2 CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA 78 (Roman Frydman et al. eds., 1996). Their survey placed the figure at 65% as of December 1993. The survey had a relatively low sample size of 170 firms across several regions in the country, but the firms (through management) were interviewed extensively and thus the survey proved to be a rich source of material pertaining to corporate governance. *See also* John Earle & Saul Estrin, After Voucher Privatization: The Structure of Corporate Ownership in Russian Manufacturing Industry (June 2, 1997) (unpublished manuscript, on file with *Pacific Rim Law & Policy Journal*). They determine that 66.1% of privatized manufacturing firms were insider held. Their survey was conducted in the summer of 1994, and although it only sampled manufacturing firms, the sample size was much larger than any other sample conducted to date (439 firms). It also sampled firms that had not participated in privatization and included samples from firms privatized through the lease option. *See also* Roman Frydman et al., *Investing in Insider-Dominated Firms: A Study of the Russian Voucher Privatization Funds*, *in* 1 CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA 187 (Roman Frydman et al. eds., 1996). This survey estimates that as of June 1994, nearly 70% of privatized firms were insider dominated. The survey was conducted through a sample of the voucher funds (148 funds out of 516).

[21] BLASI ET AL., *supra* note 2, at 88. *See also supra* note 20 and accompanying text.

[22] BLASI ET AL., *supra* note 2, at 122.

[23] *Id.*

[24] *Id.*

[25] *See supra* note 20.

[26] Some enterprises, most notably those with ties to the defense industry, were not allowed to privatize during the early stages of privatization. *See* Earle & Estrin, *supra* note 20, at 32.

inflation, fifty-one percent of the total shares at a price of 1.7 times the July 1992 book value of the company.[27] Because this purchasing frenzy took place during a period of extreme inflation, the book value declined more sharply than did the market value of the actual assets.[28] Thus, the majority of a firm's shares were sold to employees at a greatly reduced rate.[29] These firms remained under insider control as employees, and especially management, continued to buy more shares to consolidate their control.[30] Under Option One, the state gave employees twenty-five percent of the shares free of charge and then allowed the workers to purchase an additional ten percent and managers an additional five percent at nominal prices.[31] The number of companies that chose Option Three, which allowed for a management buy-out based upon the fulfillment of a performance contract, was almost negligible.[32] Finally, the lease buy-out option, Option Four, gave insiders the greatest proportion of control.[33] This program, from January 1992 to the end of June 1994, distributed sixty-five to seventy percent of the shares of some 14,000 firms to the employees of those firms while only an average of eighteen percent of each firm's shares were offered to the public.[34] These options effectively redistributed firms, and their assets, from the state to the employees of the firms.

Thus, the privatization program, especially under Options Two and Four, allowed managers to consolidate their control over the privatized firms. Although employee-shareholders held most of the shares of these firms, senior management held the largest blocks and consequently were able to elect entire boards.[35] These results ran contrary to requirements established by the Russian Federation State Committee for State Property ("GKI") that demanded one board seat for worker-shareholders out of five

[27] Book value refers to the ruble value of the corporate assets as defined by governmental officials in July 1992. MAXIM BOYCKO ET AL., PRIVATIZING RUSSIA 139-92 (1995). In this initial analysis of the privatization program in 1993, over 60% of the firms chose this option. Earle & Estrin, *supra* note 20, at 36 & n.36. The sample also suggests that about 60% chose Option Two.

[28] Earle & Estrin, *supra* note 20, at 36 & n.36.

[29] *Id.*

[30] *Id.*

[31] The average insider holdings amounted to just over 50% of all shares (some of these shares are not voting shares). Earle & Estrin, *supra* note 20, at 36-41. The authors contend that once voting shares are tabulated outsider control, as a percentage of all voting stock, rises considerably.

[32] *Id.* at 36.

[33] The lease buy-out option was used by over 25% of the privatizing firms between 1993-95. These firms averaged insider shareholdings as 90.6% of the total. *Id.* at 18, 36.

[34] *See* Frydman et al., *supra* note 20, at 190.

[35] *See* Blasi & Shleifer, *supra* note 20, at 80. In fact, rank-and-file employees owned the majority of all insider owned shares but were intimidated into either selling their shares to management or, at least, allowing managers to vote their shares. *See* BLASI ET AL., *supra* note 2, at 107-108, 193. These employees were also told that outsider shareholders would mean lay-offs. *Id.* at 113.

board members.[36] Moreover, further GKI requirements that limited the number of managers on the board and imposed cumulative voting were largely ignored.[37] Therefore, management controlled not only the daily operations of the companies, but the boards as well.[38] This manipulation allowed senior management to exercise complete authority over most firms.

B. *Outsider Involvement*

The architects of the privatization program had hoped for greater outsider involvement.[39] The architects thought that the workers would take their vouchers and cash them in on the huge premiums expected from the mass giveaways.[40] These shares would then be consolidated among managers and outsiders comprised of investment funds, foreign investors, and domestic firms.[41] The managers would thus have a stake in the continuing efficiency of the firm and outsiders would monitor against such managerial opportunism such as voting themselves high salaries, stealing corporate assets, and pursuing self-interested transactions.[42] Outsiders, in an attempt to create profit by cutting unneeded labor, would also push for extensive restructuring of thousands of severely over-employed firms—a legacy of the inefficient labor armies from the Soviet-era.[43] Unfortunately, foreign and bank investment remained extremely low in the first few years of the privatization process.[44] Domestic firms were able to invest only limited resources into other firms and the lack of available capital impaired their ability to acquire substantial blocks of shares in many firms.[45]

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36 Blasi & Shleifer, *supra* note 20, at 80-81.

