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This paper develops an approach to drafting corporate law for emerging capitalist economies that is based on the case study of a model statute recently completed for the Russian Federation. The paper describes the contextual features of emerging economies that make the import of statutes from developed countries inappropriate, including the prevalence of controlled companies and the weakness of private institutional, market, cultural, and legal enforcement. Against this backdrop, we argue that the best legal strategy for giving necessary protection to outside investors in emerging economies while simultaneously preserving the discretion of companies to invest is a "self-enforcing" model of corporate law. Unlike the "prohibitive" corporate law that characterized developed economies in earlier periods, self-enforcing law does not regulate or prohibit substantive corporate decisions. Instead, it tightly structures decision-making processes in the company to allow outside shareholders to protect themselves from insider opportunism with minimal resort to legal authority including the courts. Among the many examples of self-regulatory statutory provisions are a mandatory cumulative voting rule for the selection of directors, which assures board representation to minority blockholders in controlled companies, and dual shareholder- and board-level approval procedures for self-interested transactions. In addition to reviewing such specific statutory provisions, the paper addresses the issues of inducing voluntary compliance and structuring remedies in emerging economies, as well as the drafting challenges posed by special classes of investors such as employee-shareholders and state shareholdings. We conclude by examining the implications of the self-regulatory model of corporate law for the on-going debate over the efficiency of corporate law in developed economies -- and particularly in the United States.

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I. Introduction

What should corporate law to govern publicly owned companies in newly privatizing or emerging capitalist economies look like? This question is important because the corporate form plays a key role in the privatization of formerly communist countries and the development of other emerging market economies. But the question has no ready answer. Newly privatizing or developing countries should not simply copy the corporate laws of developed Western economies. The corporate laws of developed countries depend upon highly evolved market, legal, and governmental institutions,[1] and upon cultural norms, that often do not exist in emerging economies. And even if these laws could be exported to emerging markets without modification, there would be a case for not doing so before first taking a very hard look -- since these laws are likely to be as much the product of idiosyncratic historical developments in their countries of origin as of purely functional imperatives.

We believe that the principal goal of corporate law should be similar in developed and emerging economies -- succinctly stated, corporate law should maximize the value of corporate enterprises to investors, thus reducing the cost of capital. But the differences in institutions between developed and emerging economies require different means for achieving this goal. Moreover, in many emerging markets, corporate law must serve a second goal -- to foster public confidence in capitalism, and in private ownership of large firms.

If corporate law is to work within the infrastructure that is available in an emerging market, it must be designed substantially from scratch. Fortunately, this can be politically feasible. Existing law is often rudimentary, and interest groups are often less organized than in developed economies. Thus, the bias toward the status quo that limits departure from existing legal rules in developed countries is often weaker in emerging economies. One can rethink, from first principles, what corporate law *ought* to look like, and what related legal and financial institutions it *ought* to rely on and promote.

In an important sense, no law can be designed completely from scratch. Emerging economies have *some* legal and market institutions, *some* norms of behavior, *some* distribution of share ownership, and *some* set of financial institutions. Corporate law must reflect existing institutions, and encourage the development of missing or weak beneficial institutions. For example, if employees are an important class of shareholders as a result of mass privatization, company law must adapt to this background fact. Company law must also limit the influence of existing bad institutions, such as widespread official corruption.

This article sketches the basic elements of a model corporate law for emergent economies through a case study: an effort, in which we participated, to develop corporate law for Russia.

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[1] We use the term "institution" here in a broad sense, to include private organizational structures such as stock trading systems and securities registrars, public organizational structures such as securities regulators, skilled commercial courts, and a reliable mail system, and mixed public-private structures such as self-regulatory organizations, an accounting profession, and sophisticated financial accounting rules.

We begin with three central claims. The first is that the elements of an effective corporate law depend on time, place, and culture. The law that works in the United States, Britain, Germany, or Japan (our principal developed country prototypes) will not satisfactorily resolve the basic problems that corporate law must address in an emerging market. It will not achieve a sensible balance among company managers' need for flexibility to meet rapidly changing business conditions, companies' need for low-transaction-cost access to capital markets, large investors' need to monitor what the managers do with investors' money, and small investors' need for protection against self-dealing by managers and large investors. The defects in the law will increase the cost of capital and reduce its availability.

In developed countries, corporate law is only one of a number of legal, institutional, and cultural constraints on the discretion of corporate managers and controlling shareholders that together achieve a satisfactory balance among these sometimes competing needs. As Ronald Gilson has argued, where other constraints work more effectively, corporate law should play only a minor role.[2] In emerging economies, non-legal constraints are weak or absent. Thus, corporate law is central in the effort to give the participants in the company incentives to create social value, and prevent them from transferring wealth to themselves from others. When these market institutions are absent, the "market" cannot fill the regulatory gaps that an enabling-type corporate law leaves behind.

Moreover, corporate law in developed countries has evolved together with legal institutions that make the law work. For example, the U.S. relies heavily on expert judges to assess the fairness of transactions where managers have a conflict of interest, as well as the reasonableness of takeover defenses. These judges can make decisions literally overnight when necessary, so that judicial delay does not kill a challenged transaction. In emerging markets, weak legal institutions often further limit the available regulatory options. In Russia, for example, courts function slowly if at all. Many judges are holdovers from the Soviet era who don't understand business and are disinclined to learn. Some are simply corrupt. One can hope for better courts, but only over a period measured in decades. In the meantime, corporate law must rely on courts as little as possible.

Our second central claim is that despite the context-specificity of corporate law, there is a large class of "emergent capitalist economies" (including formerly communist countries) that are sufficiently similar to permit useful generalization about the features of corporate law that will be useful for them. For example, Russia is perhaps extreme, but hardly alone, in having malfunctioning courts, weak and sometimes corrupt regulators, and ill-developed capital markets.

As we argue below, four aspects of national context are critical to the design of corporate law: (1) the background factors that shape the goals of corporate law, such as the ownership structure of public companies (most Russian companies today have majority control by managers and employees, but only limited residual state ownership); (2) the sophistication and reliability

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[2] Ronald Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 **Stan. L. Rev.** 819 (1981)

of the legal system; (3) the sophistication of capital markets and related market institutions; and (4) the cultural expectations of managers, shareholders, and the general public (in Russia, Sergei Mavrodi can run a pyramid scheme, put tens of millions of dollars into his own pocket, and after the pyramid collapses be elected to public office[3]).

Emerging capitalist economies are less developed than Western economies on each of these dimensions. Russia serves as a useful prototype of an emergent economy both because of its size and intrinsic importance and because it is at the far end of the continuum from developed economies on all of the key dimensions that are critical to the design of a corporate law. Thus, it can illustrate with special clarity the ways in which corporate law for emergent economies differs from corporate law for developed economies.

Our third claim is that it is possible, despite the constraints of weak markets and weak legal infrastructure, to design corporate law that will work tolerably well: that will vest substantial decisionmaking power in the hands of those with incentives to make good decisions; that will reduce, though it cannot eliminate, fraud and self-dealing by corporate insiders; that will give managers and controlling shareholders incentives to obey the rules, even where they could probably get away with ignoring them; that will reinforce desirable cultural attitudes about proper managerial behavior; and that will still leave managers with the flexibility they need to take risks and make quick decisions. Indeed, good law -- corporate or otherwise -- is enormously important in emerging economies precisely *because* related institutions are weak. In developed countries, corporate law often plays a minor, even "trivial", role in an overall system of corporate governance.[4] A good law can add far greater relative value in developing economies.

Every corporate governance system yet devised fails with uncomfortable frequency in the often volatile circumstances faced by companies in emerging markets.[5] Thus,

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[3] See, e.g., Claudia Rosett, *P.T. Barnum Missed a Marvelous Thing: Russian Investments*, **Wall St. J.**, Sept. 27, 1994, at A1; Steve Liesman, *A Moscow Promoter Goes from Jail Cell to Parliament Seat*, **Wall St. J.**, Nov. 1, 1994, at A16 (Mavrodi elected to Parliament, his stated reason for running was to obtain legislative immunity from prosecution for tax fraud).

[4] See, e.g., Bernard Black, *Is Corporate Law Trivial?; A Political and Economic Analysis*, 84 **Nw. U.L. Rev.** 542 (1990); Mark Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 **Yale L.J.** 1927 (1993).

[5] For a sample of recent scholarship on comparative corporate governance, see **Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance** (1994); Ronald J. Gilson & Reinier Kraakman, *Investment Companies as Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate*, 45 **Stan. L. Rev. 985** (1993); Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 **Yale L.J.** 871 (1993); Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior under Limited Regulation*, 92 **Mich. L. Rev.** 1997 (1994); **Jonathan Charkham, Keeping Good Company: A Study of Corporate Governance in Five Countries** (1994).

corporate governance will oten fail in emerging economies. Yet precisely because occasions for governance failure are common in emerging markets, the marginal value of good company law will be significant if it can prevent even a fractions of the failures that might otherwise occur.

The central features of the company law that we develop below for the Russian context are:

(i) Reliance on self-enforcing mechanisms for shareholder protection to the extent possible. By self-enforcement, we mean that the law relies for its success on actions by direct participants in the corporate enterprise (shareholders, directors, managers), rather than indirect participants (judges, regulators, legal and accounting professionals, financial press). In particular, the law relies as little as possible on formal enforcement by judges and regulators. The principal mechanisms are: shareholder approval, including in some cases supermajority approval or approval by a majority of outside shareholders, for broad classes of major transactions and self-interested transactions; approval of self-interested transactions by a majority of outside directors; cumulative voting for directors, which gives large minority shareholders the power to select minority directors (protected with requirements for one common share, one vote; minimum board size; and no staggering of board terms); a unitary ballot, on which both managers and large shareholders can nominate directors; and pass-through of voting power from nominee holders to beneficial owners. The honesty of the vote is protected through confidential voting and independent vote tabulation.

(ii) A higher degree of protection of outside shareholders than is common in developed economies, to respond to the combination of a high incidence of insider-controlled companies; the weakness of other constraints on self-dealing by managers and controlling shareholders; a distribution system for shares (voucher privatization) that did not let investors insist on contractual protections as a condition of investing; and the need to control fraud to strengthen the political credibility of a market economy. The protection comes through a combination of the self-enforcement mechanisms discussed above, preemption rights when the company issues new shares, and appraisal rights for shareholders who don't approve major transactions (enforceable either in court or through arbitration).

(iii) Reliance, for the most part, on procedural protections, especially transaction approval by independent directors, independent shareholders, or both, rather than on flat prohibitions of categories of transactions. The reliance on procedural protections balances the need for shareholder protection against the need for business flexibility.

(iv) An overall effort to build legal norms that participants in the corporate enterprise will see as reasonable, and comply with voluntarily. The need to induce voluntary compliance reinforces our preference for procedural rather than substantive protections. For example, managers are more likely to evade a flat ban on self-interested transactions than a procedural requirement for shareholder approval, if they think that they can obtain the approval. Yet, once they decide to obtain shareholder approval, they may voluntarily make the transaction more favorable to the company, to be certain of approval and to avoid embarassment.[6]

(v) Apart from major transactions and self-interested transactions, giving the board of directors broad power to set dividends, establish company policy, and hire, fire, and compensate the chief executive. The default rule is a unitary board, but a two-tier board as in Germany is a permissible alternative.

(vi) Takeover rules adapted largely from the British City Code on Takeovers and Mergers, which require notice to the company and the public when a shareholder exceeds 15% ownership; a delay period before a change-of-control transaction (30% ownership is our proxy for control) to provide a market check on the fairness of the price; a requirement that a shareholder who acquires a 30% stake offer to buy all other shares at the same price unless other shareholders waive this requirement; and a ban on defensive actions that could frustrate a takeover bid unless the actions are approved by the target's shareholders.

(vii) Shareholder protection against dilutive share issuances through a requirement that shares be issued only at market value, as determined by the board of directors; shareholder approval for issuances to insiders (under the self-interested transaction rules); shareholder approval for large issuances; and preemptive rights.

(viii) Safeguards for the rights of employee shareholders, to prevent managers from controlling the voting of employee shares. These rules reflect the importance of employee ownership for Russian firms that went through voucher privatization.[7] The principal safeguards are a ban on manager control of trusts and other entities formed to hold employee shares, opt-out rights and a maximum 2-year life for any such trusts, individual decisions on whether to sell shares, and confidential voting.

(ix) Strong legal remedies, *on paper*, for failure to follow required corporate procedures, to encourage corporate actors to comply with the rules rather than risk strong penalties for ignoring procedures. For example, a shareholder who acquires a 30% interest without giving the required advance notice, or without offering to buy all remaining shares, loses voting rights for *all* shares, although voting rights can be restored by majority vote of the other shareholders. Strong remedies compensate, in part, for the low likelihood that remedies will be exercisable in fact.

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[6] In the economic literature, "self-enforcement" is sometimes given only this narrower meaning -- a contract is said to be self-enforcing if it induces voluntary compliance. See, e.g., Lester Telser, *A Theory of Self-Enforcing Agreements*, 53 **J. Bus.** 27 (1980). Inducing voluntary compliance is an important element of our approach to company law, but it captures only part of what we mean by a "self-enforcing" law.

[7] See Joseph Blasi, *Corporate Governance in Russia* (this volume 1995) (survey of 200 privatized Russian companies shows mean employee ownership of 65% and median ownership of 60%). For background on Russia's voucher privatization, see Maxim Boyko, Andrei Shleifer & Robert Vishny, *Voucher Privatization*, 35 **J. Fin. Econ.** 249 (1994).

(x) Where possible, use of bright line rules, rather than standards, to define proper and improper behavior. Bright line rules can be understood by those who must comply with them, and have a better chance of being enforced. Standards, in contrast, require judicial interpretation, which is unavailable, and presuppose a shared cultural understanding of the policy underlying the rule, which is also largely nonexistent.

The combination of easily understood rules and strong sanctions for noncompliance can potentially initiate a virtuous cycle, in which cultural norms of proper behavior by corporate managers, now weak or absent, are reinforced as some managers comply voluntarily with the new rules, others comply to avoid legal risk, still others comply because they have strong shareholders who can punish deviation, and all managers observe how other managers behave.

There are limits to what a self-enforcing corporate law can accomplish. For example, cumulative voting won't directly help a small shareholder, who owns 5 shares. Nor will a small shareholder who opposes a merger find it worthwhile to exercise appraisal rights. Thus, small shareholders remain vulnerable to expropriation of their wealth by managers and controlling shareholders. A self-enforcing law can *partially* protect small shareholders in three principal ways. First, rules such as cumulative voting that strengthen the influence of *large* outside shareholders encourage outside investors to buy large stakes and become active monitors. These large investors' actions will often benefit all outside investors. Second, the effort to build independent boards, and vest key decisions in independent board members, will sometimes protect small shareholders. Third, all shareholders benefit when managers are induced to follow the law.

The effort to develop corporate law from scratch for developing economies can also expose weaknesses in developed country corporate laws. It can highlight the ways in which developed country corporate laws, often assumed to reflect evolution toward efficiency, instead reflect path-dependent evolution from a historically contingent starting place, to an ending place that is shaped by preexisting institutions, by the inertial power of the status quo, and by the political power of key participants in the corporate enterprise.

In developed countries, corporate law evolved together with and reinforced existing institutions. Differences in these institutions across countries -- Germany had strong banks and labor unions; the United States had strong capital markets -- led to differences in corporate law. Moreover, corporate law developed in a manner congenial to key political constituencies -- notably, in the United States, the managers of large companies. The decade-long political battle in the United States over the American Law Institute's *Principles of Corporate Governance*[8] is but an unusually visible example of this politically influenced, path-dependent evolution.

[8] American Law Inst., Principles of Corporate Governance: Analysis and Recommendations (Final Draft 1994) (hereinafter Principles of Corporate Governance).

Some of the approaches developed here, especially heavy reliance on self-enforcement by large minority shareholders rather than judicial oversight, are adaptable to developed countries, and could be preferable to current practice. Yet American state corporate laws have never tried them, just as the U.S. has never tried the British practice of placing sharp limits on takeover defenses. Path-dependent evolution, along a path shaped by the political power of managers of large companies -- can explain why not.

We sketch the basic requirements that a corporate law for emergent economies must satisfy, and our approach to drafting such a law, as follows. Part II describes the contextual elements that affect the shape of corporate law, including the goals of corporate law in an emerging economy. Part III outlines the alternative drafting strategies open to emergent economies and introduces our own preferred strategy: one designed to yield a "structural" or "self-enforcing" corporate law. Parts IV and V describe the primary components of a self-enforcing corporate law in the context of the Russian Federation. Part VI addresses remedies, an area of special concern if legal institutions are weak. Part VII considers how corporate law can address the abilities or disabilities of particular classes of participants in the corporate enterprise, including creditors, employee-shareholders, venture capitalists (often including foreign investors), and the state (which is an important residual shareholder in many newly privatized economies). Finally, Part VIII considers the lessons from the self-enforcement approach for the supposed efficiency of developed country corporate laws.

This Article focuses on large companies where some shareholders do not work in the business. We do not, for the most part, consider the special problems of close corporations. The law, however, must carefully attend to the needs of small companies. The procedural protections that are appropriate for a company with 10,000 shareholders would be ludicrous and crippling for a tiny company with five shareholders who all work in the business.

We focus also on *company law*, conventionally understood: that is, the law that articulates company structure and regulates relationships among shareholders, as well as between the and corporate managers. American corporate law, for our purposes, includes state corporation statutes, the common law of fiduciary obligation, the provisions of the securities laws that regulate corporate voting, control contests, and other fundamentally internal matters of corporate governance and structure, and stock exchange listing standards that impose corporate governance requirements on listed companies. Similarly, British company law includes statutory company law, the common law of fiduciary duty, the listing standards and guidelines of the London Stock Exchange, and the British City Code, which regulates control transactions with the effective force of law although it is administered by a self-regulatory organization. By contrast, issues bearing on the relationships between workers and companies, such as whether to mandate union selection of a portion of the board along the lines of German co-determination, or to encourage employee ownership through tax benefits or other means, as in American employee stock ownership plans, are beyond the scope of this article.[9]

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[9] A brief word on codetermination, for those who think that this issue is too important to be excluded from our article: Our own reading of the German experience leaves us unconvinced that *mandatory* union participation on

II. The National Contexts that Shape Corporate Law

We begin by examining four aspects of national context that in our view shape and limit corporate law: the goals of corporate law, the sophistication of market institutions, the development of legal institutions, and the cultural expectations of participants in the corporate enterprise. We first describe how these features interweave to form the context of corporate law in developed economies. We then demonstrate, using Russia as a case study, how these features differ markedly in emerging economies -- differences in context that require differences in company law.

