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STAKEHOLDERS AND CORPORATE GOVERNANCE IN RUSSIA

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¹Abstract

This paper examines the role of stakeholders in the corporate governance debate in Russia. In particular, we focus on employees and banks as two main groups of stakeholders. The first section concentrates on stakeholder representation outside Russia, briefly outlining different perspectives on stakeholder representation and reviewing the evidence on the impact of stakeholder policies in OECD countries, with particular reference to the US, UK, Germany and Japan. The second section synthesizes the authors' recent studies of Russian privatized enterprises and banks to provide evidence on the actual extent of stakeholder ownership and participation in governance as well as evidence of the effects of such involvement. The third section analyzes the appropriateness of different governance regimes under various contingent situations. The fourth section brings the previous three sections together and considers future Russian corporate governance in the context of previous experiences and of conceptual and theoretical issues. The paper concludes that while there are clear pressures for US-style shareholder governance, major barriers to its implementation creates a "second-best" situation where stakeholder control (e.g. bank involvement) may be needed to at least provide some discipline over managers. However, the costs as well as the benefits of such an approach need to be recognized.

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Introduction

The role of stakeholders in the governance of enterprises has been the subject of vigorous debate, both in general and in the context of Russia. This debate has embraced both network-type governance systems as well as market-based systems. The OECD Principles on Corporate Governance recognize that the contribution of stakeholders constitutes a valuable resource for building competitive and sustainable companies. These Principles suggest that mechanisms for effective stakeholder participation may include employee stock ownership and ESOPs, profit sharing mechanisms, employee representation on boards, creditor involvement in governance and other processes that permit stakeholder involvement in key decisions.

In Russia, open capital markets based on the Anglo-American model, nominally at least, formed a major plank of market reform programmes. However, a rather different outcome has evolved, a unique hybrid of different systems. For example, mass voucher privatization resulted in widespread equity ownership by management and employees as two of the main stakeholders in enterprises. Subsequently however, the 'loans-for-shares' scheme resulted in transferring ownership of some of the largest, most important companies to a few well-placed Russian financial institutions, and Financial-Industrial Groups (FIGs) represent large diversified holding companies focused on banks. However, the most recent trends in the Russian economy are associated with the rapid development of non-bank holding companies, in the oil industry in particular, such as Sibneft, Tyumen Oil Company (TNK) and YUKOS. These holding companies are fixing the borders of their empires through intra-holding consolidations, mergers and share swaps. These holdings have two common features: ownership is concentrated and outside shareholders, at different stages and to various degrees, has suffered equity dilution. In addition, many industries in Russia have also experienced a rapid development of holdings by trading companies, etc.

Some authors argue that these variations on the theme of the holding company provide a form of industrial organization that may create a private, internal capital market through developing long term relations between other members of the group in which banks play an important role (Johnson, 1997; Perotti and Gelfer, 1998). The ability of the holding company to capture the benefits from control ensures a steady supply of financing (Modigliani and Perotti, 1997), though some FIGs disappeared after 1998.

This paper examines the role of stakeholders in the corporate governance debate in Russia. In particular, we focus on employees and banks as two main groups of stakeholders. The first section concentrates on stakeholder representation outside Russia, briefly outlining different perspectives on stakeholder representation and reviewing the evidence on the impact of stakeholder policies in OECD countries, with particular reference to employee share ownership and participation in decision-making in the US, UK and Japan and the role of banks. The second section synthesizes the authors' recent studies of Russian privatized enterprises and banks to provide evidence on the actual extent of stakeholder ownership and participation in governance as well as evidence of the effects of such involvement. The third section analyzes the appropriateness of different governance regimes under various contingent situations. A fourth section brings the previous three sections together and considers future Russian corporate governance in the context of previous experiences and of conceptual and theoretical issues. Finally, some conclusions are drawn.

1. Stakeholder Representation Outside Russia

A firm's stakeholders have been defined broadly as individuals and entities that can be influenced by, or can impact on, a firm (Wheeler & Sillanpää, 1997). Primary stakeholders include shareholders, employees, managers, customers, local communities, suppliers and business partners. Secondary stakeholders comprise government and regulators, civic institutions, pressure groups, media and academic commentators.

While there is general agreement on these broad conceptual issues, controversy arises in relation to the degree to which firms should give priority to the claims of different stakeholders, i.e.

stakeholder salience (Mitchell et al., 1997). It is asserted that stakeholder salience depends on three elements:

- A stakeholder's power to influence the firm, usually market power, as the stakeholder supplies some resource vital to the firm,
- The legitimacy of a claim, or the extent to which the stakeholder has invested (human or financial) capital in the firm, i.e. the stakeholder's risk of loss,
- The urgency of a claim, determined by the dedicated nature of the asset supplied to the firm, i.e. how easily it can be replaced from a market.

Besides this controversial notion of salience, governments, agencies and writers differ widely in relation to the *channels* considered most appropriate for the representation of stakeholder interests. Broadly, the available structures for stakeholder representation range from (a) market governance at one end of the spectrum through (b) hybrid intermediate structures such as stakeholder management to (c) the sharing of hierarchical control with stakeholders.

Market governance implies that the legitimate stakeholder interests of employees can best be accommodated through the mechanisms of the labour market, managers through the market for managerial labour, customers on product markets, banks on credit markets etc. While market governance perhaps implies an emphasis on short-term expediency, and arguably on a "hire-and-fire" approach, contracts can be designed to safeguard the long-term interests of both buyers and sellers, always assuming that market power is evenly distributed.

