

SESSION IV: ENFORCEMENT OF MINORITY SHAREHOLDERS RIGHTS

Presentation by

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HOW SHOULD WE ENFORCE MINORITY SHAREHOLDERS' RIGHTS IN RUSSIA ? – OVERHAULING THE SELF-ENFORCING MODEL OF CORPORATE LAW IN TRANSITION ECONOMIES¹

Abstract:

Various problems of corporate governance have arisen in privatized companies in Russia. Professor Black proposed seemingly a comprehensive and exhaustive plan of reforms. Though most proposals are proper, the plan has several flaws. First of all, though strong securities markets could be a solution, monitoring by blockholders seen in countries on the European Continent could also fix the problems, and there are no compelling reasons for Russia to throw over the latter idea. It is not the time to choose either of those directions. Secondly, some similarities between the Russian economy today and the U.S. economy in 1920's could be a caveat to too much emphasis on securities markets. Both of them have small, dispersed shareholders as well as huge conglomerates that suffer from problems in both industrial organization and corporate governance. These similarities account for recent development of the Federal Commission on Securities Markets in Russia. Thirdly, we need to prioritize among proposals. And finally, "the self-enforcing model of corporate law" as a basis of the reforms should be modified in part. Clear-cut provisions authorizing minority shareholders to seek for judicial remedies may as well prevent the managers and the controlling shareholders from doing self-dealings such as asset stripping and transfer pricing. This paper will show some examples of elaborating this approach for shareholders derivative actions and other legal matters.

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¹ The views expressed in this paper are those of the author and do not necessarily represent the opinions of the OECD or its member countries. This paper is subject to further revisions.

I. The Theme

1. Quite a few previously state-owned (mostly large) companies in Russia have been privatized. Since 1996, they have been under the Law on Joint-Stock Companies (JSCL), which is based on the self-enforcing model of corporate law advocated by two American law professors.² It is getting more and more apparent that those Russian companies have serious problems in their corporate governance. Many abuses have been reported. Partly due to those abuses, foreign investors are feeling less enthusiastic for the future of Russian economy: foreign direct investment (FDI) in Russia in 1998 was only USD 1.5 billion, less than FDI in Hungary, and slightly more than 2 % of the inflows that China enjoyed.³ One of the advocates of the self-enforcing model, Bernard Black, modifies the idea and presents a long list consisting many proposals from establishing the property rights to disclosure to education in law and business schools. The central idea of those proposals is to create strong, transparent securities markets in Russia.⁴
2. I agree with most of Professor Black's proposals. However, they are not free from some flaws as I will show below.

II. The Cause – Looking Back the History

A Two Theories

3. The 1990's was the decade for the former-communist countries to implement massive privatization. Each country took a course that was a bit different one after another, and each of them more or less suffers from problems. Two accounts were made for the matter:

4. Self-dealing Story: The Russian privatization failed because of countless self-dealings in privatized companies. A self-dealing means the managers and/or the controlling shareholders of a privatized company exploited the company by various means.⁵ According to this story, the reason the self-enforcing model did not work is in the bad property rights⁶ in Russia, in other words, the lack of a fair and accessible judicial system that provides a person who has legal rights with an enforcement mechanism. This story predicts that the solution will be, among others, establishing the property rights and making stock markets transparent.

5. Insider Control Explanation: Most privatized companies suffer from the insider control. Insiders are either the managers or the employees of a company, or both. According to the explanation, in a company controlled by its insiders without sufficient intervenes or disciplines imposed by outside stakeholders, insiders do not have adequate incentives to maximize the company's performance. This explanation insists that a powerful outsider, or a budget-breaker in an economic term, such as a *main bank* in Japan or a *Hausbank* in Germany, together with

² Bernard Black & Reinier Kraakman (1996), "A Self-Enforcing Model of Corporate Law", Harvard Law Review vol. 109: 1911. The central features of the model are summarized at 1916, as follows: (i) enforcement by direct participants such as shareholders than indirect participants such as judges, (ii) greater protection of outside shareholders than is common in developed economies, (iii) reliance on procedural protections such as transaction approval by independent shareholders rather than on flat prohibitions, (iv) bright-line rules, and (v) strong legal remedies on paper to compensate for the low possibility that the sanction will be realized.

³ Stilpon Nestor & Fianna Jesover (2000), "OECD Principles of Corporate Governance on Shareholder Rights and Equitable Treatment: Their Relevance to the Russian Federation", working paper presented at the OECD/ World Bank Corporate Governance Roundtable for Russia, held in Moscow on 24-25 February, 2000 [hereinafter referred to as "the Conference"], paragraph 3.

⁴ Bernard S. Black (1999, revised in 2000), "The Legal and Institutional Preconditions for Strong Stock Markets: The Nontriviality of Securities Law", working paper available at: http://papers.ssrn.com/paper.taf?abstract_id=182169

Though every proposal made in the paper will certainly improve corporate governance in Russia in the long run, some of them seem to find a better fit to Japan or Korea than to Russia on a short-term basis, such as reform of investing culture, financial disclosure pursuant to international standards and education in law and business schools. Black's coupling a direct self-dealing such as asset stripping with an indirect self-dealing such as insider trading of securities, into a single notion seems to me a misconception. To implement the entire list of the proposals would be as difficult, or unrealistic, as to carry out the self-enforcing model. See II C. Unfair securities trading such as insider trading and price manipulations that Black believes to have securities markets transparent and efficient, are actually of little relevance to the poor function of Russian stock markets. See III C.

