Corporate Governance After Mass Privatization
The Ukrainian Perspective

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"Well, are you hiring a chairman?" Asked the old man, while putting on his patched-up Panama hat. "I see your outfit needs a chairman. I do not charge much: one hundred and twenty rubles per month while in freedom and two hundred and forty in jail. There is one hundred percent hazard premium."
"I suppose we will take you," said Ostap. "Submit the application to the man in charge of hoofs."

The Golden Calf
Ilia Ilf and Evgeni Petroff

About the author
Alexander Krakovsky is the President and CEO of Prime Capital Securities, an investment company founded by him and partners to provide investment banking and corporate finance services in the CIS. Until recently, Mr. Krakovsky was the Vice-President for Investment Projects for NCH Capital, Inc. NCH runs investment funds for the CIS with the total capital of about $3 billion. In both capacities, Mr. Krakovsky lead take-overs, restructuring and corporate actions in several well known Ukrainian companies that emerged from mass privatization. Among them are Borispol Cereal (now Cerealia AG Breakfast Ukraine), JSC Ukrnafta, and many others. Prior to NCH, Mr. Krakovsky was a manager in the consulting practice of Coopers and Lybrand, where he worked in CIS bank restructuring, corporate finance and US mortgage-backed securities market. Mr. Krakovsky received a Master of Science degree in business from the University of Maryland, College Park with a focus in corporate governance.

Abstract

This essay surveys the state of Ukrainian companies that emerged from mass privatization and attempts to suggest where to look for remedies to the corporate governance problems. Specifically, it discusses how market for corporate control, securities market regulations and development might play a positive or a negative role in restructuring and shareholder rights in these companies. It also argues that the key economic goal of corporate governance is nothing less than a functioning market economy. While this paper does not attempt to take a fully academic approach, it does attempt to add to the knowledge by providing an insider's view into the mass privatized economy. It also uses some most relevant works to provide a theoretical framework to the claims made herein. The paper concludes that increasing the vitality of the market for corporate control will save the greatest amount of value that has been privatized. It also suggests a measured and attainable approach for developing capital markets and public companies. Finally, it cautions against taking steps or using methods that might actually worsen the situation.

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Introduction

In the past couple of years, Corporate Governance and shareholder rights have become the buzzwords that sometimes even overshadow privatization in the CIS. In 1996, this author launched a complaint to the Gore-Kuchma committee regarding the abuse of minority shareholders in the conduct of the JSC Dniproshina and JSC Dniprokishen share issues. Although these problems did not receive much attention and were not resolved, one of the compromises was the establishment of the Corporate Governance and Shareholder Rights Task Force.

During the past five years, this author has taken corporate action many times on behalf of investors. Some of the projects were great commercial successes, resulting in millions of dollars in profits for investors, not to speak of the satisfaction of saving a business. Others were disasters, one resulting in my arrest and even somewhat comically trumped-up attempted murder charges[1].

It is beyond the scope of this paper to have extensive references to academic literature[2] or to provide a comprehensive program for corporate governance reform. I only hope to provide an essay of:

1. How things are. This is from six years of experience in the CIS, four of which were spent in sunflower fields buying Ukrainian companies, in director's offices understanding what drives them, in board rooms and on factory floors restructuring companies, and in Ukrainian police interrogation answering attempted murder charges of a disgruntled director.
2. How things should be, as perceived from my academic background and from my experience in the trim and proper world of "the big six… now the big five."
3. Some indication of how to get from where things are to where things should be. While originally, the intent of this paper was to point out some issues and assumptions that are important to the development effort, many comments were calling for more suggestions for the Government and the development community might take. I have tried to provide some of the "what to do." However, it is not the scope of this essay to provide the comprehensive corporate governance program for the CIS. My best hope is to lay some ground to developing the corporate governance program on the right track, as well as the kind of work that will both improve the "how things are," and add to knowledge.

This paper will proceed as follows:

1. Definition of corporate governance for the purpose of this paper. This is not just for the benefit of those who do not distinguish between corporate governance and business management, but to set forth the basis and assumptions for this paper.

[1] See for example: Investors In Row…, Kyiv Post, June 3, 1999

[2] Fairly comprehensive review of relevant literature can be found in **Dyck (1999), Stiglitz (1999)** and many other recent works on corporate governance and privatization.

2. Description of why corporate governance is so important in the post-mass-privatization environment.
3. Review of market for corporate control as one of the key components in post-mass privatization restructuring.
4. A short review of mass privatization and key legal points in Ukraine.
5. Address the issue of public company privatization format as a sustainable form for privatized companies.
6. Provide recommendations for public policy and Western assistance programs.

Definition of Corporate Governance

Corporate Governance is the practice and study of improving the inter-relationship between different stakeholders in a corporation. Corporate governance primarily focuses on relationship between the management, different classes of shareholders (minority, majority, controlling, etc.) and the debtors. The central issue is the mechanisms of control by the outside claimants (usually debtors and minority shareholders) of the insiders (management and controlling shareholders)[3].

This problem is normally addressed by four distinct, but inter-related mechanisms[4]:

- Internal is usually exercised through the company's board. Since shareholders in a public corporation can not effectively manage or monitor the management of the corporation, they elect the board of directors (or supervisory board in some countries). This board's main purpose is to monitor managers[5].
- Contractural. This usually focuses on developing corporate charters, bylaws, shareholder agreements, debt contracts, management contract, etc[6].
- Legal and regulatory. This includes, but not limited to company laws, stock market regulations, bankruptcy and work-out laws, commercial code, common laws on issues such as fiduciary responsibilities, and accounting rules[7].
- Implicit solutions. These are market, social and political mechanisms, such as: market for corporate control and concentration, agents with hold-up authority (such as unions), capital budget constraints, dividend policy, financial structure, etc.[8]

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[3] The text book academic works were: Berle and Means "The Modern Corporation and Private Property" 1932 and Jensen and Meckling (1976) that point out to potential expropriation by insiders (management) of outside claimants in a corporation. Extensive references to works on corporate governance can be found in most recent works, such as La Porta Lopen and Shleifer (1998) and Stiglitz (1999).

