International Institute for
Applied Systems Analysis
Schlossplatz 1
A-2361 Laxenburg, Austria

Tel: +43 2236 807 342
Fax: +43 2236 71313
E-mail: publications@iiasa.ac.at
Web: www.iiasa.ac.at

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Russian Enterprises and Company Law in Transition

Soili Nysten-Haarala (soili.nysten-haarala@urova.fi)

Approved by

Sten Nilsson
Leader, Forestry Project

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Contents

Abstract

Privatization and company law have been the most important instruments of transforming Russian enterprises. State enterprises have been privatized and modern company law governs how they function, but privatized companies have not changed their business culture. Privatization did not divide management and ownership and did not create efficient stock markets to monitor managers. Managers were able to keep their authoritarian methods inherited from socialist management and rent-seeking in the absence of control.

Protection of minority shareholders does not function in practice, since managers can easily circumvent the rules. They can also ignore the rules of company law, which are not widely known and differ from earlier practices.

There are already too many forms of companies in Russia. Only two forms of companies are mostly used; namely the joint stock company (open and closed) and the limited liability company. Difficulties already emerge with registration. Local authorities may apply their own rules. Corporate governance is not yet a big issue in Russian company law studies, which concentrate on the rules of forming and dissolving juristic persons.

Bodies of companies are in principle modern. The board of directors is already powerful on the basis of the law for joint stock companies, but in practice it is even more powerful. The governance of limited liability companies has been arranged in a flexible way to make the running of a company as easy as possible for small enterprises.

Russian company law also recognizes personal liability of managers or shareholders in some exceptional cases. Such rules have been adopted from European company laws and it remains to be seen how they are used in Russian circumstances.

Russian enterprises still have a lot of social responsibilities to bear. The situation is quite different from Western company law, where stakeholder theory is being introduced. In Russia too heavy social responsibilities are an obstacle for restructuring and transforming into a profitable modern company. Environmental questions are widely ignored both because of old attitudes and new aspirations of profit and maintaining jobs.

Russian enterprises are experiencing the same learning process, which Western companies have encountered over centuries. The most difficult problem in transplanting modern company law is that law is not respected. Law is ignored because there is a huge gap between formal rules and business culture. The hopes that are vested on courts to effect a change of business culture are exaggerated. Everywhere courts have only limited possibilities to effect issues, which are mainly decided within private governance. The courts alone are not able to change the business culture.

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About the Author

Soili Nysten-Haarala was a research scholar in the Forestry Project at IIASA in 2000, studying the institutional aspects of the Russian forest sector. Her home institution is the Faculty of Law of the University of Lapland in Finland.

Russian Enterprises and Company Law in Transition

Soili Nysten-Haarala

1 Introduction

1.1 A Firm in Company Law and in Institutional Economics

Law defines a company as an organization regulated by certain legal rules. These rules are some kind of preconditions, which are set for the companies to be able to define them and then operate with legal methods. From the point of view of company law, companies differ from each other according to different company law regulations. However, legal regulations do not make a company. Each company has its own corporate culture within the framework of legal regulations. Thus, setting new regulations does not necessarily make companies function in a new way. Law is not only a simple and practical technical tool; it is much more. Law is an institution, which is connected with other institutions of society. Institutions are the rules of the game, of which law constitutes a significant part of the formal rules (North, 1992). The significance of law in each society is dependent on its connection with informal institutions. Law counts more in some societies than in others. Legal scholars representing legal realism express the same idea claiming that law is not only a system of norms. It becomes law only when it is implemented and when people feel that law binds them (Ross, 1966).

Legal studies, however, usually focus only on formal legal rules omitting other institutions and the interaction between them. Specializing on legal regulation protects the autonomy of law and separates law from other social studies (see, e.g., Hart, 1978; Kelsen, 1968). It can be claimed that law is to a large extent endogenous. Legal studies have built a system of concepts and their own methodology in studying legal rules. Such studies are needed in interpreting law in courts. Endogenous law, however, protects its boundaries and has difficulties in responding to the needs of a changing society. Law in itself is a good example of institutions, which resist change and tries to stick to its own stable rules and ways of thinking. Changes have to be transferred into this “legal language”, before they have any chance of being accepted in the circle of lawyers, who guard the endogenous legal system. However, even if law is endogenous, it has to interact with the surrounding society and at least to some extent respond to its needs. Otherwise law will become insignificant and overruled by informal rules.

Company law is needed to define certain rules for business organizations, such as norms protecting minority groups in a company or third parties such as creditors or others whom companies may damage. In this respect the state also has important

political aims and power to regulate business activities. The legislator can decide what principles should be followed in implementing company law. According to Tolonen (1974) the traditional ideological model, which understands that the company fulfills the will of the shareholders, is being displaced by a more dynamic theory. In this new approach the company is seen as a rational actor aiming at economic efficiency and other practical objectives, which should guide legal interpretation.

Tolonen's idea suggests that the aims of a company should be found outside the legal system of norms. Legal studies cannot answer the question: "What is a company?" Therefore economic and business studies have always affected the legislator. After Berle and Means (1967) established the concept of managerialism in the early 1930s in the United States, the focus of the legislator has been on regulating the relations between shareholders and managers. In economics, the institutional approach took a long step towards a new dynamic theory on the firm. It really tries to answer the question "what is a firm and what are its aims?", while neo-classical economy focuses on markets and different variables, which may affect how they function. Coase's (1937) article on The Nature of the Firm, gradually started to draw attention to a firm. Coase saw that a firm is a way of organizing activities and that the organization is chosen among different possibilities in order to reduce transaction costs. A firm is actually a nexus of contracts,[1] the organizing of which vary between contracting in a market without any organization and a hierarchy, which draws the contracts within the organization. The nexus of contracts idea moves the focus from the relations between shareholders and managers to a broader understanding of a firm.

Coase's focus on a firm and transaction costs has created a wide range of studies. Transaction costs are not the only factor in choosing the organizing forms. Williamson (1985) has paid attention to governance structures. He found a lot of aspects that affect governance structures. There are behavioral aspects such as the assumption that human beings are "intendedly rational, but only limitedly so" (Simon, 1961). Therefore all forms of complex contracting are unavoidably incomplete. Another behavioral assumption is that human beings are given to opportunism. Their self-interest seeking leads them to opportunistic behavior if promises are not supported by credible commitments. These two assumptions suggest that economic activity has to be organized so as to economize on bounded rationality and simultaneously safeguarding the transactions in question against the hazards of opportunism (Williamson, 1988:68).

Williamson also identifies critical dimensions with respect to which transactions differ. The principal dimensions for the purposes of describing transactions are:

- the frequency with which their appear,
- the degree and type of uncertainty to which they are subject, and
- the conditions of asset specificity.

Contracting parties commit themselves in a credible way if they have specific assets. They can use the specific asset to tie their partner in business cooperation in a credible

[1] The nexus of contracts idea was later developed in the 1970s by Jensen and Meckling (1976) and Fama (1976) as well as Alchian and Demsetz (1972). It took several decades before Coase's articles started to interest other economists.

way. For instance, a contracting party may have special technological knowledge, a special site or specialized production capacity for a specific customer.[2] Asset specificity does not exist in occasional market contracts, but is connected with relations of mutual dependence.

Williamson also combines a process analysis to studies of organizations. It applies North's ideas of institutional change to a microlevel (cf. North, 1992; North and Thomas, 1973). Processes should be studied in connection with specific contracts. A process outcome is often an unanticipated consequence and also unwanted. For example, demands for control cause both greater control and make those, who are subject to control, adapt. The focus on process introduces a richer model of organization, which takes unanticipated adaptations into account. A "machine model" of organization cannot explain unwanted results.

1.2 Transition and a Firm

Economic and institutional theories have been developed in a market economy environment. This development can be described as a long process of learning (Tolonen, 1974). In market economies, types of firms have developed in practice. Company law has then responded to the needs to control and monitor, to sanction human opportunism. The most significant feature of a capitalist firm is that ownership and control are separated (Berle and Means, 1967). The managerial revolution occurred quite early in the United States and turned the focus of company law on corporate governance. The significance of the role of professional managers was identified and thus emphasized. Since the interests of managers differ from those of the owners, responsibility to shareholders also became an important issue of company law. Corporate governance has also later extended responsibility to other stakeholders.

The development of a firm has been totally different in socialist economies. In Russia the learning process of a market economy was disrupted by the October Revolution of 1917. In a planned economy enterprises were governed in an administrative manner. The whole economy worked like a huge hierarchy. Agency problems were great, because it was quite difficult for the state owner to control and monitor such a huge hierarchy. Managers found unwanted means to effectuate their own interests. They had to arrange production in such a way that it pretended to fulfill the plan, but under this umbrella managers treated the enterprises as their own. Privatization did lead to a managerial revolution, but this revolution did not separate ownership and control. On the contrary, managers became the main owners in most privatized companies. However, they did not turn into such entrepreneurs who created capitalism in the western world, but continued to survive in an economy that is neither a market economy nor a planned economy. Modern company law was then transplanted into this environment.

The Russian economy turned into that, which Gaddy and Ickes (1998) started to call a virtual economy. Socialist pretense has survived in a virtual economy, where signals of

[2] Williamson (1996:105) distinguishes six types of asset specificity, namely, site specificity, physical asset specificity, human asset specificity, dedicated assets, brand name capital and temporal specificity.

market prices are effectively blocked. A virtual economy pretends to create value, but destroys it in reality. Prices do not reflect the signals of the market and restructuring has not occurred. It is not certain that a virtual economy will eventually turn into a market economy. The problems of the Russian economy are institutional. Unwanted adaptations of the transition process have to be studied in their context. North and Thomas's (1973) focus on change in economic history shows that change is path-dependent. There is certain path-dependency vested in institutions making transition complicated to direct.

Abundant empirical data shows that the absence of trust is the main obstacle for development towards a functioning market economy, as well as being an obstacle toward the development of democracy and the rule of law.[3] In studying the development of enterprises, an institutional approach is therefore needed. When focusing on organizations in transition, Williamson's approach has a lot to offer, even if transaction cost economizing may not seem to be the main objective of privatized large enterprises in Russia. The reason is the peculiar environment in which firms function. Therefore some basic assumptions of Coase's and Williamson's approach to firms such as private property and functioning markets do not completely apply to the Russian environment. However, Williamson's behavioral and dimensional assumptions seem to explain Russian institutional peculiarities. Process analysis is also of vital importance in studying transition. Furthermore, Williamson's idea of asset specificity helps to understand the need for credible commitments in an environment where opportunism has to be controlled privately under great uncertainty. Fundamental transformation from opportunism to trust is needed, but it is not easy in the Russian environment.