A. Corporate Law in Developed Economies

Corporate law as we define it above is generally understood to have a largely (although not exclusively) economic function in developed economies. This function might be characterized as facilitating production through the corporate form, as reducing the cost of capital to the corporate enterprise, or as minimizing the sum of the transaction and agency costs of contracting through the corporate form.[10] Under this perspective, corporate law is understood to provide a convenient set of rules (usually default that can be varied in the corporate charter) to encourage profit-maximizing business decisions, provide professional managers with adequate discretion and authority, and protect shareholders (and to some extent creditors) against opportunism by corporate insiders including entrenched managers.

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boards of directors is a good idea *even there*. See, e.g., **Jeremy Edwards & Klaus Fischer, Banks, Finance and Investment in Germany** (1994). Moreover, the case for mandating such participation is especially weak in Russia for several reasons. First, employees own ample shares to elect their own directors under our proposal for mandatory cumulative voting. Second, in Russia and other newly privatized economies, many companies must greatly reduce the size and change the composition of their work force. Current employees will often resist these changes in an effort to preserve the jobs of those who are employed today -- sometimes at the cost of bankruptcy tomorrow. See, e.g., Julie Tolkacheva, *Caramel-Kneading Grandmas Snub Philip Morris*, **Moscow Times**, Oct. 22, 1994, at 13 (workers at candy factory reject plan to sell stock and use the funds to purchase automation equipment). Third, under Communism, Russian company unions had symbolic but no real power. They remain weak and often corrupt. The Russians with whom we have discussed codetermination find the assumption underlying codetermination -- that a labor union can aggressively represent the interests of employees -- amusing. We also note that the effort to transplant the two-tier board to the Czech Republic has failed. Investors there care only about what they see as the "real" board -- the management board. See John C. Coffee, Jr., *Investment Privatization Funds: The Czech Experience* (this volume, 1995).

[10] See, e.g., ALI Corporate Governance Project. Thus, the **Principles of Corporate Governance** provide that subject to certain constraints, "a corporation ... should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain." **Principles of Corporate Governance**, supra note ----, §2.01(a). The comment to this sections makes clear that the **Principles** are drafted chiefly to facilitate the corporations' "economic function." See. §2.01 comment 2. There are, of course, important departures from this norm, such as German co-determination or the provisions in some American state corporate laws that are intended to deter hostile takeovers. But these are seen as just that -- departures from an overall efficiency norm. We do not enter here the debate over whether corporate law can or should seek to encourage companies to pursue goals other than profit maximization.

But no one assumes that the corporate law of developed markets accomplishes these objectives alone. For most public companies, the law is but one of many control mechanism operating on corporate insiders. A competitive product market, an efficient capital market, and a market for corporate control exert strong pressures on corporate managers to enhance shareholder value. Sophisticated professional accountants, elaborate disclosure, and strict antifraud provisions assure shareholders reliable information about company performance, and permit savvy institutional shareholders to play an increasingly active role in corporate governance, even in the United States. And sophisticated courts (such as the Delaware Chancery Court), administrative agencies (such as the SEC), and self-regulatory organizations (such as the New York Stock Exchange and the City of London) keep sharp eyes out for corporate skullduggery.

This backdrop of multiple private and legal controls picks up much of the burden of protecting investors in public companies in the United States and Great Britain. As a consequence, the corporate law itself can tilt far in the direction of protecting managerial discretion and enhancing transactional flexibility. For example, the Delaware corporation statute is a highly discretionary enabling law, many of whose major provisions are default rules. Moreover, even Delaware's mandatory rules have survived as mandatory rules, in many cases, because they are either unimportant, avoidable through advance planning, or match reasonably well what the parties would have chosen anyway.[11] If the statute is accompanied by fiduciary doctrines that permit the Delaware courts wide latitude to review for opportunistic behavior ex post, it is nonetheless true that the law punishes only the most egregious instances of self-dealing or recklessness. All else is left to private institutions and the market.

By contrast, corporate law in an emergent economy such as Russia is likely to function with a different mix of goals, and a far less evolved market and legal infrastructure, than it does in a developed economy. As we detail below, the paradoxical consequence for emergent economies is that the protective function of corporate law becomes more important precisely when fewer legal resources are available to support it.

B. The Goals of Corporate Law in Emergent Economies

Consider first the goals of corporate law in emergent economies. The abstract economic (or efficiency) goal of encouraging production in the corporate form and reducing the cost of capital to the corporate enterprise presumably remains the principal function of corporate law in these markets, just as it does in their developed counterparts. But this goal is likely to inform the balance between investor protection and the business discretion of corporate managers quite differently in emergent and developed economies. In addition, political goals other than pure efficiency concerns are likely to carry far greater weight in emergent than in developed economies.

[11] See Black (1990), *supra* note 4.

To begin, the efficiency goal dictates a more protective corporate law in emerging economies than elsewhere for several reasons. One is that corporate insiders are likely to exercise voting control over the great majority of public companies in these markets. Such controlled ownership structures raise the obvious concern that the insiders, whether they are managers or controlling shareholders, will behave opportunistically toward other company participants. In Russia, this concern is especially acute due to the peculiar composition of the ownership structures that resulted from mass privatization over the past two years. The great majority of privatized public companies in Russia are controlled by management-led coalitions of managers and workers, which hold between 51% and 75% of company voting shares. By contrast, outside shareholders -- including large investment (voucher) funds -- generally hold about 20% of the voting shares, while the remaining shares are likely to be held by a state property fund.[12] Given this ownership structure, the risk of opportunism toward public shareholders is clear[13] -- as is the implication that efficient public investment in Russian companies requires strong minority protections. Moreover, while the particular form of controlled ownership in Russia may be unique,[14] experience with American companies suggests that minority protection is equally important when non-management shareholders control the company.[15] Thus, family-controlled companies with minority public participation -- the classic ownership structure in newly industrialized economies -- would seem to require strong minority protections as well.

Of course, strong contractual protections for minority public shareholders would result automatically in a world of perfect contracting, without informational asymmetries or naive investors. Indeed, commentators often assume that financial markets in developed countries can approximate the conditions necessary for efficient corporate contracting. An efficient capital market, fueled by extensive disclosure and populated by savvy investors, forces corporate planners to offer optimal charter terms to investors. Sophisticated market intermediaries such

[12] See Joseph Blasi, *Privatized Enterprises in Russia: Organizational Trends & Problems* (unpublished draft, Feb. 1994) (reporting ownership averages for sample of 150 companies). Blasi reports that the top 5-10 managers in a company held 10% of the voting stock on average (although only 5% in the median firm). Id. at 9.

[13] A recent example in which even sophisticated investors were hurt was an unaanounced share issue at the Komineft Oil Company, once among Russia's most popular stocks. The share issue, which was available only to shareholders of record prior to May 1994, effectively diluted large shareholders who invested during the summer boom market of 1994. Neela Banerjee, *Russian Oil Company Tries a Stock Split In the Soviet Style*, **Wall St. J.**, Feb. 15, 1995, at A14.

[14] The experience of the Czech Republic, where two or more outside shareholders (usually investment funds) hold control stakes may be more typical of privatizing economies. See Coffee (1995), *supra* note 9.

[15] See **Principles of Corporate Governance**, *supra* note 8, §§5.10 - 5.14 (duty of fair dealing of controlling shareholders). It is well established that controlling shareholders frequently extract private gains from corporations at the expense of minority shareholders. See, e.g., Stuart Rosenstein & David Rush, *The Stock Return Performance of Corporations That Are Partially Owned By Other Corporations*, 13 **J. Fin. Res.** 39 (1990); Michael Barclay & Clifford Holderness, *The Law and Large-Block Trades*, 35 **J. L.& Econ.** 265 (1992).

as investment banks and accounting firms further ameliorate informational problems.[16] And after shares are issued, the same efficient capital market -- together with the product market and the market for corporate control -- continues to police the managements of public companies. As a consequence, corporate law should be "enabling," or permissive, rather than mandatory; and its terms should be freely alterable in the company's charter.

This characterization of contracting conditions in developed markets points to the second, more general reason why efficiency concerns favor a protective corporate law in emerging economies. The enabling model has both strengths and weaknesses as applied to the United States.[17] But it is clearly inapposite to emerging economies where informational asymmetries are severe, markets are far less efficient, market participants are less experienced, and the economy itself is more likely to be in flux. Each of these factors allows opportunism that the parties to transactions will be unable or unwilling to avoid by contract.

In addition, in emerging economies that are also privatizing, such as Russia, the entire initial structure of private relationships among participants in companies is imposed by the government and not contracted for at all. The ownership structure of privatized Russian companies was imposed by the privatization program, its initial charter was prescribed by the privatization ministry, the company's principal bank lenders were often selected before privatization began. These relationships were not negotiated by the relevant parties with an eye toward their own self-protection. Moreover, to the extent that Russian firms hope to rely on subsidized bank credits for their future capital needs (a hope that is slowly dwindling for most firms), or have unrealistic notions of the protections that sophisticated investors would insist on before investing substantial sums of new capital, or the prices that these investors will pay (today, unrealistic expectations abound), the prospect of future need for equity capital may exercise only a weak restraint on managers in their treatment of public shareholders. In this respect, as in so many others, Russian is at the opposite pole of a continuum from an economy like that of the United States, where market controls are strong.

Apart from minority shareholders, moreover, other classes of corporate participants may be threatened by informational asymmetries, weak markets, and controlled companies that are characteristic of emergent economies -- in which case these stakeholders may also have an efficiency-based claim for some form of protection in the corporate law. For example, creditors

[16] For an account of the contribution of such private informational intermediaries to the efficiency of the U.S, market, see, e.g., Ronald Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency*, 70 **Va. L. Rev.** 549, 613-621 (1984).

[17] The most eloquent American proponents of the enabling model are **Frank Easterbrook & Daniel Fischel, The Economic Structure of Corporate Law (1992)**; **Roberta Romano, The Genius of American Corporate Law** (1994). For efforts to develop the limits of the enabling approach, see, e.g., Jeffrey Gordon, *The Mandatory Structure of Corporate Law*, 89 **Colum. L. Rev.**1549 (1989); Melvin Eisenberg, *The Foundational Structure of the Corporation*, 89 **Colum. L. Rev.** 1461 (1989); Lucian Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 **Harv. L. Rev.** 1820 (1989). We do not enter here the debate on the proper limits on the enabling approach in a developed economy.

in privatizing economies are vulnerable because business failures will be common, which puts stress on the shareholder-creditor relationship and creates incentives for opportunism by shareholders or managers at creditor expense. In addition, privatization that is structured to create substantial employee ownership leads to dual concerns. On one hand, employees must be protected in their capacity as shareholders against management schemes to control their votes through coercion, selective provision of information, or the creation of trust structures to hold employee shares with managers serving as trustees.[18] Such tactics, which are common in Russia, deprive employees of the full value of their shares and distort collective shareholder decisionmaking in favor of management's agenda. On the other hand, if employee-shareholders become a powerful constituency in their own right, they may hold corporate decisionmaking hostage to the distinctive employee concern with job preservation. In a privatizing economy in need of massive restructuring, an employee veto over corporate policies is clearly more risky is clearly more risky than it would be in a mature economy already in equilibrium with the world market.[19]

Finally, beyond the efficiency justifications for protective corporate law in emergent economies, there are strong political goals that press in the same direction of shareholder protection. Although political goals also shape the law of developed economies, they are predictably more important where capitalism is less firmly rooted. Thus, egregious opportunism or scandals may erode the political legitimacy of corporate ownership in emergent countries -- or even erode support for the market economy generally.[20] The political risk of a destructive public reaction to scandal is a negative externality of insider discretion that law in an emergent market must take very seriously. And even if corporate scandal does not threaten to trigger a

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[18] In Russia, managers at many companies are seeking to acquire employee shares outright, or to encourage employees to place their shares in trust structures controlled by managers. Despite the fact that employees are the largest shareholder group, they appear to be passive in corporate governance. Employee directors are extremely rare. See Joseph Blasi, "Russian Privatization: Ownership, Governance, and Structuring," (unpublished report 1994).

Note too that general protection of minority shareholders also serves to protect employee shareholders. To the extent that outside stakes in companies have real value, employees have the option to cash out their shares, and their individual bargaining leverage with their managers is presumably enhanced.

[19] Blasi (1995), *supra* note 7, reports that since 1991, post-privatized Russian firms have cut employment by 21% and that Russian senior managers would like to cut an additional 20% of their workforces. The real cuts are far greater, since many firms keep former employees on the payroll without paying them. (This increases the employee's future state pension, makes stronger the firm's claim that it needs state subsidies, and gives former employees with real jobs elsewhere a conveniently low official income, to be reported to the tax collector.)

As the discussion in text suggests, we support efforts to protect the value of employee shares but not efforts to enhance employee ownership rights at the expense of other shareholders. If shares carry the same value to employees as they do to other investors, our expectation is that some employee-dominated firms will eventually emerge, but only where employee ownership is efficient.

[20] Thus, elements of the Russian right, including the former Speaker of the Russian Parliament, Ruslan Khasbulatov, attack the entire privatization program as a mafia scheme. Blasi (1995), *supra* note 7.

political maelstrom of populist reaction, it may significantly damage investor confidence in environments where disclosure is minimal.

A second political justification for protective corporate law emerges in privatizing economies that have transferred equity to employees or to the general public (Russia and many other countries have done both). A mass privatization programs in these countries reflects, in part, a political bargain on how to distribute social wealth.[21] When the state distributes 20% of the shares of privatized companies to the public, the recipients expect these shares to have real value, and expect that value to be proportional to ownership interest. If corporate insiders expropriate nearly all of the cash flows of privatized companies, the political bargain will be breached. Whatever the efficiency consequences of such a breach, there will be enormous political cost in reduced popular support for further privatization, and for other reforms needed for a market economy.

C. Legal and Market Controls in Emergent Economies

Even if the economic and political goals of corporate law in emergent economies favor a strong protective function, however, limitations on enforcement resources constrain how this protective function is discharged. Thus, a third important features of emergent economies for purposes of drafting corporate law are the limitations on the legal and market tools that can support compliance with the law.

The most significant legal limitation is a weak or ineffectual judicial enforcement mechanism. At least three sorts of weaknesses in judicial system can hobble the enforcement of corporate law in emergent markets. First, the substantive legal remedies available to judges for enforcement purposes may be ill-defined or inadequate. A simple but telling example is the absence of a rule permitting Russian judges to adjust damages for inflation. Without this adjustment, in a high-inflation environment, damage awards nominally equal to monetary losses at the time of injury will compensate for a small fraction of the actual loss. Second, judicial procedures may be cumbersome, or the court system may be overtaxed, with the consequence that timely judicial action may be impossible to obtain except in the simplest matters. Third, the judiciary itself may lack experience with corporate law cases, or it may simply be corrupt, or so ill-paid that competent, honest lawyers won't take judicial jobs.[22]

If these weaknesses are present in too extreme a form, judicial enforcement of corporate law will collapse. But total breakdown is merely one end of a continuum. It is likely that courts can enforce simple rules and resolve relatively simple cases, at least some of the time. Just as

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[21] See, e.g., Boyko, Shleifer & Vishny (1994), *supra* note 7.

[22] For example, the Russian arbitrage courts that exercise jurisdiction over commercial disputes have experienced little change in personnel since the demise of the Soviet Union. And current official judicial salaries are as laughable as other official salaries. A senior judge today earns an official salary of around $100/month --barely a subsistence wage. A competent judge can increase his salary by 10-fold or more by returning to the private sector as a lawyer -- leaving the incompetent and the corrupt to staff the judiciary.

the criminal law deters as long as the police catch *some* criminals, the corporate law can deter misbehavior as long as *some* misdeeds can be remedied in the courts.[23] The effectiveness of courts will be enhanced if disputes turn on bright line rules, rather than on application of broad standards. And a successful corporate law must still economize as much as possible on judicial resources.

A weak judiciary is hardly the only enforcement limitation in emergent markets. Such markets are also unlikely to have administrative agencies that can handle corporate law matters such as disclosure policy, which benefit from detailed rulemaking and administrative enforcement.[24] Moreover, they lack the entire range of nonlegal enforcement resources found in developed economies, from self-regulatory institutions (such as the New York or London Stock Exchanges and the British Takeover Panel) to private firms that protect clients against abuse and reduce informational asymmetries (such as investment banking, law, and accounting firms). Accounting rules in emergent economies are likely to be weak or nonexistent, and administered by a commensurately undeveloped profession. Russia, for example, now has only rudimentary accounting rules, developed for state enterprises, and no accountants with training comparable to American certified public accountants.

Lack of good accounting and good accountants is only the tip of a much larger iceberg. Disclosure is an important constraint on management behavior in developed economies. Disclosure of management self-dealing can lead to formal enforcement. Disclosure of self-dealing or business problems can lead to market sanctions, such as a lower stock price, or reduced availability of credit, or difficulty in hiring employees. The embarrassment factor of public disclosure is also important. In many cases, American boards of directors have acted to replace a poor CEO after -- and only after -- sharply critical stories appeared in the business press.

In an emerging market, disclosure and its attendant benefits is diminished or absent. Russia forms an extreme case where the benefits of disclosure are outweighed by its costs. A company that discloses its profits honestly can easily find itself paying taxes that exceed 100% of profits. Plus, among the most interested readers of public financial disclosure are the local mafia, who can then better judge how much payment to demand. Even small, private companies

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[23] For example, Russia uses a dematerialized system of shareholding, in which the company register is the only official record of shareownership. This creates a risk that company managers will simply erase an unwanted shareholder from the shareholder register. Russian lawyers whom we have asked about this express confidence that this effort will fail -- the shareholder can go to court and get his ownership interest. An important test for this belief involves Krasnoyarsk Aluminum, a reputedly mafia-controlled firm whose managers recently canceled the register entry for a foreign investor who owned 20% of the company's shares, and used armed guards to block the shareholder's representatives from attending the shareholder meeting. See *Russian Aluminum: King of the Castle?*, Economist, Jan 21, 1995, at 62.

[24] For example, the Russian Securities Commission was formally created only by Presidential decree only in November 1994. At this writing (February 1995), It has, a tiny budget and a nonexistent staff, and has yet to hold its first meeting.

dare not report honestly to the government, because corrupt officials often deliver these reports to the mafia.

As a result, smart investors don't even *want* companies in which they invest to report their profits honestly. This leaves the investors vulnerable to the managers stealing the hidden profits, but the alternative to possible theft by the managers is certain payment of whatever the managers might steal and more to the government or the mafia. Thus, one lacks even the market mechanism of investors insisting on disclosure as a condition of investing.

