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**Dolgopiatova T.G.** Corporate Control in the Russian Companies: Models and Mechanisms.

This paper analyses the emergence of relations of ownership, models of corporate control in Russian industrial enterprises, and the underlying mechanisms of corporate governance that are used by owners to overcome managers' opportunism on the one hand and by managers to oppose owners' control on the other. The analysis was performed with due consideration to the processes of stock concentration and redistribution between insider and outsider owners. It is based on the results of formalized and in-depth interviews with top managers of joint-stock companies conducted by the Bureau of Economic Analysis and the State University — Higher School of Economics in 1999—2001.

# 1.Introduction

This paper analyses the emergence of relations of ownership, models of corporate control in Russian industrial enterprises, and the underlying mechanisms of corporate governance that are used by owners to overcome managers' opportunism on the one hand and by managers to oppose owners' control on the other. The analysis was performed with due consideration to the processes of stock concentration and redistribution between insider and outsider owners. It is based on the results of in-depth interviews with top managers of 19 enterprises in 5 regions of Russia in 1999 and formalized interviews with top managers of over 300 joint-stock companies in 39 regions of Russia conducted under the author's guidance in summer of the same year.

The paper is based on the results of a number of projects implemented by the Bureau of Economic Analysis and the State University — Higher School of Economics in 1999—2001.

Over the last few years the situation with ownership and corporate governance in the Russian economy has been the topic of lively discussions in the Russian and international literature (see, for example, Radygin and Entov, 1999). Quite often the focus of attention is on establishing the extent of similarity between Russian corporate practices and the main models of corporate governance in other countries, on possibilities of Russia gravitating towards a particular one. A number of studies have covered the issues of quantitative analysis of ownership—performance relationship (see comprehensive overview of Western papers in Bevan, Estrin and Schaffer, 1999; also see recent Russian papers including Aukuctionek and Batyaeva, 2000; Basargin and Perevalov, 2000; Kusnectov and Murav'ev, 2001).

We believe that an adequate interpretation of quantitative data requires that closer attention should be paid to the processes within enterprises and to understanding the emerging interactions at the qualitative level. Building on the tradition of empirical studies of enterprise behaviour (Dolgopiatova, 1995; Dolgopiatova, 1996) we analyzed the trends in changes of ownership relationships and corporate governance since the 1998 crisis. In doing so the empirical data are set to reflect the practices of conventional manufacturing enterprises rather than of unique corporations of the "GAZPROM" or "NORILSK NICKEL" caliber. Normally, relationships of ownership and corporate control at such enterprises are formed outside the established stock markets.

In late 1980s state-owned enterprises de facto fell under control of their managers in coalition with the employees. Voucher privatization resulted in legalization of control within the primary structure of share capital. By the end of the mass privatization process corporate property of the Russian industrial firms had been reasonably considered as dispersed and insider—owned. Radical changes have taken place since that time. However it is too early to talk about any one type of corporate governance becoming predominant. Various models of corporate control emerge at micro-level. (We define a model as frequent and *stable* distribution of control over a joint-stock company (JSC) between its owners and managers relative to insignificant changes in the ownership structure.).

## 2. The main trends in corporate ownership structure

The quantitative data give some insight into the main trends in ownership redistribution over the last few years. First of all, the available evidence points to a *reduction in the share of insiders* (employees and managers) and to outsiders partially taking their positions. In 1995, on the basis of a sample of 277 comparable JSCs (see Table 1) insiders accounted for almost 50% of the share capital but by the end of 1998 their share dropped by almost 10 percentage points. It should be noted that the respondents did not expect any serious changes of the ownership structure in 2000. By sector differences between the average insiders stakes were significant with the biggest one registered in machine—building (39%) and the smallest — in the light industry (51%).

In 1995 insiders obviously dominated (owned over half of corporate property) 45% of the enterprises in the sample. However, in three years the share of such enterprises dropped to 29%. Reduction of the insider stake was accompanied by a significant fall in the number of shares owned by individual investors, investment funds and companies, and industrial enterprises. The share of insider property was underestimated as part of outside shareholders had become affiliated with enterprise management. The formalized survey failed to provide clear evidence of relations of affiliation and coalition between shareholders. Indirect estimates suggest that on average insiders control at least half of the share capital.