Company law and courts also have their role to play in establishing trust in the legal system and contributing to the objective of reaching a market economy. According to Williamson's theory on a firm as a nexus of contracts and a governance structure, the role of the courts and the legal system on the whole is often exaggerated. It is due to the mainstream legal centralist standpoint, which emphasizes the role of the centralist court system above those, who operate in business. Of course, courts are always important as the ultimate place to appeal. They have *ex post* means to partly cover the damage and also establish rules that can be enforced *ex post*. "However, courts are not available to enforce intrapersonal and intraorganizational agreements. Organizations can use lower-powered internal incentives and control instruments. Bureaucratic costs, of course, rise as a result" (Williamson, 1988). Analysis of alternative modes of organization always requires an examination of context. In a transition economy the role of the courts extends to establish and enforce legal rules for a developing market economy. Even if the role of the courts is not powerful enough in this huge task as Williamson's approach suggests, company law has an important role to gradually enforce good corporate principles to protect outsider shareholders against the company insiders and creditors against fraudulent debtors. The legal centralist approach exaggerating the role of the

[3] For example, Rose *et al*. (1999) and Kääriäinen and Furman (2000) found in surveys a low level of trust in institutions. Russian and foreign businessmen complained of the low respect of the law, contradictory legal rules and the high frequency of breaches of contract (IIASA survey on Russian forest sector referred to in Carlsson *et al*. (2000); interviews with businessmen in Lapland by Ollila (1999); and in case studies by Törnroos and Nieminen (1999)). In such an environment maintaining hierarchy is a more secure governance method than making market contracts.

courts should, however, be avoided. In the development towards a market economy, it is still crucial to change the business life. It is here, where legal norms either function or not and where the rules in use develop.

1.3 National and International Company Law

The long socialist period abolished company law completely from Soviet law. Enterprises formed part of the state bureaucracy, the huge machine, which had abolished the market completely by drawing them inside a hierarchy. This development did not take place voluntarily to save transaction costs but through an authoritative order of the ruling Communist Party. Contracting within this hierarchy was done according to tight administrative rules in order to fulfill the state economic plan. Enterprises were juristic persons, but in practice they were only units of the state bureaucracy (Tolonen, 1976). They had only possession rights on the property with which they operated.

During *perestroika* the tight control of enterprises was eased to give them more economic decision power. Private entrepreneurship in small businesses became legal after being criminal for half a century. There were no forms of companies in the Soviet Union except cooperatives, which had previously been cooperatives only in name and were in fact governed by the state (Mozolin, 1992). Soviet managers, who had run state companies for their own benefit for a long time and had increased such activities along with decreasing state control, soon found new possibilities for rent-seeking. Parasitic cooperatives were founded alongside state enterprises. The state paid overheads, but the profits were channeled to parasitic private enterprises, the owners of which were the managers of the mother enterprise (Bim, 1995; Jones and Moskoff, 1991).

The first Russian decree by the government on joint stock companies was passed in December 1990. The forms of enterprises were also regulated in the law on Enterprises in December 1990. The law determined several forms of enterprises, such as state enterprise, municipal enterprise, mixed enterprise (commandite), limited liability company/closed joint stock company, and open joint stock company. Cooperatives were not included in the list, which meant that they had to be transformed into other types of companies, usually joint-stock companies. Privatization of state enterprises was effectuated on the above-mentioned legal basis. State enterprises had to be transformed to open joint stock companies and privatized according to a presidential decree on corporatizing (No. 721 of 1992). The decree contained a model of a company charter.

A new Civil Code was passed on 30 November 1994. It determined the forms of companies in a new way differing from the earlier decree. A new Law on Joint Stock Companies was passed on 26 December 1996, 18 months after the main wave of privatization was over and after 75% of the state enterprises had been transformed into open joint stock companies with mainly private ownership. In 1998, a new Law on Limited Liability Companies was passed, which started a boom for limited liability companies. A limited liability company is popular in smaller and middle-sized companies, because its administration is regulated more flexibly than that of a joint stock company.

In drafting new company law Russian legislators have had a lot of models from developed market economies. Western countries have demanded modern company law legislation in Russia to make business in Russia more understandable for foreign investors. In the Partnership and Cooperation Treaty (1997) between the EU and the Russian Federation modern company law is one of the commitments, which Russia has promised to conduct. Thus, the example of EU company law directives is shown in current Russian legislation.

Company law even in the EU is still quite national by character. Each country has its own types of firms with different regulations.[4] On the other hand, there is also a tendency to harmonize company law. EU directives aim at developing one type of company, which can fulfill the requirements of community directives. Harmonization is needed not only to integrate the European market but also because of the pressure of the globalization of competition in international markets. Corporate governance in an enterprise in market economies creates the decision-making process by balancing the interests of owners, managers and employees. In spite of different interests there is a common final objective, which is the profitability of the enterprise. Corporate governance has been arranged differently in Anglo Saxon legal systems than in continental systems. The differences reflect the relative importance of different stakeholders in the economy in which they operate.

In the Anglo Saxon system, there is a board of directors collectively responsible for the shareholders. In practice there may be a two-tier system inside the company in such a way that some of the directors are executive and others control. The shareholders' meeting chooses the directors, and usually the well-developed stock markets and skillful investors, who know the markets, can control and direct the decision-making of the company management. In the German system there is a two-tier system of management with an executive board and a board consisting of representatives of interest groups, which are important for the company. Banks are the most important stakeholders, which appoint their representatives into the supervisory board. Employees are also regarded as an important stakeholder group in Germany. Employees' representation in the management and control of big companies is also guaranteed. The German *Mitbestimmung* system has raised a lot of resistance in the United Kingdom, where it is not understood at all. The EU directive proposal for the administration of companies, which also contains workers' representation, is therefore frozen at the moment.

Even if company law is national by character, Russia has chosen to follow European models. However, there are still great differences due to differing business cultures. Company law is so new in Russia that most of the Russian lawyers do not include company law in the Russian system at all. Company law is regarded as part of the civil law concerning regulation of juristic persons.[5] Corporate governance is not an

[4] According to Werlauff (1993) the differences in European company law are emphasized too much. Therefore he wrote a book focusing on the common nominators of European company law. In this way, he can actually show that company laws in European countries have a lot more in common than there are differences.

[5] This differing approach occurs frequently in the Tacis/Tempus project, in which the author participates as a coordinator (Teaching comparative law JEP 10465-98: a consortium with Pomor State University,

important issue yet, since managers keep shareholders in their control. It is not a difficult task, since managers themselves are usually majority shareholders. Thus the principle of equality of shareholders is not clear. There are also cultural differences. Russian managers are authoritarian and used to keeping the enterprise under their control without delegating power. Transforming formal regulations of company law to meet international standards is thus a much easier task than transforming authoritarian management culture and the economic environment.

1.4 The Aim and Structure of the Study

This study focuses on Russian enterprises in transition. The approach to transition is on the enterprise level. The aimed objective of transition is to have capitalist firms in a market economy. There are, however, great institutional obstacles in reaching this objective. Special focus is on company law in its context. Does company law facilitate the change for enterprises or is it one of the obstacles? Or does it have any effect at all? In studying corporate governance behavioral aspects, the process nature and other institutional explanations are taken into consideration. The focus is on what the ratio is and what the aims are of a Russian firm and how they are changing. What is the role of law in this process and does company law reflect the aims of a Russian firm?

The author of this report shares the idea that efficient markets are built from below with assistance from the political structure but that the central figures in this development are the managers of individual firms (cf. Carlsson *et al*., 1999). In establishing the rule of law, courts are important, but the legal centralist emphasis on courts must be rejected. In establishing the rule of law, civil society and informal institutions are at least as important as the formal hierarchy of norms.

First, we focus on the general development of company law in the Russian legal system. Company law is a totally new regulation, which has been drafted according to modern Western models. On the other hand, Russian "company law" also includes remnants from the socialist past. From the legal positivist point of view company law has to be integrated into the legal system and from the legal realist point of view company law should also be able to function sufficiently on the enterprise level. In the first part we focus on the formal legal framework presenting the forms of companies and how they are founded and registered. The gap between formal legal rules and the rules in use is already met with the registration of companies.

Arkhangelsk, Russia; University of Lapland, Rovaniemi, Finland; University of Umeå, Sweden; University of Abertay/Dundee, Scotland). Every time, when Western specialists use the concept corporate law or company law, the Russian specialists want to remind them that there is no such branch of law in the Russian legal system, but that the question is about the doctrine of juristic persons. Because the word company or the concept company law or corporate law is not used in Russia, Butler uses the word "association" instead of a company in his translations of Russian company laws (Butler and Gashi-Butler, 2000:introduction). Company law will, however, gradually become a new branch of law in Russia too. Also in Germany and other continental legal systems, company law emerged from the law of obligations. Because of rapid changes in the economic environment, Russian civil law doctrine should soon be able to develop to a more modern stage. The hindrance for doctrinal development is the deep rooted legal positivism and conceptualism in Russian legal theory and dogmatics (see, Nysten-Haarala, 1998 for a discussion about the continental roots of the Russian legal system).

The main concern of company law is the corporate governance aspect: regulating the responsibility of company management as well as the relations of different interest groups inside the firm. The relationship between shareholders or minority shareholders and owner managers is complicated and informal rules stemming from the socialist past still have an important role to play. Corporate governance, which stems from a quite different tradition and should start to change, is the second part of the study. The rules for liability of losses and damages show how bad corporate governance is sanctioned within company law.

Russian enterprises are starting to orient themselves towards capitalist objectives such as maximizing profits. The third part of the study focuses on the transformation of Russian enterprises through studying the change of their aims. Comparing this transformation towards profitability with the stakeholder ideas in Western companies shows the contradicting requirements Russian enterprises must face and how profound the process of transformation actually is for them.

2 Forms of Companies (and Other Juristic Persons) in Russia

2.1 Juristic Persons According to the Civil Code

Only partnerships or companies are called commercial enterprises in Russia. According to the Civil Code, there are two types of partnerships: full partnership and limited partnership (commandite); and three types of companies: joint stock company, limited liability company, and company of additional liability. The division between partnerships and companies stems from Germany. Partnerships are associations of physical persons cooperating in business, while companies are combinations of capital (Komm./CC 1996).

All natural persons, who run a business, have to register as private entrepreneurs in the State Company register. These physical persons are allowed to run a business as private entrepreneurs without being a juristic person. These registered physical persons can also be partners in full or limited partnerships. Also a juristic person can be a partner in partnerships (CC 66 § 4.1). State and municipal administrative bodies cannot be partners in partnerships without a special stipulation in the law.

2.2 Partnerships in Russia

2.2.1 Full Partnership (polnoe tovorishchestvo)

Full partnership is defined in the Civil Code (§ 69). A full partnership is based on an agreement between partners, who are responsible for the obligations of the partnership with their whole property. The relations between the partners are based on confidence. Each partner is responsible also for each other's transactions and this liability cannot be limited in a contract (CC 75 §). Each partner can represent the company. Power to represent the company and take care of the management can be divided in a contract. A

new partner is also liable with his property for such obligations of the company, which have arisen already before his partnership. A partner, who has withdrawn from the partnership, is legally obligated for two years after withdrawal.

