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Ongoing Issues in Russian Corporate Governance

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Ongoing Issues in Russian Corporate Governance

MERRITT B. FOX*

This Article concerns Russian corporate governance today. It starts by arguing that there are fundamental differences between the policy questions raised by SOEs and those raised by non-SOEs and that the analysis needs to separate out these two kinds of corporations. The Article then goes on to consider several ongoing issues relating to non-SOEs. To start, it suggests the need for a set of rules, backed by reliably applied stiff sanctions, requiring disclosure of all situations where a person, by himself or as a member of a coordinated group, is the beneficial owner of sufficient shares to be able to influence corporate action. Second, the Article argues for consideration of a minimum dividend requirement, suggesting that the resulting social benefits may well exceed the additional transaction costs involved. Third, the Article advocates creating a meaningful system of civil liability which, through its deterrence value, could, at least in the longer run, improve disclosure by Russian corporations. Finally, the Article argues for the share value maximization model regarding the question of non-shareholder stakeholders and their interests as especially appropriate for Russia.

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INTRODUCTION

Fourteen years ago, my colleague Michael Heller and I published *Corporate Governance Lessons from Russian Enterprise Fiascoes*,¹ an article whose title reflected the then uniformly bleak state of affairs with regard to Russian corporate governance. Since that time, surveys suggest that substantial progress has been made, at least in terms of law on the books, but that much remains to be done.² The range of issues that remain is much too broad to discuss them all seriously in an article such as this. Instead, I will make brief remarks about five particularly important topics: whether state controlled enterprises (SOEs) should be subject to the same governance regime as purely private enterprises; disclosure of beneficial ownership; divi-

1. Merritt B. Fox & Michael A. Heller, *Corporate Governance Lessons from Russian Enterprise Fiascoes*, 75 N.Y.U. L. REV. 1720 (2000).

2. By the middle of the last decade, there were rays of hope. See, e.g., THE NATIONAL COUNCIL ON CORPORATE GOVERNANCE, *CORPORATE GOVERNANCE AND ECONOMIC GROWTH IN RUSSIA* (2004) [hereinafter 2004 Survey]; Sergei A. Porshakov, *Recent Corporate Governance Trends in Major Russian Companies*, in 1 *CORPORATE GOVERNANCE IN RUSSIA AND TRANSITIONAL ECONOMIES* (2005). Subsequent assessments suggest further progress, but still a situation far short of ideal. See Olga Lazareva et al., *A Survey of Corporate Governance in Russia* (CEFIR/NES, Working Paper No. 103, 2007), available at http://pdc.ceu.hu/archive/00003405/01/survey_of_corporate_governance.pdf; John Bowker, *Russia Held Back by Corporate Governance Weakness: Fund*, REUTERS (Sept. 10, 2010), <http://www.reuters.com/article/2010/09/10/us-russia-investors-idUSTRE6893BO20100910>; Rajesh Pathak, *Corporate Governance in Russia: A Report* (Mar. 10, 2011) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1782684.

dends; enforcement of financial and business disclosure requirements; and the role of non-shareholder stakeholders and their interests in corporate governance.

These topics take on their importance because they typify the problems that many former socialist economies continue to face twenty years into their transition to being market economies. The first topic—whether SOEs should be subject to the same governance regime as purely private enterprises—goes to the basic terms of the discussion. Because SOEs still play such a large role in these transition economies, it is tempting to develop one overarching approach to corporate governance that covers both SOEs and non-SOEs. I argue that this is a fundamental mistake that distorts what is best with respect to non-SOE firms. With the agenda properly set, I go on to discuss the other four topics as they apply to non-SOEs. These topics go to the heart of the legal structure in which corporate decisions are made and deserve special consideration in light of the particular institutional milieu prevailing in transition economies.

I. SEPARATING THE CORPORATE GOVERNANCE DEBATE CONCERNING SOES AND NON-SOES

About one-third of Russia's largest corporations are controlled by the national government through direct or indirect share ownership.³ Much of the discussion concerning Russian corporate governance concerns these firms.⁴ I suggest here that the corporate governance issues that these SOEs present are sufficiently different from those presented by other Russian firms that an analysis that does not separate out these two kinds of corporations seriously distorts the discussion of what is best with respect to the non-SOE firms.⁵ Clarity with respect to what is best for non-SOE firms is im-

3. STANDARD & POOR'S, TRANSPARENCY AND DISCLOSURE BY RUSSIAN COMPANIES 2010 13 tbl. 5 (2010), available at http://www.russianipo.com/publications/5_S&P%20report%20on%20transparency_ENG.pdf.

4. For an excellent overview of the government's role in operation of Russian SOEs, the extent and pattern of government ownership and trends over time, and the primary governance issues associated with Russian SOEs, see Carsten Sprenger, *State Ownership in the Russian Economy: Its Magnitude, Structure, and Governance Problems* (Int'l C. of Econ. and Fin., Working Paper, 2010), available for download at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1311223.

5. For a scholar who believes that the substantial role of the government in many Russian corporations calls for a different model for all Russian firms, see Lazareva et al., *supra* note 2.

portant. Non-SOEs represent 60% of the capitalization of Russian stock markets.⁶ And they are likely to be the predominant origin of innovation that will drive Russian economic growth as oil, gas, and mineral extraction inevitably run their course as the main sources of such growth.

A. The Meaning of Corporate Governance

Corporate governance concerns the design of decision-making structures relating to a firm's choice of new investment projects and the operation of its existing ones. The appropriate focus here is on the factors that influence the decisions at the top of a corporation. Internal controls beyond those applied to the directors and top managers, important as they are for a well-functioning corporation, do not involve issues of corporate governance. Rather, they are part of the tools of good administration needed by any organization, whether a government ministry, a for-profit corporation, or a non-profit organization. Such internal controls simply assure that the organization as a whole behaves in accordance with the decisions and goals of top management.

Normatively assessing a firm's corporate governance involves two considerations. One is the effectiveness of the firm as a creator of value: its capacity to give back to society resources of greater value than what it takes. The other is the fairness with which the firm treats those who have to deal with it on a longer-term basis, including non-control equity shareholders.

B. The Importance of the Reasons for Government Control of SOEs

In assessing the effectiveness of the corporate governance of the large Russian SOEs as creators of value, it is important to focus on why the government possesses control amounts of the shares of these firms in the first place. For the typical Russian SOE, the government's shareholdings do not reflect an inability of the SOE to mobilize new capital in some other way besides a sale of shares to the state. This is very different than, for example, the situation with the United States government's controlling interests in General Motors or AIG, where the government was the financier of last resort and obtained temporary control simply as an incident of providing essential financing. The Russian government retained, or obtained, control of the SOEs because, in its view, such control served important state in-

6. Sprenger, *supra* note 4, at 10.

terests. The government has suggested that the aims in furtherance of which this control is being held include national defense, regulation of natural monopolies, provision of adequate supplies of goods despite regulated prices, the protection of cultural values, the provision of infrastructure that provides externalities, and the coordination of economic development.⁷ The trend has been toward SOEs of larger size in strategic sectors and SOEs deemed important for industrial development, and away from smaller firms and other sectors.⁸

If there is a legitimate purpose to the state possession of control for its own sake, it reflects the view that government control can be used in a way that increases such a firm's net contribution to society relative to what would be expected if the shares were in private hands. This is a very important observation. It means that corporate governance has not failed just because the firm does different things than those done by a well-functioning firm whose shareholders are all private. Indeed, inducing this difference in firm behavior is the whole point of government control.