Thus, commentators like McTaggart et al. (1994) argue that only specialist outside shareholders should be involved in the monitoring of managerial decisions, and that stakeholder interests should not be allowed to distract managers from their main task of creating shareholder value. They do concede however (McTaggart et al., p19) that investments by the firm in employee training and treating employees "like partners" (p20) may be consistent with value maximisation. In this sense, market and hybrid stakeholder governance and full decision sharing with stakeholders may differ little in practice.

At the other end of the spectrum from market governance, stakeholder interests are incorporated in the decision making process of the firm by giving them *seats on main boards* of directors (or supervisory boards), i.e. a full share of control. This implies that stakeholders have at least two roles within the firm, i.e. as decision-makers and as stakeholders (employees, banks, etc), and this can lead to conflicts of interest as well as advantages. For example, high levels of trust are needed to prevent stakeholders opportunistically exploiting the informational advantages that seats on boards may offer. Noteboom observes (1999) that full stakeholder participation in control probably requires stakeholders to be institutionally embedded in communities of firms, trades or industries.

Between market governance and stakeholder control, there is a wide range of schemes giving opportunities for stakeholders to be consulted on decisions that can be described as *stakeholder management*: Hillmann & Keom (2001) find that this has been a successful option in terms of raising shareholder value.

The OECD's principles of corporate governance contemplate the desirability of establishing stakeholder consultation or full stakeholder control within firms, and of providing stakeholders with the requisite information to fulfil these roles. Employees form a key stakeholder group and a large number of studies have examined the impact of employee share ownership on performance in OECD countries, primarily in the US. These studies, which encompass ESOPs, cooperatives and other forms of employee ownership, in general find either a neutral or a positive impact of employee share ownership. A meta-analysis of these studies (Sesil et al., 2001) identifies a significant positive relationship between employee ownership and performance, with the average increase in productivity following adoption of an ESOP estimated to be 4.4%. There is also evidence from the US that employment growth is faster after ESOP adoption, especially where firms have a greater degree of employee participation in decision-making (Winther and Marens, 1997). A study of US public companies with

broad-based employee ownership finds that these companies had significantly lower variability of employment but that this employment stability was not at the expense of firm efficiency (Blair, et al., 2000). Sesil et al. (2001) also find that US firms offering broad-based stock options had higher productivity.

Evidence of the effects of ESOPs in Japan, where there appears to be a higher incidence and participation rate and less senior executive involvement than in the US, shows that their introduction leads to a 4-5 per cent increase in productivity (Jones and Kato, 1995). This study also finds that the productivity effect of bonuses is enhanced by the presence of an ESOP and suggests that in Japan ESOPs may create a climate conducive to profit-sharing by enhancing long-term commitment and peer monitoring.

OECD studies of the impact of employee ownership on attitudes and behavior generally report better employee attitudes and behavior under employee ownership. There are mixed results concerning the link between improved attitudes under employee ownership and the degree of ownership; some studies suggest it depends on the *size* of employees' equity stakes while others indicate it is sufficient just to be an equity holder (see Pendleton, et al., 1998 for a review). A recent UK study of employee ownership in four privatized bus companies found that opportunities for participation in decision-making were more important in generating feelings of ownership than employee ownership per se (Pendleton et al., 1998). The study also suggested that variations in feelings of ownership were associated with the number of shares held by individuals. Employees who have higher relative levels of share ownership and perceptions of participation were significantly more likely to feel more like owners and in turn to have relatively high levels of commitment and satisfaction with the organization.

Banks form a second key group of stakeholders and are particularly important in enterprise governance in Germany and Japan. In Germany, banks exercise power through their presence on supervisory boards, which are required in joint stock companies (AGs) and larger private companies (GmbHs). Bank shareholdings and supervisory board presence of banks are however quite limited and are concentrated primarily in a few large banks. In contrast, in larger AGs employing more than 2000 people, half the members of the supervisory board are elected employees. Nevertheless, banks exercise influence through their presence on the supervisory board in terms of information exchange and the discussion of common strategies between the banks and executive management (Clarke and Bostock, 1997). However, recent evidence (Edwards and Nibler, 2000) suggests that German banks do not play a role in corporate governance that is distinct from their position as one of several different types of larger shareholder. In Japan, banks play a major stakeholder role in Keiretsu, business groups that are tied with cross-shareholdings and links to a main bank. The main bank is effectively the monitor of group firms in the Keiretsu and provides financial assistance when they face problems. Access to information for monitoring is enhanced by inter-personal connections, bank employee representation on the boards of group firms, and the use of councils of presidents' of core firms (Gilson and Roe, 1993).

In Anglo-American governance systems, increasing attention is being given to the development of bank relationships (Mayer, 1988). In the UK, for example, both case study evidence (Holland, 1994) and large-scale survey evidence (Binks and Ennew, 1997) shows that close relationships between banks and their clients generally involve rich information flows, high loyalty and commitment between parties, and expectations of fair dealing and longevity of relationships. The operation of debt covenants also involves the extensive use of relationships to resolve problems when covenants are breached, as opposed to the formal recall of a loan and bankruptcy proceedings being initiated (Citron, Robbie and Wright, 1997).