In industry, *share capital concentration was increasing* too (see Table 2, data for comparable 242 JSCs). In 1998, the total stake owned by the biggest shareholder increased almost to 28%, and by the top three shareholders — to 45%. As this took place, a significant increase in concentration was forecast for 2000. The survey demonstrated that in 1998 the biggest shareholder controlled below 10% of the share capital only in 15% of all the cases. This shareholder had a controlling block of shares in every fifth enterprise. By the Western standards corporate ownership in Russia can be viewed as a concentrated one. At the same time the disagreement between the mean and median testifies to the fact that a high concentration of part of corporate property is accompanied by a high dispersion of the other part. It should be stressed that a formalized survey helps also identify the lower limit of the corporate property concentration.

Among the sectors the food processing industry was the leader with the owner having a controlling block of shares in every third enterprise. In the machine-building sector the owner had such a stake in every fifth enterprise while in the light industry sector — only at every tenth JSC.

The combination of increasing ownership concentration and maintaining of high insider stakes is an indirect evidence *of ownership concentration in the hands of managers*. For obvious reasons there is no hard evidence to support the statement. The survey data show that contraction of the employee stake is accompanied by an insignificant growth of the managerial one. Materials of the interviews and other data demonstrate that in reality managers control significant stakes hidden as property of affiliated entities. Normally the chief executive officer (top managers) is a medium-sized or a large shareholder in such an entity thus having a say in corporate governance in the industry.

**Table 1.** Ownership structure by shareholder groups (by a sample of comparable JSCs)

| Shareholder group | Stake size (%) | | |
|---|---|---|---|
| | 1995 | 1998 | 2000 |
| Employees* | 42.0 | 31.1 | 29.8 |
| Management | 7.8 | 9.0 | 9.5 |
| Federal authorities | 5.1 | 4.6 | 4.3 |
| Regional and municipal authorities | 4.6 | 3.8 | 4.6 |
| Foreign shareholders | 1.8 | 3.7 | 3.3 |
| Russian banks | 1.6 | 1.3 | 1.2 |
| Russian investment companies. funds | 9.0 | 11.8 | 11.2 |
| Industrial enterprises | 12.0 | 13.9 | 14.9 |
| Outside individuals | 13.5 | 18.6 | 19.0 |
| Others | 2.6 | 2.2 | 2.2 |

* Many enterprises provided aggregate information on employee ownership without differentiating between employee and managerial ownership. That is why it is would be reasonable to apply the stake belonging to the employees and management of the JSCs when performing the analysis.

The main feature of the established ownership structure in the Russian industry is *the owner and the manager being the same person*. That is why the standard problem of the corporate governance theory — relations between owners and managers — should be modified. One of the owners enjoys a considerable advantage derived from his position within the management system but not from the property rights. As a result for outside owners the costs of overcoming opportunistic behaviour by managers become relatively higher. For managers the owners status opens the way to reducing the costs of defending their positions.

**Table 2.** Indicators of the degree of ownership concentration (by a sample of comparable JSCs)

| | Stake size (%) | | | | | |
|---|---|---|---|---|---|---|
| | 1995 | | 1998 | | 2000 | |
| | Mean | Median | Mean | Median | Mean | Median |
| Biggest shareholder | 26.3 | 22.0 | 27.8 | 23.0 | 28.8 | 24.2 |
| Three biggest shareholders | 40.5 | 40.0 | 45.1 | 44.5 | 46.5 | 46.3 |

## 3. Conditions of corporate ownership emergence

The following reasons underlie the above trends: path-dependency, i.e. the development processes determined by historical conditions (both pre-reform and those that came into existence in the first years of the reforms); formally and informally established rules regulating relations of ownership in the interests of the main stakeholders. Privatization procedures adopted by the coalition of the state and employees in combination with the informal institutions of the Russian economy in transition resulted in insiders coming to dominate the initially dispersed ownership structure. The final stage of the privatization processes and the subsequent ownership redistribution to a large extent were carried out under control of managers and the actor playing an increasingly important role in business — regional authorities.