A full partnership is created by a partnership agreement (constituent or founding agreement). This founding agreement must contain the name of the partnership, the place of its location and the managing procedure, the amount and structure of joint capital, regulations for possible changes in the shares of the partners, regulations for capital investments and the liability for violation of this duty. A partnership must be registered and its legal capacity as a juristic person is attached to the moment of registration (CC §§ 50 and 51).[6]

There is no minimum requirement for the amount of the capital of the partnership. In this respect Russian regulation of partnerships follows the Anglo-Saxon model. In continental law the requirement for minimum capital is regarded as a rule protecting creditors. There is, however, no evidence that the absence of minimum capital requirements would have increased deceitful business in Anglo-Saxon countries (Memorandum…, 2000). Partners anyhow have full personal responsibility for the debts of the company. The absence of the minimum capital requirement makes starting a small business easier. Since it is still difficult to acquire credit from a bank in Russia to start a business, requirements for minimum capital might be an obstacle for starting small businesses.

Partners can agree upon sharing profit. If there is no agreement, profit or loss is divided according to each one's share in the founding capital (CC 74 §). The Civil Code also stipulates that partners must have the right to withdraw from the partnership (CC 77 §). There is a term of notice of six months, which has to be followed unless there are especially worthy reasons for a shorter period. A withdrawing partner is entitled to compensation, which is defined according to the balance of the partnership (CC 78 §). A partner can also be excluded from the partnership. Other partners can demand this before the court, if they have a unanimous decision, which is based on a serious reason such as gross violation of duties or incapability of reasonable management (CC 76 §).

2.2.2 Limited (Commandite) Partnership (tovorishchestvo na vere)

The Russian Civil Code also recognizes a limited partnership (§ 82) according to the example of German *Kommanditgesellschaft*. In a limited partnership there are one or several silent partners (commanditaire) along with general partners, whose liability is similar to that in a full partnership. Silent partners are mainly investors, having a right to profit and a right to get information about the financial situation of the partnership. A silent partner bears the risk of losses within the amount of his investment. He has the right to withdraw and the right to transfer his share of the partnership to another silent partner. A silent partner can also be a juristic person and does not sign the founding agreement. He can for instance make a deposit agreement with the general partners. The anonymity of a silent partner is complete in Russian law.

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[6] In Scandinavian countries, partnerships are created and also become juristic persons by the founding agreement. Registration only has a declaratory meaning.

Compared to western partnership regulations, a silent member has as few rights as possible in Russia. In some countries a silent partner may have the right of inspect as well as the right of action for disputing the accounts. Furthermore, there are issues contravening the partnership agreement or ordinary course of business that have to be decided with the consent of the silent partners. In Russia, however, the silent partner is clearly only an investor dependent on a partnership agreement, which he has not even signed himself. He only has the right to withdraw from the company.

2.3 Companies in Russia

2.3.1 Limited Liability Company (obshchestvo s ogranichennoj otvetstvennost'yu)

A limited liability company is one of the forms of company regulated in the Civil Code. A new federal law on limited liability companies entered into force on 1 March 1998. The new law contains detailed regulation, but it also stipulates that the Civil Code is applied to limited liability companies as well. The new law was drafted on the basis of the Civil Code regulations. After the new law came into force with more detailed regulation, a limited liability company became very popular in Russia. It seems to be a suitable form of company for small and medium sized businesses, which is actually the purpose for which a limited liability company was originally created.

Members of a limited liability company are not personally liable for the commitments of the company, but bear the risk of losses within the costs of the contributions they have made. Typical for a limited liability company is the share capital. Law determines a certain minimum capital for the company, which is a hundred times the minimum wage according to the law on minimum wage,[7] which is in force when the company is registered (14 §). The investment of a member in share capital can be other items than money, e.g., securities, property and other rights, which can be evaluated in money.

The founding capital is divided into shares, which have been decided in the founding documents. These shares are determined in precise sums. The founding agreement must include the names of the founders, the size of the founding capital, the share of each of the members and the timetable within which the capital must be paid (12 §). The agreement must also contain provisions in case the members do not pay their shares on time, the rules according to which the profit is shared as well as the governing bodies. The charter of the company may have more detailed regulations of, e.g., the rights and obligations of the members, transfer of the share or rights of the shareholders meeting.

The minimum capital requirement was adopted to emphasize the nature of a limited liability company as a company — a combination of capitals. In Germany, there is also a minimum requirement of DEM 50,000 (GmbHG 5 §). In England, where the private company (PrC) corresponds to a Russian limited liability company, there are no

[7] The minimum salary, which is used as an accounting unit is 83.49 rubles per month. According to a new law on Minimum Salary, which was passed in June 2000, the amount was raised to 132 rubles in 2001, but it only affects the minimum salary, which employers have to pay. As a calculation unit, the amount stayed at the former level.

minimum capital requirements. The minimum capital requirements have been criticized for hindering the free choice of the company form for small and medium sized businesses. In Russia, the minimum capital requirement is, however, quite small to fulfill the purpose of protecting company creditors. Especially for a foreign investor the minimum requirement is low. Therefore, Russian company law specialists have suggested that the minimum capital for a limited liability company, with foreign ownership should be 1000 times the minimum salary (Suhanov, 1998; Kommentarii…, 1998). This opinion is based on a Presidential Decree from 1994 on Registering State Subjects of Enterpreneurship (No. 1482). This decree is, however, usually not applied. If it were applied, it should also apply to joint stock companies with foreign shareholders. Special requirements for foreigners are also against the spirit of the new Foreign Investment law of 1999, which aims at non-discrimination of foreign investors. Implementation and application of company law, however, vary in different regions and state bodies. There is also a widespread habit in Russian society of charging foreigners more than its own citizens. Therefore, companies with foreign ownership may face special requirements in founding a company.

There may also be an obligation for additional investment in the company, but this obligation has to be stipulated in the charter and decided at the members' meeting. This regulation resembles the English guarantee system. The members give a guarantee to pay more in certain circumstances. In an English private company the additional share is only connected to the liquidation of the company (Davies and Prentice, 1997). In Russia it is not limited to liquidation, but can materialize at any time.

The law on limited liability companies also sets limits for the number of members in the company. There has to be at least one member but not more than fifty members. The law thus allows one-man companies but only in the event that the member is not another one-man company. Allowing a one-man company has also been a gradual tendency in European company law. Germany allowed a one-man limited company in 1981 and England a one-man private company after the EC 12th Company Law Directive (89/667). Limiting the maximum number of members to 50 has been explained by the fact that too many members could make governing the company too difficult and cause conflicts (Kapkov, 1998:6). In Germany there are, however, no limits on the number of members, and there are also GmbH companies with a wide range of members (Lutter, 1998). In Russia limited liability companies are meant for small businesses. Big privatized enterprises were not even allowed to choose to have a limited liability company as their new form. They were all corporatized into joint stock companies and cannot change the form of the company as long as the state has unprivatized shares in the company (see Nysten-Haarala, 2001).

If the charter does not forbid it, new members can be accepted to a limited liability company. The charter can also close the company to newcomers by stipulating that members do not have to accept newcomers (Kommentarii…, 1998). The closed nature and flexibility have made limited liability companies popular in Russia. They are good for small business and also quite practical for a big privatized joint stock company to start and channel profitable activities. A limited liability company is regarded as a daughter company, when another company governs 20% of the share capital (CC 106 §). In practice, the share of the company may be smaller and the share of its managers as private founders much more. In the charter the company can be closed to outsiders,

which is not possible in open joint stock companies. Transferring more profitable activities to limited liability companies may be a possibility for former *nomenklatura* managers to continue business, if they have to abandon the non-profitable privatized joint-stock company, and eliminate outsiders from the more profitable business. Limited liability companies are also preferred in foreign direct investments. The company may then be kept in foreign or shared ownership with carefully chosen reliable and Russian partners.

2.3.2 Company with Additional Liability (obshchestvo s dopolnitel'noi otvetstvennost'yu)

The Civil Code also recognizes a company with additional liability (CC 95 §). It is a limited liability company but the liability is larger. The members have subsidiary liability for the debts of the company with their own property in the amount, which is for all of them equally multiplied to the cost of their contributions according to the charter. There is no special law on additional liability companies, but the law on limited liability companies mentions it (§ 56). Additional liability is also possible to arrange to an agreed amount and in agreed circumstances. The rules on the limited liability company shall otherwise be applied toward the additional liability company (CC 95 art.). Companies of additional liability are not as popular as limited liability companies.

2.3.3 Joint-Stock Company (aktsionernoe obshchestvo)

Joint stock companies are regulated in the Civil Code (96-104 §§). The code stipulates that joint stock companies are also regulated in a Law on Joint Stock Companies, however, without regulating the relationship between the code and the law. The Law on Joint Stock Companies came into force in 1996. It regulates the foundation of the company, the legal position of companies and the legal rights and duties of shareholders. The law also contains rules on protecting shareholders' rights and benefits. The relationship between the code and special laws seems to be disputed among Russian scholars. Some regard the Civil Code as higher legislation in the hierarchy of norms and therefore prior to special laws. Braginskii (1998),[8] who sees that the Civil Code has priority before the Law on Joint Stock Companies, represents this approach. However, if the Civil Code were regarded as a general law and the Law on Joint Stock Companies as a special law, the latter would have priority according to the *lex specialis derogat legi generali*-rule. The Law on Joint Stock Companies has also come into force later and would according to the rule *lex posterior derogat legi anteriori* also override the Civil Code.[9]

This dispute is not just theoretical as there are contradictory regulations in the code and the law. One example is the rules on increasing the charter capital. According to the Civil Code increasing the charter capital is an issue, which is decided upon at the

[8] Braginskii is one of the main drafters of the Civil Code.

[9] The hierarchial position of the codes and its consequences is a disputed issue among Russian civil lawyers. In a seminar in Vaasa 1997 preparing a book (Tolonen and Topornin, 2000), the leading specialists of Russian civil law from the Institute of State and Law of RAS, Moscow, had a heated dispute on the issue with contradicting opinions.

shareholders' meeting. The joint stock company law, however, regulates that deciding on increasing the charter capital can be transferred to the directors' board with a stipulation in the company charter. Another example is that buying one's own shares is not allowed in the Civil Code, but has been made possible in the Joint Stock Company Law. The nature of the supervisory board also changed in the Joint Stock Company Law because of taking into account the lobbying of the industrialist (Golubov, 1998:173).

According to Pistor (1997), letting the stipulations of the Civil Code concerning companies stay in force was a mistake and caused a lot of contradictions in company law. The situation is due to rapidly changing attitudes in a transforming society. The drafters of the Joint Stock Company Law focused more on companies than the drafters of the Civil Code. The Civil Code, however, contains the general doctrine of juristic persons, which is considered to be the starting point of further regulation. The coherence between the code and the new laws governing different forms of companies should, however, have been dealt with.[10] The legislator should have corrected the regulations of the Civil Code to correspond with the new Joint Stock Company Law.

The new Joint Stock Company Law took Russian company law closer to the European countries' legislation. Already in the Civil Code (§97) Russian legislators paid attention to European company law directives. Joint stock companies were divided into open and closed companies, which corresponds to the division of public and private companies in the European Union. An open (public) company can offer its shares in the stock markets and is therefore subject to stricter rules for informing shareholders and the public. A closed (private) company does not function in stock markets. Other shareholders are entitled to purchase the shares, which a shareholder is going to sell outside the company. There is no limit for the number of shareholders in an open company, while in a closed company there cannot be more than 50 shareholders. One-man companies are also allowed but, in the same way as in limited liability companies, the only shareholder cannot be a juristic person. The minimum number of shares is two but there is no limit for the nominal price of the share. The amount of charter capital in a closed company is at least 100 times the minimum wage, while in open companies it is 1000 times the minimum wage. Half of the capital has to be paid before registration and the rest within a year afterwards.[11] As in limited liability companies the share of capital can also be other items than money.