2. Employee and Bank Stakeholders in Russia

This section reviews empirical observations on the involvement of employee and bank stakeholders in the actual governance of Russian firms. We synthesize the findings of a number of recent studies by the authors on corporate governance in privatized Russian enterprises based on surveys conducted between 1994 and 2000. The emphasis is on the relatively neglected Russian industrial privatized firms, that are more homogeneous and have been described as "manager-controlled, employee-owned" firms (Earle & Estrin, 1996, p33).

a) Employee Ownership

Employee shares undoubtedly overstate the salience of employee stakes in the circumstances of Russian industrial firms in the 1990s, due to relatively weak market power, asset-specificity and legitimacy. The evolution of the ownership distribution of the various stakeholders in Russian privatized enterprises is reported in Table 1 which presents the findings from available studies over time. Despite some methodological differences between studies (Estrin and Wright, 1999), it is clear that, on average, insiders are majority owners in Russian privatized enterprises, with managers alone owning around a fifth of shares. Indications are that insider ownership in Russia is falling over time, albeit slowly, and that among insiders there is a shift in equity-holding from employees to managers. Most recent evidence from 1999, however, indicates a sharp fall in employee ownership as insiders on average now hold below 50 per cent of equity, with a corresponding increase in ownership by outsiders (Table 1). Direct evidence about changes in share ownership from longitudinal studies of panels of firms over time also indicates a shift in the balance towards managers (Jones, 1998; and Aukutsionek, et al. 1998) and shows a marked fall in state holdings in companies and a notable increase in outsiders' stakes.

There is also important evidence about changes in dominant ownership. Aukutsionek, et al. (1998) find a growth in the importance of dominant managerial shareholders in Russia between 1995 and 1997, with managers forecasting that they will become more dominant by 1999.

b) Employee Control

In discussing trends in employee ownership it is important to recognize the difference between ownership and control. Russian evidence suggests that although employees may have significant equity stakes, their involvement in boards of directors and other control mechanisms is generally very low (Filatotchev et al., 1996). In the early stages of the transition process, employee board representation appears to have declined between the year prior to privatization and one year afterwards (Table 2). In contrast, employee participation in decision making increased a little after privatization in terms of formal and informal consultations, particularly in terms of formal consultation with workers' assemblies on strategic issues.

Later evidence indicates that during 1995-97 there was a slight fall in the number of companies in Russia which had employees sitting on the Board. State representation on boards seems to have declined quite sharply over this period (Table 3). Corresponding increases in representation were most notable in respect of outside private individuals, management, corporations and investment funds. Board representation by banks remained unchanged at a low level. About one third of privatized enterprises had external private individuals on their supervisory boards and approaching a quarter had corporate representatives.

Where they do have board representation, employees are the second most important stakeholder representative, on average holding 2.7 seats compared to management's 3.3. By comparison, investment funds hold 2.5, corporations 2.3, outside private individuals 2 and banks 1.5.

c) Impact of Employee Ownership

Non-managerial employees do not seem to have been responsible for either blocking or promoting restructuring in Russian enterprises (Earle, et al., 1996). Evidence from the present authors' sample of privatized Russian enterprises surveyed in 1998 also indicates that, contrary to expectations, employee ownership is not significantly related to a reduction in restructuring actions (Buck, Filatotchev et al., 1999) nor to adverse effects on exporting (Buck et al., 2000). This may be either because the substantial levels of employee ownership in the enterprises (see above) did not afford a significant degree of decision control in the face of acute business crisis or because the effect of their control is neutral in retrenchment terms. The unresponsiveness of restructuring to employee ownership may have been because of employees' apathy and social immobility (Bim, 1996), the giveaway nature

of the share distribution process (i.e. low stakeholder legitimacy), restrictions on share sales that gave employees little incentive to act as shareholders or because of the generally low level of employee representation on boards or strategic decision-making bodies. In contrast to employees, other outside stakeholders, notably private individuals and corporate private ownership were found to be significantly positively associated with restructuring activity involving capacity reduction but not with reductions in employment levels.

A survey of Russian enterprises by the International Labour Organization (ILO), conducted in 2000 and analyzed by the authors shows that there is no significant association between employees' shares and wages for managers, skilled and unskilled workers. Bonuses for managers and skilled workers were, however, found to be significantly higher when employee ownership is high, and similarly for the two categories of workers' benefits.

Despite this evidence of some association between employee governance and two sources of immediate employee utility (but not wages), it should be emphasized that higher employee welfare need not necessarily imply lower firm performance. Indeed, higher rewards for employees in the form of wages, bonuses and benefits could conceivably raise labour productivity and firm performance.

In parallel with its Russian study, the ILO also conducted more extensive surveys in Ukraine, where employees experience roughly the same circumstances of stakeholder salience. Here, the data produced similar results to Russia concerning employee ownership and employee rewards, but this had no detrimental effect on firm performance. Indeed the opposite was the case, and employee rewards of each kind were positively associated with firm performance.

(d) Banks

While this section will focus mainly on privatized manufacturing firms in Russia, it should be noted that studies of the 1996-97 situation reported that firms under the control of FIGs apparently improved the efficiency of their investment decisions (Volchkova, 2000). However, the vast majority of privatized companies in Russia do not have a significant representation of outside financial institutions in either ownership or formal Board level control (Frydman, et al., 1996a and b; and Wright et al., 1998). The authors' survey finds that banks were members of executive boards in 5.4 per cent of cases and a member of a supervisory board in 7.1 per cent of cases. Investment funds, private individuals from outside the company, industrial organizations and the state all had greater degrees of involvement on supervisory and executive boards than did the banks.

In the authors' sample of privatized enterprises surveyed in 1998, banks were found to have very low influence on the appointment of directors, on restricting operational and strategic decisions of managers and on the setting of directors' remuneration. Their main channels of influence were reported to be, in declining order of importance, telephone contacts, the review of accounts of the enterprise on a regular basis, the monitoring of debt covenants, visits to the company and supervisory board representation (Table 4).