Managers had a number of obvious advantages. In the course of privatization and the secondary sale of shares they used in their own interests the information they possessed about the production situation and the property rights distribution. Management also used the administrative and financial resources of the enterprises to increase their own stake. They usually establish close alliances with regional and local administrations and can manipulate the employees' opinion. After the completion of the voucher privatization managers became less dependent on employees and not always needed their support. Being owners managers could initiate reorganization processes, additional emission of shares and participate in them. To tighten their control over enterprises managers also used the form of a closed JSC.

Managers had access to financial flows and assets of enterprises and used them to acquire property and to prevent invasion by outside investors. Quite often such activities have hidden forms with application of "gray" mechanisms of funds accumulation. Thus in fact ownership concentration in the hands of insiders was carried out at the expense of the enterprise and the state (as the tax recipient) with the funds being diverted from investment.

Outsiders had only limited opportunity to participate in the privatization processes: they depended on decisions by employees and management and on the position taken by the organizers of the voucher auctions — the federal and regional governments. Banks and voucher investment funds were under statutory limitations on their stake ownership in any one company. Outsiders that were not affiliated with management used their own resources and paid additional costs to overcome administrative barriers. For outside investors the voucher privatization was a cheap way of buying small blocks of shares but the costs of acquiring a controlling block were prohibitive. However, later on the ownership redistribution made this possible.

For outsiders the costs of corporate property acquisition — both direct costs of buying, and the transaction costs — related to getting acquisition rights happened to be many times higher than those for insiders. Outside investors became actively involved in the struggle for control over an enterprise if the production was highly effective (or if they saw other benefits for their business that would offset the buying costs). In such cases they had to incur costs to overcome resistance of the incumbent management, employees, executive authorities and/or to invest in establishing coalitions with them.

## 4. Emergence of corporate control models at micro-level

Under the conditions of unequal access to ownership distribution specific features of sectors and markets and business scales affect the process of establishing corporate control. In effective sectors the benefits of ownership control bring about competition between insiders and potential outsiders providing incentives for the latter to pay additional costs of establishing corporate control over enterprises of every size. As a result control over effective enterprises is concentrated in the hands of their management or outside owners. Ownership of ineffective enterprises is concentrated in the hands of their management (the concentration costs are insignificant) or remains dispersed. The enterprise size that determines the minimum level of costs to buy the property and to establish control affects the degree of capital concentration. Irrespective of the ownership structure control over ineffective enterprises goes over to the management that derives benefits from the situation of crisis.

Drawing upon the interviews results we attempt to identify the basic models of corporate control in the Russian industrial companies. In-depth interviews cannot bring representative results but they illustrate relationship between enterprises' main characteristics of activities and models features (see Table 3).

We could identify the following models at the micro-level (see Dolgopiatova, 2001 for more detail):

1. *"Private enterprise" model" (model I),* where the functions of owners and managers are combined. Under this model the chief executive officer is the biggest owner while the other managers, rank and file employees, and executive authorities are minority shareholders with whom a balance of interests is maintained. The model could be formed in effective sectors oriented first of all towards the consumer market or narrow segments of other markets. Due to the specific management features such enterprises tend to fall within the small and medium-sized categories.

The model is characterized by internal stability and in future can be transformed into the family business. However, such enterprises might face increasing risks of poor management and — in case of the business expansion — the risks of a mismatch between the new production scales and the old management styles.

2. *"Collective managerial ownership" model (model II),* where the functions of owners and managers are also combined. In such "co-operatives of managers" a group of top managers — four to six persons — normally accumulates a controlling block of shares. As a rule none of the biggest shareholders has a controlling block of shares but the director owns a stake that is bigger than any of the team members has. The model was formed in enterprises of various sizes: it is characteristic of small and medium-sized enterprises, and to a lesser degree of large ones. The enterprises can belong to both effective and ineffective sectors (in the latter case relatively small enterprises are involved). This model is more widespread in industry than the "private enterprise" one.