The belief that government control of a firm is needed to foster its net value contribution to society implicitly rests on a theory of market failure of some kind that cannot be effectively corrected by regulation. In other words, the belief rests on a perception that the firm pays less for the resources that it uses than at the margin is the value of these resources to society and/or that the firm is paid less for its output than at the margin is the output's value to society. These miscues in pricing would lead to behavior, if the firm were entirely in private hands, that would deviate from what would provide the greatest net contribution to society. And this deviation is thought to be more effectively and efficiently correctable through direct government control than through regulation, taxes, and subsidies.⁹

C. The Important Public Policy Issues Raised by SOEs

Viewed from this perspective, SOEs raise two important is-

7. *Id.* at 16.

8. *Id.* at 15.

9. See *infra* Part V for a discussion of how corporations that maximize share value also maximize social welfare if they are operating in competitive markets and if potential externalities from their activities, such as environmental damage, are properly regulated. Governmental control that is justified on the belief that a share value maximizing corporation will not in fact maximize social welfare implies that one or both of these conditions is not satisfied and that government control is a better way to correct for the resulting problems than seeking to promote competition or control the externalities through regulation or taxes.

sues of public policy. First, with respect to any given SOE, there is a question of whether the beliefs set out above are correct. Is it as a practical matter possible for government control of the SOE to be used to operate it in a way that would contribute more to society than the way that it would be run if owned entirely by private shareholders? Second, even if it is possible, are the agents of the government who exercise this control doing so in the desired fashion? These are the issues that animate the debate in Russia today concerning SOEs. The first goes to the question of the size of the government in the economy: should the government be selling its control shares in many or all of the SOEs or should it maintain its current holdings? President Putin, for example, recently said “the share of the state in the Russian economy . . . remains rather high” and advocated privatizing key assets for structural reasons so as to “boost the competitiveness of our economy and clear the way for the private initiative.”¹⁰ The second goes to the question of whether there are directors representing the government on SOE boards who need replacement because they were appointed as a result of cronyism or corruption within the political system, and are making incompetent or self-interested decisions inconsistent with goals justifying government control in the first place. Prime Minister Medvedev, for example, in calling for the replacement of government ministers on many SOE boards, stated that they must be replaced by persons who were “impartial [and] uncorrupted.”¹¹

10. Vladimir Putin, *Russia Needs More Technology and Less Corruption*, FIN. TIMES (Jan. 30, 2012, 1:12 PM), <http://blogs.ft.com/beyond-brics/2012/01/30/guest-post-by-vladimir-putin-russia-needs-more-technology-and-less-corruption/#axzz2kZXo45uH>. It should be noted, however, that in the mid-2000s, during Putin’s initial presidency, the state’s share actually increased from approximately 30% to 35%. Piotr Kozarzewski, *Corporate Governance Formation in Poland, Kyrgyzstan, Russia, and Ukraine* (Ctr. for Soc. and Econ. Research, Studies and Analyses Case No. 347, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1016064. Whatever share the state does retain, it appears that the government wishes to keep a strong voice in directing the affairs of SOEs. First Deputy Prime Minister Shuvalov stated that government appointees will serve as “professional trustees,” and defined the term by saying that “an independent director acts in line with his vision of what is best for the company’s development while a professional trustee acts on the government’s orders.” Denis Dyomkin, *UPDATE 2—Russian govt says will keep clout on company boards*, REUTERS (Apr. 22, 2011), <http://it.reuters.com/article/idUKLDE73L0B620110422>.

11. Dyomkin, *supra* note 10. As a general matter, directors representing the government on SOE boards are reported to be chosen by highly informal and nontransparent procedures. Sprenger, *supra* note 4, at 17. These problems can reach down into the top full-time managers as well. For a story of former government officials with questionable competence and integrity serving as the top managers of Norilsk Nickel, see Mikhail G. Delyagin, *Why Corporate Governance is Once Again on the Agenda and Do Russian*

D. Difference From the Important Policy Issues Involving Non-SOEs

Neither of these important policy issues relating to SOEs has much in common with the corporate governance problems faced by Russian corporations that are fully privately owned. The first issue relating to SOEs concerns how well markets external to the firm function in terms of the prices of goods, services, and resources, and to the relative capacities of government to correct for market failures externally, through regulation, taxes, and subsidies versus internally through the exercise of control. The second issue concerns the day-to-day functioning of the political system. In contrast, the corporate governance problems facing non-SOE firms relate to the rules by which its basic constituents—in particular its suppliers of managerial skills, capital, and labor—relate to and among each other.

It might be argued that the SOEs and non-SOEs nevertheless raise similar issues with respect to the fairness with which the firm treats those who have to deal with it on a longer-term basis, which is also a normative issue in corporate governance. Fairness, though, relates to whether the issuer's behavior meets the legitimate expectations of these other parties. Non-control shareholders of SOEs are on warning that for reasons authoritatively determined by the state, the issuer will be run in a fashion that may not be in these shareholders' best interests. It should not be a surprise to these shareholders when this in fact happens and any expectations on their part that it would not happen cannot really be said to be legitimate. Admittedly, when directors who are appointed by the government as a result of cronyism or corruption make incompetent or self-interested decisions, the resulting corporate behavior is not the product of authoritative determinations of the state. Still these shareholders may not be genuinely surprised and again the failure is really one of the governmental political processes, with the shareholders merely suffering "collateral damage."

With respect to a firm that the government has decided to privatize, it may be worthwhile for the government to try to replicate what would be good corporate governance for a non-SOE. This, however, is simply a transitional policy reflecting the government's desire to receive a good price at the time of sale and its abandonment of a belief that control to change the behavior of the corporation from what it would be in private hands is socially desirable.

In sum, where state control of a corporation can be justified,

the whole point of this control is for the corporation to act in a fashion different from a non-SOE. Thus, the standard of what is good corporate governance—whether a corporation achieves the aims that society expects of it—are very different for the two types of corporations. Whether governmental control of an SOE is well-exercised is more a matter of good governmental governance than good corporate governance. Thus, these are fundamental differences between the policy issues raised by SOEs and those raised by non-SOEs. The remainder of this paper will focus on the latter.

II. DISCLOSURE OF BENEFICIAL OWNERSHIP AND INTERESTED PARTY TRANSACTIONS

The difficulties in knowing who are the beneficial owners of a firm's shares and how the shares have been voted are close to being the root of all evil in Russian corporate governance. Think of the worst things that have happened in the Russian corporate economy over the last twenty years: asset stripping, tunneling, and the squeezing out of minority shareholders for little or no compensation by various means such as dilution or sham bankruptcy.¹² All of these unfortunate events have involved interested transactions. Interested transactions are ones in which a benefit is derived by an insider, i.e., a director, a high-level manager, or a shareholder who has enough power, alone or in conjunction with a group of other shareholders, to influence corporate action. If, as is often the case, the terms of the transaction are less favorable to the corporation than would be the terms of a comparable arms-length transaction, the benefit received by the interested insider will come at the expense of the rest of the corporation's shareholders. No method can work to combat interested transactions to which a publicly traded corporation is a party on unsatisfactory terms without an effective means of disclosing the identity of the beneficial owners of control of the corporation's shares and of those who have a significant beneficial interest in the other party to the transaction.