[4] Contractural, Legal and Implicit Described in Dyck (1999)

[5] For a good review of literature on board effectiveness, see John and Senbet (1998)

[6] Contracting predominated as the key solution to corporate governance problems in early works with Coase (1961), Jensen and Meckling (1976), Eastbrook and Fschel (1991), ……These works point out that a) a corporation is a contract, b) there is an incentive for agents to bind themselves in order to get financing, c) if perfect contracts and written, then regulation and bankruptcy become unnecessary, while work-out of financial becomes cost-less.

[7] The most recent work by La Porta, Lopez, Shleifer and Vishy (LLSV) (2000) point out that not everything can be contracted and that enforcement of the contracts is not certain, therefore regulations should supplement contracts. Additionally, they point out that countries with common law have the best protection for corporate rights because judges can use their sense of fairness and a "sniff test" as applied to situations not described in the law.

It is important to point out that while there might be some debate as to what is the most effective instrument, there is little doubt that all three instruments are important to achieve the maximum efficiency in a corporation.
Another very important point for this paper is that most works on the above issues, especially on regulation, have been directed to publicly held corporations. Most private companies, also benefit from regulations, good contracts and implicit solutions, however the appropriate solutions could be different for private deals[9]. For example, an employee at USAID who used to structure deals in developing countries told me how upon being hired, local managers in developing countries had to sign a resignation letter that stated they were stealing. Clearly, such solution would be completely inappropriate for a public company.

Let's be clear: Why do we need it?

I have asked several western advisors working on related projects: "why are shareholder rights and corporate governance so important right now?" Some of the answers were: "Well, without Shareholder Rights, privatized companies will not be able to attract capital," or "This is part of building the law and order in the society." On the topic of shareholder rights in Central Europe, The Economist recently wrote:

> This is worrying, for if such [small] investors withdraw from the market and liquidity shrinks, economic growth will suffer. Without fluid capital markets, Central Europe's emerging economies will find it hard to attract the capital they need."[10]

This is only partly true and does not get to the heart of the matter. **Without the Corporate Governance and Shareholder Rights focus, microeconomic reform would be inconsistent with economic model of the market economy. Privatization will not succeed, and the market economy will never come to exist.** This is a bold statement. Here is why:

Even before the collapse of the Soviet Union, Western advisors were preaching privatization. Why privatization? Because, the theory goes, private business owners will be motivated by profit to run businesses in the best way possible. In contrast, the Government can never be an effective owner because the Government officials are not motivated by profit, as private owners would be.

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[8] Dyck (1999) points out that corporations in countries with poorer regulation resort to second-best solutions, such as concentration, agents with hold-up power and artificial constraints. Hart (1995), quoted in LLSV (2000) focus on investor power and not on formal cash flow or voting rights. Stiglitz (1999) summarizes his idea of a corporate model where all stakeholders (governments, regulating agencies, unions, even civil groups) have bargaining power for corporate control vis-à-vis their authority and political access.
[9] OECD Principles of Corporate Governance clarifies this issue: "The Principles focus on publicly traded companies. However, to the extend they are deemed applicable, they might also be a useful tool to improve corporate governance in non-traded companies…" 1999 booklet p. 9
[10] The Rights Issue, May 29, 2000, The Economist

If, however, after privatization the new owners can not exercise their rights as owners, then the new owners can not be effective. If the new owners cannot be effective, then the now-privatized companies would not be ran with a profit motive any more than they had been under state ownership. The goal of privatization would not be achieved.

The only difference would be that the Government under the Soviet Union was motivated by social and "state interests" (whatever those may be). The Soviet central planning system enforced certain controls to that end, using its vast powers. After mass privatization, ineffective owners have little or no powers at their disposal, so the companies are ran entirely for the benefit of individuals whose hand is in the pot, and not for the benefit of the value maximizing owners.

Possibly some politicians and consultants can claim success – companies were sold-off, but the economy would not be better off as a result of privatization without achieving effective ownership. However, anyone who believes that privatization in and of itself would bring about incentives to restructure and increase efficiency was greatly mistaking.

In fact, I would go a step further, without labeling anyone: most post privatized companies in Ukraine now are controlled by people or groups who do not own these companies. A typical Ukrainian company is owned by a large number of shareholders that are not capable of organizing any kind of corporate action, not to speak of replacing management (ineffective owners). The management, along with partners who run or help to run parallel companies fleeces the privatized companies through price transfers to the parallel structures. The majority of the owners (shareholders) get nothing or close to nothing. The management is incentivized by current profits in the parallel structures, not by increasing the shareholder value. Not only are these companies investment unfriendly because of bad corporate governance, they are not functional as companies. Instead of taking advantage of opportunities and developing or restructuring as companies naturally would, Ukrainian privatized companies have become mere dilapidating, filthy production facilities, eking out another few years of production before total collapse. In other cases, they are simply stripped of assets without regard to shareholder rights. What's more: While Soviet central planning system, with all its ludicrousy kept tight control on enterprise management and cash flow, the privatized companies have no system of controls over the management and its cronies.

Market for Corporate Control

We (Western advisors) decided nonetheless that privatization would bring about effective owners. In fact, the political compromise of mass voucher-based privatization was considered as preferable to leaving a large sector of the economy in the Government hands for the near future[11]. The voucher privatization, however, placed shares of

[11] See for example **Stiglitz (1999)** "Washington Consensus" referenced in **Black, Kraakman, Tarassova.** Another example of support for rapid mass voucher privatization was the large USAID mass privatization project, running the auction centers in Ukraine. USAID country profile from 1996 (still posted on USAD web site on the date of this paper), states "To help Ukraine implement its mass privatization program successfully, and in that context to develop its securities market." As the first of six specific targets for USAID over the next 12 to 15 months.

thousands of companies – many quite small – in the hands of 50 million individuals who traded in their free vouchers. (Ukrainian voucher funds did nothing but add another layer of moral hazard to the situation.) Among many small, uninformed individual shareholders, few have been able to exercise their shareholder rights – hardly effective ownership.

Some of us can say now: "Ah, but we weren't advising the CIS governments at that time," but this is not a discussion of what could have been done differently. The same governments, agencies, Universities and banks advised these governments then as do now. More importantly, a seemingly solid theory backed the mass privatization:

The individuals who can not be effective owners and control their companies will sell their corporate rights to those who can. The market will thus take care of itself. In fact, even if criminal elements initially get control, they will still resell it to those who can manage the companies better.[12]

This theory, however, is based on the assumption that the market has to be complete for these kinds of transactions.[13] (In other words, it has to be feasible and practical for companies to change hands en-mass before falling into total operational and financial distress from ineffective ownership). However, it is far from clear that this assumption holds.

