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Corporate Governance Lessons from Russian Enterprise Fiascos

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CORPORATE GOVERNANCE LESSONS FROM RUSSIAN ENTERPRISE FIASCOES

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This Article draws on a rich array of deviant behavior in Russian enterprises to craft lessons for corporate governance theory. First, Professors Fox and Heller define corporate governance by looking to the economic functions of the firm. Based on this definition, they develop a typology that comprehensively shows all the channels through which bad corporate governance can inflict damage on a country's real economy. Second, they explain the causes of Russian enterprise fiascoes by looking to the particular initial conditions prevailing at privatization—untenable firm boundaries and insider allocation of firm shares—and the bargaining dynamics that have followed. This focus offers a new perspective for a comparative corporate governance literature derived from United States, Western European, and Japanese models. The analytic tools created in this Article can inform pressing debates across contemporary corporate law, ranging from the theory of the close corporation to the viability of "stakeholder" proposals.

INTRODUCTION

Russian industry has performed poorly since privatization. The voluminous literature on transition economies explains this poor performance primarily in terms of continued bureaucratic meddling, poor macroeconomic and tax policy, and low human capital; problems in corporate governance often are mentioned as well but little analyzed.[1]

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[1] See, e.g., Organisation for Econ. Cooperation & Dev. (OECD), OECD Economic Surveys 1997-1998: Russian Federation 129-35 (1997) (listing "[b]arriers to restructuring and investment: corporate governance, capital markets, the tax system, and regional protectionism"); Bernard Black et al., Russian Privatization and Corporate Governance: What Went Wrong? 52 Stan. L. Rev. 1731 (2000) (offering comprehensive and thoughtful account of Russian privatization failures); Anders Aslund, A Crisis of Confidence, Moscow Times, June 3, 1998, at 8, 1998 WL 11690335 (noting that "the fundamental issue is . . . not

The goal of this Article is to open the black box of "poor corporate governance" by detailing its consequences for the Russian economy and by tracing its causes to the initial structure of Russian privatization. Understanding what went wrong in Russia teaches lessons not only for transition policy in particular, but also for corporate governance theory in general.

After the fall of Russian Communism, state enterprises were privatized rapidly, stock markets created, and a corporate legal code adopted. However, even at its peak, before the 1998 collapse, the total stock market capitalization of Russia's 200 largest companies only reached about $130 billion[2]—less than that of Intel Corporation. In early 1999 the numbers were "phenomenally abysmal; if they could sink any further, shares would literally have a value of zero. As it is, the entire market is made up of penny stocks."[3] These numbers represent a trivial fraction of the apparent value of the underlying corporate assets controlled by Russian corporations.[4] The low prices reflect severe corporate governance problems, including the high probability that the firms' underlying assets will be mismanaged grossly and that whatever cash flow is produced will be diverted to benefit insiders or reinvested in unproductive projects.[5] In this Article, we extract lessons for corporate governance theory by focusing on

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primarily macroeconomic. All along, Russia has suffered from serious problems in corporate governance.").

[2] See Gary Peach, 1997 an Outstanding Year Despite Market Narrowness, Moscow Times, Jan. 13, 1998, Lexis, World Library, Mostms file. This peak represented an elevenfold improvement over 1994, when total stock market capitalization, based on voucher auctions prices, was under $12 billion. See Maxim Boycko et al., Privatizing Russia 117 (1995). By the summer of 1998, "the Moscow Times index of 50 leading shares hit an all-time bottom, lower than its starting level four years ago." Katy Daigle, Bill Improves Shareholder Rights in Russia, Moscow Times, July 14, 1998, Lexis, World Library, Mostms file; see also, e.g., Patricia Kranz, Fall of an Oligarch, Bus. Wk., Mar. 1, 1999, at 44, 44 ("From its peak in October, 1997, the market capitalization of [these] three big industrial holdings—Sidanko Oil, Svyazinvest Telecommunications, and Norilsk Nickel—has dropped from about $31 billion to $3.8 billion.").

[3] Gary Peach, Poor Management Destroys Sberbank, Tatneft, MGTS, Moscow Times, Dec. 15, 1998, at 14, 1998 WL 11691867.

[4] Put another way, as measured by stock prices, a barrel of proven oil reserves owned by a Russian oil company was worth about one-twentieth of a similar barrel owned by a Western oil company. See Boycko et al., supra note 2, at 120; Das Kapital Revisited, Economist, Apr. 8, 1995, Survey, at 15, 16 ("[A] barrel of oil in the ground owned by a Russian company is worth 10 cents. A barrel owned by a western company is worth $5.50."). This disparity is striking because oil is a quintessential export product with a uniform and well-recognized global value. Of course, poor corporate governance is just one important factor in the low stock price equation; other factors include political instability and expropriation risk.

[5] See Floyd Norris, The Russian Way of Corporate Governance, N.Y. Times, Apr. 5, 1999, at A20 (noting that Russia's second largest oil company stock value declined 98% due in part to poor corporate governance).

two questions: What are the consequences of these corporate governance problems for the real economy in Russia? Why have these problems become so widespread and persistent?

To answer the first question, we define corporate governance in a way that looks to the economic functions of the firm rather than to any particular set of national corporate laws. Firms exhibit good corporate governance when they both maximize the firm's residuals[6]—the wealth generated by real operations of the firm—and, in the case of investor-owned firms, distribute the wealth so generated to shareholders in a pro rata fashion. Bad corporate governance is just the failure of a firm to meet one or both of these conditions. Whether managers operate their firms in ways that meet these conditions depends on the structure of constraints and incentives in which they operate, a structure that depends in part, but only in part, on the prevailing legal system. In this Article, we give more precision to the idea of "bad" corporate governance by developing a novel typology of the kinds of damage to the real economy that loosely constrained and poorly incentivized managers can inflict. By canvassing a rich array of deviant behavior, we identify why this damage has been particularly severe in Russia.

As for the second question, we go beyond standard causal explanations of poor corporate governance, such as the low level of corporate transparency, the lack of effective adjudication of corporate law violations, the weak enforcement of judgments, and the absence of a network of trust among Russian businesses, factors that are common to all post-socialist corporate economies. We expand this inquiry by introducing the role of initial conditions—specifically, the initial boundaries of privatized firms and the initial allocation of firm shares to insiders—and the bargaining dynamics that have followed from these conditions. Our new perspective identifies previously overlooked factors that help explain why Russian corporate performance remains so much worse than that of other transition countries.

Our analysis is not confined to the Russian experience alone; rather, it provokes rethinking of corporate governance theory more generally. Though our typology emerges from studying Russian corporate fiascoes, it has global applicability; for the first time and in a comprehensive way, we link poor corporate governance to real economy effects. We create an analytic tool that identifies the complete set of vulnerabilities to corporate governance problems that may arise

[6] A firm's residuals are defined as the difference between what a firm pays at contractually pre-determined prices for its inputs and what it receives for its outputs. See infra Part I.A for a more precise statement of this definition.

in any economy and that helps to generate more tailored policy responses than previously possible. Our work on initial conditions also has more general applicability. The existing scholarly literature on comparative corporate governance reflects the range of firm boundaries and dominant share ownership patterns in the United States, Western Europe, and Japan. The Russian experience falls, at least initially, outside this range and teaches provocative new lessons about the roles that firm boundaries and ownership structure may play in corporate governance theory, lessons that may benefit Russia, other countries in transition, and even the United States.

Part I defines bad corporate governance and, using Russian examples, develops a typology of its consequences for the real economy. Part II describes the initial conditions of Russian privatization and shows how they continue to cause corporate governance failures. The Article concludes by suggesting how the analytic tools we create here may inform pressing debates in contemporary corporate law.

I
A TYPOLOGY OF CORPORATE GOVERNANCE FAILURES

A. A Simple Definition

Commentators on transition economies invariably discuss the consequences of "poor corporate governance" but without specifying what that means. What little commentary does exist tends to focus on some idealized set of corporate law rules.[7] In contrast, we measure the quality of corporate governance in terms of the social welfare impact of firm decisionmaking. We make no prejudgments about which institutional arrangements work best in any particular country. Under our definition, good corporate governance requires two things: (1) Managers must maximize their firm's residuals, and (2) firms, at least investor-owned firms, must distribute those residuals on a pro rata basis to shareholders. Let us consider each element in turn.

The first key feature of a well-governed firm is that its managers make decisions that seek to maximize the residuals that the firm generates over time, discounted to present value. Residuals are defined as the difference between what a firm pays at contractually predetermined prices to obtain its inputs and what it receives for its output.[8]

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[7] See, e.g., OECD, OECD Principles of Corporate Governance (1999) (outlining principles of corporate governance recommended for OECD countries).

[8] Note that cost of inputs includes expenditures for real investment. Thus, in any given period, a firm's cash flow from operations—its cost of inputs other than real investment minus its revenues from sale of output—either can be distributed to the firm's residual claimants during that period, in which case they become residuals in that period, or can be expended to purchase real investment assets. The rationale for such reinvestment is to

We define this criterion in terms of *residual* maximization rather than *share value* maximization to avoid foreclosing the possibility that labor- or consumer-owned firms may be optimal in certain situations.[9] In an ordinary investor-owned corporation, however, the residuals go to shareholders who provide the firm's equity-based capital, which is the only input not obtained at contractually predetermined prices. Thus, for such a firm, *maximizing share value is equivalent to maximizing residuals*.[10]

The conclusion that it is socially desirable for a firm to maximize its residuals flows from two assumptions, both of which are standard in simple models of the corporation: (1) that the firm purchases its inputs and sells its outputs in competitive markets, and (2) that there are no important externalities or subsidies. Thus, the contractually predetermined prices the firm pays for its inputs (other than its equity-based capital) are equal to the value of what the firm takes from society; similarly, the firm's selling prices for its output equals the value of what it gives to society. Maximizing the difference in value between inputs and outputs maximizes the firm's contribution to society and hence constitutes efficient behavior.[11]

In the case of an ordinary investor-owned firm, the second feature of good governance is that the *residuals are distributed to shareholders and in a pro rata fashion*.[12] Meeting this second condition is not strictly necessary for one-period, static efficiency. For a single period, all that is necessary is that the residuals be maximized, regardless

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create a larger firm cash flow in some subsequent period that then would be available for distribution as residuals to residual claimants.

9 See generally Henry Hansmann, The Ownership of Enterprise (1996) (discussing circumstances in which labor-owned, customer-owned, and other types of firms may succeed).

10 See Oliver Williamson, Corporate Governance, 93 Yale L.J. 1197, 1198-1200 (1984) (discussing problems created by multiple classes of corporate constituencies).

11 We make the standard assumptions that the firm purchases its inputs and sells its outputs in competitive markets and that there are no important externalities or subsidies, but not because we believe they are consistently true in Russia or any other country—clearly they are not. Instead, we make these assumptions because they allow us to focus on the social welfare effects of activities that take place within the firm in reaction to the constraints imposed directly by the legal system and by the firm's markets for inputs, outputs, and capital. Such a focus allows us to separate out more precisely the different problems in the Russian economy. Thus, these assumptions allow for more precise policy analysis. Their standard nature also makes it easier to draw larger corporate governance lessons from the Russian experience because most analyses of corporate governance problems in other countries make the same assumptions.

12 See Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 5, 63 (6th ed. 2000). Fast-growing firms, such as Microsoft, frequently reinvest all operational cash flow rather than pay dividends. Nevertheless, the only reason to hold shares in such a company is the prospect that, at some point, it will make pro rata dividends or other distributions to its shareholders. See supra note 8 (discussing reinvestment of cash flows from operations).

of who receives them. The pro rata distribution condition is helpful, however, in achieving the efficient allocation of resources over time because pro rata distribution greatly increases the ability of firms to raise capital by issuing new equity.

For a firm to raise capital by selling equity at a price worthwhile to its owners, a firm needs credibly to promise to abide by both principles of good corporate governance—striving to maximize its future residuals and guaranteeing shareholders some determinable proportion of these residuals as dividends or other distributions. The expectation of eventually receiving such distributions is what makes holding a share worthwhile as a financial instrument and what induces outsiders to provide cash in return for shares. A firm gains credibility in several ways: by developing a record of abiding by its promises, by being subject to a binding legal system, and by structuring incentives so that managers gain if they fulfill their promises and suffer if they do not. If a firm acts contrary to its promises, it undermines its own record and becomes less able to acquire new equity financing.[13] Note, also, that when a legal system fails to punish such a firm, an individual firm's decision to break its promises imposes externalities: Investors become generally less willing to buy equity of other firms governed by the same legal system. In other words, weak corporate governance in existing firms poisons the well for new firms that hope to use equity markets.[14]

Defective corporate governance means that a firm does not meet one or both elements of our definition. Most attention in reports on transition economies has focused on problems relating to non pro rata distributions: for example, when insiders dilute shares of outsiders, loot companies, fail to pay dividends, or engage in other tactics that deprive outside shareholders of their pro rata share of the wealth generated by the firm.[15] Non pro rata distributions indeed do help explain low stock prices and the poor performance of the corporate sector. But failure to maximize residuals has the same effect, indeed even more directly. The vast transition economy literature never makes clear which failure dominates in any particular enterprise fiasco. Instead, bad corporate governance becomes a catch-all explana-

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[13] See Bernard S. Black, The Legal and Institutional Preconditions for Strong Securities Markets, 48 UCLA L. Rev. (forthcoming 2000).

[14] See id.; see also Andrew Jack, Pouring Oil on Troubled Waters, Fin. Times (London), Jan. 19, 2000, at 21 (noting that, because of poor corporate governance, "[f]oreigners were also far less keen on the Russian stock market last year. . . . [T]here was a net outflow of $400 m[illion] in portfolio investment during the first nine months of 1999, compared with an inflow of $8 b[illio]n for all of 1998.").

[15] See, e.g., Black et al., supra note 1, at 1765 (focusing on self-dealing explanations for poor Russian corporate performance).

tion for problems that should be understood as being quite distinct.[16] Pinning down and separating out these distinctions should prove helpful when it comes time to prescribe policy cures.

A cautionary methodological note is in order at the outset, however. The study of corporate governance in Russia is hampered by two problems. First, serious firm-level econometric study of corporate governance changes in Russia is difficult, if not impossible, because meaningful hard data on enterprise behavior are hard to come by. Firms do not publish credible accounts of their own performance because managers hide their ongoing thefts of firm assets from outside shareholders and from others who would likewise seek to steal those assets themselves, including labor and the mafia.[17] Back tax debts, which pervade the corporate sector, mean that any reported income may be seized, making the effective tax rate one hundred percent.[18] Thus, most income statements and balance sheets are fictional. Second, econometric work testing propositions about corporate governance based on country-level comparisons of economic performance is similarly difficult. Good corporate governance is neither a necessary nor a sufficient condition for achieving a developed capitalist economy—it simply helps. Italy, for example, has a vibrant economy even though the governance of its corporations generally would fall far short of the standards set out here.[19] Russia, in contrast, likely would continue to languish economically absent a solution for some of its other pressing problems even if its firms all fully met these standards. The sample size of countries is small relative to all the other factors that affect national economic performance.

These two problems mean that we are left with anecdotal accounts and surveys as our main sources of empirical information.

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16 The mixed corporate governance problems may be difficult to tease apart. For example, one commentator notes that "problems range from murder to bad market trends, but all boil down to basic corporate governance: Directors and their cohorts appear to have milked or outright plundered the companies to the detriment of any outside shareholders, real or potential." Mark Whitehouse, The Other Side of the Boom, Moscow Times, Sept. 16, 1997, Lexis, World Library, Mostms file. When insiders gut a firm, they could be failing to maximize residuals according to several of the pathologies we identify as well as making non pro rata distributions.

17 See World Bank, World Development Report 1996: From Plan to Market 55 (1996); Dmitru Vasilyev, Remarks at the Luncheon of the American Chamber of Commerce in Russia (Dec. 4, 1998), in Lexis, News Library, Sovnws file (stating that "[a]t present . . . the board of directors and the excessive power of the director make theft of company assets possible").

18 See Anna Meyendorff, Barter in Russia 17 (Dec. 1998) (unpublished manuscript, on file with the *New York University Law Review*).

19 See Luigi Zingales, The Value of a Voting Right: A Study of the Milan Stock Exchange Experience, 7 Rev. Fin. Stud. 125, 146 (1994) (suggesting that huge control premium for shares of Italian firms shows poor corporate governance regime).

These sources involve their own biases; nevertheless, they present a reasonably coherent picture of the landscape of corporate governance failures. Imposing a theoretical framework on this picture yields a plausible and informative account of the relationship between corporate governance and national economic performance.

B. The Failure to Maximize Residuals

In this Section, we identify five distinct pathologies that loosely constrained and poorly incentivized managers may inflict on firms and that may result in the firms' failure to maximize residuals.[20] We focus first on this prong of bad corporate governance because it is crucial to explaining why insiders sometimes do not operate their firm even to maximize their own joint benefit, a puzzle we take up in Part II.B. As we shall see, the initial structure of ownership makes Russian firms particularly vulnerable to these five corporate governance pathologies. When the initial ownership structures intersect with untenable firm boundaries, the pathologies we identify here become self-reinforcing and even more intractable.

1. Pathology 1: Continued Operation of Value-Destroying Firms

Any economy has some unreformable value-destroying firms that should be shut down immediately.[21] Continued operation of these firms, even if undertaken as efficiently as possible, represents a negative net present value decision from a social point of view: The cost of operation in the current period results in a social loss too great to be offset by social gains, if any, from continued operation in subsequent periods.[22] Despite the social harm, institutional arrangements in an economy nevertheless may permit such a firm to continue operating.

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[20] Note that we continue to assume that the firm purchases its inputs and sells its outputs in competitive markets and that there are no important externalities or subsidies. Therefore, the firm's input costs should reflect the social opportunity costs of continued operation and its output prices should reflect the social benefits of production.

[21] For some American examples, see James Surowiecki, Why Won't Anyone Pull the Plug on UPN?, New Yorker, Apr. 3, 2000, at 32, 32 (puzzling over question why "companies and divisions are kept afloat long after they've stopped creating value and started destroying it. Plenty of businesses exist only—well, because they exist.").