**Table 3.** Emergence of corporate control models in the Russian enterprises (based on in-depth interviews)

| | Branch of industry | Number of enlisted employees at the moment of: | | Legal form | The model of privatization | Bankruptcy, reorganizations | Outside shareholders, state property | The model of corporate control |
|---|---|---|---|---|---|---|---|---|
| | | privatization | the survey | | | | | |
| 1 | Machinery building | About 4000 | 3700 | Public JSC | The third | — | Individuals —39%, legal entities — about 8% | II is emerging |
| 2 | | About 1000 | 350 | Public JSC | Leasing (buyout) | — | Minor block of share was sold to outsiders | II, likely will transform into I |
| 3 | | More then 10000 | 7150 | Public JSC | The first | — | Institutional (including foreign) investors — more then 30% in sum | IV |
| 4 | | More then 1000 | 300 | Public JSC | The first | Bankruptcy proceedings | 15 businessmen are buying the bankrupt's estate | (probably IV)** |
| 5 | | About 10000 | 3600 | Public JSC | Special conditions of privatization | Will take over by the public JSC with state ownershp | State — 44%, institutional (including foreign) investors — about 30% in sum | — |
| 6 | | About 400 | 110 | Public JSC | The second | Threat of bankruptcy | Outsider (most likely affiliated with top management) — 25% | II |

Table 3 continued

| | Branch of industry | Number of enlisted employees at the moment of: | | Legal form | The model of privatization | Bankruptcy, reorganizations | Outside shareholders, state property | The model of corporate control |
|---|---|---|---|---|---|---|---|---|
| | | privatization | the survey | | | | | |
| 7 | | More then 10000 | 4500 | Close corporation | Leasing (buyout) | — | One of the main suppliers, one of the main customers and the bank serving the company — 30% in sum | IV |
| 8 | Wood processing and furniture | About 1500 | 500 | Public JSC | The second | Bankruptcy proceedings | More then 20 businessmen are buying the bankrupt's estate | Had not been emerged |
| 9 | Construction materials | More then 700 | 370 | Public JSC | The second | — | State — 8%, There are about 10 minor outsiders too | II |
| 10 | Light | More then 1200 | 740 | Public JSC | Leasing (buyout) | — | A bank — 10%, there are minor outsiders affiliated with top management | II |
| 11 | | More then 600 | 200 | Close corporation | Leasing (buyout) | Threat of bankruptcy | There are outsiders (there are no clear data) | Has not been emerging |
| 12 | | About 800 | 200 | Close corporation | Leasing (buyout) | After external administration | The main supplier bought controlling block of shares | III (probably IV) |

Table 3 finished

| | Branch of industry | Number of enlisted employees at the moment of: | | Legal form | The model of privatization | Bankruptcy, reorganizations | Outside shareholders, state property | The model of corporate control |
|---|---|---|---|---|---|---|---|---|
| | | privatization | the survey | | | | | |
| 13 | | More then 400 | 200 | Close corporation | Leasing (buyout) | — | There are no outsiders | II |
| 14 | | 60* | 140 | Close corporation | New private business (co-operative) | Reorganized in 1992 from a co-operative | One of founders of the closed company (former manager) — about 15% | II |
| 15 | Food processing | About 500 | 450 | Public JSC | The second | After external administration | Wholesale company — 52%, supplies of raw materials — 40% in sum | III (probably IV) |
| 16 | | About 800 | 740 | Public JSC | Leasing (buyout) | — | A group of affiliated legal entities has controlling block of shares | III |
| 17 | | More then 200 | 190 | Public JSC | The second | Probably will be reorganized (take-over) | A group of affiliated individuals and legal entities owner the firm | III |
| 18 | | 600 | 600 | Public JSC | The second | — | State — 12% | I |
| 19 | Pharma-ceutics | 1250 | 1300 | Division of close corporation | The first | Reorganized from the public JSC | Private firm (wholesale and retail seller of medicines) — 79% | III |

* The data illustrate situation at the moment of changing legal form in 1992.