Black, Kraakman and Tarasova (1999) were among the first to challenge the myth that market for corporate control is complete in mass-privatized economies. They noted that this (mass transfer of assets to effective owners) could happen only in a "mythical thick market." In reality, they pointed out that things went quite astray because of many real barriers to this kind of transition from non-effective owner to effective owner. Dyck (1999) also supports the same idea. Following is a list of a few such barriers from this author's own practical experience. This practical experience (be it anecdotal) confirms similar examples reflected in Black's article, as well as the points brought up by Dyck:

- Criminals can extract significantly more profit than legitimate businesses by controlling a company and operating it in a criminal manner. For example, illegally stripping the assets or cash flows from the company whose management they control. After asset stripping, the company becomes worthless.

- Damaged title to shares: shares are acquired from the Government in a questionable manner that can later be challenged. "Good faith buyer" principle would apply if the shares weren't encumbered, but the privatized shares are often encumbered by investment obligations. It is up to the state officials to decide after the fact whether

[12] This reflects "the Coase theorem" after a 1961 article "The Problem of Social Cost" where this Noble Laureate describes how initial allocation of property rights does not matter, but clear property rights are of primary importance for efficient outcome.
[13] Assumption in the Coase theorem is that the market has to be complete. In other words, all kinds of transactions must be able to take place efficiently and costlessly.

the investment obligations are met or not. If the officials decide that the investment obligations are not met, however, the state has the right to take the shares away.

- It is very difficult to do due diligence if you wish to acquire a privatized Ukrainian company. These companies normally do not keep western books, do not have a working financial controlling function and do not have any sort of management accounting. (The recent transition to western accounting is merely symbolic because the economy does not have enough trained accountants to supply even a few companies with qualified auditors, controllers and accountants)[14]. What's more, the corporation and underlying asset documents might have intentional mistakes, to be used by officials or management if disgruntled. This author has run across situations when, for example, the local Government simply canceled the title of a company to its real estate when it found out that the company changed owners. Sometimes, undiscovered debts, liens, leases, encumbrances, obligations and rights of way were discovered after control was taken. These obligations were usually in favor of someone close to original management, local government or local gangs.

- Barriers to tendering a purchase: This author has put in his time organizing buy-outs at the factory gate, in the sun-flower fields and door-to-door. This is an extremely costly and risky operation. Imagine chasing down several thousand farm workers in a collective farm (Kolholz) "Road to Communism," explaining to them that they might be shareholders in some company they probably haven't heard (because the Kolhoz director told them to trade in their vouchers for shares of this company). Then telling them that if they are shareholders, they could sell their shares for cash, and that they have to bring their documents to a certain place the next day to get money. Then you have to come to this place with money (sometimes equivalent of several hundred thousand US Dollars in cash) and a notary in tow, hoping that your security is better than the gangs are. Visits and all consuming audits from KRU (control directorate of the Ministry of Economics), SBU (formerly KGB), MVD (Ministry of the Interior), Procurator and other "controlling agencies" are a certainty, and they are never to protect the brokers from the gangs. Several times, brokers buying shares in this way were arrested by the police, who let them out only after getting a "small percentage" of what was in the pot.

  Unfortunately, however, there is no structural way to make an official, transparent tender to all shareholders of the company at once. The Registrar is not allowed to disclose the shareholder list or facilitate tenders. The only way to find shareholders is through workers, motivated general director, hearsay, and observation at the shareholder's meeting.

- Transaction barriers. To purchase shares from individuals, contracts must be notarized, often at a cost of up to $50 per contract – a hefty percentage, considering many individuals do not own shares worth $50. (Alternatively, the registrar can

[14] According to Gerry Parffitt, the managing partner of Price Waterhouse Coopers, there are only about fifty (50) certified accountants (CMA, ICCA or CPA) with Ukrainian nationality. (Conversation September 5, 2000).

verify the contract, but that is usually impractical.) Additionally, the executing broker is responsible for assuring proper collection of taxes from the seller and registering the purchase after the money transfers hands, taking a risk that the extract or the certificate is forged. Opening a depository account for each individual would often cost more than the shares are worth, while notarization requirements will not be eliminated. Smaller towns (with population of less than 300,000 people) often only have one or two notaries, who are used to conducting business in their offices, and not at the factory gate.

- General directors have a good incentive to "keep it in the collective." While the shares are with workers, they can influence the workers to keep the shares and give full control to the management. Depending on the situation, this can be done by threats of being fired, under the threat of local police officials abusing their powers or just through personal influence. Many workers in rural Ukraine have been taught to do "as the boss says" without question. They even vote that way. Many of them also rely on the enterprise management to explain their rights (to sell or not to sell, to vote or not to vote, to leave or not to leave). Not only are worker's rights to sell are violated this way, they can not exercise any other shareholder's rights, leaving the director in absolute power.

This is not to say that the market for corporate control does not exist. It exists, and it is robust is some situations. In fact, this author has made some successful buy-outs in this market. However, it is very limited, complicated and costly to the extend that vast majority of privatized companies simply can not be put with effective owners under current conditions due to high barriers and costs to transactions. Many of these barriers, however, can be removed by economically focused reforms.

Ukrainian Privatization

Ukrainian privatization was fundamentally similar to other mass privatization schemes in Check Republic, Russia, Bulgaria and other countries. Various blocks were distributed to employees, vouchers, tenders, cash auctions, etc. Just like in other countries, it was marred with scandals, accusations and a variety of problems. A few peculiarities for Ukraine were:

- The pace of privatization was relatively slow. That did not, however, improve the situation, but only provided the management more time to entrench. It has not been uncommon for privatization to take two or three years from the sale of the first block to the last. This only exacerbated the inefficiency, resulting in the “inevitable governance problems that emerge before the controlling stake is assembled…” described by Dyck (1999).
- Privatization plans weren’t fixed, as they were in Russia. The allocation between employees, voucher holders, cash auctions and tenders was a political process that generally allowed insider to tailor the most advantageous scheme for them. It was common for each enterprise’s privatization plan to change several times.