12. 2004 Survey, *supra* note 2, at 13, 18, 37–39. The extent of these problems is illustrated by a study of just one of the many methods that persons with control used to divert funds to them: “spaceman transactions” with short-lived special purpose entities beneficially owned by a corporation's insiders. Maxim Mironov found, through a survey of 236 million banking transactions, that diversions using spacemen aggregated an amount equal to 11.3% of Russian GDP in 2003 and 13.1% of GDP in 2004. Maxim Mironov, *Cash Flow Diversion and Corporate Governance: Evidence from Russia 3* (Nov. 7, 2008) (unpublished working paper), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1357730.

A. Treatment of Interested Transactions Under Russian Corporate Law

The Russian Federal Law on Joint Stock Companies (JSC) as originally adopted in the mid-1990s appeared to have had a means for dealing with interested transactions. The draftsmen understood that Russia would for some time have a weak judicial system and that its judges would be inexperienced in matters of business and capital.¹³ Russian courts, unlike the courts in a jurisdiction such as Delaware, would not be up to the complicated task of separating out those interested transactions that benefit the corporation as a whole from those that enrich the insiders at the expense of everyone else. The legislation therefore required that interested transactions be approved by a majority (for very large transactions, a supermajority) vote of disinterested directors and/or shareholders.¹⁴ The assumption was that these disinterested parties would reject transactions involving terms that they were not convinced were as good as would have been found in a comparable arms-length transaction. Where these special procedures were not followed, an objecting outside shareholder would, to void the deal, merely need to demonstrate to the court the absence of proper approval. Determining whether approval was proper was assumed to be much easier for a court to adjudicate than determining whether the transaction was fair.¹⁵

B. Interested Transactions in Practice and the Problem of Disclosure of Interest

This approach has not worked as well as was hoped. There has been a long history of the beneficial ownership of shares in Russian corporations being unknown, or at least not known definitively enough to provide legally sufficient evidence in court. At least until very recently, no Russian corporations even had a legal obligation to provide this information.¹⁶ As a result, it has been hard for an object-

13. See Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1914 (1996).

14. Federal Law on Joint Stock Companies, Federal Law No. 208-FZ, arts. 78–83 (Russ.); see also Black & Kraakman, *supra* note 13, at 1916–17. The procedures in these Articles were somewhat tightened in an amendment that became effective in 2002. Federal Law No. 120-FZ.

15. See Black & Kraakman, *supra* note 13, at 1915–16.

16. In 2006, Porshakov, after reporting that a handful of issuers had recently made available information on their beneficial owners, stated that such disclosure is a “rather rare exception from the general rule, since the majority of Russian companies are still non-

ing shareholder to establish critical elements of her case. A person who has substantial undisclosed beneficial ownership of an issuer's shares can hide the fact that he is an insider with influence over the issuer's decisions. Alternatively, or in addition, an insider of the issuer who has an undisclosed beneficial ownership of shares in the party on the other side of the transaction (or in an entity related to the party on the other side) can hide this fact and hence her interest in the transaction. Even where an insider's interest in a transaction is acknowledged and the corporation goes through the formal independent shareholder approval process, the insider can frustrate the process by having the shares that she beneficially owns voted in favor of the transaction and falsely counted as ones that are held by independent shareholders. She can engage in this deception because insiders control the counting of the votes and it has often been impossible for outsiders to determine even the identity of the owners of those shares that were voted in favor of the transaction.¹⁷

C. Legal Reforms Not Related to Disclosure

A number of the legal reforms unrelated to beneficial owner-

transparent." Porshakov, *supra* note 2, at 8; see also 2004 Survey, *supra* note 2, at 44 (reporting that it is hard for an outsider to determine even the *record* owners of large blocks of shares). Until recently, the formal rules required an issuer only to report to the Russian securities authorities (the FSFM) the record holders of blocks in excess of 20% of its outstanding shares. *Id.* at 51. Compliance with this modest rule is low since there were no penalties for non-compliance. Moreover, the FSFM was not required to disclose to the public any information that it did receive. *Id.* As for *beneficial* ownership, until recently there was no rule requiring disclosure even to the FSFM. *Id.* This non-transparency in the structure of ownership has topped the list of investor concerns with Russian corporate governance. *Id.* at 80–81. It may have been possible through hard work to get a picture of a Russian issuer's beneficial ownership structure. A presentation made by Vostok Natfa Investments Ltd. at the OECD Corporate Governance Roundtable in Moscow on November 12, 2004, reflects this view: "The existing Russian disclosure can be combined with GAAP accounts, international company searches and press statements to build up a fairly accurate picture of ultimate ownership." Vostok Nafta Investments Ltd., *Presentation at the OECD Russian Corporate Governance Roundtable: The Costs/Benefits of Disclosing Beneficial Ownership* 7 (2004), available for download at <http://www.oecd.org/daf/ca/corporate-governanceprinciples/33975254.ppt>. However, this exercise requires time, money, and effort. Because this information could only be obtained at substantial cost rather than by easy reference to officially filed documents, shareholder monitoring of compliance with the provisions that are supposed to protect against interested transactions has been deterred. Moreover, it is not clear that the information obtained by such a search would be admissible in court.

17. These problems are discussed in more detail in Fox & Heller, *supra* note 1, at 1764–65.

ship disclosure have been undertaken since the original adoption of the JSC that are aimed at preventing one kind of bad transaction or other, such as dilutions arising from low-priced share offerings made only to insiders.¹⁸ In large measure, these reforms represent patchwork solutions, however. They may be helpful, but they are not a complete cure. As long as there is no credible way of knowing who the beneficial owners of Russian company shares are, there is no effective way of stopping any type of interested transaction that is not specifically banned. When any one type of interested transaction is banned, ingenious insiders simply develop new ways of advantaging themselves at the expense of the other shareholders.¹⁹

D. The Need for Beneficial Ownership Disclosure Reforms

The more complete solution is a set of rules, backed by reliably applied stiff sanctions, requiring disclosure of all situations where a person, by himself or as a member of a coordinated group, is the beneficial owner of sufficient shares to be able to influence corporate action. A 2005 Organisation for Economic Cooperation and Development (OECD) White Paper on related party transactions in Russia recommended the adoption of rules requiring an issuer to disclose its significant beneficial owners.²⁰ An October 2010 amendment to the Securities Market Law, requiring issuers listed on a stock market to disclose beneficial owners of as little as 5% of the issuer's shares, appears to be an effort to implement this recommendation.²¹

An effective disclosure regime, however, needs to be imposed not just on the issuer, but also on the beneficial owners themselves.

18. 2004 Survey, *supra* note 2, at 13–14, 39–40.