Apart from law, the activities of joint stock companies are regulated in the company charter. The charter is the founding document of the company and is accepted in the founding meeting. A founding agreement can also exist, which is applied only to the

[10] In his article concerning the contradictions between the Civil Code and the Joint Stock Company Law Golubov (1998), who was one of the drafters of the latter, explains that the drafters' starting point was to make the law and the code consistent, but that it was sometimes impossible. Golubov tries to explain the differences and underestimate their impact. Several times, however, he mentions that the Civil Code was not always clear.

[11] The rule concerning paying the charter capital has been tightened in European Union countries where, according to a company law directive, it has to be paid completely before registration of the company. In this respect Russia did not follow the EU company law directives but chose the older European rule.

relations between the founders.[12] The charter regulates the legal relation of the company to its shareholders and third persons. The registered charter binds the company, and all the changes to it become binding towards third parties as soon as they have been registered (14 §). The law on joint stock companies only knows simultaneous subscription. Successive subscription is not possible at all.

According to the law (11 §) everybody has a right to get acquainted with the charter. In practice this requirement is not always fulfilled. Companies themselves do not want to give information about the ownership and relations within the company, and the registrar authorities have not always understood everybody's right to acquire knowledge about the charter (Clarke and Kabalina, 1995). Transparency, which is an important principle of European company law directives, is not included in the virtues of Russian companies. The reason is that in Europe transparency is needed to attract investors, while in Russian companies portfolio investors are usually not needed and even information about company management is regarded as a trade secret, which competitors might use against the company.

The law lists all the information, which the charter must include. This list, though, is not complete. Other requirements, which are not contradictory to law, can be included. The charter must include the general information about the company. It has to regulate the legal position of shareholders and the company bodies. Then there are non-mandatory rules in certain issues, such as the qualifications for a member of the directors' board. In drafting the charter the regulations of the law have to be followed strictly, otherwise the company cannot be registered. This has led to repetition of the rules of the Law on Joint Stock Companies. First, the text of the law concerning, for example, the bodies of the company is repeated word by word followed by the special company-wide regulations (Lehtinen, 1997). Charters have become standard documents in practice. Before entering into force of the joint stock company law, company charters had to fulfill the gaps in law and create the legal position of the company (Lehtinen, 1997).

2.4 State and Municipal Enterprises (gosudarstvennye i munitsipal'nye unitarnye predpriyatsiya)

State and municipal unitary enterprises are also included among commercial enterprises in Russia. However, they still have their own form of company, which is inherited from socialism. They are independent juristic persons; regulated both in the Civil Code (§§ 113–115) and in special legislation.[13] A unitary enterprise is defined as a commercial organization, which is not endowed with the right of ownership to the property that the owner (state or municipality) allotted to it. The property is entrusted to the unitary enterprise with either the so-called right of operative administration or economic management. These constructions are inherited from the socialist economy. Economic

[12] A regulation of the Supreme Courts on applying the Law on Joint Stock Companies, 2 April 1997, No. 4/8.

[13] Decree on Federal State Unitary Enterprises based on the Right of Economic Jurisdiction of 6 December 1999; Decree on the Transfer of Federal State Unitary Enterprises to the Ownership of Subjects of the Russian Federation of 9 December 1999.

management means restrictions in the rights concerning immovable property. In operative management the restrictions concern all the property entrusted to the enterprise. In economic management the owner is not liable for the obligations of the unitary enterprise, while in operative administration the state is subsidiarily liable for the debts of its enterprise (Komm./CC 1996:141–146).

Unitary enterprises are not a dying form of juristic persons even if privatization changes state enterprises into open joint stock companies. Nowadays, municipalities have started to have a lot of economic activity and the form, which the law offers them for this activity, is a unitary enterprise.

3 Registration of Companies

Registration of companies is mentioned in the Civil Code. Legal norms governing registration can be found in a law stemming from the RFSFR and in the President's Decree on the Regulations of the State Registration of the Enterprises and Individual Businessmen on the Territory of the Russian Federation of 1994. There are also rules on registration in special laws governing the different forms of companies.

According to the Civil Code the state registration is dealt with by the administration under the Ministry of Justice (CC 51 §). However, this procedure is not functioning, as putting it into practice has failed. The Law on Enterprises regulates that registration is dealt with by the executive bodies of the Soviet of the People's deputies. Such bodies no longer exist. In current practice registration occurs in the departments of local administration. Therefore there are different procedures for registration in different towns and municipalities.[14]

There are some exceptions from this procedure. The Ministry of Justice registers religious and social associations, even if the procedure does not work with companies. The Federal Ministry of Justice registers companies with foreign investment with the exception of oil and gas companies. Banks are registered by the Central Bank of Russia.[15]

The application to register a company may be turned down for some reasons. If the company or members of the company have violated laws, the application may be turned down. Applications have also been rejected for reasons such as inexperience of the members or the existence of too many companies in the same branch. Antimonopoly bodies can also reject the application because of a dominant position or restrictions of competition. Antimonopoly regulations are, however, quite weak since positive social consequences can overweigh a dominant position. Social consequences can be jobs or new houses (see footnote 14). Actually, if antimonopoly regulations were strict, Russian industry and commerce would be split into smaller entities, since a dominant position is typical stemming from the socialist economy.

[14] Lectures by Maria Kotova in the summer school of the Faculty of Law, Universtity of Lapland on 4 August 2000.
[15] ibid.

A registered company gets a stamp on the charter and a certificate proving that the company is a juristic person and has a right to conclude contracts. There are still unregistered companies, which do not have the right for legal actions. One way to find out whether the company is a juristic person and has the capacity for legal actions is to ask for the certificate. Nowadays, local executive bodies should also give information to everybody asking for it.

4 Corporate Governance in Russian Companies

4.1 Introduction

The current Russian Law on Joint Stock Companies has been praised as a long step towards company law of a market economy (Orlov, 1999). There is no doubt of this. As a formal system of norms it does not differ much from the company law of any western market economy. The law has clarified a lot of earlier unclear rules. However, the rules on corporate governance have been criticized as giving too little protection to the shareholders (Orlov, 1999; Pistor, 1997).

Corporate governance can be defined in different ways. The Advisory Group of the OECD, which produced a recommendation for corporate governance principles in 1999 defines corporate governance to "comprehend that structure of relationships and corresponding responsibilities among a core group consisting of shareholders, board members and managers designed to best foster the competitive performance required to achieve the corporation's primary objective."[16] This definition is a traditional Anglo-American view of the corporation, according to which the board members are solely responsible to the shareholders (Dignam and Galanis, 1999).

Corporate governance is a completely new issue in Russian civil law and even if, in practice, there have been a lot of infringements of shareholders' rights, corporate governance has not yet been raised up as an important issue of company law or actually the doctrine on juristic persons (cf. page 6). In Western countries corporate governance has been the main issue due to several governance failures and misconduct in the recent past.[17] The reason for paying only marginal attention to corporate governance in Russian legal studies is due to the fact that legal scholars are not yet acquainted with such problems. Even corporate lawyers seldom come across with corporate governance, because the authoritarian management inherited from the communist period is still taken for granted.[18] Above all, shareholders' rights, which are the core of Western,

[16] The primary objective, according to the Advisory Group of the OECD (1999), is creating long-term economic profit.

[17] These failures have led to a lot of reports to provide standards of corporate governance. In the UK there are the Cadbury, Greenbury and Hampel Reports. The American Law Institute, the American Bar Association and the Business Roundtable have all passed their reports for US companies. France has the Vienot report, Australia the Borsch Report and so on.

[18] According to empirical research by Hendley *et al*. (1997), conducted in 1996 in fifteen enterprises in Moscow and Yekaterinburg analyzing questionnaires of sixty officials, even lawyers assumed the powers of the general director being stronger than the Joint Stock Company Law regulates. They were actually astonished to hear that the law regulates differently.

especially Anglo-Saxon corporate law, did not even exist in the Soviet Union. Getting rid of Soviet State control emphasized the interests of the managers and employees. The managers saw privatization as freeing themselves from outside control. Shareholders, who are not managers or employees, are regarded as intruders, who should not invade "our company".

The discussion on corporate governance has had several approaches in market economies. In the United States, Berle and Means (1967) already noticed in the 1930s that division of ownership and control had led to a class of professional managers, who run the company for the benefit of the owners. The interests of managers and shareholders are partly conflicting when the managers are interested in increasing their salaries and other benefits, while the shareholders are interested in profit. Berle and Means's theory brought the concept of managerialism into organization studies and led to managerial corporate doctrine. The managerialist approach puts corporate management at the strategic center of the large firm. Because of their expertise and organizing resources, managers have the power to determine the processes of production and distribution to dominate hierarchical bureaucracies and represent the company to third parties. The power of managers was accepted and even facilitated in company law.

There were, however, also those who denied the legitimacy of management's position claiming that managers were not accountable enough to higher authority. Realizing the conflict between shareholders and management has led to company law protecting shareholders' rights with detailed regulations. Rights of minority shareholders to challenge management and demand information stem from this origin.[19]

New economic theory, however, put forward a completely new approach displacing the management-centered concept of the firm. The nexus of contract approach, which stemmed from Coase's ideas, did not regard a firm as a hierarchy where managers determine terms by fiat. They did not describe management as a hierarchical exercise but as a continuous process of negotiation of successive contracts (Alchian and Demsetz, 1972).

The contractual approach developed the agency theory. Agency costs have tried to be reduced in firm contracts. Jensen and Meckling (1976) developed the basic thesis of agency theory. According to them, managers act as agents to shareholder principals. Managers sell securities publicly to outside shareholder principals. The purchasing shareholders assume that the managers maximize their own welfare and will bid down the price of the securities. Thus management bears the costs of its own misconduct and has an incentive to discipline its own behavior. Management increases self-control and thereby increases the selling price of the corporation's securities by offering monitoring devices. These devices include independent supervisory directors and accountants as well as legal rules against self-dealing. Corporate governance was seen as a result of contracting and bargaining.

[19] According to Bratton (1989) anti-managerialists dominated law reviews in the United States in the 1970s. However, company law remained substantially pro-managerialist into the 1980s.

These new theories have led to demands for more flexible legal rules and allowing more to be decided with agreements between management and shareholders. The earlier approach, which in Germany and Scandinavian countries led to protective rules after some scandals and grave misuses, has experienced criticism and recommendations to replace formal binding rules with a more market-oriented approach.[20] When the stock markets have developed and widened, a new group of skillful shareholders has emerged, who invest in companies that are well run and give profit. They can affect the decisions of the managers by leaving the company and finding better firms for their investments. Therefore it can be claimed that in countries with a sufficiently developed stock market, it is the market that controls the power of the managers. The OECD Corporate Governance Principles rest on these market oriented ideas of the Anglo-Saxon model.