- Vouchers weren't transferable, as they were in Russia. Ukrainian citizens could only contribute vouchers to voucher investment funds in exchange for fund certificates. These certificates were transferable. Brokers, therefore, set up elaborate schemes of buying vouchers through investment funds. As a result, virtually all investment funds are really vehicles for investors who bought shares through accumulation of vouchers. Shares are being held in investment funds until that time when the fund is allowed to close and distribute shares to its owners (all funds are being closed now through next year). Since ultimate owners for most shares in investment funds are not known, it is probably not a very good idea to rely in any way on investment funds for partnership in any corporate governance program.
- In addition to regular privatization vouchers, there were compensation vouchers that gave people more opportunity to participate in privatization in exchange for savings lost to inflation. However, the volume of sales for these vouchers was small.
- There are a variety of tenders: commercial, non-commercial, international. Foreigners were allowed to participate in all, but so far Ukrainians appeared to be better suited to win most of these tenders.
- The Government is also in the process of selling major stakes in large enterprises. The new official policy is to focus on foreign strategic investors for these stakes. So far, there was only one major sale: unfinished hydroelectric station DnisterEnergo to American Energy Systems (AES), a public US corporation. Controlling blocks in some regional electricity distribution companies and in Zaporozhye Aluminum Works are now upcoming for privatization to international buyers. At the same time, the shares in UkrTelecom are expected to be sold off to employees on preferential terms. Brokers are getting ready to buy these shares from day one.
- Agricultural enterprises are being privatized now. For the most part, the farm workers receive shares in incorporated farms and/or land vouchers and property allocation from collective farms.

Legal Environment

- One share one vote is the law.

- Charters of companies created by the State Property Fund for privatization are all typical, regardless of the type of business: a department store or a large energy generator.

- Cumulative voting is allowed, but not required. It was not pre-designed into charters of privatized companies. To the best of my knowledge, only three companies incorporated cumulative voting (DniproEnergo, Ukrnafta, and OdessaCable). Neither company, however, actually implemented cumulative voting. DniproEnergo outright ignored this provision in the last shareholder meeting. Ukrnafta and OdessaCable have not yet had shareholder meetings under the new provision.

- The shareholder meeting quorum is 60%. The proposed new law changes this to 40% if the 60% quorum is not met the first time.

- Notice of shareholder meetings has to be given 45 days in advance in the paper and in writing to each shareholder. Only issues on the published meeting agenda can be voted at the meeting.

- There is no mail-in proxy voting.

- The board, called Supervisory Council (*Nahliadova Rada*) must be elected from individuals who are either shareholders or represent shareholders. Board members can theoretically be sued for causing losses to the company, but such suits have not occurred yet to the best of my knowledge.

- Share issue in theory has to be approved by 75% of the vote, but up to 33% of this vote can be given to subscribed, but not registered shares. Therefore, effectively, the second issue has to be approved by 66% of the vote.

- The shareholders have pre-emptive rights to subscribe to new issues, but there is also first come first serve basis. This means that a shareholder with one share, who shows up first to the physical place of subscription can subscribe to the entire issue.

- Simple majority is 50%, absolute majority is 75%. Absolute majority is required for change in charter, reorganization, and creation new subsidiaries.

- The register is secret by law. This means that proxi proposals or tender offers can not be offered transparently to all shareholders.

- Disclosure requirement is for company produced income statement and balance sheet. There is no independent audit or qualified control requirement.

- Management has the same employment rights as labor for dismissal, despite shareholder rights to replace management. This means that the management can sue the company if dismissed without cause at the shareholder meeting.

The Public Company Issue

Ukraine, as did many other CIS and CE countries privatized almost all companies (tens of thousands) as “Open” or public with many small shareholders. This does not mean, however, that many of those companies can practically be public.

There is a lot of debate over the most effective means to make mass privatized companies more effective. A lot of this debate and effort assumes away market for corporate control and focuses on changing the mechanisms of control: regulatory, contractual, implicit and board functioning.

Interestingly, some point to the problem that there was no ex-ante relationship between insiders and shareholders, which would make management feel resentful that the shareholders are simply bestowed upon them, did not provide anything to the company,

and therefore are not real. Anyone can counter this feeling by stating that certainly, owners who acquired shares in the secondary market are real, though they did not contribute anything to the company. Feelings aside, however, the root of this issue is important, and it is in the origin of the mass-privatized companies. Mass privatization started without adequate contracts, without adequate regulations or institutions, while the assumption was that these contracts, regulations and institutions would catch up. Unlike investment bank placed companies, neither the seller (the Government), nor the management had any ex-ante incentive to bind the management by any kind of contractual or regulatory constraints[15]. This is because the privatization was not about raising funds, but merely to give-away and to meet the demands of the multilateral institution for achieving the maximum quantity of privatized assets. So instead of some kind of value-maximizing negotiation between the seller and the buyer on binding the insiders, the shareholder rights were set as low as possible so that the insiders could enjoy at least the same or greater private benefits after the privatization as they did before. **Now, we are telling the insiders to change the contracts ex-post. However, the insiders do not have ex-post incentive to bind themselves**. "Agree at the shore…" says the old proverb, "because once the ship left the port, both the passenger and the captain are stuck." They assumption was otherwise. Now the ship left the port, both parties are stuck with the deals made on-shore.

We are also trying to push development of regulations and institutions. However, contracts and institutions supplement themselves. Without realistic contracts, regulation is not as effective. Neither is public ownership. Besides, the same insiders who benefit from poor regulations will lobby to keep the regulations poor. The complicating factor is that all mass-privatized companies are in dire need of restructuring. Only a strong and entrepreneurial board can lead such effort. A lot can be legislated, but one can not legislate the board to be entrepreneurial. The only way to achieve effective ownership for most companies is through concentration, so the majority owner would be able to exercise one of the few rights afforded in mass-privatized charters: to change management with 51% and to change charters with 75%, but not without jumping through a variety of extraordinary means from management and bureaucrats who would try to prevent them from exercising these rights.