Enterprises report apparently active monitoring by banks of situations where interest and capital repayments have not been met (Table 5). The most common form of action is to engage in personal discussion to resolve the problem. However, in a significant percentage of cases banks have either rescheduled loans or refused to grant new loans. Between the two years covered by the survey there is some indication of a hardening of the approach adopted by the banks in terms of a shift from discussions or ignoring the problem towards refusing to give new loans and the taking of legal action.

Our detailed interviews with banks reinforce these findings (Wright, et al., 1998). In addition to evidence that banks use formal monitoring mechanism, there is also evidence that in the light of problems with these mechanisms banks also engaged in personal relationships with client management. Qualitative analysis of the banks' monitoring behaviour found that all banks interviewed reported the use of debt covenants in lending agreements, although there were differences in attitude about their efficacy and the ability to enforce covenants in the Russian environment. There was thus a tendency to rely on relationships. Banks stated that financial reporting requirements involve the provision of regular financial and other reports, typically on a monthly and/or quarterly basis. However, although

information is supposed to comply with legislation enacting the use of international standards, either this is not the case or the nature of the accounting system in enterprises does not permit accurate adjustment of information to a true GAAP basis. Enterprises were also reported to be reluctant to provide information on financial problems, even if it is in the loan agreement that they should do so. In these circumstances, banks considered that good personal relationships and trust as well as liquid collateral were important. Timely notification was also important in giving the bank time to take rectifying action. Some of the banks reported using firms' financial difficulties as a means of putting pressure on companies to sell shares to them. Banks have differences in their approach to seeking board representation. Because of some resistance to board representation, this may be negotiated rather than required. Moreover, the objective of board representation was seen as focusing on financial rather than strategic actions.

Extensive and varied personal contacts between banks and their client enterprises are a means of gaining access to reliable information and effecting monitoring. Whether or not there was a representative on the Board of the company, there is a need for good contacts with the company in order to have a reasonable chance of verifying whether the information was reliable or not. Personal contacts with clients can help in probing behind the reported figures to identify the nature of the management, regardless of the extent of a company's market-orientation or the level at which the company is operating. Visits also help the bank check whether management are using the funds in the manner agreed at the time the loan was made. Telephone contacts were widespread, with bank officers also making regular visits to clients. However, although relationships appear to play an important role in the monitoring of clients, they can be problematical; hence the need to "trust but verify". Loan officers may need to be remunerated sufficiently well to take away the incentive to accept bribes that might be offered by borrowers. In some cases the largest clients have a personal relationship manager who works closely with the loan officer.

Although banks were making some progress in Russia in monitoring of clients, the turmoil of late 1998 undermined their ability to intervene. Many banks became technically insolvent and some lost their licenses, including banks such as Inkombank that were actively involved in monitoring enterprises (Wright, 1998). However, in the post-1998 period other banks are trying to impose more stringent control over managerial discretion. For example, one of the directors of the United Financial Group (UFG), Mr Fyodorov, is well known for his outspoken criticisms of the Russian oil and gas company Gazprom over its related-party transactions with the Florida-based firm Itera which is allegedly controlled by the management of Gazprom. Mr Fyodorov's suggestions include board re-elections, a thorough audit of deals between Itera and Gazprom and other shareholder 'activist' measures. The hardening of budget constraints on enterprises may, in principle, both help the banks' financial position as well as place pressure on enterprises, but the feasibility of this option in the current environment is unclear.

More recently, a 1999 survey of privatized manufacturing firms in Russia conducted by Russian Economic Barometer (REB, Filatotchev et al., 2001) provided evidence of a mixed pattern of banks' involvement in enterprises after the 1998 crisis. This survey, focused specifically on patterns of ownership structure and concentration in privatized firms, revealed that bank share ownership remains relatively low compared to insider stakes: in 88.8 percent of the sample of 160 firms, share ownership by banks and bank-controlled investment funds was below 10 percent of the total number of voting shares. However, in 2.6 percent of the REB sample, share ownership of financial institutions was above 40 percent. In addition, in 15 percent of cases a bank was the largest single shareholder in the firm. This may be an indication that Russian banks normally do not hold direct ownership interests in privatized firms. However, when they do take a financial interest in the firm, their share ownership is relatively high. This finding is consistent with the assumption that banks are trying to obtain controlling interests in firms. The REB survey also revealed that the concentration of ownership by banks and other financial outsiders was associated with relatively weaker financial performance and lower levels of investment. Filatotchev et al. (2001) attribute this to a possible collusion between banks and incumbent managers who may try to obtain private benefits of control at the expense of minority shareholders. In response, minority shareholders may refuse to provide additional funding necessary for restructuring and modernization.

3. Stakeholder Participation and Contingent Variations

In this section we analyze conceptual issues concerning the involvement of stakeholders in corporate governance. As noted earlier, the involvement of different stakeholders as participants in, and/or controllers of, enterprise decisions implies the creation of some form of relational/network (or “stakeholder”) governance in contrast with pure US/UK-style market (or “shareholder”) governance, where share price and the threat of hostile takeovers represent the main channels of managerial discipline by shareholders. Relational governance can be expected to offer great advantages to firms through stakeholder identification with the firm leading to higher productivity and through economies of scope in information collection. For example, banks with seats on different boards may be able to pool their knowledge of different firms.

