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Privatization and Corporate Governance: The Lessons from Securities Market Failure

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PRIVATIZATION AND CORPORATE GOVERNANCE:

The Lessons from Securities Market Failure

by John C. Coffee, Jr.*

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By John C. Coffee, Jr.

Introduction: Corporate Governance Rediscovered

A specter is haunting neo-classical corporate finance theory.[1] It is the specter that law matters- - that a positive theory of the firm is incomplete unless it incorporates and explains the role of legal variables. Recent research on corporate governance has found systematic differences among nations in ownership concentration, capital market development, the value of voting

1 This reference is to a quotation from a now obscure 19th Century economist, Karl Marx, who coined the phrase in 1848. See Karl Marx and Freidrich Engels, Manifesto of the Communist Party (1898) (observing that the specter of Communism was haunting Europe). Younger scholars are not expected to be familiar with this material.

rights, and the use of external finance.[2] More importantly, these differences seem to correlate closely with the strength of the legal protections given minority investors.[3] In turn, this level of legal protection seems to depend upon, and vary systematically with, the nature and

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2 The principal efforts have been by four financial economists, writing jointly, who are sometimes called "the Gang of Four," but will be hereafter more neutrally referenced as "LLS&V." See, e.g., Rafael LaPorta, Florencio Lopez-de-Silanos, and Andrei Shleifer, Corporate Ownership Around the World, 54 J. Fin. 471 (1999); LaPorta, Lopez-de-Silanos, Shleifer & Vishny, Law and Finance, 106 J. Pol. Econ. 1113 (1998); LaPorta, Lopez-de-Silanos, Shleifer & Vishny, Legal Determinants of External Finance, 52 J. Fin. 1131 (1997). For another provocative effort in this same vein, see Simon Johnson, Peter Boone, Alasdair Breach, and Eric Friedman, "Corporate Governance in the Asian Financial Crisis, 1997-1998" (Working Paper 1999).

3 For the latest commentary by LLS & V on this theme, see LaPorta, Lopez-de- Silanos, Shleifer & Vishny, Investor Protection and Corporate Governance, (Working Paper, June 1999).

origins of each nation's legal system. In particular, common law legal systems seem to vastly outperform civil law legal systems (and particularly French civil law systems) in providing investor protections- - and, in turn, encouraging capital market growth and ownership dispersion. The size, depth and liquidity of securities markets has clearly been found to correlate directly with the quality of the legal protections given shareholders. In consequence, because the nature and quality of these protections differs widely across nations, the corporate world subdivides today into rival systems of dispersed ownership and concentrated ownership, with different structures of corporate governance characterizing each.[4]

A paradigm shift is now underway in the manner in which financial economics views corporate governance, with the new scholarship emphasizing both the centrality of legal protections for minority shareholders and the possibility that regulation can outperform private contracting.[5] Although this article recognizes the importance of this transition, it is far more skeptical about whether this new scholarship has identified the critical elements that have given the "common law" nations a comparative advantage over the "civil law" world. Here, a mystery remains. One possibility is that substantive differences in corporate law may matter far less than

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4 Although these systems may seem static, individual firms can migrate from one to the other, principally by listing on a stock exchange in a "dispersed ownership" nation. I have suggested elsewhere that such migration and the need for global scale is destabilizing the traditional concentrated ownership system. See John C. Coffee, Jr., The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications, 93 Nw. U.L. Rev. 641 (1999).

5 Financial economics, as a field, has long been skeptical of regulation. For an indication that this attitude is changing, see, e.g., Simon Johnson and Andrei Shleifer, Coase v. The Coasians : The Regulation and Development of Securities Markets in Poland and the Czech Republic. (Working Paper, September 1999)

differences in enforcement practice. In turn, enforcement may depend more upon the strength of

the incentives to assert legal remedies than upon the availability of legal remedies, themselves. Even this hypothesis, however, oversimplifies, because once one examines closely the differences among various systems of corporate governance, the assumed homogeneity of even common law legal systems begins to break down. Another possibility is that differences in substantive corporate law are less important than the differences in the level of regulation that different nations impose on their securities markets.[6] Under this latter hypothesis, the focus should be less on the minority shareholder, and more on the investor generally. The critical question becomes: Does local law establish adequate disclosure and market transparency standards, restrict insider trading, and regulate takeovers and corporate control contests adequately? If it does, then arguably the exposure of shareholders to unfair self-dealing transactions at the corporate level may have only a second-level significance. This article finds some evidence in the Polish and Czech experiences to be consistent with this hypothesis, but also finds other evidence to suggest that deficiencies in Czech corporate law contributed to the systematic looting of Czech companies by their controlling shareholders.

Even if the critical protections upon which minority shareholders depend have not yet been clearly identified, the available data still strongly support the interpretation that law matters - - that in some not yet well understood manner, certain legal systems have encouraged dispersed ownership, while other systems have rendered it an unstable and transient phenomenon. This new emphasis on legal variables has potentially subversive implications for at least some aspects of neo-classical corporate finance theory. Much of the modern "law and

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6 This possibility was first implicitly noted in Coffee, supra note 4, and has been explicitly advanced in convincing detail by Katharina Pistor. See Katharina Pistor, Law As a Determinant for Equity Market Development: The Experience of Transition Economies (Working Paper 1999).

economics" literature on corporate governance has assumed that financial market regulation was unnecessary and that the role of corporate law was simply to offer a model form contract to investors to enable them to economize on contracting costs. This conclusion that regulation was superfluous (or worse) rested on twin premises: (1) Sophisticated parties can write financial contracts that were far more detailed, sophisticated and fine-tuned to their specific circumstances than any body of standardized regulations could hope to be, [7] and (2) Entrepreneurs had adequate incentives to minimize agency costs (in part by bonding themselves and otherwise limiting their discretion) in order to maximize the value for their stock when they brought their fledgling firm to the capital markets.[8] In short, because, under the standard Jensen and Meckling model of the firm, entrepreneurs bore the weight of agency costs, they had good reason to surrender any discretion to expropriate wealth from their investors and to bond themselves to serve their shareholders faithfully; hence, regulation seemed unnecessary. From this perspective, the survival of regulation could best be explained by reference to public choice theories about interest groups and rent-seeking.[9]

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7 Essentially, the sentence in the text is a very short summary of the arguments advanced by Judge Easterbrook and Dean Fischel for why much corporate and securities regulation is unnecessary. See Frank Easterbrook and Daniel Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991). For an earlier statement of this view, see George Stigler, Public Regulation of the Securities Market, 37 J. Bus. 117 (1964).

8 See Michael Jensen and William Meckling, Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure, 3 J. Fin. Econ. 305 (1976).

9 For well known such efforts, see Jonathan Macey & Geoffrey Miller, Toward An Interest Group Theory of Delaware Corporate Law, 65 Tex. L. Rev. 469 (1987); Roberta Romano, The Political Economy of State of Takeover

This claim that financial contracting largely renders regulation irrelevant cannot explain, however, the close correlation between a given country's level of capital market development and the nature of its legal system. The more logical conclusion is that law does matter, and regulation can somehow better promote economic efficiency than can reliance on financial contracting alone. By themselves, private contracting and the voluntary incentives for disclosure seem incapable of producing the level of continuing disclosure necessary to sustain active securities markets.

More importantly, standard economic models of financial contracting within firms do not fit the privatization context. Chiefly, this is because privatized firms do not evolve over time from smaller firms, beginning with the usual incubation period at the venture capital stage and progressing through the initial public offering, but instead are created Minerva-like by governmental fiat. Dispersed ownership is more transient and vulnerable in this context, because it does not gradually develop over time, but instead arrives overnight at the outset of the firm's existence. Hence, managers do not either contract with shareholders or pledge a reputational capital that they have carefully built up over years of service; rather, managers and shareholders are thrown together as legal strangers.[10]

This point has important implications for a policy debate that has begun among scholars

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Statute, 73 Va. L. Rev. 111 (1987); Jonathan Macey, Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty, 15 Cardozo L. Rev. 909 (1994) [add other examples].

10 Neo-classical economic theory views the firm as a "nexus of contracts." See Jensen and Meckling, supra note 8. Yet, privatization often short-circuits this contracting process by simply creating a dispersed shareholder base. A stable equilibrium is thus not reached. The result is that the shareholders have less well defined legal rights and are more vulnerable to opportunistic actions by those in control.

who have studied the transitional process: should privatization be "fast" or "slow"?[11] Should policy makers adopt a "Damn-the-torpedoes-full-speed-ahead" approach that accepts the inevitability of some overreaching by controlling shareholders, but justifies this cost as necessary to realize and expedite the efficiency gains incident to privatization? Or, should privatization proceed more cautiously because of the risks of market failure and political corruption that may result when control seekers are tempted to bribe and seduce the judicial and regulatory systems to achieve the private benefit of control? These tempting private benefits arise, of course, precisely to the extent that privatization preceded the creation of an adequate legal foundation. The cases examined in this article illustrate this tension and lead this article to favor a prudential course of phased privatization, which does not make a hasty and potentially corrupting scramble for control the inevitable consequence of creating a dispersed ownership structure.

This article will proceed through four stages. Part I will examine some of the difficulties in attempting to distinguish common law from civil law systems or identifying the critical factors that lead one to outperform the other. Part II will then focus on the Czech and Polish experiences, along with earlier, more tentative efforts at privatization to understand what has chiefly gone wrong. Part III will then focus on the techniques recently used for expropriating value from privatized firms and suggest that these techniques do reveal some deficiencies in civil law systems. Finally, Part IV will suggest functional reforms and priorities, but these proposals

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11 For examples of this new critique of "fast" privatization, see John Nellis, Time to Rethink Privatization in Transitional Economies?, 36 Finance & Development 16- 19 (International Monetary Fund, June 1999); Bernard Black, Reinier Kraakman, and Anna Tarassova, Russian Privatization and Corporate Governance: What Went Wrong? (Stanford Law School Working Paper No. 178, September, 1999).

will not give primary emphasis to specific doctrinal rules. Indeed, their premise will be that wholesale adoption of U.S. or U.K. legal rules is not feasible and might not be effective in any event.

Part I. Are Common Law Systems Homogenous?

The new comparative research on corporate governance has found that some legal systems give minority shareholders greater protection from fraud and expropriation than others and has assumed that the critical differences largely inhere in the statutory law of these rival systems. This assumes, however, what is to be proven. For example, differences in substantive law could be far less important than differences in enforcement practice. But, once we focus on enforcement practice, a blunt, but overlooked, truth quickly confronts us: common law legal systems may not be that much alike. Thus, while it has been an implicit premise of this new learning that the U.S. and the U.K., as the two leading common law systems and the two leading economies characterized by dispersed share ownership, are highly similar, this premise is very debatable. To be sure, both systems share a common legal history. But to stop at this point is to ignore volumes of more recent and highly relevant history over which their two paths have diverged. For much of the late 19th Century Robber Baron era in the United States, controlling shareholders regularly overreached and plundered minority shareholders and creditors in the United States. Colorful rogues- - such as Jay Gould, Jim Fisk and Daniel Drew- - regularly manipulated the market and invented the technology for "watering" the stock of minority shareholders.[12] Meanwhile, these predators battled for control of railroad empires against even

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12 Gould, Fisk and Drew engaged in a famous battle with Commodore Vanderbilt for control of the Erie Railroad. When Vanderbilt sought to buy control by acquiring Erie's shares in the open market, his three antagonists used

more imperious barons, such as Commodore Vanderbilt, with each side buying and corrupting local judges. Much of this era seems to have been recently replayed in Russia and Central Europe. Throughout this 19th Century era, the common law proved a frail reed upon which minority shareholders could not safely rely. Over time, investment bankers (most notably, the House of Morgan) and the New York Stock Exchange brought some semblance of law and order to this Wild West environment, and legal standards (particularly those applicable to stock issues and fiduciary standards) were consciously tightened by courts and state legislatures. Still, as of 1900, little suggested that shareholders in the United States received greater protection than shareholders in, say, France.

Another aspect of this puzzle emerges if we look at the legal system in contemporary Russia. Although the Russian legal environment seems even closer to the Hobbesian state of nature with the looting of corporations and financial institutions being a fairly common event, Russian corporate law has largely borrowed (in a simplified fashion) the principal features and protections of U.S. and U.K. corporate law.[13] Apparently, expropriation can occur even when the law "on the books" is nearly optimal. Perhaps, this should not surprise us, as the legal realists have taught us for most of the 20th Century that the "law on the books" is often different from, and less important than, the "law in practice."

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their control over the Eric board to dump an endless stream of watered stock on the market. Both sides bribed judges and state legislators. See Maury Klein, THE LIFE OF JAY GOULD at 80-86 (1986). Cf. Lawrence Friedman, A HISTORY OF AMERICAN LAW at __].

13 Russian company law has borrowed heavily from U.S. and U.K. sources and, in its current version, was heavily influenced by a model developed by two American law professors. See Bernard Black and Reinier Kraakman, A Self- Enforcing Model of Company Law, 109 Harv. L. Rev. 1911 (1996).