There was also no discussion whether the efficient outcome for any at all of the mass privatized companies can ever possibly be public trading, or are they rather destined to be private. It is important to identify companies destined to be public because for all practical reasons, the regulations, the contracts and the levels of formalization are different for public vs private companies. If anyone goes forward in advising the Ukrainian Government on shareholder rights, one has to know whether the rights recommended are practical. For example: suppose you are an informed individual who owns 1/1,000 equity in a small shoe factory. Then:

a) the cost of printing and mailing financial information is more than the value of your profits,
b) the financial data can easily be doctored,

[15] As opposed to the Coasean logic that a motivated seller in the primary market will be motivated to bind themselves.

c) it is beyond the size of the shoe factory to retain qualified controller and qualified auditors. Besides the cost of such individual, fifty is just not enough accountants for an economy with 50 million people and over 10,000 Open Joint Stock companies.
d) it will cost you more to travel to the shareholder meeting than the value of the potential share of your profits,
e) Under current conditions, the transaction cost of selling your shares is probably higher than their value.

Suppose now that this shoe company is owned by 1000 such individuals. This is not an example of effective ownership, even if all proper rules are in play. Why then try to makes public company rules for a company that can never be public. The economically efficient outcome would be for this company to be taken over by an operating owner. This can not be mandated, but must be recognized and facilitated.

Corporate structure in a public company usually differs greatly from the corporate structure in a private company. This is because one or a few shareholders can exercise more direct and less formal control than a large group of shareholders. For a large group of shareholders to be effective, extensive rules are needed on how decisions are adopted and actions are taken. A shareholder in a private company makes most decisions unilaterally and does not need rules. Moreover, the contracting of rights between different groups of shareholders (minority, majority, etc.) is usually simpler in private company.[16] Certainly many regulations being proposed apply in the West only to public companies.

What's more, institutions, such as courts and the securities commission are new and have to deal with new issues. They can not possibly cope effectively with the same issues in 10,000 companies. If institutions were to cope with fewer companies that were more appropriate for the purpose of these institutions, they could actually start doing some real regulating instead of being completely over their head in problems.

The identification of a public company depends on your definition. If any Open Joint Stock Company (OJSC) is a public company, then there are tens of thousands public companies in Ukraine, as described above. Most companies were privatized as OJSC. Will anyone be convinced that one of these companies can have a project that would have a positive NPV to shareholders, not just insiders? Probably not.[17] However, in order to attract capital for new expansion, these companies need to deliver positive NPV's to the shareholders and this can be done through relatively costly mechanisms for corporate

[16] For more in depth discussion of private vs public company in this context, see for example: ……

[17] Although, such company might find a positive NPV project, the investors factor in their expectation for expropriation. One point that many local brokers make: Ukrainian and Russian shares trade at sometimes 90% discounts to similar companies in the West. This means to me those shareholders correctly value potential for expropriation. Suppose that a Ukrainian company would propose a projects that might be NPV positive in the West. The shareholders in this situation, however, would expect to receive only 10% of its expected cash flows and would most likely say that it does not have a positive NPV. Obviously, no one in their right mind would finance such expansion through an equity issue.

control[18], which these companies can not afford by virtue of relatively small size and lack of current management structures. Besides, the management is not motivated to create controlling mechanisms because they are better skilled and get more private benefits from expropriating than from their ability to propose positive NPV projects.

If, however, you take a Western legal definition of a public company with all its attributes, developed over the past 100 years in the USA and Europe, then Ukraine will not have a public company in a very long time.

I recommend a practical definition of a public company to be one where the ownership, made up of a large number of small shareholders, is effective ownership. This does not mean that each shareholder must act as an effective owner. On the contrary, a public company is based on specialization. Most shareholders in the West, for example, are much more passive than most shareholders in Ukraine, yet we would consider public ownership to be optimal for these companies. Effective public ownership means that the mechanisms through which outsiders control insiders are effective:

- First of all, there has to be a motivated, informed and responsible board.
- There has to be minimal amount of information in form of objective accounting statements and other necessary disclosure.
- The management has to be bound by the decisions of the shareholders and the board.
- The shareholding must be widely held with certain guarantees for passive shareholders. Even if active shareholders make more money by having insider access, passive shareholders have a stake in the profits of the operations that can not be taken away in a gaming scenario. Such stake creates fundamental value for the shares regardless of their liquidity[19].
- Management has transparent and adequate incentive in the shareholder value. Even if management is somewhat incentivized by consumption of excessive perks (to put it mildly), they still have a fear of getting fired for poor performance (or at least arrested for stealing) and have a direct financial stake in the company, rather than parallel structures. Note that merely owning shares of the company is not enough to show that the management is incentivised in the shareholder value. If the other attributes are missing, for example, then the management will never be assured that their shares will be worth anything. Additionally, the total incentive in the company has to be much stronger than the incentive in the potential parallel structures, so the management would a) have incentive to collapse parallel structures, b) have no interest to set up new ones.
- Company is enabled to be restructured as a public company. This means that there is a potential group (management, active shareholders, board, effective agents in the market for corporate control) that is incentivized by shareholder value and can lead

[18] As a necessary, but not sufficient condition, these mechanisms would have to be: a) meaningful audited financial statements, b) qualified independent controller, c) qualified motivated and legally responsible board.

[19] **Jensen and Meckling (1976)** treat limitation to expropriation as the residual equity ownership by entrepreneurs for example.

global change in the company, in its corporate documents, management and operations to make it better.

- The company is large enough to justify the expenses of trading, voting, fighting for shareholder rights and researching its equities. (At the extreme, a shoe factory with 100 employees is not a good candidate for becoming a public company).

While this is subject of a separate discussion (maybe debate), this author believes that currently in Ukraine there are NO companies destined to be public as they are now, without intervention. Even the largest companies listed on PFTS stock market: Ukrnafta, Dnepro Energo, Donbas Energo, Center Energo, Zakhid Energo, Kiev Energo, Zaporozh Stal', Zavod Illicha, Mariupol Stal' are all closely controlled by the management or by local insiders who have no interest in restructuring these companies to deliver value to minority shareholder, but in making these facilities a part of their own business.

While the public company status of the above listed companies may be subject to some debate, surely the tens of thousands other privatized Open Joint Stock Companies can not ever be deemed destined for **effective public ownership**.

The activity on the PFTS stock market (some $20 mln per week) is not a capital market activity, but the market for corporate control. Any time there is an interest in acquiring control in one of the companies, trades get registered on PFTS, and there is appearance of some activity. As soon as this take-over activity is completed or stopped, the market for the shares of that company becomes dormant again. For example, activity in certain energy distribution companies ("OblEnergoes") in March was the result of locals wanting to take control of some "OblEnergoes." Once that interest was either satisfied or stopped, "Oblenergo" equity market became dormant again.