As emergent capital markets mature over time, enforcement and disclosure limits will diminish. Judges will grow more familiar with corporate transactions, and the market itself will induce the development of self-regulatory organizations, investment banks, law and accounting firms. Hopefully, the government will reduce confiscatory taxes (which don't even raise much revenue because few pay them), and rein in organized crime. Yet, these developments may take decades, while emergent economies need corporate law now. Today's law must take enforcement institutions largely as it find them.

D. Cultural Norms for Manager and Large Shareholder Behavior

A final reason why developed countries can make do with relatively weak constraints on manager and large shareholder opportunism is that managers and large shareholders are embedded in a culture that discourages opportunism. The culture reflects in part the underlying legal norms, and the penalties for violating those norms. But cultural attitudes also exist independently of, and reinforce, the legal norms, so that formal enforcement is infrequently needed. Few American corporate managers doubt that they work for the shareholders, even if they and their shareholders have different ideas about what this concept means. Moreover, developed country managers are accustomed to routinely following laws of all kinds, and to thinking of themselves as law-abiding.

Russia offers a marked contrast. Russian enterprise managers cannot follow the law and stay in business. They must lie about their income to the tax authorities, bribe the tax inspector, the customs inspector, the local police, and many other government officials as well, pay off the local mafia, and so on. To succeed, Russian managers must learn how to get things accomplished in spite of the rules: that is, how to get supplies delivered when others can't, how to conduct business within an intricate web of senseless rules. It is not surprising, then, that these managers often see corporate law as merely another obstacle, to be gotten around in any way possible. Some have declared their charter, or the ownership of top management, a "commercial secret." Some simply lock unwanted shareholders out of the shareholder meeting, or conduct a shareholder vote by show of hands (dominated, of course, by employees), or refuse to transfer shares if they don't approve of the new owner.[25] Misconduct so basic is rare in

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[25] Moreover, a not uncommon reaction to a privatization decree that required two-thirds of the board of directors to be non-employees, was by the company who reported to an interviewer that "we fired our deputy director, and he was elected [to the board] as [an] outsider. After some time will pass we will hire him back." Interview with

developed markets, precisely because it would be instantly condemned as making hash out of the ground rules of the corporate form. Of course, there are some useful cultural understandings, even in Russia. Managers may refuse to record a transfer of shares, if they distrust the new owner. But there are few instances where managers have simply wiped an unwanted shareholder out of the share register, leaving the shareholder to go to court to prove ownership. This is fortunate, because proof might be slow and difficult. Our more general claim is that cultural understandings as to proper management behavior will often be limited in emerging markets, that the law must rely on whatever limited cultural understandings actually exist, and that the narrower the scope of useful cultural understandings, the larger the role that corporate law must play.

One way in which corporate law must respond to managers' lack of understanding of proper behavior is through greater precision in its requirements, not only so judges can enforce it, but so that managers can understand it. In the near term, vague standards will rarely be understood, and rarely followed even if understood. Moreover, the law must try to inculcate a sense of proper behavior. It should contain explicit instructions to managers and directors on how they should behave.

Compare the following alternative standards, as guidance to directors who must decide whether to approve a transaction between the company and a manager. Assume in each case that judicial enforcement is unavailable.

(i) a general instruction that the directors should act in the best interests of the company, but no specific guidance on how they should act in reviewing conflict-of-interest transactions.

(ii) an instruction to the directors that transactions between the board and a director or manager should be approved by non-interested directors, who should approve the transaction only if they conclude that it is fair to the company.

(iii) an instruction to the directors that transactions between the board and a director should be approved by non-interested directors, who should approve the transaction only if the consideration for any property or services transferred by the company equals or exceeds the market value of the property or services, and the consideration paid by the company in exchange for property or services does not exceed the market value of the property or services.

The first approach is essentially the one taken today in the United States and Great Britain, though courts and legislatures have over time added some explanatory gloss. Its defects

company manager (St. Petersburg, Russia, Oct. 11, 1994). This and other direct quotes from company managers are mostly taken from transcripts of interviews conducted under Prof. Joseph Blasi, who kindly provided us with transcripts of interviews.

in an emerging economy are readily apparent. It offers very meager guidance to managers and directors, and little possibility of judicial enforcement.

The second is borrowed from best practice in the United States today -- vesting the decision in non-interested directors, and explicitly expecting them to review the transaction for "fairness."[26] In the U.S., This best practice reflects a shared cultural understanding of how honest directors should behave in this situation. Written into law in an emerging economy, the procedures are explicit, and simple enough to be potentially enforceable. But the standard for approval is vague and unreviewable -- neither directors nor judges will know what it means for a transaction to be "fair."

The third approach adds content to the concept of fairness, at the cost of not reaching situations where a transaction, although at market prices, is nonetheless unfair to the company. In an emerging economy, this approach has strong advantages. First, it tells directors who want to behave properly how to do so. Ideally, the norms that transactions between a company and insiders should be at market prices and should be reviewed by non-interested directors will gradually become part of the culture. Second, enforcement is easier. Even a judge who is unsophisticated in business matters can understand that the company's sale of a piece of property to a manager, who then resells it for five times the price that he paid, was not at market value.

III. A Self-Enforcement Approach to Corporate Law

Having surveyed the institutional constraints that shape corporate law in emerging markets must operate, we turn to the question: What form should such a law take? Some aspects of corporate law for emergent markets follow easily from the protective function that it must discharge and the limited tools available to enforce it. To the extent possible, the law should consist of relatively simple rules that can be easily understood and applied, by corporate participants and judges alike. Weak market checks on corporate insiders and the prevalence of controlled companies mean that core rules should often be mandatory, rather than default provisions changeable by shareholder vote. The rules should, where possible, avoid broad standards such as "reasonableness" and "good faith" that will tax the interpretative skills of an inexperienced judiciary and whose content depends on a shared understanding of proper behavior that may be absent. Broad fiduciary standards are also important -- but principally for their long-term value in inculcating a manager culture of duty to shareholders, not their near term value as enforceable limits on manager behavior. The enforceable core must be based on bright-line rules.

When we turn to the task of designing specific rules, there are two general approaches that the law could follow. One we term the "prohibitive model": a statute that bars a wide

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[26] Contemporary American corporation statutes explicitly encourage review of conflict-of-interest transactions by non-interested directors but are less explicit regarding the standard of review these directors should employ. See, e.g., Del. Gen. Corp. L. §144(a)(1) (interested transactions not automatically voidable if approved by disinterested directors).

variety of suspect corporate behavior in considerable detail. The second we term the "self-enforcing model": a law that creates corporate decisionmaking *processes* that allow vulnerable minority shareholders to protect themselves by their own voting decisions.

A. The Prohibitive Model

The prohibitive model is familiar from nineteenth century corporation statutes in the United States and Great Britain, and to some extent from European corporate codes today. These codes simply bar many kind of corporate behavior that are open to potential abuse, such as self-dealing transactions, cashout mergers, and all activities outside the specific business purpose(s) permitted by the corporate charter. Such prohibitive statutes were adopted in market circumstances that resemble in some respects those of emergent economies such as Russia. One plausible approach to corporate law for emergent economies is to return to the restrictive drafting strategy of the past. In Russia, the company law provisions of the Civil Code and of one government drafting team charged with proposing a Russian joint stock company law contain large elements of the prohibitive model.[27]

That developed economies have evolved away from the prohibitive model toward an enabling model -- far away, in the United States and Great Britain, less far in Continental Europe -- does not mean that the prohibitive model is inappropriate for emergent markets. Experience with the discretionary model in Great Britain and the United States teaches that it only weakly protects minority investors from controlling insiders who are determined to exploit hem. Both countries have their share of scandals and scoundrels -- Robert Maxwell in the UK and Victor Posner are prototypical examples.

To be sure, gross abuse of power by controlling insiders of large companies is not very common in either country. Partly, this is for lack of opportunity -- controlled companies are relatively uncommon. But the primary reason -- as we have already argued -- is that multiple markets and institutional controls constrain insider opportunism. Discretionary statutes would predictably fare far worse in emergent economies where controlled firms are the norm and nonlegal restraints on controlling insiders are weak.[28]

But these considerations suggest only that the prohibitive model is a worthy competitor to the discretionary model in emerging economies -- not that it dominates other possible approaches. Prohibitive statutes have severe drawbacks, even in emergent markets. First, they impose major costs on companies by mechanically limiting the discretion of corporate managers

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[27] For the Russian civil code, the borrowing from the past was conscious. A key drafter, Dean Yevgeny Alexeyevich Sukhanov of the Moscow State University Law Faculty, proudly presented to one of us a reprinting by his students of a 1917 textbook on corporate law, and explained his view that current abuses were much like those described in the book, and required a return to the solutions advocated in this ancient text.

[28] From this perspective, it is unsurprising that European corporate codes have evolved less far from prohibition to the enabling model. European companies are more likely to be insider-controlled than U.S. and American companies, and less likely to have active public stock markets, which implies weaker market controls.

to pursue legitimate business decisions. By most accounts, the driving force behind the rise of discretionary statutes in developed markets was the value of flexibility to transactional planners, corporate managers, and ultimately, to shareholders.[29] The inflexibility of substantive prohibitions can be (and in Continental Europe often is) reduced by creative judicial interpretation, but this requires creative and knowledgeable judges.

Second, we know very little about how effective prohibitive statutes really are in thwarting opportunism. Certainly many formal constraints become ineffective as practitioners discover how to avoid them. The classic example in the Anglo-American context is the demise of the protective function of legal capital following the introduction of low-par stock.[30] Moreover, severe substantive prohibitions will tend to be relaxed by legislators to meet business needs -- and once they are relaxed, the prohibitory model offers nothing to replace them with.

Third, prohibitive statutes require significant judicial or administrative involvement. Even clear rules must be enforced by courts or administrative agencies. Moreover, disputes about rules governing specific corporate behaviors are inevitable -- not least because transaction planners will look for ways to comply with the letter of the statute but not its spirit. These disputes, in turn, require knowledgeable judges who can resolve the disputes in sensible ways.

B. The Self-enforcing Model

A central claim of this article is that in emerging markets, what we have called the self-enforcing model of corporate law -- in which mandatory procedural and structural rules empower outside directors and large minority shareholders to protect themselves against opportunism by controlling insiders -- dominates both the prohibitory model and the enabling model. The self-enforcing model greatly reduces the need to rely extensively on courts and administrative agencies for enforcement. Thus, it is robust even when these resources are weak. And it combines much, though not all of the flexibility of the enabling model with a degree of investor protection that the enabling model cannot match, and perhaps the prohibitory model cannot match either.

The structural constraints that define the self-enforcing approach to corporate law can be introduced both at the shareholder level and at the level of the board of directors. At the shareholder level, these constraints typically assume the form of shareholder voting requirements. For example, a statute might require supermajority shareholder approval for a central business decisions, rather than the simple majority approval that characterizes the enabling approach. It might require a shareholder vote for a broader range of corporate actions

[29] See. e.g.. **Romano** (1994), *supra* note 17.

[30] **Robert Clark, Corporate Law** § 14.3 (1986). For us, there was perverse amusement in watching the Russian Civil Code drafters resolutely relying in 1994 on charter capital as a basic form of investor protection, while Russian company managers, having quickly learned the lessons that American managers had learned early in the 20th century, were routinely selling stock with a market value many times its par value (aided in this effort by high inflation). *See* Russian Civil Code arts. 96-102.

than an enabling statute -- including, say, decisions to issue significant amounts of new equity or purchase major assets.[31] For related party transactions, a self-enforcing statute can replaces prohibition on the one hand, and permission loosely policed by courts on the other, with approval by independent directors, a majority of noninterested shareholders, or both. The voting decisions of shareholders with their own money at stake, if obtained through fair procedures and full disclosure, provide a way to distinguish between good and bad transactions that is more fine-grained than the substantive rules of the prohibitive approach could possibly be.

To enhance the value of the voting mechanism, the self-enforcing statute can include a universal ballot that large shareholders can use to place appropriate matters, especially director nominations, on the voting agenda, and procedures, including share registration and vote tabulation by an independent registrar, to ensure honest vote counting. Other structural constraints on the shareholder level can include shareholder audit commissions with certain powers to review management conduct and comment on manager proposals submitted for shareholder vote,[32] and shareholder preemptive rights when companies make significant new issues of stock.

A self-enforcing statute also introduces structural constraints at the level of the board of directors. For example, the statute can mandate that a certain proportion of the directors on company boards must be independent and vest approval of some decisions exclusively in hands of these independent directors -- such as decisions involving related party transactions. Moreover, the statute can create board structures, such as an audit committee to be composed of independent directors, that hold authority as a matter of law -- and are not merely an option as in enabling statutes.

An important feature of a self-enforcing statute, we believe, is a voting rule for election of directors that allows outside shareholders to elect a fraction of the board for selection by outside shareholders -- such as a cumulative voting or class voting rule. Such a voting rule links decisionmaking constraints at the shareholder and the board levels by assuring that large outside shareholders can elect a fraction board, as protectors of their interests. Although majority insiders retain control within this structure, outside representation makes it harder for insiders to ignore or deceive minority shareholders. And over the long run, cumulative voting, by making possible the election of some directors who truly represent shareholders, can influence how all directors come to understand their role in the corporate enterprise.

C. Can Law Function without Official Enforcement?

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[31] To the extent that an enabling statute contains *any* mandates for shareholder votes on particular types of transactions, it partakes of the self-enforcement approach. The differences are ones of degree. The self-enforcing approach contains more and stricter mandates because it places greater weight on the goal of protecting outside investors against insider opportunism, and lesser weight on maximizing business flexibility.

[32] See part IV.D *infra*.

How well can the self-enforcing model work, if judicial enforcement is as weak, corruption as widespread, and organized crime as strong, as is currently the case in Russia? To what extent can it be self-enforcing not only in the sense of empowering outside shareholders but also in the basic sense of eliciting compliance without relying on consistent official enforcement? To explore this question, let us imagine, counterfactually, a world with *no* official enforcement: that is, no official organ to turn to to enforce corporate law rules. If the self-enforcing approach can "work" there -- in the sense of setting standards that are often complied with -- then it can only work better if official enforcement is merely weak, rather than absent, as is in fact the case in Russia.

The concept of rules without enforcement is not entirely new. Robert Ellickson, in particular, has explored situations in which norms of conduct emerge, either when no official enforcement is possible, as for fishing vessels in international waters, or where official rules are out of touch with practical needs and a consensus develops around different norms.[33] One of us has explored, more generally, the potential for written law to be effective without official enforcement.[34] Here, we consider the potential for law without official enforcement in the specific context of corporate law.

Suppose, then, that company directors can simply remove a shareholder from the register, or ignore the requirements for independent vote tabulation, with no fear of official intervention. Suppose too that the company has a 20% shareholder, who wants a seat on the board. What recourse does the shareholder have, if the company erases him from the shareholder register, or refuses to provide cumulative voting, or conveniently loses his ballot?

One answer is that the question has been posed too starkly. Some companies will comply with the written law simply because it is both written and reasonable. Some managers will comply, because otherwise they risk embarrassing news stories, or being looked down on by their more law-abiding friends. Some will comply because this is how their peers behave. Companies that want to raise capital will have to comply with the rules, so as to build a reputation for honest behavior. Companies that want long-term contractual relations with others also must pay some attention to their reputation for honesty and fair dealing.

There are darker possibilities as well. A world without official enforcement will surely have unofficial enforcement. Suppose, plausibly, that some shareholders will resort to violence if what they see as their "rights" are violated, but company directors aren't sure who will and who won't react this way. A director is unlikely to be shot without warning for merely making a bad business decision. That would be foolish on the shareholder's part -- unlikely to encourage better business decisions in the future -- and likely to encourage retaliation in kind. But the situation is very different if the directors break a clear rule. A wrong has been committed. The shareholder must respond however he can. The directors face personal liability

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[33] **Robert Ellickson, Order Without Law** (1991).

[34] Jonathan Hay, *Law Without Enforcement: The Case of Russia* (working paper forthcoming 1995).

of a very tangible kind. It follows that few will act in such blatant disregard of the written law. At the very least, the directors will take the demand of a 20% shareholder for board representation seriously. They will weigh the benefits against the costs, much as they would do if official enforcement were one possible cost.

From this perspective, the Krasnoyarsk Aluminum case, discussed earlier, where a company wiped a 20% investor out of its share register, can be seen as the exception, not the rule. The investor was foreign, and thus unlikely to resort to private enforcement. The company was, reputedly, mafia-controlled, further reducing the incremental personal risk to its managers from their action. For a typical Russian firm, with a large outside *Russian* investor, the managers' cost-benefit calculus would look very different. Moreover, Krasnoyarsk Aluminum suffered indirect consequences. This action surely reduced, if not killed, the chances for completing a management-supported plan by Alcoa Aluminum to invest $500 million and provide badly needed technical assistance, in return for an equity stake in Krasnoyarsk.

To be sure, private enforcers need not enforce only the written rules. But private enforcement will often develop this way. The corporate law will be -- quite literally -- a set of default rules, that the participants in the corporate enterprise can depart from, jointly or unilaterally. But if the default rules match tolerably well what contracting parties would choose for themselves, they will often be followed. As for any set of default rules, it is costly to contract around them -- indeed, contracting around will be especially difficult in precisely the assumed situation of no official enforcement.

It is not necessary that all shareholders be willing to act extralegally, or even capable of doing so. It is enough that a few can. Fear of these few can cause directors to behave properly toward all shareholders. Directors will anticipate that the more blatantly shareholder rights are violated, the more likely it is that some shareholder will take extralegal action, and thus the greater the expected sanction associated with the violation will be . For example, wiping a shareholder off the register is more likely to provoke a violent response than refusing to use the required procedures for approving a related-party transaction.

We do not suggest that such a world is ideal, or anything close. Some directors will be shot for imagined wrongs. Shareholders, too, are at risk if they buy shares in the wrong company, and then complain when the company is looted. Large shareholders will often succeed in obtaining private benefits from the company, especially if these can be hidden from other shareholders. But on the whole, men with guns will often be polite to each other, especially if, as will be the typical case for corporate enterprises, they expect to meet each other again. Repeated interaction magnifies the importance of reputation, and magnifies the risk of retaliation for misbehavior. A corporate law that defines norms of politeness, in ways that the participants perceive as reasonable, can be effective, in the absence of any official enforcement.

Once we introduce the possibility of some recourse to courts, even corrupt courts, or courts whose decisions can be ignored because the loser can bribe the enforcer, the effectiveness of corporate law quickly increases. A corrupt judge can twist a "reasonableness" standard to reach the decision he was paid to reach. He cannot so easily twist a requirement that the company provide cumulative voting. If he finds an exception on some spurious grounds, it will be obvious to all. The judge will lose face in the community -- few corrupt officials want to admit their corruption in public. And such a judge will risk personal retaliation, much as corporate managers do.