19. See Fox & Heller, *supra* note 1, at 1740–45, for examples of these methods.

20. Organisation for Economic Cooperation and Development: Improving Transparency of Related Party Transactions in Russia (2005) (on file with the *Journal*).

21. Federal Law No. 264-FZ, Oct. 4, 2010 (Russ.), amending Federal Law on the Securities Market (Federal Law No. 39-FZ, Apr. 22, 1996). It is unclear how effective this legislation has been, however. A 2011 paper presented to the United Nations Conference on Trade and Development, which reported this legislative change, concluded that “many Russian companies do not name their beneficial owners.” INTERGOVERNMENTAL WORKING GROUP OF EXPERTS ON INTERNATIONAL STANDARDS OF ACCOUNTING AND REPORTING, CORPORATE GOVERNANCE DISCLOSURE IN THE RUSSIAN FEDERATION 9, 21 (2011), available at http://www.unctad.org/sections/wcmu/docs/ciiisar_28th_BelikovPaper_en.pdf. A Standard & Poor's survey of the ninety largest publicly traded Russian firms found that in 2010, thirty firms disclosed all beneficial owners with more than 10% of the outstanding voting shares, and forty-six firms reported a beneficial owner holding with more than 75% of the outstanding voting shares. STANDARD & POOR'S, *supra* note 3, at 11.

The issuer may not know who the significant beneficial owners are. And even if the issuer does, it can be hard for an enforcer or private party to prove that the issuer knew who the beneficial owners were in a case where the firm fails to disclose them.

The obligation imposed on the beneficial owners would need to include ones whose individual holdings alone are too small on their own to influence corporate decisions but who gain such influence by being a member of a coordinated group of holders. The October 2010 amendment to the Securities Market Law appears to go a long way, at least in terms of law on the books, to accomplishing this result. Persons who are the registered owners of 5% or more of the voting shares are obliged to disclose information about any person controlling the registered shareholder and persons owning or controlling jointly with others more than 5% of the voting stock must report changes in their positions. These are not going to be easy rules to make effective, however. Consider the U.S. experience with Section 13(d) of the Securities Exchange Act of 1934, requiring 5% and greater beneficial owners to disclose this fact, and the SEC rules and case law that have developed around it. This experience shows that it is a complicated task requiring some time to develop a set of authoritative interpretations that effectively impose disclosure obligations on such smaller beneficial owners who form a control group that in aggregate meets the statutory threshold.²² Getting the new Russian legislation to work will require a sustained and determined effort on the part of regulatory authorities, who will face the opposition of those who profit from continuing to keep their control positions hidden.

Finally, for the procedures in the JSC intended to protect the corporation against interested transactions on unfavorable terms to work, individuals and entities that have been identified as having control amounts of beneficial ownership need to be required by the corporation law to disclose to the corporation whether they also have a beneficial interest in the other party to any transaction into which the corporation enters.

III. DIVIDENDS

Many Russian firms with positive earnings pay no dividends.²³ For those that do, there is a widespread perception among

22. LOUIS LOSS ET AL., *FUNDAMENTALS OF SECURITIES REGULATION* 607–23 (6th ed. 2011).

23. Porshakov, *supra* note 2, at 13–14; 2004 Survey, *supra* note 2, at 65. There is

investors that the dividends are not in reasonable proportion to earnings.²⁴ Trading in the shares of many Russian issuers is very thin, reducing the exit-through-sale option for anyone but the smallest holders. This fact is probably both a partial explanation of the paucity of dividends and a reason for special concern. This concern suggests that serious consideration should be given to mandating that corporations pay out a specified percentage of their annual earnings as dividends. As discussed below, while such a reform would impose additional transaction costs on corporations that have good new investment projects into which to invest their earnings, a dividend requirement has a sufficient number of benefits—better discipline of managers and control shareholders, making more salient the costs of using internally generated funds to fund corporate investments, vitalizing Russian capital markets, and reducing the information asymmetries between managers and outside shareholders—to quite possibly make this disadvantage worth incurring.

A. Proposals for Mandatory Dividends

There have been calls from time to time, including proposals by State Duma deputies, to require Russian corporations to pay out a certain percentage of each year's earnings as dividends.²⁵ These proposals have historical precedent in nineteenth century U.S. corporate law.²⁶ In the United States, the laws were abandoned long ago and instead the directors of publicly held corporations have been given almost unlimited discretion concerning the level of dividends.²⁷

evidence that Russian corporations have recently been paying more in dividends, reportedly in part due to the urging of then-President Medvedev. Sophia Grene, *Takeovers Full of Eastern European Promise*, FIN. TIMES, Jan. 29, 2012, available at <http://www.ft.com/intl/cms/s/0/b0a4879a-4803-11e1-b1b4-00144feabdc0.html#axzz2kaispaUf>. Tax laws have also been changed so that corporate income from dividends paid by other companies is no longer taxable. NALOGOYVI KODEKS ROSSIYSKOI FEDERATSII [NK RF] [Tax Code] 275, 284 (Russ.). The Ministry for Economic Development and Trade has also called for a reduction in corporate income taxes for the portion of profits paid out as dividends. Lazareva et al., *supra* note 2, at 37–39.

24. Porshakov, *supra* note 2, at 13–14. One indication of the firms' reluctance is the fact that when they decide to declare a dividend, it is often not paid until many months later.

25. Porshakov, *supra* note 2, at 11.

26. See, e.g., 1901 N.C. Sess. Laws 13; N.J. GEN. STAT. § 220–36 (1895); N.M. STAT. ANN. § 451-3-16 (1953).

27. For a discussion of the demise of these rules and the development of a legal regime in which the directors of a publicly held corporation have almost unlimited discretion concerning the level of dividends, see Victor Brudney, *Dividends, Discretion, and Disclosure*, 66 VA. L. REV. 85, 99–106 (1980). A classic statement of broad discretion given

More recent calls, including one by me,²⁸ for a reconsideration of this broad grant of discretion have not gained much traction. Rather, for good or for bad, the hostile takeover mechanism has been relied upon as the primary way to force greater dividend payouts from firms retaining too much of their earnings.²⁹

In Russia, as mentioned, there is a particularly strong rationale for a mandatory dividend payout, however, and so proposals to impose one deserve especially serious attention. These same rationales apply as well to proposals to give dividend payments more favorable tax treatment.³⁰

B. The High Transaction Costs Objection

The obvious objection to such a rule is that expanding firms generally use internally generated cash flow as their first source of funds for their new investments. To force such a firm to pay out a portion of this cash flow as dividends requires that these funds be raised instead through outside finance. As a result, the objection runs, the firm incurs unnecessary additional transaction costs. These transaction costs are particularly high in Russia both because asymmetries of information between corporate insiders and outside sources of finance are initially very high, requiring these sources to undertake particularly expensive investigation of the issuer, and because the asymmetries remain relatively high even after such sources of finance have undertaken their initial investigation.³¹

to directors even in closely held corporations is found in the textbook case *Dodge v. Ford Motor Co.*, 170 N.W. 668, 682 (Mich. 1919).