[22] More precisely, for a firm to fall into this category, two requirements must be met. First, the social benefit from the firm's output in the current period must be less than the social cost of its inputs. Second, after comparing the social benefits and costs for each subsequent period, and discounting the difference to present value, the aggregate of these discounted differences must be either negative or, if positive, less than the deficit in the current period. In terms of current operations, this assumes that the firm operates at lowest possible cost for the level of output chosen and that it chooses the level of output that will maximize its cash flow from operations. In terms of decisions made in the current period that affect future periods, this assumes that the firm follows an optimal investment policy, which commonly would mean undertaking no investment at all.

For example, in Russia the Tutayev Engine Factory continues to operate despite the plant manager's estimate that "it costs the plant about 1.33 rubles to produce about 1 ruble in output."[23] In the case of many unreformable value-destroying firms, poor corporate governance is the main cause of their continued operation, and hence the reason for identifying this problem as the first type of potential corporate governance pathology. Firm managers wish to continue operations in order to hold onto their jobs and the associated perquisites.[24] Because they are not constrained by effective corporate governance mechanisms, the managers get their way. In other cases, however, good corporate governance is not necessary to shut down a firm that in fact should be closed. And in yet other cases, good corporate governance is a necessary but not a sufficient condition to close the firm. Making these distinctions is important for identifying effective policy responses.

a. When Is Corporate Governance Relevant? Retain the assumption for a moment that an unreformable value-destroying firm purchases inputs and sells outputs in competitive markets, that there are no important externalities, and that credit and other finance is extended to firms only on a reasonably informed, rational basis. Even with no new investment, such a firm's ordinary operations result in a negative cash flow in the current period (one that is sufficiently negative that expected future cash flow, discounted to present value, would, even if positive, be unable to offset it). The firm thus would lack enough current cash flow to purchase the inputs it needs to continue production and would lack cash flows in the future to use as a basis to obtain credit or other finance sufficient to cover this deficit.

The importance of corporate governance here depends entirely on whether the firm has any cash reserves or assets with significant salvage value. Without reserves or salvageable assets, the firm would

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[23] Maura Reynolds, A Russian Company Town's Miracle, L.A. Times, Mar. 5, 1999, at A1.

[24] See European Bank for Reconstruction & Dev., Transition Report 1998, at 32 (1998) (noting lack of effective checks on insider managers in transition economies); id. at 142 (describing conflict of interest between "private objectives of managers" and investors in bank privatizations); Roman Frydman et al., Investing in Insider-Dominated Firms: A Study of Russian Voucher Privatization Funds, in 1 Corporate Governance in Central Europe and Russia 187, 219-20 (Roman Frydman et al. eds., 1996); Cheryl W. Gray & Kathryn Hendley, Developing Commercial Law in Transitional Economies: Examples from Hungary and Russia, in The Rule of Law and Economic Reform in Russia 139, 154 (Jeffrey D. Sachs & Katharina Pistor eds., 1997); Meyendorff, supra note 18, at 15. For an analysis of the same phenomenon in the American context, see Surowiecki, supra note 21, at 32 (noting that "[t]he value that the [firm] is destroying can seem distant; the rewards it brings to those on [the] payroll are immediate").

be forced to close immediately, regardless of how much its managers wanted to continue operations, and regardless of how ineffective existing corporate governance mechanisms were in restraining them. Russia's generally outmoded factories suggest that many firms lack assets with any significant salvage value.[25] There is also a general cash shortage.[26] Thus, absent subsidies and problems in the way credit is extended, many firms whose continued operation is value destroying would shut down promptly even though the corporate governance regime is highly ineffective. Neither improved corporate governance nor an effective bankruptcy regime is necessary to eliminate such firms.[27]

On the other hand, for firms with reserves or salvageable assets, effective corporate governance is necessary to shut down the firm immediately. Otherwise, managers can indulge their desires to continue operation. Where cash reserves are available, the cash can be used directly to buy the needed inputs. Where the firm has salvageable assets, cash can be raised by selling the assets or using them as a basis for gaining credit. Many value-destroying Russian firms do have assets with significant salvage value.[28] Manufacturing businesses, for example, often are located inside large cities on real estate with far more value in other uses. If the firm has a negative cash flow, its managers nevertheless may be able to keep operating by cashing out the salvage value of these assets to acquire needed inputs. Even with a positive cash flow, closing the firm may be socially desirable once the rental value of the land is counted properly as an opportunity cost.[29]

b. The Role of Subsidies and Inappropriate Credit and Finance. Now, drop the assumptions made above concerning subsidies, credit, and finance. Where there is a subsidy, or credit or finance is extended on other than a reasonably informed and rational basis, a firm can have a positive cash flow even though the social benefit from the firm's output might be less than the social cost of its inputs. Under

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[25] See Maura Reynolds, Yeltsin Legacy Impressive but Clouded, L.A. Times, Jan. 1, 2000, at A1 (stating that "shareholders have no guarantee that their stock certificates have real value").

[26] See Meyendorff, supra note 18, at 16.

[27] See World Bank, supra note 17, at 45 (noting that government policies such as macroeconomic stabilization and credible commitment to reform play largest role in whether enterprises in transition economies actually adjust).

[28] See European Bank for Reconstruction & Dev., supra note 24, at 33 (describing how loss-making Russian firms use various devices to solve cash flow problems); World Bank, supra note 17, at 55 (describing how Russian corporate insiders divert assets to other firms they also control).

[29] See Brealey & Myers, supra note 12, at 123 (describing alternate use of land as opportunity cost).

such circumstances, the firm's continued operation, even though involving a social loss, can be perfectly consistent with maximizing residuals. Corporate governance mechanisms that push a firm's managers to maximize residuals will not lead by themselves to the socially desirable result of closing down these firms. Indeed, for firms without reserves or salvageable assets, the quality of corporate governance is not even relevant. Such firms will be shut down, regardless of the quality of corporate governance, only if the subsidies or inappropriate credit provision is ended.[30]

Russia continues to provide many subsidies, particularly in the energy area.[31] The system by which input suppliers are paid, often involving barter, is highly chaotic, implying that credit is not extended in a rational, well-informed fashion.[32] Workers often become involuntary creditors when firms do not pay them.[33] All this suggests that, while many Russian firms that are continuing to operate should be shut down immediately, improved corporate governance will not, or will not by itself, solve the problem. Instead, elimination of subsidies and improvement of the credit process are necessary reforms.

In sum, Russian firms that should be shut down immediately fall into three groups. The first consists of firms with no cash reserves or assets with significant salvage value that do not benefit from subsidies or unsuitable credit extensions. These firms are presumably closing on their own, no matter how bad their corporate governance mecha-

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30 See European Bank for Reconstruction & Dev., supra note 24, at 33 (showing how subsidies and credit extension support failing Russian firms); World Bank, supra note 17, at 45.

31 See World Bank, supra note 17, at 45 (noting drop in direct subsidies but significant increase in tax arrears and ad hoc tax exemptions); IEA Urges the Elimination of Subsidies in Developing Nations, Petroleum Economist, Dec. 1999, at 59, 59 (noting that sizable subsidies remain in Russia's energy sector); Coal Sector to Develop Without State Subsidies, BBC Summary of World Broadcasts, Feb. 11, 2000, Lexis, News Library, Non-US file (relaying ITAR-TASS report of February 1, 2000, that Ministry of Fuel and Energy set goal of subsidy-free energy industry for 2000).

32 See Clifford Gaddy & Barry W. Ickes, To Restructure or Not to Restructure: Informal Activities and Enterprise Behavior in Transition 6-7 (William Davidson Inst. Working Paper No. 134, 1998), available at <http://eres.bus.umich.edu/docs/workpap-dav/wp134.pdf> (discussing causes of pervasive barter in Russian economy); Meyendorff, supra note 18, at 3 (indicating that Russian firms increasingly are using barter trade, which is inefficient means of transacting business).

33 For purposes of this analysis, workers can be considered involuntary creditors, but only for the wage arrears that have accumulated during the period before sporadic wage payment became their firm's ordinary and usual behavior. Once the pattern of sporadic payment becomes expected and there is no reasonable prospect that the arrears are going to be paid, the practice is more appropriately viewed as a de facto wage reduction. At that point, the decision of workers to stay in the firm's employment suggests that the alternatives available to them were no more desirable. Thus, the de facto lower level of wages is presumably a reasonable measure of the social opportunity cost of their labor.

nisms. In the second group are firms with no cash reserves or assets with significant salvage value but that do benefit from subsidies or unsuitable credit extensions. Given the pervasiveness of these problems in the economy, particularly the provision of energy at below world market prices, this second group may well be much larger than the first.[34] Effectively addressing the subsidy and credit problems will cause these firms to close, but they will not close otherwise. Improvements in corporate governance will have no effect on this second group. The third group, which is also large, includes firms with cash reserves or assets with significant salvage value that also benefit from subsidies or unsuitable credit extensions. These firms will not close until there is both an improvement in corporate governance and an end to the subsidies and unsuitable credit extensions.

c. The ZiL Example. Moscow's ailing ZiL truck company is a useful example of a firm in the third group. The company is a "dinosaur"[35] that continues to produce many of the same poor quality trucks as it did under the Soviet regime, despite the trucks' terrible reputation and scant market.[36] As two reporters note:

> The total amount of [post-privatization] state assistance to ZiL through various channels is estimated at approximately $100 million. . . .
> . . . "[T]he plant never regarded the money it received as credits that had to be paid back." . . .
> While receiving money for the production of trucks that customers were unwilling to pay for, ZiL continued to ship them out. . . .
> . . . [F]rom force of old Soviet habit, it kept pushing to fulfill a plan that was long gone, at a time when it should have been cutting production and thinking about structural reorganization.[37]

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[34] The Soviet Union built its whole manufacturing sector on a base of deep energy resource subsidization. These subsidies continue to a considerable extent even today through provision of these resources at prices below the world level, a problem that is somewhat disguised by the prevalence of barter transactions. Most of the firms that resulted from the privatization of this sector would be unprofitable in an open economy. See Gaddy & Ickes, supra note 32, at 7-8.

[35] Peter Galuszka & Patricia Kranz, Look Who's Making a Revolution: Shareholders, Bus. Wk., Feb. 20, 1995, at 60, 60 (noting that ZiL has been "turning out the same basic truck for 30 years").

[36] See Michail Berger & Dmitry Dokuchayev, Divided Authority at ZiL: The Giant Can No Longer Live in the Old Way but Doesn't Yet Want to Live in the New Way, Current Dig. Post-Soviet Press, May 15, 1996, at 10, 10-11 (quoting Aleksandr Yefanov, head of Mikrodin Company).

[37] Id. (quoting Aleksandr Yefanov); see also James Rupert, Post-Poll Jitters for Russian Industry, Int'l Herald Trib., July 6-7, 1996, at 9 ("If Mr. Yeltsin now gets serious about ending state support for dying industries, Zi[L] faces desperate times. Despite having been privatized, the plant seems to be having trouble weaning itself from Soviet-style subsidies . . . .").

As the company continued to fall apart, Moscow Mayor Yuri Luzhkov acquired for the city a controlling stake in the firm but kept incumbent management in place.[38] Rather than closing the firm and liquidating its main assets, the Mayor reportedly began ordering city services to buy ZiL vehicles only.[39] He also secured a large new line of credit on the basis of the firm's main asset, "tens of hectares of prime land in south Moscow with a potential market value of hundreds of millions of dollars."[40] The Mayor's plans were to relocate the firm's production facilities, raise about $35 million by selling forty-nine-year leases to some of the land, and then transfer the new funds to the company rather than to shareholders or to more viable firms.[41] But, as one commentator suggests, "it is not clear that even Luzhkov can create a market for Zi[L] trucks."[42]

Shutting down the firm at the outset likely would have been the residual-maximizing decision. The government could have targeted its limited subsidies to providing a social safety net for workers,[43] and the land could have been sold to its highest value users at a price that

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[38] Moscow increased its stake to 60% by buying the 30% stake previously owned by Mikrodin, the main outside shareholders, who had, for a short period, brought in new management before the city government, labor, and the old managers intervened. See Sergey Lukianov, Mayor Pulls Out Stops to Rescue ZiL, Moscow Times, Sept. 27, 1996, at 12 ("Luzhkov blamed Mikrodin for failing to boost production. He said lack of proper management was the main reason . . . ."); Elizabeth Sullivan, Reforms Sour for Disenfranchised, Plain Dealer (Cleveland), June 9, 1996, at 1-A (outside managers were "forcibly escorted off the premises by the security forces of the old" managers).

[39] See Lukianov, supra note 38, at 12; ZiL Takes Alternative Road to Capitalism, Russia Express Briefing, Jan. 13, 1997, 1997 WL 9450577.

[40] Poul Funder Larsen, Buying Land Is Next Hurdle for Private Firms, Moscow Times, Nov. 26, 1996, at III (stating that:

> Most of Russia's 120,000 privatized firms do not own the land they stand on. They do not even have a clear lease agreement. Instead, they occupy the land under a Soviet-era concept of temporary management which gives city officials a big say in how the land is used and gives companies few rights to sublet, sell or redevelop.);

see also Lukianov, supra note 38, at 12 (noting that rescue plan includes local and federal tax breaks, direct subsidies, guaranteed purchases of ZiL output by city, and auctioning some ZiL real estate, "with 70 percent of the proceeds going to the company and 30 percent to the city government").

[41] See Larsen, supra note 40, at III.

[42] David Hoffman, The Man Who Rebuilt Moscow: Capitalist Style Could Propel Mayor to National Power, Wash. Post, Feb. 24, 1997, at A1.

[43] See Moscow Truck Maker Mulls Upgrade Plans, BBC Summary of World Broadcasts, Jan. 22, 1999, Lexis, News Library, Non-US file. As it was, "the plant stopped housing construction long ago, and the plant workers, dissatisfied that they have not received the apartments once promised to them, intend to petition the International Court of Justice in the Hague." Id.

would have substantially benefited shareholders.[44] As it was, outside shareowners "realized that, despite the municipal and federal authorities' special treatment of this flagship of the automotive industry, the enterprise was a hopeless failure, and [when] they tried to exert some direct influence on the situation . . . [it] proved to be not such an easy thing to do."[45]

2. *Pathology 2: Failure to Use Existing Capacity Efficiently*

The second type of pathology arises when continued operation, if undertaken as efficiently as possible and without new investment, would be a positive net present value decision, but operation is not done as efficiently as possible. Costs are not minimized, the best price is not obtained for a given level of output, or a non profit-maximizing output level is chosen—again, all common problems in Russia.[46] Thus, residuals are not maximized. Such firms should not shut down, but they should deploy existing facilities more efficiently.[47] Their residuals shortfall represents a social welfare diminishing corporate governance failure.

Consider, for example, the Baltic Shipping Company (BSC), "Russia's oldest and best known shipping enterprise."[48] Under the Soviets, the firm already had wide experience working on world markets, but they relied on inexpensive Russian fuel to cover for management deficiencies, and these deficiencies, unlike the low fuel prices, have persisted into the post-privatization period:

> [N]early everyone admits that the management at BSC has simply not been up to the challenges of a new economy. . . .
>
> . . . .

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[44] Cf. Michael A. Heller, The Tragedy of the Anticommons: Property in the Transition from Marx to Markets, 111 Harv. L. Rev. 621, 639 (1998) (suggesting difficulties in selling land because of fragmented ownership in Russian enterprise assets).

[45] Berger & Dokuchayev, supra note 36, at 10-11.

[46] As one account notes:

> Eyeing [outside investors] warily are entrenched company directors, many of whom enjoy virtually unchecked command of the production lines they've presided over for decades. Outside investors allege these "Red Directors" are used to running enterprises according to Soviet tenets: overpricing supplies, underpricing output and pocketing the rest.

Natasha Mileusnic, The Great Boardroom Revolution, Moscow Times, July 16, 1996, at I.

[47] One investment banker looking over the Volga Paper Company "noticed huge, dust-covered crates packed away in the corner of the factory. They contained $100 million worth of brand-new Austrian-made equipment. The Russians hadn't bothered unpacking the stuff." Paul Klebnikov & Caroline Waxler, The Wild East, Forbes, Dec. 16, 1996, at 348, 349.

[48] Rachel Katz, The Strange Case of the Disappearing Ships, Moscow Times, May 14, 1996, at VII.

> In his parting words, former president Filimonov, who retains a place on the board, pretty much admitted the management could not adapt. "Those titles we've become accustomed to hearing, such as deputy chief of finances, are simply not those functions that these people have become used to fulfilling."[49]

Though the firm could be profitable today, Baltic Shipping faces a "spiral of decline" that could "lead to the company's fleet disappearing completely."[50] According to one official, "'It's difficult to say how many ships we have in operation, because at any moment, we could get another call saying another ship has been seized [by creditors].'"[51]

The widespread existence of Pathology 2 may mask the potential extent of Pathology 1. If firms generally are not using their inputs efficiently, the marginal products of these inputs are likely to be lower, and thus, in a competitive economy, the price that needs to be paid for them and the opportunity cost of their use will be lower as well. A wholesale reduction in Pathology 2 will increase the price and social opportunity cost of at least some, and quite possibly all, major classes of inputs.[52] Input price adjustments may increase sharply the number of firms displaying Pathology 1 as the increased opportunity cost of their inputs makes their continued operation socially undesirable.

3. *Pathology 3: Misinvestment of Internally Generated Cash Flow*

The third type of pathology arises when a firm uses its internally generated cash flow to invest in new negative net present value projects. Instead of making bad investments, such a firm should pay out this cash flow to shareholders. Shareholders could invest these

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[49] Id.

[50] Id.

[51] Id. (quoting Yury Sukhorukov, foreign affairs chief, Baltic Regional Organization of the Seafarers Union of Russia).