37 *Id.* at 82. No more than one-third of the members of the board were to be employees. Cumulative voting allows minority shareholders to consolidate their votes behind one candidate to the board. Instead of voting for one individual, shareholders are allowed to distribute their votes among all the possible candidates. Majority shareholders would then have to carefully balance their votes for several candidates whereas minority shareholders could pool all their votes behind a friendly candidate. Normal voting allows the majority shareholders to ensure that the entire slate of elected candidates is friendly to the board, whereas cumulative voting allows minority shareholders to elect at least one candidate.

38 *Id.* at 89.

39 Frydman et al., *supra* note 20, at 189.

40 *Id.*

41 *Id.* Investment funds are entities whose sole purpose is to make a profit by investing in companies' shares, corporate or governmental securities, or other assets. *Id.* at 191-92. These funds are owned by numerous individual investors and managed by licensed investors. *Id.*

42 *Id.* at 189.

43 *Id.* at 191. Observers agreed that firms should cut their employment by half. *See* BLASI ET AL., *supra* note 2, at 36. *See also* Marta Bruno, *The Business Culture in Russia*, *in* BUSINESS CULTURES IN CENTRAL AND EASTERN EUROPE 128, 146 (Milford Bateman ed., 1996).

44 Earle & Estrin, *supra* note 20, at 24.

45 *Id.* at Table 20. The average shareholding for domestic firms among privatized, industrial firms is 7.3%.

The primary hope for outsider involvement lay in the voucher funds. These funds were to act as mutual funds: individuals who own shares would invest their vouchers in the fund, and the fund, in turn, would own the shares of the various firms.[46] These funds would then either have a large enough ownership stake to acquire voting rights, or at least enough information to make informed investment decisions. However, these funds were not allowed to acquire more than ten percent of the securities of one issuer.[47] In 1994, this legal limit was raised to twenty-five percent[48] and by the end of that year voucher funds had acquired moderately significant blocks of shares in many firms.[49]

The investment funds represented the primary means by which Russian corporate governance could effect widespread, needed restructuring. Investment funds that want to ensure a healthy profit have incentives to become active in a firm, whereas managers who can skim profits and exact favors have an incentive to maintain the status quo. Due to the illiquidity of the Russian securities market during the end of privatization, analysts argued that given a choice, a fund would rationally opt for a voice within the firm to increase the health of its investment, rather than merely wait for the opportunity to sell its shares.[50] In fact, funds were active in a large majority of their investments.[51] However, their level of investment made these actions less effective at controlling the influence of management.[52] Although other domestic firms owned a considerable portion of shares, there were reports that many of these firms were supportive of management.[53] Thus, the investment funds were the most important outside investors to provide an alternative voice to effectuate change.[54]

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[46] Frydman et al., *supra* note 20, at 191.

[47] *Id.* at 193 & n.11. *Cf.* Earle & Estrin, *supra* note 20, at 44 (arguing that this legal limit was ignored).

[48] *Id.* at 194.

[49] *Id.* at 193 n.11 (of 148 funds, 76 owned stakes between 20% and 25%, 27 between 25% and 50%, and four own stakes greater than 50%). *Id.* at 199 (funds held 20% or greater stakes in only 8.4% of the 6,882 companies in the sample funds' portfolios). *But see* Earle & Estrin, *supra* note 20, at 49 ("Only about 15 percent of investment fund stakes are less than five per cent (but greater than zero), and 85 per cent of their stakes are five per cent or greater!"). *Id.* at 51 ("Thirty-three percent of all privatized firms have institutional ownership at least at the 20 percent level, and 20.6 percent of firms have institutional ownership over 30 percent.").

[50] The average percentage of the fund's companies traded was 24.9%. Of those traded, 88.6% were traded in private trades. Frydman et al., *supra* note 20, at 225.

[51] Funds were active in close to 80% of the companies in their portfolios. *Id.* at 212. "A fund is considered to be an "active investor" if it spends significant resources and/or effort on monitoring and/or influencing major decisions, such as employment, investment, structure of production, sales, organization, etc." *Id.*

[52] *Id.* at 208.

[53] *Id.* at 210.

[54] *Id.*

Even though most funds were active in the companies in which they had invested, in many cases management had no outside, profit-driven rival in the corporate structure.[55] This was reflected in the quality of the financial information disclosed to the funds by their firms as well as the need to get support from management to be on the board.[56] Even if an outside director was elected to the board, management would have the necessary quorum to convene meetings at any time without the presence of outsider directors.[57] Management would, at times, not allow funds to increase their investment in the company,[58] while at other times they would not tell investors about shareholder meetings. If that did not work, management would resort to locking investors out of the meeting.[59] If outside investors could get their hands on enough shares to make demands on managers, managers would simply issue new shares at nominal prices to themselves, thereby diluting outside ownership.[60] Indeed, managers were the big winners from the privatization program and they acted like it.

III. EFFECTIVENESS OF THE RUSSIAN COMPANY LAW

A. *Shareholder Rights under the Russian Company Law and the Self-Enforcing Model*

Passed in December 1995, the Federal Law of the Russian Federation on Joint-Stock Companies defines the legal rights and obligations of all joint stock companies operating in the Russian Federation.[61] The law enumerates the procedures and requirements for creating, maintaining, and dissolving a joint-stock company.[62] Along with introducing many technical changes, the law fills in gaps left by previous legislation and incorporates many legal concepts derived from more mature western commercial law systems, some

[55] The state still had a large number of shares in many privatized firms. *Id.* at 208 (finding that the state was represented on the board in 46.9% of the firms in the funds' portfolios). Earle & Estrin, *supra* note 20, at 29 (finding that the state held an average 15% in privatized firms). Blasi & Shleifer, *supra* note 20, at 94 (finding the average state shareholdings was 10% in December 1994).

[56] Frydman et al., *supra* note 20, at 205, 216. A third of sampled funds reported that the information they got, if they were to get any, would be poor. Only 0.8% reported that they received good information, whereas 82.7% of funds reported that they cooperated with management to obtain board representation.