On the other hand, it can also be claimed that the stock markets are not well developed except in some countries such as the United States and the United Kingdom. There are also opinions according to which the recent crisis in the financial markets caused by the Asian, Russian and Brazilian crises, casts doubt on the ability of the market to provide adequate and efficient prudential mechanisms (Dignam and Galanis, 1999). In continental European countries such as Germany it is often the interest groups, mainly banks, which control the management of companies. In the Anglo-American system the banks' rights to own shares or officially participate in corporate administration is restricted (Pistor, 1997). Stiglitz (1993) claims that banks are better controllers than shareholders. While shareholders' control is nominal, banks have managerial knowledge and can control with their credits. The most common criticism of the control of the banks is that the banks might act more for their own interests as lenders than in the shareholders' interest of profiting. There are both market control and network control countries. The interest group control is usually concentrated in the supervisory board controlling the managers (Nooteboom, 1999).[21]

In the dispute between the market control (exit) system and the network (voice) system, both sides have defended their approaches with cultural differences. Corporate law has developed within centuries and in different legal and corporate cultures. Quoting Tolonen (1974) it has been a long learning process. Russia has its own cultural features, which affect its formal rules and especially company culture. The Russian disrupted "learning process" has been quite different from the continuous western one.

[20] A recent example is a Memorandum of the Ministry of Justice on Reforming the Joint Stock Companies Act in Finland (Memorandum…, 2000), which explains that there is a tendency to market regulated company law.

[21] The third form of corporate control is the Japanese *keiretsu* system, which also is a network of banks and holding companies. Banks do not, however, play as important a role as in the German system. A *keiretsu* is a wide network of stakeholders such as business partners, government and local authorities. Employees are also regarded as an important stakeholder group. After the Asian economic crisis, Anglo-Saxon features have been adopted into Japanese company law.

4.2 Relations of Different Bodies of a Company in Russian Company Law

4.2.1 Bodies of Russian Joint-Stock Companies

The highest governing body of the company is **the shareholders' meeting**. Once a year there must be a general meeting of shareholders. There can also be additional meetings. The law on joint stock companies (48 §) lists the issues which belong to the exclusive power of the shareholders' meeting and which cannot be delegated to other bodies. In principle decisions are made with a simple majority. There are issues, however, which according to the law require a qualified majority of 3/4 of the votes. Such issues are, e.g., changes and amendments to the company charter, reorganization of the company and liquidation of the company (49 §).

Shareholders, who own at least two percent of the voting shares, can deliver two propositions to the general meeting agenda. An extraordinary meeting can be called according to a board of directors' decision on of its own initiative, or on the initiative of the audit commission. An auditor, external auditor or shareholders, who own at least ten percent of the voting shares can also initiate an extraordinary meeting (55 §). The shareholders' meeting is competent to make decisions, when more than half of the voting shares are represented (58 §).

External voting is possible, except in decisions on the most important issues of the general meeting such as the election of the executive bodies, audit commission and consideration of the annual report (§ 50). In a company with more than 100 shareholders, voting at the general meeting with regard to agenda matters is carried out only by voting ballots (60 §). In a joint stock company with at least fifty shareholders, a board of directors must also be established (64 §).

The board of directors is a supervisory board responsible for the general management of the company except decision-making in issues, which are given to the exclusive power of the shareholders' meeting. If the number of shareholders who own issued shares with voting rights is less than 50, it can be stipulated in the company charter that the shareholders' meeting deals with the functions of the board of directors (64§). The shareholders' meeting chooses the members of the board of directors for one year. The law lists the issues, which belong to the exclusive decision power of the board of directors and cannot be transferred to the decision power of the executive body (65§).

The board of directors is a mixture of the British and German system. The tasks of the board of directors resemble those of the executive board of directors in the Scandinavian and German joint stock companies. The difference is that the executive board of directors is an obligatory body in those systems, while in Russia it is obligatory only in companies with more than 50 shareholders (open companies). Scandinavian and German systems have also another administrative board as a supervisory body, which can be established in public joint stock companies. In Russia there is no such two-tier system, which draws outside directors or governors of different outside interest groups into the management of the company. The Russian board of directors has the functions of both the executive and the supervisory boards of the Scandinavian and German systems. In this respect it resembles the British board of

directors. Directors of the executive body cannot form the majority of the board of directors. If the general director is the only executive, he cannot be the chairman of the supervisory board.

The functions of the board of directors are a bit unclear in Russian company law. The main reason for obscurities is that the Civil Code regulated the board of directors as a supervisory board in a more German style. The lobby group of Russian industrialists, however, wanted to make the board of directors a governing body resembling more the Anglo-Saxon system. The drafters of the Joint Stock Company Law took their opinions into consideration and made the board of directors a mixture of a supervisory and executive body (Golubov, 1998:173). The law, however, stipulates that it is a supervisory and governing body not an executive body (ibid, 171).

The executive body of the company is either one person as a **general director** or the **executive board** (or some other collective body mentioned in the charter). If the charter stipulates that there should be both a general director and an executive board, the authorities of both of them have to be regulated in the charter.[22] The general director is the chairman of the executive board of directors. The executive body takes care of the regular business of the company including ordinary legal actions and nomination of personnel. Founding or liquidating executive bodies belongs to the authority of the shareholders, if the charter does not stipulate this to the powers of the supervisory board of directors (69 §). Large transactions, meaning purchasing or selling property in the value of more than 25% of the balance value of the company's property, belongs either to the powers of the board of directors or the shareholders' meeting (§§ 78–79).[23]

The shareholders' meeting chooses the **audit commission** or the auditor. Auditing takes place yearly. The audit commission or auditor himself can initiate additional auditing. Also the shareholders' meeting or the board of directors can decide on extra auditing. A shareholder or shareholders possessing together at least 10% of the voting shares can demand for extra auditing. Auditors must be outsiders and cannot be members of any of the company's bodies.

4.2.2 Comparative and Practical Aspects

In principle, the regulation of the Russian Law on Joint Stock Companies fulfills the minimum requirements of the OECD principles. However, the board of directors has more power than the shareholders' meeting compared to European company law regulations. Even if the Civil Code denies delegating issues placed within the exclusive

[22] However, according to Golubov (1998:174), the drafters of the Joint Stock Company Law saw that a collective board alone cannot be the executive body. It can only exist with the general director. This is again a contradiction to the Civil Code article 103, which allows three versions of executive management: an individual, collective, or both. The reasoning given by Golubov is that a collective body cannot be responsible for the executive tasks because it would make decision-making too complicated. Here, the opinion of the Russian drafters corresponds to the ideas of American corporate governanace with a lot of power concentrated in the hands of the managing director. In Scandinavian company law it is the executive board, which is obligatory in all joint stock companies, while a managing director is obligatory only in big open joint stock companies.

[23] According to the empirical study of Hendley *et al*. (1997) in Moscow and Yekaterinburg, most lawyers did not even know that a general director cannot make a decision on large transactions alone.

authority of the general meeting to the executive bodies (103 §), the Law on Joint Stock Companies does not stipulate questions concerning amendments to the charter in connection with an increase of the charter capital to the exclusive authority of the general meeting. Furthermore, the formation of the executive bodies are not within the exclusive power of the general meeting. On the other hand, the general meeting does not have the right to consider or adopt decisions with regard to matters not referred to its authority. The shareholders' meeting does not have any authority to intervene into the authority of the board of directors. Russian company law specialists consider that the law strictly restricts the authority of the general meeting (Komm./ZAO, 1996; Glushetskij, 1996). The administration of a joint stock company can be arranged in such a way that the directors can choose each other and increase the charter capital without consulting the shareholders' meeting (Orlov, 1999).

The power of the directors is also strengthened with the stipulation of the law that a decision of the general meeting with regard to, e.g., the reorganization of the company, annual dividends and large-scale transactions as well as acquisition and redemption of issued shares by the company require the proposal of the board of directors (42 § and 49§). Even if the shareholders owning no less than 2% of the voting shares are entitled to submit not more than two proposals to the general meeting agenda, the board of directors can refuse to take the issues to the agenda. In such cases the shareholders may appeal to a court (53 §). Likewise, the directors can refuse to call an extra shareholders' meeting on the proposal of shareholders owning at least 10% of the voting shares, in which case such a decision may be appealed to a court (55 §). The role of the court is different than in Western countries company law, since the board of directors has the right to refuse. Turning to the court is not merely requesting a declaratory action, but the opinion of the court. Rights of minority shareholders are therefore already, in principle, weaker than in Western countries.

In practice, the rights of minority shareholders are even weaker because the corporate culture in Russia is still highly management-centered.[24] In the Soviet Union soviet managerialism without shareholders existed. Managers were employees of the state. They were not always professionals, since they were chosen according to their political merits. It is the same directors, who now continue to control privatized companies. Turning to the court is a new right and the right of the courts to "interfere" in the management of the company is new to the directors, who already got used to dictatorial power after the collapse of the ill-functioning monitoring system of the state-owner.

In Western countries the role of the courts is usually regarded as minimal in company law. The courts are reluctant to interfere in the inner conflicts of companies (Pistor, 1997). In Russia the courts are the only bodies, which in principle could implant rules of modern company law into Russian corporate culture, but their opportunities to affect on corporate culture should not be exaggerated. It is very difficult for a court to also

[24] A typical example of Russian corporate governance, reported in OECD proceedings (Brom, 1998), is the case of Novolipets Metallurgical Kombinat. The managers of this privatized company refused to allow a group of outside investors, together owning 40% of the shares of the company, appoint four of the nine members of the board of directors to represent their interests. Company management blocked the procedure claiming that the outside investors were intruders and managed to obtain their shares paying much less than they were worth.

solve inner conflicts of companies in Russia. A court can give a final decision, but it does not guarantee that management practices of the company will change. It is also doubtful whether courts have such knowledge and ability to decide on inner conflicts of business organizations.

The board of directors can also dominate the shareholders in an open joint stock company with formal requirements. In the general meeting personal participation is not provided and the board of directors has effective means to hinder the use of the right of a shareholder to speak. They can effectively use the rules on the agenda. The opportunity of shareholders to effectively participate, which is one of their basic rights according to OECD principles, can be circumvented. Russian managers are masters in circumventing rules. In the Soviet Union they dominated workers' collectives. Managers made the decisions beforehand, which the working collectives were supposed to do. Also the labor union was under the managers' control, since there could not be conflicts of interests between managers and workers in socialism. Nowadays, when managers and workers own the majority of the shares together in most privatized companies, managers continue to treat the shareholders' meeting in a similar fashion to how they used to treat the workers' collective.[25] This kind of management is possible also because the labor union is weak in Russia. The labor union has always been dependent on both the government and the managers of the enterprises.

Many important principles of company law are not codified in Russian legislation. For instance, the principle of equality of shareholders is not directly codified. It is, of course, a significant part of the OECD principles and a clear principle in every western country as well. In the Russian legal system, codifying everything is important, because of the narrow doctrine on the sources of law. Neither court decisions nor legal studies are included in the sources of law (Alekseev, 1999).[26] The role of legislation is therefore extremely significant. Since there are still not always official preparatory works and even if there were, they have no value in interpreting legislation. The wording of the legal text becomes extremely important in interpretation. A principle, which is not codified, does not exist for Russian lawyers.

