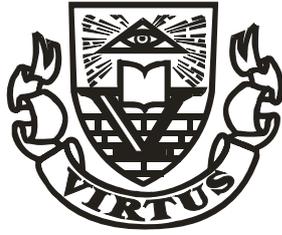


# CORPORATE GOVERNANCE IN A TRANSITION ECONOMY

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*“Serve to principles, but not persons”*

*To my daughter Liza.  
I hope that you will live in  
a democratic country and  
be proud of being a Ukrainian.*



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## **PREFACE: RECONSIDERING BERLE & MEANS**

The new millennium presented citizens of the corporate world - shareholders, executives, employees and others - with the bankruptcies of Enron and other giants of the most developed segment of the corporate world - the USA. Corporate America, which was perceived before as an example to follow, showed the corporate world citizens many disadvantages in the existing systems and instruments of corporate governance. This rather deflated the trust of shareholders in the existing principles and concepts of corporate governance both in developed and developing countries, including Ukraine.

Recent studies, undertaken by *Saul Estrin, Adam Rosevear, Alex Krakovsky, Alex Pivovarsky* contributed remarkably to understanding the corporate governance mechanisms in Ukraine. All these experts concluded that many corporate governance mechanisms, such as the board of directors, financial reporting and others, hardly work in Ukraine.

One of the well-known reasons is the absence of an Act of Joint Stock Companies. The draft of this Act had been written in 2001. However, the Act has still not been approved by the Ukrainian parliament, where a strong political lobby protects the rights of large owners, named "oligarchs". Therefore, joint stock companies in Ukraine have to work with reference to "The Act of Enterprises", which does not explain the nature of many corporate governance mechanisms, i.e. board committees, non-executive directors, executive nomination, executive monitoring, etc. As a result, corporate governance in Ukraine allows violation of minority shareholders rights, weak transparency, inadequate corporate social responsibility. Under such circumstances, one of the ways out is through developing a set of internal statements (within each company) to make all these corporate governance mechanisms work. Owners should be responsible for doing this work.

Regrettably, all these researchers just analyzed the corporate governance mechanisms in Ukraine and did not try to find out, what the type of owner is the most efficient in Ukraine, i.e. employees, executives, foreign institutional shareholders, Ukrainian financial-industrial groups. Moreover, nobody researched the reasons why corporate governance mechanisms, which are so popular worldwide, are still not applied in Ukraine effectively. There are about 35 thousand joint stock companies in Ukraine that is much more than in many developed economies. Annually, the state commission on securities and stock exchanges notes over 12 thousand of cases of breaking the principles of corporate governance in

Ukraine. From this perspective, it is very important to know the role of ownership structure in corporate governance, i.e. why owners buy shares and what corporate governance mechanisms they use.

The results of our research, presented in this book are very important for Ukrainian joint stock companies, which suffer from agent conflicts. An increase in agent costs reduces growth opportunities at the market. Therefore, after developing corporate governance mechanisms, such as executive compensation, board of directors and its committees, financial reporting and executive monitoring, it will be possible to say that this research is based on the principle of social responsibility, deflated strongly as a result of the bankruptcies in the USA and worldwide.

We tried to do our utmost to put our research on the basis of the most ancient problem in corporate governance - separation of ownership and control, proposed by *Berle* and *Means*. Who are shareholders in Ukraine? Are they investors, controllers or both?

*Berle* and *Means* found that shareholders of the beginning of the 20th century in the USA were rather investors than controllers. That time, attracted by the stock exchange, investors forgot about their duty to control the corporation. Therefore, managers, who had stayed inside of the corporation, picked up the reins of powers, dropped down by shareholders, who had stayed at the stock exchange. Probably, it was "a silent consent" between managers and shareholders. Is the same "a silent consensus" in Ukraine at the beginning of the third millennium?

The central message of "*the Modern Corporation*" is the need to go beyond traditional legal and economic theory to develop a new concept of the corporation that can serve as a foundation for a theory of corporate governance. Only then, *Berle* and *Means* contended, could Americans come to terms with the emergence and significance of corporate economy. Aimed with this understanding, the community would then be in a position to demand that the modern corporation serve the interests of all society.

Are the corporations at transition economies serving interests of society? The answer is still explored. We are going to find a reply for the corporate governance practices popular in Ukraine.

*Berle* and *Means* were not content that corporations must be run only in the interests of shareholders. The role of shareholders in decision making is dominant in comparison to stakeholders. Shareholders, with reference to their dominant role in corporate governance, must bear much more responsibility for the company in whole than stakeholders. In this case, interests of society will be taken into account. Herewith, the role of ideal shareholder would play a superior role in corporate governance. *Berle* and *Means* were not sure that an ideal owner exists.

All groups of shareholders, playing at the market at the time of *Berle* and *Means*, could not be taken for ideal owners. Passive shareholders are

reluctant to apply corporate governance mechanisms. Therefore, they are not able to control management of companies and prevent managerial opportunism and agency conflicts development, destroying shareholder wealth. Large shareholders, taking care of keeping their own interests, do not care of keeping interests of all shareholders balanced. Under such circumstances block shareholders will distort a system of mechanisms of corporate governance to make it centered only at their own interests. Therefore, interests of minority shareholders are violated, that leads to conflict of interests among shareholders and destroys shareholder wealth too. Executives of companies, owing their stock, need not those mechanisms of corporate governance at all, responsible for controlling themselves. But, absent of transparent executive compensation system, decision system, monitoring system, lets management avoid accountability to the rest shareholders. Under such circumstances executives are motivated to increase their own wealth through well known unjustified high compensation, insider stock trading and assets tunneling. We are not sure that *an ideal owner* exists with application to the corporate governance practices in Ukraine. But we are aimed to finding *the most effective owner* in transition economy - employees, executives, institutional shareholders. We want to stay on the position that an ideal shareholder is an expert in balancing interests not only between shareholders and management. He is able to take an active participation in balancing interests of all shareholders, despite their stake in company, their intentions on free riding or long-term shareholding, their social status, etc. To do all these, ideal owner finds incentives to govern companies and equips himself with required knowledge. So, incentives and knowledge should follow an ideal owner. Besides this, ideal shareholder, well-motivated and equipped with knowledge, is an owner, who feels himself responsible not only for his own stake in a company, but for the company in whole. He bears this responsibility not only to shareholders, management and employees. He bears this responsibility to the society in whole. So, ideal owner is well-motivated, equipped with knowledge and responsible for his company in whole, to society. He must know WHY to own stock of company, HOW to own stock, and how to make these WHY and HOW responsible to society in whole. We are not going to propose a new concept of corporation - a third millennium concept. We only want to conclude whether there is a concept of corporate governance, special for transition economy - economy, where the corporate governance practices are still in transition from a chaos to the best corporate governance practices, applied in the developed countries. We do not want to refuse *Berle* and *Means* ideas. We want just to reconsider it.