[52] If the efficiency gains are spread evenly around all classes of inputs, the effect on the marginal product of each would be positive. If the gains were concentrated primarily with respect to one class of inputs, for example labor, the effect on marginal productivity is, as a theoretical matter, ambiguous. On the one hand, the gains increase the number of effective units of labor represented by each actual unit. On the other hand, the increase in effective units of labor relative to other inputs decreases the marginal product of each effective unit of labor. If the first effect outweighs the second, then the marginal product of labor will increase even if the more effective use of labor is the primary efficiency gain from restructuring. Whether this is the case depends on the elasticity of substitution of labor for other inputs. Empirical studies of the United States and other developed economies suggest that the elasticity is large enough that the marginal product of labor would increase even under these circumstances. For a more detailed discussion of these points, see Merritt B. Fox, Securities Disclosure in a Globalizing Market: Who Should Regulate Whom, 95 Mich. L. Rev. 2498, 2562-69, 2630-31 (1997).

funds better elsewhere in the economy.[53] An example of Pathology 3 includes the seemingly responsible act of using funds labeled by accountants as depreciation to replace worn out plant and equipment, if doing so is a negative net present value project. Pathology 3 can arise in conjunction with, or independently of, Pathology 2. Significant indirect evidence from two sources suggests that Pathology 3 is widespread in Russia.

First, consider the paucity of interfirm cash flows in Russia. In any economy, good investment opportunities are unlikely to be spread so evenly among existing enterprises that interfirm transfers of cash flows through capital markets are not called for. Nor is the quality of existing firms' opportunities likely to be consistently superior to the opportunities that could be found by new firms. Thus, some existing firms (capital surplus firms) will have cash flows greater than what is needed to fund all their positive net present value projects; other existing firms (capital deficit firms) will have insufficient cash flows to fund all such projects. In addition, there will exist new firms with positive net present value projects but that, by definition, have no cash flows at all. Thus, interfirm cash flow transfers are called for from surplus firms to deficit firms and new firms. In a market economy with clearly distinct firms, these transfers are accomplished when surplus firms pay dividends and deficit firms and new firms enter the capital markets, for example through the offering of new equity. In Russia, firms pay little or nothing in the way of dividends[54] and equity finance is negligible.[55] The lack of interfirm transfers strongly suggests that the surplus firms are instead displaying Pathology 3 and likely investing in negative net present value projects.[56]

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53 See Brealey & Myers, supra note 12, at 178.

54 See Merton J. Peck, Russian Privatization: What Basis Does It Provide for a Market Economy?, 5 Transnat'l L. & Contemp. Problems 21, 32 (1995); John Thornhill, "World's Last Greatest Emerging Market" Back in Favor, Fin. Post (Toronto), July 18, 1997, at 49, 1997 WL 4100028.

55 See Vladimir Popov, The Financial System in Russia Compared to Other Transition Economies: The Anglo-American Versus the German-Japanese Model, 49 Comp. Econ. Stud. 1, 26 (1999) (finding that equity financing accounts for less than one percent of capital investment in Russia).

56 The lack of interfirm transfers undoubtedly is also in part due to various techniques that managers use to make non pro rata distributions that result in cash flow diversions to accounts that they control overseas. Because of these diversions, the firms involved have less cash, if any, available to pay dividends. To the extent that a foreign destination was chosen for these diversions because of a desire to protect what at home would have been considered stolen money or because it assists an attempt at tax evasion, the expected returns of the foreign investment funds by these diversions are likely to be lower than those of some of the unfunded projects of Russian firms. The idea here is that absent any distortions on transnational capital flows, the risk-adjusted expected return on investment opportunities in Russia should equal those abroad even if there are fewer good investment

The second source of indirect evidence for Pathology 3 relates to firms' failure to make pro rata distributions of residuals. One way that controlling shareholders can divert a disproportionate share of residuals to themselves is to have the firm invest in projects personally benefiting these shareholders. On balance, controlling shareholders may prefer to fund such projects, even if they have a negative net present value—their personal benefits more than outweigh the reduction in share value from implementing the project. Controlling shareholders will be able to indulge these preferences if the mechanisms to constrain non pro rata distribution of dividends are weak. The abundant evidence of non pro rata distributions in Russia also strongly suggests that Pathology 3 is likely to be prevalent.

4. *Pathology 4: Failure to Implement Positive Net Present Value Projects*

The fourth pathology of residual nonmaximization arises directly or indirectly when a firm identifies, but then fails to act on, positive net present value projects. If others do not pick up the opportunity, the firm's failure reduces social welfare because of the forgone chance to deploy funds to produce a return greater than the cost.

Pathology 4 is a direct result of corporate governance failures in cases where managers, due to weak control mechanisms, reject a positive net present value project because they wish to avoid personal risk. Managers tend to be risk averse because they cannot diversify away the unsystematic risk associated with any individual firm project. If managers can get away with it, they may reject projects with high expected returns if the projects have high unsystematic risk as well, even though such rejections are not in the interests of shareholders or society as a whole. By contrast, portfolio shareholders, who can diversify their holdings, are risk neutral with respect to unsystematic project-level risk. Management risk aversion causes problems everywhere, but the problems are likely accentuated in established Russian firms because incumbent managers typically internalized a high degree of risk aversion through Soviet-era careers in which punishment for major mistakes far exceeded gains from major successes.[57]

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projects in Russia due to the Russian economy's serious problems. The diversions cited here represent a diversion that creates a capital shortage in Russia relative to the quality of its investment opportunities. The reductions in residuals resulting from such diversions are examples of the complex mixture of corporate governance failures in which the method by which a non pro rata distribution is undertaken leads to a failure to maximize residuals as well, a point discussed in more detail infra Part I.D.

[57] The average age of enterprise directors is still over 50 years. See Joseph R. Blasi et al., Kremlin Capitalism: The Privatization of the Russian Economy 203 tbl.10 (1997). The OECD notes that "[t]hese directors were trained under the Soviet system. Although man-

Corporate governance failures also can lead firms indirectly to forgo positive net present value projects. Consider a firm with willing managers and with the prospect of a value-creating project that is nevertheless unable to proceed because financing is unavailable at a price equal to the capital's social opportunity cost.[58] The lack of financing may be an externality imposed by corporate governance failures in other firms. When firms generally fail to make pro rata distributions and to maximize residuals, they may undermine severely the ability of firms with good projects to acquire financing through new equity offerings. Banks are the usual alternative sources for outside finance, but in Russia, banks are providing little long-term corporate lending. The lack of a vibrant new equity market or of bank financing proves fatal for good projects in firms that do not generate sufficient internal funds to self-finance the project.[59]

In Russia, failures by established firms to take advantage of what appear to be positive net present value projects can be spectacularly large. Consider, for example, the saga at Segezhabumprom, one of Russia's biggest pulp and paper mills.[60] Swedish owners acquired a fifty-seven percent stake in the firm, while a major pulp distributor and the Karelian regional government controlled most of the rest of

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agement skills were often important for promotion (as were political ties) during Soviet power, entrepreneurial ingenuity for successful restructuring or reorganization involving risk was usually not rewarded." OECD, supra note 1, at 158 n.171.

58 It is hard to get a sense of the extent of this problem for established (as opposed to new) Russian firms. Many firms face one of three choices: continued operation in its current form, massive investment to build an entirely new factory, or dissolution. Often, continued operation in the firm's current form would be a highly inefficient choice because there is no market for its product at prices sufficient to pay for the inputs and for any opportunity costs associated with its fixed assets. And funds for a massive investment in a new factory are often not available. As a result,

> The conflict between production-oriented Soviet-era management and aggressive new owners has been played out at hundreds of factories across the country. The fledgling entrepreneurs have lacked the massive capital required to make the ageing red giants profitable and their attempts to make money by shutting them down and selling off their assets have proven politically explosive. As a result, privatisation has often failed to deliver effective restructuring.

ZiL Takes Alternative Road to Capitalism, supra note 39. It is not clear whether the lack of funds is solely due to capital market defects that arise from economy-wide corporate governance problems or whether, even without these problems, the new factory would be an insufficiently promising investment project to get funded. In general, entrepreneurs seem likely to claim the former reason.

59 Non pro rata distributions that result in cash flow diversions to accounts that managers control overseas also may result in firms without sufficient internal resources having to forgo projects that have a positive net present value when discounted at a rate reflecting capital's true social opportunity cost. See supra note 56 (discussing diversions).

60 See Greg McIvor, Risk and Reward in Equal Measure, Fin. Times (London), Mar. 3, 1998, at 17.

the shares. Early in the relationship, when the town of Segezha had run out of fuel oil, the Swedes were sufficiently eager that they agreed to "burn expensive wood chips, normally used in paper production, to prevent the town from freezing."[61] Later, the Swedes identified, and committed to make, over $100 million in new investments. However, the modernization plans provoked local suspicion of job losses, prompting a campaign to force the Swedes out, which included judicial findings that the Swedes' initial share purchases had been illegal.[62] A break point occurred when the Russian co-owners—the regional government and the major distributor—refused to co-fund the working capital to keep the plant open.[63] By the end, the Swedes abandoned the investment and wrote off their ownership stake, but only after the existing managers and local government officials drove them off using "mafia-style threats against [their] staff."[64] A story of this sort is likely to scare off even a determined large-scale investor, which in most countries could protect itself using the control powers that come with large shareownership. This story is even more discouraging for individual noncontrol portfolio investors. As discussed further in Part II, stories like that of Segezhabumprom also suggest that Russian corporate law enforcement may be so weak that the results of the ordinary processes of corporate decisionmaking are not respected by officials charged with enforcing property rights. Incumbent managers still appear to have de facto property rights in assets whose title is nominally in the hands of the corporation.

5. *Pathology 5: Failure to Identify Positive Net Present Value Projects*

The fifth type of pathology arises when a firm's managers fail even to identify positive net present value projects that the firm, through its specialization and the resulting accumulation of knowledge, is particularly well positioned to find.[65] Organizational capacity to identify these opportunities is related to the incentives available to

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[61] Swedish-Owned Paper Mill in Karelia Paralyzed by Fuel Shortage, BBC Summary of World Broadcasts, Jan. 3, 1997, available in Lexis, News Library, Non-US file.

[62] See McIvor, supra note 60, at 17.

[63] See Greg McIvor, Assi Hurt by Russian Plant Write-Off, Fin. Times (London), Feb. 13, 1998, at 29.

[64] McIvor, supra note 60, at 17; see also infra notes 85-87 and accompanying text (discussing Sidanko story).

[65] See Whitehouse, supra note 16 (describing paper and pulp company that failed to produce more paper in face of declining pulp prices and suffered financially).

firm employees for identifying such projects as well as the incentives for them to help each other in a joint endeavor to do so.[66]

In the United States, venture capital significantly reduces the social costs of Pathology 5 by making available funds for promising projects that employees identify, but managers misassess. Venture capital also significantly lessens the effects of Pathology 4 on the U.S. economy by making spinoffs possible in which employees proposing promising projects can implement the proposal by creating a new firm, despite the employer's rejection. The possibility of getting rich in a spinoff gives employees substantial incentives to identify positive net present value projects even if they work for firms that ultimately may not implement the ideas.[67] Furthermore, when spinoffs occur, Pathologies 4 and 5 do not harm the economy because the project is implemented anyway.[68]

In Russia, venture capital is not readily available.[69] Therefore, Pathology 5 is likely to be more prevalent in Russia than in the United States, and Pathology 4 is likely to be more damaging. Ronald Gilson and Bernard Black have argued persuasively that a necessary condition for developing venture capital is a vibrant equity market.[70] But Russia will not be able to develop equity markets until most of its firms try to maximize residuals and give pro rata distributions.[71]

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66 See Joseph Bankman & Ronald Gilson, Why Start-ups?, 51 Stan. L. Rev. 289, 301-04 (1999) (arguing that providing incentives to individual employees to develop innovations may hamper overall research and development efforts of firms, as individuals may hoard information that is useful to other research and development personnel in effort to protect their proprietary claim over information).

67 See id. at 306.

68 A record of successful spinoffs demonstrates a failure in the finance processes of established firms and hence shows some mix of Pathologies 4 and 5. One study of the semiconductor industry shows the reason that proponents of successful spinoffs took their ideas elsewhere is that top management of employer firms simply did not perceive the ideas to be worth substantial investment. See Merritt B. Fox, Finance and Industrial Performance in a Dynamic Economy: Theory, Practice, and Policy 305 (1987).

69 See World Bank, supra note 17, at 64 fig.3.2 (showing that direct foreign investment inflows as percentage of 1994 GDP is lower for Russia than for several other transition economies).

70 See Bernard S. Black & Ronald J. Gilson, Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets, 47 J. Fin. Econ. 243, 245 (1998) (explaining that vibrant venture capital market is dependent on ability of venture capitalists to exit from start-ups through initial public offerings, because venture capital providers desire exit mechanism that will allow them to enter into implicit contracts with entrepreneurs concerning future control of firms).

71 See, e.g., Norris, supra note 5, at A20 (concluding that:

> If Russia is ever to become an economic success story, its oil will play an important role. But before that happens, a Russian Morgan—someone who understands Russian capitalism and earns the trust of overseas investors—will have to come along to assure that a dollar invested is not sure to become a dollar stolen. The Yukos affair shows Russia is a long way from that goal.).

Again, we see the cumulative, self-reinforcing tendency of multiple corporate governance pathologies.

C. *The Failure to Make Pro Rata Distributions*

The second feature of good corporate governance is that a firm makes the residuals it generates available on a pro rata basis to the residual claimants, that is, to the common shareholders in an investor-owned company. Much of modern corporate law has been built around this principle, not only rules requiring that dividends and distributions be made pro rata, but also the basic fiduciary rules policing non arms-length transactions involving insiders and the corporation.[72] In postprivatization Russia, violation of this second feature has been the most visible and widely reported symptom of bad corporate governance. Just as nonmaximization comes in different flavors, Russian firms exhibit a wide range of non pro rata distributions that we simplify into two main groups, each with many variations. Loosely, one type is what we call "diversion of claims" and the other "diversion of assets." We explore each in turn.

1. *Pathology 6: Diversion of Claims*

To give just a few illustrations ranging from blatant to subtle, managers divert claims of the corporation when they refuse to register share purchases by outsiders,[73] refuse to recognize board directors properly elected by outside shareholders,[74] dilute stock in ways that

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[72] Frank Easterbrook and Daniel Fischel argue that this statement of basic norms in corporate law needs refinement. Unequal divisions of gains from corporate activity will be tolerated, they suggest, provided that the transaction makes no shareholder worse off. See Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 143-44 (1991). Their refinement is valid to an extent, but whether the refinement should be stated so broadly is irrelevant to our discussion of the Russian situation. Few of the many blatant violations of the principle against non pro rata distributions that we see in Russia possibly could be justified as necessary to permit transactions that leave no shareholder worse off.

[73] See, e.g., David Fairlamb, Moscow Madness, Institutional Investor, July 1995, at 132, 134 ("Some companies think nothing of striking shareholders' names off registers if they look like they're becoming a nuisance."); Mileusnic, supra note 46, at I ("One notorious incident involved Krasnoyarsk Aluminum, which deleted from its share register—the only legal proof of ownership—a 20 percent stake held by the British Trans World Group, effectively wiping out its holding.").

[74] One long-running case involves the Novolipetsk Metal Factory, one of Russia's largest metal producers. Western investment funds were unable, over the course of several years, to place anybody on the board of directors, despite controlling over 40% of the firm's shares and despite cumulative voting rules that should have guaranteed them some voice. See Mark Whitehouse, Novolipetsk Slams Foreign Investors, Moscow Times, Mar. 15, 1997, at 10. According to Novolipetsk's chairman, Vladimir Skorokhodov, "'In Russia's special situation, the master is, after all, not the shareholder.'" Id.; see also Mileusnic, supra note 46, at I (describing Western investors' unsuccessful attempt to gain board seats);

freeze out outsiders by issuing shares to insiders for inadequate consideration,[75] or engage in fake bankruptcies that wipe out shareowners' interests.[76] The key feature of these non pro rata distributions is that the people perpetrating them, usually insider owner-managers, are keeping the firm intact, including its assets and opportunities. They gain instead by manipulating the corporate legal system, the bankruptcy law, and other laws to reduce or eliminate the claims of some or all of the firm's shareholders on the firm's residuals—usually wiping out the outside minority shareholders.[77] As one investor put it, "'A 51% shareholding interest in a Russian company conveys to the owner a license to steal from the remaining 49%.'"[78]

John Thornhill, Risks of Russian Market Exposed, Fin. Times (London), Mar. 25, 1997, at 2 (same). Finally, in 1998, the outside investors were able to win seats on the board after the general director switched sides in this "marquee shareholders' rights case." Shareholders Win Two-Year Case, Can Appoint Board Members to Firm, Int'l Sec. Reg. Rep., Jan. 29, 1998, at 10, 10.

75 See Geoff Winestock, Ship Firm Managers, Shareholders Face Off in Russia, J. Com., Apr. 24, 1995, at 10A (reporting that:

> Managers have seen their position change dramatically over the last year with the public sale of their stock to outside investors. Shareholders, for one, have started to ask for higher profits and a voice in the company.
>
> Investors charge that management decided on a simple solution to the problem. They unilaterally issued themselves enough shares to take back control of their companies.);

see also Gary Peach, Financial Ethics Crackdown Bodes Well for Shareholders, Moscow Times, Feb. 24, 1998, available in Lexis, World Library, Mostms file ("Dalmoreprodukt, Russia's largest seafood exporter, is in the process of watering down outsiders' interest by means of an insider share issuance for select major stakeholders, managers, and employees.").

76 See, e.g., Andrew Higgins, As One Bank Shows, Bankruptcy in Russia Is a Real Cat Fight, Wall St. J., Apr. 5, 1999, at A1 (reporting that:

> [J]ust as Russia's earlier drive to put state property in private hands often yielded cozy inside deals instead of a spur to efficiency, bankruptcy has mutated into a cat fight often involving shadowy cabals and allegations of asset stripping. "Many enterprises are being artificially bankrupted, to be taken over by some groups," Prime Minister Yevgeny Primakov [said].);

Kranz, supra note 2, at 45 ("In regions across Russia, both local governments and creditors have filed bankruptcy suits against subsidiaries of Potanin's Sidanko Oil. The suits ostensibly seek payment of back taxes and delinquent energy bills. But the real prize could be Sidanko's oil assets.").

77 See Norris, supra note 5, at A20 (citing Yukos example, in which minority shareholders were barred from voting:

> A judge had ruled that since the minority holders all planned to vote the same way, they must be in league with one another and therefore in violation of antitrust laws because they had not registered as such. The minority shareholders were not invited to the hearing that led to the ruling.
>
> The shareholders managed to get another judge to rule that they could vote at one of the meetings. But his ruling was simply ignored.).