28. MERRITT B. FOX, FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY: THEORY, PRACTICE, AND POLICY 383-402 (1987); see also Zohar Goshen, *Shareholder Dividend Options*, 104 YALE L.J. 881 (1995).

29. Michael C. Jensen, *The Takeover Controversy: Analysis and Evidence*, in KNIGHTS, RAIDERS, AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 314 (John C. Coffee Jr., Louis Lowenstein & Susan Rose-Ackerman eds., 1988).

30. See Lazareva et al., *supra* note 2, at 39.

31. *Id.* at 7 (capital markets in Russia are "plagued by information asymmetries"). See generally, Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have*, 13 J. FIN. ECON. 187, 188 (1984) (information asymmetries with outside sources of funds can cause corporations that would need such funding to invest in promising, positive net present value projects, rationally not to proceed).

C. The Benefits of Mandatory Dividends Despite Outside Finance Transaction Costs

The increased likelihood with mandatory dividends that firms will need to seek outside finance has a number of collateral social benefits, however, that in aggregate probably outweigh the social costs stemming from outside financing transactions.

1. Better Discipline of Management and Control Shareholders

A firm that is forced to raise external funds subjects itself to the scrutiny of the market. The prospect of facing this scrutiny disciplines management to do a better job both at operating existing capacity and finding the best new projects.³² The prospect of such scrutiny also makes insider diversions of firm income and assets less likely.

Such scrutiny is particularly valuable in Russia because for most issuers, other disciplining mechanisms are weak. For example, the quality of periodic securities disclosure, though perhaps improving, is still poor³³ and the risks to incumbent management of hostile takeover is low or nonexistent. Many Russian corporations have a majority control shareholder, making takeover impossible. Even for those that do not, corporate law is quite protective of incumbents, in part because of an early experience of takeovers that were motivated by the intent to loot the target.³⁴ Information asymmetries also make secondary markets less liquid and as a result increase an issuer's cost of capital at the time of the initial offering of shares because low liquidity makes them less valuable to hold.³⁵

2. Making Salient the True Cost Investments Using Internal Funds

Managers forced by a mandatory dividend rule to seek external financing for some of its investments are more likely to realize

32. See FOX, *supra* note 28, at 138–39; Frank Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 654 (1984).

33. Porshakov, *supra* note 2, at 8–9; 2004 Survey, *supra* note 2, at 16–17, 62–64; see also *infra* Part IV.

34. Lazareva et al., *supra* note 2, at 22–24.

35. Lawrence R. Glosten & Paul R. Milgrom, *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 J. FIN. ECON. 71 (1985); LARRY HARRIS, *TRADING AND EXCHANGES: MARKET MICROSTRUCTURE FOR PRACTITIONERS* 287–91, 299–302 (2003).

the true opportunity cost of the funds required for all the investment projects that they are considering, both those funded by remaining internal funds and those funded by external funds. While managers may tend to regard internally generated funds as free money, they cannot do that with funds raised outside because outside funds have a self-evident cost of capital.³⁶ As a result, a dividend requirement is likely to reduce the number of negative net present value investment projects implemented by Russian firms and thus improve efficiency in the economy.³⁷

3. Vitalizing Capital Markets

The flow of cash into the market generated by a mandatory dividend rule would also result in a pool of liquid funds that would create incentives for potential intermediaries to begin to build a real financial system. Among other benefits, this is likely to make the Russian economy more innovative. I have argued previously that in the United States, a larger flow of dividends from established corporations would add to the economy's growth-promoting capacity for innovation by placing decisions relating to which new investment projects get funded into more imaginative hands.³⁸ This is likely to be at least as true in Russia because there is substantial evidence that new firms are more innovative than firms formed from former Soviet enterprises.

4. Reducing Information Asymmetries

Akin to the "bird in the hand" theory of dividends in old-fashioned corporate finance texts,³⁹ forced dividends represent a valuable disclosure device in an economy where other means of disclosure often function poorly. Where directors are given discretion over whether or not to pay dividends, a firm lacking positive earnings can

36. See Jensen, *supra* note 29; FOX *supra* note 28, at 116–40; Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Schleifer & Robert W. Vishny, *Agency Problems and Dividend Policies Around the World*, 55 J. FIN. 1, 7–8 (2000).

37. The 2004 Survey suggested, for example, that it was not necessarily best for the large cash flows then being generated by the mineral extractive firms in Russia to be totally reinvested in these same firms. 2004 Survey, *supra* note 2, at 27.

38. FOX, *supra* note 28, at 186–206; Merritt B. Fox, *Promoting Innovation: The Law of Publicly Traded Corporations*, 5 CAPITALISM AND SOC'Y 1 (2010).

39. See, e.g., BENJAMIN GRAHAM & DAVID L. DODD, *SECURITIES ANALYSIS: PRINCIPLES AND TECHNIQUES* 432 (3d ed. 1951).

hide this fact by claiming that its earnings are positive but that they are being entirely reinvested. With a mandatory payout rule, the lack of earnings would quickly become obvious because the firm would likely not have sufficient cash to pay the dividends that the claimed level of earnings requires.

In addition, because the high cost of outside finance is primarily a product of information asymmetries between outsiders and insiders, the need to seek outside finance creates incentives for those managers to enhance the scope and credibility of their financial and business disclosures. They can do so by using devices such as having the firm retain accountants with a high reputation,⁴⁰ underwriting an offering of its securities with a high reputation investment bank,⁴¹ and cross-listing its shares abroad in order to subject the firm to the strict mandatory disclosure regime of the country of the foreign market.⁴²

Moreover, firms that choose this high disclosure route because of their need for more external finance would be aware that they would be able to further distinguish themselves from firms that hide their poor performance with low disclosure if all firms in the economy were subject to a stricter mandatory disclosure regime concerning their businesses and finances. Thus, because of the dividend requirement, the firms that choose this high disclosure route would form a natural political constituency to fight for a stricter mandatory regime.

IV. ENFORCEMENT OF FINANCIAL AND BUSINESS DISCLOSURE

Russia's adoption of international accounting standards for stock exchange-listed issuers, and of rules concerning business disclosure consistent with European Union and International Organization of Securities Commissions standards, are steps forward.⁴³ With-

40. Linda E. DeAngelo, *Auditor Size and Auditor Quality*, 3 J. ACCT. & ECON. 183 (1981).

41. James R. Booth & Richard L. Smith, *Capital Raising, Underwriting and the Certification Hypothesis*, 15 J. FIN. ECON. 261 (1986); Ann E. Sherman, *Underwriter Certification and the Effect of Shelf Registration on Due Diligence*, 28 FIN. MGMT. 5 (1999).

42. John C. Coffee, Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757 (2002). A 2010 survey found that Russian corporations with U.S. listings "are far more transparent than their peers listed elsewhere, while those listed only in Russia are on average less transparent." See STANDARD & POOR'S, *supra* note 3, at 15.

43. 2004 Survey, *supra* note 2, at 14, 49.

out enforcement, however, these rules are just law on the books. To be real, they must be enforced. There is significant evidence that because of lax enforcement, disclosure by Russian corporations, though improving, is far from ideal.⁴⁴ I argue here that creating a meaningful system of civil liability could, at least in the longer run, help significantly.