One likely answer to this puzzle of when law matters (and why) may lie in the hypothesis that what really counts is not the content of the substantive law, but the adequacy of the enforcement mechanisms that underlie it.[14] The concept of enforcement mechanism needs, however, to be understood in a broader sense than simply the availability of specific legal remedies. For example, the one characteristic that the Robber Baron era in the United States shares with contemporary Russia is that in both the central government was weak and largely unable to enforce its commands in outlying areas. In the late 19th Century, the federal government in the United States was almost powerless to control private business entities; no centralized body (such as the SEC) had jurisdiction over investor protection, and business rivals could establish strong political fiefdoms in one state and largely ignore the commands of judges in a different state. In contemporary Russia, the central government appears similarly unable to control local provincial administrators, who may confiscate or extort assets from corporations operating in their area of effective control.[15]

If we focus on enforcement, however, it immediately becomes clear that the differences

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14 There is already some empirical support for this modest rephrasing of the L,L,S & V thesis. See text and notes infra at 83 to 86.

15 For example, the foreign (and largely institutional) shareholders of Far Eastern Shipping Company, Russia's largest commercial shipping line, have protested that the provincial governor of Vladivostok objected to their large ownership stake (42%) in Far Eastern and demanded that they surrender 7% of their shares to him. Otherwise, he allegedly threatened to reduce their voting rights by provincial decree. See Banerjee, "Shareholders Charge Extortion in Russian Far East," New York Times, June 16, 1999 at C-3. For a discussion of other instances in which regional barons and local political groups have extorted value from foreign investors in privatized Russian firms, see Merritt Fox and Michael Heller,
Lessons From Fiascos In Russian Corporate Governance, (Working Paper Sept. 1999).

between the U.S. and the U.K. are probably as great as between the U.S. and France (a nation generally thought to enforce its investor protection laws only weakly). In the U.S., class and derivative actions are permitted, and plaintiff's attorneys may charge contingent fees, which are usually awarded by the court based on a percentage of the recovery that the attorney obtains for the class. Under the standard "American Rule," each side bears its own legal fees (which means that the plaintiff's attorney faces only the loss of time and expenses invested in the action if the action is unsuccessful and is not generally liable for the winner's legal expenses).[16] In the U.K., the reverse is generally true. Class actions and contingent fees are not authorized, and the losing side must normally compensate the winning side for its expenses. When the individual plaintiff sues the large corporate defendant, the latter will likely incur the larger legal fees, and this disproportion can turn the prospect of fee-shifting under the English rule into a prohibitive deterrent to litigation. As a result, while a highly entrepreneurial system of private enforcement has evolved in the United States that largely overcomes the collective action problems that dissuade individual investors from suing,[17] nothing comparable exists in the United Kingdom.

Another sharp contrast involves the level of judicial activism in the two countries. For common law systems to behave similarly, it would logically seem necessary for them to accord a similar role to the judge. But it is not clear that they do. Although the U.S. and the U.K. share a

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16 See Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240, 247 (1975) ("In the United States, the prevailing litigant is ordinarily not entitled to collect a reasonable attorneys' fee from the loser.")

17 This is not to claim that the U.S. system is optimal. Class actions could in principle result in over deterrence; conversely, the availability of liability insurance could nullify the legal threat. But at least one can understand why such legal remedies might create socially desirable deterrence.

common law tradition, judges in these two systems appear to behave quite differently. Comparative law scholars rate U.S. courts near the top of the scale in terms of "judicial daring"- - that is, the willingness of judges to create new legal rules in the absence of legislation- - , but place the U.K. near the bottom of this same scale.[18] In short, the more that one looks at the supposedly obvious differences between common law and civil law countries, the more that those differences begin to blur.

On the other hand, the U.K. has other institutions- - most notably its Takeover Panel- - which appear to be highly effective and which lack any true parallel in the United States. In general, takeover defensive tactics are much more restricted in the U.K. than in the U.S. Finally, given the more concentrated character of the British financial community (both in terms of institutional ownership and physical location in the City of London), reputational effects may matter more in the U.K. than in the U.S. These differences may be important, but they have little to do with the line between the common law and the civil law.

The point here is not to compare the enforcement mechanisms of the U.S. and the U.K., but only to indicate that they may be very different. In turn, this implies a conceptual problem with the new academic research that broadly and boldly contrasts common law countries with civil law countries. Although real differences are clearly observable in terms of ownership concentration, the depth of markets, and the value of control, the presumed legal homogeneity of

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18 For a survey of comparative law scholars who rated U.S. courts as second in "judicial daring" (after Israel) and U.K. courts as third from last (out of fourteen industrialized countries), see Robert Cooter and Tom Ginsburg, Comparative Judicial Discretion: An Empirical Test of Economic Models, 16 Int'l Rev. L. & Econ. 295 (1996). Professors Cooter and Ginsburg suggest that differences in political structure and the role of dominant political parties best explain these national differences.

either common law or civil law countries may be more illusory than real. For example, many of those substantive legal rules that the U.S. and the U.K. share in common may have only trivial significance (or may have importance in one legal system and not the other[19]). Thus, to return to a distinction that I have made in earlier work, formal legal convergence may be less important than functional convergence.[20] Although the U.S. and the U.K. (and other common law countries) have similar legal systems that share a common origin, their common history may be less important than the fact that they have developed quite different mechanisms for dealing with the same "agency cost" problems that in the end achieve functionally similar results. For example, the issuance of a materially false financial statement may cause a significant drop in the company's stock price upon its discovery in both nations. In the U.S., it may elicit a class action; in the U.K., institutional investors may protest to the board and demand corrective action. However, in both countries, responsible senior management may lose their jobs over about the same period. Similarly, in both countries, a chief executive officer whose company's stock price and earnings underperform the industry averages for a given number of successive quarters will likely find himself out of office- - although the mechanism of his removal (a board coup d'etat or a hostile takeover) may differ between the two countries.[21]

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19 Preemptive rights, for example, play in important role in constraining managements in the U.K., but almost none in the United States. See Bernard Black and John Coffee, Hail Brittania: Institutional Investor Behavior Under Limited Regulation, 92 Mich. L. Rev. 1997 (1994).

20 See Coffee, supra note 4, at 679-80.

21 Indeed, this is what several empirical studies show about practices across the leading industrial nations. See Steven Kaplan, Top Executive Rewards and Firm Performance: A Comparison of Japan and the U.S., 102 J. Pol. Econ.

In short, the danger in focusing on legal commonality is that it may obscure very different functional mechanisms that are in fact more responsible for the similar ownership structure and market characteristics of two economies. Also, the recent research on comparative corporate governance has largely focused on the firm level, examining specific characteristics of corporate and bankruptcy law that were thought to generate higher levels of investor protection in "common law" legal systems. Although important, this focus slights the importance of securities markets themselves. The one feature that the U.S. and the U.K. clearly share is strong securities markets, with high disclosure and transparency standards. Rather than attribute the strength of these markets to the alleged commonality of U.S. and U.K. corporate law, it may make more sense to look at the even clearer commonality of U.S. and U.K. securities law.[22] Their similar listing, disclosure, and corporate governance standards may be more important in producing functional convergence (at least for larger companies) than the legal remedies available to individual shareholders. Nonetheless, the indicators used by LaPorta and others[23] in their provocative comparisons of common law and civil law systems have largely focused on the

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510 (1994); Steven Kaplan, Top Executive Turnover and Firm Performance in Germany, 10 J.L. Econ & Org. 142 (1994). [cite other studies].

22 It is noteworthy, for example, that the Securities Act of 1933 was modeled after the earlier English Companies Act of 1900, which ironically was, itself, intended to reverse the common law's tolerance for fraud. For a discussion of the different philosophies underlying the Securities Act of 1933 and the eventual triumph of a disclosure philosophy over a more regulatory philosophy, see Joel Seligman, THE TRANSFORMATION OF WALL STREET: A History of the Securities and Exchange Commission and Modern Corporate Finance 39-42 (1982).

23 See La Porta, Lopez-de-Silanos, and Shleifer, supra note 2.

corporate level and ignored the differences in securities market regulation.[24] Not only have the differences among nations in securities regulation been material, but equally important, international convergence is today proceeding more rapidly at the securities market level than at the corporate level.[25] Indeed, functional convergence among securities markets seems more attainable than formal legal convergence at the corporate law level, both because large firms can migrate between markets and because securities markets, themselves, face global competitive pressures that may lead them to change and adapt, even when their national governments are resistant to change.

Recent comparative corporate governance research has clearly been focused on reform. In particular, the recent comparative studies seem to have come as a natural progression from the earlier efforts (and frustrations) of many of these same scholars in attempting to implement viable corporate governance systems in transitional economies that were just emerging from their socialist cocoon. That experience quickly showed two strong tendencies: First, securities markets are fragile and could collapse, and, second, expropriation by managers and controlling shareholders could (and did) occur on a massive scale. The response of some scholars to this experience has largely been to call for legislative reform to implement the principal features of the "common law" systems. Such reform may be desirable, but calls for legislative reform or formal legal change often go unheeded. In a path-dependent world, it may simply be politically impossible to get from here to there, even when it is clear to most that such a transition would be

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24 This point has been earlier emphasized by Pistor. See Pistor, supra note 6.

25 See Coffee supra note 4, at 663-676.

efficient (in the Kaldor-Hicks sense) and would yield significant economic growth.

II. Fallacies and Blunders: A Short History of Mass Privatization

In 1995, the Prague Stock Exchange had 1,716 listings.[26] Blessed with relatively low inflation and nearly full employment, its strong macroeconomic position made it seem the country in Central or Eastern Europe most likely to make a smooth transition into a market-oriented economy. Yet, by early 1999, the number of listings on the Prague Stock Exchange had fallen by more than 80% to 301, and observers estimated that fewer than a dozen of these enjoyed any liquidity.[27] Correspondingly, over the same period, the value of an investment in an index of the leading 50 stocks on the Prague Stock Exchange fell by over 60%.[28] Trading dried up, and the viability of the Prague Stock Exchange was itself threatened. Where

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26 See Peter S. Green, "Prague Exchange's Failed Reform Efforts Leaves Some Predicting Its Demise," Int'l Herald Tribune, Mar. 17, 1999 at 16.

27 Id. It must be acknowledged that the Prague Stock Exchange ("PSE"), itself, delisted many of these companies and imposed higher listing standards during this period as part of its struggle to survive. At the outset of Czech privatization, there were no real listing standards, and the vast majority of privatized companies were listed. Still, the decision to delist these stocks was not truly voluntary. Their continued trading on the PSE would likely have left that market without any credibility.

28 Id. Specifically, the PX-50 index fell from 1,000 to 371.

there had been 1,486 brokers in 1997, there were only 358 in mid-1999.[29]

What happened? The fundamental fallacy in Czech privatization was that securities markets would develop spontaneously, simply because voucher privatization would create an initially dispersed ownership structure. By widely distributing the stock in privatized companies to a broad segment of the Czech adult population, Czech planners expected that an active secondary market would develop naturally. The militantly laissez-faire attitude of the initial Czech government also made it highly resistant to any regulation of this market.

In fact, for an initial period of high optimism, which lasted into 1995, share prices did rise. But then, after a series of scandals, the Czech bubble began to burst. First, foreign portfolio investors began to flee the Czech market. Foreign direct and portfolio investment dropped from $103 million in 1995 to $57 million in 1996 and then turned negative in 1997.[30] By 1998, the Czech economy entered a general recession.[31] In its wake, momentum gathered to reform the Czech securities market, and reform legislation was adopted in 1998 that established a Czech SEC and curbed some of the more egregious abuses.

Behind this massive disinvestment in the Czech market lay a pervasive loss of investor confidence, as small dispersed owners witnessed widespread looting of Czech investment funds and the systematic exploitation of the remaining minority shareholders in Czech firms once any

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29 Id.

30 See Czech Ministry of Finance, "Current Aspects of the Czech Capital Market" (internal report dated 1997).

31 Czech GDP contracted by more than 2.5 % in 1998 (whereas neighboring countries experienced a 4-5 % annual growth). See John Nellis, Time to Rethink Privatization In Transitional Economies, 36 Finance & Development 16-19 (International Monetary Fund, June 1999).

faction acquired a controlling position. In consequence, small shareholders systematically divested their shares and moved savings to other forms of investment. At the outset of mass privatization in the Czech Republic, over 7 million Czech citizens purchased shares through voucher privatization, but by 1999, the number of Czech shareholders had fallen to "barely five million."[32]

If the Czech experience then seems a paradigm of a market failure caused by inadequacies in the legal system, it is still important to identify what precisely went wrong. After a period of initial optimism, investors clearly lost confidence in the Czech market, causing it to decline sharply, even though the underlying macro-economic conditions remained relatively stable on a regional basis. Moreover, the apparent Czech failure contrasts sharply with the experience of neighboring Poland, where the privatization process was slower and where stronger disclosure and governance standards were established as preconditions. This section will therefore move from a brief review of this seeming natural experiment to a more detailed assessment of what differentiated these two efforts and then a broader look at other privatization programs.