78 Investor Hell, J. Com., June 15, 1998, at 6A (editorial) (quoting E. Michael Hunter, president of Dart Management).

In one notorious case that has dragged on for years, the incumbent manager at Kuban Gypsum-Knauf refused to vacate even though he had been fired by the *majority* owner, a German company.[79] Supported by the local government, the manager installed Cossack guards, held his own shareholder meetings, locked out the owners, diluted the owners' stock, and ignored dozens of court rulings against him over the years.[80] Finally, and for the first time in Russia, the German owners were able to wrestle their way back in, following intervention by a commission headed by the Prime Minister.[81] According to one Knauf lawyer, "'It's a sort of legal nihilism. . . . The farther from Moscow, the less attention they pay to the legal side of things. There is no understanding of a final court decision.'"[82]

And managers are not the only ones diverting control. Recent reports suggest that local and regional governments with minority share interests have begun engaging in the same game, forcing firms into bankruptcy over unpaid taxes and then asserting control, essentially a form of renationalization in cases where tax rates are absurdly high, exceeding 100% marginal rates.[83] Also, outside shareholders such as those associated with financial-industrial groups (FIGs) may take over firms, replace managers, and then also freeze out minority shareholders, including employees.[84]

Many of these tactics are familiar to students of the history of western corporate law, but in Russia this game seems limited only by the creativity of those controlling the firm: The Russian regulatory apparatus has been notoriously ineffective in controlling such diversions. To give one example, in late 1997, insider shareholders had the Sidanko oil company offer exclusively to themselves, for nominal con-

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79 See Lyudmila Leontyeva, Red Director's Stronghold in Kuban, Moscow News, Oct. 30, 1997, in Lexis, World Library, Mosnws file.

80 See Mark Whitehouse, Germans Cry Foul in Gypsum Plant Feud, Moscow Times, Nov. 29, 1997, in Lexis, World Library, Mostms file; Mark Whitehouse, Under Siege, Moscow Times, Dec. 9, 1997, in Lexis, World Library, Mostms file.

81 See Katy Daigle, Nemstov Hails Win for Investors' Rights, Moscow Times, Mar. 10, 1998, at 13, 1998 WL 11690493.

82 Mark Whitehouse, Take 'Em to Court, Moscow Times, Feb. 10, 1998, in Lexis, World Library, Mostms file (quoting Innokenti Ivanov).

83 See Elizabeth V. Mooney, Russia Must Implement Tax, Corporate Governance Reforms, RCR Radio Comm. Rep., Feb. 28, 2000, at 26, 2000 WL 9540310 ("'The tax burden is arbitrary and capricious, frequently more than net earnings because companies are taxed on gross income,' [Professor Richard E.] Ericson said. 'This amounts to confiscation of the capital available for investment.'").

84 See European Bank for Reconstruction & Dev., supra note 24, at 143 box 8.1 (discussing financial-industrial groups (FIGs) and need to limit their powers); see also infra notes 214-27 and accompanying text (discussing FIGs).

sideration, a form of bonds that was convertible into Sidanko shares.[85] Once the conversion occurred, the remaining shareholders would see their ownership stake diluted down to one third of their original claim, yet the company gained no significant new assets.[86] The only unusual aspect of this share dilution was that for the first time in its history, the Russian Securities and Exchange Commission, in the glare of particularly intense negative press about the scheme, intervened in early 1998 to block the issuance of the convertible bonds. As a result, the majority insiders agreed to negotiate with minority shareholders.[87] Such regulatory oversight has been extremely rare in Russia. But even this victory was Pyrrhic. Since then, Sidanko insiders apparently have forced the company into a fake bankruptcy, effectively freezing out another major shareholder, British Petroleum, which had invested $500 million in the firm for ten percent ownership, a stake now apparently worthless despite the valuable assets that the reorganized firm will control.[88]

2. *Pathology 7: Diversion of Assets*

The second major class of non pro rata distributions, and the last pathology in our framework, involves direct diversion of assets and opportunities belonging to the firm. The key feature of this type of corporate governance failure is that insiders leave the ownership structure intact as they hollow out the firm.[89] For managers, diversion of assets may be accomplished by outright looting of the firm—taking cash or assets belonging to the firm and effectively giving title to

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[85] See Jeanne Whalen, FSC Cracks Down on Yukos, Sidanko, Moscow Times, Feb. 19, 1998, in Lexis, World Library, Mostms file (noting that Russian Federal Securities Commission action to cancel offering perhaps marks "'turning point'" (quoting attorney Walter Rieman)); Jeanne Whalen, Shareholders Rights: Round 2, Moscow Times, Feb. 17, 1998, available in Lexis, World Library, Mostms file [hereinafter Whalen, Shareholders Rights] (reporting subsequent developments). In the interest of full disclosure, the authors of this Article should state that they served as consultants to some minority shareholders in this matter.

[86] See Whalen, Shareholders Rights, supra note 85 (stating that convertible bond issue excluding minority shareholders would have tripled Sidanko's charter capital).

[87] See Sidanko Offers Settlement to Minority Shareholders, Russia & Commonwealth Bus. L. Rep., Mar. 25, 1998, in Lexis, News Library, Rcblr file.

[88] See Dilemma Over BP Role in Oil, Gas Industry, BBC Summary of World Broadcasts, Nov. 12, 1999, available in Lexis, News Library, Non-US file; Vitaly Makarchev, British Petroleum—Amoco Intends to Secede from Sidanko, TASS, Nov. 22, 1999, available in Lexis, Europe Library, Tass file.

[89] See, e.g., Mooney, supra note 83 ("Asset stripping and its companion, transfer pricing, are two other commonplace occurrences that victimize investors. [According to one analyst], '[a]sset stripping involves transactions with affiliates on non-market terms, and it siphons assets from minority shareholders. . . . Transfer pricing involves the sale of goods and services at below-market prices.'" (quoting Lee Wolosky)).

themselves.[90] Or it may take the form of sweetheart business deals with firms controlled by insiders or their families,[91] using, for example, transfer pricing agreements that move profits to subsidiaries or parents in which the insiders have a larger interest.[92] According to one report,

> Protecting sweetheart financial deals is behind much of the hostility to outside investors. Virtually every Russian enterprise, big or small, is surrounded by 'independent' companies set up by managers or their families. In many cases, sales and purchasing contracts are structured to go through these firms, raking off profits from the main enterprise.[93]

Russian firms also engage in non pro rata distribution of residuals when they continue to pay for redundant shareholder employees or when they provide public services without compensation or relief from reasonably and equitably imposed tax obligations. The experience of Tatneft shows a simple but creative form of non pro rata distribution in favor of a local government shareholder. According to one report,

> Tatneft is the victim of parasitism, pure and simple. . . . [Regional] bureaucrats who control the company essentially were under orders to borrow as much money as possible on international capital markets to support the region's economy and the government's pet programs. . . .
> . . . The company piled on almost $800 million in debt in 1997 alone, and now has over $1 billion of the stuff on its balance sheet. Tatneft was forced to make sizeable loans to the regional government (now broke) . . . .[94]

Neither the diversion of assets nor the diversion of claims noted in the previous section necessarily decreases social welfare in a static analysis—the diversions merely redistribute wealth from one group of

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[90] See, e.g., Edwin Dolan, Resisting Shock of New, Moscow Times, Apr. 8, 1997, at 10 (calling some insider managers "simply bandits").

[91] See Daigle, supra note 2 ("In Russia, company directors and managers are routinely accused of insider dealing, which includes everything from accepting bribes to act against their company's interests to selling assets or shares to relatives or friends.").

[92] See, e.g., Jeanne Whalen, Navigating the Russian Subsidiaries Minefield, Moscow Times, Mar. 10, 1998, at III, 1998 WL 11690632 ("Share swaps aside, transfer pricing is the practice most feared by subsidiary shareholders. Holding companies force subsidiaries to sell their oil at below-market prices, and then resell it for a profit that is kept by the holding company."); Whalen, Shareholders Rights, supra note 85 (discussing transfer pricing at Tomskneft, about which one minority shareholder protested, "[t]ax debts and the cost of production are left with the subsidiaries, while profits are illegally upstreamed to the parent" (internal quotation marks omitted)).

[93] Patricia Kranz, Shareholders at the Gate, Bus. Wk. (int'l ed.), June 2, 1997, at 60, 1997 WL 8270209.

[94] Peach, supra note 3.

owners to another. But moving to a dynamic analysis changes the story. If outsiders do not believe that they will receive pro rata distributions, then they will be unwilling generally to treat shares as financial assets, and they will be unwilling to provide equity finance in exchange for anything less than total control.[95] So the prevalence of diversion imposes a substantial externality on the Russian enterprise sector. Because potential outside investors cannot protect against ex post diversions of their investments in firms that turn out to be successful, they have little ex ante incentive to invest on terms that would be appealing to firms with positive net present value projects.[96]

D. A Simple Framework Meets Complex Failures

Table 1 below summarizes our framework of Russia's corporate governance pathologies. Real world cases do not fit neatly into one or another of the boxes we describe, but rather represent complex mixtures of several failures. To start, if managers are neither sufficiently constrained nor given incentives to prevent the diverting of claims, they similarly will be able to divert assets—both types of diversion may be undertaken at once, often in ways that are hard to tease apart.[97] Next, there is a potential interaction between the failure to make pro rata distributions and the failure to maximize residuals.

Some tactics used to effect a non pro rata distribution of a firm's wealth have no direct effect on residual maximization. This generally would be true of diversion of claims and of brazen, outright theft of assets. Other tactics, however, do reduce a firm's residuals; for exam-

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[95] See, e.g., Blasi et al., supra note 57, at 165.

[96] See id.

[97] Consider the recent looting of Moscow City Telephone Network (MGTS). Even though it is the largest telecommunications company in Russia, its share price dropped 95% from its high. According to one report, majority ownership was transferred from a public body to a

> secretive outfit that has links both political and economic to Moscow Mayor Yury Luzhkov. Any growth potential for the stock has thus been eliminated .... [I]t is safe to say that [the new owners] have no concern for shareholders of MGTS. What [they] care about, though, is getting Luzhkov elected to the presidency, so MGTS' available cash will be utilized accordingly.

Peach, supra note 3; see also Gary Peach, Mayor's Industrial Policy Carries Big Costs, Moscow Times, Dec. 8, 1998, at 16, 1998 WL 11691775 (noting that diverting control of "prize municipal assets" ensures that these firms' "bountiful cash flow" will be available to help Luzhkov "meet the presidential challenge in 2000").

For another complex diversion example, see Alan S. Cullison, Russian Share Shuffle Maddens Investors, Wall St. J., July 23, 1999, at A12 (discussing Yukos Oil company's quiet transfer of bulk of its two most valuable petroleum-producing assets to offshore entities); see also Alan S. Cullison, Yukos Transfers Two Oil Units to Offshore Firms, Wall St. J., June 4, 1999, at A12 (noting earlier part of saga in which tycoon who controls Yukos had "barred minority investors from shareholder meetings at three Yukos subsidiaries and pushed through permission for massive share issues that will dilute investors' holdings").

TABLE 1
FRAMEWORK OF RUSSIAN CORPORATE GOVERNANCE PATHOLOGIES

I. Nonmaximization of Residuals	
Pathology 1: Unreformable value-destroying firms fail to close	Arises when an unreformable value-destroying firm can stay in operation by dissipating cash reserves or salvageable assets. Corporate governance is not the key issue when the firm has no reserves or salvageable assets, or when subsidies or unsuitable credits are present.
Pathology 2: Viable firms fail to use existing capacity efficiently	Arises when continued firm operation, if undertaken as efficiently as possible and without new investment, would be a positive net present value (NPV) decision; but costs are not minimized, the best price is not obtained for given output, or a non profit-maximizing output level is chosen.
Pathology 3: Firms misinvest internally generated cash flows	Arises when a firm uses internally generated cash flow to invest in new negative NPV projects instead of paying out this cash flow to shareholders who could invest the funds better elsewhere in the economy.
Pathology 4: Firms fail to implement positive NPV projects	Arises when a firm identifies but then fails to act on positive NPV projects. Managers tend to be risk averse because they are unable to diversify away unsystematic risk of a firm's project. If others do not pick up the opportunity, the firm's failure also reduces social welfare.
Pathology 5: Firms fail to identify positive NPV projects	Arises when a firm's managers fail to identify positive NPV projects that the firm is particularly well positioned to find. The possibility of venture financing and spinoffs can reduce this pathology's prevalence and social costs.
II. Non Pro Rata Distributions	
Pathology 6: Firms fail to prevent diversion of claims	Arises when some residual owners of a firm manipulate corporate, bankruptcy, and other laws to shift claims on residuals away from other residual owners—often by diluting shares held by outside minority shareholders.
Pathology 7: Firms fail to prevent diversion of assets	Arises when some residual owners privately appropriate assets and opportunities belonging to the firm, but leave the firm's formal ownership structure intact.

ple, when owner-managers grant themselves unjustifiably large perquisites,[98] make non arms-length sweetheart deals involving the company and its insiders,[99] or engage in direct thefts of assets that require considerable efforts to cover up.

Finally, a management intently focused on, and especially skilled in, diversions may have neither the time nor the ability to give adequate attention to maximizing residuals as well. Consider AvtoVAZ,

[98] See, e.g., Blasi et al., supra note 57, at 87.

[99] The perquisites are unlikely to give the insiders as much utility as the cash that they would cost. See Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure, 3 J. Fin. Econ. 305, 312-13 (1976) (outlining increase in appropriation as owner-managers' percentage of equity decreases). The sweetheart deals are unlikely to be with the least cost provider of the service or good needed.

Russia's largest automaker. The company evidences several of the pathologies of nonmaximization of residuals: They continue to employ 114,000 workers and essentially comprise the town of Togliatti; production takes 450 worker-hours per car, compared with fifteen worker-hours for Toyota; seven of ten current production models were designed in the 1970s; the firm lacks working capital; and the size of the plant makes changeover to new production extremely expensive.[100] Poor management undermines the company in many ways: Working capital disappears, "insider deals and criminal groups sap would-be profits, and attempts at reform have been half-baked at best."[101] According to one analyst, "'The company is going to die a death by a thousand cuts. It's just going to sit there . . . until someone sees the potential value in some of its assets, strips them out and creates a different franchise or does a complete management overhaul.'"[102] With its mix of management failures, the company became the country's largest tax laggard.[103] To get an extension on tax arrears, the firm guaranteed that it would dilute its stock enough to give fifty-one percent of voting shares to the government if the firm missed two tax payments.[104] But then the firm proved unable to finish cars, because "'[a]lmost the entire amount of income [was] used to pay taxes.'"[105] After missing several tax payments, AvtoVAZ agreed to what amounts to renationalization.[106]

II
THE ROLE OF INITIAL CONDITIONS IN RUSSIAN PRIVATIZATION

The preceding discussion establishes the severity of corporate governance problems in Russia and the mechanisms by which these

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100 See Alexander M. Jenkyn, Russian Auto Manufacturers, Hobbled by Inefficient Management, Look to Foreign Investors, East/West Executive Guide, May 1997, available in Dow Jones Interactive <http://djinteractive.com>.

101 Mark Whitehouse, Slow Death, Moscow Times, June 16, 1998, in Lexis, World Library, Mostms file (recounting at length AvtoVAZ's management difficulties and slow decline).

102 Id. (quoting automobile analyst Victor Frumkin).

103 See Russia's Nemtsov Threatens Asset Seizures, Bankruptcies over Huge Tax Arrears, AFX News, Sept. 23, 1997, available in Dow Jones Interactive <http://djinteractive.com>.

104 See Avtovaz to Issue New Shares, Russian Bus. News Update, Sept. 1, 1997, 1997 WL 9832802.

105 Auto Giant Labours Under Tax Burden, BBC Summary of World Broadcasts, June 5, 1998, in Lexis, News Library, Non-US file (quoting AvtoVAZ chairman Vladimir Kadannikov).

106 See Kirill Koriukin, Debt-Laden AvtoVAZ Hands State 50% Stake, Moscow Times, Dec. 31, 1998, 1998 WL 11692046.

problems inflict damage on the real economy. Standard explanations of these corporate governance failures include the low level of corporate transparency, the lack of effective methods for adjudicating claimed violations of corporate law and enforcing the resulting judgments, and the absence of a network of trust among Russian businesspersons.[107] While these explanations are important, they are common to all transition economies to one extent or another.[108] Without discounting these other explanations, we believe that to understand why Russian corporate governance problems have been so severe[109] it is helpful to include consideration of the initial conditions of Russian privatization, in particular, the often untenable boundaries of newly privatized firms and the insider-dominated ownership and control structures.

These initial conditions are unique to Russia and most of the other former Soviet republics.[110] They result from a privatization program that followed the course of least resistance. The domestic Russian architects of privatization and their foreign advisers believed it politically necessary to move quickly. As with real estate privatization,[111] the initial path in corporate privatization represents not only political expediency, but also the primacy of pure economists over those more sensitive to the bargaining implications of packaging rights. The reformers hoped, naively as it turned out, that regardless of whoever initially received resources, these resources would flow naturally to their highest value users after markets were established. The reformers underestimated the roadblocks that the initial conditions would continue to impose for resource reallocation. In this Part, we detail some of these initial conditions and then explore how they have contributed to Russian corporate governance failures and the resulting dismal economic performance.

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107 See Black et al., supra note 1, at 1750-77 (discussing these factors).

108 See, e.g., Bernard Black & Reinier Kraakman, A Self-Enforcing Model of Corporate Law, 109 Harv. L. Rev. 1911, 1915 (1996) (emphasizing similarities among different emerging capitalist economies but characterizing Russia as extreme).

109 See, e.g., id.; Melissa Akin, Stalled Transition, Moscow Times, Nov. 16, 1999, at 15, 1999 WL 6809815 (discussing release of 1999 European Bank for Reconstruction and Development Transition Report criticizing Russia's economic reforms).

110 See, e.g., Black & Kraakman, supra note 108, at 1915; Martin Wolf, Transition Proves Long and Hard, Fin. Times (London), Nov. 10, 1999, at II (contrasting transition in republics of former Soviet Union with smoother transitions made in eastern and central Europe and Baltics).

111 See Heller, supra note 44, at 633-59 (showing how poorly conceived real estate privatization can lead to "tragedy of the anticommons").