At the same time however, all dual roles bring potential costs as well as benefits, including the sacrifice of some specialist skills as banks and employees devote time to decision-sharing etc. The particular balance of costs and benefits in the case of any single firms depends on contingent factors at the levels of firm, industry and national economy.

Figure 1 analyzes the main distinctions between stakeholder and shareholder-based governance systems. These issues are discussed both conceptually and using insights from stakeholder governance systems such as Germany and Japan. Some Russian firms have corporate governance arrangements that resemble Germany’s, with two-level boards and the involvement of employees and banks as stakeholders (Charkham, 1995). Smaller German companies are not required to have two-tier boards and similarly many Russian firms have single boards and significant bank involvement. Additionally, the development of FIGs in Russia has parallels with the Keiretsu in Japan (Modigliani and Perotti, 1997).

At a national level (row 1 of Figure 1), stakeholder involvement in corporate governance must rely on a culture of community and consensus rather than of individualistic opportunism as in a shareholder-based system. In the case of Germany, for example, a sense of *Gemeinschaft* (community) within the firm ensures broadly that managers, employees, banks and industrial partners do not exploit their seats on Supervisory Boards for personal gain. For example, all Board members must treat company information as confidential (Baums, 1993, p164) and should not use Board membership as a channel for promoting their immediate self-interest.

Even with a national culture of community however, stakeholders may promote strategies that advance their own interests at the expense of shareholder value. For example, labour representatives who comprise 50% of supervisory boards in a German *Aktiengesellschaft* with more than 2,000 employees have been found generally to oppose redundancies and to block hostile takeovers (Berndt, 1998, p26). Similarly, banks as creditors and employees with board seats and/or shares in a firm have been seen to protect their financial and human investments by advocating massive internal cash transfers within German firms into hidden reserves, that can be used to smooth declining firm income in a crisis. This amounts to banks and labor forming a coalition with managers to keep down dividends payable to outside shareholders (Hopt, 1998, p235; Baums, 1993, p175). While remembering that bank ownership and control of industrial firms can offer significant economies of scope that may be crucial to particular stages of national development, it must also be recognised that evidence exists (Thomas & Waring, 1999) that bank holdings distort investment decisions: they report that investment decisions in large, bank-controlled firms in Japan and Germany are influenced more by liquidity considerations than by expected investment returns, as is the case in the US.

At the same time, it seems clear that powerful stakeholder influences in Germany and Japan would be infeasible without considerable support from prevailing legal institutions. In governance systems that emphasize the role of stakeholders, there is typically relatively low protection of minority investors and extensive expropriation of minority outside shareholders by controlling shareholders (La Porta, et al., 2000). As a result, the primary agency problem in this context is not the failure of professional managers to satisfy the objectives of diffuse shareholders, but rather the expropriation of minority shareholders by powerful stakeholders such as banks and insiders (Filatotchev et al., 2001). Bank influence over firms in Germany, for example, is magnified by the legality of depository shares in relation to bearer shares deposited with them. Disclosure requirements concerning transfers to hidden reserves are weak (Baetge & Thiele, 1998, p725). Large companies are permitted to put caps (typically 5%) on the maximum number of votes that can be voted by one shareholder (Baums, 1993,

p154), thus eliminating takeover threats to these firms. Cross-shareholdings and cross-directorships with suppliers and competitors are encouraged by the permitted existence of undisclosed stakes in firms, and despite the EU's Transparency Directive (1997) requiring disclosure of stakes above 5%, the disclosure of large stakes is widely avoided through use of intermediate company structures (Adams, 1998).

Thus, legal institutions reinforce stakeholder governance, just as the law in the US promotes control by outside shareholders. In addition, German capital gains taxation (until 2002) provides an obstacle to share liquidity by applying penal rates to the liquidation of blocks of shares by banks and industrial partners. In 2001, however, German banks such as Deutsche Bank are in the process of transferring their industrial equities to separate holding companies, with a view to subsequent divestment when capital gains taxes fall in 2002. The general absence of liquid share markets makes the application of US-style stock options for executives extremely problematical (Bernhardt, 1998).

In environments with weak legal protections it may be optimal to have more than one large stakeholder. When control is dissipated among several large investors, a decision to expropriate minority shareholders requires the consent of a coalition of investors, and this coalition might hold enough cash flow rights to choose to limit the expropriation of remaining shareholders and pay the profits as efficient dividends (Bennedsen and Wolfenzon, 2000). Therefore, coalitions of stakeholders may be an equilibrium response to a firm's operating characteristics and its legal and competitive environments.

The next two rows in Figure 1 emphasize the relevance of stakeholder involvement at the industrial level. Stakeholder governance may be more appropriate than outside shareholder-based governance systems for industries with long production cycles that need long term investors. Alternatively, stakeholder governance may be appropriate in technologically complex industries where operations are opaque and costly to monitor for unrelated outside investors. In both Germany and Japan, national strategies of specialising in technologically complex industries with long production cycles requiring long-term investors fit neatly with a cultural and institutional environment favouring stakeholder involvement (row 1 of Figure 1).