[57] Blasi & Shleifer, *supra* note 20, at 89, 99.

[58] 27.8% of funds found that management refused to register an increase in the fund's ownership of the firm on the share registry. *Id.* at 226-27.

[59] *See, e.g.*, Steve Liesman, *Roiling Stock: Shareholder Meetings in Russia Set Stage for Free Market Fight*, WALL ST. J. EUR., Apr. 20, 1995.

[60] *See e.g.*, BLASI ET AL., *supra* note 2, at 92-96.

[61] *See* Russian Company Law.

[62] *Id.*

of which were previously unknown in Russia.[63] The law more clearly enumerates the powers and duties of company directors and officers.[64] It authorizes a variety of classes of preferred shares.[65] Most importantly, for the purposes of this Comment, the law significantly strengthens shareholders' rights, particularly for minority shareholders, and shareholder participation in the governance of the company.

The Russian Company Law mandates a greater recognition of, and respect for, shareholder rights and protections. For example, it clarifies certain rights provided for in earlier laws.[66] It also establishes a more sophisticated legal framework for the rights of shareholders who are absent from shareholder meetings or vote against certain decisions.[67] Such shareholders may demand that their shares be bought by the company at the fair market value if a decision is made regarding the reorganization of the company, the entering into a major transaction, or an amendment of the company charter which would be detrimental to those shareholders.[68] It is the company's responsibility to inform shareholders of this right.[69]

Shareholders have greater control over board elections, large-scale transactions, and the issuance of new shares. Cumulative voting is mandatory for elections to the board of directors in companies with more than 1,000 voting shareholders.[70] This requirement enables minority shareholders, by concentrating their ballots, to elect a proportional number of board members.[71] Shareholders have control over transactions that involve the alienation of real property and assets.[72] For deals involving

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63 *See* BLACK ET AL., *supra* note 1, at 9-13.

64 *Id.*

65 Russian Company Law arts. 22-26. The Articles contain provisions dealing with convertible and cumulative preferred shares, as well as the issuance of different classes of preferred shares, affecting dividend payments and priority rights in liquidation. The Articles also list those situations in which holders of preferred shares are automatically vested with voting rights at the general shareholders' meeting, irrespective of any limitations imposed by a company's charter.

66 BLACK ET AL., *supra* note 1, at 9-10.

67 Russian Company Law art. 75.

68 *Id.*

69 *Id.* art. 76.

70 *Id.* art. 66. Article 66(4) provides for cumulative voting in companies with over 1000 holders of common stock (smaller companies may provide for cumulative voting in their charters). *Id.*

71 *Id.*

72 *Id.* art. 78. Article 78 section 1 defines large-scale transactions as:

> [A] transaction or several mutually-linked transactions connected with the acquisition or alienation or possibility of alienation by the company directly or indirectly of property whose value comprises more than 25% of the balance sheet value of the assets of the company on the date of the adoption of the decision concerning the conclusion of such transactions, except for transactions concluded in the process of the exercise of ordinary economic activity; a transaction or several mutually-linked transactions connected with the issuance of common stock or preferred stock convertible into common stock comprising more than 25% of common stock previously issued.

assets valued at over fifty percent of the company's book value, a seventy-five percent vote of shareholders is required.[73] If the deal equals twenty-five to fifty percent of book value, the unanimous consent of the board of directors, or majority shareholder approval, is required.[74] The law also allows for provisions in the charter of a joint stock company to authorize preferential rights, so that existing shareholders may acquire shares of an additional issue by open subscription in proportion to the number of shares held by them.[75]

The most important shareholder protections enumerated in the law include the following requirements:

- joint stock companies with 500 shareholders must employ an independent share registrar;[76]
- a company must maintain, publish and present specified information to shareholders upon request;[77]
- shareholder(s) owning at least two percent of voting shares in the company are entitled to propose up to two agenda items at each annual general meeting of shareholders;[78]
- open joint stock companies must maintain a minimum number of members of the board of directors;[79]
- members of the board of directors are elected for one-year terms rather than two, and are subject to recall.[80] The law also prohibits the management of the company from constituting a majority of the board.[81]

The law also stipulates that members of the board of directors, the general director, and the members of senior management are liable to

Id. art. 78.

Section 2 states that the board shall determine the value that is the subject of a large-scale transaction. *Id.* art. 78(2).

[73] *Id.* art. 79.

[74] *Id.*

[75] *Id.* art. 40.

[76] *Id.* art. 44.

[77] *Id.* arts. 89, 91.

[78] *Id.* art. 53.

[79] *Id.* art. 66. For companies with more than 1,000 holders of voting shares, there must be no fewer than seven board members; for companies with over 10,000 such shareholders the minimum number is nine. *Id.*

[80] *Id.* arts. 66 (specifying the one year term requirement), 48 (authorizing shareholders to recall board members).

[81] *Id.* art. 66. Thus, quorums of the board with sole representation by management were outlawed. *Id.* art. 68 (requiring a majority of board members to be present in order to establish a quorum). This provision, at least on paper, would take away a very powerful tool used extensively by managers to maintain control of the firm prior to the passage of the law. *See* BLASI & SHLEIFER, *supra* note 20, at 99-100.

companies for losses attributable to their culpable actions (or inactions), unless they voted against the action or were absent from corresponding meetings.[82] Legal standing to sue these persons is vested in shareholder(s) owning one percent of the placed common shares of the company.[83] Moreover, shareholders shall exert control over transactions in which board members and their affiliates are personally interested.[84] Transactions carried out in violation of this set of rules may be declared void.[85] The aggregate of these rights and protections embodied within the Russian Company Law is, at least, a partial realization of the novel "self-enforcing" model advocated by Professors Black and Kraakman.