A. Poland Versus the Czech Republic: Divergent Approaches to Privatization. In geopolitical terms, Poland and the Czech Republic share much in common, as similar Central European countries with a common Slavic culture and a common historical experience as former members of the Soviet bloc. But their approaches to privatization could not have been more divergent. The Czech Republic rushed into privatization in the early 1990s, with regulatory

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32 See Green, supra note 26.

controls being developed on an ex post basis in response to a series of crises and scandals.[33] Determined to move assets into the private sector as quickly as possible, Czech authorities privatized some 1,491 joint stock companies in the first wave of Czech privatization, and another 861 in the second wave[34]- - thereby increasing the private sector share of Czech Gross Domestic Product from 12% in 1990 to 74% by 1996. In fairness, this was a considerable logistical achievement.

In contrast, Poland moved far more slowly and equivocally, privatizing only some 500 firms and only pursuant to a procedure that created a state-created investment fund as the controlling shareholder of each privatized firm. Rather than assuming that a secondary market would develop spontaneously, Poland designed voucher investment funds as a mechanism to solve the perceived powerlessness of the individual shareholder in a mass privatization program. To assure that these state-created investment funds would control the privatized firms, Poland neither permitted the creation of private investment funds (which had sprung up overnight in the Czech Republic) nor initially allowed citizens to invest directly in the stock of the newly privatized firms. Rather, Polish law mandated that citizens could invest their voucher certificates only in state-created financial intermediaries, known as National Investment Funds

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33 I have discussed the contrasting experiences of these two nations at greater length elsewhere. See John C. Coffee, Jr. "Inventing a Corporate Monitor for Transitional Economics: In K. Hopt, H. Kanda, M. Roe, E. Wymeersch and S. Prigge, COMPARATIVE CORPORATE GOVERNANCE: The State of the Art and Emerging Research (1998).

34 See Saul Estrin, Domenico Nuti, and Mulica Uvalic, "The Impact of Privatization Funds on Corporate Governance in Mass Privatization Schemes: The Czech Republic, Poland and Slovenia," in Marko Simoneti, Saul Estrin, Andreja Bohm (eds.), THE GOVERNANCE OF PRIVATIZATION FUNDS: Experiences of the Czech Republic, Poland and Slovenia (1999) at 137, 142.

(or "NIFs"), which were to serve as controlling shareholders of the to-be-privatized firms.[35] At the outset, only fifteen NIFs were chartered, with each being assigned a controlling 33 1/3% stake in its share of the 500 privatized firms. The balance of the stock in each firm was held by other NIFs and by the state. Each NIF then hired a management company to advise on restructuring those companies in which the NIF held a controlling stake; in fact, a number of Western investment banking firms were hired to perform this role, sometimes in preference to Polish commercial banks.

In short, viewing continued state ownership as the greater danger, Czech authorities rushed into privatization and gave relatively little attention to problems of regulation, while in Poland state planners took the reverse view of the relative dangers, and therefore moved slowly and cautiously to implement a limited privatization program that effectively substituted state created monitors (in which citizens could invest) for direct state ownership.

Some results of these two very different approaches were easily predictable: The Czech Republic quickly developed an active securities market, while the Polish securities market developed haltingly with only very thin trading (which actually declined between 1994 and 1996).[36] In the Czech Republic, private investment funds appeared as a spontaneous, unplanned

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35 For a detailed description of the NIF which essentially resembled closed- end mutual funds and were created by the Polish Ministry of State Treasury to hold controlling stakes in privatized firms, see Jannsa Lewandowski and Roman Szyszko, "The Governance of Privatization Funds in Poland" in Simoneti, Estrin and Bohm, supra note 34.

36 See Eva Thiel, The Development of Securities Markets in Transitional Economies: Policy Issues and Country Experiences, 70 Financial Market Trends 111 (June 1998) (available on LEXIS/NEXIS, news library, curnws file).

market development, with over 600 funds being formed during the two Czech Privatization waves. Necessarily, these funds could only be regulated on an after-the-fact basis. In contrast, in Poland, privatization was delayed repeatedly by political infighting over the a variety of issues, including selection of the management companies that would run the NIFs.

Both systems encountered serious problems, but of a very different character. Three distinct problems compromised Czech privatization, and each was at bottom attributable to legal failures. First and most noticeable was the near total lack of transparency in the Czech securities market. Because trading was not centralized and trading off the Prague Stock Exchange did not require contemporaneous price reporting, only the prices of those transactions that the trading participants wished to disclose (and so transacted on the Exchange) were reported. In fact, it appears that the majority of all trading transactions occurred off the Prague Stock Exchange,[37] with the minority of transactions that did occur on the exchange being widely thought to have been at inflated prices. In effect, current securities prices were revealed only when the traders wanted to post a price- - either to influence Western portfolio investors or inflate the value of a privatization fund's portfolio. For this and other reasons, including the absence during this period of any SEC-like authority with power to regulate trading or require contemporaneous price disclosure, foreign investors quickly grew skeptical that the reported prices on the Prague Stock Exchange reflected real values. Moreover, in this non-transparent world, informed

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37 According to Thiel, only 3% of actual trades were executed on the Prague Stock Exchange. See Thiel, supra note 36. In part, this was attributable to the existence of a a Nasdaq-like alternative system, which also disclosed prices contemporaneously. Still, investment funds could trade on a face-to-face basis off the exchange and use the exchange only for transactions at inflated prices.

predictably flourished because it was more profitable than in an efficient market.[38]

A second problem quickly arose that further compromised restructuring efforts. During the course of the two Czech privatization waves, some 600 investment funds were created, and they competed vigorously to convince individual investors to convert their privatization vouchers into their shares. Potentially, such vehicles could have become effective corporate monitors because they aggregated large stakes in Czech corporations and thereby potentially solved the collective action problem that the dispersed ownership resulting from voucher privatization necessarily implied. However, the largest investment funds were established by the principal Czech commercial and savings banks, which had obvious reputational advantages in convincing Czech citizens to deposit their vouchers with them.[39] Owning only small stakes in their own investment funds, the banks had little incentive to undertake costly restructuring activities. Instead, many sought to use their investment fund's influence over its portfolio companies to secure banking clients for themselves. Rather than concentrating their holdings (and thus maximizing their influence), most bank-administered funds sought to diversify their holdings

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38 Emerging markets appear in general to have very different characteristics from mature efficient markets. In particular, stocks in emerging markets exhibit strong "momentum," meaning that one period's performance tends to predict the next period's performance; also, high beta stocks do not outperform low beta stocks. See K. Geert Rouwenhorst, Local Return Factors and Turnover in Emerging Markets, 54 J. Fin. 1439 (1999).

39 Of the thirteen largest investment funds in the first wave of Czech privatization, eleven were created by financial institutions. See Saul Estrin, Domenico Nuti, and Mulica Uvalic, The Impact of Privatization Funds On Corporate Governance in Mass Privatization Schemes in Simoneti, Estrin and Bohm, supra note 34, 137 at 151. This was probably predictable, because citizens were already familiar with the local savings, commercial or postal bank that sponsored these funds.

in order to hold stakes in as many firms as possible- - in part to solicit banking clients for their parents.[40] Also, to protect their banking parents from potential hostile takeovers, the bank-run funds invested heavily in the common stock of their banking parent (or in the stock of other banks). An incestuous web of cross-ownership quickly developed to insulate the major banks from hostile takeovers. Finally, most privatization funds (both bank-related funds and non-bank funds) found it more profitable to concentrate on trading than on restructuring often inefficient portfolio companies. The combination of a non-transparent market and their privileged position as insiders made such activities profitable, but constantly filled the media with news of recurring insider trading scandals.

If the bank-related funds were passive, the non-bank funds were far worse. A subsequent study by the Czech Ministry of Finance found a negative correlation between a privatized firm's performance and the percentage of its shares held by non-bank investment funds. [41] In the first wave of Czech privatization, three percent of the funds became insolvent and were placed into "forced administration," [42] but, in the second wave, the rate of insolvency accelerated, and some

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40 Other motivations can also explain this failure to concentrate holdings (which continued in secondary market trading as well as in the original privatization auctions). For example, in non-transparent markets, trading in the stocks of newly privatized firms may be highly profitable for informed traders with seats on the boards of their portfolio company.

41 See Czech Ministry of Finance, supra note 30.

42 See Jozef Koterba, Evzen Kocenda, and Jan Hanouek, "The Governance of Privatization Funds in the Czech Republic," in Marko Simoneti, Saul Estrin and Andreja Bohm, THE GOVERNANCE OF PRIVATIZATION FUNDS: Experiences of the Czech Republic, Poland and Slovenia (1999) at 7, 29-30.

ten funds amounting to over 21% of the market capitalization in that wave were placed in "forced administration."[43] The common cause appears not to have been excessive leverage or investment failures, but "tunneling out" - - the fraudulent siphoning off of assets.

The ease with which funds could be looted is shown by the similar ease with which they could escape regulation. Although Czech law did regulate the operation of investment funds, it did not restrict the ability of an investment fund to elect to deregister and become an unregulated holding company. Symptomatic of the civil law's literal narrow-mindedness, the difference between an investment company and a holding company under Czech law was formal, not functional. Simply by surrendering one's license to operate as an investment company, an investment fund could escape virtually all regulation. Because share ownership of investment companies was extremely dispersed, a small control group, holding as little as ten percent of the voting stock of an investment fund, could usually dominate shareholder meetings and pass a resolution to convert the fund into a holding company. Once unregulated, all forms of self-dealing were effectively made possible, and the entity might reincorporate outside the Czech Republic (as some did).

The extent of such conversions seems extraordinary. In terms of market share, fully 28% of the investment privatization funds in the first wave of Czech privatization and 21% of the funds in the second wave were converted into unregulated holding companies.[44] Although this may sound as if the rate of conversion declined, it must be remembered that an additional 21% of

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43 Id.

44 See Jozef Kotrba, Evzen Kocenda, and Jan Hanousek, "The Governance of Privatization Funds in the Czech Republic," in Simoneti, Estrin, and Bohm, supra note 34, at 30.

the funds in the second wave were placed in "forced administration" by the Czech authorities. [45] Hence, nearly half of the funds in the second wave of Czech privatization failed or escaped regulation by converting into unregulated entities. Although major bank-run funds generally stood apart from this race to convert, their motives, while non-fraudulent, were rather to use the funds as a vehicle by which banking clients and others benefitted.

The eventual upshot of these repeated scandals was that the administration of investment funds became a contentious political issue in the Czech Republic and helped result in the downfall of the Vaclav Klaus Government (which had generally opposed market regulation) and the passage of reform securities legislation in 1998. But by then, public confidence in the securities market had been largely eroded.[46]

The Polish experience was in many respects the reverse of the Czech experience. Privatization was delayed and delayed again, as demanding disclosure rules and fiduciary standards for directors were drafted. Polish citizens were given only one choice: which NIF (of the 15 originally created) to invest in, as direct investment in either portfolio firms or private investment funds was not initially permitted. Trading was centralized on the Warsaw Stock Exchange, and price transparency appears never to have been a serious issue. Polish disclosure standards also won high marks from most observers, and the EBRD Transition Report rated Poland and Hungary as the two Central European countries that had most closely approximated

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45 Id.

46 For a similar assessment that emphasizes the "very visible exploitation of opportunities for wealth creation by collusion and arbitrage," see Theil, supra note 36.

IOSCO standards.[47]

Still, while the Polish authorities planned a carefully integrated program of market reforms and privatization, their success in actually developing their securities market arguably presents a closer question. Advocates of "fast" privatization might point to the fact that, as of late 1998, only some 253 companies were listed on the Warsaw Stock Exchange [48] (much less than the number in the considerably smaller Czech Republic). Indeed, the Polish mass privatization program was limited to some 500 enterprises, representing only 10% of Polish Gross Domestic Product.[49] Similarly, it remains debatable whether the Polish, state-created financial intermediaries (the NIFs) have functioned as effective monitors, although some commentators believe they have at least been more active than the Czech investment funds in attempting to

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47 See EBRD Transition Report, Nov. 1998 (available on LEXIS/NEXIS, news library, curnws file). The EBRD Transition Report evaluates the progress of transitional economies toward a free market system in a variety of different areas (e.g., banking, bankruptcy, and securities market reforms) using a common index rating system. In 1998, it awarded Poland a rating of 3+ (and the Czech Republic a rating of 3) for their efforts at securities market reform.

48 See PAP News Service, December 28, 1998, "Securities Commission Head Displeased with 1998." (available on LEXIS/NEXIS, news library, curnws file).

49 See Mario Simonetti, Saul Estrin and Andreja Bohm (eds.), THE GOVERNANCE OF PRIVATIZATION FUNDS: Experience of the Czech Republic, Poland and Slovenia (1999) at p. 5; see also EBRD Transition Report, supra note 44. In 1997, Polish IPOs issued stock having a value equal to 1% of GDP. Id.

encourage efficient restructuring.[50]

On the other hand, the most impressive evidence in favor of the Polish approach has been the ability of its securities market to support cash offerings of equity securities. Between 1991 and 1998, no Czech company sold equity for cash as part of its privatization program; conversely, some fifty Polish companies did.[51] Over the same period, no Czech company effected an initial public offering over the Prague Stock Exchange, while some 136 Polish companies did on the Warsaw Stock Exchange.[52] In short, only the Polish system intentionally developed its stock exchange so that it could perform the classic role of serving as an engine of economic growth.