⁵ Bernard Black, Reinier Kraakman & Anna Tarassova (1999), "Russian Privatization and Corporate Governance: What Went Wrong?", working paper available at http://papers.ssrn.com/paper.taf?abstract_id=181348

⁶ Property rights in an economy do matter in its corporate governance. See Curtis J. Milhaupt (1998), "Property Rights in Firms", Virginia Law Review vol. 84:1145 [comparing the property rights enforcement in the U.S., Japan and Korea].

improved property rights, well-defined antitrust laws and bankruptcy codes, can give a second best solution to the situation.⁷

6. Each of those explanations has its generalized version: the theory of “monitoring by capital markets” (or *the Anglo-American monitoring system*) is behind the first story, while the theory of “monitoring by blockholders”⁸ (or *the European Continent monitoring system*) is behind the second. As a matter of fact good stock markets and good banks can live together in an economy. In other words, both monitoring systems are not necessarily incompatible to each other to some extent. Moreover, we observed a slow convergence between those systems in developed economies during the last two decades. Nonetheless, the details in a corporate law do depend on which system is adopted in an economy.⁹

7. Although the two theories above are a bit artificially contrasted, this contrast adds a cautious footnote to the Black’s proposals.

B What happened in Russia after mass Privatization? Why?

8. Many anecdotes have been told to show how managers and controlling shareholders deprived assets and profits of the company. Three popular tactics have been often utilized:¹⁰

9. Asset Stripping: The managers of a privatized company (A) form a shell company (B) and transfer A’s main assets to the shell (B) at a price that is well below their market value. Minority

⁷ Masahiko Aoki (1995), “Controlling the Insider Control”, in M. AOKI & H. KIM (eds.), CORPORATE GOVERNANCE IN TRANSITIONAL ECONOMICS: INSIDER CONTROL AND THE ROLE OF BANKS, EDI Developmental Studies, the World Bank; Erik Berglof (1995), “Corporate Governance in Transition Economies: The Theory and Its Policy Implications”, in AOKI & KIM, supra; Harry G. Broadman (1999), “Comments on Ownership and Control of Russian Industry”, working paper available at <http://www.oecd.org/daf/corporate-affairs/governance/in-Russia.htm>

⁸ By blockholders I mean large creditors such as banks as well as large shareholders such as institutional equity investors. Some would draw a different line between those two theories: they will consider institutional equity investors as a part of the market monitoring paradigm. As both Aoki, supra note 6 and Berglof, supra note 6, think of monitoring by banks, this line is drawn by me. I classify monitoring by institutional equity investors in blockholder paradigm, because it could work to some extent even without efficient capital markets.

Though main banks in Japan ceased to be efficient monitors during the so-called “bubble” era in the midst of the 1980’s, I still think blockholders are generally better monitors than securities markets in transition economies. The collapse of the main bank system in Japan must be attributed to that prolonged deregulation in the financial sector generated inconsistency and disincentives in the system.

⁹ While General Principle VI in “General Principles of Company Law in Transition Economies [hereinafter cited as ‘Transition Economies’]”, Private Sector Development Journal Supplement No. 1, 1998 (OECD’s Centre for Co-operation with Non-Members), favors dispositive corporate statutes, the issue is much more complicated than it looks. Monitoring by capital markets requires legal rules of equality among shareholders in two directions: both curtailing outsiders’ rights and enlarging insiders’ rights must be restricted. See New York Stock Exchange Listed Company Manual §§313.00, 314.00. In a sense, it is easy to rely on this model because what we need is only prohibit contractual change of the shareholders’ rights provided in the company code. On the other hand, monitoring by blockholders works better with statutes that enables (or allows) outside blockholders to contract with the company an extra rights that can be useful in their supervising the managers. Difficulties, however, often lie in distinguishing outside shareholders and inside shareholders in provisions in corporate laws if we adopt blockholders’ monitoring.

In Russia, several cases are reported in which foreign investors are playing a good monitoring role. See Elena Krasnitskaya, “Corporate Governance in Russia: Tipping the Scales”, (Troika Dialog Research February 2000), at 24; Pavel Skitovich (1999), “Case Study: Corporate Governance Practices, Norlisk Nickel”, working paper available at: <http://www.oecd.org/daf/corporate-affairs/governance/in-Russia.htm> It seems that flexible, enabling Russian company law is used not for enlarging the outsiders’ leverages but for entrenching the insiders’ positions.