B. The Self-Enforcing Model

Unfortunately, the recognition of these rights would be very difficult given the insider domination of many firms and the general lack of regard for minority shareholders. Black and Kraakman were well aware of the obstacles. Contrasted against the role of corporate law in developed economies, which "plays a relatively small, even 'trivial' role," the Russian law was to be "a much more central tool for motivating managers and large shareholders to create social value rather than simply transfer wealth to themselves from others."[86]

This "self-enforcing" model contains five features as a means for creating such "social value." First, restrictions and rights are enforced through the activities of direct participants, as opposed to reliance upon the courts or regulators.[87] Second, greater protection is accorded to minority

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82 Russian Company Law art. 71.

83 *Id.*

84 Russian Company Law articles 81-83 concern self-interested transactions. Article 81 defines these transactions according to the pecuniary involvement of a member of the board of directors, person holding office in other management bodies of the company, shareholder(s) holding jointly with their affiliated person(s) 20% or more of the voting stock, or their spouses, parents, etc. *Id.* art. 81.

Article 82 states that the aforementioned persons must inform the board of directors, audit commission and the auditor of the company of conflicts of interest concerning: legal entities in which they possess 20% or more of the voting stock; legal entities in whose management bodies they hold office; transactions known to them to be concluded or proposed in which they may be deemed to be interested persons. *Id.* art. 82.

Article 83 states that, for a company with over 1000 shareholders, a decision concerning the conclusion of a self-interested transaction shall be adopted by the general meeting of holders of voting stock by a majority of those present who are not interested, in the following instances: if the amount of payment and the value of the property which is the subject of the transaction exceed 2%of the assets; if the transaction is the issuance of voting stock in a quantity exceeding 2% of voting stock previously issued. *Id.* art. 83.

85 *Id.* art. 84.

86 Black & Kraakman, *supra* note 8, at 1914.

87 *Id.* at 1916.

shareholders.[88] This feature is meant to compensate for the high incidence of insider domination.[89] The third feature consists of procedural protections for various types of transactions as a means of inducing interaction among larger shareholders rather than setting forth flat prohibitions which would probably not be recognized anyway.[90] The fourth feature provides bright-line rules, rather than standards, to define proper and improper conduct.[91] These rules make it easier for investor-participants to be aware of improper conduct that might otherwise fall into a gray area. Moreover, such rules make it more difficult for corrupt judges or regulators to maneuver around broad standards. Finally, the fifth feature provides for strong legal remedies, assuming that most of the sanctions will not be enforced.[92]

Black and Kraakman believe that these features can "build legal norms that managers and large shareholders will see as reasonable and comply with voluntarily."[93] They argue that "some managers will comply with the written law simply because it is both written and reasonable; some will comply because their peers do; others will comply so as not to risk embarrassing news stories."[94] Moreover, "companies that need capital will comply with the rules to build a reputation for honest behavior, and companies that plan to enter long-term contractual relations must safeguard their reputation for honesty and fair dealing."[95] The rules should also make it apparent once misconduct takes place. It is relatively simple to determine whether a vote was taken or whether required information was provided to shareholders. Black and Kraakman hope that even "without official enforcement, the entire corporate law. . . becomes a set of default rules from which the participants in the corporate enterprise can depart, jointly or unilaterally. But, as with any set of default rules, it will be costly to ignore them or contract around them."[96]

The Russian Company Law incorporates several of Black and Kraakman's features. The significant shareholder protections and rights provided by the law to a considerable extent reflect the third and fourth features discussed above. For example, the procedural protections over certain transactions are reflected in the law's procedural requirements for

88 *Id.*
89 *Id.*
90 *Id.*
91 *Id.*
92 *Id.*
93 *Id.* at 1917.
94 *Id.* at 1940.
95 *Id.*
96 *Id.*

large-scale and self-interested transactions.[97] However, the law fails to include bright-line rules to determine improper board member and officer behavior.[98] Moreover, with regard to the first feature, it remains to be seen whether the direct participants will enforce the various rights and restrictions on their own or if they will have to resort to using the courts. With regard to remedies, the Company Law provides for the complete compensation of any loss to the company derived from an unauthorized self-interested transaction by the party involved.[99] However, Russian law fails to provide for any criminal sanctions arising from non-compliance with the law.[100]

C. *Results of the Russian Company Law*

The Russian Company Law has not effected a widespread recognition of, or respect for, minority shareholder rights.[101] The general lack of compliance with the law appears to be a direct result of the managerial domination in the majority of firms.[102] General directors have been quite successful in holding onto their control, as against rank-and-file employees and outsider influences.[103] Those general managers who desire outside investments have primarily accepted the Company Law.[104] The activities of the Federal Securities Commission, along with several high-profile cases, managed to thrust shareholder rights into the spotlight in early 1998.[105] Yet, given the overall inadequate enforcement mechanisms, voluntary acceptance of the law by certain general managers has been the key to a greater recognition of shareholders rights since the law was passed.[106]

Compliance with the Russian Company Law has been limited at best.[107] As of May 1997, two of the largest companies had not amended their charters to comply with the law.[108] Recent news reports have described

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[97] *See supra* notes 73-74 (concerning large-scale transactions) and 84 (concerning self-interested transactions) and accompanying text.

[98] Russian Company Law art. 71 (defining the standard for board member or officer liability as actions or inactions which are not in good faith and unreasonable).

[99] *Id.* art. 84. It also legally nullifies the transaction. *Id.*

[100] Dmitry Vasilyev, Press Conference with Federal Commission for the Securities Market, *in* OFFICIAL KREMLIN INT'L NEWS BROADCAST, Aug. 27, 1997, at 5, *available in* LEXIS, Europe Library, Sovnws File.

[101] *See infra* pp. 14-17 and accompanying notes.

[102] *See infra* pp. 17-18 and accompanying notes.