Another strong contrast between the Czech and Polish experiences involves market performance during conditions of adversity: when the Asian financial crisis struck in 1998, Poland had a relatively mild experience. Between the end of 1996 and August 1998, the Polish stock index fell only 13.1%,[53] while the Czech market had already partially collapsed and fell

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50 These commentators have argued that only in Poland did the investment privatization funds acquire sufficiently large stakes to attempt active management and restructuring. See Marko Simoneti and Andreja Bohm, "The Governance of Privatization Funds in Poland" in Simoneti, Estrin, and Bohm, supra note 34, at 163, 166.

51 See Simon Johnson and Andrei Shleifer, Coase v. The Coasians: The Regulation and Development of Securities Markets in Poland and the Czech Republic (Working Paper, September 1999) at p.26.

52 Id.

53 See Simon Johnson, Peter Boone, Alasdair Breach and Eric Friedman, supra note 1, at p. 48. This paper groups countries by severity of stock market decline between the end of 1996 and August 1998 and places Poland in the "relatively moderate" decline category.

further.[54] Up until late 1998, the NIFs that had listed on the Warsaw Stock Exchange seemed to be trading at or near their net asset value, while Czech funds during this period often traded at steep 20% to 70% discounts off their net asset value.[55]

Another measure of a securities market's success is the number and percentage of firms listed on it that migrate to foreign stock exchanges. Such dual listings may imply that the listed firm cannot raise capital on its home country exchange; alternatively, it may be a bonding mechanism by which a firm credibly pledges to comply with disclosure and corporate governance standards that are not enforced (or enforceable) in its home country.[56] In any event, companies in Central Europe have recently migrated to German stock exchanges (most notably the Berlin

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54 The Czech market collapse worsened after the time of the Asian financial crisis and hit bottom following the 1998 Russian financial crisis. Between August 1998 and March 1999, the Czech market decline was 30.5%, which far exceeded the 17.5% decline on the Polish market or the very mild 5.7% decline on the Hungarian market. See Pistor, supra note 6, at 46. Katharina Pistor also finds that Czech market capitalization declined 35 % following the 1998 Russian financial crisis, while Polish market capitalization actually increased 17.8 % over this same period. See Pistor, supra note 6, at 47. The Prague Stock Exchange has since recovered, although this may be partly attributable to stock market reforms enacted largely in 1998.

55 See Simoneti and Bohm, "The Governance of Privatization Funds: Open Issues and Policy Recommendations" in Simoneti, Estrin, and Bohm, supra note 34, at 163,174. In addition, roughly 25% of the first 500 privatized firms are now also publicly traded. This contrast between the steep discounts in the Czech market and the absence of discounts in the Polish market is, however, subject to an important qualification: because of the absence of transparency in the Czech market, reported prices on the Prague Stock Exchange were often inflated, thereby overstating the discount.

The subsequent history of the NIFs after 1998 is discussed infra in the text at notes 59 to 61.

56 See Coffee, supra note 4, at 673-76 (discussing foreign listings as a bonding mechanism).

Stock Exchange). As of early 1999, one study finds that 117 stocks from Eastern Europe were listed on the Berlin stock Exchange, of which 24 were from the Czech Republic, but only 13 from considerably larger Poland.[57] Prior to the onset of the Russian financial crisis in late 1998, Poland had 2% of its listed companies traded on German stock exchanges, while the Czech Republic had 5% (or more than twice as much).[58] This disparity should not be surprising. Having the weaker legal protections, Czech companies had the greater need to list on a foreign exchange with "stronger" governance standards in order to attract foreign portfolio investors (most of whom had already fled the Czech market because of its lack of transparency).

This happy story contrasting the regulated and unregulated worlds encounters one serious difficulty that arose in late 1998. Beginning in approximately December1998, the stock prices of the Polish NIFs fell sharply, and they currently trade at discounts to their net asset values as steep as ever existed in the Czech Republic.[59] Meanwhile, the surviving Czech investment funds now trade at relatively modest discounts to their net asset value (typically around 20%).[60]

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57 See Pistor, supra note 6, at 45.

58 Id. at 46.

59 Data showing these discounts as of the Fall of 1999 has been provided to me by Professor Andrew Weiss, an economist at Boston University. He informs me that, as of late September, 1999, the average discount on the Polish NIFs relative to their net asset value had grown to 60%, which was as great or greater than the standard discount on Czech funds earlier in the decade.

60 Professor Weiss points to the example of the Restitution Fund, which is the largest Czech fund and which now trades at 1,300 (as of late September, 1999) and has a net asset value of 1,550 (or less than a 20% discount). In 1994, it traded for between 500 and 600. Another example is SPIF Cesky,

What explains this sudden reversal? Although any answer is speculative, most NIFs experienced board coup d'etats in 1998 that have replaced their old investment managers. Until late 1998, the Polish government held the majority of the voting power in NIFs. But since then, shareholders have replaced the management company in 14 of the original 15 NIFs. In effect, the same fear of opportunistic control struggles that eroded investor confidence in the Czech market appears to have devastated the value of Polish NIFs. No longer the stable pawns of the state, these NIFs appear to have suffered a sharp and fairly sudden loss of investor confidence.

Still, the number of firms traded on the Warsaw Stock Exchange has continued to grow, and its overall market capitalization now exceeds that of the Prague Exchange.[61] Nor has evidence yet surfaced indicating that privatized companies have been looted or "tunneled" in Poland. Nonetheless, the bottom line evaluation must be cautious: in transitional economies, it may take little to disturb investor confidence and produce a flight for the exits. As they have been "deregulated" (or, perhaps more accurately, "privatized"), the Polish NIFs may be repeating the sorry history of the Czech funds.

B. <u>What Really Distinguishes the Czech and Polish Experiences?</u> To this point, the Czech and Polish experiences have been differentiated in terms of the highly spontaneous character of Czech privatization versus the carefully planned – indeed, constrained – character of Polish privatization. But, both nations share one common fact that is troubling for the new

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which now trades at 1,346 and was trading at 400 in December, 1994. One possible reason for this resurgence may have been reform legislation, which was adopted in 1998; also, pursuant to this legislation, many Czech funds converted to a basically open-end status. Open-end funds do not, of course, have the same discount as a closed-end fund because their sharers can be redeemed.

61 See Pistor, supra note 6, at 48.

scholarship that emphasizes the importance of differences in substantive corporate law: they each had a corporation law heavily based on the German civil law structure. Put simply, their experiences were very different, but their corporate laws were largely the same. As a result, because the corporate laws of Poland and the Czech Republic each provide only weak protection for minority shareholders,[62] their different experiences cannot be used to corroborate the claim that differences in substantive corporate law are the key causal factors that determine the success or failure of privatization.

Yet, if Poland and the Czech Republic had similar corporate laws, their approaches to securities regulation were entirely different. Not only did Poland impose high disclosure standards from the outset (including quarterly reporting), it also created an SEC-like agency to enforce its laws from the beginning of its privatization experience.[63] In addition, Poland adopted provisions that resembled the Section 13(d) of the U.S.'s Williams Act in order to require ownership transparency - - that is, the disclosure by a potential acquirer of ownership of specified thresholds of a company's shares.[64] Finally, Poland (but not the Czech Republic)

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62 For a closer assessment of the similarities and differences in Czech and Polish corporate law during the period , see Pistor , supra note 6, at 35-44. She notes that the Czech Republic did have a considerable lower quorum requirement (30%), which may have facilitated some frauds , and a higher (and hence less protective) mandatory bid requirement, but overall she finds that both countries provided only weak protections in their corporate law for minority shareholders.

63 See Pistor, supra note 6, at 37-38.

64 Id. at 37. (Noting that Polish law has required ownership disclosure at the 10% and 25% levels). Section 13(d) of the Securities Exchange Act of 1934 requires shareholders of a "reporting company" to disclose to the issuer and the SEC both their identity, their sources of financing, their plans and

followed the British model of takeover regulation by requiring any shareholder who acquired more than a specified level of stock to make a mandatory bid for the remaining shares.[65] In sum, as Katharina Pistor has shown, Poland had "weak" corporate law, but "strong" securities law.[66]

In overview, these restrictions on the undisclosed acquisition of control and the mandatory requirement that a control acquirer offer to purchase the remaining shareholders may have been responsible for some of the differences in the Czech and Polish experiences. At the least, these restrictions helped to stop (or at least slow) the frantic scramble for control that occurred in the Czech Republic. Accordingly, the Polish experience may suggest the need for refinements in the model developed by those scholars of corporate governance who have focused, somewhat single-mindedly, on differences in substantive corporate law.[67] In comparing systems of corporate governance, many of the most important differences may lie at the level of securities regulation. Here, rules prohibiting insider trading, requiring ownership transparency, and restricting coercive takeover bids may do more to protect minority shareholders from expropriation than do the same jurisdiction's substantive corporate law rules. Indeed, as earlier suggested, the most important common denominator between the "protective" legal regimes in

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intentions, and certain other information when- - either alone or as a part of a group- - they acquire more than 5% of any class of equity security of such an issuer.

65 Poland adopted a 33% threshold (originally, it was 50%), while the Czech Republic introduced this reform (but only at the 50% level) only more recently. Id. at 37-38.

66 Id.

67 See sources cited supra at note 2.

the U.S. and the U.K. may be their highly similar securities laws, not their common law origins.

Another hypothesis, however, must also be noted: more important than these legal differences may have been the creation of the Polish NIFs. By holding controlling stakes, these state-created financial intermediaries blocked the path of entrepreneurs who have otherwise might have competed to seize control of newly privatized companies. A critical, if possibly unintended, role of the NIFs was to provide an assurance to smaller shareholders that they need not fear the potential expropriation of their investment in a privatized company, at least because of its vulnerability to a predatory control seeker.[68] Indeed, much of the scramble for control in the Czech Republic seems to have been defensively motivated: each large shareholder essentially realized that if they did not acquire control, someone else would with resulting injury to them. In short, the fear of loss may have provided a greater incentive to compete for control than the expectation of any synergistic or opportunistic gain.

In this light, the inefficient exposure to loss that the Czech system imposed on minority shareholders may also explain the earlier noted absence of equity offerings for cash in the Czech Republic as contrasted with their frequency in Poland.[69] Because an offering of equity securities inherently dilutes large shareholders, it exposes them to an increased risk of exploitation;

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68 Lucian Bebchuk has theorized that these competitive struggles for a controlling position are inevitable whenever the private benefits of control are large and control is not locked up by special charter provisions. See Bebchuk, A Rent- Protection Theory of Corporate Ownership and Control, NBER Working Paper No. 7203 (July 1999). These conditions would seem always to be satisfied when voucher privatization is used in a transitional economy, because it exposes control to acquisition and the private benefits of control are necessarily high when judicial controls are undeveloped.

69 See text and notes supra at notes 51 to 52.

correspondingly, it also disturbs and potentially upsets any equilibrium that may have been achieved among large shareholders. Having acquired a majority position, a controlling shareholder might prefer to rely on high-cost bank financings than to utilize equity financing where use of the latter could interfere with its ability to realize the private benefits of control. But this fear was not a danger in Poland, where the NIFs gave greater assurance of continuity at least for an interim period. Thus, one implication of the Czech experience may be that unregulated control contests and the rapid transition from dispersed to concentrated ownership can give rise to externalities - - both political and economic.

Correspondingly, the sharp decline in the stock prices of Polish NIFs once shareholders were permitted to take control of them from the government also reinforces this interpretation that unregulated control contests expose minority investors to the risk of expropriation and result in reduced share prices.[70] Had the Polish government instead placed some maximum ceiling on the percentage that any investor (or group of investors) could own in an NIF, this decline might have been reduced.

C. Other Privatization Experiences: Do Securities Markets Develop Naturally?

Although the Czech and Polish experiences probably supply the closest approximation to a natural experiment that can be found in this area, their experiences are not unique. A brief review of earlier privatization efforts finds similar cases in which emerging securities markets collapsed after a loss of investor confidence, including in the United States. Although in the public mind the term "privatization" first probably came into popular usage with the of the Thatcher Government in Great Britain in 1979 to sell off government-owned enterprises, important earlier

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70 See text and notes supra at notes 59 to 61.

instances can be identified. The first large-scale privatization offering to public investors seems to have occurred in 1961, when the Konrad Adenauer government in the Federal Republic of Germany sold a majority stake in Volkswagen in a public offering that was aimed at small investors in Germany.[71] This was followed by an even larger offering in 1965 of the government-owned shares of VEBA A.G., a German heavy mining company. Both offerings were initially successful, but share prices fell dramatically thereafter, forcing the Adenauer government to develop "a rescue operation... aimed at protecting small shareholders."[72] The experience appears to have dissuaded both Germany and other European governments from embarking on similar programs until the Thatcher Administration initiated its ideologically-motivated wave of privatizations in 1979.