Though it is often difficult for a provision to distinguish the inside and outside shareholders, there are some easy cases. One example is the prohibition of shares with multi-voting rights for a listed or a publicly-held company because those shares would be held by insiders and the prohibition thereof serves to both the blockholders’ and markets’ monitoring. This is the case in the recent reform in Germany Stock-Company Act. See Franz-Joerg Semler (1999) in MUENCHNER HANDBUCH DES GESELLSCHAFTSRECHTS, BAND 4 AKTIENGESELLSCHAFT (hrsg. von MICHAEL HOFFMANN-BECKING), 2 Aufl., S. 495-6, spezielle FN 16, 21 (Beck). See also Nestor & Jesover, supra note 2, paragraphs 37-38.

Also one advantage of monitoring by banks over monitoring by large equity holders or by securities markets is that this approach results in less complicated legal structures. A mandatory corporate law forbids the legal entrenchment by insiders while the freedom of contract between creditors and debtor companies enables bank as a monitor to obtain larger measures for disciplining the debtor.

Another issue in corporate laws calls for attention. An economy with a high level of property rights suffers less from dispositive provisions than an economy with a low level of property rights. This is why the U.S. and the U.K. have less mandatory corporate laws.

¹⁰ Detailed illustration is shown in Oleg Fedorov (2000), “Three Case Studies on Abusive Self-Dealing”, working paper presented at the Conference.

shareholders are substantially foreclosed from the company.

10. *Transfer Pricing*: *A* sells its products or materials to *B* at a lower price and *B* sells its products or materials to *A* at a higher price than a fair market value. The differences between the sales prices and the fair values are transferred from *A* to the shell (*B*).

11. *Share Dilution*: A company issues a huge number of new shares and the managers allocate them only to themselves or their friends. The subscription price is set quite low, well below the fair price. The outside shareholders suffer from decrease in both their voice (the percentage of their holding) and economic values of their shares, while the managers and the controlling shareholders politically entrench themselves as well as economically exploit outsiders' property. Mergers with another company at an unfair ratio are sometimes utilized for the same purpose.

12. Though those tactics look outrageous, they are within a range that basic microeconomics predicts. The tactics and the results above are, though being the worst, just examples of agency costs that arise in situations where shareholders being principals, managers being agents. A cheap theory insisting that Russian people have not been accustomed to the market economies and that the culture and tradition explains the corruption, is hardly a theory.¹¹ Instead, we should focus on the lack of a system in Russia that can control the agency costs. Incentives have not been structured in a way managers find high cost or low benefit in a self-dealing. With the same incentive structure as in Russia, the same kinds of self-dealings would be also found anywhere else— in the U.S., Japan, Germany, Sweden and everywhere.

13. At the same time, we should bear in mind that we may not grasp the entire picture of the problem. Back to the argument in A, anecdotes tell us visible stories of self-dealings, but there may be hazardous but invisible insider controls in many companies as well.

14. Moreover, we should also note that each pair of the diagnosis and the treatment in the self-dealing or insider control theory is not necessarily of perfect consistency in itself: some hazards caused by self-dealings could be corrected by blockholders: no matter how effective banks could be in coping with the insider control problems, we no longer have banks to rely upon in Russia today.¹² Although Black dismisses bank financing because of its shortcomings,¹³ attention should be paid on that the OECD Principles of Corporate Governance¹⁴ themselves show no preference as to ownership structures.¹⁵

C A Caveat: Repeated History

15. Here I pose another story that could also account for the collapse of privatized companies. That is, what we see in Russia is somewhat similar to what we had in the U.S. in 1920's in several respects. This is a caveat to too much emphasis on securities markets.

16. From the late nineteenth century to the early twentieth century, large corporations were born in several developed economies that had been unknown to the human beings till that time. Among others, the U.S. public corporations were distinct in consisting of many, dispersed shareholders remote from the company's management and the managers that controlled the company and enjoyed free hands. They were the stereotype of Berle-Means corporations.

17. Nobody knows which is more efficient generally, dispersed ownership or concentrated ownership. It does depend on various factors, including legal institutions. The weakness of dispersed ownership lies in the difficulty for shareholders to unite with each other for monitoring the managers (collective action problem). And one of the similarities between the U.S. corporate governance in the 1920's and Russian governance today is that dispersed shareholdings were/are not necessarily the product of the free choice of each economic

¹¹ More than half of the culture or tradition accounts can be explained by the structure of incentives in a society. Not vice versa.

¹² Nestor & Jesover, supra note 2, at paragraph 2.

¹³ Black, supra note 3.

¹⁴ Meeting of the OECD Council at Ministerial Level, 1999.

¹⁵ Nestor & Jesover, supra note 2, at paragraph 24. It is the transparency of the ownership and control structures that is essential. Ibid.

individual: in the U.S., the ownership structure was distorted to some extent by the heavy restriction on equity holdings of banks and other institutional investors:¹⁶ in the Russian Federation, the situation is worse, because most small, dispersed shareholders became shareholders unexpectedly through the privatization.¹⁷

18. Even more implicating is the fact that gigantic conglomerates are (were) formed in monopolistic or oligopolistic industries in both the economies: many conglomerates belong(ed) to an energy or resource industry: complicated and sometimes interlocking share holdings cover(ed) information and prevent(ed) the exercise of minority shareholders' rights: the controlling shareholders abuse(d) the pyramidal forms. Here and there, the complexes of weak governance and poor industrial organization (*i.e.*, monopolistic concerns) was and is hard to disentangled solely by private initiatives. Most reported cases of abuses in Russia are found in natural resource industry or industries closely related to it. Perhaps it is much easier for the managers to exploit minority shareholders in those industries than it is in other industries. And also it is as difficult for them to run a company well as it is in other industries. Managerial disincentives must be stronger because of these characteristics of those industries.