A. How Civil Liability Can Promote Economic Efficiency

A regime of civil liability imposed on some mix of issuers, directors, managers, and gatekeepers for losses due to an issuer's disclosure violations suffered by both primary market and secondary market traders can be a powerful force for enforcement. Through its deterrent effects, such a regime can improve the quality of disclosure and, with the resulting improved share price accuracy, lead to a more efficient functioning of the economy. The more accurate prices are in the primary market—the market where issuers are offering new securities to investors in return for funds to be used for new investment—the more likely that capital will flow to the firms with the most promising investment projects.⁴⁵ More disclosure and more accurate prices in the secondary market—the market where investors trade already outstanding shares—signal when managers are doing a poor job. Price accuracy in this market also helps align the interests of managers with those of shareholders by assisting in the effectiveness of the share price-based compensation and the hostile takeover mechanisms for reducing the agency costs of management.⁴⁶

Anecdotal evidence suggests that in the United States, fear of such liability may be the single biggest reason for compliance.⁴⁷ Moreover, cross-country data collected by La Porta, et al., suggest that the presence or absence of civil liability is a key factor in explaining why some countries' securities regulation systems work and others do not.⁴⁸ This is not surprising: civil liability can fill in for

44. INTERGOVERNMENTAL WORKING GROUP OF EXPERTS ON INTERNATIONAL STANDARDS OF ACCOUNTING AND REPORTING, *supra* note 21, at 5.

45. Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 249 (2009).

46. *Id.* at 254, 259.

47. *Id.*; see also, John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1536 (2006) (“Deterrence . . . is the . . . rationale that can justify the significant costs . . . that securities class actions impose on investors and the judiciary.”).

48. Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Schleifer, *What Works in Securities Laws?*, 61 J. FIN. 1 (2006).

many of the shortcomings that arise in connection with public enforcement.⁴⁹

B. The Value to Russia Despite the Likely Only Small Near Term Effect

For Russia, imposition of civil liability for disclosure violations would be unlikely to play an important enforcement role in the short run because of the lack of a strong, effective, business-savvy judiciary. Centralized administrative enforcement, whatever its shortcomings, will need to be the principal tool for now.⁵⁰ Russia would nevertheless be wise to include within its legal system rules that give aggrieved plaintiffs a reasonable prospect of recovery, because, over the longer run, these rules could play an increasingly valuable enforcement role as the judicial system matures.

1. The Argument That Civil Liability Would Serve No Useful Purpose

It might be argued that, at least in the case of secondary market trader losses due to an issuer's disclosure violations, an effective system of civil liability would serve no useful purpose in Russia because, for most corporations, a majority of shares, or at least a substantial bloc large enough to assure entrenched control, are owned by a single person, entity, or control group.⁵¹ The behavior of such corporations, the argument runs, would be little-influenced by any civil liability-induced improvements in corporate transparency and share price accuracy, because the control person or bloc of such a corporation can get information without a civil liability backed system of mandatory disclosure, and the other shareholders play no role in governance.

Such an argument is short-sighted for a number of reasons, as

49. Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 WIS. L. REV. 297 (2009).

50. See RUSSIAN CORPORATE GOVERNANCE ROUNDTABLE, IMPLEMENTING INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) IN RUSSIA: 25 RECOMMENDATIONS TO FACILITATE THE TRANSITION TO IFRS (2005).

51. Olga Lazareva, Andrei Rachinsky & Sergey Stepanov, *A Survey of Corporate Governance in Russia*, in CORPORATE GOVERNANCE IN TRANSITION ECONOMIES 318 (Robert W. McGee ed., 2008) (finding that in 2004, the largest shareholder held more than 50% of the shares in 48% of Russia's largest companies, and that the largest shareholder held 25–50% of the shares of 27% of the remaining companies).

discussed below, particularly if there is gradual progress overall in the competency of the judiciary and in the other reforms advocated here.

2. Signaling Managerial and Control Shareholder Breaches of Duty in Majority Controlled Corporations

Consider first improved transparency and share price accuracy in the secondary markets for the minority shares of majority owned corporations. To start, by signaling when there are problems, increased transparency and share price accuracy can assist both in the effective exercise of the shareholder franchise (for important interested transactions, a majority vote of disinterested shareholders—i.e., the outside shareholders—is needed) and in shareholder enforcement of management's duties to the corporation.⁵²

In addition, when there is sufficient disclosure to the market of information generated within the firm, market prices can predict a corporation's future cash flows better than can the majority control shareholder. This is because the market price, in addition to reflecting the information generated within the firm that has been disclosed, reflects as well the differing sets of information and expertise held by outside buyers and sellers of a corporation's shares. These sets of information and expertise held by outsiders concern the environment in which the corporation operates and consequently are useful in refining the assessment of what the corporation's future cash flows are likely to be. Thus market prices can guide control shareholders to make decisions that better enhance firm value.

Also, where the control shareholder or shareholders do not themselves run the firm day to day, agency costs arise from the separation of management from ownership, just like in a firm with truly dispersed ownership (though perhaps only to a smaller extent). By reducing the riskiness associated with holding a corporation's stock in a less than fully diversified portfolio, additional disclosure increases the willingness of managers to take a larger share of their compensation in share price based form. It also makes this kind of compensation a more reliable reward for good performance and a more reliable punishment for poor performance. In these ways, additional disclosure provides greater incentives for managers to make firm

52. See Merritt B. Fox, *Required Disclosure and Corporate Governance*, 62 L. & CONTEMP. PROBS. 113 (1999). This is obvious when disclosures themselves suggest the possible existence of such a problem. It also can occur when a share price declines, indicating, if the price has a relatively high level of accuracy, that something is amiss.

value maximizing decisions and hence reduces managerial agency costs.⁵³

3. Better Allocation of Capital

Improved price accuracy in the primary market for the shares of majority owned firms is socially useful as well. Greater share price accuracy at a time when such a corporation contemplates financing a new project by means of a share offering will bring the corporation's cost of capital more in line with the social cost of investing society's scarce savings in the contemplated project. As a result, these savings are allocated more efficiently, going more consistently to the most promising proposed projects in the economy.⁵⁴

4. Increasing the Possibility of Dispersed Ownership Corporations

Finally, looking toward the future, the argument that civil liability induced improvements in transparency and share price accuracy serve no useful purpose because most Russian firms are majority-owned ignores important reasons why majority owned firms currently predominate in Russia.⁵⁵ In a world where there are inadequate protections for non-control shareholders, securities cannot be offered at a price equal to their pro-rata claim on projected future cash flow of the corporation. Non-control shares sell at a steep discount and so a majority shareholder pattern of firm ownership dominates.