During the early 1970's, the Pinochet government in Chile sought to reprivatize industries that had earlier been nationalized by the Allende government. Sales were made at extremely discounted prices, and, when the Chilean economy later entered a debt and payment crisis in the early 1980's, it renationalized many of these same industries. Not until the late 1980's (at roughly the same time as the Thatcher government) did Chile effect a more successful privatization program through the public sale of shares in state-owned enterprises.[73] However,

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71 For a fuller description of these offerings, see William Megginson, Robert Nash, & Matthias van Randenburgh, The Financial and Operating Performance of Newly Privatized Firms: An International Empirical Analysis, 49 J. Fin. 403 (1994). An arguably controlling stake in Volkswagen continues to be held by a one German state (Lower Saxony).

72 Id. at 407.

73 See Pan Yotopoulos, The (Rip) Tide of Privatization: Lessons from Chile, 17 World Development 683 (1989).

the key event in this later, successful privatization was the 1990 privatization of Telefonos de Chile, which was largely targeted at U.S. investors through ADRs. Mexico's very large and successful privatization program in the 1990s has similarly been effected through privatizations of large state-owned companies that were directly listed on the New York Stock Exchange.[74]

Mass privatization efforts that have not been implemented through established exchanges have fared less well. The most notable example is, of course, Russia. By virtually all accounts, Russian privatization has been a spectacular failure, and most recent discussion of privatization have been largely preoccupied with the Russian experience.[75] But the lessons from the Russian failure are more difficult to draw because the Russian privatization effort was flawed from the outset by critical design failures and macro-economic conditions that were not present in either Poland or the Czech Republic. First, Russian privatization was significantly different from Czech privatization in that substantial blocks of stock were allocated to the incumbent managers as a political accommodation that was essential to the implementation of privatization. The result was probably easily predicted: within 2-3 years after mass privatization, most minority shareholders had sold their shares to the insiders, thereby producing the same highly concentrated

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74 For an overview of Mexican privatization, see Rafael LaPorta and Florence Lopez-de-Silanos, Benefits of Privatization- - Evidence from Mexico, Private Sector, at 21-24 (World Bank June 1997).

75 For recent detailed accounts, see Fox and Heller, supra note 15, and Bernard Black, Reinier Kraakman, and Anna Tarassova, Russian Privatization and Corporate Governance: What Went Wrong? (Stanford Law School Working Paper No. 178, September 1999).

ownership structures that are the norm elsewhere.[76] Second, in contrast to other recent privatization experiences, the Russian government lacked control over its outlying regions. In these regions, privatized companies have been more subject to expropriation by the local government (or coalitions led by, or affiliated with, it) than by controlling shareholders.[77] Third, the legal system in Russia was almost uniquely primitive, indeed to the point that few contractual obligations could be routinely enforced, and resort to extra-legal means (most notably, violence) was the norm, not the exception. Finally, the macro-economic condition in Russia proved to be particularly perverse.[78] As a result, in 1998, the Russian government defaulted on its domestic and international debt, and the RTS stock market index fell almost 90% from its level eleven months earlier.[79] When an experiment fails from multiple causes, it is difficult to attribute primary responsibility to any one cause.

In contrast, what makes the Czech story more interesting than the Russian story is that the same transition from dispersed to concentrated ownership occurred even without the built-in bias for insider ownership or the poor macro-economic conditions that characterized the Russian context. Nor is the Czech experience unique. To the extent that Czech privatization became

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76 See Joseph Blasi and Andrei Shleifer "Corporate Governance in Russia: An Initial Look" in Roman Frydman et. al. (eds.), CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA (Central European University Press 1996).

77 See text and notes supra at note 15.

78 See Black, Kraakman, and Tarassova, supra note 75.

79 William Megginson and Jeffrey Netter, From State to Market: A Survey of Empirical Studies on Privatization, NYSE Working Paper 98-05 (Dec. 1998) at p.16.

stalled, the lack of regulation would appear to play a greater causal role, because other explanations are simply not as available. More generally, except when companies have been privatized through offerings listed on international stock exchanges, the Czech progression to concentered ownership seems to be the dominant pattern, with the exceptions being few in number. Poland appears to be the most notable exception, but its story has not yet played out fully. As next discussed, this pattern raises the question of whether this transition is an inevitable progression.

D. The Re-appearance of Concentrated Ownership. Both in Russia and in the Czech Republic, mass privatization through the sale or distribution of privatization vouchers to the citizenry inevitably created a highly dispersed ownership structure- - but only for a transitory period. Over time, concentrated ownership has re-emerged. Because numerous studies have concluded that privatized firms become more efficient,[80] it is not surprising that some studies attribute this increased efficiency to the emergence of concentrated ownership. For example, one detailed study that examined the performance of a sample of 706 Czech firms that were privatized in 1991-92 over the period from 1992 to 1995 concluded that the greater the

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80 See e.g., Juliet D'Souza and William Megginson, The Financial and Operating Performance of Privatized Firms During the 1990s, 54 J. Fin. 1397 (1999) (finding significance increases in profitability and efficiency); Nicholas Barberis, Maxim Boycko, Andrei Shleifer, and Natalia Tsukanova, How Does Privatization Work? Evidence from the Russian Shops, 104 J. Pol. Econ. 764 (1996) (study of 452 retail stores); Roman Frydman, Marek Hessel, and Andrej Rapaczynski, Why Ownership Matters?: Politicization and Entrepreneurship in the Restructuring of Enterprises in Central Europe (C.V. Starr Center Working Paper No. 98-14 April 1998) (summarizing other studies); Megginson and Netter, supra note 79.

ownership concentration, the greater the improvement in profitability and market valuation.[81] Unfortunately, this study examined a period that ended in 1995, prior to the subsequent free fall in price levels on the Prague Stock Exchange. Possibly, the higher stock market valuations that they found were a transitory phenomenon as control groups were forming and controlling blocks were being assembled.

Still, let us assume, for a moment, that newly privatized firms with concentrated ownership do initially outperform comparable firms with dispersed ownership. Does this imply that an economy characterized by concentrated ownership will be more efficient than one characterized by dispersed ownership- - at least in the case of transitional economies? The problem with any such conclusion is that the benefits from concentrated ownership may prove to be short-lived, while the costs surface only at a delayed point. Even if concentrated ownership implies superior monitoring of management, these benefits have to be balanced against the enhanced risk of expropriation by controlling shareholders. Such expropriation risks the phenomenon of securities market collapse, which in turn may result in a variety of social costs. For example, as earlier noted, Polish securities markets have been able to support IPOs and other cash offerings of equity securities, while Czech markets have not.[82] Economic growth then may be at risk.

The extent of this risk has only recently begun to emerge in new research that documents an apparent global pattern. The Asian financial crisis of 1997-1998 adversely affected economic

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81 Stign Claessens, Simeon Djankov, and Pohl, Ownership and Corporate Governance: Evidence from the Czech Republic (World Bank Policy Research Paper No. 1737 1997).

82 See text and notes supra at notes 51 to 52.

development in most emerging markets, but to varying degrees. Although most analysts have assumed that its causes lay in macroeconomic and banking policies, one provocative new study concludes that "the weakness of legal institutions for corporate governance had an important effect on the extent of [exchange rate] depreciations and stock market declines in the Asian crisis."[83]

Essentially, this study argues that the rate of expropriation increases when the rate of return on investment falls. In short, managers and controlling shareholders tend to steal more in bad times than in good times- - and investors expect this. Hence, given any adverse shock to the financial system of a region (or the world generally), the relative decline will be worst in those countries with legal systems that confer the weakest protections on minority shareholders. Using as its sample the 25 emerging markets that are currently open to significant capital flows (and hence the most vulnerable to speculative attack), this study concluded that "weak enforcement of shareholder and creditor rights had first-order importance in determining the extent of exchange rate depreciation in 1997-1998."[84] Indeed, three indices of legal institutions- - which it termed "efficiency of the judiciary, corruption, and the rule of law"- - were found to better "predict the changes in exchange rates in emerging markets better than do the standard macro measures."[85] Other measures reflecting the strength of shareholder rights were also found to be significantly correlated with the severity of the financial crisis, but only "as long as these

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83 Simon Johnson, Peter Boone, Alasdair Breach and Eric Friedman, Corporate Governance in the Asian Financial Crisis, 1997-1998 (Working Papers,1999) at p.3.

84 Id. at 4.

85 Id. at 6.

measures reflect how rights are actually enforced."[86] To sum up, the strength of legal protections (as measured by actual enforcement practice) appeared to be the independent variable that best predicted the dependent variable of severity of financial crisis.

At this juncture, it is useful to return to the Czech experience. As noted earlier, a number of studies have found that privatized firms became more profitable to the extent that their ownership was more concentrated.[87] But is this advantage sustainable over time? The subsequent sharp decline in stock prices on the Prague Stock Exchange suggests that some financial shock (from whatever source) destabilized the economy and produced a sudden withdrawal of investor capital. Why was the market decline so extreme in the absence of any major macro-economic change in the Czech economy? Perhaps investors were aware of their potential vulnerability, but expected that managers would constrain their rate of expropriation during "boom" times. At the first sign of "bust," however, investors race for the exits because they expect the rate of expropriation to increase.

Whether or not one accepts this premise that the rate of expropriation rises with any decline in return on investment, the critical factor in this scenario is that investor loss of confidence will be greatest in those economies where they believe they are least protected legally. In truth, assumptions about the relationship of the rate of expropriation to the return on investment are probably unnecessary to drive this model. All that one need hypothesize is that investors will ignore legal risks and their vulnerability to expropriation by controlling shareholders during "boom" times, possibly on the premise that managers and controlling

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86 Id.

87 See text and notes supra at notes 80 to 81.

shareholders will not risk disrupting the momentum that is benefitting them all. Essentially, the Czech experience seems consistent with this pattern.

Although such data can be read to mean that legal development has a decisive influence on the viability of securities markets, the true independent variable in such a model may be investor confidence, and the level of such confidence may be influenced by factors other than the strength of legal protections. Investors may learn that a particular venue (whether a country or a stock exchange) has frequently experienced scandals- - and decide to avoid it. Even within the United States, there is evidence consistent with this hypothesis. In 1992, the Amex launched the Emerging Company Marketplace ("ECM") to trade the stocks of small, high growth companies.[88] By 1995, it was forced to close this market after a series of scandals had "damaged the ECM's reputation for monitoring the quality of its listings..."[89] Yet, investors in the ECM had the same legal rights as investors trading on the NYSE. Although other factors also inhibited the growth of the ECM,[90] the role of scandal seems critical. Investors are neither legal scholars nor comparativists; they learn principally from experience, not theory. Moreover, they may expect any apparent pattern that they observe to continue (even if it was in fact simply an unconnected series of random events). Hence, scandal predicts future scandals, and investors expect more expropriation. This expectation of continuity may explain the relatively high failure

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88 For a detailed discussion of the ECM, see Reena Aggarwal and James Angel, The Rise and Fall of the Amex Emerging Company Marketplace, 52 J. Fin. Econ. 257 (1999).

89 Id. at 283.

90 Aggarwal and Angel in fact give greater weight in their account to an adverse selection problem: "good" firms matured from the ECM to the Amex, while "bad" firms remained behind. Id. at ___.

rate of "emerging company" or "incubator" stock exchanges.[91]

The bottom line then may be that anything that invites public scandal (including weak legal protections) creates a negative externality. If so, public policies intended to protect market integrity and preserve investor confidence can be easily justified, even if they may sometimes impede the ability of small and non-fraudulent firms to raise capital.

III. The Technology of Expropriation

Although a variety of tactics were used to expropriate wealth from Czech companies and investment funds, the best known strategy was popularly referred to as "tunneling." Essentially, this practice involved the sale or transfer of a controlled firm's products or assets at below market prices to another company, which was controlled by the same controlling group as controlled the original firm. Gradually, through a series of transactions that might involve a number of such shell companies, the controlled corporation's assets could be hollowed out (hence, the term "tunneling"); alternatively, its expected future cash flow could be transferred to the shell company by causing the controlled firm to enter into long-term production contracts under which most of its output was effectively sold at cost (or less) to one or more shell companies.

