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Corporate governance and Restructuring: The experience of transition economies

What is corporate governance?

Definition

*Incentive-based rules ensuring providers of external finance*

(irrespective of whether they invest in equity or debt)

- managerial *selection, monitoring, influence and replacement* if necessary
- a fair return on their investment

Where the cg problem derives from?

Design

- general P-A problem: separ. of ownership and control
  → likely to be more relevant for larger firms
- specific P-A problems: concentrated/dispersed ownership
- choice of *monitoring technology* adequate to attract specific forms of fixed capital

Implementation

*Effectiveness* of corporate governance is shaped by regulations and supporting institutional capacity

*Good governance systems* should involve a combination of:

* large investors;
* mechanisms to ensure *legal protection* of all investors.
Elements of an effective corporate governance framework

1. Internal mechanisms of governance

1. Clear rules for board directors, including duties enforceable by any shareholder to:
   - act in the best interests of the company;
   - disclose any personal interest in a transaction and not to vote;
   - ensure no creation of substantial risk of loss to creditors.

2. Disclosure and transparency, improvements in flow of information by:
   - obligation to disclose financial statements and annual reports
   - accounting and auditing standards – via independent bodies
   - independence of external auditors
   - external auditors to be sued for negligence

3. Shareholder rights and equitable treatment, self-enforcing:
   - by reducing the threshold to call a general meeting and question management to 5% of share capital
   - by entitling any shareholder to obtain a full copy of the list of all shareholders
   - by requiring any general meeting to include a min proportion of all shareholders
   - by allowing cumulative voting to strengthen the influence of small shareholders in the board
   - by reducing the threshold at which large shareholders must offer to buy-out of minority shareholders to 25-30 %
   - by requiring prior shareholder approval of the purchase or disposal of substantial assets
   - by modifying the board system so that the supervisory board is elected by the shareholders and has direct power to appoint or remove management board members
2. External mechanisms of governance

1. *Enhance the banks’ capacity to handle problem debtors* by:
   - privatising remaining State commercial banks through sales to strategic investors
   - reviewing tax rules to allow a faster build up of provisions
   - privatizing any bad-debt consolidation institution, or allowing it to auction its classified loans, or outsource collection and restructuring in exchange for a collection fee.

2. *Introduce or streamline the bankruptcy process* by:
   - reducing the discretion of the court to decide whether or not to grant a bankruptcy petition
   - enhancing the function of the administrator by allowing any person licensed to practice law or accountancy to be eligible
   - making the fee structure for administrators more based on performance
   - allowing debtors suffering from liquidity difficulties to seek reorganisation under court protection
   - allowing debtors and creditors to develop any solution that best preserves their interests including swaps of debt for equity

3. *Strengthen enforcement capacity*, by:
   - introducing or strengthening independence of a securities commission, together with an institutional development program with staff training
   - ensuring sufficient training for court judges and court officials to handle commercial disputes and bankruptcy work more efficiently
   - strengthening other institutions charged with enforcement (the police and the judiciary)
Key Lessons

- **Protection of minority shareholders** is one of the key elements of the business environment that should be in place prior to privatisation to ensure effective corporate governance. More generally, **supportive regulations and institutions for restructuring** have been grossly under-emphasised.

In the absence of sufficient legal protection for minority investors, new owners (especially if insiders) may find it more profitable to loot and divert assets rather than restructure. It is also important that the privatisation process be perceived as legitimate. Otherwise, it becomes difficult to attract outsiders, as well as to sustain restructuring and avoid backtracking. To ensure an incentive structure favourable to restructuring, further regulatory changes are necessary to enhance flexibility and facilitate social changes. In particular, competition (especially via new entry) and hard budget constraints put effective pressures on owners and managers not to postpone restructuring.

- **The initial privatisation design** should be structured to promote restructuring, including **facilitation of post-privatisation ownership changes** that enhance restructuring.

Second-stage asset reorganisations have generally turned out much more difficult than initially envisioned. Early privatisation decisions that have not led to restructuring will be hard to unravel unless the initial privatisation design explicitly prevents individual/collective blocking of resale to outsiders.

- **The combination of transparent corporate governance rules and the choice of direct sales to strategic outsiders**—where feasible—**represents the recommended policy choice for r**.

Investors with a strategic share have comparatively stronger incentives to bring in appropriate restructuring agents. In addition, foreign outsiders bring new techniques of production and help implant new standards of corporate governance. Resistance to foreign ownership might be overcome by attaching greater visibility to appropriately-sequenced secondary methods.