A. Initial Conditions in Russia

1. Untenable Firm Boundaries

The first unique feature of Russian privatization is the bizarrely tangled and complex pattern of firm boundaries. To crystallize the problem, we compare the way in which firm boundaries are defined in developed competitive economies with how they were determined during privatization in Russia.

a. Firm Boundaries in Developed Competitive Economies. Transaction cost economics provides an easy way to understand the nature of firm boundaries in a developed competitive economy. As transaction cost economists envision the world, a country's productive economic activities consist of a set of transactions—potentially value-enhancing reallocations of goods and services—that occur between two or more parties. Every transaction that is not simultaneous and unambiguous in its implications for each party requires some kind of mechanism to govern the actions of the parties over time. In the simplest model, there are only two possible mechanisms, either an easily enforceable *contract* that specifies for each possible future state of nature what each party must do (referred to as a "well-specified contract"), or a *firm*. With a firm, one party owns all the assets related to making the transaction value-enhancing. The owner enters into an agreement with another party in which the owner promises compensation and the other party promises in return to do whatever, within a specified range of activities, the firm owner commands it to do.[112] In this simple model, every transaction in the economy occurs in one of two places: either within a firm—i.e., it occurs under this command arrangement—or between a firm (or other individual) and another firm (or individual) pursuant to a well-specified contract. A firm's boundary is defined, on the one hand, by the transactions that occur within it and, on the other, by the transactions that occur between it and others. Thus, for example, an auto manufacturer might produce its own seats or it might purchase them from outside suppliers. In the first instance, the reallocations of resources within the firm necessary for seats to be available to install in the cars would involve transactions within the firm. In the second instance, the transaction necessary to make the seats available would be

[112] This is the simple model that underlies Coase's seminal 1937 article. See Ronald H. Coase, The Nature of the Firm, 4 Economica 386 (1937), reprinted in R.H. Coase, The Firm, the Market, and the Law 33 (1988). Modern work in transaction cost economics identifies a wide range of governance mechanisms between the two extremes described in the simple model, see infra note 114, but the simple model is sufficient to illustrate the important points in the discussion here.

governed by a contract and would involve a transaction between the auto firm and another firm.

The least cost approach to governing some transactions is by command within a firm; for other transactions, by well-specified contracts with outsiders. The central tenet of transaction cost economics is that, in a competitive economy, market forces push transactions toward the mechanism that minimizes governance costs, referred to as "transaction costs,"[113] a process that in turn determines firm boundaries. The work of transaction cost economists suggests plausible, and in some instances empirically verifiable, reasons why in developed competitive economies we see the existing pattern of firm boundaries.[114]

b. Firm Boundaries in Russia. In Russia, the privatization process created an initial set of firms that divided up national economic activity in ways largely unrelated to the concerns of transaction cost minimization. Each privatized firm had a management team, workers, assets, and product mix that roughly corresponded to an administrative unit in the old Soviet economy. Often this unit was largely geographically based, so that a firm might encompass all the economic activity occurring within a given town or district, perhaps including a major enterprise such as an auto manufacturer, activities constituting any locally produced inputs for that enterprise, and other activities that meet consumption needs of local residents, such as a dairy or a bakery. The firm was also often highly integrated horizontally, being the only such firm in the country, or one of only a few, that produced its main product, even though in many cases scale economies did not require such a high level of concentration.[115] The boundaries of such a firm may (or may not) have made sense within a centrally planned and managed economy, but they in no way correspond to the bounda-

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[113] See Williamson, supra note 10, at 1200.

[114] For representative work, see Oliver E. Williamson, The Economic Institutions of Capitalism (1985) (applying transaction cost economics to various economic institutions); Benjamin Klein et al., Vertical Integration, Appropriable Rents, and the Competitive Contracting Process, 21 J.L. & Econ. 297 (1978) (discussing postcontractual opportunistic behavior as impetus for intrafirm contracting). Oliver Hart's "property rights" approach further explains the forces that define firm boundaries in a competitive economy. Hart builds on the transaction costs approach by exploring in more detail exactly what changes when the same transaction occurs within a firm instead of between firms. See Oliver Hart, Firms, Contracts, and Financial Structure 13-91 (1995).

[115] Putting issues of market power aside, there is in any given industry an optimal firm size that involves a tradeoff between scale economies (to the extent that they exist) and the managerial incentive problems that tend to grow with firm size. See Hart, supra note 114, at 51.

ries that would minimize transaction costs in a competitive market economy.

Severstal, one of Russia's largest steel companies, illustrates the plight of large employers in one-factory towns. The company's 48,000 employees make up the dominant wage base of Cherepovets, a city of 300,000; and the firm alone contributes more than one-third of the regional government's budget.[116] Even though the company is headed by an "energetic 31-year-old general director, who was elected by shareholders,"[117] the firm faces numerous difficulties raising capital, shedding labor, and spinning off apartments and other social services. The general director notes that "[t]he economy of Cherepovets largely depends on Severstal. Employment is an important issue, especially in this time of political uncertainty."[118]

A firm such as Severstal, with poor firm boundaries, massive overemployment, and increasingly obsolete equipment, cannot drum up much outside investor interest even with a relatively benign corporate governance reputation.[119] "[O]utside bidders for the stake would be taking a risk by buying into a company with a closed management style."[120] Recently, the regional office of the State Property Committee decided to sell its ten percent share in the company, but the only likely bidder is the insider management whose current share is a "well guarded secret."[121] Most likely, acquiring the ten percent would boost management from its current majority control position to over seventy-five percent, at which point it would have "absolute control"[122] of the company, free of many protections for minority shareholders.[123]

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116 See Stephanie Baker-Said, Steel Mill Begins Crawl to Productivity, Moscow Times, July 2, 1997, in Lexis, News Library, Mostms file; see also Neela Banerjee, Russian Firm Controls Elections, Profits by Buying City's Media, Dallas Morning News, June 15, 1997, at 16A ("[A]lmost everyone works for the steelmaker or has a relative who does.").

117 Baker-Said, supra note 116.

118 Patrick Ninneman, Growth in China and India; Turmoil in Russia, New Steel, Aug. 1997, at 76, 77 (reporting on discussion of vast employment rolls of Russian steel company at 1997 Steel Survival Strategies conference).

119 According to one firm analyst, "'Severstal does not have a track record of either cheating investors or treating them fairly. . . . They are not interested in the capital markets, but at the same time they don't engage in share issues or transfer pricing to the extent that other companies do.'" Brian Humphreys, State to Sell 10% Stake in Northern Steel Giant, Moscow Times, May 12, 1999, at 11, 1999 WL 6807252 (quoting metals anaylst Kakha Kiknavelidze).

120 Id.

121 Id.

122 Id.

123 The insiders may secure absolute control, not just of the firm, but also of the surrounding governments. The firm's odd boundaries make it particularly vulnerable to political depredations by local and regional governments. Rather than restructure, Severstal has defended itself by buying all of the newspapers and radio and television stations in the region, even though they are for the most part unprofitable. See Banerjee, supra note 116,

Thus, we get a preview of how poor firm boundaries can lead to potential corporate governance problems and inflict more economic damage than simply the increased transaction costs they cause.

2. *Dominance by Insider Groups*

a. Insider Control Before Privatization. Russia has a long history of control by a combination of management, labor representatives, and local government insiders. During the Soviet era, central planning and ministry supervision disciplined insiders' decisionmaking to some extent. Beginning with Gorbachev's reforms in the late 1980s and Yeltsin's reforms in the early 1990s, central ministry control was loosened without installing any outside monitor as a replacement. Managers quickly came up with the idea that enterprises needed owners, and that they indeed were those owners.[124]

Before firms were privatized, they went through an intermediate step called "corporatization," in which the enterprise was formally created as an incorporated business unit with a separate legal identity, a board of directors, senior management, and a notional economic value ascribed to its assets.[125] When a firm was corporatized, the state owned 100% of its stock but central ministries lost day-to-day control. During this preprivatization stage, boards of directors explicitly divided control among the general director who received two votes, rank-and-file workers who received one vote, and the local and federal governments that each received a vote.[126] The employees elected the senior management during this period,[127] but employees rarely exercised their power in anything but the most nominal sense.[128] By

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at 16A. These captive media then backed company-sponsored candidates who captured all of the city's elected positions and then "voted to cut Severstal's property taxes retroactively for all of 1996, despite budget shortfalls. The decision saved the company several million dollars in taxes." Id.

[124] As Blasi, Kroumova, and Kruse recount:

> The Russian general director is similar in authority to the chief executive officer (CEO) of a capitalist company . . . . In the past, a Soviet ministry could hire and fire him. Once Gorbachev removed cabinet supervision from the top managers of [the general director's] plant, the only formal authority over his enterprise was a distant state bureaucracy that was spinning out of control, and the now independent, authoritarian [general director] could do what he pleased. [The general director] was probably tempted to treat the company as his personal property. This process has been called spontaneous privatization.

Blasi et al., supra note 57, at 33.

[125] See id. at 40.

[126] See id.

[127] See id.

[128] See id. at 91.

cooperating with or intimidating the workers, managers positioned themselves to keep control of the firm at privatization.[129]

b. Management-Employee Buyout Disguised as Stock Ownership. Russia's mass privatization program from 1992 to 1994 transferred more than 15,000 medium and large state-owned firms to private ownership[130] with "a speed that is quite unprecedented in the post-Communist world."[131] These firms employed over seventeen million workers and managers and included the bulk of the Russian industrial core,[132] except for a few key categories of firms, including energy, defense, and infrastructure.[133] By 1996, when the big wave of privatization was over, 77.2% of medium and large state enterprises were privatized, accounting for 88.3% of industrial output.[134]

At the time of privatization, most issuers chose an option whereby a majority of their shares went to three groups of insiders: issuer management, the issuer labor force, and regional governmental agencies. The government decision to give firms this option involved following the path of least political resistance by granting a continuing stake to each group that had had significant power running the firm prior to privatization. Although the mass privatization used vouchers and formally created open stock ownership, the program "was basically a management-employee buyout program because of its preferential treatment of managers and workers."[135] After insiders bought

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129 See, e.g., id. (stating that trade union officials were sometimes kept on board of directors for "window dressing," and describing instance of silent intimidation by managers); see also Mileusnic, supra note 46, at I (describing how Russian company directors "intimidate employees who side with" foreign investors).

130 See Blasi et al., supra note 57, at 192 tbl.3 (discussing slight discrepancies in number of firms privatized and citing sources); World Bank, supra note 17, at 55 (estimating that insiders acquired around two-thirds of shares in 15,000 privatized firms).

131 Frydman et al., supra note 24, at 189.

132 In 1988, medium (more than 200 employees) and large (more than 1000 employees) enterprises accounted for about 95% of employees and production in Russia. See Blasi et al., supra note 57, at 25.

133 In 1995, a few large, rich firms, such as oil and gas companies, were privatized through a controversial "shares for loans" program that handed shares over to a number of financial-industrial groups controlled by new private tycoons. See infra text accompanying notes 215-17 (discussing "shares-for-loans" scheme).

134 See Blasi et al., supra note 57, at 25-26. The totals now are higher: 4600 mainly small and medium enterprises underwent some form of privatization in 1996. See European Bank for Reconstruction & Dev., Transition Report 1997, at 195 (1997).

135 World Bank, supra note 17, at 55. Insiders had several privatization options. About one-quarter of enterprises chose option one, which gave minority employee ownership for free. About three-quarters of firms chose option two, which allowed managers and workers to acquire 51% of the firm for extremely low prices (and therefore to take formal control of the firm). A third option attracted only two percent. This option allowed a management buyout on the promise of reaching particular restructuring targets. See Blasi

shares, each citizen could bid, using vouchers they were given, for some of the remaining shares at auctions. Immediately after privatization, insiders undertook additional share purchases on the open market and typically ended up owning about two-thirds of the shares of firms. On average, managers owned nine percent and workers about fifty-six percent.[136] Outsiders used vouchers to buy about twenty to thirty percent, split between investment funds and individual investors. The government retained the remainder of shares, and, even more importantly, it often retained control of the land on which enterprises were located.[137]

Postprivatization, senior managers used numerous mechanisms to thwart the power of employees and outsiders and to maintain control. These mechanisms included, for example, keeping share registries locked up in their offices and refusing to acknowledge ownership by people they disfavored, threatening to fire workers who sold shares to outsiders, and reducing the power (as well as the financial claims noted earlier) of outsider shareholders by means of stock dilutions.[138] Managers also provided little or no disclosure about the business operations or finances of their firms. Even voucher investment funds, which are the most aggressive and informed outside shareholders, often cannot get rudimentary information about the firms in which they hold shares[139] and instead "resort to spying on their own companies."[140] Thus, managers did not acquire a majority of shares during the initial privatization, but they locked up nearly unshakeable control.[141] Workers, who did acquire majority shareownership, did not

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et al., supra note 57, at 41 (describing three plans for transfer of shares at privatization, each of which transferred "40 to 51 percent of ownership to managers and employees").

136 See Frydman et al., supra note 24, at 189; World Bank, supra note 17, at 55.

137 See Larsen, supra note 40, at III ("Many companies seeking to get a clearer title to their land still face stiff resistance from regional authorities who see land ownership as a source of power in dealing with local enterprises . . . ."). This is reported to be a declining problem in the big cities but is still serious in the rest of the country.

138 See Galuszka & Kranz, supra note 35, at 60 ("[N]ew tricks . . . range from diluting the ownership stake of investors to such simple ploys as erasing the names of outside investors from computerized shareholder lists."); Carole Landry, Russia's Communist Bosses Are On the Way Out, Agence France-Presse, Dec. 15, 1994, 1994 WL 9647596 ("Old-guard managers, who supported privatisation in exchange for assurances they would keep their jobs and full array of perks, are desperately fighting back. Some managers physically threaten challengers at shareholder meetings, rig shareholder votes or illegally change corporate charters." (citing Prof. Andrei Shleifer and Dmitry Vasilyev)).

139 See Mooney, supra note 83 (noting that, according to one analysis, "'[t]here is a need for transparency and disclosure because accurate information is hard to come by. Companies frequently hold their shareholder meetings in remote places like Siberia.'" (quoting Lee Wolosky)).

140 Frydman et al., supra note 24, at 204.

141 A reporter notes:

achieve anything like a "workers' democracy."[142] Instead, they remained locked in an uneasy arrangement with management, often able to block restructuring but not able to seize control.[143] Among the many reasons for continued employment of redundant labor, managers sometimes kept employees to prevent them from selling shares to outsiders.[144] If managers fired workers, they could no longer use the threat of job loss to deter share sales.

c. The Persistent Pattern of Initial Privatization. The effects of the initial privatization are persistent. Insider ownership is declining slightly (dropping from sixty-five percent in 1993 to about fifty-six percent in 1995),[145] but the problems of majority insider ownership remain pervasive. By 1996, the typical board contained four managers, one state representative, and two outside shareholders.[146] Because five directors were required to make decisions, the insiders and the state representative always could prevail, if they cooperated.[147]

The 1996 corporate law includes measures that respond precisely to the problem of insider domination that emerged from the initial privatization scheme and from the immediate postprivatization enterprise behavior.[148] For example, the new corporate law improves the position of minority outside shareholders by mandating cumulative

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> Most Russian enterprises are still run by red directors—former communists who stack their boards with old-regime subordinates or cronies, bully workers into selling their shares back to management, and deny outside shareholders access to their books, boardrooms, and shop floors. Many consolidate control of their companies by issuing large blocks of new shares to company insiders, often at bargain-basement prices.

Kranz, supra note 93, at 60.

142 A reporter notes:

> [I]f [directors] see outside shareholders trying to get hold of their company, these managers often shout down their proposals at meetings, intimidate employees who side with them and hold tight to the board—which is often still considered a Soviet-era workers' council. . . .
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> . . . .
>
> Most employee shareholders, . . . are still passive and exert little influence over corporate governance because they are underrepresented on company boards . . . .

Mileusnic, supra note 46, at I.

143 See, e.g., Blasi et al., supra note 57, at 147 (describing stockholders' meeting where workers used their votes to prevent holding company from gaining influence in Lebedinsk Ore Processing Company).

144 See id. at 135, 147.

145 See World Bank, supra note 17, at 55.

146 See Blasi et al., supra note 57, at 99.

147 See id.

148 See id. at 98 (describing provisions of 1996 corporate law); Black & Kraakman, supra note 108, at 1924 (describing problem of entrenched insider control).

voting.[149] As a result, outside owners of share blocks are increasingly able to get themselves elected to the board of directors, despite resistance by insiders to the cumulative voting rule.[150] In turn, Roman Frydman and Andrzej Rapaczynski show that outsider representation on the board has had some positive effect on firm performance.[151] Also, significant transactions in which insiders are interested are supposed to be approved by the outside shareholders. Nevertheless, insiders have found numerous mechanisms to circumvent the protections offered by the 1996 reforms and to continue effecting non pro rata distributions.[152]

d. The Enduring Cost of Insider Ownership. To summarize, we observe three interrelated failures in Russia that are associated with the initial structure of insider ownership and control. First, the three groups of insiders have been unable to work together to operate their firms in a way that would maximize even their own joint benefit. They have tended to view their shares more as control rights than as financial instruments. Each group has, despite privatization, continued to focus primarily on how the firm could be run in a way that would most benefit that group directly. Managers extract extensive perquisites and sweetheart business deals for themselves and associates. Labor ensures continued employment of redundant workers. Regional government entities continue receiving public services for the community.[153] Each group goes along to get along; it agrees to meet the other groups' minimal demands in exchange for getting its direct ben-

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149 See Blasi et al., supra note 57, at 99 (describing details of cumulative voting law).

150 See id. at 99. But see id. at 148 ("Most of the companies do not . . . use cumulative voting, and the number of blockholders' seats on the board does not reflect the size of their ownership stakes."); id. at 201 tbl.9 (indicating that 39% of companies used cumulative voting in 1996).

151 See Frydman et. al., supra note 24, at 214-18.

152 While new bills keep being introduced to close loopholes, they do not appear to be effective. Thus,

> [C]ritics said the legislation fails to attack the real problem—insider dealing—and doubt anything but better information disclosure requirements and an understanding of basic ethics will help the situation. In Russia, company directors and managers are routinely accused of insider dealing, which includes everything from accepting bribes to act against their company's interests to selling assets or shares to relatives or friends.