Variations on this basic pattern were numerous. For example, an entrepreneur might borrow funds to buy a controlling stake in a Czech company, using a personally owned

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91 Aggrarwal and Angel observe that: "During the 1980s, virtually every stock market in Europe established a special section for companies that were too small to meet the normal listing requirements... . Many of these markets appeared to prosper for a short time, but ultimately they all suffered from severe illiquidity and attracted few companies or investors." Id. at 281. Amsterdam closed its Official Parallel Market in 1993, and London closed its Unlisted Securities Market in 1996. Id.

corporation as the vehicle that borrowed the acquisition debt from a bank. Then, once control of the firm was acquired, the entrepreneur could merge his personally controlled firm into the privatized firm, in order to make the latter liable for his personal acquisition indebtedness.[92]

Such unfair self-dealing is not particularly novel or imaginative. But, precisely for that reason, the fact that it worked so effectively in the Czech Republic suggests there must be some characteristic weakness or vulnerability in Czech law and (because Czech corporate law was largely patterned after German law) in the civil law generally. A key reason why "tunneling" was successful involved the availability of legal techniques by which it could be insulated from judicial scrutiny. A 1997 study by the Czech Ministry of Finance examined a variety of tactics for looting privatized companies and reported that:

> 'tunneling' into companies is a frequent phenomenon. Current 'corporate raiders' have discovered a risk-free method of removing money from companies. This method consists of holding a general meeting of shareholders in which the 'raiders' have a voting majority; this meeting passes a decision on a transaction involving corporate property. . . and the Board of Directors of the company then carries out this operation, with consequent damage to the company. No (minority) shareholder can blame the Board of Directors of the company for this operation as it is bound by the decision of the general meeting. [93]

In short, if the self-dealing transaction were approved by a majority of the shareholders, the directors were effectively insulated from legal liability. Although minority shareholders could sue to challenge action taken at the shareholders' meeting, they would receive little disclosure about the terms of the transaction and hence were not in a position to raise an effective challenge.

To the extent this assessment is accurate, it reveals a sharp contrast between the

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92 For these and other examples, see Coffee, supra note 33, at 113-114.

93 See Czech Ministry of Finance "Current Aspects of the Czech Capital Market" (memorandum dated 1997).

constraints of Czech and those of common law jurisdictions. For example, although U.S. law gives considerable weight to shareholder ratification, U.S. law generally does not permit a self-interested shareholder to ratify a transaction between the corporation and itself (or an affiliate). [94] Typically, only the vote of a disinterested majority of the shareholders can have this impact. Thus, the practical consequence of this difference is to accord the majority shareholder (or shareholder group) far greater power to impose self-dealing transactions on the minority and hence to create a far stronger incentive for a shareholder or group seeking control to obtain a majority interest. Although German corporate law (and hence Czech law as a legal system substantially based on that model) permits the shareholder to attack the results of a shareholder meeting, this is a uphill battle, because it asks the court to overrule the majority of the shareholders, not simply the board of directors.

Majority ratification was not, however, the only technique by which "tunneling" could be effected. Well before achieving an absolute majority, a shareholder or a shareholder group might achieve de facto control of the board and thus be in a position to approve the same self-dealing transactions without shareholder ratification, based rather on board approval. Directors who approved a clearly unfair self-dealing transactions might face some risk of legal liability, but this risk is mitigated by two key factors that characterize many civil law systems. First, shareholders will not necessarily learn of the self-dealing transaction. Under the German corporate law, an

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94 Some U.S. statutes specifically sterilize the votes of interested shareholders in establishing the procedures by which a conflict of interest transaction may be approved by the board or shareholders so as to overcome the presumption against fiduciary self-dealing. See California Gen. Corp. Law § 310 (1976). Others, including Delaware, have reached a similar result by judicial decision. See Fleigler v. Lawrence, 361 A.2d 218 (Del. 1976) (shareholders approval merely removes "cloud" and does not sanction unfairness).

elaborate body of law regulates the relationship between the companies that belong to a holding structure, or "Konzern." This body of law permits a majority shareholder to dominate its subsidiary, but expects the majority to compensate the minority for any detriment that they suffer.[95] Although the firm's auditors must report on such intercompany dealings, they report only to the controlled firm's supervisory board, not to its minority shareholders. German commentators have candidly acknowledged that this non-transparent approach to the regulation of self-dealing leaves at least a potential loophole in the civil law's system of corporate governance: shareholders cannot challenge transactions of which they are unaware.[96]

More generally, German corporate law views the shareholders' meeting as the appropriate forum at which different issues are to be debated and resolved. This may work adequately in a system of concentrated ownership, where large shareholders can be expected to attend the meetings. But privatization inherently creates dispersed shareholders with small stakes, and they are less likely to attend such a meeting. In addition, management can schedule the meeting at remote sites on little notice, which tactic will work to discourage at least small shareholders. Moreover, Czech law exacerbated this problem by establishing a particularly low quorum requirement (30%) that effectively permitted as few as two large funds to satisfy this

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95 For a brief overview, relating the application of this law to transitional economies, see Pistor, supra note 6, at 17-18.

96 See, e.g., Herbert Wiedemann, "The German Experience with the Law of Affiliated Enterprises," in Klaus Hopt (ed.), GROUPS OF COMPANIES IN EUROPEAN LAW: Legal and Economic Analysis on Multinational Enterprises (1982); Ulrich Immenga, "The Law of Groups in the Federal Republic of Germany," in Eddy Wymeersch (ed.), GROUPS OF COMPANIES IN THE EEC (1993) at 85.

requirement and vote through action at a hastily convened meeting.[97]

In transitional economies, these dangers are further aggravated by the greater likelihood that the supervisory board may not be independent or may simply be too inexperienced or passive to evaluate the transaction's fairness. Second, the judicial systems in transitional economies have not been able to develop remedies or standards on their own to reduce the risk of expropriation. Third, even if shareholders do learn of the transaction, they may lack the incentive to take action or sue. Here, the standard collective action problem surfaces: small shareholders will seldom have sufficient economic reason to undertake costly litigation. In addition, once a control block is formed, it is rare to find any other substantial shareholder group;[98] instead, other potential competitors for control typically exit quickly once de facto control has been achieved by a rival. Thus, few individual shareholders will face a sufficiently substantial loss to justify the cost of litigation on an individual basis. In the U.S., this collective action problem is at least partially solved by (1) the existence of the contingent fee agreement (which is essentially a risk-shifting device by which the small shareholder transfers the risks of the litigation to an entrepreneurial plaintiff's attorney), and (2) the legal rule that a successful plaintiff in a derivative action is entitled to have the corporation pay its reasonable attorney's fees. Absent similar enforcement mechanisms, minority shareholders will predictably remain passive, even if they learn that they have been defrauded.

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97 See Pistor, supra note 6, at 35-44. These techniques were in fact used in practice by one notorious Czech entrepreneur; see also Charles Wallace "The Pirates of Prague," Fortune, December 23, 1996 at 78 (discussing career of Victor Kozeny); See also, Coffee, supra note 33, at 115.

98 See La Porta, Lopez-de-Silanes, and Shleifer, supra note 2, at 505 (in 75% of cases, no other large shareholder exists when there is a controlling shareholder).

IV. Policy Lessons from the Privatization Experience

Several common denominators are discernible in the early efforts to privatize state-owned enterprises and to develop securities markets in transitional economies. First, most recent studies of the privatization process have reported that the most obvious corporate monitors (namely institutional investors and, in particular, privatization investment funds) have shown little interest in monitoring. Either they have been clearly ill-equipped for such a role, or, more typically, they have used their "insider" positions to engage in informed trading in thin and non-transparent markets or to pursue other self-interested ends. While the circumstances vary, the underlying cause seems the same: restructuring is a costly undertaking in which the gains are necessarily shared with other shareholders. In contrast, so long as markets are non-transparent and minority protections largely non-existent, it may be easier and more profitable to expropriate wealth than to create it. Second, to the extent that large shareholders are active, their primary focus seems to be on obtaining a controlling position- - either to exploit the private benefits of control or as a defensive measure to protect themselves from expropriation, or both. Once this scramble for control produces a victor, "tunneling" begins. Third, emerging securities markets seem vulnerable to sudden collapses. Once a market becomes stigmatized, the decline is fast, not slow, as a sudden exogenous shock can cause both foreign and domestic investors to race for the exits- - if they lose confidence.

To remedy these problems, some have called for the wholesale reform of corporate and securities laws in order to introduce the more protective features of Anglo-American law into the typically civil law codes of most transitional countries. This sounds desirable, but closer analysis reveals a problem in this approach: little consensus exists as to precisely what are the

most important and protective features of Anglo-American law. For example, preemptive rights play an important role in the U.K., but virtually no role in the U.S. In contrast, class actions may generate a desirable level of deterrence in the U.S., but are unknown in the U.K. Although research seems to show that common law systems outperform civil law systems in protecting minority shareholders, a satisfactory explanation for the common law's apparent superiority remains elusive. Other commentators have stressed that the development of strong securities markets requires high disclosure standards and protection for minority shareholders from expropriation (both of information and property) by insiders.[99] This seems clearly valid, but it still leaves open the considerable problems of how to get to such an ideal state from the existing starting points.

In overview, possible reforms can be grouped under three headings: (1) judicial reforms (which respond either to the underdeveloped state of the judiciary in transitional economies or to special problems relating to the alleged rigidity of the civil law); (2) structural reforms (which may require legislation but do not involve legal rules), and (3) legislative reforms (which might relate to either substantive corporate law or securities regulation). This section will begin with judicial reforms because it seems necessary to assess frankly what can and cannot be expected of the judiciary in developing countries. Thereafter, it will consider both structural reforms and possible legislative revisions.

A. Judicial Reforms. Although it is conclusory to simply assume that common law systems necessarily offer greater protection to minority shareholders than do civil law systems,

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99 See Bernard Black, The Legal and Institutional Preconditions for Strong Stock Markets: The Nontriviality of Securities Law, (Working Paper, July 1999).

the evidence is strong that dispersed ownership persists primarily in common law legal regimes.[100] Potentially, this could be the result of statutory provisions that are generally found in common law systems, but to date proponents of the common law's superiority have not been able to provide a convincing explanation of the critical statutory deficiencies of the civil law or the common law's features that better protect minority shareholders. Alternative hypotheses need therefore to be considered.

1. A Hypothesis of the Common Law's Advantages. One plausible hypothesis is that the real superiority of common law systems lies in the distinctive role of the common law judge. A considerable "law and economics" literature views the corporate charter as a highly incomplete contract.[101] Necessarily, there are gaps in this contract that must be filled in . "Law and economics" theorists have disagreed over the years as to what principle or formula the court should use in seeking to fill these gaps,[102] but consensus exists that the common law judge can and should fill these gaps. In contrast, the civil law judge may not have the same authority or the

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100 Japan is the marginal case, because it has dispersed ownership (along with a unique control structure). It is primarily a civil law country, but with American securities laws having been imposed in the aftermath of World War II. This pattern may suggest that securities laws are more important than common law remedies, or it may just be that Japan has developed unique institutions by which to preserve investor confidence.

101 For standard statements of this perspective, see Frank Easterbrook & Daniel Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991) at 1-39; see also Jonathan Macey, Corporate Law and Corporate Governance: A Contractual Perspective, 18 J. Corp. L. 185 (1993).

102 Compare Ian Ayres and Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 Yale L.J. 87 (1989) (recommending "information forcing" rule) with Easterbrook and Fischel, supra note 101 (preferring wealth maximizing rule).

same expansive understanding of the judicial role. To the extent that the civil law distrusts judicial activism or views it as a usurpation of the legislature's role, the civil law judge is confined to the narrower role of interpreting what comprehensive civil codes have actually specified. Thus, at least at the margin, the common law encourages gap filling, while the civil law tends to impede it.

Any summary description of the differences between the civil law and the common law will necessarily omit much and risks stereotyping legal systems that have considerable subtlety and variation. Nonetheless, the role of the judge does appear significantly different under the two systems.[103] If it overstates to say that the civil law judge is simply a bureaucrat whose job it is to interpret and apply a written body of statutes, it is still true that the civil law jurist lacks the same freedom and discretion as the common law judge to search through a vast storehouse of legal precedents to find the rule best suited for the case before the court.[104] By definition, the inventory of potentially applicable precedents that the common law creates confers greater discretion upon the legal decision-maker.

This distinction has even greater force in the area of private law. On the one hand, civil law codes tend to be especially comprehensive in this area and thus arguably leave less room for gap-filling. Conversely, the common law (and particularly corporate law) does not view statutes as the only (or even principal) source of law. Under the common law, legal duties can arise that

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103 See, e.g., R. David and J. Brierley, MAJOR LEGAL SYSTEMS IN THE WORLD TODAY (ad ed. 1978) at 339.

104 See M. Damaska, THE FACES OF JUSTICE AND STATE AUTHORITY (1986) (emphasizing technocratic role of common law judge); see also, M. Shapiro, COURTS: A Comparative and Political Analysis (1981).

are independent of any statutory source. The most important example for corporate law is the concept of fiduciary duty. Fiduciary duties can develop out of a course of dealing or a relationship involving trust and confidence where neither side has contractually assumed any duty to the other.[105] In corporate law, the best example of how the concept of fiduciary duty invites common law judges to fill gaps involves the duty of loyalty. Although some American states do define the duty of care by statute, the broader duty of loyalty is generally left to the common law process of judicial interpretation. There, it rests on a common law foundation consisting of several centuries of judicial precedent. Even before the modern corporation arose, the law of agency and the law of trusts held the servant accountable to the master for secret profits obtained from use of the master's property. These decisions were later applied to hold corporate officials- - including officers, directors, and controlling shareholders- - to similar standards. In Delaware, the foundational decision defining the contours of this duty is Guth v. Loft, [106] which in broad and somewhat rhetorical prose instructs corporate fiduciaries that they are held to an "uncompromising duty of loyalty."[107] Equally famous decisions in New York and elsewhere have used similarly broad language, including, of course, Justice [then Judge] Cardozo's famous phrase that a fiduciary must observe not merely the "morals of the marketplace, but the

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105 The law of insider trading has shown how complex this issue can be of when a fiduciary duty arises, but the key criteria are (1) the possession of discretion to act for the beneficiary by the party to be charged with the duty, and (2) dependence by the beneficiary. See, e.g., United States v. Chestman, 947 F. 2d 551 (2d Cir. 1991), cert. denied, 503 U.S. 1004 (1992).