** *Types of corporate control just before the beginning of bankruptcy procedure see in brackets.*

The model is not free from the risk of destroying the team control structure. An important feature of the model is a deferred conflict between the owners. Disintegration of their coalition is quite possible which will result in revival of the painful and costly process of ownership redistribution. Besides, even in the short-term perspective other risks related to the functioning of the management system are obvious: difficulties with replacement of managers-owners, problems of setting up a united management team through a combined effort by the shareholders and the employees working under a contract. As far as small enterprises are concerned this model can be gradually transformed into the model of private enterprise.

3. "*Concentrated outsider ownership*" *model (model III),* where an outside owner has a controlling block of shares, while managers are employees working under contracts or owners of small stakes (3—5%). This type of control is characteristic of enterprises of every size in the effective sectors.

The model is internally stable. Changes are possible in case of the enterprise restructuring upon a decision by the outside owner. Some risks for the enterprise are rooted in the owner's motivation defined by the general interests of his business. Other risks are related to opportunistic behaviour of the management. Owners make use of widely accepted mechanisms to overcome such behaviour (see below).

For the most part the model was formed in the course of the secondary ownership redistribution. Over the last few years bankruptcy procedures have been applied to establish it.

4. *"Dispersed ownership" model (model IV),* where enterprises are in fact controlled by management. Under this model the chief executive officer (a team of managers) is normally the owner of a mid-size stake (5—10%) while the rest of the shares are partially dispersed as microstakes among insiders and outside individuals and partially in the form of small stakes belong to the state, institutional investors, and other owners. The dispersed model is formed in large and very large enterprises in ineffective sectors that are burdened with substantial social infrastructure. They often depend on government procurement orders, operate within narrow market segments, have considerable arrears in respect of creditors and employees, and use extensively barter and other non-monetary means of payment.

At first sight, the model is similar to the type of corporate management accepted by the Western economies where its efficiency is supported by a number of internal and external mechanisms: first of all, by the well-developed stock market and the transparent corporate control market. Under the Russian conditions it would be premature to talk about availability of such markets. The main features of the model are: a combination of lack of control over management, the managers' feeling of insecurity, and their inability/unwillingness to increase the stake that they own.

This model is also stable provided there are no long-term shifts in the economic situation that might change the perception of the business profitability and create a demand for the shares. As this takes place, management and regional authorities will resist any attempts to bankrupt large enterprises.

In such cases the enterprise size makes it difficult for any owner to obtain a significant stake. The unfavourable economic situation stimulates opportunistic behaviour by the managers, which might take the form of stripping the assets, using by the shareholders of certain specific techniques to exercise their property rights.The assets thus stripped are applied in a more efficient way in other sectors. For outside owners the costs of capital concentration are higher than for insiders. That is why additional incentives exist for preservation of the dispersed ownership model in the case of an enterprise having good prospects under the condition of restructuring.

The above models do not exhaust the multitude of the forms of corporate control.The processes of ownership concentration have not been completed in many enterprises. It is safe to say they are still at the stage of transition. The enterprises where the state has a controlling block of shares or is a dominant owner have been left outside the scope of the analysis.

In respect of the first three models it would be to a significant degree reasonable to argue that there is a correlation between the structures of corporate control and corporate ownership. (Of course we should take into account the stakes owned by entities affiliated with management and the fact that small and ultra-small shareholders are inevitably poorly represented in companies' executive bodies). Significant misalignment of structures of ownership and control (that is in fact in the hands of managers) is characteristic of the dispersed ownership model. The costs of opportunistic behaviour of managers are markedly lower here than in the case of the concentrated outsider ownership model while the owners incur immeasurably higher costs of maintaining control over managers.

## 5. Mechanisms of corporate governance: defense of shareholder rights?

Within market economies the mechanisms of corporate governance are aimed to secure property rights and to form adequate structures of corporate control. Normally such mechanisms are divided into internal and external ones. In the Russian transition economy the mechanisms act as owners' tools of control over the enterprise management and at the same time as top managers' tools of self-defense. In practice, other influential stakeholders — authorities of various levels, large groups of employees — are involved in the corporate control processes. They realize their own interests by forming coalitions with the main actors — shareholders and managers.