Another little bit of anecdotal indication of how this is not a capital market: in this market, all else equal, shares of companies with alcoholics as top managers are often more coveted than those were general directors are intelligent, strong and business minded. This is because an alcoholic is less likely to use extraordinary means to fight a take-over.

All the appropriation going on in the large so-called public companies, however, does not mean that productive assets in these companies will never come into play on the secondary (or even public share) market. This just will not happen in the current form. The assets or control will eventually become part of another private business either through bankruptcy or through stripping. Less likely, these companies will be privately restructured, and then put on the block either as a public company or a private sale.

A good example that comes to mind is the case of Russia's OAO Sviazinvest, where the most profitable services, such as cellular were ventured off to Telecominvest, a closely held company. Certainly, with backers such as George Soros, had Sviazinvest been restructured, it would have no problem issuing its own securities to develop the cellular business instead of venturing it off to another Russian Company. However, this never

happened, as it was more expedient for the company (and probably profitable for insiders) to venture off the cellular service, along with many others. The funny thing is that Telecominvest will probably become a public company sooner than Sviazinvest because it is closely held and can be restructured faster and easier than Sviazinvest.

Still, Sviazinvest is a very large Telecom with positive cash flow. In time, it will probably restructure with whatever is left. The question for most companies in post-communist states is which of these companies are destined to be public. In other words, which companies are capable of becoming public (as in my definition) before there is nothing left in those companies to make public?

This is one of the first answers the policyholders need to obtain. My guess is that the best source for the future public companies are currently new, privately initiated companies, and not the "publicly traded" privatized open joint stock companies.

Shareholder Rights Paradigm

Proper board, controls, reporting, information, transparency, and transparent management incentives, among others protect shareholder rights in public companies. With effective ownership and strengthened shareholder rights, the management will have incentive to restructure the companies, improve operations, and look for profitable opportunities to take the company forward and attract investors.

What happens, then, when the company is either not destined to be public or beyond repair? As in the example with the shoe company, no matter how regulations are enforced, the company will not work with the same owners and mechanisms any better because the implementation of these rights by many individual shareholders will be either impractical or too expensive. A Ukrainian colleague of mine, making a comment about formalizing the rights of individual shareholders in dysfunctional companies pointed out: "You can also give them the right to fly to the Moon on weekends. The effect will be the same, and the management will not object either. No level of formalization will guarantee rights if there is no realistic venue to exercise those rights." So what would most protect the rights of those who can not be effective owners? **The right to sell**. This would also require facilitating effective owner's ability and sometimes the obligation to buy.

The ironic part is that Western advisors have modeled the securities commissions in post-mass-privatization countries after the Western securities commissions with similar powers, authority and principles. Two of the five Georgian Securities Commissioners are former US SEC employees, for example. These commissions, however, are charged with regulating vast markets made up exclusively of equities, which would not be qualified for listing at any of the Western markets. This is futile. At the extreme, if the Ukrainian SC acted as the US SEC, it would probably demand to de-list all Ukrainian equities. However, de-listing these equities is not the right thing to do because the shares are already distributed to wide shareholders, and despite all the problems, there is some kind of hope that through market mechanisms, something will get better.

However, this situation does not inspire trust in the market, even if the regulations are good, and the Securities Commission would be effective with a set of companies more appropriate for its mission. Consequently, both the foreign and the domestic investors rightfully shy away from the Ukrainian market, and any attempt to place anything decent on the Ukrainian market at a realistic price will only sink in the cesspool of the junk currently traded. There is neither hope for forming new IPO's nor plucking out privatized companies destined to be public. In public companies, the management and the board need to be incentivized in the shareholder value, but the Ukrainian markets will not be able to provide credible incentive because there is no trust in the market among anyone, including the potential managers and directors. The solution is to separate the men from the boys, even if there aren't any men yet. In the next section, I propose how to do this.

Reform Priorities

Recognizing that the current stock market is the market for corporate control, and that the economy is full of dysfunctional companies that are not destined to be public, provided herein is a set of reform priorities that would achieve effective ownership in the shortest time possible. These reform priorities should be at the foundation of a comprehensive governance program for Ukraine and possibly for other post-mass-privatization economies:

1. Make it easier for effective private owners to take over companies by completing the market for corporate control. This is a bit controversial, but I am sure that making take-overs easier will not only facilitate effective ownership, but equally protect the rights of minority shareholders. "How?" You say, "But there is always a conflict between the big guys and the little guys." Here is how:

    - The mere threat of take-over will force the management of some companies to at least start paying dividends, or compete for control by buying shares, or start pushing forward with the necessary changes, thus raising share value and leaving less to convert into personal perks.
    - Less costly ability to take control will raise the price paid to small shareholders, where the transaction costs were high.
    - More ability to take control will attract more potential buyers, thus increasing competition and prices offered for shares.
    - More ability to take control will attract more strategic participants, creating competition and increasing the speed with which the companies will change hands. Someone may say what is the difference how quickly the take-over process will take, so long as it happened in the long run? Not only are we all dead in the long run, in the long run these dysfunctional companies will die too and there will be nothing left to buy-out.
    - More transparent market for corporate control will attract more honest and transparent investors, thus dissolving any potentially criminal element that might then run companies in unscrupulous ways.

- Easier market for corporate control will quickly clear out many small and medium companies that will fall through the cracks of shareholder rights advocacy and corporate governance programs. **No Company with worthwhile business or assets will be spared from the wrath of reform by relative obscurity.** It may be the Italian haberdashery manufacturer taking over the button factory, a Turkish shoe manufacturer buying the shoe factory, or the Ukrainian retailer buying the large, but ugly Gastronom across the street. The privately ran businesses would put these companies to work without any help from any of the well-meaning consultants or bureaucrats.

2. Facilitate private restructuring. Advise on legal reform and changes in corporate documents (contracts) need to reflect that most companies are not destined to be public and instead focus on the current practical issues facilitating restructuring, rather than those points that should regulate or structure public companies. Without getting over current barriers to restructuring, the companies will not survive to be either public or private companies. Specifics are listed in the next section.

3. Facilitate development of public companies. Recognizing that there are no companies that are destined to be public, intervention is needed.