Over the longer term, blatant violation of norms can also create a constituency for enforcement. Shareholders will bring political pressure to strengthen enforcement capability. They will have obvious abuses to point to. News stories will highlight the scandals, bringing further pressure for enforcement. Test cases, even if they fail in corrupt courts, will form a base for public opinion -- and there will be repeat players in financial markets who are willing to underwrite the cost of a test case.

Finally, even official enforcement is weak today, it may be stronger tomorrow. Corporate actors will be reluctant to rely on non-enforcement, if the downside risk from violating the rules extends far enough into the future so that future enforcement is possible. This will be double true if corporate rules are designed with a long tail and with relatively severe enough sanctions if enforcement takes place. For example, managers may prefer to seek shareholder approval of a self-interested transaction, if they judge that approval is reasonably likely, rather than risk having the transaction unwound sometime in the future.

In short, the claim that corporate law can be reasonable effective under conditions of weak official enforcement is not as strange as may first appear. And the possibility of law doing much to shape private behavior, despite no official enforcement at all, is not an oxymoron.

D. The Limits to the Self-Enforcement Approach

Self-enforcement introduces costs as well as potential benefits for the corporate enterprise. The costs fall into three principal categories. First, a shareholder vote, or other shareholder remedies such as preemption rights for new stock issuances, introduces both administrative cost and delay. Thus, while mandated shareholder votes and other procedures should be more common under the self-enforcement model than under the enabling model, in emerging than in developed markets, *how much* more common requires balancing, at the margin, the expected costs and benefits of expanding a particular protection. In some instances full shareholder protection will be less economic than partial protection. For example, one advantage of cumulative voting is that it creates a more shareholder-loyal board, which in turn permits us to vest more decisions exclusively in the board, and require a shareholder vote less often. Although these board decisions provide less shareholder protection than a shareholder vote, they will also be faster and less costly.

There are no clear lines, only informed judgment, on how much procedural shareholder protection is optimal in a particular institutional environment, or when one should settle for 75% of the protection at 50% of the cost. We offer below our own judgments in the Russian context, but these are only first approximations, which will surely need revision in light of experience.

A second cost of giving a veto over corporate decisions to outside shareholders or outside directors, or requiring supermajority votes to approve certain decisions, involves the usual costs and risks in departing from a majority vote rule. A large outside shareholder will have holdup power, and may be able to obtain personal benefits by threatening to use this power to block a value-increasing transaction. Or the rational apathy of small shareholders may make it hard for the company to obtain approval of a value-increasing transaction. The two concerns interact: the rational apathy of some shareholders increases the holdup power of other shareholders. Suppose, for example, that a company's managers wish to sell a significant fraction of its shares to another company in return for new investment that will preserve value for investors, but cost jobs today. A high shareholder approval requirement will increase the risk that employee-shareholders can block this value-enhancing transaction.

For Russia today, given roughly 60% manager-employee ownership, relatively concentrated outside ownership of most firms, and modest residual state ownership, our judgment is that approval of key corporate actions such as mergers, by 2/3 of the outstanding shares strikes a rough balance between setting an approval threshold high enough to make shareholder protection meaningful, and limiting the holdup power of outsiders. For share issuances, we think that a simple majority of outstanding shares should suffice. But a different ownership structure could lead to a different judgment.

A third cost of self-enforcement protections is a subtle loss of flexibility in designing the business enterprise. The self-enforcement model controls the structure within which corporate decisions are made, while leaving freedom over the substantive decisions themselves. That is its principal advantage over the prohibitive model. But a single decisionmaking structure will not fit all companies. To some extent, the law can allow for this, by providing different rules for companies of different sizes, and by dictating structure only when there seems strong need to do so. But we cannot anticipate in advance all the ways in which companies might want, for good reason, to depart from the prescribed structure. In theoretical terms, we cannot fully escape the usual expanded choice argument for an enabling law.

Again, judgment is needed, on when to provide different rules for differently situated companies. The *direction* of difference of a self-enforcing law from an enabling law is clear: more of the structure must be prescribed. The *extent* of the difference will increase with firm size. More elaborate procedures, such as independent registrars, or separate audit committees, will be appropriate only for larger companies. Which procedures are appropriate for which firms is an exercise in balancing.

IV. Governance Structure and Voting Rules

The self-enforcing approach to corporate law constrains the discretion of managers and majority shareholders by granting voice and sometimes veto rights over important corporate actions to outside directors, non-controlling shareholders, or both, in the expectation that these directors and shareholders can police whether the proposed corporate action is value-increasing for the enterprise as a whole, or merely a wealth-transfer. These constraints can be described in terms of the level on which they operate, i.e., shareholder or board. They can also be characterized in terms of the actions they affect: the voting mechanism by which shareholders elect directors, the mechanism by which the board or the shareholders appoint and dismiss top management, the transactions that require special approval procedures, and finally the rules that constrain decisions -- by shareholders or managers -- to buy and sell control in corporations.

The self-enforcing model relies heavily on board and shareholder voting mechanisms. Thus, it requires careful specification of governance structure and shareholder voting rules. To avoid manipulation, governance structure must be simple, and malleable only within narrow limits. Some of the enabling model's flexibility over governance, voting processes, and capital structure is sacrificed to preserve flexibility over the range of substantive decisions that the corporation is permitted to take.

This and the next two parts of this article describe in greater detail the elements of the self-enforcing model, with particular references to a proposed approach to a Russian statute. We will repeatedly justify the particular structural rules we favor as concrete examples of the theoretical framework for a self-enforcing law developed above.

A. Allocation of Management Powers

There are two basic options in choosing a review process for corporate actions: representative democracy, in which shareholders act through elected representatives (the board of directors); and direct democracy, in which shareholders vote directly for or against particular actions. Representative democracy alone is often unsatisfactory because boards can too easily become lazy or captured by management. Thus, the company law of every developed country provides for direct shareholder review of selected corporate actions such as mergers. Conversely, however, direct democracy is often even more unsatisfactory in large companies because it is slow and costly, and shareholders must act on limited information and often face severe collective action problems. Pure direct democracy can thus quickly deteriorate into total manager control where shareholders are numerous and small.

We mediate between the weaknesses of each approach with a simple hierarchical governance structure that allocates managerial power to a board of directors, subject to shareholder review for particular actions. The shareholders elect the board; the board chooses the managers (subject to shareholder review of its choice of top manager); the board (sometimes a defined subset of the board) approves particular types of actions, including those that require shareholder approval; for all other actions, the board decides when the managers can act unilaterally and when they need board approval.

This structure has the advantage of transparency: Shareholders know whom to blame if things go wrong. The structure provides double review, by both board and shareholders, of important or suspect transactions. It provides reasonable, though not total flexibility -- the board decides, within broad limits, how best to use its own limited time. The structure requires enough of the board so that a conscientious board must meet often enough, and involve itself in enough business decisions, to make the board unlikely to descend into ill-informed irrelevancy -- a strong risk in the German two-tier board model, where the supervisory board meets rarely and does little other than choose management.[35] And the structure does not require more of shareholders than they can deliver.

Apart from choosing the board, shareholders do not make decisions unilaterally. Instead the shareholders review actions that have already been approved by the board. These limits on direct democracy reflect the limits on the information available to small shareholders. They also ensure that the managers cannot circumvent the board of directors by appealing directly to shareholders for support.

The broad power of the board of directors is constrained, in turn, by granting shareholders broad power over its constituency, e.g., by requiring directors to be elected annually through cumulative voting, and permitting shareholders to remove the board without cause.[36] The path toward effective shareholder use of these tools to increase company value is smoothed in various ways -- including restricting companies to a single class of voting securities, which also carry a residual economic interest in the company's profits, and procedural rules that facilitate shareholder nomination of director candidates and free shareholder choice from among all nominees.

B. Allocation of Voting Power: One Share, One Vote

Shareholder voting rules for the election of directors must resolve two basic issues: how votes are allocated among investors, and how votes are tabulated to select directors. The goal of a self-enforcing statute is to increase the likelihood that corporate actions maximize corporate value. The natural resolution of the first issue is to match, as closely as possible, voting power to economic interest -- to mandate a single class of voting common stock that has a residual interest in corporate profits and votes according to the one share, one vote principle.[37]

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[35] The structure has enough flexibility to allow a company largely to replicate the two-tier management structure, if the board so chooses. The "board of directors" can hire a "board of managers," and delegate to it all day-to-day management responsibility, subject only to whatever limited oversight the board of directors chooses to exercise. However, the board of directors remains responsible to the shareholders for the consequence of this choice; it cannot blame a legal structure that limits the board's power over management.

[36] For mechanical reasons, a system with cumulative voting must allow shareholders to remove the entire board, but *not* individual directors. If directors could be removed individually, a majority shareholder could vote to remove a director elected cumulatively by a minority shareholder, and thus nullify the effect of cumulative voting. *Cf.* Del. Gen. Corp. L. §141(k)(i) (cumulatively elected directors may not be removed if votes against removal would be sufficient to elect).

[37] In practical terms, this means limiting the voting rights of securities (preferred stock and debt) that are senior to a company's common stock, and limiting the company's ability to issue securities, principally options to purchase common stock, that are equivalent to or junior to common stock.

The one share, one vote principle is widely accepted across jurisdictions. It is the dominant rule in the U.S., Great Britain, and Japan. Moreover, nonvoting or low-voting stock is under strong criticism from large investors in countries, like Germany, where it has been common.[38] The conventional intellectual case for the rule turns primarily on its value in matching of economic incentives with voting power and in preserving the market for corporate control as a check on bad management.[39] By contrast, in developed economies the case for permitting companies to deviate from a one share, one vote rule turns on (i) the usual justification that informed parties can choose their own optimal contracting arrangements; and (ii) the existence of an efficient market, in which founders realize a lower price if they sell lower-voting shares.

In emerging markets, the arguments against a one share, one vote rule lose much of their force. First, public offerings are unlikely to be priced with a high degree of efficiency. Second, in privatized economies, including Russia, there were no true founders who could make an economic decision whether to sell control rights as well as economic rights. Instead, one faces the much more troubling prospect of midstream charter changes, proposed and perhaps coerced in various ways by managers who can gain control without losing much economic value.[40]

Third, the need for investor protection against egregious self-dealing by company managers is much higher in emerging markets. In the U.S., the Victor Posners and Donald Trumps who extract maximum value from control, enriching themselves while impoverishing other shareholders, are an aberration. Robert Maxwell is similarly an aberration in the U.K. That these remain aberrations is essential to the viability of the enabling system, which has limited ability to handle them.

In Russia, behavior like this, and much worse, is common. Stories abound of, say, the managers of a natural resources company selling a most of its output to another company, and never collecting the accounts receivable, meanwhile not paying the company's rent, taxes, utilities, or even employees for months or years. One suspects, but the government rarely proves (and rarely tries), that much of the profit from these dealings ends up in the managers'

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[38] In the United States a one share, one vote rule is maintained by agreement among the principal stock exchanges, rather than by company law. In Britain, one share, one vote is essentially universal because of strong support from institutional investors, who refuse to buy the shares of a company that has a different rule. See Black & Coffee (1994), *supra* note 5, at 2024.

[39] For pieces of the extended debate over one share, one vote in the U.S., see Ronald J. Gilson, *Dual-Class Common Stock: The Relevance of Substitutes*, 73 **Va. L. Rev.** 807 (1987); Louis Lowenstein, *Shareholder Voting Rights: A Response to SEC Rule 19C-4 and to Professor Gilson*, 89 **Colum. L. Rev.** 979 (1989); Easterbrook & Fischel (1992), *supra* note 17, at 63-65; Jeffrey Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 **Calif. L. Rev.** 1 (1988); Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 **Geo. Wash. L. Rev.** 687 (1986).

[40] For discussion of the special problems created by midstream charter changes, see, e.g., Lucian Bebchuk, *supra* note 17; Gordon (1989), *supra* note 17, at 1573-85; Black (1990), *supra* note 4, at 566-70.

personal overseas bank accounts.[41] Voting common shares are no panacea for this behavior, but at least they can help.

A multiple-class voting structure creates incentives to abuse control. Put simply, control, like other assets, will tend to move to those who value it most. Yet, control is worth more to someone who will abuse it than to someone who will not. Bad owners can outbid and thus drive out good owners. In a developed economy, it is possible (though uncertain even there) that other market and cultural constraints will be strong enough to overcome this built-in incentive and keep abuse at manageable levels. In emerging markets, abuse will proliferate.

From this perspective, a mandatory one share, one vote rule protects even shareholders of companies who, under an enabling regime, would initially issue only one class of voting stock, by assuring these investors that their company will not change the rules on them in midstream. The rule can thus lift the value of all shares.

To analogize to ordinary product markets, whenever product quality is difficult for buyers to measure (the "lemons" situation), minimum quality rules can be welfare-enhancing. The case for quality rules in securities markets is especially strong because of the risk in securities markets, largely unique to securities markets, that the quality of what one has bought will be changed after the date of purchase, and the strong incentive for unscrupulous investors to profit by doing precisely that.

C. Voting for Directors: Cumulative Voting

The one share, one vote rule has the advantage of being widespread and having easily understood virtues. Our approach to how votes are to be tabulated in selecting directors relies on a less common solution, whose advantages are also more subtle: mandatory cumulative voting, and related requirements for minimum board size (a 7-director minimum ensures that a 15% shareholder can elect one director) and annual election of directors (staggered board terms, by reducing the number of directors elected at one time, have the same effect as small board size in diluting the effectiveness of cumulative voting).

For us, cumulative voting addresses several problems at once. First, it serves the obvious function of giving large minority shareholders a voice in board actions, though not a controlling voice.

Second, a seat on the board is an important source of information about the company's affairs. Thus, for large or organized shareholders cumulative voting can be an imperfect substitute for the disclosure provided more directly in developed economies through financial disclosure rules; through reports from stock market analysts and the financial press; through the

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[41] See, e.g., *Russian Capitalism*, **Economist**, Oct. 8, 1994, at 21, 23.

signals provided by market prices; and, especially in Germany and Japan, through non-public financial reports to the company's lead bank.

Third, cumulative voting increases the likelihood that at least a minority of directors is truly independent of management, and -- what is also important though often neglected in the U.S. -- that these directors will owe affirmative loyalty to shareholders who elect them.[42] Director independence takes on special importance for us because it interacts with rules, discussed below, that vest in outside directors the power to review transactions in which managers have a personal financial stake. This independent director review is especially important because of the weakness of fiduciary rules and cultural constraints as checks on self-dealing. In addition, the influence of a minority of outside directors can be extended beyond disclosed self-dealing transactions if, in large companies, the law requires an audit committee composed of independent directors to choose the company's auditors, outside registrar, and "counting commission" (i.e., persons who will count shareholder votes).

Fourth, cumulative voting reinforces the principle that directors owe their loyalty to shareholders, not to the company's officers. As such, it forms a piece of a broader effort in the corporate law to develop and reinforce voluntary compliance with behavioral norms that have served developed countries well. For example, a Presidential Decree mandating cumulative voting for privatized firms already seems to have triggered this norm-reinforcing effect in Russia over the past year. Almost no firms had outside directors prior to the decree, but today they typically have outside directors in rough proportion to the holdings of outside blockholders.[43] Paradoxically, most firms have ignored the decree on the surface by not implementing cumulative voting. Nevertheless, in those firms where investors would have had the power under cumulative voting to elect a director or two, investors have often achieved the same result without an open election contest -- exactly the result one hopes for. Similarly, as some Russian firms appoint outside directors, it is becoming the norm, so we hear, for others to do so. We do not claim that these voluntarily appointed "outside" directors are always truly independent. But some are, and before long, norms of behavior for outside directors will develop that will encourage others to be more independent than, perhaps, the managers who chose them initially expected.

Precisely because cumulative voting serves these multiple purposes, it is a central element of our effort to develop a self-enforcing corporate law. It will not ensure truly independent directors, or directors accountable to shareholders, at all companies. Moreover, we are not so sanguine as to rely on the board of directors, or even on nominally independent directors, as the sole protection of outside shareholder interests -- we also contemplate a relative broad range of transactions, including self-interested transactions, for which shareholders also have veto power

[42] See Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 Stan. L. Rev. 863 (1991).

[43] See Blasi (1995), supra note 7, at 20.

or other protections. But cumulative voting will strengthen the boards of at least some companies, and that will help.

The fact that cumulative voting is optional in most developed countries, and many companies do not adopt it, does not detract from its value as a cornerstone of a self-enforcing law. In most of these other countries, market, legal, and cultural forces combine to achieve the goals that only cumulative voting can help to achieve in developing markets.

Consider outside shareholder representation on the board of directors. In the U.S., large outside shareholders often obtain representation on the board of directors in rough proportion to their ownership interest. Management might be able to defeat the large shareholder's nominees in an election contest. But this is not certain, and company managers would rather allow a large shareholder to have a couple of board seats than risk losing the election contest, which would probably mean losing their jobs. Or a company will give an large investor representation on the board to get the investor to invest. Or the company will, simply because it is normal to do so, appoint independent directors -- often, an absolute majority of the board -- who can perform much of the oversight that would be undertaken by directors chosen by large shareholders under cumulative voting.

Some developed countries do not rely heavily on oversight by outside directors, but other oversight mechanisms act as substitutes. In Great Britain, outside shareholders often lack direct board representation. But directors and managers know that a modest number of institutional investors, if the need arises, can combine forces to oust the board. And large British institutions are pressing for enhanced board independence, in the hope that independent directors can supplement the limited, crisis-oriented oversight that the institutions now engage in. Similarly, in Japan, large shareholders can act through the main bank to force a change in management.

The principal argument raised against cumulative voting is that it creates the possibility of a divided board, which might be less effective than a board elected through a winner-take-all election. But the available evidence suggests that this is not a large risk in practice. The experience in other countries with proportional representation of large shareholders on the board, whether that representation results from explicit cumulative voting or from an agreement between management and large shareholders, is that it usually works well. Large shareholders often insist on proportional representation, of the type that they would receive with cumulative voting.

Moreover, the argument that cumulative voting can be divisive lacks not only supporting evidence, it also lacks a theoretical explanation for why cumulatively elected directors will act this way. It is rarely in the interests of a large shareholder to try to interfere with the smooth functioning of the board of directors. And when it is, that is often a sign of some other pathology, for which cumulative voting might be an incomplete cure, but still perhaps better than the alternative, which might be a unified board stolidly supporting management as it marches the company toward disaster.[44]

Empirical studies in developed countries suggest that shareholders benefit from the availability of cumulative voting.[45] For emerging markets, where other sources of shareholder protection are weak, we believe that the likely benefits of cumulative voting for minority shareholders greatly outweigh its potential costs.