Civil liability induced improvements in transparency and share price accuracy and the other reforms discussed here would tend to reinforce each other and move Russia toward a day when the conditions allowing for truly dispersed ownership corporations begin to

53. See Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498, 2548–50 (1997).

54. See Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1358–63 (1999).

55. See Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3, 14 (2000) (collecting studies and concluding that “[t]he data show that countries with poor investor protection typically exhibit more concentrated control of firms than do countries with good investor protection.”); cf. Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 576 (2004) (“The ability of a controlling shareholder to appropriate some of the value generated [in a sale of business] is limited by the possibility of being sued. Thus, a greater ability to sue should translate into smaller private benefits of control. The same reasoning applies to any legal right attributed to noncontrolling shareholders.”) (internal citations omitted).

emerge and such firms start to play a significant role in the Russian economy. The practical availability of this form of corporate ownership would have distinct advantages. It reduces investor risk by permitting greater diversification. It also appears to enhance entrepreneurship and innovation by allowing venture capitalists to exit via initial public offerings.⁵⁶

C. Procedural and Substantive Law Needed to Make the Threat of Civil Liability Real

What can Russia do to start a system of private enforcement that in the longer run will realistically bring the benefits discussed just above? For a system of civil liability to effectively deter disclosure violations, there needs to be some kind of mechanism for collective action. This is because, for most investors, if they were only able to act individually, the high costs of securities litigation would be greater than any expected recovery. Experience around the world suggests that only a system, like in the United States, involving an opt-out class action (a court approved procedure where each member of the class as defined by the person bringing the action is included unless, after a notice procedure, the putative member affirmatively opts out) combined with some method to pay the lawyer for the class such as a contingent fee system (where the lawyer receives a court approved percentage of any recovery) generates significant class litigation.⁵⁷ Russia currently has only “opt-in” class actions⁵⁸ and con-

56. Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243 (1998).

57. See John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 245, 274 (2007) (noting that the total monetary sanctions imposed by the SEC and class action plaintiffs came to \$11.5 billion in 2005 and that the United States class action system “has no functional analogue anywhere else in the world”); Samuel Issacharoff & Geoffrey P. Miller, *Will Aggregate Litigation Come to Europe?*, 62 VAND. L. REV. 179, 199 (2009) (arguing that “[i]t is difficult . . . to design an effective class action procedure in the absence of a contingent fee” because no litigant would shoulder the entire cost of a litigation and earn only her share of the recovery); *id.* at 202–07 (suggesting that opt-in procedures pose problems for class actions, because they fail to incentivize named plaintiffs, they make attracting adequate participation difficult, and because they fail to “offer[] defendants the opportunity to achieve global peace through the class procedure”); Manning Gilbert Warren III, *The U.S. Securities Fraud Class Action: An Unlikely Export to the European Union*, 37 BROOK. J. INT’L L. 1075, 1085 (2012) (suggesting that contingency fee prohibitions are one reason why securities fraud class actions have not developed in Europe); *id.* at 1089–90 (suggesting that opt-in requirements help to explain why European aggregate litigation mechanisms have not been effective).

58. The Supreme Arbitrazh Court, the highest commercial court, promulgates

tingent fee arrangements seem at best rare and may not be allowed at all.⁵⁹ Also, for such class actions to provide an effective remedy, the underlying securities law cause of action cannot require the investor to show that she relied on the misstatement, because a reliance requirement would make an important element of the claim not be provable in common for the class as a whole. Instead, the law must provide that the claim can be based simply on the argument that the misstatement raised the price of the security.

V. THE ROLE OF STAKEHOLDERS

Russia needs to make important choices concerning the appropriate role of non-shareholder stakeholders and their interests in the governance of the corporation. This is a question that has been the subject of a hard-fought transnational debate.

A. The Share Value Maximization Approach

In the United States, a rough consensus has formed among most (though not all) academic commentators that the proper goal for good corporate governance is that the firm should be operated to maximize its residuals—the difference between what the firm pays at contractually pre-determined prices for its inputs and what it receives for its outputs—over the life of the firm, discounted to present value.⁶⁰ Doing so maximizes the social wealth generated by the real operations of the corporation, assuming that firms operate in competitive markets and that the potential externalities resulting from their

procedural rules for commercial cases. Opt-in class actions are authorized. Commonality of subject matter and the rights/duties of plaintiffs and defendants is required. ARBITRAZNO-PROTSESSUALNYI KODEKS ROSSIISKOI FEDERATSII [APK RF] [Code of Arbitration Procedure] arts. 28, 46 (Russ.).

59. See Ivan Marisin & Vasily Kuznetsov, *Russia Chapter—Class and Group Actions 2014*, in THE INTERNATIONAL COMPARATIVE LEGAL GUIDE TO: CLASS AND GROUP ACTIONS 2014, available at <http://www.iclg.co.uk/practice-areas/class-and-group-actions/class-&-group-actions-2014/russia>.

60. See, e.g., 1 PUBLICLY TRADED CORPORATIONS: GOVERNANCE & REGULATION § 2:5 (2013) (collecting sources arguing that sole goal of corporation is to maximize shareholder value); Henry Haansman & Reiner Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001) (“There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.”); see also Milton Friedman, *The Social Responsibility of Business is to Increase Its Profits*, N.Y. TIMES MAGAZINE, Sept. 13, 1970 (arguing that the social responsibility of a businessperson is to increase the corporation’s profits).

activities, such as environmental damage, are properly regulated. Under these circumstances, the value of what the firm takes from society is, at the margin, properly measured by what it pays out at market-determined prices for contractually obtained resources, and the value of what it contributes to society, at the margin, is what it receives at market-determined prices for its output. The difference, the residual, is the firm's value added and its contribution to society.

For investor-owned firms, shareholders are the recipients of these residuals. Thus, according to the U.S. consensus, such firms need to operate in a fashion that maximizes share value. This need in turn suggests that the directors of the corporation should primarily represent the shareholders.

B. The Multiple Stakeholder Approach

In Europe and Japan, many voices advocate that the governance mechanism of the corporation be designed to take significant account of the interests of other stakeholders.⁶¹ These other stakeholders include labor, the communities in which the corporation operates, and customers. According to this view, these interests should be taken into account even when decisions furthering these interests reduce share value. The larger society is injured when the governance mechanism fails to take the interests of these stakeholders into account because of the resulting disappointment of expectations that, though not protected by formal contract, are long and deeply held. One way to take account of these interests is for other stakeholders to have a formal role in the firm's governance, for example the representation of labor on the supervisory board under the German scheme of co-determination. Another, less extreme, way is to include among the duties of directors the obligation to take account of such interests.⁶²

Corporate decisions that advance the interests of other stakeholders beyond what is required by the corporation's existing con-

61. See, e.g., Paul L. Davies & Klaus J. Hopt, *Corporate Boards in Europe—Accountability and Convergence*, 61 AM. J. COMP. L. 301, 339–46 (2013) (summarizing and discussing differences in employee representation on boards of directors in various European countries); Curtis J. Milhaupt, *Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance*, 149 U. PA. L. REV. 2083, 2091–92 (2001) (describing how Japanese corporate cultural norms have protected other stakeholder interests).