In a similar way the clear rule of the free right to sell shares is not clear at all in Russia, where the insiders try to keep companies in their control. Control over the shareholder register has given companies an opportunity to raise transaction costs for share trading. New shareholders are often required to pay for registration. Entry barriers are common. Companies frequently require not only documentation of the transaction, which in turn needs to be certified by a specially authorized firm with a notaries certified copy of the licenses of this firm attached, but also a variety of other documents. The shareholder may have to formally apply to open an account, powers of attorney by the seller or

[25] Even the clear rule, one share–one vote proved to be difficult to follow. To make voting simple it often turned into one man–one vote rule with voting by raising hands, which was the old fashion of the production brigades (Pistor, 1997).

[26] Such a doctrine on the sources of law also diminishes the role of the courts. If the courts are given a task to transplant new company law legislation into practice, there should be more court cases and be easily available. Court cases are almost never commented on in legal text books. Decisions of arbitration courts are published with comments in a series of books, which are sold out quickly. The Supreme Arbitration Court also has a webpage (http://www.arbitr.ru), and their cases can be found in other legal databanks, too.

buyer, which has to be certified by a notary in case they send an agent to perform registration, as well as prove that taxes are paid on the transaction (Pistor, 1997:173). Abundant formal requirements are inherited from socialism. People simply continue to orient themselves according to these requirements without realizing that more simple rules might bring more flexibility and efficiency (Hendley *et al.*, 1997).

The legal rules protecting creditors are also weaker in Russian law than in Western countries. Both the division of a company and the decrease of the charter capital could be decided in the general meeting with only informing the creditors. It is also possible that, in principle, the company itself decides that it has no creditors and distributes its assets after the decision of liquidation directly. There is only the requirement that the liquidation commission must publish the information beforehand. The creditors must be quite active — they have to keep an eye on the debtor. Banks, however, are creditors, which look after their assets. Therefore it is important to create financial markets in Russia (Stiglitz, 1993). Financial markets are being created in Russia, but unfortunately in a very monopolistic way. In a very short time a small number of banks have managed to build up their own empires with the help of holding companies. Since the banks are weak in Russia and their power is based on holding companies controlled by a few businessmen, who are called *oligarch*s, it has been suggested that Russian corporate control is going to develop into a direction, which is similar to the Japanese *keiretsu* system (Pistor, 1997).[27]

If creditors and shareholders did not exist earlier, employees did. They are therefore important stakeholders and actually at the core of corporate governance. According to socialist ideology, the workers in a way "owned" the enterprise where they worked since it was state property in their possession. This was one of the moral claims, which was used to support insider privatization (Bim, 1995). Employees, who used to think that the managers were responsible for arranging social benefits for them and look after their needs, were told that with the help of insider privatization they were able to keep their jobs. Therefore employees are still very important stakeholders.

Even if workers are an important group of stakeholders, workers' representation in the administration of the company was not arranged in the German way, let alone in the Yugoslav way. There was a discussion on including workers' participation according to the Yugoslav example, but this option was finally rejected (Krüssmann, 1998:289). In practice, however, those workers who own shares are represented in the administration of the company but managers effectively control them.

There are also serious gaps of transparency in Russian corporate practice. A lot of information, which is published in Western countries to ensure the potential investors of the good financial situation of the company, is in Russia regarded as trade secrets. Enterprises have refused to inform outsiders, who their shareholders are or to give information to minority (outsider) shareholders about the financial situation of the company. Such behavior casts a shadow on such companies, especially when it is widely known that illegal black market production is quite widely spread. Managers, who have gained a lot of autonomy, have every incentive to convert firms' assets into

[27] The banks, which have gained a significant position in the markets, have managed to do this with the help of good connections to politicians (The Big Seven, 1998).

their own because of limited future horizons (Stiglitz, 1993). Except for pure self-seeking, there are several rational reasons why Russian managers have to make informal profits and keep the company formally unprofitable. If they were to show profits, they would have to pay taxes, which are regarded as arbitrary and confiscatory in Russia. Double bookkeeping is common in order to avoid taxes.[28] Another reason to make informal profits is that criminal organizations might become interested in a profitable company. Managers also fear takeovers, especially those from foreigners. A company showing profit might start to interest investing shareholders, whose presence in the company may turn out to be disturbing (Gaddy and Ickes, 1998). There are no stock markets in Russia, which could control the managers. A controlling network control system does not exist either.

4.2.3 Bodies of Limited Liability Companies

The administration of a limited liability company is possible to arrange in a much simpler form than that of a joint stock company. The supreme governing body is the general meeting of the members. The charter may provide the foundation of the board of directors. The executive body of the company can be either a board or one person. Members of the executive body must be natural persons, but not necessarily members of the company. Either an internal or external audit commission may be provided in the charter. An audit commission is, however, obligatory only for companies with more than 15 members (32 § and §§ 40–42).

Meetings of the members can be general or extraordinary. The latter can be initiated by the decision of the executive body, the board of directors, audit commission, auditor or members possessing at least 10% of the votes (35 §). The article does not mention directly that also one member possessing at least 10% of the votes could initiate an extraordinary meeting. The wording of the Joint Stock Company Law also allows the initiative of one shareholder. Tihomirov (Kommentarii…, 1998) supports a narrow interpretation of the Law on Limited Liability Companies according to its wording. This issue is not clear.

The Law on Limited Liability Companies lists the issues, deciding which belongs to the exclusive power of the meeting of the members. These issues are:

- general direction over the activity of the company,
- changes to the charter including changes in the amount of the charter capital as well as the founding agreement,
- formation of the executive bodies and audit commission,
- approval of annual reports and bookkeeping balance sheets and the distribution of the profits,

[28] According to a survey conducted within the framework of the New Russian Barometer (Rose, 1998:16) 56% of the population are of the opinion that there is no need to pay taxes if you do not want to do so. If caught, 27% think the problem could be solved by paying bribes. The reason for such opinions is not simply low morals of the Russians. Such opinions reflect the arbitrary and contradictory tax legislation as well as the totally unrealistic and punitive tax penalty regime. Furthermore, taxation did not play a significant role in the Soviet system where the state allocated resources without being dependent on tax revenues. Paying taxes is simply a new duty.

- the decision on the reorganization and liquidation of the company,
- as well as other decisions provided by the law (32 §).

The issues, which are placed within the exclusive authority, cannot be delegated to the executive body according to the Civil Code (91§). However, the decisions on the formation of the executive bodies as well as large-scale transactions, interested party transactions and organization of general meetings may be delegated by the charter to the board of directors according to § 32 of the Law on Limited Liability Companies.[29]

Participation of a member in voting at the general meeting requires his registration. The general meeting is not allowed to adopt decisions on issues, which were not included in the agenda unless all the members of the company are present. Most decisions should be adopted by the majority of votes of all company members. Amendments to the charter and some other issues, however, require 2/3 majority of the members' votes. Decisions on amendments to the founding agreement as well as the reorganization and liquidation of the company shall be made unanimously. Other decisions except the approval of annual reports and the balance sheet can be adopted through external voting (38 §).

In practice in small limited liability companies with a few members, the general meeting decides on even routine business, which usually belongs to the executive body (Kommentarii…, 1998). Members often accept a charter, which determines too many issues to the authority of the general meeting. Then handling day-to-day business may suffer. The idea of the general meeting is that it would decide on matters, which affect the mutual benefit of all members (Kommentarii…, 1998).

The authority and decision-making of the executive bodies of the company is defined in the law, but it may be detailed in the charter as well as in a contract between the company and an external manager. Members of the board or the general director can be others than members of the company, but they have to be natural persons. The general meeting chooses the board if the charter requires a board to be formed. A member of the company can appeal to a court, if he thinks that his rights or legal interests were violated by a decision of an executive body (§§ 40–43).

Exceptional for a limited liability company is that the so-called large-scale transactions can be delegated to the general director. This can be stipulated in the charter. In the absence of such a stipulation, it is the general meeting of the members that decides upon large-scale transactions. The charter may define such decisions also to the board of directors (46 §). A limited liability company can be made much more manager centered than a joint stock company.

[29] This is one of the disputed contradictions between the Civil Code and the Law on Limited Liability Companies. The same contradiction also exists between the Civil Code and the Joint Stock Company Law. Golubov (1998), however, explains that the Civil Code only prohibits delegating issues, which are placed within the authority of the shareholders' meeting to executive organs. The board of directors is, however, not an executive organ but a governing organ like the shareholders' meeting. On the other hand, Golubov does not mention that the board of directors also has executive tasks, even if it is called a governing body in the Joint Stock Company Law.

A member of a limited liability company, who has not participated in the general meeting or who has resisted the decision, has the right to bring an action before a court. He then has to consider the decision to be illegal or against the regulations of the charter. A shareholder of a joint stock company has a similar right. The time limit is two months. The court can hold such a decision as void, provided that it is illegal or against the rules of the charter and infringes upon the rights of the member or shareholder as well. In practice, the courts require that the infringement should be significant (Lehtinen, 1998).

The Law on Enterprises of 1990 defined a limited liability company and a closed joint stock company as the same type of company. Until the Law on Joint Stock Companies entered into force most companies with foreign ownership were limited liability companies. Closed joint stock companies started to be used after the joint stock company law regulated closed joint stock companies. A closed joint stock company has, however, after the Limited Liability Company Law came into force, become less popular because the joint stock company law includes a lot of general rules, which concern all joint stock companies. For a small company these rules are too clumsy. Limited liability company law allows the administration of the company to be arranged quite flexibly. It also allows completely closed companies, where no outsiders have to be accepted.

Limited liability companies are new companies having no long inheritance of socialist corporate culture, as do the privatized joint stock companies. Flexibility is important for small companies, but there may be difficulties in using flexible rules, since corporate governance of a market economy type is new and there is no experience with it. The Law on Limited Liability Comp0anies also allows a management-centered administration, which encourages continuous use of old socialist management traditions. Russian businessmen are only in the initial phase of the learning process, which in western market economies has lasted for centuries (cf. Tolonen, 1974).

We share the opinion of the so-called Austrian economics according to which small business is where Russian enterpreneurship can be found (e.g., Kregel *et al*., 1992). It is enterpreneurship that can change Russia into a market economy not monopolistic privatized enterprises. Small entrepreneurs are, however, not such a lobby group as the managers of big companies. Enterpreneurship is not supported. Thus, attitudes are not favorable towards enterpreneurship. With profits small businesses have the same problem as big corporations. They cannot show profits so as to keep both tax authorities and criminal organizations at a distance. Also small business has its tricks to make informal profits.

4.3 Liability of Managers, Shareholders and Members for Losses

4.3.1 Liability of Shareholders and Members for Losses

Neither the Law on Limited Liability Companies nor the Law on Joint Stock Companies contains a general rule on a member's or shareholder's liability for losses. The rule of the Civil Code (53 §) on liability for damages touches only on the liability of the representative of the company. It does not apply to a member or shareholder

provided that he does not represent the company in legal actions. The Civil Code does not require willful action for the basis of liability. Negligence is enough to constitute liability. So, if a member or a shareholder represents the company and causes damage to the company, he is liable to pay damages if the other shareholders so demand.