It stands to reason to review the mechanisms of corporate governance in relation to the dispersed ownership and concentrated outsider ownership models and to the cases where corporate ownership is still in the process of concentration. The above two models of manager control depend on the mechanisms of control on the part of the most influential stakeholders.

The basic *mechanism of internal control* over realization of the rights of shareholders are: setting up a Board of Directors or any other higher governing body, holding a general shareholder meeting, and putting up opposition.

Empirical data from over 270 JSCs testify (see Table 4) that representatives of management and employees dominate membership of an average Board of Directors — that was the case in almost every enterprise in the sample. Industrial enterprises were represented relatively often while the other shareholders were in minority. Insiders accounted for 57% of the seats. In total, outside owners (minus executive authorities) occupied maximum one third of the seats.

**Table 4.** Structure of the JSCs Boards of Directors

| | % of the total number | Representation coefficient | |
|---|---|---|---|
| | | Average value* | № of JSCs |
| Average number of members | 7.9 | 1.00 | 278 |
| of which representatives of: | | | |
| — employees and management | 57.4** | 1.92 | 254 |
| — federal authorities | 3.2 | 0.97 | 48 |
| — regional and municipal authorities | 5.7 | 1.75 | 44 |
| — foreign investors | 2.1 | 0.55 | 43 |
| — Russian banks | 2.1 | 2.06 | 32 |
| — investment companies, funds, etc. | 9.1 | 0.74 | 124 |
| — industrial enterprises | 15.0 | 1.47 | 117 |
| — big shareholders — individuals | 5.4 | 0.25 | 207 |

* Calculated through division of the group of shareholders in the Board of Directors by its share in the stake where it exceeded 0.1%.

** Of which 38.0% are representatives of managers, and 19.4% — of employees.

Comparison between the structure of a Board of Directors and the structure of share capital by groups of shareholders (see Table 5 for details) demonstrated that if insiders are the dominant owner (have a stake higher than 50%) they practically always retain their control. For a small number of the JSCs (3% of the sample) insiders were in minority in the Boards of Directors, which was normally accompanied by a strong representation of the federal government. In half of the cases when insiders were not officially dominating Boards of Directors their representatives controlled them. Partially this fact is evidence of the management control over the property belonging to the affiliated outside shareholders and partially it is characteristic of a dispersed ownership structure.

**Table 5** Comparison of insiders dominating corporate ownership and a Board of Directors

| Insiders' share in corporate ownership | N of JSCs | Insiders' share of seats in a Board of Directors | |
|---|---|---|---|
| | | More then 50% | Equal or less then 50% |
| — more then 50% | 81 | 27.5% | 2.6% |
| — equal or less then 50% | 188 | 29.0% | 40.9% |
| N of JSCs | 269 | 152 | 117 |

To demonstrate comparative advantages of having a shareholder group represented in the Board of Directives we shall make use of the representation coefficient defined as percentage of the Board membership per 1% of the share capital owned by each of the group. The coefficient was introduced in (Basargin, Perevalov, 2000, p. 124). Columns two and three in Table 4 demonstrate that in some enterprises representatives of regional and local authorities, banks, and to a lesser degree industrial enterprises make their positions stronger alongside the insiders. Individuals, investment funds and companies are loosing ground.

According to the information provided by some JSCs representatives of regional and local authorities are often represented in Boards of Directors without being shareholders. In this way the executive authorities aggravate the practices of administrative regulation, informal relations, and hidden contracts by using methods of direct corporate control over activities of joint stock companies.

Shareholder meetings can be manipulated by the management or by the biggest shareholder. If the model of control has not been established yet or takes the shape of the dispersed ownership model the probability of emergence of opposition is high. In developed economies opposition quite often is a form of an information signal. Under the Russian conditions shareholders choose to face a conflict and to pay opposition costs only when chances to win and, consequently, to change management and/or to redistribute ownership are very high. The driving force behind opposition is not the stock market and the distribution of the relevant information but an internal mechanism of conflict, in which the employees are involved and administrative, political, and criminal levers are applied. Additional mechanisms of ownership redistribution — emission of shares and reorganization are used to consolidate the victory.