Specifics

Herein, I provide a list of SOME specific changes or reforms that would improve corporate governance, according to the priorities listed above. **This list is by no means complete.** It is merely examples of the kinds of changes that need to take place, and hopefully will lead to a more comprehensive set of solution. A thorough, but expedient study of the equities market, governance and law needs to be conducted to develop a complete corporate governance program:

1. Facilitating takeovers:
   - In the law on registrars, provide the requirement that registrars must deliver communication from a shareholder to all other shareholders at sender's expense. This communication can be tender for shares, as well as advise of corporate action. The law should also set the price, charged by the registrar for this service. Additionally, the law must require that nominees must deliver the messages to beneficial shareholders and owners of Depository Receipts. This law will also facilitate restructuring by assisting the delivery of notice of corporate action.
   - Either law or PFTS should provide for a method for tendering a take-over in mass-privatized companies to remaining shareholders. This method does not have to be exclusive, but the information on this method should be provided to the people as widely as possible. It could be detailed down to forms and registrations. Many legal advisors do not like prescribed ways of making offers, believing in free form. I agree with them, except in this situation. First, there are many companies with millions of shareholders, who do not trust anyone anymore. Seeing a tender in the already familiar form will dispose small shareholders to trust the offer as genuine. Second, tendering an offer in a prescribed fashion will

lessen attempts by ignorant and corrupt courts to challenge its legality. Third, this will reduce the amount of work brokers would have to do to tender an offer, thus making the market for corporate control more robust. Note also that this indicative method would apply only to mass-privatized companies, thus leaving free form to flourish in the long term.

- Eliminate the requirement for notary to certify each share purchase-sale contract from individuals at least in tender situations.
- Facilitate a list of other details to simplify buying shares from a large group of people, such as tax collection, reporting, etc. This list is beyond this paper and should be compiled with consultation of Ukrainian brokers.
- Change the law on business associations to expressly disallow first come, first serve principal in secondary issues. Management has control of who comes first and uses this principle to sell control of companies very cheaply to its cronies.
- More concerted effort should be made to advise on effective bankruptcy law, possibly with separate provisions for mass-privatized companies. I had observed a deal to invest close to $25 mln in a bankrupt Ukrainian sugar mill collapse because the property rights on the assets after bankruptcy were muddled in a variety of potential loopholes. My own criticism of this paper is that it does not devote enough attention to bankruptcy, but this issue is a very important component of the corporate governance.
- Take measures to eliminate the hold-in-hold-out problems in the market for corporate control. Hold-in is when a controlling shareholder decides that he can expropriate the minority shareholders, and therefore does not need to buy them out. Hold-out is the opposite: minority shareholders see a western investor and decide that they will not sell, but free ride on his restructuring efforts. Even worse, the minority investor may either have a swing or a blocking vote or ability to influence the courts through illicit means, thus thwarting restructuring or making it very expensive. For example, a disgruntled management group, having a few shares, may bring action in court that the shareholder meeting violating some obscure principle that does not even have any legal basis. With a small bribe to the judge, they could cause a stay on being re-elected, allowing themselves time to loot the company. Most investors (even Ukrainian) considering buying and restructuring an enterprise will not start while there is an unresolved swing vote or powerful minority shareholder problem.

  One important law protecting minority shareholder rights against hold-in in a take-over situation is now submitted to Parliament. According to the draft law on business associations, anyone who bought out at least 60% of company's equity must offer to buy out the remaining shareholders. This law will complement the increased ease of buying companies by assuring that control will not be enough to do what you want. This law will facilitate effective ownership by aligning control and cash flow rights, and is an important component of the overall corporate governance reform. There are still problems: first, it is easy to avoid this law by illegitimately distributing ownership among several seemingly unrelated legal entities. Second, without a tender process, it may be difficult to prove that a buy-out offer had been made. Third, this law creates a hold-out problem because in a

buy-out situation, a shareholder with a significant block will hold-out to test if he has a swing vote because if he does not have a swing vote, he still has an automatic put option on his shares.

One solution could be that any majority shareholder that has gone through a formal tender process to offer a buy-out to other shareholders should have certain special rights. For example, this shareholder could have the ability to make decisions normally reserved to the shareholder meeting simply by virtue of having the corresponding majority and notifying the other shareholders. This will help mitigate: a) the hold-in problem by giving majority investors the incentive to come clean and get special rights, b) the hold-out problem by giving the hold-outs something to loose, c) help restructuring by making the decision implementation occur faster.

2. Facilitating Private Restructuring
   - Expressly allow for a tender offer to be combined with a secret offer/deal for severance to the management to leave. (This also facilitates take-overs by incentivizing management to cooperate). This almost looks like corruption, but it will have exactly the opposite effect: First, it will incentivize red directors to go in peace. Second, it will stop the cycle of pilfering companies, third it will actually incetivize the red directors to actively seek out buyers for the company, rather than trying to pilfer a company.
   - Change the law on business associations to require that regular shareholder meetings of mass privatized companies always include on the agenda the following: reelection of the supervisory council (the board), reelection of the audit committee, reelection of the management. Today, a disgruntled shareholder must notify the management at least 20 days in advance of their intention to include these issues on the agenda, thus disclosing their intention to change management and allowing the management to take steps (legal or not) to defend themselves, often successfully. Many Western investors had ran into this problem.
   - Change the labor code, specifying that the right of the management is not the same as the right of the labor force. Currently, the management has at least the same rights as the labor force, including protection from being fired without reason. They often use this to assert that the shareholder's meeting dismissed them illegally, demanding "moral damages" and reinstatement among other things. The law should be specific that management can be fired any time without explanation, and that their rights are only specified in the contract.

3. Facilitate development of private companies and capital markets

- First, separate companies destined to be public from the rest. This can be done by creating new listing levels. One level can be for the companies that have proven destined to be public, and the other level for the companies that are truly public. Each listing level would have increasing stringent corporate governance requirements. Recognizing that current market is not a capital market, the new listing levels should facilitate capital markets. New IPO's could only be listed at the highest level. It's

OK if no company qualifies for these levels now. This will give existing mangers and enterpreneurs an idea that they could bind themselves for finance, and will separate the men from the boys (the public companies from the junk).