19. In 1929, or twelve years after the Russian Revolution, the American economy was hit by the Great Depression. The Securities and Exchange Act of 1934 conferred upon the Securities and Exchange Commission (SEC) the authority against large or listed companies generally. The Public Utility Holding Company Act of 1935 then gave the SEC even more powerful authority against public utility companies and conglomerates. It should not be a mere coincidence that the new Law on the Protection of Investor Rights in Russia sixty-four years later, or in 1999, conferred upon the Federal Commission on Securities Markets (FCSM) an authority that is more than supervising corporate disclosures and regulating unfair securities trades.

20. Needless to say, not all the details in history had repeated themselves. History gives us hints, but not the exact answer. Nevertheless, we should not overlook the experience the United States had around seventy years ago. There are several predictions that could be derived from the history:

21. *An efficient market cannot be built in a day.* The U.S. securities markets finally proved themselves as one of the most effective monitors in the world fifty-seven years after the enactment of the Securities Act of 1933, if we set 1990 as the year of the recognition. Also attention should be paid to the fact that Japan once attempted to reform its corporate governance into the U.S. style, but the intensive reform plan resulted in a very different, but efficient, model as building efficient capital markets was unrealistic under the circumstances.¹⁸

22. *(1)' A Corollary: We should not decide which to take at present, blockholders' monitoring with concentrated ownership or monitoring by market with dispersed ownership.* I do not mean strict securities regulations such as in the U.S. are meaningless in the economies with concentrated ownership. The opposite: more and more are arguing for strict securities regulations in Germany, France, Japan and so forth. Russia will probably be better off with those regulations. However, that doesn't mean you need to regulate equity holdings by banks

¹⁶ MARK J. ROE (1994), STRONG MANAGERS, WEAK OWNERS – THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE. The word “distorted” may be too strong: dispersed ownership may have occurred even without those regulations just as it occurred in the United Kingdom without those regulations. See Roberta Romano (1993), “A Cautionary Note on Drawing Lessons from Comparative Corporate Law”, Yale Law Journal vol. 102: 2021, at 2027-8.

¹⁷ Oxana Kozyr (2000), “Rights of Shareholders in the Russian Federation: Legislation and Judicial Practice”, working paper presented at the Conference, at paragraph 12.

¹⁸ During the United Nations' occupation of Japan after World War II, General Headquarters (GHQ), aiming at bringing up individual investors and transparent securities markets, ordered disbanding *Zaibatsu* conglomerates, distributing the shares to employees and community neighbors that had been previously held by family-owned holding companies, and setting up a law and agency for securities regulations. However, those new shareholders were just too poor to keep on holding the shares. The stock market got filled with shares those shareholders sold, but it did not result in a takeover market but in the interlocking shareholding among companies that grew up to be a *Keiretsu* group under a main bank. See Hideaki Miyajima (1995), “The Privatization of Ex-Zaibatsu Holding Stocks and the Emergence of Bank-Centered Corporate Groups in Japan”, in AOKI & KIM, supra note 6.

and other financial institutions only to make robust securities markets.¹⁹ Regardless of which to take, we have many things to get done before the choice. It is not the time to choose.

23. Shareholders' rights should be enforceable in the courtrooms. Without enforceable shareholders' rights, the U.S. might not have been able to overcome its disadvantages in corporate governance even with other elements such as powerful governmental agencies. At first, the efficient markets were probably not the cause but the result of good corporate governance supported by both private and public enforcement mechanisms.

24. Along with private enforcement mechanisms, governmental intervention is essential, at least in the process of creating efficient securities markets. Nobody can assess the cost and benefit of the SEC accurately. However, it is safe to argue that it was quite essential during the time that the U.S. was in the middle of the process toward the robust securities markets. Some movements in Russia look like a way back to the controlled economy, such as creating the powerful FCSM, re-nationalization of some privatized companies,²⁰ the state's veto power on reorganization plans for a company in monopolized industry²¹ and so on. Reportedly the FCSM is doing a good job in bringing lawsuits against companies and managers on behalf of shareholders.²² Breaking up the complicated conglomerates and untying the knots of weak governance and poor industrial organization perhaps need both the private and governmental initiatives.²³ Remember the U.S. experience that the SEC played a major part in coping with the public utility conglomerates, especially in the process of "simplification".²⁴

25. Some Solutions-- Overhauling the Self-Enforcing Model

26. A *In-depth Observation: Loopholes in the Self-Enforcing Model*

27. Now we know the self-enforcing model did not enforce itself. Several legal deficiencies to be fixed are as follows:

28. First, some cases of share registrars' dishonesty are reported. A person *A* holds stocks issued by a company *C*. *A* sells her stocks to *B*. This share transfer must be reflected in the record of shareholders and, if *C* has 500 shareholders or more, this paperwork must be implemented by a share registrar, or a transfer agent. In most cases, a registrar is under the influence of the issuing company.²⁵ Managers often interfere with the operation if the new shareholder *B* is not supposed to be friendly to them. Among others, foreign investors feel uneasy about this dishonesty.