[103] *See infra* pp. 18-20 and accompanying notes.

[104] *See infra* notes 132-137 and accompanying text.

[105] *See infra* notes 114-123, & 168-170 and accompanying text.

[106] *See infra* notes 175-178 and accompanying text.

[107] *See, e.g., infra* note 112 and accompanying text.

[108] Boris Nemtsov, Press Conference with Boris Nemtsov, *in* OFFICIAL KREMLIN INT'L NEWS BROADCAST, Apr. 28, 1997, at 9, *available in* LEXIS, Europe Library, Sovnws File (relating how two oil companies, RAO-UES and Gazprom, have not harmonized their charters with the Russian Company Law).

how the large oil companies in particular have attempted to abuse outsider shareholders' rights.[109] Almost ninety percent of foreign investors say that companies failed to provide adequate financial, operational, and strategic information to shareholders.[110] In 1997 alone, the Federal Securities Commission stopped more than twenty attempts to dilute outsiders share value.[111] Empirical research conducted in mid-1996 revealed widespread illegal practices and prompted the researchers to rate corporate governance standards in nearly sixty percent of firms as either "bad" or "horrible."[112] Several recent incidents involving quarrels between outside investors and management can help to illustrate non-compliance practices.

Recently, the Federal Commission for Securities Market publicly censured the Russian management at Krasnodarsky Gips-KnaufAG, a Russian-German joint venture. Although German nationals own fifty percent of the common stock, management has denied them access to the company's offices as well as access to any of its records.[113] One can see the flagrant disregard for the law by some managers when they will not even allow access to the actual owners, not to mention access to minority shareholders.

One of the most dramatic examples, culminating in December 1997, involved Novolipetsk Metallurgical Kombinat ("NLMK"), the country's largest steel producer. The clash between investors and management arose when Cambridge Capital Management, which owned twenty-five percent of common stock, tried to nominate candidates to the board in January 1997.[114] The Russian Company Law allows shareholders with two percent of the common stock to nominate candidates to the board.[115] However, NLMK refused to recognize the submitted nominations even after the Federal Commission on the Securities Market and the local prosecutor ordered NLMK to comply.[116] Cambridge and another outside shareholder, Sputnik

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[109] *See, e.g.*, Patricia Kranz, *In Russia, a Rising Chorus: Enough is Enough*, BUS. WK. INT'L, Feb. 23, 1998, at 38 (describing how expected windfalls to investors arising from mergers actually diluted the value of the investors' holdings). *See also* Christia Freeland, *Investors Lose Audit Fight*, FIN. TIMES (London), Feb. 7, 1998, at 2 (relating accusations by Western investors that Russian oil companies are siphoning value from their oil production subsidiaries to the parent holding company).

[110] Vincent Boland, *Investor Confidence in Russia Improves*, FIN. TIMES (London), Aug. 21, 1997, at 24 (relating a survey of U.S. investment institutions conducted by Brunswick Consultants, a New York firm).

[111] Vasilyev, *Press Conference with Federal Securities Commission Head, in* OFFICIAL KREMLIN INT'L NEWS BROADCAST, Jan. 28, 1998, at 1, *available in* LEXIS, Europe Library, Sovnws File.

[112] BLASI ET AL., *supra* note 2, at 201. Forty-six percent of the firms were rated "bad," 13% were rated "horrible," whereas 39% were "good," and only 2% were "excellent."

[113] Vasilyev, *supra* note 100, at 2.

[114] *See, e.g., All Sides Seek Protection of Shareholders' Rights in Novolipetsk Case*, 8 RUSS. & COMMONWEALTH BUS. L. REP. 18, Jan. 14, 1998, at 12.

[115] Russian Company Law art. 53.

[116] *All Sides Seek Protection of Shareholders' Rights in Novolipetsk Case*, *supra* note 114, at 12.

Fund, went to court and received a favorable ruling in May 1997.[117] NLMK not only ignored the ruling but held a general meeting of shareholders in July without allowing an election for a new board.[118] Eventually, Cambridge and Sputnik, along with MFK-Renaissance Capital, acquired enough common stock to prevent the passage of a new charter and even voted in a majority of the board.[119]

Another incident pitted Mosenergo, Moscow's electricity company, against foreign investors and the federal government. The company proposed not only to limit shareholder voting rights to one percent of share capital, regardless of the size of the shareholders' stake, but also to restrict the nomination of directors to candidates with twenty-five years of experience in the Russian power industry.[120] Moreover, the company planned to sell another thirty percent of its shares to Moscow as a means of diluting foreign ownership.[121] Foreigners held an estimated thirty-five percent of its shares owing, in part, to the company's reputation for openness.[122] Mosenergo capitulated under pressure from the federal government and threatened cancellation of a $100 million loan from the European bank for Reconstruction and Development.[123]

A quarrel involving the Lebedinsky Mining and Processing Plant did not have a happy ending for investors. Clients of Rossinsky Kredit acquired thirty percent of the plant but, after a series of quarrels, were barred from the 1996 annual general shareholders meeting at which the company diluted the investors' shares to five percent.[124] The investors subsequently went to court, got a favorable ruling, but could not enforce it.[125] At the 1997 shareholder meeting, the investors tried to submit candidates to the board (as in the NLMK case) but were not allowed to do so by the current board of directors.[126]

Non-compliance with the Russian Company Law may also be attributed to ignorance and a dearth of professional support to implement provisions. The cumulative voting protection for minority shareholders

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[117] *Id.*

[118] *Id.* Annual elections for a new board are mandatory under Russian Company Law, art. 47. Hence, NLMK managed to ignore another provision of the Russian Company Law. *See* Russian Company Law art. 47.

[119] *All Sides Seek Protection of Shareholders' Rights in Novolipetsk Case, supra* note 114.

