



NATIONAL RESEARCH UNIVERSITY
HIGHER SCHOOL OF ECONOMICS

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CORPORATE GOVERNANCE LEGAL ISSUES

BASIC RESEARCH PROGRAM

WORKING PAPERS

SERIES: LAW

WP BRP 58/LAW/2015

CORPORATE GOVERNANCE LEGAL ISSUES²

This paper aims to add to the literature on the connection between corporate governance and corporate law development. “Corporate governance” came into vogue in the 1970s in the United States. Corporate governance had become the subject of debate worldwide by scholars, regulators, investors etc. This paper considers the nature and extent of corporate law contribution to the development of corporate governance and vice versa.

In the last years, Russia and most continental countries (Germany, France, Italy) have enacted significant corporate law reforms. In Europe these reforms aim to strengthen the mechanisms of internal governance, empower shareholders, enhance disclosure requirements, and toughen public enforcement, which are the most effective tools for countering abuses by dominant shareholders.

It is very much discussed among legal professionals in Russia that now we have the urgent need for the comprehensive review and modernization of corporate law and governance. However, the last two years Russian Civil Code and Federal Law “On Joint Stock Companies” were changed deeply. Under the new Civil Code, all legal entities (both commercial and non-commercial) are divided into corporate and unitary entities.

JEL Classification: K29

Keywords: Russian corporate law, soft corporate law, corporate governance.

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² This study (research grant No №14-01-0151) was supported by The National Research University Higher School of Economics’ Academic Fund Program in 2014/2015

This Working Paper is an output of a research project implemented at the National Research University Higher School of Economics (HSE). Any opinions or claims contained in this Working Paper do not necessarily reflect the views of HS

Introduction.

This paper aims to add to the literature on the connection between corporate governance and corporate law development. The question is what are good rules for corporate governance.

Widespread use of the term "corporate governance" requires understanding of its original meaning, as well as establishing its value in legal science. In business practice there are cases when corporate management is used as a marketing tactic, which is not created for the true purposes of a corporate management system.

One can agree with I. S. Shitkina that "representatives of economic and legal sciences approach the definition of corporate governance on the basis of different purposes and the conceptual apparatus relevant to each branch of knowledge."³ However, since the term is not formed in the science of law, a development of common approach to its use is required.

It is suggested⁴ to change the semantic meaning of the phrase "corporate governance", the concept of which is able to transmit only English language. Corporate management has always existed in corporations, in one form or another⁵. However, the term "corporate governance" began to be used only in the mid 70-ies of the last century⁶. Rapid development of the new management concept is demonstrated by the fact that in 1978 in the United States was held a symposium on "Corporate Governance in America."⁷

By 1998, corporate governance has gained international interest, what is evidenced by the report⁸ made by the Business Sector Advisory Group on Corporate Governance for the Organization for Economic Cooperation and Development (OECD). In 1999, the OECD adopted The Principles of corporate governance on the basis of the report of the Advisory Group. Thus, corporate governance since the mid 70-ies of XX century gradually develops into a theoretical concept. It is represented by a system of views on key issues of not only corporate management, but, in general, of providing a balance between the interests of different groups of persons with an interest in the corporation.

The system of corporate governance generally supported by voluntary and statutory rules. As main voluntary rules for corporate governance the OECD Principles of Corporate Governance 2004⁹ are regarded. According to this OECD Principles corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

The Principles are intended to assist OECD and non-OECD governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance. The OECD is currently conducting a review of the Principles to ensure their continuing high quality, relevance and usefulness, taking into account recent developments in the corporate sector and capital markets. The review is scheduled for release in September 2015.

³Corporate law: textbook / E.G. Afanasieva, V.Y. Bakshinskas, E.P. Gubin and others.; editor I.S. Shitkina. 2nd ed., M.: KNORUS, 2015// SPS Consultant plus

⁴Grebennikov V. G., Lvov D. S., Erzikyan B. A. Tendencies and problems of development of corporate firms in Russia. Preprint. M.: TSEMI, 2000, p. 23.

⁵Historically corporate forms of business appeared more than 300 years ago (if counted from the end of 17th century, though the legal framework started to develop only at the end of 19th century)

⁶Brian R. Cheffins. The History of Corporate Governance// available:http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1975404

⁷Brian R. Cheffins. The History of Corporate Governance// The Oxford Handbook of Corporate Governance/ ed. by Mike Wright, Donald S. Siegel, Kevin Keasey, Igor Filatotchev. Oxford University Press, 2013, p.49.