Compared to regulations of company law in other countries', it is exceptional that Russian law does not regulate the liability of a shareholder or a member. For example, the German Limited Liability Companies Act contains a rule on the liability of a member towards the company. A member is liable to pay damages, if he has caused the damage with willful action or gross negligence (GmbHG 9a§). Usually other members are not allowed to receive damages in such cases. The Finnish Joint Stock Companies Act also extends the liability of a shareholder towards other shareholders. The liability includes damages to the company, shareholders or third persons (Koski and af Schulten, 1992:353).

In the absence of a rule in law, liability for damage that a shareholder has caused to the company is regulated only in the charter. The Civil Code is completely silent on for example, the liability for not paying the share to the company capital. The code delegates the issue to the founding agreement of the company (89§). Likewise the Law on Limited Liability Companies delegates regulating damages caused by not paying the share to the founding documents of the company to the company charter, which may include a regulation on such liability (12§).

The company charter of a limited liability company can extend the duties of a member considerably. He may have a duty to represent the company or participate in the administration. In such cases, his liability naturally falls under the 44 § of the Law on Limited Liability Companies concerning a manager's liability.

4.3.2 Managers' Liability for Losses

The § 53.3 of the Civil Code contains a general rule on liability for losses. It stipulates that the members of the governing bodies of companies must act in good faith and reasonably. If they cause damage to the company, they are liable to pay damages, if not otherwise regulated in legislation or contracts. According to this general rule their liability is for negligence.

The Law on Limited Liability Companies contains a corresponding rule in § 44. The general director, a member of the board of directors and members of executive bodies have a personal liability. There is a narrow interpretation, according to which the list is complete and does not extend to, for example, a founder, auditor or a member of the audit commission. Both the regulations of the Civil Code and the one of the Law on Joint Stock Companies (71.2§) are interpreted in a similarly narrow way.

Good faith and reasonable behavior is defined to mean that the managers of a company have to take care of the business as carefully as if it were his own and take the necessary precautions like an ordinary person in his position would take (Kommentarii…, 1998). The same rule stipulates further that in determining the grounds and extension of the liability, ordinary business practices and other relevant considerations must be taken into account. The Law on Joint Stock Companies

regulates liability in a similar way. Ordinary business practice means that a manager shall look after the benefit of the company. He also has to make decisions carefully and with good business practice. These interpretations are quite similar to those of western company law. It is difficult to say whether there are differences in court practice. The benefit of the company as well as good business practice can be understood differently in Russia. Taking care of employment even at the cost of shareholders' rights to profit would probably be understood as good practice. The shareholders are not regarded as the core of the company, because previously the same company was explained as belonging to the workers, who possessed it as state property.

Both the Law on Limited Liability Companies (§ 44) and the Law on Joint Stock Companies (71 §) require that a manager can be held responsible for damage, when he has caused it. The loss must be his fault and there has to be a causal relationship between the damage and the activity, which the director is at fault. The rule of the Joint Stock Company Law has been the model for the law of limited liability, while the model for the regulation of the Joint Stock Company Law has been the German regulations of directors' liability in joint stock companies (AktG 93 § and 116 §, Ivanov, 1998).

The regulation on directors' liability has not been simple to apply. The general rule of the Civil Code requires responsibility for losses, which are caused by negligence. The law on joint stock companies, however, seems to assume intentional fault. The regulation of the Limited Liability Companies act is interpreted in the same way. At least in legal studies it has been suggested that a director is liable for damage, which he has caused intentionally, for instance, omission of his obligation to arrange reliable bookkeeping (Glushetskij, 1996). The regulation is thus interpreted differently than in Germany, where liability to pay damages may already emerge through negligence (GmbHG 43 §, Lutter *et al*., 1987; Kraft and Kreutz, 2000). It has been suggested that the wording of the Joint Stock Company Law is unclear. The law mentions losses, which are caused by activities of a director who is at fault. It has been suggested that such wording, which emphasizes the fault, should be interpreted to concern situations, where managers have violated their obligations regulated in the law or the charter (Ivanov, 1998).

There is no limit for damages. The law assumes the principle of full compensation regulated in the Civil Code. According to § 15 of the Civil Code both the physical damage and the loss (lost benefit) have to be compensated. In practice, the amount of the damages can be quite high (Suhanov, 1998:42). On the other hand, the circle of those, who are entitled to receive damages, is narrow. Only the company can receive damages, not other shareholders, members or outsiders. For instance, according to Finnish company law shareholders or creditors can also receive damages.

If there are several directors liable for the losses, then there is joint liability. The company can claim damages from any one of those, who are jointly liable or from all of them. A manager who has paid more than his share of the damages, however, has the right of recourse from the others, who are jointly liable (CC 325§). However, those persons, who did not take part in the administration or voted against it shall not bear liability (72.2§ ZAO). The right to bring the action for damages is held by the company or its members in a limited liability company (44 §). In a joint stock company

shareholders also have the right to bring the action for damages, but only provided that he or they own more than 1% of the shares of the company (71.5§). Since good faith and reasonable behavior is presumed in the Civil Code, it has been interpreted that it is the plaintiff, who has to prove that the manager deliberately caused the loss (Margolin, 1995:32).[30]

4.4 Personal Liability for the Debts of the Company

The main principle in companies is that a shareholder is not liable for the debts of the company, except with the value of his shares, and a member is liable only to the amount of his share in the capital. This is a principle separating companies from partnerships, where liability is unlimited. In limited liability companies this principle is not absolute, since there may be rules for additional responsibility.

A shareholder's or member's liability for debts is possible in some situations. If a member has not paid his share, the founders of the company are jointly liable to the amount of the unpaid share.[31] A member, who has invested property given as subscription in kind, may be held liable, if the subscription in kind has been evaluated too highly. Such liability is, however, limited to the real value of the subscription in kind. The joint liability of the too highly evaluated subscription in kind is limited to the next three years after registration of the company. Also an auditor or an outside expert can be held liable for his overvaluation. Their liability is also limited to three years. Such liability for overvaluation is also only subsidiary. The creditors have to collect a claim first towards the company. Furthermore, a member or a shareholder in a dominant position may be held personally liable for all the debts of the bankrupted company.

Both the Law on Limited Liability Companies (3.3 §) and the Law on Joint Stock Companies (3.3 §) include a regulation according to which a member, a shareholder or another person, who has a right to give binding orders or who has the possibility to direct its activities in some other ways, be held personally liable for its debts subsidiarily, if the bankruptcy of the company is due to his activities. This rule is a clear exception from the principle of limited liability. A member or a shareholder can be held personally liable to creditors of the company for the debts of the company. The liability of the member in a dominant position is identified to the liability of the company.

A shareholder or a member owning 50% of the company has a dominant position. There has to be a direct causal relationship between indebtedness and the activity of the dominating owner (Komm./ZAO, 1996:35). The Law on Limited Liability Companies is silent about how the causal relationship can be detected, but the Law on Joint Stock

[30] According to general principles of western procedural law the burden of proof can be reversed only with a special stipulation in the law. In the absence of such a stipulation, the plaintiff is obliged to prove that the manager caused the loss deliberately. Margolin's way to argue his point indicates that the rules for using reversed burden of proof are not as clear in Russia as they should be in a rule of law country.

[31] There is already a decision of the Supreme Arbitration Court, in which the court held the members of a limited liability company jointly liable for the 6 million rubles, which one of the members had not paid for his share (No. 5411/98).

Companies has a rule in 7.3 §, which according to legal scholars can also be applied to limited liability companies. A causal relationship exists, when a person has used his dominating position in such a way that there has been a decision in the company, which caused the bankruptcy. It is also required that the person in a dominating position has acted knowing that his actions would cause bankruptcy (Komm./ZAO, 1996:35).

When a court sets a subsidiary liability on the debts of the company for a member or shareholder, it also has to determine the amount of the personal liability (Komm./ZAO, 1996:45). Since personal liability is subsidiary, the debtor has to try to collect the amount first from the company (399 § CC). The creditor can collect only the amount, which the company has not been able to pay. According to the Law on Bankruptcy (2 §) the creditor can turn to the shareholder and demand payment after 3 months from the maturity of the debt.

The Russian regulation on the identification of the liability of the company with the liability of the dominating person most corresponds to the French rule in the Bankruptcy Act. Identification presupposes that the creditors can prove that the dominating member actually caused indebtedness with his negligence. In England the *Salomon v. A. Salomon Co. Ltd*. case from 1897 still constitutes the principle of separating the company from the owner. The decision admitted the right to separate the company from personal property even in small companies with practically only one active owner. In the Insolvency Act of 1986 it has been regulated that if it is found that the company intended to defraud the debtors or the company was used in an otherwise fraudulent way, then such a member can be held liable to add an amount, which the court finds fair. It is also required that the member has actually participated in a decision with a fraudulent aim. English courts have sometimes exceptionally held members liable for the debts of the company, reasoning the decisions with fraudulent trading (Davies and Prentice, 1997).[32]

German courts have also held that the liability of a member of a GmbH company for the debts of the company can in some cases be personal and unlimited. However, a rule does not exist in the GmbHG about the principles of personal liability instead of the company. There is, however, the rule of the 32 a § in the GmbHG concerning indirect identification. If the company has not had enough capital and a member has granted a credit to the company when a bank would not have granted it the member may be held liable to the debts of the company (Hueck, 1991:368). Identification is thus connected with an extraordinary situation, when the principle of limited liability is violated. A member can be held liable, when he mixes his own property with the property of the company, or misuses the form of the company (Lutter, 1998; Hueck, 1991). The EU has issued a directive to give an entrepreneur an opportunity to do business in a one-man company within limited liability in all member countries (89/667 12th company law directive). The directive does not, however, prevent the member countries to regulate that in some extraordinary situations the liability of the company can be identified with the personal liability of a member (Werlauff, 1993).

[32] In common law countries the doctrine for makjing people behind the company liable is called *lifting the corporate veil* or *piercing the coporate veil*.

Since the protection of creditors is much less effective in Russian than in English or German company law, it may be grounded to hold a member liable for the debts of the company in some situations in connection with bankruptcies. It will be seen in the future whether Russian courts are going to follow the international rule on a wider liability in some extraordinary situations. At least written law clearly allows it.

In a virtual economy, bankruptcies are not for anyone's immediate need. Even unprofitable companies are kept going, because the creditor would not win anything in his positions where he is tied to a network, where everybody is indebted (Gaddy and Ickes, 1998). There are, however, more and more bankruptcies occurring in Russia. In the Russian extraordinary situation, it is obvious that bankruptcies are going to occur in the long term. For the time being it is small new companies, which are more likely to become bankrupt than the big privatized ones, which function within a network of a virtual economy. In practice, this means that it is not the most unhealthy companies that become bankrupt, but those who do not find their place in a virtual economy. According to Bim (1995) the policy of managers refusing to restructure and operating partly in the black market is going to drive companies to bankruptcy, which in the long run can turn out to be good for the Russian economy. Bim (1995) assumes that bad management will abolish non-profitable companies from the market. For the managers themselves it may also be an opportunity to get rid of the unprofitable privatized company, when they already have been able to secure their future in a profitable new company, which has been created beside the unprofitable privatized company.