[120] *See, e.g.*, Chrystia Freeland & Arkady Ostrovsky, *Investor Fury at Russian Share Move*, FIN. TIMES (London), Apr. 17, 1997, at 3.

[121] *Id.*

[122] *Id.*

[123] *See, e.g.*, Chrystia Freeland, *Mosenergo Forced to Give Way*, FIN. TIMES (USA), Apr. 18, 1997, at 3.

[124] *See, e.g.*, Patricia Kranz, *Shareholders at the Gate: Russian "Red Directors" Dig in Their Heels as Outside Investors Try to Oust Them*, BUS. WK., June 2, 1997, at 60.

[125] *Id.*

[126] *Id.*

dumbfounded one management team responsible for the annual shareholders meeting.[127] They even went through the trouble of studying the law as well as employing outside counsel.[128] The disclosure requirements established by the Russian Company Law include independent annual audits.[129] Unfortunately, accountants are in high demand; furthermore, asking enterprises on the brink of survival to pay for an audit, which could expose further weaknesses in the company or conversely invite higher tax liabilities, is probably too much to expect. Likewise, many companies simply lack mechanisms for disseminating such information.[130] Moreover, although there were several articles in the Russian media discussing the passage of the Company Law, official dissemination of the law was non-existent.[131]

Despite the publicized incidents, some blue-chip companies are moving to comply with the law as a default mechanism to protect shareholder rights in the hopes of attracting foreign investment. Insiders at Sidanco, a Russian oil company, had previously agreed to dilute minority shareholder stakes through a closed convertible bond issue.[132] After aggrieved shareholders called the Federal Securities Commission into action against the issuance, insiders are now planning to offer minority shareholders "equal access" to the bonds.[133] Mr. Vladimir Potantin, one of the most powerful business magnates in Russia, and director of Sidanco, said that in Russia today "it is not possible not to respect shareholder rights."[134] Another powerful oil company, Yuksi, was also alleged to have mistreated minority investors by diluting shareholder value through asset stripping.[135] Yuksi has decided to resolve the incident by establishing an international board of western consultants to create a "charter" as a means to protect minority shareholder rights.[136] Gazprom, yet another large oil company, has promised to become more transparent and open in the hopes of attracting foreign investors.[137]

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[127] Kathryn Hendley, *Legal Development in Post-Soviet Russia*, 13 POST-SOVIET AFF. 228, 238 (1997).

[128] *Id.*

[129] Russian Company Law art. 88.

[130] *See* Gregory L. White, *Lukoil's Unofficial Release of Earnings Highlights Bugs in the Russian Market*, WALL ST. J., Dec. 20, 1996, *available in* 1996 WL-WSJ 11810430.

[131] Telephone interview with Valvio Musim, Professor of Law, St. Petersburg State University (Mar. 21, 1998).

[132] Chrystia Freeland, *Shareholders Win Russian Bond Fight*, FIN. TIMES (London), Feb. 26, 1998, at 2.

[133] *Id.*

[134] *Id.*

[135] Matthew Brzezinski, *Western Investors Cheer Russian Ruling That Upholds Minority Holder Rights*, WALL ST. J., Feb. 19, 1998, at A-17.

[136] Chrystia Freeland, *Russian Oil Group Hits Back at Critics*, FIN. TIMES (London), Feb. 19, 1998, at 27.

[137] *Da, Kapital*, WALL ST. J., Nov. 20, 1996, at A-22. Seven months later Gazprom had complied with the cumulative voting requirement although it still had the reputation for being "notoriously secretive." Steve Liesman, *Outsiders at Russia's RAO Gazprom Vie for Crucial First Seat on Firm's*

In short, compliance with the law has been haphazard at best. Scandals over shareholder rights continue to rock Russian security exchanges.[138] Although larger companies are moving toward greater compliance, smaller companies tend to be more concerned about tight insider control.[139] Managers are willing to comply only when they realize they need outsider money.[140] This attitude will be explored more fully, along with other factors that would tend to explain the lack of widespread compliance, in the next section.

D. *An Explanation of the Results of the Russian Company Law*

Several factors tend to explain the lack of widespread compliance with the law. The largest obstacle remains the influence and attitude of the general directors.[141] In most firms, their control is virtually absolute.[142] They have successfully undermined the governance rights of the rank-and-file workers who generally own the greatest aggregate of shares. General directors see the law and outside investors as a threat to their control[143] and outsiders have been active in attempting to assert their rights.[144] Moreover, the courts and the Federal Securities Commission have earned a respectable reputation for their acts on behalf of minority shareholders.[145]

One analyst for the Moscow Times proclaimed, "The record shows that Russian corporate chieftains care as much about shareholder rights as they do about Uruguayan agrarian reform, and their propensity will not change anytime soon."[146] This propensity stems from a desire to maintain personal control over the firm.[147] Compliance with the law would

Board, WALL ST. J., June 25, 1997, at A-18.

[138] *See, e.g.*, Kranz, *supra* note 109 (relating how a spate of scandals helped bring the Moscow exchange down by some 30% in January 1998).

[139] Paula Hawkins, *Salomon Gets Serious*, 7 CENTRAL EUR. 44, 44-45 (1997) (containing excerpts from an interview with Jim Dannis, Managing Director for Emerging Markets with Salomon Bros., wherein he states that there are two tiers of companies. The first tier is concerned with attracting investments and exhibits "no major corporate governance challenges." The second seeks to remain closed and works with closely affiliated "banks or trade suppliers.").

[140] In mid-1996, only 29% of senior managers in a survey said that they would sell ownership over the firm to an outsider if that investor would make all the capital investment necessary to restructure the firm. *See* BLASI ET AL., *supra* note 2, at 201.

[141] Gary Peach, *Financial Ethics Crackdown Bodes Well for Shareholders*, MOSCOW TIMES, Feb. 24, 1998, *available in* LEXIS, Europe Library, Mostms File. *See also* Hendley, *supra* note 127, at 243.