Daigle, supra note 2. Insider dealing is not limited to management, but also includes deals in favor of local governments and labor. See, e.g., Stephanie Baker-Said, Watchdog Gives Nod to MGTS Floatation, Moscow Times, Apr. 22, 1998, available in Lexis, News Library, Mostms file ("Moscow City Telephone Network, or MGTS, is planning to increase its authorized capital by 50 percent, handing the shares over to a single shareholder linked to the Moscow city government for next to nothing.").

153 In Moscow, "[t]his cozy relationship is multiplied a thousand times. According to many business people, [Moscow Mayor] Luzhkov used property as leverage. The property

efit. But these insider deals ignore the cumulative effects on the value of the firm for themselves and for outsider shareholders.[154] One Russian fund manager notes that "the majority of directors still fear loss of control to an outside investor and have not yet recognized that a smaller piece of a growing pie is more valuable than ownership of a dead enterprise."[155]

Second, the three groups run the firm in a way that is particularly disadvantageous to outsider shareholders.[156] The primitive state of the Russian legal system and the general lack of corporate transparency mean that outside shareholders gain no real protection from the fiduciary duties nominally placed on managers and only weak protection from procedural rules designed to police interested transactions.[157] Majority insiders usually can crush what otherwise would be the only meaningful constraints on their behavior: the ability of outsiders to vote out the board and the threat of a hostile takeover.[158]

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was leased for a nominal sum, but the city also made unwritten demands not in the lease: to plant trees, rebuild a hospital, pave a highway." Hoffman, supra note 42, at A1.

154 One reporter notes:

> [T]he reluctance of many directors to use the stock market to their benefit is a paradox: After all, an overwhelming majority of directors managed to grab sizable portions of equity in their companies during the wild privatization years of 1993 to 1994, usually by buying out swathes of shares with the help of cheap bank loans through a highly abused process known as closed subscription. Were directors to understand the virtue of shareholder value, they could help make themselves even richer.

Peach, supra note 2.

155 Neither CEOs nor Red Directors, The Managers of Russia's Privatized Industrial Firms, Russia Express Briefing, Dec. 9, 1996, 1996 WL 8619171.

156 Commenting on the aluminum smelting industry, one reporter suggests that

> Since they aren't now looking to attract capital through share issues, the companies' directors are not concerned about plummeting stock prices, and don't really care what the market thinks about them. Aluminum shares last traded actively in 1994 and 1995, when various insiders were trying to establish control of smelters during the privatization process.

Whitehouse, supra note 16.

157 Cf. Stefan Wagstyl, Region's Financial Transparency Uneven: Corporate Governance, Fin. Times (London), Sept. 24, 1999, World Economy & Finance, at 28 (stating that:

> A critical role is played in the economy by laws affecting pledges, bankruptcy and company formation because these protect the position of creditors and outside shareholders vis-a-vis majority shareholders and/or managers. In virtually every country in the region, there are complaints about securing redress under pledge, mortgage and bankruptcy laws. A common concern is about the effectiveness of courts to produce rapid judgments. Justice delayed is often justice denied.).

158 According to the 1997 EBRD Transition Report:

> In over 65% of Russia's 18,000 privatised medium-sized and large firms management and employees have majority ownership, whereas non-state outsiders control only 20% of these companies. While in the top 100 largest companies outsiders have an ownership stake well above the average, the wide dispersion of these shareholdings often ensures a controlling position for the manage-

Third, the above failures inside existing firms in turn limit capital market development, with collateral consequences for both existing and new firms. Established firms cannot raise new capital through the public sale of new equity, a particularly grave problem given the primitive state of banking in Russia.[159] Further, the resulting lack of vibrancy in the secondary market for insider shares means that primary and secondary markets do not develop for the shares of new, post-privatization firms.[160] This lack of stock market vibrancy also slows outsider purchases of employee shares and delays the resulting conversion of firms with majority insider ownership to majority outsider ownership. The result of these three failures has been an overall lack of much-needed restructuring.[161]

B. How Initial Conditions Cause Corporate Governance Failures

This Section establishes the causal links between the initial conditions just described, the corporate governance failures detailed in Part I, and the resulting harms to the Russian economy.

1. Peculiar Firm Boundaries and the Failure to Maximize Residuals

Poorly defined boundaries render firms with weakly constrained and weakly incentivized management particularly susceptible to several of the five residual nonmaximization pathologies. To start, consider Pathology 1: continued operation of a value-destroying firm. From the moment of privatization, Russia had many such firms that

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ment. Insiders typically focus more on maintaining control over their firms than on restructuring.

European Bank for Reconstruction & Dev., supra note 134, at 195.

159 See, e.g., World Bank, supra note 17, at 100 box 6.1 (describing Russian banking reform in 1980s and 1990s).

160 See European Bank for Reconstruction & Dev., supra note 134, at 195 ("The main source of the expansion of the private sector remains the privatisation process and the contraction of the state sector. . . . The creation of de novo businesses continues to lag far behind the pace typical for the central European countries and many newly established businesses continue to operate in the informal economy.").

161 According to the 1997 EBRD Transition Report:

> Enterprise restructuring has hitherto been achieved mainly through changes in the product mix, shedding of labour through attrition, expanded use of unpaid leave or reduced hours. Deeper restructuring in the form of factory shutdowns, changes in management, major reorganisations and modernisation is at a very early stage and is constrained by, among other factors, limited access to investment resources. Recent evidence suggests that roughly 25% of the medium-sized and large companies are engaged in serious restructuring, many of them being members of Financial and Industrial Groups (FIGs). About half of the medium-sized and large companies have not as yet undertaken any meaningful restructuring.

Id.

should have been shut down instantly.[162] Because of their peculiar boundaries, these stillborn firms made little sense as a way to match location, assets, workers, and product mix, but they often had assets with significant salvage value, urban land in particular. Despite the damage they cause to social welfare, managers of such firms indulge their personal preferences by continuing firm operations. When land is the salvageable asset, managers can easily avoid taking the residual-maximizing decision because Russia does not have a well-developed land market. There is, therefore, no effective way to make salient the opportunity costs of using the land for continued firm operation.[163]

A similar story can be told with respect to Pathology 2, in which potentially viable firms fail to use existing capacity efficiently. Most Russian firms not displaying Pathology 1 are likely to display Pathology 2. Cost minimization is a necessary condition for residual maximization. By definition, what made these firms' borders peculiar was the fact that they were not transaction cost minimizing, so by definition, firms in this second category require major restructuring.[164] Unlike the case of managers of firms in the first category, it is not self-evident why loosely constrained managers of these firms would avoid restructuring and operate their firm in a residual nonmaximizing way.[165] However, the story told below of bargaining failures among the insider groups suggests that, in a large number of cases, managers may have reason to avoid restructuring, thus dooming their firms to the long-term display of Pathology 2.

The peculiar borders of Russian firms also have made them more prone to Pathology 3. This pathology is more likely to occur in an enterprise encompassing an unnecessarily large number of different activities: If the cash flow from one activity exceeds the positive net present value projects arising out of that activity, then the managers are likely to invest the surplus in negative net present value projects associated with other firm activities.[166] If the two activities were split into different firms, the cash flow more likely would be paid out as

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[162] See, e.g., Reynolds, supra note 23, at A1 (describing company that continues to operate despite consistent net losses, and noting that such businesses are not considered bankrupt in Russia); see also supra Part I.B.1 (giving examples of value-destroying firms).

[163] See Roman Frydman et al., The Privatization Process in Russia, Ukraine and the Baltic States 71-74 (1993) (describing slow development of land markets in Russia, which has resulted in part from 10-year moratorium on alienation of land, established in 1991).

[164] See supra Part I.B.2 (giving examples of firms exhibiting Pathology 2).

[165] See, e.g., Simon Clarke & Veronika Kabalina, Privatisation and the Struggle for Control of the Enterprise, in Russia in Transition: Politics, Privatisation, and Inequality 142, 151-52 (David Lane ed., 1995) (suggesting that managers' own stake should motivate them to maximize company prosperity but identifying rent-seeking and short-term goals as factors that may temper incentive to maximize company profits).

[166] See supra Part I.B.3 (giving examples).

dividends, and investors would have the chance to fund projects with more promising returns.

Finally, compared with outside investors facing a fragmented set of single purpose firms, the management of an enterprise encompassing an unnecessarily large number of activities will—because of its distance from idea sources and the rigidity of internal communications channels—likely have more difficulty finding positive net present value projects. Thus, the peculiar boundaries of Russian firms also aggravate the effects of Pathology 5.

2. *Insider Dominance and the Failure to Maximize Residuals*

a. The Nature of the Failure and the Need for a Credible Promise. As discussed above, after privatization, most Russian firms were majority owned by three groups of insiders: management, employees, and regional governmental authorities.[167] At first glance, this ownership pattern appears to offer many advantages and to solve several firm-level problems. Management's large stake, typically over twenty percent of what are often very large enterprises, should have led to a substantial identification with the interests of shareholders, while not being so large as to provide an insuperable barrier to takeover. The employees' stake substantially should have helped some of the contracting problems associated with long-term employment relationships—such as encouraging asset-specific human capital investments by employees—and should have reduced resistance to needed downsizing significantly, by offering implicit compensation through increased share value.[168] More importantly, when the stakes of the three groups were taken together, the groups typically had a right to receive seventy percent or more of the residuals. Thus, they had huge incentives to agree that the firm itself should be operated in a fashion that maximizes these residuals. Yet, the structure of ownership and control actually has worked in the opposite direction, contributing to the failure to maximize residuals.[169]

Traditionally, the choice between public and private ownership has been seen as involving a tradeoff. Public ownership leads to a lower cost of capital because the firm's shares can be sold for a higher

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[167] See supra note 135 and accompanying text.

[168] See, e.g., Milica Uvalic & Daniel Vaughan-Whitehead, Introduction: Creating Employee Capitalism in Central and Eastern Europe, in Privatization Surprises in Transition Economies 1, 23 (Milica Uvalic & Daniel Vaughan-Whitehead eds., 1997) (offering reasons why employees' stakes do not solve problems of control and inefficiency).

[169] Irrationality may be a problem here too. In one odd report, "'one company director who owned over 51 percent of a company . . . took personal bribes of about $10,000 to push through decisions that robbed the company of millions. Obviously, this man doesn't understand what he's doing.'" Daigle, supra note 2 (quoting Konstantin Kontor).

price due to both their liquidity and their capacity to be part of a diversified portfolio.[170] Public ownership also permits a degree of outside monitoring.[171] Private ownership, however, greatly reduces the substantial residual-reducing agency costs of management that are associated with public firms.

At first glance, Russian firms have an ownership structure that would appear to come close to that of a private firm, suggesting that they should do well at maximizing their residuals. A large portion of the shares not owned by management are owned by just two other entities—the workers and government. This, one should expect, radically would reduce the transaction costs and collective action problems associated with shareholder monitoring and action that plague the public firm. But Russian firms are falling far short of maximizing their residuals, suggesting that they are suffering instead from the worst of both worlds. They do not seem to be getting the benefits of a private ownership structure; yet, the existence of insider control combined with weak corporate law makes raising capital by public sale of equity impractical and so they are not receiving the traditional benefits of public ownership either.

The three groups of insiders have been unable to work together to operate their firms in a way that would come close to maximizing their own joint benefit. Their actions suggest that they continue to view their shares more as control rights than as financial instruments. Therefore, each group has, despite privatization, continued to focus primarily on how each firm could be run in a way that would most benefit the group directly. For example, managers cut side deals, labor ensures that redundant workers stay on, and regional government extracts public services. These behaviors are major deviations from the decisions that would maximize the firm's residuals. By failing to cooperate through good corporate governance, the insiders fail to capture the potentially large financial value of their shares. The aggregate benefit to these three groups from these deviations is less than the resulting diminution in the residuals. Management's gain from the sweetheart contracts is less than the price improvement or other advantages of using the suppliers and purchasers chosen on an arms-

170 See Easterbrook & Fischel, supra note 72, at 230-31 (explaining how illiquid market in shares provides investors with less information and with less ability to sell quickly without sacrificing price, both of which decrease their willingness to invest).

171 See Bengt Holmström & Jean Tirole, Market Liquidity and Performance Monitoring, 101 J. Pol. Econ. 678, 679 (1993) (explaining that "a firm's ownership structure influences the value of market monitoring").

length basis.[172] Labor's gain from receiving wages and benefits beyond what they could in alternative employment is less than the reduced residuals enjoyed by the firm as a result of their continued employment.[173] And government savings from not having to pay other suppliers of services is less than the cost to the firm of providing these services, which would be outside the boundaries of the firm if it were operated in a transaction cost-minimizing fashion.

Explaining why insiders do not agree to maximize the firm's residuals as part of an obvious Coasian bargain starts with the following observation: Under existing arrangements, the insiders receive their benefits *immediately*, as they are generated by the firm's ongoing operation. Under any kind of bargain to run the firm to maximize its residuals, they would not receive them until *later*, in the form of shareholder distributions.[174] This delay is significant: A deal is not possible unless management is able to make a credible promise that it will live up to its end of the bargain. Otherwise, labor and local government would be put in a position of having to give up their benefits now without an assurance that management, which runs the corporation from day to day, would live up to its end of the bargain: i.e., giving up its special benefits and subsequently distributing the gains from the overall deal as dividends.

b. The Difficulty in Making the Promise Credible. Under current conditions in Russia, management would find it almost impossible to make credible promises to live up to its end of the bargain.

i. Legal enforcement. One way that a promise can be credible is if the promisee can use the courts easily and economically either to

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172 See Whitehouse, supra note 101 (noting adverse effect of insider deals on financial health of AvtoVAZ).

173 See Bogdan Lissovolik, Rapid Spread of Employee Ownership in the Privatized Russia, in Privatization Surprises in Transition Economies, supra note 168, at 204, 223-24 (suggesting that managers maintain overemployment levels so they will receive government subsidies).

174 The reader may raise two questions here. The first is that the failure of insiders to come to these deals may be related intimately to the delay because the insiders may have very high rates of time discount, and hence receiving benefits now is preferred to receiving larger benefits later. The answer to this, however, is that the Coasian bargain that we are contemplating already takes such discounts into account. Efficient operation of the firm contemplates that the residuals be discounted to present value.

The second question concerns whether an insider could avoid the delay problem by selling her shares to others. But this does not make the problems associated with delay go away; the buyer instead must suffer them. If delay also implies uncertainty as to whether the gain will ever in fact be received, the buyer will pay commensurately less for the shares, and so in this regard, the insider is just as badly off as she would be had she held onto the shares.

gain the promisor's compliance or to obtain damages.[175] For a number of reasons, labor and local government are unlikely to be able to do so. For a promise's credibility to be based on the availability of court enforcement, there must be a legal obligation on the part of the promisor. As a formal matter, Russian managers may be bound to maximize residuals and distribute them pro rata even without an explicit deal with other insiders, but this is not clear as a matter of law. The Russian corporate code nominally imposes on the management of joint stock companies the obligation to act in the interests of the company reasonably and in good faith.[176] The language of this obligation is similar to the statutory provisions for fiduciary duties under U.S. corporate law,[177] which are interpreted as banning extensive perquisites[178] and prohibiting transactions between the corporation and management or its associates, unless the transactions offer the firm terms as good as can be obtained in an arms-length deal.[179] There is essentially no judicial gloss, however, to affirm that this language would be interpreted in the same way in Russia.

The second step is the actual availability of court enforcement. Russian law again nominally provides for a form of derivative suit for damages in the event of a breach of management's statutory obligations.[180] Even if we assume that as a formal matter management is obliged to behave in the fashion contemplated by the Coasian bargain hypothesized here, labor and local government are unlikely to be able to use the courts to stop violations of that obligation.[181] According to

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175 See Chong Ju Choi et al., A Note on Countertrade: Contractual Uncertainty and Transaction Governance in Emerging Economies, 30 J. Int'l Bus. Stud. 189, 195 (1999) (describing most effective enforcement mechanism for promises with different ex ante conditions).

176 See Federal Law on Joint Stock Companies, Federal Law No. 208-FZ, art. 71(1) (Russ.) (Bernard S. Black & Anna S. Tarrassova trans., 1997), reprinted in Bernard S. Black et al., Guide to the Russian Law on Joint Stock Companies III-1, III-59 (1998).

177 See, e.g., Model Bus. Corp. Act Ann. § 8.30(a) (Supp. 1998-99) (offering model statute that imposes obligations on directors to act "in good faith, and . . . in a manner the director reasonably believes to be in the best interests of the corporation"); see also id. commentary at 8-178 (noting that majority of jurisdictions have adopted version of model statute).

178 See William L. Cary & Melvin Aron Eisenberg, Cases and Materials on Corporations 689-700 (7th ed. 1995) (collecting cases in which executive compensation was challenged but noting difficulties of prevailing in such challenges).

179 See id. at 673 (noting that self-interested transactions in which corporations deal with management must be "on fair terms" and "in the corporation's interest").

180 See Federal Law No. 208-FZ, art. 71(1), (5), reprinted in Black et al., supra note 176, at III-59 to III-60 (providing for suits by company or shareholders against directors and management for negligent actions). The Russian joint stock company law makes no provision for shareholders to receive injunctive relief against management. See id.

181 See, e.g., Mooney, supra note 83 (stating that "'[t]ransfer pricing already is against the law in Russia. However, it is an example of a larger problem. The body of law is not

Bernard Black and Reinier Kraakman, "[i]n Russia . . . courts function slowly if at all, some judges are corrupt, and many are Soviet-era holdovers who neither understand business nor care to learn. Better judges and courts will emerge only over several decades, as the old judges die or retire."[182]

Another possible way of gaining managerial compliance while relying less on the court system is through legal regulation of the corporation's own process of transaction authorization.[183] Russian law has procedural rules designed to make less likely the authorization of transactions in which management or a major shareholder is interested and that are disadvantageous to the corporation. These rules require that such transactions be approved by the vote of a majority of those directors who are not interested in the transaction or, in certain cases, by a disinterested majority share vote.[184] Special procedural rules apply also to the approval of very large transactions.[185] The theory is that these rules require much less court intervention to be effective because the factual determination of whether or not there has been compliance is sufficiently simple and clear as to make the rules nearly "self-enforcing."[186]

In the end, however, these rules may not be much help either.[187] To show that management or a major shareholder is interested in a transaction requires proving that it is associated in some specified way with the other party to the transaction. A general lack of transparency concerning who owns the shares of, or has managerial positions in, the corporations involved makes this proof difficult.[188] Even

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that bad, but it lacks reliable means of enforcement, legal systems, regulatory regimes' . . . ." (quoting Lee Wolosky)).