D. Voting Procedures: Universal Ballot and Independent Tabulation

Of course, cumulative voting is only part of the architecture of a voting system. Ancillary rules are necessary to articulate procedures and safeguard the distribution of voting power that is implicit in the cumulative voting rule. In particular, the voting regime must provide rules to govern the form of shareholder proxies (or ballots), the nomination of candidates for election to the board, the introduction of proposals for shareholder votes, and the tabulation shareholder votes. In addition, voting regimes for companies in emerging economies must take special precautions against efforts to subvert shareholder voting through coercion or fraud.

We endorse the so-called "universal ballot," or consolidated proxy, both as form of the shareholder proxy and as the framework for nominating directoral candidates and introducing shareholder proposals. Where the voting regimes of conventional company laws typically require each faction in a proxy contest to distribute its own proxy, the universal ballot lists the qualified candidates of all factions on a single consolidated proxy, which is prepared at company expense and made available to shareholders well in advance of the shareholder meeting. Under this regime, the incumbent board and all shareholder groups exceeding a threshold size may nominate candidates on the company's ballot. In addition, shareholder groups exceeding the same threshold size may list one or more proposals (in the Russian statute, two) for a shareholder vote at general meetings, with no restrictions on subject matter.

Like cumulative voting itself, these liberal provisions for including shareholder nominations and proposals on the company's ballot permit relatively small aggregations of shares to participate in shaping the company's voting agenda. Of course, the precise size at which shareholder groups ought to receive the right to list board candidates on the company's ballot is a matter of judgment. On one hand, a very low threshold invites abuse by shareholders with little incentive to take the company's interests seriously. On the other hand, it is our judgment that shareholder groups well below the size required to elect a director under cumulative voting should enjoy nomination rights in order to facilitate the representation of disaggregated

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[44] See generally Jeffrey Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 **Colum. L. Rev.** 124 (1994).

[45] See Sanjai Bhagat & James Brickley, *Cumulative Voting: The Value of Minority Shareholder Voting Rights*, 27 **J.L & Econ.** 339 (1984).

shareholders with common interests. The Russian statute sets the size threshold that permits shareholder groups to place board nominations and shareholder proposals on the universal ballot at two percent.[46]

The best voting procedures in the world are useless, however, when they are subverted by coercion, vote buying, or fraud -- chronic dangers in emerging economies such as Russia. Coercion and vote buying occur when someone -- typically a company insider -- induces shareholders to vote against their investment interests by threatening to punish "wrong" votes, reward "right" votes, or both. In the Russian case, coerced voting is a particular danger because management is in a position to exercise its workplace authority to command the votes of the large blocks of stock held by employee shareholders. Although this problem merits specialized regulation,[47] the first defense against the coercion of workers' votes is equally appropriate to all forms of coercion and illicit vote buying: namely, placing a mandatory rule of confidential voting in the company law. Insiders who cannot monitor shareholder votes lose the power to manipulate votes through rewards or sanctions.

In contrast to coerced voting, voting fraud occurs when outsiders cannot monitor insiders -- or, more specifically, when outsiders cannot monitor the insiders who have the power to alter or miscount ballots in the service of their own agenda. Moreover, voting fraud is a particular concern when controlled companies operate under cumulative voting, because relatively small changes in vote tallies can importantly affect minority representation on the board.

The obvious way to reduce the danger of voting fraud -- and to protect confidential voting simultaneously -- is to separate the functions of collecting, tabulating, and storing shareholder ballots from the company's management insofar as this is possible. The Russian statute accomplishes this separation in two ways. For large companies (of more than 1,000 shareholders), it vests the tabulation function in the independent share registrar that the statute requires such companies to maintain for the quite different reason of assuring the reliable recording of share transactions. For smaller companies unable to afford an independent share registrar, the tabulating function is vested in a separate commission of outsiders who cannot include directors or company officers -- although they are approved by the board of directors. While such a board-appointed commission clearly provides less protection than an independent share registrar seems to assure, voting fraud may also be easier to detect in small companies where shareholders often know firsthand who supports whom in contested elections.

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[46] By contrast, the statute sets the threshold for petitioning to convene a special shareholders meeting (as distinct from the annual regular meeting to elect directors) at ten percent of qualified voting shares. This higher threshold reflects not only the considerable expense of holding a shareholders meeting but also the fact that most decisions such a meeting might take would require at least a majority vote -- as opposed to the 10% - 15% necessary to elect a director under the cumulative voting rule. In the face of opposition from an incumbent board, majority approval is unlikely unless a proposal has widespread or large-block backing from the outset.

[47] See Part VII.A *infra* (protection of employee shareholders).

But if such statutory protections against manipulated voting are effective, a last troubling question about cumulative voting remains: How much will it really matter, given that insiders generally control the board in Russian companies and presumably in the companies of emerging economies generally? We have already discussed how cumulative voting can matter in controlled companies, provided that outside blockholders make use of it. Minority board representation serves as a device for monitoring insiders and to leverage the authority of outsiders to pass on suspect transactions through the committee structure of the board. A concern that cumulative voting might not matter, then, must be a concern that minority blockholders will fail to take advantage of it, presumably because the costs of formally seeking board representation outweigh the benefits. But here the preliminary Russian data is encouraging because it suggests that large outside blockholders expect to have representation on the board in controlled companies.[48] Moreover, even when formal cumulative voting is not used and management's slate is the only one, the option of cumulative voting may well have an effect. Most obviously, it may determine whom management invites on its slate; less obviously, it may deter management from actions that could provoke an outsider's slate to enter the race. Thus, the important question, ultimately, is not how often shareholders will avail themselves of cumulative voting but whether cumulative voting is available when someone tries to use it, and whether minority shareholders find that the threat to resort to cumulative voting has significant deterrent and bargaining values.

V. Structural Constraints on Particular Corporate Transactions

In any corporate law the basic governance structure and voting rules alone regulate only routine business transactions. Very large, unusual, suspect, or potentially transformative transactions are often subject to more specialized regulation to protect outside investors from unusual risks of abuse. Since these key transactions are particularly risky for investors, they are logically accorded special treatment. Moreover, in keeping with the project of a self-regulatory corporate law, the special treatment we prescribe takes the form of structural constraints rather than prohibitions for four categories of transactions: mergers and similar major transactions, self-interested transactions, transactions in shares, and control transactions.

A. Mergers and Other Major Transactions

Mergers, large sales of assets, large acquisitions of assets (whether directly or indirectly through a subsidiary), reorganizations, and liquidations are essential tools for restructuring companies. However, they can also radically alter the nature of a shareholder's investment, and they have historically been a common means by which insiders can loot the company's assets. To respond to this danger, major transactions commonly require the approval of at least a majority of shareholders, even under the enabling laws of developed economies. In addition, enabling statutes also frequently provide a second, individualized mechanism of shareholder protection in the form of appraisal rights that permit shareholders to demand payment of the fair

[48] See Blasi (1995), supra note 7, at 20.

value of their shares, as determined by a court, instead of accepting the consequences of the transaction.

For emerging economies, the list of transactions that require approval in developed countries, and the required shareholder vote, should form a floor. The key decisions are (i) whether to require a tougher shareholder vote than majority approval; (ii) what additional transactions should require a shareholder vote; (iii) what appraisal rights shareholders ought to have if the company completes a transaction that they oppose.

Shareholder Vote Requirement. Setting a shareholder approval threshold for major transactions requires analysis of the typical ownership structure of public companies and of the most likely forms of potential abuse.[49] For Russia, the typical ownership structure of privatized enterprises leads us to propose approval by 2/3 of the outstanding shares.[50]

The shareholder vote requirement should be high enough so that managers and employees cannot reach it too easily without support from outside shareholders. In Russia, this means a supermajority vote because most companies today have majority ownership by managers and employees. But the vote requirement must not be so high that the company cannot complete a beneficial transaction because the necessary shareholder vote cannot be obtained. For example, managers might propose a merger that will increase productivity at the merged firm, but also lead to layoffs. If the vote requirement is too high, opposition by employee shareholders could block the transaction. The 2/3 rule strikes a balance between the benefits and costs of a supermajority vote requirement.

Transactions Requiring a Shareholder Vote. Deciding which transactions should require a shareholder vote also requires lawmakers to strike a balance between flexibility and the protection of minority shareholders. A shareholder vote to approve a transaction is costly in both time and money: managers must either call a special shareholder meeting, or wait until the next regular shareholder meeting to ask for approval of the transaction by the shareholders. This cost and delay will increase the cost of completing transactions and will deter beneficial transactions entirely. Thus, the shareholder vote requirement should only apply to transactions that transform the nature of the company, or involve a substantial risk of abuse: that is, where the value of protecting shareholders clearly outweighs the costs of a mandatory vote.[51]

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[49] These approval requirements are in addition to the rules for self-interested transactions, discussed below, that will apply in some cases, as when a parent company merges with a controlled, partly-owned daughter company, or when manager of the target company are offered an opportunity, not given to other target shareholders, to invest in the acquiring firm.

[50] For Russia, we also propose an exception for investment funds, which (i) typically have a huge number of tiny shareholders, and (ii) lack the substantial employee ownership that characterizes privatized firms. The first factor makes a 2/3 vote harder to achieve, the second makes it less important as a protection against management overreaching. Here, we think a simple majority of outstanding shares should suffice.

[51] Significant transactions must also be approved by the board of directors of the company, but this offers little protection of outside investor interests when the company's managers control the board.

For Russia, the transactions that we believe should require a shareholder vote are:

(i) a merger or other business combination involving the company and one or more other companies;
(ii) a liquidation of the company;
(iii) a transformation of the company into a legal entity of another type, such as a partnership;
(iv) a sale of assets, directly or through subsidiaries, equal to 50% of the book value of the company's assets;[52]
(v) a purchase of assets or other transaction that will result in the company owning, directly or through subsidiaries, additional assets equal to at least 50% of the book value of the company's assets.

The first three items on this list need a little comment. The requirement of a shareholder vote for mergers and liquidations is standard in most company laws. Only the fourth and fifth requirements, dealing with sales and purchases of assets, are relatively strict in comparison to developed country law.[53] The rationale for lower voting thresholds in Russia is simply that transactions in the 50% range -- i.e., very large transactions -- can destroy a company with the stroke of a pen if they happen to be self-dealing transactions designed to gut the company on management's behalf. Of course, self-dealing transactions are also subject to voting restrictions, as we will describe shortly. But we cannot be confident that self-dealing transactions will always be disclosed. Therefore, a size-based voting requirement provides a back-up constraint on the hidden self-dealing transaction. When so much of a company is at stake, multiple protections are desirable.

For the same reason we also propose a shareholder vote on smaller purchases or sales of assets, involving between 25% and 50% of a company's value, that are not *unanimously* approved by all directors, including outside directors selected through cumulative voting. Finally, for enforceability, accounting values rather than market values should trigger the shareholder vote or unaninous director approval requirements. Although market value might be

[52] There should be a normal course of business exception to handle the special case of a trading company that regularly makes large purchases and sales of good, on a thin equity base. The definition of asset sales should not include a pledge of assets to secure a loan. Such a pledge, followed by intentional default on the loan, can be used as an indirect way to sell assets without a shareholder vote. But most pledges are likely to be legitimate, and often a default under one loan agreement will have adverse consequences under other loan agreements, because of cross-default provisions. On balance, we believe that the lost flexibility from treating a pledge of security for a loan in the same manner as a sale exceed the gain in additional protection of shareholders against sales for less than fair value.

[53] For example, American corporate law imposes no restrictions on the purchase of assets, and requires a shareholder vote only for the sale of "substantially all" assets. See, e.g. Del Gen. Corp. L. §271 (1992). A sale of more than 75% of balance sheet assets generally requires a shareholder vote under this provision, which similar sales (between 26% and 75%) may trigger a vote on occasion. Leo Herzel, Sherck & Colling *Sales and Acquisitions of Divisions*, 5 Corp. L. Rev 3, 25 (1982). See **Ronald J. Gilson & Bernard S. Black, The Law and Finance of Corporate Acquisitions** (2d ed. 1995).

preferable in theory, they are not administrable in a country like Russia, with neither an efficient stock market nor reliable professional appraisers.[54]

B. Appraisal Rights

Even in enabling-type corporate laws, a shareholder who votes against a major transaction that requires a shareholder vote can typically demand payment of the fair market value of his shares, as determined by a court. Like most other shareholder protections, this so-called appraisal remedy is far from perfect. On the one hand, it has been sharply criticized for the burdens that it imposes on transacting corporations, including a possible drain on a company's liquidity that may deter value-enhancing transactions.[55] On the other hand, the capacity of the appraisal remedy to check breaches of fiduciary duty by managers is sharply limited, especially since only large minority shareholders are likely to exercise their appraisal remedy under any circumstances.[56]

The appraisal remedy, which works badly even in developed markets, will surely work worse in emerging markets. Yet there is no obvious alternative. Judicial or regulatory approval of major transactions is neither practicable nor desirable. Hence, one can only try to ameliorate the worst problems associated with appraisal rights in emerging economies. For example, appraisal rights in developed economies typically require a shareholder actively to oppose a transaction. In an emerging market, this condition weakens an already weak right. Given poor mail systems, shareholders may not learn of a transaction in time to vote against it, or find that their votes did not reach the company in time. Counting commissions or outside auditors that tally the votes in large companies will presumably count "no" votes, but smaller companies may simply discard no votes without leaving shareholders any proof of having voted. Therefore, we propose that shareholders who do not vote *for* a major transaction should be able, promptly after the transaction is completed, to obtain payment of the fair value of their shares measured before the transaction took place.

In addition, company law must be alert to the potential misuse of the appraisal remedy. For example, minority shareholders might sabotage a beneficial transaction by demanding that the company buy back their shares at a time when it is strapped for cash. One way to balance

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[54] On the difficulty of administering a market value test for shareholder votes on sales of assets, see Gilson, supra, at 523-24. A balance sheet test serves tolerably well for sales of assets, since balance sheet numbers for the assets to be sold can be compared to the total balance sheet value of the company. In the case of asset purchases, accounting numbers are somewhat less satisfactory; the value of the asset, as it is carried on the books of the seller, must be contrasted with the book value of the buyer. Although this test will lead to some arbitrary outcomes, it is nonetheless preferable to attempt to reconstruct market value.

[55] See, e.g., Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 **Yale L. J.** 223 (1962).

[56] See, e.g., Victor Brudney and Marvin Chirelstein, *Fair Shares in Mergers and Take-Overs*, 88 **Harv. L. Rev.** 297, 304-07 (1974).

the need for shareholder protection against the company's need for flexibility is to give shareholders only a short period of time after the transaction is completed to seek to have the company buy back their shares. Otherwise the right to sell one's shares back to the company will be a valuable put option that can be exercised if the value of the company's shares declines after the transaction, even if the decline is unrelated to the transaction itself.[57]

A further problem that arises with special force in emerging markets is the valuation issue of how to determine the fair market value of shares. This is important not only for appraisal, but also for other procedural protections, including those accompanying major transactions and repurchases by the company of its own shares. Even developed economies have trouble defining fair market value in a consistent fashion. In an emerging market, a simple statement that shareholders should be paid the fair market value of their shares will fail of its intended effect, merely because no one will know how to determine fair market value. Further definition of an intrinsically difficult concept is needed. We offer a possible approach below, with no claim that it is the only available one.

Fair market value: The market value of property, including the common stock or other securities of a company, shall mean a price at which a seller, who is fully informed about the value of the property and is not obligated to sell the property, would be willing to sell, and which a buyer, who is fully informed about the value of the property and is not obligated to buy the property, would be willing to buy.

Fair market value shall be determined by the board of directors, unless in a particular case the decision as to fair market value is vested by this law in the founders of a company or a court or an arbitration tribunal. If some but less than all directors are interested directors as to the transaction or transactions that require the determination of fair market value, the determination of fair market value shall be made by the non-interested directors. In the case of a public company, the determination of fair market value shall be made by the non-interested independent directors.

The person (persons) making the decision on the fair market value of property may rely on the advice of auditors or other independent valuation experts. If the property to be valued is publicly traded common stock or other securities, the person (persons) making the decision shall consider, in making their decision, the market price of the common stock or other securities over a period of time of no less than 2 weeks prior to the date of the decision as to

[57] More generally, a put option is inherent in any system of appraisal rights. This creates a collective action problem: A shareholder who seeks appraisal rights for a stock-for-stock merger can, at modest cost, obtain a significant time window in which to decide whether to pursue the appraisal rights, or abandon them and receive the merger consideration. Granting this option is costly to the other shareholders. If mails are reliable, it is appropriate to limit access to this free option by requiring that a shareholder must vote against the merger, not simply (as in our proposal) fail to vote, by imposing tight time limits for exercising the appraisal right (which reduce the option's value), and perhaps by limiting the corporate actions that give rise to appraisal rights. This is an example of a situation where a rule that is appropriate for emerging markets should change as a background institution changes -- in the is case, the mail system.

fair market value, but only to the extent that he (they) decide that the market price of the common stock or other securities is a reliable measure of its value. If the property to be valued is common stock of a company, the "value" of a share is to be understood as a pro rata claim on the underlying value of corporate assets, as these are presently organized and managed. In setting a price for this value, the person (persons) making the decision may also consider the shareholder capital of the company, the price that a willing, fully-informed buyer would be willing to pay for all of the company's common shares, and other factors that they consider important.

C. Self-Interested Transactions

Transactions by a company that personally benefit directors, managers or large shareholders are inherently suspect, because the director, manager, or large shareholder (whom we will call an "insider," recognizing that the description may not be accurate for a large shareholder) may be able to cause the company to enter into the transaction on unfair terms. Yet we cannot simply return to the broad prohibitory approach to these transactions that characterized U.S. law in the early 20th century, because sometimes these transactions are advantageous to the company -- this, after all, is the underlying reason why broad prohibitions disappeared. Outright prohibition, therefore, is justified only in exceptional cases where there is little business justification for an interested transaction and the risk of abuse is particularly high. We suggest only two such cases: loans by the company to insiders, and payments (kickbacks) by another person paid to an insider, in connection with a transaction between the company and the other person. Elsewhere, the self-enforcement approach to the regulation of interested transactions relies on an especially rigorous set of procedural protections to reduce the incidence of illicit self-dealing.