- Take a pilot project to create one or two companies where wide shareholding could be effective. This would be a truly worthwhile, but long term pilot project with lasting impact on the mentality of Ukrainian officials and on the development of capital markets in Ukraine. What's more, the limited resources (court attention, managers, accountants) ca be first focused on these companies rather than spread among many companies that in reality have not chance to be public.

An issue of whether companies should be restructured by the Government before being sold off is relevant here. In most cases, it is the private sector function to restructure the companies. However, in some situations it would be too costly for the private sector in Ukraine to restructure a large company, which is most likely to be functional as a public company:

In general, however, if the Government could have restructured the companies for optimal operation, privatization would not be necessary. The truth is that the State is too politicized and corrupt to provide for any kind of transparent personal interests to be linked with the business performance.

I recently read a note about a foreign furniture company that bought a plant in an East-European country, only to run into police problems trying to restructure this company. The note said that this foreign firm would not support leaving restructuring to the buyer.[20] Here is another example: a western fund acquired control of a hotel and wanted to restructure its management and operations. The local Government opposed restructuring with its share of the votes, including botching a shareholder's meeting, while the fund's representative was arrested and eventually forced out of the country by the police. The representative was this author. Let's suppose that this hotel was in state hands. What bureaucrat would take it upon self to restructure it properly, supposing he knew how? Who would have that kind of motivation? **Only highly profit motivated private enterprise can jump through all the fiery hoops to restructure a company in this environment.**

The Government should make sure that companies are enabled to be restructured: the necessary changes in management, by-laws and corporate structures, for example are achievable under the company initial charter and ownership structure. Additionally, it is the Government's function to assure legal, regulatory and political climate is good for businesses to restructure, develop and grow.

However, a public company is difficult to restructure unless ex-ante contracts are well written, the management is at least complacent, and proper regulations are in place. The catch 22 is that this also can not be achieved before privatization for the reasons

[20] See Stiglitz (1999) footnote 37 Stiglitz does not necessarily make a judgement that companies should be restructured before privatization.

stated above. Therefore, it is worth an attempt to select one or two State-controlled companies that could be destined to be private and structure them for a proper public offer. Why one or two? Because this has to be done only under the control and monitoring of top Government officials, who would make a public commitment to make these companies public. If and only if the highest government officials make such commitment should there be an attempt and concerted Western aid to make one or two companies truly public.

BUT FIRST, determine which companies are destined to become public, so as not to spend a lot of effort making a horse out of a donkey.

What will not work

- Be careful with muddling property rights. It is easy to apply western principles of fairness to Ukrainian privatization or formation of privatized companies by advocating reversing property rights if prvatization had been found to be improper. One might even argue that applied to Ukraine, this would be an anti-Oligarch measure because the Oligarchs usually created for themselves ways to grab as many assets as quickly as possible. Therefore, any measure reversing illegal acquisition of assets, up to nationalization is fair game against these guys. Keep in mind, however, that with corrupt and unprepared court systems, it is the Oligarchs who will have the last laugh. By working the system, they will keep their assets protected, while using the courts to interfere with the ownership rights and restructuring efforts of those who obtained their assets in a hard-won legitimate way. Additionally, muddled property rights simply will discourage any Western investor from making long-term investments in Ukraine.

- Same goes for excessive liabilities for directors (member of Supervisory Council). It is easy to apply western principles: directors should be liable and easily sued for shareholder rights violations. However, with unprepared and corrupt court systems, the parties interested in thwarting restructuring will use liability laws to harass the directors, thus creating undue legal risk for any western company attempting to restructure a Ukrainian company. At the same time, the legitimate investors will have little chance in the courts to sue a director representing a powerful group expropriating other shareholders. Currently, the law states that any company official shall not cause losses to the company. If he does, he could be sued. Leave it at that for now. In new, truly public issues, this matter can be addressed contractually.

- Regulation-forced agents with outside powers will generally not work because in Ukraine's corrupt environment, any agent with outside power is more likely to be corrupted by those with special interests than maintain impartiality. At worst, such agents can be corrupted to prevent companies already in the hands of effective owner from being restructured. The mere possibility of such outcome will prevent many potential investors from coming into the market to jump

through all the fiery hoops to restructure a company. This is not to say that private contracts can not provision for agents with outside powers.

- In general, Government-lead restructuring will not work, as pointed out above, except in the situation of a large, potentially public company.

Conclusion

It's the economy... Not only law and order, not just provisions in charters, not even the capital market development is at play. It's all about the economy, and the capitalist model is predicated on effective ownership. Without effective ownership, the companies will not act in the best interest of their owners, and therefore, will not give owners the ability to act as economic units. Without assuring effective ownership, the result of mass privatization becomes nonsense. Loosing sight of effective ownership after mass privatization is like throwing away the landing gear after take-off. That is why corporate governance should now receive at least as much attention from the development community as privatization did.

Corporate Governance and Shareholder Rights reforms need to take a practical and economic approach: get from the current post-mass-privatization situation in Ukraine to building effective ownership in currently dysfunctional companies. This should be done by facilitating the market for corporate control, facilitating restructuring, identifying companies destined to be public and providing venues for these companies to separate themselves and restructure.

However, only the market for corporate control could get the greatest quantity of companies on its feet. Corporate Governance program should not focus on more than two or three companies to remain or become public. Different listing levels should be established to refocus attention on the right kinds of regulation and to facilitate a credible capital market for public equity. Corporate governance program should not rely on the Government to get back into the private sector, giving power to agents who do not havecash flow interest in the company, muddling property rights or otherwise straining the court system.

No Company should fall through the cracks of the reform because the program should make it a priority to empower the private enterprise, not do their work. There is no need for the consultants to drink with every general director to convince him or her that shareholder rights are good for him (they are not). Let the private sector do that. However, without enabling the private sector to take control, mass privatized companies with disintegrate.

It is of note that there has to be a balance between encouraging and making it easy to buy control and assuring the rights of the remaining shareholders. Overlooking either one of these will lead to ineffective ownership.

Finally, there is no “in the long run” in corporate governance reform. Most Ukrainian companies are already in disintegration mode. This is not only leading to loss of shareholder value, but loss of human capital, economic ties, technological potential and all those intangibles that make the economy work and people happy.

The recommendations and priorities set forth in this paper might not appear orthodox, but they are based on solid economic principles and are designed to address the current state of affairs.