The above means that the Board of Directors is the vehicle for conveying ideas of the company executive bodies. In most of the cases it is "taken over" by managers who use in their own interests the property that belongs to them, to the affiliated entities, and the dispersed employee property. As an owner having strong ties with the authorities and with employees management has advantages in putting up opposition.

Faced with difficulties in applying the main internal mechanisms big outside owners have to form coalitions with management to exercise their rights to the detriment of the shareholders' interests. A popular form of coalition is the owner and the management deriving benefits from control over the enterprise financial flows. Essentially this means paying "gray dividends" to big shareholders (for more information on paying dividends to big shareholders see (Dolgopiatova, ed. 1998, pp. 86—87) or colluding to strip the enterprise of its assets and to channel them to another business.

Outside owners control the Board of Directors if the enterprise develops the model of concentrated outsider ownership. When this happens they also apply other internal mechanisms to overcome the managers' opportunistic behaviour. They resort to replacing top management with their own representatives and establish an additional control over the management's activities. Replacement of management does not remove altogether the problem of opportunistic behaviour but makes it possible to drastically reduce its scales. However, there are chances that the replacement will result in having a new leadership having no skills of production management and in cutting off the established informal business connections. Excessive control over managers' day-to-day activities brings about additional costs of delegation of powers and duplication of some of the functions of the company executive bodies. Usually this method is applied on a temporary basis.

Position taken by the employees becomes a specific internal mechanism at large industrial enterprises as they are interested in preservation of jobs, wage levels, and social guarantees — the areas outside the interests of managers and shareholders. Employees (many examples exist) put a restraint on owners' and managers' activities and even obstruct execution of court's rulings. The threat of an open conflict makes managers and owners establish and maintain friendly relations with employees in an attempt to win them round. This mechanism generates additional costs related to renunciation of the plans of workforce and social benefits reductions. In certain cases owners have to confirm their intentions by a formal contract.

*External mechanisms of corporate control* in developed economies include: bank control underpinned by the debt market, stock market control and the derivative corporate control market. In an economy in transition the above mechanisms function subject to certain limitations or in a specific way. The open stock market is accessible to a narrow range of the largest Russian enterprises. For the most part corporate control comes into being through unregistered operations outside the established financial markets with the use of "non-transparent" schemes of ownership redistribution. Given the widespread mutual debts in the industry the debt market cannot perform its control functions. Bankruptcy procedures are applied selectively and reflect the intentions to redistribute ownership. Bank control takes the form of tightening lending conditions including those related to interest rates on the one hand and becomes weaker under the pressure of the regional or local authorities on the other hand.

To consolidate their positions biggest owners (both internal and external) use excessive concentration (up to 75% and above) of the share capital which blocks the ways to legal participation of the other owners in the corporate control.

The influence of regional and local authorities promoting their own interests (social stability, low registered unemployment rates, viability of housing and social infrastructures, growing tax revenues) presents a specific external mechanism of corporate control. They use formal mechanisms of exerting influence on enterprise development (participation in ownership schemes and in Boards of Directors, adoption of regional legislation), and informal ones (direct instructions, informal agreements, etc.). Regional and local authorities become an especially strong external power in case of the dispersed ownership model characteristic of large enterprises.

Establishing friendly relations with authorities of various levels is one of the most important mechanisms of exercising ownership rights by shareholders and of control over management under the concentrated outsider ownership model. The costs incurred by outside owners to form a coalition with authorities are normally higher than those incurred by the previous management. This is especially true for a new business trying to gain a footing in a new territory. Such costs include payments to get access to the administrative market plus current costs of maintaining the established relations, social support costs, costs of retaining employees, costs of implementing regional contracts with deferred or non-monetary payments.

## 6. Mechanisms of corporate governance: management's self-defense

Let us consider now the mechanisms used by managers to resist control by owners. Obviously, managers-owners apply all the mechanisms at their disposal discussed above. Mechanisms of self-defense of the "entrenched" management include taking control over the Board of Directors and organizing opposition to the other owners with the view of pushing them out of the enterprise. Managers also establish close ties with the authorities, manipulate the employees position trying to win their support in case attempts are made to replace the enterprise chief executives. When making use of these mechanisms of self-defense managers actively promote ownership concentration.