The principal procedural protections are (i) a vote by non-interested directors or, for large companies, a vote by non-interested *independent* directors, and (ii) a vote by non-interested shareholders. The level of procedural protection appropriate to a self-interested transaction depends on balancing the risk that additional protections will prevent good transactions against the likelihood that they will deter bad transactions. Since approval by non-interested directors is relatively easy to obtain, it should be required before the company can enter into *any* self-interested transaction. But since shareholder approval is costly and time-consuming to obtain, it should be required only for large transactions.

We do not pretend that this approach will prevent all self-dealing. Sometimes insiders will hide their interest in a transaction -- but then the prohibitory approach will fail as well. Sometimes directors will not act independently of the managers. But company law can reduce the frequency of abuse. In some transactions, the insiders' interests cannot be concealed; and in others, the insiders will decide to obtain an honest vote in order to protect the transaction against later attack in the courts. Also, managers who think of themselves as honest will voluntarily follow the rules. When self-interested transactions are disclosed, shareholders, or non-interested directors, can vote down the worst transactions, and the requirement of a vote can make self-dealing more difficult, and therefore less common. The requirement that transactions be disclosed to shareholders can also deter some self-interested transactions.

The value of a requirement that self-interested transactions be approved by independent directors will be meaningful only if the directors are truly independent. There is no way to guarantee the independence of outside directors who are chosen by management. But many firms will have some directors who were elected by outside shareholders through cumulative voting. Since these directors are likely to be truly independent, their approval ought to be required for self-interested transactions in larger companies. Thus, the cumulative voting rules interact importantly with the rules on self-interested transactions.

D. Structural Constraints on Transactions in Shares

A third class of special transactions that merit structural protections are share issues and repurchases. Company sales and repurchases of shares not only have the potential of shifting company value from outside investors to company insiders (as do sales of company assets), but issuances and repurchases of shares also have the potential to shift voting power among classes of shareholders. At the same time, however, nothing may be more critical to the survival and growth of a company than its ability to raise new capital as the need or opportunity arises, without time-consuming procedural obstacles. Among developed countries, corporate law (as distinct from securities law) generally poses no requirements on issuances of shares below a critical threshold such as 20%.[58] By contrast, the regulation of share repurchases is more diverse, ranging from almost no regulation in the U.S. to a near-prohibition of share repurchases in Japan until recently.

1. Issuance of Shares

There is a deceptively simple way to protect shareholders against a company's managers selling shares for less than fair value -- forbid the company from having authorized but unissued shares. Then the managers must come to the shareholders whenever they want to issue shares. We reject this approach because either it is so strict raising capital becomes too difficult or, paradoxically, it will come to mean nothing at all. If literally every issue of new shares required a separate shareholder authorization, managers simply could not issue shares rapidly to exploit unexpected financing and investment opportunities. Moreover, the shareholder vote requirement would preclude the use of equity consideration in small transactions, and greatly complicate option-based incentive compensation plans. Given these drawbacks of barring authorized but unissued shares, however, managers would undoubtedly search for a way around the ban. Most likely they would ask shareholders for blank check authorization of share issuances at every annual meeting. Yet if this ploy were successful, the draconian restraint on share issues would collapse into an empty formality, leaving shareholders with no protections at all.

[58] In the U.S., New York Stock Exchange Rules rather than state corporate law require a shareholder vote for share issues greater than 18.5% of outstanding shares. N.Y.S.E. Listed Company Manual, §703.08A.

a. Shareholder Approval

In lieu of a ban on authorized but unissued shares, the self-enforcing approach to corporate law offers instead a more complex series of mechanisms to balance shareholder protection against the costs of regulation. The goal is to provide reasonable protection to shareholders against issuance of shares for less than fair market value, or issuance to alter the ownership, and therefore the control of a company, without unduly burdening the share issuance process.[59]

To make it easier for companies to issue shares, shareholders should be able to authorize shares that will be issued by the company only at a later date. The board of directors will decide when and if to issue these authorized but unissued shares. Of course, the shareholders can refuse to authorize shares if they do not trust the managers to sell the shares at a fair price, but we expect that this will be rare. The general requirement of approval by 2/3 of the outstanding shares to amend the charter will give outside shareholders some control over the company's ability to increase its authorized shares.

The concern that shareholders' interests will be diluted by a sale of stock for less than market value is especially strong if the stock is sold to directors, managers, or large shareholders. The proposed law addresses this concern in several ways. First, a sale of stock by the company to a director, manager, or 20% shareholder is a self-interested transaction that requires approval by non-interested directors and by noninterested shareholders, as described below. Second, a sale by a company of shares equal to 25% or more of its previously outstanding shares should require approval by a majority of outstanding shares, excluding shares held by the acquirer of the new shares. In the usual case where the acquirer is not already a large shareholder, this is less strict than the 2/3 vote for mergers and other major transactions. This is appropriate because shareholders, other than those who are acquiring the new shares, share a common interest in selling the new shares at a high price. Third, the preemptive and participation rights described below apply even for sales of stock that do not otherwise require a shareholder vote.

b. Preemption Rights

We propose that in any issuance of shares, with only limited exceptions, the company must offer shareholders preemptive rights, which are common in Britain and Europe. Preemptive rights require the company to either offer any shares prorata to existing shareholders, or obtain a shareholder vote waiving preemptive rights in a particular case. This protects shareholders against issuances for less than fair value.

Preemptive rights impose a substantial cost -- a preemptive rights offering is costly for a company with many small shareholders, and is relative slow. Thus, any preemptive rights

[59] These rules focus on the interests of the company's *existing* shareholders. It is the job of securities law to protect the interests of the purchasers of shares when shares are sold to the general public.

requirement must allow for waiver, including routine waiver at an annual meeting, when no particular offering is planned. Yet the waiver procedure revives the risk that shareholder interests may be diluted by below-market sales of stock. To combat this risk, we contemplate that shareholders who do not vote to waive their preemptive rights will receive *participation rights*, which operate after the offering, and give shareholders rights to buy the same number of shares they could have bought had preemptive rights been available, at the offering price.

If the shares are sold at a fair price, shareholders will have little reason to exercise participation rights, and an offering without preemptive rights will take place much as in Britain and Europe, where a waiver binds all shareholders. And if some shareholders exercise participation rights, this will typically be a good outcome for the company because more capital is raised.

If the company sells shares for substantially below fair value, which is the situation where investor protection is needed, shareholders who have participation rights will rush to buy additional shares at a bargain price. This will let these shareholders recoup most of the dilution caused by the below-market issuance. It will also embarrass the managers by making the underpricing obvious to all shareholders, and make it more difficult for the managers to convince shareholders to again waive preemptive rights. Conversely, shareholders should be more willing to waive preemptive rights if they know that the discipline of participation rights, albeit exercised by others, makes it less likely that managers will issue shares too cheaply.

Participation rights pose a subtle but important risk to the viability of preemptive rights waivers. Shareholders who don't vote to waive preemptive rights retain participation rights; shareholders who vote to waive preemption rights do not. The participation right is an option, exercisable for a limited period after the company sells shares, to buy shares at the same price. Like any option, it has value. Even if all shareholders are better off if preemptive rights are waived, each individual shareholder is better off if others waive the preemptive rights and he does not, and thereby keeps this valuable option.

To make participation rights viable, one must limit the value of this option. Limits can arise in several ways. First, the time period for exercising participation rights should be as short as is practical, given communication systems. A short window for exercising participation rights reduces the pure time value of the option, assuming a sale of shares at market value. Second, there will be a built in lag between the time that the rights can be exercised and the time that additional shares are received, again determined by communications technology. This will prevent riskfree arbitrage, where a shareholder buys shares at one price using participation rights, and immediately resells the shares at a higher price in the market. Third, and most critically, an emerging market is characterized by high bid-asked spreads -- and often by intervals where the market does not clear - where one cannot sell one's stake at *any* reasonable price. These attributes of emerging markets, which create the need for participation rights as a check on managers' power to sell shares below fair value, also greatly shrink the option value of participation rights for a fairly valued offering.

Our judgment is that, if shareholders trust the company's management, the value of the participation rights option will be small enough so that preemptive rights waivers will be routinely granted by shareholders at annual meetings. But the participation rights proposal should be seen as frankly experimental, and in need of revisiting if waivers become unduly difficult. One simple alternative: give all shareholders participation rights, whether or not they waive preemptive rights.

2. Repurchase and Redemption of Shares

A company can reacquire its shares a number of ways that raise different concerns. First, it can *repurchase* its own shares for cash or other property, including its own securities, in a voluntary transaction where the selling shareholder is not obligated to sell. Second, the company can *redeem* its shares, in a transaction that is obligatory for at least one party. For example, preferred stock is often redeemable. These transactions can be either prorata (open on equal terms to all shareholders) or non-prorata. The various possibilities are discussed below.

We consider here issues of fairness to holders of common stock and, for preferred stock, fairness to holders of the class being repurchased or redeemed. Stock repurchases involve conveying corporate assets to shareholders, often common shareholders, and thus also can involve wealth transfer to holders of junior securities, especially common stock, at the expense of holders of debt or preferred stock. We discuss protection of these classes of investors in part VI.B.

Prorata Offer to Repurchase Common Stock for Cash The simplest transaction is an offer by the company to repurchase its stock for cash. If the offer to repurchase is made prorata to all shareholders, this is basically the same as a dividend. The repurchase, if made at fair market value, is merely a way for the company to distribute cash to shareholders.

Repurchases of this type are a valuable corporate tool, especially if, as in Russia, they are tax-favored compared to dividends. They should be permitted by the company law, subject to any restrictions in the company's charter. A repurchase of shares where the offer to repurchase is made prorata to all shareholders does not raise significant fairness concerns, and should not require special approval by shareholders.

The law should require, however, that the repurchase be at fair market value, unless a different purchase price was agreed on by contract between the company and the shareholder at the time that the shares were acquired. The decision as to fair market value should be made by the directors of the company who are not interested in the transaction. For a public company, the decision as to fair market value should be made by the independent directors who are not interested in the transaction. This is because insiders, who are usually large shareholders, always have an indirect interest in a repurchase of shares. If they are not themselves sellers, they will want the company to buy shares for as low a price as possible. The sellers may be willing to sell because they do not know the true value of the shares.

If stock markets were well developed, it would be desirable to treat a repurchase of shares by a public company on the open market at the market price in the same manner as a prorata repurchase, since all shareholders will have a reasonably equal opportunity to sell their shares at that price in the market. But, in a highly illiquid stock market, of the type that characterizes many emerging markets, a repurchase, supposedly made on the open market at the market price, may be used as a way to repurchase shares from insiders at a favorable price. The insiders will know when the company will be buying shares, and will sell at that time, at a high price. After the company finishes buying these shares, the price will drop again.

Nonprorata Offer to Repurchase Shares of Common Stock If the offer to repurchase shares is made only to some shareholders, this raises a concern that insiders will be given preference over outside shareholders when the company offers to repurchase shares, that the company will repurchase shares from insiders at more than fair market value, or that the company will use its power to repurchase shares to buy out a troublesome shareholder at a high price.

We propose that a nonprorata repurchase of shares must be at fair market value, as discussed above, and must also be approved by a majority vote of all outstanding shares. If the identity of the shareholders whose shares are to be repurchased is known, then the vote should exclude any shares owned by those shareholders. If the identity of the shareholders whose shares are to be repurchased is not known, as in the case of a repurchase in the open market where the identity of the sellers will not be known, then all shares can vote.

A nonprorata offer to repurchase shares from an insider is treated like any other self-interested transaction, and requires approval by (i) a majority of non-interested directors, or, for public companies, approval by a majority of independent non-interested directors; and (ii) approval by a majority of noninterested shares.

Offer to Repurchase Preferred Stock for Cash The law should permit a company to repurchase its preferred stock for cash, subject to any restrictions in the charter. A repurchase of preferred stock does not raise fairness concerns for the holders of common stock, and raises fairness concerns for the holders of preferred stock only if the offer to repurchase shares is not prorata.

If the offer is prorata, no special approval should be required. As for common stock, the law should require that the repurchase be at fair market value, unless a different purchase price was agreed on by contract between the company and the shareholder at the time that the shares were acquired. If the preferred stock is junior to another class of preferred stock, the limits discussed above will apply -- after the repurchase, the company's net assets must be sufficient it permit it to pay the liquidation preference of the more senior preferred stock.

If the offer is nonprorata, it should first require approval from the holders of the class of preferred stock to be repurchased, in the same manner as for nonprorata offers to repurchase common stock.[60]

Offer to Purchase Stock for Securities or Other Property Unless the charter provides otherwise, a company should be able to repurchase its shares for securities or other non-cash property. The same rules should apply to offers to repurchase shares whether the consideration is cash or property, including other securities of the company. For non-cash consideration, the fair market value of the property delivered by the company must be determined by the board of directors, or for a public company, by the independent directors, excluding any directors with a personal interest in the transaction.

Redemption of Shares at Option of Company A redemption of shares is a transaction in which the shareholder is required, under the company's charter, to sell his shares back to the company. Because the shareholder cannot choose not to sell, the principal risk is that the price offered by the company will be too low. To respond to this risk, we believe that a company should be able to redeem stock only prorata, or by lot to the extent necessary to avoid redemption of fractional shares. A prorata mandatory redemption of common stock is the same in substance as a dividend, except for the possibility of different tax consequences.

For common stock, there is no special need to permit redemption. Non prorata redemption is too easy a way for managers to buy out unwanted shareholders, probably at a low price besides. And prorata redemption of some of the common stock is substantively equivalent to a dividend.[61]

For preferred stock, redemption should be at the redemption price specified in the charter or, if no price is specified, at fair market value. The same rules for protection of creditors and holders of preferred stock that apply to repurchases should apply to redemptions. With these protections in place, redemption of preferred stock should be permitted, subject to any restrictions in the company's charter.

Mandatory Redemption. It should be permissible for the charter, to require the company to redeem its preferred stock, or to give the holders of preferred stock the right to demand redemption of the preferred stock, at a specified date or on the occurrence of a specified event or events. The company's obligation to redeem shares would be subject to the limits on any repurchase or redemption established for protection of creditors. In addition, the board of directors should not be obligated to redeem stock if the company lacks sufficient funds to do so. This is the central difference between stock and debt -- debtholders have a contractual right to

[60] The rules on nonprorata repurchases should also apply to offers to purchase a company's stock by its subsidiaries -- daughter companies that are 50% or more owned by the parent company.

[61] Different tax treatment of redemptions, even pro-rata redemptions, and dividends, might provide a reason to allow prorata redemption of common stock.

be repaid, and can force the company into bankruptcy if they are not paid, while stockholders cannot.

The holders of common stock should not have the right to demand redemption of their shares. This is equivalent to the right to demand payment of a dividend. The decision on whether to pay dividends on common stock should be left in the hands of the board of directors.

Reverse Stock Split A reverse stock split, in which small holdings become fractions of a new share, and are cashed out, is a form of mandatory repurchase of common stock. Since it is nonprorata, it should require approval by a majority of outstanding shares, and the price paid for fractional shares should be fair market value. Because of the potential for repurchase through a reverse stock split at an unfair price, shareholders whose shares are cashed out should be able to obtain a judicial or arbitral valuation of the shares, just as for a merger or other major transaction.

E. Control Transactions

Control transactions are transactions in which a controlling shareholder purchases (or aggregates) a controlling block of stock in the company. Such transactions can assume a wide variety of forms, ranging from open market purchases and tender offers to large issues of shares by companies directly in the course of financings or merger transactions. But whatever its form, the transfer of control in our view merit regulation in its own right -- notwithstanding the fact that many control transactions will also be regulated by the rules governing reorganizations, major transactions, or self-interested transactions.

Control transactions receive disparate treatment under the statutes of developed economies. They are unregulated in the most important U.S. jurisdictions or regulated principally with a view to discouraging them, but are widely regulated elsewhere including (as we discuss below) in Great Britain. Beneath this divergent treatment lies a familiar policy dilemma. On the one hand, control transactions are frequently important engines of efficient restructuring. In a friendly sale of control, the control shareholder who pays a premium price for a control block often does so because she expects to improve the efficiency of the company in ways that will benefit all shareholders.[62] Equally important, the ability of an outside investor to aggregate a controlling block of a company's stock without the consent of the company's managers is an important constraint on bad management. Thus, there are powerful efficiency reasons to avoid overregulating both friendly and hostile control transactions. On the other hand, control transactions may also occur for bad reasons: the new controlling shareholder may plan to loot the company or use control to manipulate share prices and acquire minority shares at a price far below their true value.[63]

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[62] See, e.g., Barclay & Holderness (1992), *supra* note 15.

[63] For a systematic development of these points, see Lucian Bebchuk, *Efficient and Inefficient Sales of Corporate Control* (Harv. L. Sch. Program in L. & Econ. Working Paper 1993).

Whatever the optimal regulation of control transactions in developed economies, we believe that the dangers of looting that cannot be otherwise deterred require basic regulation of control transactions in the Russian context. Fortunately, the British City Code on Takeovers and Mergers and the proposed European Community 13th Directive on Company Law offer a self-regulatory solution that is easily adapted to the Russian statute. Our proposed law protects minority shareholders in control transactions by requiring that a shareholder who acquires a 30% interest in a company to buy all remaining shares at a fair price, which will typically be the highest price paid for any shares in the 30% control block. In effect, minority shareholders receive a "put" option to sell their shares to the new controlling shareholder. The 30% threshold that triggers the put option is simply a brightline approximation of the share ownership needed to convey effective control of the company.

This City Code rule, as it is sometimes termed, is a powerful deterrent of inefficient control transactions, since even poorly informed minority shareholders will presumably exercise their put options upon receiving any indication of possible looting or suspect management by a new controller. It is equally clear, however, that the City Code rule deters some efficient control transactions. For example, if an existing controlling shareholder is already extracting significant private returns from a company, a new and more efficient acquirer may not be able to buy the old controller's shares at a premium price if she must also pay the same extortionate price to minority shareholders. Alternatively, in the underdeveloped Russian capital market, a would-be acquirer of a control block simply may not be able to finance a put option for minority shareholders. These costs of the City Code rule can be mitigated (although not eliminated) by our further proposal to permit minority shareholders by majority vote to opt out of the requirement that an acquirer of control must offer them a put option. Thus, where the purchaser of a control block can persuade minority shareholders that the transaction is in their interest as well, she can avoid the costs of an offer to repurchase minority shares.