At the enterprise level in Figure 1 (rows 4 and 5), stakeholder-based governance may have implications in terms of the innovative behaviour of a firm and the nature of restructuring (Prowse, 1990). An innovation project with a high degree of uncertainty, would have much lower chances of getting funded in a bank-based system of governance compared to decentralized financial systems because of the conservative approach adopted by banks. Therefore, managers in a stakeholder-based system such as Japan pursue research projects that lead to incremental product improvements and process innovation as opposed to a more radical product innovation and incremental process improvements (Hitt, Ireland and Hoskisson, 1995; Kim and Hoskisson, 1996). Keiretsu and similar arrangements are also seen as more suitable to growth situations involving relational investments (Gilson and Roe, 1993). However, experiences during the last decade have meant that stakeholder governance has been a handicap in achieving downward adjustments (i.e. labour and plant downsizing) during an international economic slowdown (Berndt, 1998; Franks and Mayer, 1997). In Japan, in a situation where boards are dominated by insiders, the main banks play a passive role and only place outside pressure on managers in a crisis. There may thus be a failure to exit from non-viable projects in a timely fashion (Mayer, 1994).

With this background of (1) stakeholder representation outside Russia (2) actual stakeholder representation in Russia and (3) contingent variations in theory and practice, the next section (4) considers possible future governance configurations in Russia.

4. Future Stakeholder Roles in Russia

On the basis of the preceding surveys and arguments this section uses the framework in Figure 1 to examine the expected future roles of stakeholders in Russia.

In relation to row 1 of Figure 1, *all* Russian firms are subject to the strengths and weaknesses of Russia's national culture. National culture can be taken to mean the ideas, values, norms and

meanings shared by members of a social entity that are transmitted through families and communities. A crucial cultural dimension is power-distance, or the extent to which the less powerful members of institutions and organizations tolerate the fact that power is distributed unequally (Hofstede, 1960). In Russia, a culture of high power-distance combined with high levels of local collective orientation (Elenkov, 1997) has encouraged enterprise incumbents (employees and managers) to collude to demand a reform path that does not threaten their own power within enterprises. It also follows that a well-developed legal system may be weakly enforced locally in the face of organized interest groups, usually enterprise managers, other employees and their political contacts. Russian firms thus combine a high degree of in-firm trust with opportunism and disobedience of central decrees relating to firm-government relations.

It follows that while managers and workers may not over-abuse their dual roles within firms as employees and dominant shareholders, they will resist State efforts to protect outside shareholders. Weak regulations in Russia concerning the collection of enterprise taxes has contributed to State/firm conflict. In addition, Presidential decrees purport to reinforce US-style outside shareholder protection when most industrial firms are practicing stakeholder governance, with managers and other employees prominent.

The other distinguishing feature of Russian national culture relevant to this discussion is very high level of uncertainty avoidance (Elenkov, 1997). This implies that employees will be hostile towards new owners and towards possible redundancies. It also implies an extremely conservative input from employees to any participative process in strategy formation. Generally, Russian national culture favours US-style, market-based governance of inter-firm relations, since this has been developed in the US in a culture of opportunism and low trust. Bearing in mind these general observations, it appears that actual corporate governance in Russia in 2001 may have a *dual* nature, though of course with some blurring at the edges.

On the one hand, 200-plus natural-resource-based companies (e.g. firms in metals, timber, oil and gas, etc) are quoted on the Russian Trading System come closest to market-based governance. In the context of the earlier analysis, and particularly the contingencies outlined in Figure 1, these quoted companies face enormous investment demands that cannot be satisfied substantially by indigenous, under-capitalised banks, thus giving banks low salience. Similarly, most of these firms were not subject to mass privatization, so employee salience is also low. Some of these firms are also part of FIGs, though this is a declining influence, and may be part of wider holdings. Generally the influence of other stakeholders (certainly employees) is rather weak. This sector is expanding (row 3 of Figure 1) but investment finance is relatively easy to obtain, since natural resources can themselves be used as collateral. Technological complexity (row 3) is generally low, and this also favours shareholder governance. Share trading volumes are typically low currently, and outside shareholders' rights are seriously under-protected. However, there is at least some prospect that managers' decisions will be ultimately influenced by share price movements. This approximates to the US-style model of governance that relies implicitly on disciplines imposed on opportunistic principals and agents, but in Russia the weak enforcement of laws and taxes threatens this governance regime. Taken together, the stakeholder imperatives of the natural resource sector imply that, assuming the ultimate enforcement of laws addressing the protection of minority shareholders, outside shareholders have the highest stakeholder salience, and may ultimately develop a significant discipline over incumbent managers, with little formal control needed from other stakeholders.

Elsewhere however, most manufacturing firms privatized through the mass voucher programme do not have share quotations and are characterised by insider ownership, as seen above. Stakeholder influence here is mainly felt from managers and other employees, who continue to exhibit high stakeholder salience, though major exceptions are provided by high-tech companies previously part of the military-industrial-complex (MIC), where the State (another relational stakeholder) still retains a large degree of control in firms that in many cases have still not been privatized. Apart from the former MIC, however, the bulk of Russian privatized industry does not have long gestation periods for investments (row 2 of Figure 1), nor is it technologically complex (row 3) by the standards of developed countries. At the same time, corporate restructuring involving plant and employment *downsizing* has been the appropriate strategy (row 5) for most industrial firms needing a turnaround strategy during a long period of economic transition (Filatotchev et al., 2000). While there is a need for process innovation, restructuring necessarily precedes the major investment required (row 4).

It follows therefore that the lessons from this analysis of stakeholder governance also imply that the US-style governance would be more suited to the unquoted sector. However, managers have hitherto been able to resist it by preventing share sales and may continue to do so with the implicit support of other employees. The infeasibility of US-style shareholder salience now means that, arguably in a “second-best” situation, stakeholder control (e.g. bank involvement) may be needed to at least provide *some* discipline over managers.