182 Black & Kraakman, supra note 108, at 1914.

183 See id. at 1915-16.

184 See Federal Law No. 208-FZ, art. 83, reprinted in Black et al., supra note 176, at III-69 to III-70 (requiring that some transactions by interested directors be approved by majority of noninterested directors or by shareholders).

185 See id. arts. 78-79, reprinted in Black et al., supra note 176, at III-66 to III-67 (requiring approval by all directors or by three-fourths majority of shareholders to conduct certain "major transactions").

186 See, e.g., Black & Kraakman, supra note 108, at 1916 (describing model corporate governance rules that incorporate "bright-line rules" easily enforced by judges).

187 See id. at 1918 (noting that "there are limits to what a self-enforcing corporate law can accomplish").

188 In theory, interested persons are required to disclose this information to the company's board, inspector, and auditors. See Federal Law No. 208-FZ, art. 82, reprinted in Black et al., supra note 176, at III-68 to III-69. However, there is no obvious incentive for such persons to comply with this provision. Even if they do, it is not clear that the information would become available to anyone who, possessing it, might act to challenge the transaction for lack of compliance with the approval procedures. It was the experience of the authors, in connection with an interested transaction involving one of Russia's largest oil companies, that this information was not available, either because the insiders did not com-

when owners or managers are identified, it is hard to know whether the voting results in fact conform with the procedural requirements, in part because of similar transparency problems and in part because of difficulties in determining who voted which way.[189]

ii. Reputation. Another way that a promise can be credible is where the promisor has a prior reputation for keeping its promises in situations in which legal enforcement is difficult and the nonlegal consequences—other than damage to reputation—would not have been expected to be great.[190] Such a promisor is unlikely to breach the promise in question because doing so debases its reputation, which is costly.[191] The problem in Russia is that in the few years since privatization, the management of the typical corporation has not had the time to develop such a reputation, either through informal networks or formal verification institutions,[192] at least with respect to promises of this magnitude.

While the same management team may have been in place for a significant time prior to privatization, the team, and all those with whom it dealt, had been subject to strict ministerial supervision. Because of this supervision, the need for credible promises was lesser and the non reputation-related negative consequences of breaching the promises that were made were greater. Also, most promises were made with persons within the context of an ongoing course of dealing, but those networks have been disrupted in the new post-socialist economy.

An additional problem here is that the promise that management needs to make is contrary to the norm for managerial behavior in

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ply with Article 82 or because the company did not make the information public. See supra notes 85-88 and accompanying text (discussing Sidanko).

189 It was also the experience of the authors in connection with a Sidanko transaction that the public records of the directors' meeting and the shareholders' meeting at which an interested transaction was approved did not reveal who voted for and against the transaction.

190 See Choi et al., supra note 175, at 192 ("[T]he value of a reputation for fair trading, not restricted by any legal requirement other than sanctions of social nature, provides the basis for confidence in future performance, promotes cooperation, and thus creates networks and clusters of relational or implicit contracts."); Ronald Dore, Goodwill and the Spirit of Market Capitalism, 34 Brit. J. Soc. 459, 463-64 (1983) (discussing obligated relational contracting in Japan).

191 See Roger C. Vergin & M.W. Qoronfleh, Corporate Reputation and the Stock Market, Bus. Horizons, Jan.-Feb. 1998, at 19, 25 (noting that positive corporate reputation increases corporations ability to "obtain[ ] capital more easily and at better rates"). Vergin and Qoronfleh also note that prior financial performance, including 10-year annual return to shareholders, is a critical determinant of corporate reputation. See id. at 22.

192 See generally Ronald J. Mann, Verification Institutions in Financing Transactions, 87 Geo. L.J. 2225 (1999).

Russia. A person who makes a particular promise that he has not made before, but the promised behavior is the norm, is likely to be credible if she has fulfilled other promises that conform to the norm with respect to other kinds of behavior over time. Such a person may be viewed as a "regular fellow" or a "straight shooter." Where the behavior promised runs contrary to the norm, such a reputation is of no help.

iii. Hostages. A third way a promise can be made credible is where the promisor gives the promisee a "hostage" that can be taken by the promisee if the promisee feels that there has been a breach.[193] The ideal hostage is something that is worth much less to the promisee than the promisor. A firm's plant might serve this kind of hostage function if it were vulnerable to certain kinds of labor actions, such as sit-ins. Labor is poorly organized in Russia, however, and so collective action problems make it unlikely that it would be able to use the plant in this fashion.[194] Such actions also likely would be repressed by governmental authorities. Any promise by management to waive its rights to such governmental assistance would have its own credibility problems.

iv. The need for ex post verification. None of these ways of making a promise credible will work unless there is some method of ascertaining whether the promise has been kept or not. This is another serious obstacle to the parties' making a Coasian bargain requiring management to use its control to maximize residuals and then

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[193] See Choi et al., supra note 175, at 199 ("Where neither contracts nor trust provide a viable institutional force of enforcement, hostages can impose mutual commitment in an interlinked or reciprocal fashion. We have argued that trust, contracts and hostages are seen as alternative mechanisms of exchange . . . ."); see also id. at 194 (describing countertrade, buyback, and production sharing agreements as hostage-taking approaches, in which one party pays for asset that remains in control of other party); Dalia Marin & Monika Schnitzer, Tying Trade Flows: A Theory of Countertrade with Evidence, 85 Am. Econ. Rev. 1047, 1049 (1995) (describing countertrade agreements with assets as hostages).

[194] See John Thornhill, Russian Unions Struggling for Their Workers' Trust, Fin. Post (Toronto), Oct. 26, 1995, available in Lexis, World Library, Natpst file (noting that:

> A recent nationwide survey of 2,000 Russians by the University of Strathclyde in Scotland revealed widespread distrust of trade union representatives. Only 16% of the respondents who were trade union members said they trusted their national leaders to look after their interests.
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> . . . .
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> On paper, at least, the official trade union movement has a strong base from which to begin the reconstruction. . . .
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> But the report concluded this strength was largely illusory, given the official unions' compromised past and the slowness of its leaders to adapt to new circumstances.).

distribute them pro rata.[195] In terms of ex post verification, management is in the same position making this promise to labor and government as it would be making this promise to any noncontrolling outside shareholder. The whole apparatus of modern auditing and accounts is designed to provide a reasonable assessment of the amount of residuals that have been generated, to identify the amount of spending for management compensation and perquisites, to ferret out corporate transactions in which management is interested, to identify which investors receive how much in distributions, and to highlight outright theft. Application of this apparatus to Russian corporations is in its infancy and so most transactions remain far from transparent.[196]

c. The Lack of Strong Capital Markets. Along with the inability of management to make credible promises, the absence of strong capital markets (itself a result of widespread corporate governance failures) frustrates the parties' intentions to make a Coasian deal to maximize residuals. Even if workers were able to obtain what they believe to be a credible promise from management, they would have great difficulty selling for cash today their rights to receive in the future the benefits of the deal. This is an important additional complication because the desperate living conditions of many Russian workers, combined with a belief that the future could not be worse and might be better, may give them a strong positive time preference—an illustration of the difficulty of making social welfare evaluations of decisions involving the allocation of resources over time when capital markets fail. If discounting to present value is done at the interest rate implied by the strong positive time preference of highly credit-constrained workers, managers may be running firms in ways that suddenly appear far more efficient.

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[195] See Choi et al., supra note 175, at 191 (noting that enforcement costs, including measurement costs, are principal barriers to Coasian bargaining, especially in international context where "the level of complexity and uncertainty tends to be particularly severe").

[196] For example, consider the following account:

> [A] barrier to action by outsiders is the information vacuum that prevails in many insider-held companies. They all try to look poor. The only real books are in the director's safe, or his head. It's hard even to know which firms are worth taking over. Once a successful bid is made, one Russian consultant described the takeover itself in virtually military terms: Advance spies must learn which safes and computers hold the key files. On takeover day, armed guards must secure all of these within minutes or the data, and the cash behind them, will simply vanish. All physical assets must be nailed down or nothing will be left but an empty shell. These are little details foreign investors don't always understand, noted the consultant.

Dolan, supra note 90, at 10.

d. Applicability to Different Pathologies. Understanding the bargaining dynamics among competing inside owners of privatized Russian firms helps explain the widespread incidence in Russia of Pathologies 2 and 3: the failure to use existing capacity efficiently and the misinvestment of internally generated cash flows.[197] The preference of labor shareholders to retain redundant workers rather than maximize residuals leads directly to Pathology 2. There are two ways that the firm can keep employment high in the short run. One is to produce more output than would be called for if the firm set marginal cost equal to marginal revenue. The other is to produce this level of output using a combination of inputs that includes more labor than would the cost-minimizing input combination. Both decisions involve failures to use existing capacity as efficiently as possible, and both reduce residuals as a consequence. The labor shareholders' desire to retain redundant workers also leads to Pathology 3.[198] While firm investment in negative net present value projects is not necessary for employment to be maximized in the current period, it is necessary for employment to be maximized in the future, assuming that the new investment does not embody a radically labor-saving new technology. This is true whether the investment replaces worn out existing capacity or represents an actual expansion of capacity. Labor's interest here parallels managers' personal interest in running as large an enterprise as possible, everything else being equal.

The bargaining dynamics story is not as helpful in explaining Pathology 1. The residual-maximizing change necessary for firms displaying Pathology 1 is to close them immediately. As we have seen in Part I, to the extent that an unreformable, value-destroying firm continues operating because of corporate governance problems, it is because the firm has cash reserves (unlikely in Russia) or salvageable assets.[199] The Coasian deal here would be to close the firm as soon as these assets could be sold. There is no time delay requiring a credible promise on the part of management, and hence none of the problems discussed above should block the deal.

How then can the existence of firms displaying Pathology 1 be explained? One possibility is that such firms do not exist—i.e., that Pathology 1 is an empty set. The anecdotal evidence presented here, however, suggests that this is not the case.[200] Another possibility is that title to these salvageable assets, at least in the case of land, is not

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197 See supra Parts I.B.2, I.B.3.

198 See supra Part I.B.3.

199 See supra Part I.B.1.

200 See, e.g., Reynolds, supra note 23, at A1 (describing Russian engine factory with large losses and quoting analyst stating that continued operation of factory "'makes no

as clear as we have portrayed it; in particular, it might be that local authorities have the power to block land sales independent of the powers they have as shareholders.[201] If so, the needed reform is in property law and public law, not improved corporate governance. Yet another possibility is that the market for such salvageable assets is extremely illiquid due to severe limitations in capital markets in Russia generally. Thus, existing Pathology 1 firms gradually will be shut down as buyers are found who will pay full value for the assets, but this process will take considerable time.[202] If that is the case, the initial conditions explain the problem not by their direct effects on the Pathology 1 firms, but by their contribution to the failure of corporate governance in Russia generally with that failure's attendant deadening of Russian capital markets. Finally, Coasian deals may not be made in Pathology 1 firms because of the perception of bias among firm employees. Labor may believe that the redundant jobs it wishes to save are worth more to it than is really the case. The shareholder distribution that labor would receive upon sale of the salvageable asset then would not seem to labor to be worth the loss of these jobs. If this is the case, however, it would form an additional (or alternative) explanation for the failure of the Coasian bargain in the cases of firms displaying Pathologies 2 and 3 as well.

The failed Coasian bargain story also does not explain Pathologies 4 and 5 very well. These pathologies involve failures of suitability and capability, not conscious decisions by managers to put their personal interests above that of firm residual maximization. In essence, managers of firms displaying these pathologies are doing as well as they can, but a firm with less risk-averse or more imaginative managers could do better.[203] The problem is thus not the result of competing insiders unable to make a Coasian bargain. The social welfare effects of these failures would be corrected either by replacing the incumbent managers or by assuring that there are other venues for implementing the positive net present value projects being rejected or

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sense'" in "'economic terms'" (quoting factory director Boris N. Peshkov)); Surowiecki, supra note 21, at 32 (providing examples of firms exhibiting Pathology 1).

201 See Larsen, supra note 40, at III ("Most of Russia's . . . privatized firms . . . do not even have a clear lease agreement. Instead . . . city officials [have] a big say in how the land is used and . . . companies [have] few rights to sublet, sell or redevelop.").

202 See supra Part I.B.1.a (discussing relationship of corporate governance and other factors to when value-destroying firms close).

203 See supra Parts I.B.4, I.B.5. Outside shareholder pressure is no help here. See Jack, supra note 14, at 21 ("Profitable companies do exist within the country, even if they prefer to keep a low profile to avoid unnecessary attention from the tax authorities or extortion gangs. But with less than a 51 per cent stake in a business, an investor has no influence in how it is run.").

unrecognized by these managers. The failings here are in the market for corporate control and the market to provide capital for new firms. Thus, again, the initial conditions help explain Pathologies 4 and 5 not directly but by their contribution to the failure of corporate governance in Russia generally and the attendant deadening of Russian capital markets.

3. *Insider Dominance and Non Pro Rata Distributions*

Initial conditions in the form of insider dominance also can help explain the massive failure of Russian firms to distribute their residuals pro rata to their investor owners. The primitive state of the Russian legal system and the general lack of corporate transparency mean that outside shareholders gain no real protection from the fiduciary duties nominally placed on managers and only weak protection from procedural rules designed to police interested transactions. Privatization, as we have seen, resulted in most firms having the insiders in the majority. This crushes what would otherwise be the only remaining meaningful constraints on these insiders' behavior: the ability of outsiders to vote out the board and the threat of hostile takeover.[204]

Initial conditions also play a role, though more indirectly, in the non pro rata distributions by firms in which the insiders have less than a majority of shares but managers still control the firm. In theory, these managers would at least be subject to being thrown out by the vote of the majority outsiders or as a result of a hostile tender offer. Shareholder votes have significant collective action problems associated with them, however,[205] and as for hostile tender offers, the same story applies here as discussed just above. The initial conditions and their effect on corporate governance among Russian firms have done severe damage to the creation of vital capital markets generally. Thus, no effective market for corporate control has developed, and the hostile takeover check against non pro rata distributions by majority outsider-owned firms is a chimera.

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[204] Where insiders did not start out with unassailable majority control, they still had working control, which they often later used to attain majority status. This was frequently accomplished through discounted sales to affiliates. See Mooney, supra note 83 ("Lack of evenhanded treatment in the private sales of corporate securities is another roadblock to outside investment. . . . 'Companies often sell securities in private placements at below-market prices to participants in subsidiaries of the issuer.'" (quoting Lee Wolosky)).

[205] See Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520, 526-28 (1990) (noting that rarity of successful proxy contests, difficulty for shareholders to become informed, and relatively small gains to be derived from action lead most shareholders to choose "rational apathy" in voting); Dale A. Oesterle & Alan R. Palmiter, Judicial Schizophrenia in Shareholder Voting Cases, 79 Iowa L. Rev. 485, 486-87 (1994) (highlighting "ineffectiveness of shareholder voting as a control device").

It is worth considering the other causal factors of non pro rata distributions as well, and here the governance failure typology is quite useful. For example, of all the pathologies, Pathology 6, diversion of claims, is perhaps most amenable to traditional law reform efforts, at least in some of the pathology's forms. Perhaps registering transfers of shares could be centralized in a public or quasi-public institution rather than being left to the whims of individual firm managers. Particular loopholes in corporate law, such as those regarding convertible bonds, can be tightened; standards of review in bankruptcies can be adjusted. But even here, when so much is at stake, insiders may be able to invent ever more subtle diversion mechanisms. For example, many of the procedural protections available to shareholders depend on identifying outside disinterested owners and require a majority of their votes for important changes in corporate structure. Recent proposals attempt to strengthen these key protections.[206] But insiders have proven adept at obscuring the identity of owners and evading these procedural protections with ostensibly outside owners actually controlled by insiders.

Pathology 7, diversion of assets, is not as amenable to simple law reform efforts, even assuming that it became easier for shareholders to obtain judgments and enforce them. Even the Delaware Chancery Court, presumably the most sophisticated court in the world for detecting breaches of the duty of loyalty, has a difficult time separating out management decisions that are legitimately taken to increase residuals, but have the incidental effect of disproportionately benefiting insiders from management decisions primarily motivated by a management desire to effect a non pro rata distribution.[207] It will be a long time before Russian courts are likely to achieve Delaware's level of competence. As for the more blatant examples of non pro rata distributions, they are usually criminal and implicate a broad array of institutional and legal deficiencies in Russia. These deficiencies include the refusal of local officials to recognize, in their role as enforcers of property rights, decisions of legitimate corporate processes when these decisions run contrary to the desires of incumbent managers.[208]

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[206] See Jeanne Whalen, FSC's Vasiliyev Soldiers On Amid Dismissal Rumors, Moscow Times, Dec. 5, 1998, 1998 WL 11691750 (noting proposed "amendments to close loopholes in the Law on Joint Stock Companies and a draft Law on Affiliated Persons that would closely regulate the actions of majority shareholders").

[207] See, e.g., Lewis D. Solomon et al., Corporations Law and Policy 748 (4th ed. 1998).

[208] See, e.g., supra text accompanying notes 60-64 (discussing Segezhabumprom).

C. Trends in Corporate Control

1. Dynamics of Initial Ownership Patterns

The original allocation of shares at the time of privatization is not a sustainable ownership pattern over time. Many firms already have been taken over completely by one group of insiders, usually the managers, who purchase the shares of the other insiders. This is a predictable result because the multiple groups of insiders are unable to make joint wealth-maximizing agreements. When managers take complete control, they can operate the corporate assets more as if the assets were their sole private property. This is a more stable ownership pattern, and it represents a social gain because the managers are more motivated to put assets to their first best uses.