In addition to protecting minority shareholders from looters, a second concern associated with control transactions is the danger that disaggregated shareholders can be induced to sell control too cheaply. One way this may happen is if an acquirer secretly accumulates control through numerous open market transactions, although shareholders would have demanded higher prices had they known of a control interest and other potential acquirers might have been prepared to offer higher prices as well. To prevent such secret acquisitions of control, the proposed law requires that shareholders who acquire 15% or more of a company's stock publicly disclose their identity, shareholdings, and plans, and then wait 30 days before buying more shares. This gives the company's managers time to respond to the secret acquisition by seeking a higher bidder, proposing an alternate transaction that is more favorable to the shareholders, or convincing shareholders that their shares are worth more than the acquirer is offering to pay. Similarly, a person who plans to acquire 30% of more of a company's shares should also publicly announce this plan at least 30 days before completing the acquisition. This allows a competing bidder to make a higher offer, even when the original transaction was approved by the company's managers.

Together these provisions help to ensure that changes in control occur at fair prices. They encourage auctions of companies undergoing a change of control, by providing a time period during which the managers of the company can find an outside bidder who will offer a higher price, or an outside bidder can offer to pay a price that is higher than the price to be paid in a transaction supported by management. Thus, these delay and notice provisions protect management against secret takeovers and protect shareholders against low-priced takeovers supported by management.

Finally, the prospect that managers might ignore shareholder interests raises a third key concern associated with control transactions: that is, the risk that managers may block changes of control in order to preserve their own jobs. This danger arises in hostile takeover bids, when managers typically argue that they need to wield the power to reject bids in the interests of shareholders. We are skeptical of this argument in developed economies, where it has enjoyed a good deal of success. We are even more skeptical of this argument in the Russian context, where managers are already heavily entrenched through a combination of share ownership and effective control over the voting power of employee shares.

In response to a hostile bid for control, managers should be allowed a reasonable period of time to find a higher bidder or to persuade shareholders not to sell their shares. They should not be permitted additional power to defeat hostile takeover bids by deploying preclusive defensive tactics such as "poison pills." Experience in the US and European countries teaches that managers' claims to use these devices in the interests of shareholders are often false. Whatever managers say, when jobs and power are at stake, they often act to preserve their positions, even at great cost to shareholders. Moreover, even independent directors often act to favor the managers' interests. Thus, we believe strongly that *shareholders*, not managers or directors, should decide whether a control change occurs or not, by selling (or not) their shares. US directors with the power to do so have often turned down takeover offers priced at twice the previous market value of shares, on the supposed grounds that shareholders will do even better if the takeover is defeated. The managers who make these claims rarely offer to resign when, as usually happens, their optimistic predictions do not come true.

F. Circular Voting Structures

One particular defensive tactic -- circular voting structures among affiliated companies -- merits separate consideration because it raises difficult line drawing problems. Circular voting structures commonly turn on a parent company's power to direct the voting of large blocks of its own stock held by its own subsidiaries. The managers who direct the voting of such stock can effectively entrench themselves with their companies' resources. Yet, barring subsidiary cross ownership to prevent circular voting would be an extreme measure, since subsidiaries often hold their parents' stock for good reason, as when parents acquire target companies in reverse triangular mergers.[64] Rather, the sensible response is merely to bar the cross voting of parent stock held by subsidiaries, since this carries obvious risks and has little plausible justification.

The real complication in barring cross voting of a subsidiary's shares lies in setting the threshold size of the parent's holdings in the subsidiary that triggers the prohibition. In Delaware, as in U.S. jurisdictions generally, only majority-owned subsidiaries are barred from voting parents' stock.[65] But this rule is far too narrow. Although the managers of parent companies clearly control majority-owned subsidiaries, they may also exercise working control at far lower ownership thresholds. Thus, the model Russian statute would bar the voting of "parent" stock when parents hold 30% or more of their subsidiary's voting stock -- the same threshold for working control that triggers minority shareholders' put rights under the acquisition provisions. Needless to add, legal entities such as trusts and partnerships in which a company holds more than 30% of ownership or control rights must also be barred from voting shares in their parents.

To be sure, such a ban on cross voting subsidiary-held shares can prevent only egregious entrenchment schemes because it allows cross voting at "parent" ownership levels below the 30% threshold, and thus permits groups of companies to tie up control internally through cross holdings. For example, the rule would not bar a Japanese-style Kieretsu, in which a dozen companies held 5% stakes in one another -- even though such a structure would preclude any control challenge to the management of a member company that was not sanctioned by the group.[66] But there are reasons for permitting such structures. They may serve benign as well as defensive purposes: for example, cross ownership may encourage mutual monitoring or help to enforce relational contracts in the product market.[67] In addition, entrenchment seems a less pressing threat when controlling shares reside in a larger group of companies, as distinct from a single parent company whose managers have a powerful interest in their own incumbency.

Indeed, there is one circumstance in which even the 30% trigger for prohibiting cross voting must be relaxed: a target company in a hostile takeover cannot be permitted to strip an acquirer of the right to vote target stock by purchasing a 30% stake in the acquirer as a defensive measure. In mirror-image acquisitions of controlling blocks of stock, the rule must be that the first buyer (the "acquirer") retains its voting rights regardless of the target's response, as long as the statutory acquisition rules are observed.

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[64] In a reverse triangular merger, a parent company acquires a target by merging a subsidiary into the target. The consideration for the acquisition is parent stock held by the subsidiary, which is exchanged for the stock of the target company. The advantage of the transaction is that it does not disturb the corporate identity or contractual relationships of the target.

[65] See, e.g., Del. Gen. Corp. L. § 160(c).

[66] See Gilson & Roe (1993), *supra* note 5 (describing cross ownership in kieretsu structures).

[67] See id. (arguing that cross ownership in vertical kieretsu may serve in part to enforce and stabilize intra-group contracting).

VI. Remedies

A defining feature of the self-enforcement model is a strong effort to economize on enforcement resources. This leads, for reasons already discussed, to a preference for bright-line rules -- barring the few cases where general standards are used for their value in shaping voluntary behavior over the long term, despite their unenforceability in the near term. A related feature should be an attempt to define clearly the remedies for violations of the rules, rather than to leave their development to the courts. This won't always be possible, but some common violations can be anticipated, and their consequences elaborated, rather than left to the uncertain wisdom of judges to determine. For remedies, as for the underlying legal norms, simplicity will often trump fine-grained tailoring of the remedy to a concrete situation.

Remedies should generally be direct rights of shareholders, rather than mediated by the corporation (acting on behalf of all shareholders) or by regulators. For example, shareholders can be given direct rights to recover damages from managers or large shareholders if they discover a previously undisclosed self-interested transaction. Conversely, the cumbersome technique of the derivative suit -- a suit by the shareholder in the name of the corporation, requiring judicial oversight to determine when the board should have the right to control the suit -- has little place in an emerging economy.

In some cases, one can design remedies in the self-enforcing mode, where the decision as to remedy is left to shareholders -- as in our proposal that a shareholder who improperly crosses 30% ownership should lose voting rights, unless they are restored by majority vote of the other shareholders. The remedy for improper procedures in conducting a shareholder vote is of the same character: the vote must be retaken, and shareholders will decide how to react to the misfeasance of the managers the first time around.

A key question is how strict the penalties for violation of the rules should be. Here two factors argue in favor of strict penalties, while two others argue in favor of limiting the severity of the sanctions. The relative force of the different factors will vary depending on context. Thus, it is difficult to generalize about the optimal severity of sanctions. We describe the factors that bear on the choice of sanction below, and offer examples that illustrate our own balancing judgment.

The first factor arguing for strict sanctions is the need to provide adequate incentives for proper conduct, when actors know that the probability of enforcement is low.[68] Consider, for example, the shareholder approval requirements for self-interested transactions. We propose that managers, directors, and 10% shareholders who fail to disclose their interest in a transaction be liable to the company to return all profit from the transaction, unless the offending party proves that the transaction was at least as favorable to the company as an alternative arms-length transaction. We reject *ex post* shareholder ratification as a defense to liability. This defense is

[68] *See generally* Gary Becker, *Crime and Punishment: An Economic Approach*, 76 **J.Pol. Econ.** 169 (1968).

often available in the United States (where *ex ante* shareholder ratification is not required). But in the self-enforcing model, If *ex post* ratification is a defense, there is insufficient incentive to obtain the shareholder vote *ex ante*.

More generally, the remedy for failing to follow procedural requirements must be more than a mere reprise of the required procedures, or else managers will be tempted to ignore the need to follow the procedures *in advance*. If one asks, where is the harm, as long as shareholders approve an action *ex post*, the answer is the loss of the prophylactic value of *ex ante* approval and *ex ante* disclosure. Not every transaction that would be approved *ex post* will be proposed *ex ante*; not every transaction that would be disapproved will be challenged.

The second factor calling for strict sanctions is an offshoot of the use of bright-line rules. When actors can't be certain if their conduct is lawful, severe sanctions can chill legitimate behavior. In the corporate sphere, for example, a major justification for the business judgment rule -- which protects directors from liability even for demonstrably stupid decisions -- is the fear of chilling risk-taking, in a world where we often want managers to take gambles, sometimes long-shot gambles, on limited information. Other things equal, the more the law uses bright-line norms, the less a severe sanction will chill desirable activity.

For example, we propose that the remedy for crossing the 30% ownership threshold for the control transaction rules without prior notice, or without offering to buy all remaining shares, should be loss of voting power *as to all shares* held by the 30% shareholder and his affiliates, unless other shareholders vote to restore voting rights, or the shareholder acquires at least 90% of the outstanding shares. A severe sanction is appropriate here not only because violations may be difficult to detect (acquirers may hide ownership by buying through undisclosed affiliates), but also because a clear rules means that inadvertent violation should be rare.

Other factors cut against severe sanctions. One cannot assume that corporate managers will know the rules. Especially for rules that apply to small companies as well as large, the greater deterrence from a stronger sanction may come at an unacceptable cost in harsh outcomes for inadvertent violators. A related factor is that the law must be seen to be fair, if it is to serve its goal of inducing voluntary obedience and, ideally, the conformity, over time, of culture to the new law. The need for perceived fairness means that sanctions will fall well short of the economist's simple prescription that the sanction equal the gain from improper conduct divided by the probability of detection. These considerations explain why, for example, we propose that proof that a self-interested transaction was on arms-length terms should be a defense to profit forfeiture, and why we do not propose double or triple damages for undisclosed self-interested transactions.

Sometimes, no remedy may be better than a remedy that is too apt to be misapplied by inexpert courts. For example, we propose that directors should *never* be liable for actions taken without self-interest. That is, we close off the narrow recklessness/gross negligence exception to the business judgment rule, because we have no confidence in the ability of courts to decide when conduct is sufficiently outrageous to warrant to imposition of personal liability.

Finally, there are cases where there is no ideal remedy. Suppose that a company fails to use cumulative voting. One cannot invalidate the actions of the improperly elected board, without imposing an unrealistic burden on others having contractual dealings with the company to investigate its governance. The violation is clear enough so that one can imagine imposing personal liability on board members for loss to the company from actions approved by an improperly elected board. Yet we hesitate to do so, partly because small companies may unwittingly fail to comply with the cumulative voting rules, and partly because the directors who would resign to avoid this liability may be the best of a bad lot. We are left with the weak sanction of running a new election -- though the shareholders will, at the least, understand when they vote how the directors have behaved in the past.

VII. Regulation of Special Classes of Participants

Beyond regulating particular classes of transactions, company law for emerging economies must also recognize the needs, vulnerabilities, and limitations of particular classes of financial participants in public companies. In the case of Russia, two classes of participants require status-based protection in the company law: creditors and shareholding employees. Creditors require protection against efforts by shareholders or managers to extract wealth from a firm, leaving creditors to collect from an empty shell. Employee shareholders face the risk that managers may use their control over employment as a lever to control the voting of employee shares; outside shareholders face the risk that managers will succeed in this effort, and thereby cement their control over the firm.

A third class of shareholder, the state as residual shareholder of a partially privatized firm, has limitations that may call for restricting its power: the officials who control these holdings may have motives other than increasing share value, or may trade their votes for personal favors that the managers can supply to otherwise ill-paid officials. Finally, the law should attend to the interests of large, active investors, domestic or foreign, who demand influence or even control in exchange for large infusions of capital. Here the worry is whether the self-enforcing model is overprotective -- do its mandatory rules, such as one share, one vote, prevent these investors from structuring financial arrangements with the companies they invest in in mutualy beneficial ways?

A. Protecting Creditors and Preferred Shareholders

In developed and emerging economies alike, contract is the principal instrument of self-protection for creditors and preferred shareholders. Banks can take security interests in company assets; bondholders can demand covenants that restrict distributions of corporate assets; trade creditors can provide only short-term credit, thus limiting their loss in the event of default; and preferred shareholders can seek the power to elect the board of directors if dividends are missed. But experience also suggests a role for legal limits on distributions even in developed economies.

In the United States, for example, contractual limits on corporate distributions are supplemented by company law, which bars dividends by an insolvent company; by "look-back" provisions of bankruptcy law that allow recapture of pre-bankruptcy distributions; and by fraudulent conveyance law.

In an emerging market, creditors have even greater need for protection. Creditors may be less sophisticated; credit market institutions such as factors who purchase trade credit and monitor borrowers on behalf of small trade creditors, and information services that report a borrower's payment history or financial strength, may be absent; contracts may not be readily enforceable. Yet the available tools for protecting creditors are slimmer: In Russia, bankruptcy law does not function at all, let alone contain sophisticated look-back provisions; secured lending is crippled by a Civil Code provision that gives secured lenders third priority in insolvency proceedings, after personal injury claims and employee claims;[69] one cannot expect courts to interpret sensibly a Delaware-like rule that looks to market value, rather than book value, to determine whether a company was insolvent after paying a dividend.

To respond to the limitations of contract law and bankruptcy law, we believe that corporate law in emerging markets should include two types of protections for creditors: a limit on dividends and stock repurchases tied to the company having positive *book and market* value after the dividend or repurchase, and a fairly standard fraudulent conveyance provision that, although fuzzy, provides some additional protection against transactions, however structured, that diminish the company's assets.

1. Limits on Dividends and Stock Repurchases

The simplest ways for a company to distribute assets to shareholders, leaving less for creditors, are dividends (whether of cash, stock, or other property) and stock repurchases. These are identical transactions from a creditor's perspective, and should be regulated in the same manner.

The law should require that a dividend or repurchase be allowed only if, after the dividend or repurchase, the company will (i) have assets greater than liabilities, whether assets and liabilies are measured at book or at market value; (ii) can reasonably expect to be able to pay its bills as they come due. The first test is an asset test for solvency of the company; the second test is a liquidity test for solvency.[70] (For repurchases, the requirement that the company repurchase stock at fair market value also provides some protection for creditors since if the company is close to insolvency, its shares will have little value.)

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[69] Russian Civil Code art. 64.

[70] In the United States, a third solvency test is also used: after the transaction, the company must not have an unreasonably small amount of capital left with which to conduct its business. National Conference of Commissioners on Uniform State Laws, **Uniform Fraudulent Transfer Act** § 4(b)(i). But this extremely vague test is rarely used in practice. In keeping with our preference for defining requirements as clearly as we can, to guide both directors and judges, we do not consider this third standard to be useful in an emerging market.

To protect preferred stockholders, the law should allow a dividend on or repurchase of common stock be allowed only if, after the dividend or repurchase, the company's assets minus liabilities are greater than the amount than the liquidation preference of the preferred stock, if the company were to be immediately liquidated.[71]

We use both book value and market value tests because book value may not be a realistic measure of actual value, especially in an economy with high inflation (and, in Russia, many intercompany debts that will never be paid, but are still listed as assets). At the same time, a market value test alone is insufficient, because it faces severe enforcement problems, especially when market prices are hard for anyone to determine. In the near term, the market value test is important more because it expresses how directors should act than because it gives substantial protection to creditors.

The liquidity test is also fuzzy, but may have some bite in the Russian context. A company that has positive book value only because it has not written off uncollectible intercompany debts -- a common situation in Russia -- will have trouble convincing anyone that it met this test, if it pays a big dividend one month and defaults the next, when its creditors know that its intercompany receivables aren't real assets. Convincing a court of this is a harder task. Still, the mere statement of the rule may dissuade some borrowers from clear violations, especially in Russia, where banks are reputed to be among the major employers of Mafia hit men, the better to encourage repayment of debts, if not by this borrower, then by the next.

We also attack the problem of creditors not knowing about large dividends or repurchases that affect a company's creditworthiness until it is too late by requiring that companies notify creditors promptly about dividends or stock repurchases that decrease book value by more than 25%. This lets the creditors avail themselves of contractual rights, and evaluate whether and on what terms to extend new credit. Large creditors can, of course, insist on notice or dividend restrictions by contract, but trade creditors may not be able to, or think to, and often lack other sources of information about changes in a borrower's financial condition.

2. Fraudulent Conveyances

In addition to dividends and stock repurchases, in which a company distributes assets without receiving anything of value to creditors in return, any corporate transaction can be a vehicle for assets to leave the company, to the detriment of creditors and, often, shareholders as well.

The challenge is how to block these transactions without also stopping ordinary business transactions. Here we can do no better than the vague standard, familiar from fraudulent

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[71] If there is more than one class of preferred stock, a similar restriction would apply to dividends or repurchases of a junior class of preferred stock. The dividend or repurchase would be permitted only if, after the dividend or repurchase, the company's net assets were sufficient to pay the liquidation preference of the more senior preferred stock.

conveyance law, that a transaction is improper if the company does not receive reasonably equivalent value and, after the transaction, the company fails an asset-based or liquidity-based solvency test. The standard of reasonably equivalent value is vague, but can at least inhibit the egregious cases where a company transfers its remaining assets to third parties for nominal consideration.

A typical Russian situation involves involves a raw materials company selling its product at a fraction of market value to another company controlled by its managers, who then resell at the market price. Here, the fact of sale below market, and prompt resale at a far higher price, can potentially be clear enough to convince a judge -- or an irate shareholder or creditor. As this example suggests, fraudulent conveyance transactions are often tinged, if not reeking, with self-interest. Thus, the self-interested transaction rules may also help to protect creditors and those shareholders who don't share in the company's largess.

In these creditor protection rules, we may appear to have moved from procedural protection to substantive prohibition. In part, we have. The justification for the restrictions on dividends and stock repurchases is the combination of the strong incentives of shareholders and managers to grab what they can from a sinking ship; the limited circumstances in which a company near insolvency would normally pay dividends; and the difficulty of attacking this problem in another way, since a company's relationships with creditors are too complex to permit a voting solution. The justification for the fraudulent conveyance restrictions is even stronger -- once we go beyond payments to shareholders through dividends and stock repurchases, companies should never enter into transactions without receiving reasonably equivalent consideration in return.