29. Secondly, proceedings in a shareholders' meeting are often made in illegal or unfair manners. Even if *B* is lucky enough to have his name written in the record, a notice of a shareholders' meeting might not be sent to him. Or he attends the meeting only to find the information is rarely disclosed even if the disclosure in the meeting is required to validate a major transaction or a transaction with a person who has a conflict of interests. That's how shareholders' meetings have not been the effective deterrence to malicious self-dealings.

30. Thirdly, courts in Russia sometimes hesitate to give remedies to the plaintiff shareholders.²⁶ There are many vagueness and inconsistencies among the related acts and provisions.

B *Empowering Minority Shareholders by Clear-Cut provisions*

¹⁹ Russia may need those kinds of regulations for other reasons.

²⁰ Krasnitskaya, supra note 8, at 14.

²¹ JSCL §15 (amendment May, 1999).

²² "The FCSM has brought approximately 130 cases related to shareholder abuse and has won more than 80 % of these cases." Nestor & Jesover supra note 2, paragraph 36.

²³ Provided that there are some inefficient equilibria as well as some efficient equilibria, it needs a huge energy to get out of an inefficient one to be headed for a better one.

²⁴ See Chapter 15 in THOMAS LEE HAZEN (1995), TREATISE ON THE LAW OF SECURITIES REGULATION, 3 ed. Also see the cited materials therein.

²⁵ Nestor & Jesover, supra note 2, at paragraphs 15-16; Kozyr, supra note 16, at paragraphs 44-49. Because a company with less than 500 shareholders can be its own registrar, the abuse is even worse in that kind of companies. However, There are some good news, especially the plan of a single integrated clearance house. Cf. Krasnitskaya, supra note 8, at 8.

²⁶ Kozyr, supra note 16, at paragraph 19.

31. The advocates of the self-enforcing model believed either the prohibitive model or reliance on remedies in courtrooms did not suit Russia as it had weak property rights. However, the legal deficiencies above mentioned suggest us that we put a bit more emphasis on that which those advocates thought less significant.

32. Most company laws in the nineteenth century were prohibitive. Merger generally needed the unanimous vote of shareholders. Self-interested transactions were not allowed at all once they were included in the category, even if a transaction looked self-interested but was beneficial to the company in fact. Those kinds of rules were abolished and replaced by less restrictive rules, because the costs of the prohibition usually topped its benefits. However, the benefits may be larger than the costs without effective property rights enforcement mechanisms. A partial, temporary move back to the prohibitive model will probably be the best solution in Russia. For instance, interested transaction might as well be utterly prohibited.²⁷ Deregulation must follow the strong property rights later.

33. In addition, we should elaborate the rules on remedies. We know quite a few lawsuits were brought in Russia because the self-enforcement mechanism did not work.²⁸ Here are two basic recommendations: drafting clear-cut rules easy for judges to follow,²⁹ and correcting the informational asymmetry between plaintiff shareholders and the company and its managers so as to eliminate the obstacles to bring a suit. The latter could be broken down to two composites: widening the shareholders' access to information that potential plaintiffs need to bring and maintain a lawsuit, and allocating the burden of proof in the lawsuits adequately between a plaintiff and a defendant including shifting the burden from the former to the latter.³⁰

34. The notion is not denying the self-enforcing model but overhauling it. I do not intend increase of lawsuits which cannot be borne by scarce judicial resources in Russia. Rather this idea expects to prevent most of possible wrongdoing that would arise without the remedies. In other words, I attempt to align the incentives of parties involved through this reform.

C Refining the Black's List

35. Bernard Black have proposed a long list of possible reforms for modifying the self-enforcing model. However, I have to point out that the list overlook some essential reforms while the list contains less significant proposals. Without ample resource we could use for fixing the situation, we must refine the list and prioritize among the proposals.³¹

36. Even though monitoring by banks is unrealistic in Russia today, antimonopoly and bankruptcy law reforms that the advocates of blockholders' monitoring proposed but self-dealing theorists overlooked, are quite important. Bankrupt procedures are often abused in managers' concealing the company's assets or competitors' beating down the purchase price.³² It is obvious that the bankruptcy reform must be considered as an important element of good corporate governance. On the other hand, the regulations on insider trading and price

²⁷ Cf. John C. Coffee, Jr. (1999), Privatization and Corporate Governance: The Lessons from Securities Market Failure, The Journal of Corporation Law vol. 25: 1, at 35. Drafting a clear and useful definition of interested transaction may be difficult, though.