While this must involve costs associated with dual roles, the benefits may justify stakeholder involvement. Many contrasting governance forms around the world involve stakeholders, including employees, and produce goods and services that compete on world markets (Pedersen & Thomsen, 1997). However, a stakeholder-based industrial system combined with conflict between firms and a distant State bureaucracy does not auger well for corporate restructuring, and further regulation can contribute little without much stricter law enforcement. In the circumstances of a Russian culture featuring high uncertainty avoidance, it may be advisable to restrict participative structures for employees to discussions of business strategies that do not include the determination of wages, bonuses and employment levels. On the other hand, evidence from recent joint venture discussions, between General Motors and AvtoVAZ near Tolyatti and between Fiat and GAZ in Nizhny Novgorod, suggests that conditions in large privatized manufacturing firms have now become so bad that managers and employees are discarding some of their uncertainty avoidance in favour of a positive attitude towards outside (and foreign) strategic investors, that are of course beyond the scope of this paper. More generally, this is consistent with Table 1 which shows that employee ownership has recently been declining quite sharply, although it is not clear without further analysis to identify the nature of the acquirers of insider shares.

Leaving aside natural resource-based industries, high levels of recorded and hidden unemployment and unpaid leave have reduced the stakeholder power of most Russian employees to influence the firm, and in most cases, employees do not supply dedicated assets that raise the urgency of a stakeholder’s influence. The “giveaway” distribution of most shares in Russian privatized firms reduces the employee stakeholder’s risk of loss and thus stakeholder legitimacy and salience, though of course job stability is low and uncertainty-avoiding employees may urgently press for job preservation.

Similarly, the stakeholder power of Russian banks is heavily constrained by the relatively small volume of domestic financial resources that are available for enterprise loans and share purchases. Banks also face problems in obtaining a greater involvement in enterprise monitoring because of the reluctance of insiders to cede control to outsiders. There are implications here for enhancing the transparency of share tradability (EBRD, 1998). Banks may face difficulties in accessing information to engage in effective monitoring, even where they have board seats (Wright, Buck and Filatotchev, 1998). This problem is exacerbated by poor procedures, low information transparency and weak standards of financial reporting. This argues for greater effort towards enforcing the financial reporting framework. Finally, to fulfil their role in governance, banks need appropriate capitalization, regulation and governance (Van Wijnbergen, 1997; EBRD, 1998; Abarbanell and Meyendorff, 1997).

While the majority of mass-privatized enterprises are organizationally-complex, comprising enormous vertical hierarchies, only in the case of the former MIC can they be described as being technologically-complex. In this case (row 3 of Figure 1), stakeholder governance may be justified, presumably from outside, strategic investors in the form of foreign partners

5. Conclusions

This paper has focused on the corporate governance role of employees and banks as two main groups of stakeholders in Russia. Both groups were found to have relatively low levels of influence, even though employees in particular have significant ownership stakes, particularly in the unquoted sector.

Perhaps surprisingly, the empirical results regarding employee stakeholders provide no significant evidence that they damage the value of the firm to shareholders by promoting immediate employee welfare. This outcome is consistent with the low stakeholder salience of employees, or with

their willingness to suppress demands for immediate welfare in order to promote the firm's ability to perform and survive.

In a cultural environment of high power-distance such as in Russia, decrees and regulations promoting stakeholder participation are likely to be insufficient. Rather, and consistent with the OECD Principles on Corporate Governance, there may be a need to develop mechanisms for the enforcement of stakeholder involvement. While the benefits of stakeholder involvement in corporate governance are well-known and empirically verified, governance mechanisms must be accepted in their entirety, costs as well as benefits.

With Russian quoted companies, US-style market-based corporate governance seems feasible, given the enforcement of regulations. However, the unquoted sector of the Russian economy may be considered to need stakeholder governance to propel economic growth at a crucial development stage, as in Japan and Germany. In this case, the dis-benefits of stakeholder control also need to be accepted, and legal reform will be necessary. Bank ownership and control in Germany and Japan did not evolve spontaneously but was consciously chosen by the State, influenced by national culture, and was reinforced by legal/tax institutions. This resulted in accelerated economic development after long periods of national crisis and weak governance. But bank ownership and control brought costs as well as massive benefits: excess liquidity in industrial firms, low dividends to outsiders, low levels of information disclosure for outsiders and investment decisions influenced more by liquidity than rate-of-return considerations. More recently, the contingency of economic recession has highlighted the potential weaknesses of bank governance, notably problems in disciplining managers and achieving necessary downsizing. These exigencies have now become so severe that major changes are taking place in these systems. These changes have included the rationalization of the six Keiretsu groups in Japan into four new configurations, the emergence of leveraged buyouts of parts of Keiretsu and the acquisition of controlling stakes in major Japanese corporations by Western companies (e.g. Renault and Nissan) (Wright et al., 2001). In Germany, sell-offs of industrial shares by banks are pending.

With respect to employee stakeholders, it is evident that employee ownership in the US and UK and employee participation in Germany has offered significant efficiency gains as employees identify with their firms, offering internal flexibility and cooperation in return. However, on the downside, employee board representation in Germany, despite the presence of a greater culture of trust than in Russia, has also been associated with the blocking of redundancies, takeovers and even friendly mergers.

Faced with a system to date offering only weak governance over managers, and despite many contingent factors in favour of market-based governance, the authorities may opt in future for further support for stakeholder ownership and control. Such a preference may be appropriate for Russia at this stage of economic development, but governance systems are "package deals" and cannot offer "pick and mix" facilities for governments trying to get the best of both market-based and network-based worlds. The advocates of stakeholder governance must be prepared to accept its costs, too.