[142] Hendley, *supra* note 127, at 243.

[143] *Id.*

[144] Brzezinski, *supra* note 135, at A-17.

[145] Chrystia Freeland, *Scourge of Moscow's Moguls*, FIN. TIMES (London), Feb. 27, 1998, at 2.

[146] Peach, *supra* note 141.

[147] *Id.*

necessitate a loosening of personal control by following provisions that may not be responsive to management's interests.

For example, in principle the use of cumulative voting, independent auditors, and counting commissions wrests control from management. Cumulative voting is meant to lead to greater outsider representation on the board of directors,[148] which has the power to terminate the general director and other managers.[149] Likewise, the auditors and counting commission are accountable to the shareholders and not the management.[150] Such provisions diminish the general director's authority. Thus, general directors who are primarily interesting in retaining control over "their" firms would be unlikely to comply with many of the provisions in the law.

One of the greatest problems faced by minority shareholders is the lack of adequate disclosure of financial information.[151] Such disclosure is mandated in Article 92 of the law. However, many general directors have been fearful to expose such information.[152] The reason general directors may be loathe to disclose such information is that such disclosure may expose violations of other provisions.[153] Indeed, Professor Black has stated "greater disclosure of corporate dealings will ultimately prove the key tool in wiping-out shareholder-rights violations. Sunshine has proved to be a great disinfectant in American companies . . . It will prove to be effective in Russia, too, if given a chance to operate."[154]

Not only do general directors lose a measure of control by complying with the law, compliance demands a shift in engrained behavior patterns and attitudes towards the role of law. The rules, which the Russian Company Law mandates, are quite alien and not a reflection of Soviet customs. Directors of enterprises in Soviet times relied largely on personal contacts rather than the rules of laws as a means to promote their interests and resolve disputes.[155] This engrained behavior will likely take years to overcome.[156] Moreover, Russians have consistently seen the laws used as a "sword brandished by the state" rather than as a "shield to protect society."[157]

[148] *See supra* note 37 and accompanying text.
[149] *See* Russian Company Law art. 65 (10).
[150] *Id.* art. 48. Furthermore, management is strictly barred from representation in these bodies. *See, id.*, art. 85 (6) (concerning the auditors); art. 56 (2) (concerning the counting commission).
[151] *See supra* note 56 and accompanying text.
[152] BLASI ET AL., *supra* note 2, at 98, 200.
[153] *See, e.g., supra* notes 84-85 and accompanying text.
[154] Jeanne Whalen, *Shareholders Rights: Round 2*, MOSCOW TIMES, Feb. 17, 1998, *available in* LEXIS, Europe Library, Mostms File.
[155] Hendley, *supra* note 127, at 240-41.
[156] *Id.* at 242.
[157] *Id.* at 237.

Currently, "[e]conomic actors do not view law as being useful to them, as a mechanism either to advance their interests or to defend themselves from arbitrary acts by the state."[158] These attitudes and engrained behavioral patterns would tend to explain the inconsistency between current business practices and compliance with the law.

Rank-and-file employees have had a difficult time exerting control over the firms. As of mid-1996, these workers actually held controlling stakes in the vast majority of insider-controlled firms,[159] yet for the most part they have been hapless in asserting their rights.[160] One reason for this is the weakness of the organization among the workers through their labor unions.[161] Another reason is fear of losing their jobs if they would attempt to vote against management in shareholders meetings.[162] Yet another explanation is the historical respect for the head official: "[t]heir instinct was to obey orders, not to question [management's] legitimacy."[163] In short, rank-and-file employees have not, in general, asserted their rights to the extent they could under the Company Law.

Conversely, both domestic and foreign investors have been quite active in trying to assert their rights. Yet, given the overall compliance with the law among firms, the extent to which these outside investors have effected changes in respect for shareholders' rights have been limited to those firms interested in attracting investors.[164] The Financial Industrial Groups ("FIGs") have been quite effective in corporate restructuring and are considered "key players in Russia's economic game."[165] Yet, their impact on the overall economy as a whole is very small.[166] These outside investors have been somewhat successful in attempting to assert their rights, and yet, this trend is not widespread.

A further explanation for the lack of compliance is reflected in the weakness of enforcement mechanisms, namely, the courts and the Federal Securities Commission. The Federal Securities Commission is the federal

[158] *Id.* at 239.

[159] BLASI ET AL., *supra* note 2, at 193.

[160] *Id.* at 113.

[161] Labor unions were not, during the Soviet regime, meant to exercise worker rights. Now, most are managerially controlled and thus do not assert themselves against the dictates of the general director. *Id.* at 107-08.

[162] *Id.* at 107. *But see* Kathryn Hendley, *Struggling to Survive: A Case Study of Adjustment at a Russian Enterprise*, 50 EUR.-ASIA STUD. 91, 95 (1998).

[163] Kathryn Hendley, *supra* note 162, at 95.

[164] Hawkins, *supra* note 139, at 44-45.

[165] U.S. Embassy Report, *Demystifying Russian FIGs: Banker Barons Versus Industry-Led Financial Groups* (visited Mar. 22, 1998) <http://www.itaiep.doc.gov/bisnis/cables/cable.htm>. There are two types of FIGs: bank led and industry led (holding companies). *Id.*

[166] *Id.*

agency delegated with the task of protecting shareholders rights.[167] Recently, it has been praised for taking on large companies on behalf of investors.[168] Such acts have signaled a new "avenue of activity" towards regulating enterprises as it has previously focused on licensing registrars and registering emission prospectuses.[169] Unfortunately, the commission can only apply pressure to firms and refer abuses to the civil arbitration courts, as it has no power to issue fines or bring criminal charges for violations of the law.[170] The courts themselves are in the process of overcoming a bad reputation. Foreigners have been concerned about a court's ability to make "independent, even-handed" decisions.[171] Many Russian businessmen believe that submitting disputes to these courts is a waste of time.[172] Even with a favorable judgement, it can be extremely difficult to ensure its satisfaction.[173]

E. Corporate Governance and Self-Enforcement in Russia

Although there are widespread and deeply rooted problems with corporate governance practices in Russia, the Russian Company Law has already realized some of the aspirations of its designers. The realization of these aspirations can be overshadowed by comparisons with corporate governance standards in the West. Largely, the "self-enforcing model" has not lived up to its name. However, the Company Law was introduced into a very hostile environment of unflinching managerial control over most privatized firms and an extremely weak legal culture. The small successes over the last two years should not be underestimated.