106 23 Del. Ch. 255, 5 A 503, 510 (Del. 1939).

107 Id. at 510-511.

punctilio of an honor the most sensitive."[108] Sophisticated judges recognize today that such broad norms must be applied in a context-specific fashion, and this may lead them to de-emphasize the rhetorical flourishes of an earlier generation and instead consider the hypothetical bargain into which shareholders and corporate fiduciaries have entered. But attempts to "contract out" from the duty of loyalty through broad exculpatory charter provisions have generally failed.[109]

The immediately relevant point is that the common law's concept of fiduciary duty both enables and instructs the common law judge to fill in the gaps in an incomplete contract. Indeed, the fiduciary concept both tells the court that implied and non-cancellable conditions must be read into the corporate contract and provides a rich repository of illustrations in the form of cases to guide the court. No similar deep inventory of legal precedents existing apart from the statutory law of the corporations code arms the civil law judge. To be sure, some modest steps towards recognizing a fiduciary duty to minority shareholders have been taken in some civil law jurisdictions (most notably, Germany),[110] but the concept has been stated only in the abstract

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108 See Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928).

109 See, e.g., Irwin v. West End Dev. Co. , 342 F. Supp. 687, 701 (D. Colo. 1972) ("Exculpatory provisions of corporate articles create no license to steal."), modified on other grounds, 481 F. 2d 34 (10th Cir. 1973).

110 The German Federal Supreme Court recognized that controlling shareholders owe a fiduciary duty of loyalty to minority shareholders in the much discussed "Linotype Case" in early 1988. See 103 ENTSCHEIDUNGEN DES BUNDESGERICHTSHOFES IN ZIVILSACHEN [BGHZ] 184 (1988). See generally, Hwa-Jin Kim, Markets, Financial Institutions, and Corporate Perspectives from Germany, 26 Law & Pol'y Int'l Bus. 371, 392-394 (1995). In addition, Germany has a separate body of law called "Konzern law" which is

and lacks any effective enforcement mechanism. As a result, although the differences between the civil law and the common law can easily be overstated, the civil law essentially views the corporations code as the law and confines the judge to, more or less, mechanically applying it, while for the common law judge, corporate law is a complex amalgam of statutes and judicial decisions. Rather than replacing or superceding earlier judicial precedents, the statutory corporations code can be seen as attempting to codify those precedents.

This hypothesis that the common law tends to encourage gap-filling, while the civil law discourages it, certainly remains open to challenge. Some empirical evidence finds British judges, for example, to be less "daring" than their civil law counterparts in France or Germany.[111] But whatever the overall level of caution of British judges, the context of corporate law may be distinctive. There, the concept of fiduciary duty- - with its clear statement that there exists a legal duty, independent of statute or contract, to be fair to minority shareholders- - invites and prods courts to fill in apparent gaps in the corporate contract.

Still, even if the common law does better arm the judge to resist opportunism, what relevance does this contrast have for transitional economies? That is, even if common law judges

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intended to protect both minority shareholders in, and creditors of, companies that belong to a group of companies. See generally, J. Bantz Bonano, The Protection of Minority Shareholders in a Konzern Under German and United States Law, 18 Harv. Int'l L.J. 151 (1977). See also Ulrich Immenga, "The Law of Groups in the Federal Republic of Germany," in Eddy Wymeersch (ed.), GROUPS OF COMPANIES IN THE EEC (1993) at 85.

Whatever the situation in Germany, far fewer rights (or remedies) seem to be recognized elsewhere on the Continent that can be exercised by minority shareholder. See Jonathan R. Macey, Italian Corporate Governance: One American's Perspective, 1998 Colum.. Bus. L. Rev. 121 (1998).

111 See Cooter and Ginsburg, supra note 18, at 300-301.

have greater discretion and can fashion novel remedies, it does not follow that their style of judicial behavior can be imposed on civil law judiciaries. It is simply not a feasible reform to attempt to convert civil law judges into common law judges (it would be easier to convert financial economists into law professors, or vice versa). But such pervasive reform is not needed, because only a small portion of the workload of most judges in either system will deal with corporate or securities law matters. The simpler course may be simply to transfer this portion of their caseload to a specialized tribunal, as next discussed.

2. Specialized Courts. The inflexibility of civil law courts has already led to the creation of specialized courts in some civil law countries, which specialized courts have exclusive jurisdiction over some subject matters.[112] One example is the German experience with labor law courts, which were created because labor law inherently requires a difficult style of decision-making.[113] Indeed, even common law countries have made substantial use of specialized tribunals to hear securities law disputes. For example, the federal securities laws now also contemplate their enforcement before administrative law judges.

Thus, a practical approach to effective enforcement may lie in creating a cadre of

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112 Russia has experimented with an "economic court" system, but with mixed results at best. See Karen Halverson, Resolving Economic Disputes in Russia's Market Economy, 18 Mich. J. Int'l L. 59 (1996). In contrast to an independent economic court, the proposal here made is for a specialized court that is located within the agency in whose law the court is to specialize.

113 German labor courts date back to the Weimar Republic and were designed "to force labor-management disputes into a procedural framework similar to the political process of party competition and parliamentary decision making." See Blankenburg, Patterns of Legal Culture: The Netherlands Compared to Neighboring Germany, 46 Am. J. Comp. L. 1,26 (1998). The German labor courts now have ten divisions at the federal level and twenty-seven judges at this level alone. Id. at 27.

administrative judges within an SEC-like agency, who would be authorized to broadly enforce both disclosure obligations and certain rules against self-dealing (such as the insider trading prohibition). Such judges would be trained within the agency and would be empowered to impose substantial civil penalties. Their jurisdiction could be limited to enforcement cases brought by the agency, or it could be expanded to include suits by investors for restitution.[114] Although these judges would presumably lack criminal law jurisdiction, they could also be authorized to grant bar orders that could effectively suspend or disbar an individual or entity from the functional activity of being a broker, investment adviser, accountant, or attorney or from having any association with any entity that engaged in these activities. As a further backstop, persons who knowingly engaged in such specified activities with such a defendant after the time of the entry of the bar or suspension order could face similar penalties. Further, appeal of such orders or decisions might only be made to the jurisdiction's court, which would be authorized to reverse it only on a finding that it was without any factual or legal support.

At this point, the agency acquires an in-house enforcement arm that lacks only the traditional judge's power to issue injunctions. Indeed, "cease and desist" orders could be authorized that partly fill even this gap. The remaining problem may be how to enforce bar or suspension orders. In transitional economies, a broker or investment adviser barred from that activity may persist in soliciting customers, effecting transactions, and giving investment advice. One answer may lie in centralizing trading on a more easily monitored exchange and penalizing persons who work with or for the suspended person. Another answer may be to allow

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114 In civil law countries, there is no right to a jury trial which is the factor most responsible for limiting the jurisdiction of administrative law judges in civil cases in the United States.

customers and counter parties to rescind transactions (or refuse to pay for losing transactions) with any barred, suspended or unauthorized person. Whatever the means used, enforcement problems can be solved, so long as the agency does not have to depend on (or can be nullified by) the traditional judiciary.

B. Structural Reforms. Even if legal rules cannot be predictably enforced in transitional economies, other structural mechanisms might be used to prevent the kind of systematic expropriation that characterized the Czech experience.

1. Phased Privatization. The Polish experience with NIFs- - in effect, state-created controlling shareholders- - may supply a useful model for a more gradual form of privatization. Such controlling shareholders could serve several distinct functions: (1) they prevent (or delay) the scramble for control that characterized the Czech experience- - at least until the legal and regulatory structure has gained some experience with privatization; (2) they may constitute more active monitors than private investment funds; at a minimum, they can at least be charged with the mission of developing a restructuring plan for their portfolio companies, and (3) they serve as a means of aggregating individual shareholders and thus partially solving collective action problems.

Ultimately, however, true privatization requires that the NIF wither away- - or else firms would still remain under indirect state control. Thus, a strategy for a phased downsizing of the NIF is necessary. Here, the Polish model was incomplete, because it gave the NIFs a ten year life, but did not provide for the gradual shrinkage of their controlling blocks. Instead, a subtler approach might have been to reduce their stakes from the 33% starting point on an annual basis: i.e., down to 30% after year one; 25%, after year two; 20% after year three, etc. In addition, it

might be wise to stagger this schedule so that some NIFs downsized and disappeared faster than others- - thereby creating a natural experiment and permitting legislative or regulatory reforms if the first generation of NIFs to disappear gave rise to a series of scandals. Such a phased reduction makes more sense than simply turning the NIFs over to private owners at a single stroke, as this approach invites the same rent-seeking struggle for control as occurred in the Czech funds.

Another attraction of this approach is that it should encourage foreign portfolio investors (who will not seek control and know they cannot actually manage portfolio companies) to remain active in the equity market and possibly become a monitoring substitute that over time could collectively replace the state-created NIFs. Still, the overriding attraction of this approach is that it is "self-enforcing" and does not require judicial implementation in order to discourage rent-seeking control contests.[115]

2. Stock Exchange Listing Standards. Long before there was an SEC in the United States, the New York Stock Exchange (and the London Stock Exchange) had succeeded in winning investor confidence. They did so by imposing relatively rigorous disclosure and listing standards and transparency requirements that exceeded those prevailing in other markets. Exchanges do not have ideal incentives, however, for the task of enforcement. They profit on trading volume, and they compete to list companies. Similarly, their incentives to take enforcement action against powerful broker-dealers may also be suboptimal. For these reasons, at least in a transitional economy, the control over listing standards may better belong with a government agency.

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115 I use "self-enforcing" here in the same sense as that term was originally used by Professors Black and Kraakman. See Black and Kraakman, supra note13.

Here, the contrast between the Czech and Polish experiences is particularly instructive. As of late 1998, only 253 companies traded on the Warsaw Stock Exchange, while some 1,716 firms traded in the Czech market in 1996- - a nearly 7:1 ratio, despite the fact that the Polish economy dwarfs that of the considerably smaller Czech Republic.[116] Yet, the Prague Stock Exchange was forced to delist over 75% of its companies in order to maintain its credibility.[117]

Of course, if exchange trading is restricted, substitutes will develop, including formalized over-the-counter markets. Such markets may be risky, and characterized by dubious offerings and practices. So be it. Their potential failure should not jeopardize the higher quality market. Indeed, markets may naturally self-segregate into high quality and lesser quality markets. In times of economic stress, the lower quality market should incur the greater decline.

Such a pattern would both permit significant privatization (greater, in particular, than that yet experienced in the highly tentative Polish system), without exposing the principal securities market to the same risk of a Czech-style collapse. Enforcement resources might also be concentrated on the higher quality market to maintain its reputational integrity. One goal of this effort would be to convince foreign portfolio investors that the higher quality market could be trusted and to encourage their investment in it.

3. The Optimal Monitor. The Polish and Czech experiences represent polar extremes. Essentially, the Czech privatization process relied on highly entrepreneurial, but legally unconstrained, monitors in the form of investment funds that more or less spontaneously arose.

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116 See text and notes supra at note 26 and note 48.

117 See Pistor, supra note 6, at 39 (1,301 of 1,716 Czech firms delisted under pressure from regulators).

In contrast, the Polish approach was to rely upon highly constrained, state created NIFs, whose entrepreneurial skills and incentives remain unproven. Neither choice seems optimal. There is, however, a third obvious candidate: the existing foreign portfolio investor. Not only do foreign institutional investors have relatively scandal free histories (and reputations that they wish to preserve), but there is evidence that they make superior monitors. One recent study, using data from India during the 1990s, finds that foreign institutional investors significantly outperformed domestic financial institutions as corporate monitors.[118] Domestic financial institutions, it concluded, had insufficient incentives or skills to monitor management or play any effective role in corporate governance. In contrast, foreign institutional ownership proved to be positively correlated with changes in Tobin's q (while domestic financial ownership was actually negatively correlated with such changes).[119] Such a finding that domestic financial institutions play only a modest monitoring role is essentially consistent with the Czech experience and with similar findings about Russian privatization.[120]

Equally important, this study found that foreign institutional investment only occurs under circumstances of high transparency (for example, institutions tend to avoid investment in affiliated business groups). Hence, a stock exchange with rigorous listing requirements and high transparency seems likely to attract the most effective and experienced corporate monitors. In

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118 See Tarun Khanna and Krishna Palepu, Emerging Market Business, Foreign Investors and Corporate Governance, (NBER Working Paper 6955 February 1999).