At the same time managers apply methods based on the access to the enterprise controls they enjoy:

- Taking control over ownership redistribution. Limiting access to the process for outside owners through regulation of stock sales, keeping shareholder registers, setting up trusts, using closed JSCs. Well known the practice of registering private limited companies that consolidate employees' shares for joint voting.
- Exercising control over the enterprise financial flows and using them to build up property at their disposal, to maintain relations with authorities and employees, to establish alliances with certain owners. This mechanism is closely associated with the practices involving non-monetary settlements, various tax evasion schemes, and transfer prices. Complexity of such schemes produces an illusion that current enterprise management is indispensable.
- Exploiting the information asymmetry that includes having recourse to "non-transparency" of business transactions, concealment and distortion of information, and even releasing distorted data on company's assets. In a transition economy asymmetry of information increases significantly as clear market signals are lacking, information is subject to distortion and is not disclosed in violation of the law.
- Maintaining business connections, networks and positive image. Business connections and networks make a normal mechanism of relations within a market economy. Under the Russian conditions possibilities are high that they will be personified as business ties are regulated first of all through informal and hidden contracts. Russian economy follows unwritten rules (see for details Ledeneva, 2001). On the one hand, the hypertrophy of personified connections is the legacy of the past: it was characteristic of the Soviet economy and persisted in the first years of the reforms. On the other hand the system of connections today persists thanks to non-monetary settlements and tax evasion schemes.

The above methods of self-defense are used under the concentrated outside ownership and dispersed ownership models. However, in the latter case managers have much wider opportunity of evading owners' control as they take advantage of certain specific features of large enterprises where the multitude of transactions with partners is hard to control.

## 7. Conclusions

Various models of corporate control emerge in the Russian industry. All other things being equal, this process is affected by quality of management, individual qualifications of top managers, interests of other stakeholders as much as it is by such objective parameters as enterprise size and sector. All the models of corporate control have common characteristics: they are aimed to guard business against new investors and to maintain "non-transparent" relations of ownership. The insider models are most representatives in this respect. Making use of enterprise assets by the managers to buy it out in their own interests is typical of the two models with concentrated managers' ownership (i.e. the private enterprise model and the collective managerial ownership model). The dispersed ownership model of control makes it possible to drain assets in order to invest them into other types of business or to consume.

The mechanisms of corporate control fail to provide an effective protection of the outside owners' rights thus making them incur additional costs of excessive concentration of share capital, establishing relations with important stakeholders, and excessive monitoring of managers' day-to-day activities. The mechanisms of managers' self-defense that ensure their status as owners make it possible to realize successfully their opportunistic behaviour. The unstable situation in the Russian industry and the established institutional environment contributed to strengthening of the managers' control in many enterprises. Clearly the way the corporate governance mechanisms function has been pre-determined by the ownership structure emerged in the course of the mass privatization.

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# Contents

**Dolgopiatova T.G.** Corporate Control in the Russian Companies:
D 70 Models and Mechanisms = Долгопятова Т.Г. Модели и механизмы корпоративного контроля на российских предприятиях: Препринт WP1/2002/05. — М.: ГУ ВШЭ, 2002. — 26 с.

В работе анализируются процессы становления отношений собственности и моделей корпоративного контроля на российских промышленных предприятиях, а также поддерживающие их механизмы корпоративного управления. Эти механизмы используются собственниками для предотвращения оппортунистического поведения менеджеров предприятий, а последними — в целях противодействия контролю со стороны собственников. Анализ выполнен с учетом процессов концентрации акционерного капитала и его перераспределения между внешними и внутренними собственниками. Использованы материалы формализованных и глубоких интервью с руководителями акционерных обществ, проведенных в 1999—2001 гг. в ряде проектов Бюро экономического анализа и Государственного университета — Высшей школы экономики.

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# NOTES