The critical misjudgment in self-enforcing model was that, along with the paralysis of shareholders' meetings that had been thought to be the monitors, independent appraisers for the exercise of put option conferred upon the dissenting shareholders in major transactions, were often dishonest. Fedorov, supra note 9, at paragraphs 3, 31.

²⁸ Several legal problems are specifically shown in Ildar Faizutginov (2000), "Opportunity to Seek Legal Redress in Russia", working paper presented at the Conference. It also emphasizes the importance of judicial remedies.

²⁹ Clear-cut provisions are necessary to change the courts' attitudes. "Courts admit only documentary evidence." Nestor & Jesover, supra note 2, at paragraph 35.

Being "easy for judges to follow" means more than the words. Judges in Russia are underpaid and often susceptible to political pressures. Ibid. at paragraph 8. Clear-cut provision are the attempts to encourage them to follow their conscience.

³⁰ This idea of shifting the burden of proof was recommended by Mr. Manne Airaksinen, Counselor of Legislation, Ministry of Justice, Finland, in the Conference. For instance, let's suppose a general principle regarding a certain matter is that the plaintiff must prove, and that if she does not, she loses the case. Shifting means that, if she succeeds in showing appropriate facts that reasonably cause the suspect that the matter may have happened, the defendant in turn has to prove that the suspect is false.

³¹ I got inspiration for this phased, strategic approach of law reforms from the metaphor of domino games in Sadanori Ito (1998), "Redesigning Corporate Governance Structure in Japan: Informational Problems Regarding Human and Financial Capital within a Firm" (working paper filed with the author).

³² Krasnitskaya, supra note 8, at 12, 17.

manipulations are of far less importance. The improvement of Russian stock markets lies not in the fairness or the integrity but in the volume and liquidity of the traded shares.³³ The importance of robust and transparent securities markets is a bit overemphasized by Black and others, partly because mandatory securities regulations are argued in the U.S. academics.³⁴ Also the takeover rules have small significance. Despite that many control transactions happened in 1999, most problems in them rarely related to the fair distribution of the control premium but to freezing out the minority through asset stripping. Though the takeover rules in the U.K. or the U.S. are pretty good, they do not help fix the failure of corporate governance in Russia.

D Priorities

37. First of all, honesty of the share registrars is the absolute condition of all other reforms.³⁵ Also effective judicial enforcement of rights is the supreme command. Speaking of property rights, a criminal law reform is on the agenda in the Duma. It is expected that the Duma will finish the work within several months. I will not discuss those matters in this paper.

38. The second priority must be given to 1) reforms of the JSC, bankruptcy- and antimonopoly laws. A bankruptcy reform is also under way in Russia, which of course is a good sign. Perhaps the financial, eventual and structural disclosure rules could use some modifications. I will discuss several legal issues on company law in the next chapter.

39. Securities regulations except mandatory disclosures come the third. Regulation on insider trading, proxy rules and tender offer rules will be essential only in the future.

E Liability Rules and Shareholders' Derivative Action

40. Effective judicial remedies will increase foreign direct investments that are the most needed in the Russian economy. For effective remedies, the most important is the system in which minority shareholders are able to initiate the directors' and controlling shareholders' civil liability. Specifically, liability rules, the shareholders' derivative action for their enforcement, and the access to the information essential to the lawsuit are three keys which are discussed here.

41. To put a preventive effect on managerial wrongdoing, the rules in the Russian company law should probably be more strict than those in other states. In drafting the detail, we must be creative and imaginative.

42. Duty of loyalty must be established both on paper and in practice. For example, a provision may work well that defines interested transactions loosely and widely, and makes clear that the plaintiffs have only to show the appearance of conflicts of interests and an approximate amount of the damages and that she can show an approximate amount of the gain the defendant obtained from the dubious transaction as a substitute of the proof of the loss incurred, and that, once the plaintiff succeeds in that, the transaction is presumed to be self-interested and that the defendant has to rebut the presumption by proving that the transaction was not self-interested in fact or that the price was within the fair market value, or he can reduce his liability amount by proving the actual damage was less. The drafters must write the detail clearly so that the judges will not

³³ The problem of the thin, illiquid securities markets in Russia was pointed out by Mr. Roger Munnings, KPMG Moscow, at the Conference.

Although these *indirect* self-dealings could decrease the volumes of shares traded in the markets, *direct* self-dealings do far more harm on the markets in decreasing the volumes.

³⁴ There are arguments against mandatory regulations on insider trading, price manipulation and even on disclosures. *See, e.g.*, Henry G. Manne (1970), "Insider Trading and the Law Professors", *Vanderbilt Law Review*, vol. 23: 547; Henry G. Manne (1974), "Economic Aspects of Required Disclosure under Federal Securities Laws", in H. MANNE & E. SOLOMON EDS., *WALL STREET IN TRANSITION* 23; Roberta Romano (1998), "Empowering Investors: A Market Approach to Securities Regulation", *107 Yale Law Journal* vol. 107: 2359.

Though I am not persuaded by the arguments above, I suspect some opponents may have attach too much importance to those regulations.