119 Id. at 19.

120 See generally, R. Frydman, E. Phelps, A. Rapaczynski, and A. Shleifer, Needed Mechanisms of Corporate Governance and Finance in Eastern Europe, in Economics of Transition 171 (1993).

turn, as stock exchange listing is seen to attract foreign equity capital, the willingness of other companies to list and accept such conditions may increase. To be sure, this strategy has its limitations: small capitalization corporations and small market countries tend to be ignored by institutional investors. But that is no reason to reject a partial answer.

More can, of course, be done to attract foreign investors. While the use of voucher privatization was politically necessary at the outset of privatization for a variety of reasons, contemporary sales of the remaining state-owned shares in partially privatized enterprises might be made through auction sales to which foreign institutional investors were specifically invited.

C Legislative Reform. The Czech experience with "tunneling" does suggest that at least the German civil law system of corporate governance unnecessarily exposes minority shareholders to risks of expropriation. The key problems center around disclosure and enforcement.

1. Overview. Because concentrated ownership systems of corporate governance have few companies in which a majority of the shares are held by public (i.e., non-controlling) shareholders, their focus has been on protecting the minority shareholder from the controlling shareholder, not from management. Management, it is assumed, can be controlled by the supervisory board. Hence, German law does not authorize an American style derivative action in which a small shareholder and cause the company to sue management. This role is instead given to the supervisory board.

But privatization inherently creates publicly held companies with dispersed ownership, and hence it gives rise to the danger of managerial expropriation (possibly through a conspiracy with some large shareholders). In short, there is a mismatch: a system of legal rules designed to

deal with concentrated ownership works less well when confronted with the new phenomenon of dispersed ownership.

2. Disclosure. German law does provide that a managing director is liable if the director intentionally or negligently fails to prevent the corporation to its disadvantage from doing business with a company affiliated with the director.[121] But German law does not obligate the director to disclose any personal financial interest that the director has in a proposed transaction to the company.[122] Even when disclosure is required (as it is in the case of transactions of parent corporations and its majority owned subsidiaries within a "Konzern" or affiliated group), disclosure must only be given to the supervisory board, not the shareholders. This makes any right to sue largely academic if shareholders lack the knowledge that will cause them to raise objections. This critique is by no means new or novel and has long been raised by German academics , themselves.[123] Yet, even if disclosure were required (as surely it should) and even if a derivative action were permitted, it might have little impact unless American-style contingent fees were permitted- - and this seems unlikely, given the shock that civil lawyers express at such a system. As discussed below, disclosure to shareholders should be required , and might be enforced through listing standards.

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121 I here rely on the advice of Professor Theodor Baums of the University of Osnabruck for this proposition, who cites me to Section 93 of the German Stock Corporation Act.

122 I again rely on Professor Baums for this statement. See also Ekkehard Wenger and Christogh Kaserer, "The German System of Corporate Governance- - A Model That Should Not Be Imitated," (Working Paper) at 27-29 (discussing absence of disclosure obligations under German corporate law and weakness of German proxy system).

123 See text and note supra at note 96 and note 110.

3. Self-Dealing: Listing Standards Versus Prophylactic Rules. A consensus seems to exist that it is unrealistic to place high expectations on either the judiciary or independent directors in transitional economies.[124] Judges are likely to enforce satisfactorily only bright-line rules. Thus, it seems ill-advised to make proof of intent or purpose or bad faith necessary elements of any cause of action, as this increases the unpredictability of results. But this premise leads to two immediate problems: (1) U.S. and U.K. law do not bar self-dealing transactions, but rather subject them to a variety of highly nuanced standards, and (2) In many transitional economies, affiliated business groups are the norm, meaning that intra-corporate transactions within such affiliated groups will be common. Yet, such transactions can often be used to expropriate wealth from minority investors.

This dilemma could be addressed in a number of ways. Corporate law could simply preclude self-dealing (or make it so legally uncertain as to place a prohibitive penalty on it). This was essentially what U.S. law did as of the late-19th Century, when the U.S. was itself a transitional economy.[125] Potentially, such a prophylactic rule would last only for the time it took the transitional economy to mature (which is again the U.S. experience). But this approach might require dismantling of all affiliated groups, and this could be economically disruptive and politically impractical.

The other, more feasible alternative would be state-imposed listing standards that kept

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124 For a strong and sensible statement of this view, see Black and Kraakman, supra note 13, at 1925 to 1927.

125 The shifting attitude of U.S. law and the progression from flat prohibition of fiduciary self-dealing to greater tolerance is described in Harold Marsh, Jr., Are Directors Trustees? Conflicts of Interest and Corporate Morality, 22 Bus. Law. 35 (Nov. 1966).

members of affiliated business groups off the "high quality" exchange, at least if their inter-company transactions reduced transparency. This would place a considerable cost on self-dealing (by denying members of affiliated groups easy access to the equity markets), but the cost is probably not prohibitive. Those firms that truly found membership in an affiliated group to be efficient could probably still obtain equity capital from the over-the-counter market. More importantly, this option forces a firm to choose between a "dispersed ownership" versus a "concentrated ownership" governance system, and it signals to institutional investors that a high quality equity market is intended to accommodate only firms that elect into the former system.

Supplementing this prohibition on listing members of an affiliated business group (other than the sole parent) would be listing rules precluding defined self-dealing transactions by management, controlling shareholders, or other insiders. Such rules would, of course, focus only on (i) transactions that were material to shareholders (excluding, for example, ordinary compensation), and (ii) transactions that could be easily monitored (for example, purchases and sales of corporate divisions or significant corporate assets by persons affiliated with management). Some low-visibility transactions would escape the scope of these rules, and some violations would inevitably escape detection. But if the enforcement of such rules were delegated to the jurisdiction's securities commission (rather than the exchange, itself), this system could be implemented with respect to the largest and most important corporations in the jurisdiction- - without relying on costly and uncertain litigation. Over time, such a system could create its own culture of compliance, with smaller firms seeking to elect in as they matured. In effect, entry into the "high quality" market would constitute a bonding device by which firms could assure investors of fair treatment and thereby lower their cost of equity capital.

4. Control Acquisition. Following repeated scandals in the Czech securities market, reform legislation was adopted in 1996 that essentially introduced a key element of the British corporate governance system: namely, no person could cross a defined ownership threshold, except by making a tender offer for all the firm's shares. Polish law interestingly already had such a limitation from its outset.[126] Under the Czech legislation, once any person crossed any of the 50%, 66 2/3%, or75% ownership thresholds, such person is required to make a public tender offer for the remaining shares within 60 days thereafter at a price equal to the weighted price on the market over the prior six months.[127] Conceptually, this protects the minority, but there would seem to be serious flaws in the particular design of this system. For example, control can easily be obtained well short of the 50% level, at which point the controlling shareholder can begin to exploit the minority (by withholding dividends, by engaging in self-dealing transactions, etc.). Once such conduct occurs or is signaled, the company's stock price should predictably decline. Thus, when the controlling shareholder elects to cross the 50% threshold, the stock price should already be deflated below its true "going concern" value. As a result, for this remedy to work, an earlier threshold (say, 20%) seems necessary.

Under a legal regime that allowed shareholders to aggregate shares up to 25%, but required

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126 Poland uses a 33 1/3% ceiling, which is a more meaningful definition of actual de facto control; also, this level corresponded to the amount assigned to the lead NIF in each privatized company. See Pistor, supra note 6, at 37-38.

127 Ironically, the Czech law already limited any investment privatization fund to a 20% ownership of the equity securities of any firm. See Coffee, supra note 33. But these rules were easily evaded, either by using multiple funds run by the same investment manager or, ultimately, by deregistering as a fund and becoming an unregulated holding company.

a public tender offer for the remainder, many would stop at the 25% level. This does not seem undesirable. Some evidence suggests that such large, but noncontrolling, shareholders enhance the value of the firm by partially solving the collective action problem inherent in dispersed ownership.[128] In a world where legal controls are weak, drawing such a line may be the most practical reform that can be easily monitored and enforced.

Yet, to work, more must be required than simply mandating that a tender offer must be made at the average price over a recent period. Such a rule allows the large shareholder to profit from undisclosed material information and may be spurned by suspicious minority shareholders who suspect that the firm has hidden value. Although full disclosure should, of course, be required in connection with this offer, full disclosure in this context can have a counter-productive, even perverse effect: if shareholders learn that the firm has greater value than the market previously had recognized, they will spurn the offer- - and thereafter be exposed to exploitation by the new controlling shareholders if it succeeds in obtaining a controlling interest. Accordingly, some minimum tender premium needs to be mandated. For example, a 20% premium over the prior average market price might be the best practical compromise. This will lock-in some shareholders at the 20% level, who might have been more efficient corporate monitors had they been able to obtain a controlling interest. Still, it protects the public minority from the "rent-seeking" contests in which the participants are principally seeking to realize the private benefits of control.

Some will object that this approach is inefficient because it chills the market for corporate

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128 See Andrei Shleifer and Robert Vishny, Large Shareholders and Corporate Control, 94 J. Pol. Econ 461 (1988) (finding firm value in U.S. firms to be maximized when there is a large but noncontrolling shareholder).

control and precludes some potentially efficient acquisitions. This cost seems highly speculative, but it must in any event be balanced against the economic and political externalities caused by rent-seeking control fights between contenders who are primarily seeking to realize the private benefits of control. When majority ownership gives one the de facto right to expropriate the minority shareholder's stake in the company, it seems best to require control seeker to offer to acquire 100% of the stock and thereby remove the company from the public market.

CONCLUSION

Why do common law systems outperform civil law systems in encouraging dispersed ownership? To be assessed intelligently, this question must be broken down into its components. Although the premise that different legal systems encourage different patterns of ownership and different systems of governance seems valid, the truth is that we do not yet fully comprehend the manner in which common law systems provide superior protection for minority shareholders. Indeed, the answers may differ widely among common law systems. Yet, although no simple formula seems likely to be soon discovered, a major part of the answer seems to lie not in their corporate law, but in their shared system of securities regulation. Although the laws of the U.S. and the U.K. are far from identical and each regulates control contests quite differently, they each seek to discourage this type of rent-seeking control contests that became endemic in the Czech Republic. The key elements of this system - - ownership transparency, high disclosure standards, restrictions on "creeping control" acquisitions that preclude a shareholder from assembling a controlling block without tendering for all shares, and high listing standards - - were at least partially present in Poland, but were absent from the Czech Republic.

More generally, privatization has produced a conceptual mismatch: inherently, it

produces an initially dispersed ownership, but under a legal regime intended to accommodate concentrated ownership. The result is necessarily short-lived. In this light, the critique advanced by LaPorta and others that civil law systems fail to provide minority protection needs to be re-formulated.[129] Civil law systems may well protect minority shareholders against the forms of abuse long known in systems of concentrated ownership (most typically, domination by a controlling shareholder). But civil law systems do not address abuses that they have not witnessed (such as the theft of the control premium in an exploitative partial takeover). Hence, they leave public shareholders in a system of dispersed ownership exposed to a "winner-take-all" scramble for control. Privatization, of course, creates just such a system of dispersed ownership that is vunerable to this form of abuse. More generally, the voting, proxy and disclosure systems under the German civil law approach do not contemplate that small shareholders will play any active role. This premise may be valid in their environment, but when this system is applied to privatized companies, it forces the transition to concentrated ownership. Rather than seeing this transition as inevitable, policy planners must recognize that it is a product of the dominant forces in the legal and market environment.

Whether there are differences in judicial style and performance between common law and civil law systems seems more debatable. One problem with any such comparisons is that the presumed homogeneity of common law systems also seems suspect. The U.S. and the U.K. have achieved functional convergence, but not formal convergence. The effective absence of litigation remedies in the U.K. that are available to minority shareholders suggests that the combination of high disclosure standards and an active, unconstrained takeover market may constitute an

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129 See sources cited supra at note 2.

effective functional substitute for litigation (or other remedies that are more available in the U.S.). Legally, as much may separate the U.S. and the U.K. as unites them. To the extent that one is skeptical of the ability of the judiciary in transitional economies to restrain opportunism, the strategic answer must lie in the use of "self-enforcing" remedies, and the Polish NIFs may supply the best feasible example of such a structural reform.

Academic attitudes are clearly changing. Where not long ago concentrated ownership was seen as efficient and dispersed ownership was taken by some to imply overregulation of institutional investors,[130] today concentrated ownership is now being viewed by others as a measure of weak protection for minority shareholders. Predictably, academic fashions will change again, but the critical issue is an applied one: how to establish strong securities markets? Here the data from the aftermath of the Asian financial crisis suggests that minority protection appears to be a necessary, but not a sufficient, condition to the emergence of viable securities markets.[131]

The bottom line as usual is that those ignorant of history are destined to repeat it. "Fast" privatization unaccompanied by minority protection and adequate disclosure standards will produce expropriation and rent-seeking. To call this inevitable is only to claim that ignorance is inevitable.

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130 See Mark Roe, STRONG MANAGERS, WEAK OWNERS: The Political Roots of American Corporate Finance (1994).

131 See text and notes supra at notes 83 to 87.