Some of the central features of the self-enforcing model have led directly to these small successes. In fact, there is presently a tier of companies that exhibit "no major corporate governance challenges."[174] This signifies a dramatic departure from the prevalent conditions surveyed just before the law was passed.[175] The departure is directly correlated to the

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[167] Freeland, *supra* note 145, at 2.

[168] *See* Peach, *supra* note 139.

[169] Vasilyev, *supra* note 100, at 5.

[170] *Id* at 5. The name of the courts does not mean to imply that these courts actually arbitrate disputes, rather, these courts were transformed from Soviet tribunals of the same name. *See*, Hendley, *supra* note 127, at 239 n. 27.

[171] *Survey—Moscow as a Business Centre: Risk-reward Balance is Shifting*, FIN. TIMES, Sep. 17, 1997, at 9.

[172] Hendley, *supra* note 127, at 237-39.

[173] *Id.* at 241-42. *See also*, *Survey—Moscow as a Business Centre: Risk-reward Balance is Shifting*, *supra* note 171.

[174] *See* Hawkins, *supra* note 139 (quoting a foreign investor's perceptions).

[175] *See supra* note 112 and accompanying text (scoring only 2% of companies as exhibiting "excellent" standards of corporate governance).

voluntary compliance of the managers as a means to attract investors.[176] Moreover, once these investors become active they are able to enjoy substantial governance rights provided by the law. As such, the departure corresponds to the central features of the law emphasizing strong shareholder rights and the hope that the market participants would voluntarily comply with the law.[177]

Unfortunately, the hostile environment remains by which many general directors with absolute control over their firm do not wish to relinquish their control. Legal incentives can only become tangible if these directors wish to attract outside investors. Protections for minority shareholders necessitate a diminution of control from the majority shareholders. For example, protections such as cumulative voting and independent registrars hamper the majority shareholders' ability to vote in an entire board or to disguise true share ownership in order to retain tight control. General directors whose primary concern is to maintain maximum control have little incentive to comply with the law. The lack of large outside investors and the weakness of the state as a regulator only exacerbate this fundamental problem.

As the capital markets in Russia develop, more powerful outside investors will become more significant equity participants in Russian joint-stock companies. They will seek undervalued companies and attempt to invest in them. One likely outcome is that general directors will become attracted to the much-needed capital these investors have to offer. If this attraction can overcome a director's fear over the loss of absolute control and if outside investors become large, possibly even majority shareholders, then a director would seek refuge in the law's minority shareholder protections. At such a point, the directors themselves may become the strongest supporters of the law as a means to protect themselves as minority shareholders.

Moreover, the enforcement mechanisms have been improving. Several court cases, including the NMLK and the Monsenergo cases, have developed important precedents for future violations of rights.[178] The Federal Securities Commission ("FSC") has also recently become quite active, not to mention successful, as a protector for minority shareholders' interests.[179] Last year alone, the FSC denied twenty emission prospectuses

[176] *See* Hawkins, *supra* note 139, at 44-45.

[177] *See* Black & Kraakman, *supra* note 8, at 1939.

[178] *See supra* notes 111-123 and accompanying text. *See also*, Chris Plath, *Shareholder Victories Move Russia One Step Closer to Good Corporate Governance*, CORP. GOVERNANCE BULL. May-June 1997, at 26, (1997).

[179] *See supra* notes 167-170 and accompanying text.

that would have led to share dilutions.[180] The press and international agencies have also been successful in exerting pressure.[181] Although these "indirect" participants were not the locus from which rights were to be protected, their positive involvement would have diminished but for the law's strong protections highlighting the illegality of the acts in question.

Overall, the Russian Company Law has been moderately successful given the difficult circumstances posed by the Russian environment. It has been a valuable tool for effectuating better corporate governance. Yet, not until more general directors desire outside investors will widespread conditions for compliance become ripe.

IV. CONCLUSION

The Russian economy has experienced rapid and dramatic changes since the onset of privatization in late 1992. The governing structures of the privatized firms have been the key to effectuating much needed restructuring in order to make these firms more efficient and profitable. Yet, the privatization process led directly to insider domination in the great majority of these firms. This insider domination, in turn, led to widespread abuses, such as blatant theft of corporate assets and the mistreatment of other investors. Many of the general directors were more concerned with exercising control and safeguarding their positions than the realities of the market. The Russian Company Law was introduced as a means for those market participants interested in profits to realize their goals. The features and protections of this law make it a novelty. Its early successes in the wake of extremely hostile conditions provide hope for Russia, and make it a model for states and observers interested in legal reform in emerging capitalist markets.

It has not even been three years since the law was passed. Given the prevalent corporate governance conditions existing at the time of its promulgation, the law has managed to promote some modest improvements. These improvements are attributable to the features inherent within the law. As such, the designers of the law can be satisfied that they have laid the legal framework for probable future gains in Russia's corporate governance standards.

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[180] Vasilyev, *supra* note 100, at 5.

[181] *See supra* note 123 and accompanying text (describing the role of the EBRD as a factor in the resolution of the Monsenergo case).