The management control equilibrium is still far from ideal, however, and its shortcomings represent large continued failings in the Russian system of corporate governance. First, the deals necessary to buy out the other insiders are not easy to make because management itself has no ready access to capital. Often, their aims are achieved by extralegal means. Thus, the new equilibrium will take considerable time to reach and often does not put assets, at least immediately after the ownership restructuring, in the hands of the persons most capable of using them.[209] The stakes are especially large because these assets include control over cash flows that the managers often cannot invest sensibly within their own firms, but capital market failures mean cash flows are denied to other entrepreneurs who could make better use of them. These failures, as we have seen, stem from the continued ability of insiders to divert wealth from the remaining outside shareholders, which makes raising capital through public sales of equity by any firm virtually impossible. Given the paucity of other sources of capital, many promising investment opportunities go unfunded. Moreover, the absence of outside investor voice in the affairs of the firm may mean that it is not run efficiently even to the extent that doing so is now in the best interests of the management insiders. These managers are often still holdovers from the Communist era and would be able to act more in their own and society's best interests if prodded by more market-oriented outsiders, but their continued desire to engage in non pro rata distribution makes such consciousness-raising advice inadvisable to obtain.

Early empirical work suggests that the greatest improvement in corporate performance in Russia comes when firms have substantial outside ownership and those owners place outside directors on the

[209] See Black et al., supra note 1, at 1763.

board.[210] This observation may be causally backward, in that outsiders tend to invest in the best firms, particularly those that are generating sufficient positive cash flow that payment of dividends becomes possible.[211] The question is whether the privatized enterprises can move systematically in the direction of increasing outsider ownership and control. The analysis in the sections above suggests cause for concern. When multiple insiders block each other, there is little commitment by insiders to the financial aspects of shareownership. Similarly, when manager insiders take control and divert assets illegally, outside investors have little incentive to purchase minority interests.[212]

Privatization is intended to create wealth that is available for reinvestment in Russia, but the insider structure of corporate ownership may stimulate capital flight instead. Diversifying risk through portfolio investment in domestic firms is impossible.[213] Domestic equity investments, to be worthwhile, must be in controlled amounts under the current system. A system that started with fragmented insider ownership has led to one in which public offerings are impossible, and capital leaves Russia in part because of the unavailability of viable domestic portfolio investment opportunities to reduce risk through diversification.

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[210] For example, consider Baltika Brewing. "Business has boomed thanks to a steady stream of foreign investment, effective marketing and a good management team." John Varoli, Baltika Plans to Boost Output 250%, Moscow Times, Apr. 22, 1999, 1999 WL 6807006. The firm has been implementing a large capital investment program using its own reserves as financing, has secured outside credit, and has been one of the few firms in Russia to pay dividends. One element in the firm's success and credibility on international financial markets has been firm oversight by a Scandinavian brewing group that holds 70% of Baltika's shares. See id.

[211] See Popov, supra note 55, at 27 (stating that:

> In the largest and most attractive Russian companies with high market liquidity, outside investors by now own more shares than workers and managers, and this pattern is likely to emerge in other companies, whose shares are not yet traded in the market and which are still controlled by work collectives. While in the large, but not the largest, privatised Russian companies outsiders owned in 1996 only 31% of shares, with 59% of shares belonging to insiders and 9% to the state, in the 100 largest Russian companies outsiders owned on average 57% of all shares (insiders—22%, the state—21%.)).

Popov's data highlight this problem. He notes that most successful Russian firms are also majority-owned by outsiders. See id. at 23. It is unclear, however, which way the causation runs.

[212] See Jack, supra note 14, at 21 ("From now on, . . . new investment will require the strengthening of the rights of minority shareholders, enhancements to international auditing and accounting standards, and a better tax regime.").

[213] A "portfolio investment" in an issuer is an investment in an amount constituting a sufficiently small percentage of the issuer that it is easily liquidated and causes no control significance.

2. *Evolution of Financial Industrial Groups*

For a short period, Russia seemed to be moving to a system of corporate control concentrated in huge, sprawling conglomerates that came to be known as financial-industrial groups (FIGs), organized around one of seven chief oligarchs, each with a captive bank, a holding company, and multiple privatized companies as subsidiaries.[214] The most significant boon for the FIGs occurred in 1995 with the infamous "shares-for-loans" scheme in which the oligarchs' banks gave relatively small loans to the government to plug the budget deficit and in exchange received the rights to run some of the most valuable Russian resource-extracting firms: oil, minerals, timber, and so on.[215] When the government predictably did not pay back the loans, the oligarchs conducted rigged auctions through which the collateral on the loans became controlling shareownership in these firms.[216] One oligarch, Vladimir Potanin, in discussing the shares-for-loans program, noted, "'It was bad. . . . The prices were cheap. We can stop discussing this. It was bad. But it did solve the problem of having more efficient owners.'"[217]

According to one estimate, the chief oligarchs, through their FIGs, were said to control forty percent of Russia's economy.[218] These seven "gray cardinals,"[219] however, rather than each working to improve the operations already under his particular control, fought each other to extend control to additional assets. This led George Soros to compare Russia to "'a canoe in which seven men are fighting over a horde of gold [and] are too absorbed by this to recognize they are heading toward a waterfall.'"[220] The 1998 financial collapse set the FIGs back, bankrupting several of them, and so it is too early to see if they really put assets in the hands of more efficient owners. Initial indications, however, are not promising.[221]

Early in the transition, optimistic commentators argued that the FIGs roughly would parallel the Japanese experience with keiretsu

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214 See Timothy O'Brien, The Shrinking Oligarchs of Russia, N.Y. Times, Sept. 27, 1998, § 3, at 1; see also Kranz, supra note 2, at 45 (listing all seven oligarchs).

215 See David Fairlamb, Reining in the Oligarchs, Institutional Investor, Nov. 1998, at 146, 148 (explaining shares-for-loans scheme).

216 See Daniel Treisman, Blaming Russia First: Three Books Examine Russia's Woes, Foreign Aff., Nov.-Dec. 2000, at 146, 151 (book review).

217 O'Brien, supra note 214, § 3, at 1.

218 See Fairlamb, supra note 215, at 147.

219 Id.

220 Id. at 150 (alteration in original).

221 See id. at 154 (noting lack of evidence that new investors would manage oligarchs' former assets any better).

and the Korean experience with chaebol.[222] Another analogy would be Oliver Williamson's M-form corporation, in which the head office substitutes for the capital market's capital allocation and managerial monitoring functions.[223] Given the extreme weakness of Russian capital markets, this substitution seemed a step forward. FIG oligarchs argued that they were relatively more productive than other sectors of the economy because their captive banks gave them access to funds at rates much lower than what was generally available, presumably because of reduced information asymmetries. And, echoing Williamson, they argued that "subsidiaries are overseen by group executives at the center, forcing local managers to pay attention to shareholder value, something that few other firms in Russia ever consider."[224] According to Mikhail Khodorkovsky, one of the oligarchs, the FIGs "'are an excellent way of distributing scarce managerial resources throughout the economy . . . . Surely, you can see that.'"[225]

In practice, the keiretsu and chaebol were not the right analogy; rather, the FIGs more closely resemble the old Soviet nomenklatura networks of former Communist and Komsomol members,[226] and "'are to some extent a revival of the old [Soviet] branch ministries.'"[227] They have not managed the enterprises under their control any better than firms generally have in the economy. Instead, oligarchs focused on non pro rata distributions and generally continued to ignore problems of residual nonmaximization within the firms they controlled. According to one commentator, "'The oligarchs were qualified to run banks only because of their familiarity with the corridors of power . . . . Uneximbank [one of the FIG banks] never had any interest in improving manufacturing at any of its companies. It just wanted to channel money through the bank.'"[228] So far, FIGs seem to have

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[222] See generally Ronald J. Gilson & Mark J. Roe, Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization, 102 Yale L.J. 871, 872 (1993) (asserting that Japanese system, featuring investment overlaps between banks and industry, harmonizes corporate relationships and "facilitate[s] productive efficiency"); Mark D. West, Information, Institutions, and Extortion in Japan and the United States: Making Sense of Sokaiya Racketeers, 93 Nw. U. L. Rev. 767, 797 (1999) (noting similarity between Korean chaebol and Japanese keiretsu).

[223] See Williamson, supra note 10, at 1225-26 (describing beneficial effects of M-form enterprise on monitoring and capital allocation).

[224] Fairlamb, supra note 215, at 150 (summarizing oligarchs' arguments).

[225] Id.

[226] See Poul Funder Larsen, 1996: The Year Big Business Became the State, Moscow Times, Jan. 5, 1997, at 1.

[227] Id. (quoting Anders Aslund) (alteration in original).

[228] O'Brien, supra note 214, § 3, at 1 (quoting Andrei Piontkovsky, director, Center for Strategic Studies, Moscow). The usual routine was for the FIG banks to make loans to captive borrowers, and once those loans were disbursed, secretly to channel the funds directly into the bankers' private offshore accounts. See id. "It would have been O.K. if

exhibited all the corporate governance pathologies we already have noted; they do not appear to be a step forward.

3. *Some Reform "Thought Experiments"*

The critical problems we identify for Russian corporate governance lie at the intersection of uneconomic firm boundaries and control by competing groups of insiders. Poorly drawn firm boundaries exacerbate the corporate governance problems that arise when, as in Russia, managers are loosely constrained and poorly incentivized. Control by competing groups of insiders confounds the usual prediction that insider-dominated firms should be good at residual maximization and robs outsiders of their only mechanism for limiting non pro rata distributions of residuals. For Russia, at least, the firm borders at the time of initial privatization are "water over the dam," and all that can be hoped for now is greater development of a market for corporate assets. Voting rights, however, are something that can be altered by legal fiat, at least in theory. The Russian situation represents a case in which the usual rationales for "one share, one vote" do not hold. It would be preferable if the voting rights of the competing corporate insiders could be sterilized in return, perhaps, for an even greater share of equity. Unless Russia undertakes such a reform, the best it can hope for is a slow and costly transition to a low-value equilibrium in which outsiders are not available to provide public capital.

A primarily procedural approach to reform, which does not rely heavily on court enforcement, goes some way toward creating a viable corporate governance regime.[229] However, we are skeptical that such reforms alone sufficiently would protect outsiders in a way that would make public equity finance possible—even after firms made the transition to management control. Instead, as just suggested, we believe that the problems associated with insider blocks require a more sub-

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these loans were made on an arms-length basis. But they weren't . . . . When some banks made loans they didn't specify interest rates or even when the loans had to be paid back." Id. (quoting financial analyst requesting anonymity). In short, "the oligarchs' idea of shareholder value is to asset-strip the companies they control and shunt the money offshore." Fairlamb, supra note 215, at 150-52. Boris Nemtsov, a former deputy prime minister and key reform politician, attributes the failure of reform generally to the role of the FIGs. He says:

> "The reason for this crisis is that after seven years of trying to build a market economy, we've ended up with oligarchic capitalism . . . . It is characterized by the fact that a few FIGs, which, incidentally, work very inefficiently and are managed by greedy managers whose main aim is to pump money out of their enterprises and stockpile it abroad, produce the lion's share of GDP."

Id. at 152.

229 See Black & Kraakman, supra note 108, at 1932-37 (describing essential features and advantages of "self-enforcing" model).

stantive approach that effectively disenfranchises the initial groups of insiders. For example, Bernard Black and Reinier Kraakman sensibly have suggested neutralizing the voting rights of local governments, which make up one of the competing blocks of insiders and which are unlikely to use their rights to maximize shareholder wealth.[230] But, the suggestion to sterilize shares of local government owners applies with equal force to management and labor blocks. Rules allowing only outside shareholders to vote also could be used to take control of the board away from the initial group of insiders, thereby increasing the value of being an outside shareholder. Insiders with a reduced capacity to engage in non pro rata distributions could focus more on the gains to be made from increased share value if residuals were maximized. Under such a reform, the shares would regain their vote when transferred to genuinely outside hands.

A grand political deal of insider vote sterilization in return for an even greater share of equity is obviously impractical in the environment of today's Russia, in part because, again, no one would trust the results. Policing the independence of outsider shareholders and setting up effective institutions to aggregate their votes is beyond Russian capabilities today.[231] Nonetheless, over time, with the evolution of a somewhat more effective legal system and somewhat greater corporate transparency, insider vote sterilization might represent one mechanism by which Russia could move toward a modern capitalist economy, a mechanism that involves less reliance on these institutions than the bright-line procedural approach that informs the current Russian code. Such a reform basically would involve taking the logic of those reforms one step further. Instead of partially disenfranchising insiders by requiring disinterested and supermajority votes for a wide range of corporate actions, insiders would be disenfranchised entirely. The entire focus of the corporate law system then could be on policing the single question of which supposedly outside shareholders are genuinely independent from management. The incentive for a party to enter the grand political deal would be the potentially large gains that better-governed corporations could produce.

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230 See id. at 1971. Black and Kraakman write:

> Because we are skeptical about whether local officials will behave as responsible shareholders, we favor neutralizing government shares in the election of boards of directors: state bodies should neither nominate nor vote for candidates for the board of directors, although they should retain authority to vote on potentially company-transforming actions such as mergers and charter amendments.

Id.

231 See, e.g., id. at 1914.

Another possibility along these lines—equally implausible now but perhaps conceivable in the future—would be to create a mechanism that requires payments of dividends when certain benchmarks are met by a firm. Proposals for minimum dividend payments have been floated in the American context but could prove even more useful in the Russian one.[232] Most importantly, minimum dividend payments by firms with a certain level of assets or revenues could help people come to view shares as financial instruments rather than just as levers for control.[233]

CONCLUSION

A typology of Russian corporate governance can offer useful lessons for corporate governance theory. The rich array of deviant behavior we canvass in Russia helps flesh out a framework of pathologies that, in a comprehensive way and for the first time, links corporate governance failures to real economic effects. How is this analytic tool useful? It helps give more precision to the often vague notion of corporate governance failures. Scholars write about the costs of poor corporate governance without telling us the mechanisms by which loosely constrained and poorly incentivized managers cause social welfare losses. We suggest that these losses may be inflicted in differing degrees through one of seven distinct pathologies—five types of nonmaximization of residuals and two versions of non pro rata distributions. Losses that are not inflicted through one of these seven mechanisms cannot be attributed properly to something called "poor corporate governance." More positively, identifying which pathology predominates may help point to more appropriate corporate governance reforms.

The second focus of this Article—explaining what has caused the flowering of Russian corporate pathologies—also may prove useful for corporate governance theory. Not surprisingly, the existing scholarly literature on comparative corporate governance mostly reflects the experience of the United States, Western Europe, and Japan. In the United States, it is unusual for a corporation to maintain a share ownership pattern over the long term that involves a majority of

232 See Fox, supra note 68, at 375-402 (describing advantages and drawbacks of rule requiring dividend payments). Other markets experiencing corporate governance problems are contemplating minimum dividend payments. See, e.g., Long Hui Ching, Private Firms Should Also Practise Good Governance, New Straits Times (Malaysia), June 7, 1999, 1999 WL 7466714 (reporting suggestion that Malaysian government study possibility of adopting minimum dividend payments).

233 See Fox, supra note 68, at 375-402 (explaining that minimum dividend payments may encourage shareholders to see shares as long-term investment opportunities).

shares owned by insiders and a minority owned by outsiders who trade their shares publicly. Our understanding of the mechanisms that constrain management to act in relatively share-value-maximizing ways—one share, one vote, the hostile takeover threat, share price-based management compensation schemes, board elections, shareholder approval of certain interested and extraordinary transactions, ex post court review, the managerial labor market, and other reputational incentives—is built primarily against the U.S. backdrop because the typical American public corporation forms the paradigm for theorizing.

We suggest that looking at Russia introduces an analytic focus not immediately obvious from studying such long-established systems. Among other things, we see concretely how initial conditions matter for subsequent corporate governance development. The Russian experience suggests two salient initial conditions, uneconomic firm boundaries and competing groups of insider owners, that offer avenues for further research. At a minimum, the bargaining failures that followed privatization provide evidence that counsels skepticism towards the periodic claims of some scholars and activists for including "stakeholders"—such as labor, the local community, and the local government itself—in corporate governance. The Russian experience reminds us, also quite starkly, of the tradeoff between the agency costs of management in a publicly held corporation and the disadvantages of lack of access to public equity finance. This tradeoff appears in the leveraged buyouts of the late 1980s and the "going private" trend of the early 1970s: Firms involved in both movements have tended to go public again at some later point.

More generally, the Russian experience suggests that we rethink how close corporations operate. While there is a well-developed jurisprudence of close corporations in the United States, there is only a modest literature on the economics of such legal relations. Governance of the close corporation traditionally has been viewed by lawyer-economists as a contracting problem among well-informed, well-represented, and motivated individuals in which the best policy advice that can be given is to have the law not obstruct the deals these individuals reach with each other.

The bargaining failures that followed privatization in Russia could shed light on our own system by focusing attention on the understudied area of losses from fragmented ownership in close corporations and other special corporate governance arrangements such as those associated with start-up companies backed by venture capital. When competing blocks of insiders exercise their rights so that each blocks the others, corporate assets may be wasted in a "tragedy of the

anticommons."[234] If competing blocks of insiders each have incentives to veto share value-maximizing decisions, or if the costs of aggregating and negotiating insider interests to reach such decisions are sufficiently high, then corporate assets may be wasted in low value uses. In short, the Russian experience counters recent theoretical and empirical research that argues that control by multiple large shareholders may improve firm performance.[235]

The Russian experience of corporate governance is unique: Nowhere else in the world offers such ample and creative corporate governance pathologies, and nowhere else do firms have such strange boundaries and competing insiders so much control. But the lessons that Russia teaches are not parochial at all. Russian enterprise fiascoes improve our basic understanding of how corporate governance works.

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[234] See Heller, supra note 44, at 622-26 (describing such tragedy in allocation of property rights in post-Communist Russia).

[235] See Armando Gomes & Walter Novaes, Multiple Large Shareholders in Corporate Governance (1999) (draft), available at <http://finance.wharton.upenn.edu/~gomes/MLS.pdf> (arguing that maximally efficient corporate structure consists of multiple large controlling shareholders together with some noncontrolling shareholders); David Kang, The Internal Control of Organizations: How Large-Block Ownership by Insiders Leads to Increased Firm Performance (1998) (unpublished manuscript on file with authors) (abstract available at <http://papers.ssrn.com/paper.taf?ABSTRACT_ID=10576>) (presenting evidence for superior performance of insider-owned firms in textile industry).