⁸<http://www.oecd.org/daf/ca/corporategovernanceprinciples/oecdsecretarygeneralannounceslaunchofahigh-levelbusinessgroupinitiativetopromotebetterboardroompractices.htm>

⁹<http://www.oecd.org/daf/ca/corporategovernanceprinciples/31557724.pdf>

At the same time would be a fairer statement, that corporate governance is concerned with the means by which the balance of power within the corporation is negotiated, through mechanisms such as law, regulatory rules, soft law guidance and understandings of good practice¹⁰.

The notion of corporate governance: legal aspects

The term "corporate governance" in Russian legal literature is used in different meanings.

An investigation of the literature indicates that commercial corporations' general purpose of mechanism of corporate governance is effective management, and corporate governance mechanism is the process of influencing the behavior of participants of corporate relations. The process is aimed at the organization of the corporation activities and the achievement of other objectives¹¹. E.A. Sukhanov believes that the system of corporate governance is the system and competence of corporate bodies created under the law as legal persons of civil law¹².

In judicial practice, there are cases in which claimants are trying to protect their right to corporate governance¹³. Also, corporate governance is viewed as legal procedures providing the adoption of economic and organizational decisions¹⁴, or the decision on early termination of the agreement on transfer of powers of the executive body of joint-stock company and the provision of management services, is considered as a change in the system of corporate management¹⁵.

Indeed corporate governance is seen as a mechanism of a corporation's control, but is not limited to it. As a result, the system of corporate governance in the legal sense, represents not only a legal consolidation of corporate procedures, the system of governing bodies, competence strengthening and its distribution, but also the rules that set the whole system of rights and responsibilities and how they are exercised not only by the participants of the corporation, but also by a large number of stakeholders (holders of depository shares, bondholders, etc.). It is also necessary to take into account that persons performing certain functions in the corporation while executing corporate activities (the registrar, auditor, notary) may create some risks in the system of corporate management (judicial practice has already identified the risks associated with the activities of the registrar).

A national corporate law (including Russian law) should take into account types of corporate governance and ownership structure. In general definitions of corporate governance tend to cover the system regulating relationships among all parties (shareholders, board of directors, management and stakeholders) with interests in a business organization. But Russian corporate governance discourse focuses almost exclusively on issues of a management of corporations. So not only legal framework of governance structure does matter, but all rules concerned an interest protection in a corporation. Russian corporate governance model almost does not recognize stakeholders in corporate structure. Only recently the law introduces to the Securities Market Law new Articles 17.1 (Early Redemption of Bonds) and 17.2 (Acquisition of Bonds by the Issuer) and a new section 6.1 (Representative of Bondholders. General Meeting of Bondholders), together targeting the development of a mechanism for the protection of rights of the holders of bonds issued by Russian issuers. But the question of how these stakeholders can be included in the system of corporate governance is still open.

¹⁰ L.E. Talbot. Critical Corporate Governance and the Demise of the Ultra Vires Doctrine// *Common Law World Review*, 2009, № 38, p. 170.

¹¹ Corporate relationships: complex issues of theoretical study and legal regulation: monograph / A. N. Besedin, E. N. Efimenko, E. A. Kozina and others; edited by E. D. Tiagay. M.: Norma, Infra-M, 2014// SPS Consultant Plus

¹² Sukhanov E. A. Comparative corporate law. M.: Statut, 2014// SPS Consultant Plus

¹³ E.g. see: Decision of High Arbitration Court of Russia dd 23.04.2013 N BAC-4437/13 case N A40-111738/11-34-1011// SPS Consultant Plus

¹⁴ Decision of Constitutional Court of Russia dd 18.01.2011 N 8-O-II «Complaint of joint-stock company "Oil Company "Rosneft" on violation of constitutional rights and freedoms by para 1 point 1 Art 91 of Federal Law "About joint-stock companies"// SPS Consultant Plus

¹⁵ Decision of Presidium of High Arbitration Court of Russia dd 09.03.2011 N 8905/10 case N A40-93885/08-112-491// SPS Consultant Plus

Corporate governance in continental Europe (including Russia) traditionally differs from that in the common law countries, such as United States for example, in two important ways: first, most European companies have controlling shareholders, while most American corporations are widely held; second, the regulations on self-dealing have traditionally been stricter in the United States. Some scholars consider the corporate governance as an industry¹⁶. In the United States, for example, the corporate governance industry market leader Institutional Shareholder Services (ISS) may control a third or more of the shareholder votes¹⁷. According to a recent interview reported in the Washington Post, John M. Connolly, president and chief executive of ISS, acknowledges that 15%-20% of ISS clients use a service that automatically votes according to ISS recommendations, although clients can override it.