In part, however, the appearance of substantive prohibition is deceiving. A company with genuine business need to pay a dividend that would otherwise be prohibited by the book value test can do so, by first getting investors to invest new equity capital into the company to pay off the old creditors, after which the company can pay the desired dividend. The company can then even recreate its old capital structure if lenders can be found. In effect, the company must give creditors a chance to vote with their feet. This end run around the dividend restriction involves substantial transaction costs, which is why the dividend restriction is appropriately limited to the extreme case of a company having zero book or market value of assets after paying the dividend. But the possibility of an end run nonetheless softens the harshness of a book value test in an environment where book value may be a poor measure of actual value.

B. Protection of Employee Shareholders

In many Russian companies, he who controls the votes of employee shares controls the company. This is not lost on company managers, who have quickly developed ways to ensure that they decide how employee shares are voted. In part, the corporate law can respond, in the ways discussed above, by weakening the link between control of 51% of the votes, and control of everything the company does. But the law can also act directly to weaken the control that managers are permitted to have over employee shares.

The goal of the employee-protection rules is simple: To vest in employees full rights to vote and transfer the shares that they own, free of coercion by their employer. Confidential voting and independent tabulation helps -- if the managers don't know how an employee has voted, they can't threaten reprisal for a vote against management. But more is needed, lest the managers -- as some Russian managers already have -- cause/force/convince employees to transfer their shares to a long-term trust, voted by the managers, from which shares cannot be withdrawn.

The problem is familiar in developed countries in a different guise -- what time and other limits should there be on voting trusts (and other similar arrangements) that lock shares into an agreement that separates economic interest from voting power. It is acute for employees because one cannot make the background assumption that they weighed the value of what they were giving up and getting when they agreed to join the trust; and doubly acute in Russia because there is no trust law to limit managers' actions as managers of the trust, because employees wouldn't be able to make an *informed* choice if given a choice; and because employees often are given no choice -- they are told, and believe, that they must put their shares into a trust to be managed on behalf of the "labor collective."

We propose several related rules. First, managers cannot control any trust formed primarily to hold employee shares (employee trust). Second, employees should have the right, at any time, to sell their shares or withdraw them from an employee trust. Third, the maximum duration of any such trust should be short, say two years, to give employees a frequent option to opt out of participating. Fourth, company managers should not ask an employee how he has voted, or whether he has sold or plans to sell his shares, nor retaliate against an employee based on how the employee votes or whether he sells his shares.

Enforcement of these rules will be difficult, but some managers will honor it voluntarily (right now, they often believe that they act properly to defend the company's interests in locking up employee votes). Moreover, if the principle is established, the press will be interested in clear violations, and even a weak labor union can protect its members against overt retaliation.

Perhaps one ought simply to ban all employee trusts (and other form of collective management of employee shares), as too prone to manager domination. Our judgment for Russia was that this was too extreme, and would also foreclose the possibility of a labor union-controlled trust that might serve as a valuable counterweight to management.

C. The State as Part-Owner

The state is frequently an important equity holder in emerging economies -- especially in the privatizing economies of central and eastern Europe. In Russia, for example, the best available data for mid-1994 (after completion of voucher privatization, but before cash privatization) suggests that regional property funds in Russia retain some equity in the majority of privatized companies and to hold stakes of 20% or more in perhaps one-third of all companies.[72] Thus, regional property funds are not infrequently the largest single shareholders in Russian companies, although their holdings are generally smaller than the combined insider holdings of managers and employees.

The issue raised by large state holdings of voting stock is whether state organs should be restricted in the exercise of voting rights over the shares that they control -- perhaps along the lines of the American rule that requires federal employee pension funds to vote in proportion to other shareholders. Several concerns are raised. Most generally, government officials will not behave like private shareholders who bear the economic consequences of company decisions. More specifically, officials may form alliances with managers, at the expense of shareholders, competitive markets, or both; may influence company policies in inefficient directions to accomplish public ends (such as preserving employment in a particular region). On the other hand, state officials could serve as a counterweight to insider domination of Russian companies, particularly if a regional property authority were planning to sell its shares in the near future.

In Russia, we are not sure how likely local officials are to behave like real shareholders. We favor neutralizing government shares in the election of boards of directors: state bodies should not nominate or vote for candidates for the board of directors. State bodies could continue to vote on other issues, such as mergers, charter amendments, and the like. Of course, convincing government to adopt such a rule is a different matter -- officials who are likely to abuse their voting power are unlikely to support limits on that power.

D. Venture Capital

The fourth class of non-standard investors are those whom we term "venture capitalists:" large, active equity investors, foreign or domestic, who demand influence or even control as the price of their investment. Just as venture capitalists are primary suppliers of equity capital to high-risk start-up companies in developed economies, venture capitalists are likely to be important sources of equity capital in emerging economies, where most companies are highly risky because of a rapidly changing economic environment -- whatever their size or prior track record.

Venture capitalists in developed economies exploit the enabling model's flexibility laws to tailor elaborate control arrangements for their own protection. One might ask, then, whether the mandatory procedures of the self-enforcing model will prevent arrangements that these investors might otherwise prefer. Two features of our proposal seem especially likely to interfere with venture capital investments: (i) the requirement that each company have a single class of voting common stock, and (ii) the obligation, triggered by a purchase of over 30% of a company's common stock, to offer to buy all remaining shares at a commensurate price.

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[72] These estimates are from a non-representative survey of a handful of regional property funds. See Katharina Pistor & Joel Turkewitz, *Coping with Hydra-State Ownership After Privatization* (this volume 1995).

In fact, these provisions block very few of the control arrangements that venture capitalists traditionally demand in developed economies. Rather, they merely complicate in modest ways the creation of the requisite control arrangements. Suppose, for example, that a venture capitalist wants to buy newly issued shares which will represent a 40% in a firm. Our control transaction rules requires that the firm's current shareholders first vote to waive their right to sell their own shares, an action which requires only a simple majority vote. This vote entails minimal cost, since the shareholders must vote to authorize a share issuance of this size in any event. If the new investor buys shares from existing shareholders, rather than from the company, then a vote on waiver entails extra transaction costs, borne by all shareholders, and extra delay, but our judgment is that the protection that the buy-out rule provides for minority shareholders is worth imposing these costs.

A more difficult but still soluble problem arises if the venture capitalist wishes to make a minority investment while retaining veto rights over critical transactions. Under the enabling model, such a transaction is often structured by creating a second class of voting stock, that gives the investor both general voting rights and -- perhaps through a class vote -- the particular veto rights that are desired. Under the self-enforcing model, statute that we propose, the same control structure can be created by combining partial ownership of a single class of common stock with creation of a class of preferred stock equipped with voting rights limited to issues of particular concern to the venture capitalist.

The principal bargains that a venture capitalist could not strike under our proposed statute involve either: (i) receiving rights to elect directors disproportionate to its total equity investment; or (ii) receiving voting rights for directors *without* taking the risk that comes from owning common rather than preferred shares. Even these restraints can sometimes be finessed through a joint venture, because the joint venture contract can allocate management power as the participants see fit.

VIII. The Path-Dependent Evolution of Developed Country Corporate Law

Our work has important implications for the ongoing debate about the efficiency of corporate law in developed countries. In the U.S., the debate is traditionally framed as between race-to-the-bottom proponents, who see American states as competing in an effort to outdo each other in adopting lax corporate laws, the better to attract the attention of corporate managers who make reincorporation decisions,[73] and race-to-the-top proponents, who believe that (perhaps with an exception for antitakeover rules), states attract corporations by offering efficient rules.[74] The principal evidence offered by race-to-the-top proponents, which has largely carried the day in the academic community, is empirical studies showing that reincorporation in

[73] See, e.g., William Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 Yale L.J. 663 (1974).

[74] See, e.g., Ralph Winter, *State Law, Shareholder Protection, and the Theory of the Firm*, 6 J. Legal Stud. 251 (1977); Romano (1994), *supra* note 17.

Delaware either increases or doesn't decrease stock price, and thus is presumably efficiency enhancing or efficiency neutral.

We believe that the empirical evidence is ambiguous, and that the evolution of American corporate law is more complex than either camp has acknowledged. We advance the following tentative alternative -- tentative because while it fits our anecdotal sense of American corporate history, we have not yet done the historical research needed to confirm that anecdotal impression. American corporate law evolution began, in the mid-19th century, from a historically contingent starting place of rigid formal rules that reflected a mix of public suspicion of this new type of organization, relatively weak market constraints that called for strong investor protection rules, poor communications (which made impractical some of the shareholder approval procedures embodied in the self-enforcing model), and misunderstanding of basic concepts of corporate finance (how else can one explain the early obsession with charter capital?). It then evolved, subject to numerous constraints. One important constraint was that the evolution not dramatically damage the efficiency of the corporate form; indeed, there was surely some moderate pressure for greater efficiency.

A second constraint was the emergence of other institutions that filled gaps in the early corporate laws. Early on, corporate law permitted deviation from one common share, one vote. But the New York Stock Exchange filled that gap for public companies in 1926. Corporate law permitted such outrages as issuing dividend checks which, when endorsed by the shareholder, gave managers a proxy to vote the shares as it pleased. Stock exchange rules and the federal securities laws intervened, to provide a better system of voting by proxy. Corporate law required little financial disclosure by companies to shareholders -- again, the federal securities laws intervened. Common law judges had, and exercised, substantial gap-filling power.

A third constraint was the need to attract new incorporations. Here, states needed to satisfy two competing constituencies: shareholders, who were interested in efficiency; and managers, who wanted more discretion. Managers were the first movers in incorporation -- and thus a critical constituency. A reincorporation that increased share values but decreased manager autonomy wouldn't interest managers. But managers also had to appease shareholders. It would be too bold, and too potentially embarrassing, to propose a reincorporation in another state, or a change in the law of one's own state, that gave managers more discretion but visibly harmed shareholders. The path of least resistance was legal reform that *both* enhanced managers' autonomy and increased or didn't decrease company value.

As we see it, corporate law meandered down this path of least -- or at least *low* -- resistance. Consider, for example, the rules governing transactions in which directors and managers had a conflict of interest. The early rigid rules against self-dealing could have been replaced by shareholder review. Instead they were replaced by the weak constraint of board approval.

Here is one plausible story for why corporate law might have evolved in this way, without ever finding the potentially better approach of shareholder review: The prohibitive approach had problems. Managers were acutely aware of these problems, and pushed for greater discretion. Over time, legislatures responded. The managers did not suggest -- they had no incentive to suggest -- replacing prohibition with shareholder review. Nor were they especially interested in replacing prohibition with review only by outside directors Legislators were never presented with the self-enforcement option, or anything close to it. Indeed, it was left to the courts to modestly counteract legislative permissiveness by requiring review of self-interested transactions by non-interested directors. In this story, the enabling model could be an improvement over the prohibitive model with regard to self-interested transactions (though even that is debatable[75]), and yet be sub-optimal relative to a shareholder approval approach that was never considered.

Additional examples of corporate law following a path of low resistance are easy to find. As Delaware law became more friendly to mergers, it did *not* provide effective appraisal rights, and judges had to fill this gap too. Unlimited director liability for violation of the duty of care might have caused outside directors to act too timidly. The Delaware legislature might have capped director liability at a multiple of director compensation, but instead chose to give companies the option, soon taken by most large companies, to have no director liability at all. When managers' jobs were directly at risk in the takeover wave of the 1980s, they wanted power to resist takeovers strongly enough to risk supporting value-decreasing statutes -- and often, they got what they wanted. And so on.

This model of corporate law evolving by path-dependent meandering down a path of low resistance is consistent with both the realpolitik stressed by race-to-the bottom supporters (managers make reincorporation decisions) and the empirical evidence cited by race-to-the-top supporters (reincorporations tend to increase, or at least not decrease, share values). It is consistent with recent scholarship that emphasizes the importance of path-dependence and legal rules in determining the ownership structure of large public companies.[76] In effect, we seek to extend the path dependence story beyond ownership by financial institutions to the corporate law itself.

The path-dependence argument can be taken a step further. The evolution of corporate law is intertwined with the evolution of financial institutions. If financial institutions are strong, corporate law evolution will reflect their interests as well as those of company managers. And financial institutions, in turn, will evolve in ways influenced by the corporate law.

For example, both Britain and the United States have long had active capital markets, including active markets for corporate control. In the United States, financial institutions were

[75] See, e.g., Harold Marsh, *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 **Bus. Law.** 35 (1966).

[76] See, e.g., **Roe** (1994), *supra* note 5, Black & Coffee (1994), *supra* note 5, at 2082-84.

weak, in part because political decisions made them so.[77] Managers succeeded in obtaining broad discretion to oppose takeovers -- the one clear case of evolution in American corporate law *away* from efficiency. In Britain, financial institutions were strong, and opposed takeover defenses that would take the change-of-control decision away from shareholders. Is it simply accident that British managers remain sharply restricted in their power to fight off takeovers?

In Germany, universal banks have long been strong. They sit on company boards, and they also run mutual funds, and investment banks. Tight restrictions on conflicts-of-interest and insider trading would have restricted the banks' freedom to profit from their multiple roles. Is it simply accident that Germany had weak insider-trading rules until very recently, when European unification and the internationalization of capital markets created a constituency for stronger rules, or that Germany still allows conflicts of interest that even the most pro-manager Delaware judges would find intolerable?

The Russian story is consistent with the importance of politics in determining the structure of corporate law. In Russia, as elsewhere, corporate managers are influential, and many want a corporate law that insulates them from shareholder oversight as much as possible. At this writing, it seems likely that if the Russian Duma soon adopts a new corporate law at all -- that law will be a politically determined mix of the self-enforcing approach advocated here, and a strongly pro-manager approach embodied in a competing draft. The newly adopted Russian Civil Code already contains some rigid charter capital rules that are simply stupid.[78] From this starting place, we expect, it will evolve along its own path of low resistance -- with the stupid rules falling by the wayside, with managers adding to the discretion that the law gives them, but with other institutions developing over time to ameliorate the consequences of excessive managerial discretion.

IX. Conclusion: Self-Enforcing Law in Emerging Economies

In this article we have argued that the best model for company law for an emerging economy is neither the enabling model that characterizes developed economies today, nor the prohibitive model that characterized corporate law a century ago, but instead a "self-enforcing" model. The core of this model is an effort to harness the incentives of participants in the corporate enterprise to provide meaningful shareholder protection despite the absence of the multiple private and public enforcement resources of developed economies.

Because the market controls that operate in developed economies are weak, company law in emerging markets must do more to protect the interests of minority and outside shareholders.

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[77] See generally Roe (1994), *supra* note 5; Bernard Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520 (1990).

[78] For example, under Russian Civil Code arts. 99, 101, if losses cause a company's net assets to be less than its charter capital, the company must reduce its charter capital. But doing so requires giving each creditor an option to demand immediate repayment of its loan to the company, which could quickly exhaust the company's liquid assets.

Yet, because public enforcement is also weak, company law in emerging markets cannot substitute formal law enforcement for the missing market controls.

To operate effectively in this difficult environment, company law must be self-enforcing in a double sense. First, it must provide procedural mechanisms that replace absent mechanisms for formal enforcement, and allow outside and minority shareholders and directors to police the opportunism of managers and controlling shareholders. These contraints should be procedural, rather than substantive as in the prohibitive model, to preserve the great value of flexibility corporate decisionmaking.

Second, because self-enforcement in this first sense is also difficult and costly, the company law must elicit a substantial measure of voluntary compliance from managers and controlling shareholders. Toward this end, the statute must articulate bright-line and easily understood rules, and must provide terms that corporate actors recognize as appropriate to their business circumstances. Thus, although model is intended in part to substitute private enforcement for the government enforcement mechanisms of developed economies, it also rests in part on "self" enforcement of a different kind: the inherent organizing force of clear and legitimate law in an otherwise chaotic business environment.

The drafting strategy implicit in this self-enforcing model reaches almost every aspect of company law. At the most basic level, our model statute structures the company's voting system to increase the influence of minority blockholders. It mandates a single class of voting common stock, a one share-one vote rule, and a cumulative voting rule for the election of directors. In addition, it provides for a universal ballot, on which large shareholders can nominate board candidates.

Similarly, the model statute relies on process constraints to regulate classes of suspect transactions. Significant self-dealing transactions must be authorized by majority votes of both disinterested directors and disinterested shareholders. Mergers, liquidations, and large purchases and sales of all assets require an authorizing vote of two-thirds of outstanding shares -- a high threshold necessary to ensure that the management-worker coalitions that control most Russian companies must enlist at least some support from outside investors to complete these transactions. New issues of shares are subject to preemption rights. These can be collectively waived by a shareholder vote, but shareholders who don't approve the waiver receive ex post participation rights, much as shareholders who don't approve a merger receive appraisal rights. The acquisition of control stakes carries the obligation to offer to purchase minority shares, and defensive measures that might prevent shareholders from selling out to would-be acquirers are prohibited.

These and other features of the self-enforcing approach produce a company law that is novel in the aggregate, even if many of its individual provisions (such as mandatory cumulative voting) are familiar. The model flatly prohibits almost nothing except efforts to opt out of its process requirements. Nonetheless, it significantly constrains managing insiders and controlling shareholders by allocating to large-block minority shareholders -- i.e., those shareholders with sufficient holdings or support to win board representation under a cumulative voting rule -- considerable power to influence corporate decisionmaking.

It is inherent in our model that corporate law should evolve as an economy evolve. As compared to the enabling model, the self-enforcing model gives greater power to outside investors, but at the cost of greater rigidity in the basic structure of corporate governance. As market constraints and a sophisticated judiciary develop to constrain opportunism by managers and large shareholders, the comparative merit of the enabling model will increase. In 10 or 20 years, perhaps, mandatory cumulative voting, or a mandatory one share, one vote rule, will have outlived its usefulness, and can be relaxed.

Perhaps too, as the liquidity of shareholdings increases, institutional shareholders will tend to reduce their percentage stakes in companies so as to make the exit option more viable.[79] If large investors choose exit over voice, the voice-enhancing benefits of the self-enforcing model will shrink, while the costs of voice will remain. Corporate law then should, and probably will, evolve toward fewer voice-promoting rules.

But evolution toward the enabling model is not a foregone conclusion. Given the mutual interaction between the law and the evolution of companies and financial institutions, in which strong protections for large outside investors encourage large percentage investments, the self-enforcing statute may prove substantially stable. These large shareholders could also provide the political constituency to preserve the self-enforcing model against the attacks of managers seeking greater autonomy. The result would be a different model of a mature company law: one that relied much more on internal decisionmaking processes and shareholder authorization -- and much less on ex post litigation -- than is currently the practice in the United States.

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[79] For development of the argument that financial institutions will often choose exit over voice, if both options are available, see John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 Colum. L. Rev. 1277 (1991); Black & Coffee (1994), *supra* note 5 (empirical study of behavior of financial institutions in Great Britain).

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