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	Contingencies Favouring:	
Level of Contingency	Governance by Stakeholders	Governance by Outside Shareholders
National	Culture of trust Institutions of law and tax favour stable holdings Baums, 1993, p154)	Culture of individual opportunism Institutions of law and tax favour share liquidity (Roe, 1997, p18)
Industrial	Industries with long production cycles needing long term investors (Baums, 1993, pp182)	Industries with short production cycles needing short term investors and low levels of investment (Franks & Meyer, 1997, p45)
Industrial	Industries that are technologically complex: operations opaque and costly to monitor for unrelated outside investors (Bolton & Von Thadden, 1998, p4)	Industries that are technologically routine, rendering operations transparent for unrelated outside investors (Noteboom, 1999, p858)
Enterprise	Process innovation, product improvement (Hitt, Ireland and Hoskisson, 1995, pp276-7)	Product innovation, incremental process improvement (Hitt, Ireland and Hoskisson, 1995, pp276-7)
Enterprise	Expansion phase: need for large new investments (Franks & Mayer, 1997, p45)	Contraction phase: need for corrective downsizing (Franks & Mayer, 1997, p44)

Figure 1 Shareholder, Stakeholders and Contingencies

Table 1: Equity Ownership by Stakeholders in Privatized Russian Firms, 1993-97: A Comparison (% of share of ownership)

Owners	Earle Et al. ¹ (%) (1994)	Buck Et al. (%) ² (1994)	Blasi et al ³ (%) (1996)	Jones ⁴ (%) (1996)	Wright, et al ⁵ (%) (1996)	Buck et al ⁶ (%) (1997)	Aukutsionek et al ⁷ (%) (1997)	Filatotchev et al ⁸ (%) (1999)	Dolgopyatova ⁹ (%) (1999)
Insiders	69	66	58	59	59	55	52	46	42
Managers	21	19	18	13	12	16	15	14	11
Employees	48	47	40	46	47	39	37	32	31
Outsiders	20	14	32	27	31	39	39	47	50
Large	-	11	26	15	23	26	25	28	30
Small	-	3	6	12	8	13	14	19	20
State	11	20	9	14	10	6	7	7	8
Sample (no. of Firms)	214	171	357	111	314	105	139	150	200

Notes: Years in brackets refer to date of survey, share ownership represented as percentage held by each group of shareholders.

Sources: 1. Earle *et al.*, (1996).

2. Buck et al. (1996). Includes enterprises privatized through State Privatization Program and lease buy-outs.

3. Blasi and Shleifer (1996) and Blasi *et al.*, (1997). Figures do not sum to 100 in original due to rounding errors and missing data. Includes enterprises privatized through State Privatization Program.

4. Jones (1998).

5. Wright, *et al.*, (1998). Includes enterprises privatized through State Privatization Program and lease buy-outs.

6. Buck, *et al.*, (1999).

7. Aukutsionek *et al.*, (1998).

8. Filatotchev et al. (2001).

9. Dolgopyatova (2000).

Table 2: Stakeholder Board Representation in Russia, 1995-97

(total number of companies reporting a particular shareholder on the board)

Stakeholder	Companies			Average No. of Seats		
	1995	1997	Change 1995-7	1995	1997	Change 1995-7
Banks	6	6	0	1.2	1.5	0.3
Investment Funds	10	13	3	1.9	2.5	0.6
External Private Individuals	24	35	11	1.8	2	0.2
Industrial Organizations	20	24	4	2.1	2.3	2.2
Foreign Companies	1	2	1	1.1	1	0
Managers	84	89	5	3.4	3.3	-0.1
Employees	57	56	-1	3.0	2.7	-0.3
The State	27	18	-9	1.4	1.3	-0.1

Note: total sample size = 105 surveyed in 1998.

Table 3: Employee Participation in Managerial Decisions in Russian Privatized Enterprises

	Year before privatisation (% of sample)	Year after privatisation (% of sample)
Active employee board Representation	30.5	25.7
Formal consultation with workers' assemblies on strategic issues	54.0	57.6
Formal consultation with workers' assemblies on operational issues	35.5	37.3
Informal consultation with workers' representatives on strategic & operational issues	44.8	48.5

Note: Based on survey of privatized Russian enterprises carried out in 1994; figures represent percentage of sample.

Table 4: Channels of Banks' Influence in Russian Enterprises

Channel of Influence	Mean Score (standard deviation)
Representation on supervisory board	1.6 (1.7)
Review of accounts on a regular basis	3.6 (2.6)
Regular visits to the company	2.3 (2.1)
Telephone contacts	4.4 (2.5)
Monitoring of debt covenants	3.0 (2.4)

Note: scores based on scale 1 through 7 where 1 = low importance to 7 = high importance. Responses based on 105 privatized enterprises surveyed in 1998.

Table 5: Monitoring Actions by Russian Banks When Repayments Not Met

Monitoring Actions	1998 (% of sample)	1997 (% of sample)
None, problem not arisen	24.5	19.0
Personal Discussion to Resolve the Issue	24.5	31.4
Decision by bank to keep situation under review	7.2	7.6
Rescheduling of loan repayments	19.4	21.0
Legal action	4.1	1.0
Refusal to give a new loan	21.5	16.2
None, the bank has ignored it	2.0	5.7

Note: Responses based on 105 privatized enterprises surveyed in 1998. Multiple responses possible, hence columns total to greater than 100.