Recent corporate law development

The current regulatory framework in Russia has a tendency to develop the corporate legislation in several directions at the same time. This explains the formation of different approaches to the definition of corporate law. On the one hand, it is assumed that corporate law creates legal conditions for the activities of corporations. To do this legally enshrined the concept of the Corporation, in this context, corporate law is seen as a corporations law. On the other hand, effective corporate governance, as one of the elements of investment attractiveness, first of all, public business corporations, generating additional profits of the organization, shall be considered as a kind of economic "engine" of development of corporate law. In that view of legal support of corporate governance becomes a central part of corporate law. The second direction consists, as already pointed out, under the influence of demand on the development of regulatory provisions ensuring corporate governance, particularly concerning the activities of public corporations.

In the last years, Russia and most continental countries (Germany, France, Italy) have enacted significant corporate law reforms. In Europe these reforms aim to strengthen the mechanisms of corporate governance, empower shareholders, to enhance disclosure requirements.

United States have a well-developed legal framework for corporate governance, which has been further improved by the post-scandal reforms. However, the fundamental differences in ownership structure between Europe and the United States mean that laws whose focus is on managerial opportunism may not be an appropriate way to prevent self-dealing by controlling shareholders. In view of its recent evolution, corporate governance law in Europe is often described as being in a state of permanent reform, as well as Russian corporate law.

In Russia corporate law reform is combined with deep Russian Civil Code changes. The most significant revisions affect the regulations on legal entities. The modern forms of legal entities in Russia were formed at the end of the 20th century, during the period of the formation of market economy. The main aim of the legislation in the economic field in that period was ensuring the market development of Russia. This required:

- the 'satiation' of the market with entities exercising business activities;
- the creation of legal conditions for the 'availability' of business;
- the creation of the market infrastructure: above all, the system of non-commercial organizations.

In the modern period many factors have appeared that anyway affect the situation of the system of the legal entities. These concern the following tasks that Russia faces:

- the modernization of the Civil Code in the sense of its system renovation, the creation of rules that correspond the most with the current development of Russia;
- antirecessionary measures;

¹⁶ Paul Rose. The Corporate Governance Industry// ssrn-id902900.pdf

¹⁷ Id

- the creation of the International Financial Center in Moscow;
- innovational development.

The most important changes are:

- legal entities are already classed as "for-profit" or "not-for-profit"; also classed according to their organizational structure, as either "corporate organizations (corporations)" and "unitary organizations". Corporate entities (or corporations) are legal entities in which the participants hold corporate rights: participation/membership rights and the right to set up their supreme management body (the Meeting of Participants in commercial corporations);
- the establishment of differing legal regimes for public and non-public commercial corporations. A public company is one whose shares and securities convertible into shares are publicly offered or publicly traded under the terms of the law on securities;
- establishing certain rights for the members of a board of directors (or similar governing body) of a public or nonpublic corporation, with the goal to improve corporate governance. These include the right to receive information about the business, review accounting and other internal documentation, challenge certain transactions that may be harmful to the company, and initiate damage claims on behalf of the company against officers, executives, or controlling persons whose actions have caused harm;
- the provision of the authority of the sole executive body to several persons acting jointly, or the formation of a number of sole executive bodies who may act independently of each other – the so-called “two-signature rule”. At the same time, it is also possible to appoint a natural or legal person as the sole executive body;
- liability issues: under new article 53¹ of the Civil Code of the Russian Federation, a “controlling person” of a legal entity may be held directly liable for losses that the entity suffers because of his or her “fault”.

The setting of differentiated legal conditions for the activities of public and non-public companies has the aim of increasing the flexibility of the legislation on commercial entities, and the reduction of costs for non-public companies, to introduce differentiated legal regimes for listed and for the all remaining companies. It is offered to provide non-listed (non-public) companies with the possibility of more flexible regime of the contractual allocation of controlling rights that by the decision of the shareholders might allow: the possibility of the reallocation of controlling rights without complying with the information disclosure procedures; possibility for shareholders to agree on ‘supermajority’ provisions for the adoption of certain decisions; more freedom in the allocation of the authorities of governing bodies and differing procedure for the election of the members of the board of directors, etc. The idea of the differentiated approach to companies has become ripe long ago; the question is how to find again the balance of interests and not to move the costs of companies on the shoulders of their counterparties.