³⁵ *See* III A. This issue is also discussed in Petr Lanskov (2000), "Rules and Procedures of Registering the Transfer of Ownership Rights in Russia"; Elena Loginova (2000), "Depository Operations in Russia: Statistical Survey". Both working papers presented at the Conference.

hesitate to evoke the remedies.

43. While the deterrence of self-dealings is of primary concern, duty of care needs less attention. If a business judgment turns out to be a mistake, a relief should not be given unless the mistake came from gross negligence. At present we may as well neglect this issue.

44. Shareholders' derivative action is a system not omnipresent around the world: rather it is found in only a few countries most of which belong to the common law system.³⁶ Nevertheless, it is expected to be extremely useful in the Russian situation.³⁷ Care should be taken in elaborating the detail, because a derivative suit is like a super medicine. It can cure a very sick person, but also kill a healthy person. Derivative actions can be used as a means of harassment or intimidation. However, I suppose encouraging the suits should come first and discouraging them should come later in Russia. As long as most bad guys exploit companies as managers or controlling shareholders, I see few reasons to worry about the abuse in Russia. For instance, abolishing of the one-percent equity holding requirement³⁸ should be considered. In the future, the right to bring a derivative action will probably be abused by some underground groups and organized crimes, just as seen in Japan.³⁹ At that stage, Russian company law and courts will be encouraged to draw the line between a good use and abuse perhaps by the U.S. manner.⁴¹

45. In fact, a derivative action as a system in the U.S. is far from flawless. The rationale behind the derivative action is that a plaintiff is a private prosecutor in correcting the self-dealings. But who takes the initiatives? In the U.S., not shareholders but lawyers are motivated to bring this action. The suits merely recover the loss caused and the expense for the plaintiff, but they earn lots of money for the lawyers, especially when the suits are settled. To be sure, judges should be extremely careful in handling derivative cases to ensure the case is not used in a way the lawyers prioritize their own benefits to the clients'. Nevertheless, no matter how greedy the lawyers could be, we should still consider those people as doing good as private prosecutors. We cannot but accept that for a moment, and to some extent.

46. The issue of the burden of the proof was already discussed. Also important is the access to the information that is necessary to bring and maintain a lawsuit.⁴² The right to inspect company's books and records should not be dependent upon the percentage of a claimant's equity holding. Abusive request should be deterred by other measures such as the bad faith of the claimant or the harm that disclosure would do on the company. If the company rejects the request, legally or illegally, the dispute will be brought to a courtroom in the end. The rule

³⁶ Japan is one of the exceptions that have derivative actions in spite of belonging to the civil law tradition.

Professor Coffee discusses a conceptual mismatch between dispersed ownership caused by privatization and a civil-law legal regime that suits better for concentrated ownership. Coffee, *supra* note 26, at 37. Generally speaking, however, I do not think the adoption of the entire common-law regime would be a solution for Russia.

³⁷ Professor Romano empirically tested the efficiency of derivative actions in the U.S. Roberta Romano (1991), "The Shareholder Suit: Litigation Without Foundation?", *Journal of Law, Economics, and Organization* vol. 7: 55. She concluded that, though the system may be of some value, the value is quite small. I suspect, though, that the research does not count the benefit of deterrence. While deterrence by derivative lawsuits may be small in the U.S., it will probably be large enough to justify Russia's having the system.

Another possible critique: lawsuits based on securities laws perhaps play more part than derivative actions in deterring managerial wrongdoing in the U.S. However, this kind of suits are one of the most difficult for foreign countries to import.

³⁸ JSCL Article 71. *Cf.* Black and Kraakman, *supra* 1, at 1972.

The one-percent rule discourage a good initiative by a tiny shareholder as well as allows abuses by a larger shareholder.

³⁹ There are *Sokaiya* racketeers in Japan due to its imperfect property rights. They abused shareholders' rights as a leverage for their threat to extract side payments. Mark D. West (1999), *Information, Institutions, and Extortion in Japan and the United States: Making Sense of Sokaiya Racketeers*, *Northwestern University Law Review* vol. 93: 767; Curtis J. Milhaupt & Mark D. West (2000), *The Dark Side of Private Ordering: An Institutional and Empirical Analysis of Organized Crime*, *University of Chicago Law Review* vol. 67: 41.

⁴⁰ In fact, there is a valid reason to worry about another form of abuse of derivative actions. A minority shareholder is often a competitor of the company at the same time. Derivative actions may be used not only as a nuisance but also in order to obtain inside information. The need for the sophisticated approach that I will present in note 40 may come sooner than expected.

⁴¹ Rule 23.1 of the Federal Rules of Civil Procedure (1966) in the United States provides that: "Derivative actions by shareholders. [...] The derivative action may not be maintained if it appears that the plaintiff does not *fairly and adequately represent* the interests of [the entire] shareholders [...]" (italic and bracketed words added by the author). This wide range of discretion given to the judges is the feature of common law tradition. The concept of "adequate representation" is borrowed from class actions. *See* the Rule 23 of the Federal Rules of Civil Procedure and materials for class actions.