62. See Gregory Jackson, *Employee Representation in the Board Compared: A Fuzzy Sets Analysis of Corporate Governance, Unionism, and Political Institutions*, 12 INDUSTRIELLE BEZIEHUNGEN 1, 4 (2005) (identifying Austria, Denmark, Germany, Norway, and Sweden as countries with legal rights to board-level representation in private firms).

tracts may, of course, enhance share value at the same time. For example, a firm's discounted-to-present-value aggregate future residuals, and hence its share value, might increase if, despite a cost in terms of current earnings, the firm develops a reputation among current and potential workers as a good employer or among consumers as a "green" company that works to reduce global warming. Where careful, serious analysis suggests that a decision advancing the interests of other stakeholders can genuinely be expected to enhance share value, the stakeholder model simply collapses into the share value maximization model. Beware, however, of the self-evidently overly broad generalization that, at least in the long run, doing good for other stakeholders consistently benefits shareholders as well. The happy incantation of this generalization by some authorities evades the fact that often an act that benefits other stakeholders reduces share value. As a consequence, a choice between the share value maximization approach and the stakeholder approach cannot be avoided.

C. The Share Value Maximization Approach is Best for Russia

Which approach is better for Russia? In my view, the case for the share value maximization model is especially strong. One reason is historical. The particular pattern of privatization of state enterprises in Russia involved incumbent managers, employees, and local governments each receiving significant blocks of stock.⁶³ This led to a situation where restructurings that could have greatly enhanced the value of these enterprises failed to be undertaken. Instead, each of these shareholder blocks, rather than trying to maximize the pie that they could then split up as shareholders, looked, as in Soviet times, to the corporation to provide them with direct benefits beyond what they could command if they offered their services in the outside market.⁶⁴ This problem may have lessened over time as labor and local government shareholders have been squeezed out. The power of this example from near history continues to pose special dangers, however.⁶⁵ Granting non-shareholder stakeholders in Russia a formal role in corporate governance risks their using their influence again to obtain direct benefits from the corporation in ways that

63. Fox & Heller, *supra* note 1, at 1747–58.

64. *Id.*

65. For companies where the majority of shares originally went to managers and employees, which usually ended up later as predominantly owned by managers, the legacy of these effects may have extended a decade or more, with companies retaining inefficiently large labor forces. See Yaraslau Kryvoi, *Employee Ownership and Corporate Governance in Post-Privatization Russia*, 8 U.C. DAVIS BUS. L.J. 298 (2008).

are not social-wealth-maximizing.

Even if other stakeholders are not given formal roles and their interests are simply added to the list of legitimate objectives of Russian directors and managers, the resulting problems may be particularly severe in Russia.⁶⁶ The multiple stakeholder model of corporate governance provides less clear-cut criteria for judging the quality of corporate decision-making. As a result, directors and managers can claim a concern with other stakeholders as a cover for decisions favoring their own interests. In the United States, for example, the interests of other stakeholders have most frequently been invoked by incumbent managers of publicly held corporations as an excuse when they are fending off hostile takeovers that would deprive the managers of their own jobs. The problem of directors and managers invoking other stakeholder interests as a cover is likely to be particularly great in Russia, where the institutionally based corporate governance constraints on management are already weak.

A good example of Russian attitudes toward the question of stakeholders is found in the National Council on Corporate Governance 2004 survey of Russian corporate governance.⁶⁷ Another example, from Poland but reflecting views in all eastern European economies including Russia, is a 2007 survey by Piotr Kozarzewski,⁶⁸ and yet another is a 2007 Russian corporate governance survey by Lazareva and her co-authors.⁶⁹ The 2004 Survey approaches gingerly the question of the role of other stakeholders in Russian corporate governance. On the one hand, it recounts the unfortunate problems that arose from the pressures that labor and local governments put on recently privatized enterprises in the 1990s.⁷⁰ On the other hand, it seems to characterize the share value maximization approach as reflecting the thinking of the now past 1990s.⁷¹ Moreover, the 2004 Survey relates with seeming approval the recommendation of the Code of Corporate Conduct that “management and board members heed the interests of all stakeholders—employees, the company’s

66. Members of the board and the management are obliged to act in accordance with the principles of good faith and reasonableness in the interests of the corporation. FEDERAL LAW ON JOINT STOCK COMPANIES, Federal Law No. 208-FZ, art. 71 (Russ.). Because the corporation is a legal fiction, the question of the share value maximization model versus the stakeholder model is one of how to define the interests of this legal fiction, the decisions with respect to which affect a variety of kinds of real individuals.

67. 2004 Survey, *supra* note 2.

68. Kozarzewski, *supra* note 10.

69. Lazareva et al., *supra* note 2.

70. 2004 Survey, *supra* note 2, at 51–52.

71. *Id.* at 51.

partners, the federal and local governments,” and suggests that “reaching a balance of all stakeholders’ interests is essential for the company’s best, sustainable performance.”⁷² The issue of how much attention to pay other stakeholder interests is a live one in Russia because a corporation’s adoption of the various provisions of the Corporate Code of Conduct is voluntary.⁷³

Kozarzewski is similarly diffident, suggesting that the involvement of other stakeholders through tradition and their at least initial shareholdings was one argument why the Continental model of corporate governance was better for Russia at least in the first stages of transition.⁷⁴ Lazareva et al. similarly conclude that the broader perspective of corporate governance that takes account of stakeholders is “more appropriate for Russia” since stakeholders, primarily governments of different levels and workers, play an important role in a firm’s decisions.⁷⁵

It would have been better if these authorities had confronted more forthrightly the disadvantages of the stakeholder approach and explored whether or not in Russia the interests of the other stakeholders can be adequately protected by contract, as share value maximization model adherents believe is the case in the United States. Instead, these authorities simply accept the status quo with regard to the question of stakeholder involvement as the starting point for a normative analysis. The desirability of confronting these disadvantages is particularly strong if, as I urged in Part I, the governance of SOEs is treated as a different subject and the focus is on the corporate governance needs of non-SOEs.

CONCLUSION

The questions surrounding the governance of SOEs and non-SOEs are sufficiently different that they should be analyzed separately. The focus here is on non-SOEs. This Article contains some practical suggestions with respect to four important issues in Russian corporate governance: disclosure of beneficial ownership, dividends, enforcement of financial and business disclosure requirements, and the role of non-shareholder stakeholders in corporate governance. Adoption of each of these suggestions would require political will,

72. *Id.* at 52.

73. *Id.* at 33, 40, 46–47.

74. Kozarzewski, *supra* note 10, at 14–15.

75. Lazareva et al., *supra* note 2, at 3.

because important interests would be negatively affected. But each would contribute to getting corporate governance right in Russia. Going forward, these improvements could be of real value to the country as a whole.

Russia's robust economic growth over the last decade has been largely due to increases in the utilization of existing capacity and the run up in oil and other mineral prices.⁷⁶ Capacity is now much closer to being fully utilized and oil and other mineral prices cannot keep going up forever. Thus, much of any future growth must come from better, not just fuller, use of existing capacity and new investments that increase the wealth-generating capacity of firms in the non-mineral-extractive sectors. Many kinds of reforms are necessary, the most important probably being an overall reduction in the stultifying state involvement in the economy that, among other things, makes it time-consuming and difficult to get new manufacturing capacity online. Further reforms in corporate governance, though, are needed as well to develop institutions that will spur the most productive use of existing capacity and permit the firms with the most innovative and promising investment projects to get the funds they need.

76. 2004 Survey, *supra* note 2, at 21–35.