As it was mentioned above, the crucial word in the research is the word ‘system’. The main problem of forming the modern Russian legislation on legal entities is the situational appearance of the new elements of the system that, without any doubts, was based on a specific practical need. The system approach to the reform of the legislation on legal entities will allow creating the flexible legal entities, thus Russian law will ensure:

- The appearance of new business forms should contribute to the development of the system of legal entities in general, and to the co-ordination with the current legal order.
- For the development of the system of legal entities in general, the most effective way is the definition of flexible rules within the existing forms of legal entities for non-public legal entities
- The search of and setting in the legislation of the least economically expensive business forms should be balanced by the protection of the interests of all market participants, and by the impossibility of unjustified ‘transfer’ of risks from one parties to others.

Also it has to be mentioned that the development of the concept of corporate governance in relation to the public (listed) corporations had a significant influence on the formation of rules

of conduct for all commercial corporations in all countries, that is, the formation of the modern corporate legislation in general.

In the modern period the development of Russian corporate law goes in several directions simultaneously. This explains the formation of the different approaches to the definition of corporate law. On the one hand, it is assumed that the legal basis for the activities of corporations is established by the means of corporate law, in order to ensure that the term of a corporation is enshrined in the law. In this regard, corporate law is considered as a right of corporations. On the other hand, effective corporate management, as one of the elements of the investment attractiveness of primarily commercial public corporations, bringing additional profit to the organization, is considered as a kind of economic "engine" of development of corporate law. In that view the legal framework of corporate governance has become a central part of corporate law. The second direction is formed, as already noted, under the influence of the demand for the development of legal regulations to ensure good corporate governance, primarily related to the activities of public corporations.

Conclusion.

In conclusion, it is suggested that:

- ✓ the development of the market structure of the Russian economy has switched to the next stage of its development. This forward movement brings up new questions for the legislation, including the legislation on legal entities. Current Russian corporate law reform begins to move towards the creation of a comparable national corporate governance regime. Russian corporate law intends to permit the maximum amount of freedom and flexibility in organizing and directing the non-public corporations, to protect through regulation where necessary, the interests of all persons involved with corporation, including shareholders, directors, managers and stakeholders;
- ✓ the corporate governance regime has two core regulatory problems: between the board and the senior officers; between dominant shareholders and minority shareholders;
- ✓ corporate law allows providing entitlements to control rights independently of corporate ownership. The law states the norms on the distribution of powers between the corporate controller and non-controlling owners. Corporate governance system and corporate law have the same goal – to assure the balance of the interests in a corporation. Three functional areas of corporate law can be provided in corporate governance: conflict of interest in a corporation; distribution of power; corporate control transactions. However, it is one thing to say that corporate law works only as far as the empowerment of non-controlling shareholders is concerned;
- ✓ the reform effort in continental Europe needs to continue if it is to address in an effective manner the basic problems of corporate governance that are posed by the power of dominant shareholders;
- ✓ legal understanding of corporate governance in Russian legal literature in the modern period does not fully take into account the whole range of interests to be protected in the field of corporate management;
- ✓ legal framework for corporate governance is not only a legal consolidation of corporate procedures, the system of governing bodies, their competence and the system's distribution, but also the rules that set the whole system of rights and responsibilities and how they are exercised not only by the participants of corporations, but also by a large range of stakeholders (holders of depositary shares, bondholders, etc.);
- ✓ modern Russian corporate law is developing towards the differentiation of legal regime of public and non-public commercial corporations' activities. This

approach creates the legal conditions for a balanced approach and the application of a mandatory and optional strategy in the regulation; management structure of Russian companies has been gradually transforming and there are reasons to be fully guided by best corporate governance practice in relation to public companies;

- ✓ soft (non-state) regulation is an integral part of legal support of corporate governance; in the whole the question of evaluation of mandatory and recommended rules of behavior is relevant, following the recommendations has substantially increased the regulatory burden on corporations, in particular in the securities market;
- ✓ widespread belief about voluntary application of the rules which have a recommended nature does not allow to consider fully features of the application of soft corporate law. Voluntarily placed oneself under the rules established by non-state participants, corporations are required to follow these rules. In case of violation of this duty they will face adverse consequences associated with the loss of a place in a particular market;
- ✓ in the modern period, corporate law consists of the legal standards and regulations adopted by the competent authorities, as well as of soft legal rules that are optional in the objective sense, but necessary from the subjective point of view; thereby the increased regulatory burden is on public corporations that is required to take into account when assessing the impact of the total volume of conduct rules on businesses;
- ✓ corporate law and corporate governance mutually influence their development processes. Corporate law adopts the rules of conduct, which initially were created as recommended provisions; corporate governance system is adjusted to corporate legislation and legal practice.

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