⁴² Difficulties in proof is the largest obstacle to shareholders who are actual or potential plaintiffs in derivative suits.

should clearly allocate the most burden of proof on the company, like: “the request shall be dismissed if the company proves the bad faith of the plaintiff shareholders. If the company proves that disclosure of a specific part in the request does harm on the shareholders as a whole, it may apply for the restriction of the disclosure to the remaining part.” Also civil procedure rules provides for a collection of evidences. The U.S. rule has “discovery” in which an extraordinary wide range of disclosure may be ordered by a court.⁴³ In my opinion, this rule is worth being referred, though it probably goes too far for the benefit for attorneys.

F Some Other Legal Issues

47. Issues below are the list of my proposals, not exhaustive but exemplary, that seem to need immediate fixing.

48. *Illegal issue of shares and share dilution therefrom.* Clear-cut rules, access to company’s information and shifting the burden of proof may as well be of use.⁴⁴

49. *No (or little) need of protecting a bona fide purchaser.* Should a person be protected who bought assets from a company where legal requirements such as an approval in shareholders’ meeting were not met? ⁴⁵ The German and Japanese company laws are generally favorable to a bona fide purchaser. The laws in the U.K. and the U.S. provide him with less protection. In Russia, I suspect many buyers in fact conspire with managers and that too much protection of third parties will deteriorate the protection of shareholders. Imposing the cost of ascertaining the legality of the transaction on the purchaser is not a severe requirement. There are no reports that show exchanges of goods in the U.S. or the U.K. are discouraged by the weak legal protections. I see no persuasive reasons to protect the purchaser who neglected to make sure the legal steps that should have been taken. At least we should require him to prove his good faith and no negligence. As the property rights get established, this protection of third parties should be augmented little by little.

50. *Nullifying the resolution of shareholders’ meeting.* There are some cases in Russia in which the court upheld the resolution of shareholders’ meeting as valid if the result would be the same without the flaws in the procedure of the meeting.⁴⁶ This is a fallacy, because it gives managers wrong incentives not to observe the laws. The cost of this disobedience far outweighs the cost of holding the meeting once again. Therefore, this ruling should be denied by the law and the new law should clearly define the range of the cases in which the resolution may be held to be valid despite the illegal procedures. One example is: “the court shall declare the resolution at hand is null, void and invalidated if there was a flaw in the procedure of notice of calling for the meeting or the procedure during the meeting. The court may nevertheless uphold the resolution as valid in its discretion only if the flaws are trivial both qualitatively and quantitatively and that the company proves the flaw was not caused by the managers bad faith or gross negligence.” You may add a provision that prohibits courts’ upholding the resolution if the notice was not given legally and timely to shareholders whose equity shares exceed, let’s say, three percent altogether.

51. Conclusion – Looking Forward to the Future

52. In this paper, I argued for some specific legal reforms that are a common divisor of markets’ monitoring and blockholders’ monitoring. In the future when the property rights are established and business ethics that reflect the proper structure of the incentives are instilled into the managers’ hearts and investors’ brains, the Russian economy will move onto the next stage and it will stand at crossroads. Maybe the road to take will be chosen not by a theory but by the natural selection itself. It may lead to a corporate governance on the European Continent

⁴³ Rules 26 to 37 of the Federal Rules of Civil Procedure (1966).

⁴⁴ This issue is discussed in Fedorov, supra 9; Kozyr supra note 16, at paragraphs 64 to 74.

⁴⁵ This issue is discussed in Kozyr, supra note 9, at paragraphs 32-39, especially 35.

⁴⁶ This issue is summarized and discussed in Kozyr, supra note 9, at paragraph 19; Nestor & Jesover, supra note 2, at paragraph 22.

fashion. It may lead to a different system. We could not and need not know which way the Russian economy is heading for.

53. Although freezing out minority shareholders has been usually tainted with managerial self-dealings in Russia,⁴⁷ recent development of ownership concentration could be seen differently as a way toward efficiency. With the protection of minority shareholders' rights, this process will come close to a plus-sum game, rather than a zero-sum game observed in self-dealing stories. Some companies will probably move to a more proper and reasonable ownership concentration on institutional investors through tender offers, friendly or hostile, or another ownership concentration caused by exchanges of the outstanding shares with debt securities through an exchange offer or a leveraged buyout. If this happens, we should not consider this as a retrogression to a communist economy but as trials and errors in the process of fine tuning of the privatization.

54. At a first glance, the OECD Principles of Corporate Governance never seemed to be relevant to the issue discussed in this paper. However, we now understand the problems in Russia are general in their nature and to know Russia is to understand ourselves. The OECD Principles cannot be applied to Russia literally. Rather the spirit of the Principles is, and should be, applied to economies in transition.⁴⁸ While the increasing need for disclosure and transparency in the fourth principle is surely universal, the protection of shareholders in the first and second principles could take different forms from country to country.

55. I conclude this paper with the hope for the future enrichment of the OECD Principles through an ordeal in uncharted territories.

⁴⁷ Kranitskaya, *supra* note 8, at 5.

⁴⁸ *See* General Principle I in "Transition Economies", *supra* note 8.