Even if the rules for personal liability of the managers exists, typical bad management of a virtual economy, would obviously not be considered as a deliberate action causing losses for the company. The courts might accept explanations, according to which the intention was to prevent unemployment or to take care of some other social duty. The widely spread habit to produce for the black market and share the profits among a small circle of insiders, is clearly criminal and causes losses both for the company and the tax collector. Such illegal activity seems to be regarded as a phenomenon connected with transition and is therefore tolerated as long as it remains hidden. The development of market structures and business culture should gradually correct the situation. Even so, the flourishing black market business is, however, also an institutional problem connected with widespread corruption, which is dangerous for the Russian economy and the development of society. Such circumstances keep the level of trust in business and politics low and hinders sustainable economic development.

5 Social Responsibilities of Russian Companies and the Stakeholder Theory

Making profit for the shareholders is clearly the main principle of a company in the company law of most market economy countries. This principle is often also explicitly declared in the legislation. This principle can be understood to stem from the point of view of protecting shareholders' interest towards managers' personal interests. Making profit is also understood as the special feature distinguishing commercial organizations from other economic organizations. It has, however, often been argued that multinational companies and other foreign developers have a responsibility to improve

the material conditions of the people in whose territory they operate. As a matter of distributive justice it is thought that these companies should be sharing the acquired wealth with these people through the creation of 'collective goods', infrastructure development and compensation disbursements aimed at their benefit. This point of view has been called a 'stakeholder theory', the main idea of which is that the company should share the profits with affected 'non-shareholder' groups.

There have been tendencies in the developed world, especially in the United States towards such legislative development, which aims at sharing profits with the community (Lea, 1999). There are also codes of conduct for the multinationals.[33] Many multinationals, however, do not act according to the stakeholder theory. It seems that without enforceable legal rules, multinationals who are often in a position where they could make an affect on developing local business culture, still only tend to increase corruption in corrupted countries. A good example is Shell, which takes care of its public relations in developed countries, but actually finances Nigerian military dictatorship and politics oppressing the local population.[34] However, many see the development towards legislation supporting stakeholders' rights in the US as possible advancements for indigenous peoples and aboriginal groups. On the other hand, it can be shown that such duties result in the generation of excessive costs. Furthermore, such tendencies seem to lead to unrealistic expectations from the part of the stakeholders (Lea, 1999).

While the Western world discusses stakeholder theory, the post-communist world tries to transform companies to make a profit. Profiting companies could pay more taxes, which could be used for the benefit of the community. Soviet enterprises had a lot of social duties and they actually worked in a network of stakeholders. Especially after World War II the social duties of enterprises increased. They had to finance kindergartens, schools, housing, transport, medical care, and give their products (electricity and oil) freely to the local population. It was only a question of organizing the duties of the state, since enterprises were state bodies. They did not pay ordinary taxes but operated with different funds. There was often a town built around a big enterprise, which did not function simply as the only employer of the inhabitants, but also provided houses for the employees, maintained them and arranged all kinds of social services, including sports or other entertaining clubs for the local people. Drinking water supply or heating stations were often planned and constructed together with the large enterprises and on their costs, benefiting not only the company but also the surrounding community. Profit, on the other hand, was not important since enterprises had to fulfill production plans. Financial profit was not required (Commander and Jackman, 1995).

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[33] The most well-known codes of conduct are the OECD guidelines for multinational enterprises (OECD, 1986).

[34] There have been a lot of newspaper articles about Shell's poor human rights and environmental record in Nigeria, e.g., Adams (1995). The multinationals' support to Suharto's government violating human rights in Indonesia is also a well known story, e.g., Robinson and Thoenes (1998). British Petroleum has even been condemned by the European Parliament for funding death squads in Columbia. The ITT instigated the CIA's involvelment in the removal of Alliende and his replacement by General Pinochet in Chile.

It is this tradition, which still gives an enterprise an opportunity to pay its taxes with its own products. A building company can build a school or a metro station, if it does not have cash. A virtual economy functions with barter and cash reserves are rare. Formal profits are not insignificant as in socialism; they are even a nuisance, which is tried to be avoided.

Privatization of enterprises has changed the attitude towards social duties. Most of the social services were to be transferred to municipalities and private companies were to start functioning according to the rules of a market economy (Commander and Jackman, 1995). The Presidential Decree of 10 January 1993 prohibited privatizing social and cultural property together with the enterprises. According to the privatization program all these social and cultural "objects" and responsibilities had to be transferred to municipal authorities within six months from the confirmation of the privatization plan. Large enterprises are in a difficult situation where they, in principle, should start to restructure and make profit for the shareholders. It is a good reason to get rid of extra social costs. On the other hand, companies avoid taxpaying as much as possible. However, avoiding taxes is more acceptable in Russia than cutting down social benefits and causing unemployment to make the company profitable (see footnote 28, cf. Rose's opinion survey). Companies are at a crossroads, where they cannot completely abandon the old "taxpaying system" with the social benefits of socialism, but where they cannot start to show profit and pay ordinary taxes either.

Many social responsibilities of the enterprises were duties, which were based on legislation. Housing, for example, is still a duty of the enterprises, which have apartments on their account, according to the Federal Housing Code. Because municipalities have not been able to take these duties on their own cost, companies have been forced to continue providing them. Often enterprises have founded joint companies with municipalities to take care of social responsibilities. The level of social services is negatively affected, since municipalities have not had the financial resources to take care of the infrastructure costs. Additional social duties are one factor, which makes transition to a market economy complicated and hinders restructuring. Enterprises, which try to get rid of their earlier social responsibilities have ethical hindrances for restructuring, which would make most of the population of the surrounding town unemployed and leave them without social benefits. Employees also prefer to keep their jobs, even if they are badly paid, because losing the job would lead to losing all of the other social benefits as well. Usually companies can still offer better social benefits for both their employees and their families than the municipality.

The relationship to employees is different in Russia and still carries on socialist inheritance. Both managers and workers are authoritarian. The latter expect the managers to take care of them. Earlier they received a lot of social benefits, health care and perhaps even holidays in the southern parts of the Soviet Union. Nowadays workers put their trust on the managers to maintain their jobs. Such attitudes can postpone restructuring, which in the end, however, is unavoidable.

Russian managers also differ from their Western counterparts. First of all, authoritarian management was a rule and authoritarian managers were respected among the workers. A manager delegating powers was regarded as a weak manager. Most directors are engineers, because production was important, while marketing did not play any role

whatsoever. Therefore, knowledge about the economy is low among Russian managers, or actually economic skills, in the western meaning, are at a low level. Russian managers, however, do well in a virtual economy, where social skills connected with the network within which the enterprise works are of significant value. Those attempting to change the rules, would definitely suffer. The loss of control during the *perestroika* period gave directors more power, which they used for "self-seeking with a guile" as Williamson (1985) puts it. Self-made entrepreneurs are treated as "dishonest businessmen" in these established circles. With their monopoly position, big privatized enterprises can affect on small business, too. They can support those, who agree to play along with their rules and who have good personal connections with them.

In the Soviet Union, environmental protection was badly arranged. Even if companies had to take care of the community, environmental questions were not paid any attention. There was the attitude that natural resources are abundant in Russia. Nowadays, the voices for environmental protection have grown. Citizens can openly discuss the health and environmental disasters caused by pollution. Still, when jobs are weighted against restructuring and environmentally better technology, jobs weigh more. The media, however, has had an important role in making environmental catastrophes public and affecting on the public opinion. There are also many international environmental movements such as Greenpeace operating in Russia nowadays. Their active role has sometimes had negative effects on public opinion. Super-power mentality does not accept foreigners to come and advise and show obvious disadvantages of Russian society. On the other hand, this mentality easily buys the idea that foreigners have to finance environmental programs, which actually benefits them thereby reducing the environmental danger towards them.

Environmental protection is not well arranged in Russia from the enterprises' point of view. There are several authorities with their own requirements. The distribution of powers among governmental bodies is obscure.[35] It seems that the anxiety of the citizens has made the government increase control and found more and more new bodies for environmental protection. Coordination between them has, however, been forgotten. Environmental control also belongs to joint powers of the federation and its subjects, which causes additional problems. Regulations on different levels may differ considerably from each other.

There is a lot of bureaucratic environmental control, but it is not effective. Russian enterprises do not take environmental control seriously. Even foreign companies, which at home are required to take environmental protection into consideration, misuse Russian corrupted and ineffective environmental control. Examples are Finnish forest companies, which have harvested protected primeval forests in Karelia (see Piipponen, 1999). The case was made public by international environmental organizations. Globalization has reached Russia in both good and bad respects.

[35] There are examples of how complicated and contradictory rules affect on companies in the forest sector in Maria Kotova's forthcoming paper (Kotova, 2001).

6. Summary

The role of the company is changing in Russia from an administrative unit of state administration to a profit-making unit of a market economy. The administrative unit and its governance by fiat correspond easily to the legal positivist idea of system of norms and endogenic technical definition of concepts. According to such thinking, changing technical rules will change the functioning of companies. However, companies and their corporate governance do not change only by changing formal rules. Experience from Russian companies in transition proves the weakness of legal positivism and the strength of legal realism. Corporate governance can be quite different in practice in different countries, even if the technical legal rules are almost similar.

Western company law is a product of a long term learning process without significant interruptions. There have been misuses, which have affected on improving the formal regulation. There is a tendency from protecting shareholders and seeing them in the core of the company to a wider interpretation. Both stakeholder theory and a firm as a nexus of contracts saving transaction costs represent such a widening of the perspective. Shareholders have to give room to other stakeholders in the core of the company. A firm is regarded as a going concern, the aims of which should be understood in the context.

The Russian business environment differs from that of western market economies and therefore a firm is understood differently. Earlier there was a wider "stakeholder" approach, which regarded an enterprise as the unit responsible for the well being of the workers and the community at large. There is such a thing as Russian managerialism, which sees managers in the core of the company. Managers of former state enterprises privatized the enterprises for themselves in cooperation with employees. Since managers together with employees control the majority of the shares in most privatized companies, ownership and control are not divided in Russia. It reflects on a weak protection of minority shareholders and creditors. Directors managed to lobby company laws while they were drafted and further weakened the rights of minorities making the use of their rights technically complicated. Flexible rules that are now demanded more and more in Western countries would not work in the Russian environment without an effective control system of the managers. Extremely formal rules can also be misused as barriers protecting managers' benefits. Russian managers have a long tradition for such a policy. They seem to treat other shareholders in a similar way as they manipulated workers' collectives before. Agency theory explains the behavior of Russian managers, who do not have to negotiate with their shareholders, yet. No one monitors the monitors, because there are no markets to control them.

Russian firms function in a virtual economy, where networks and good connections matter and exchange is to a great extent barter. Bizarre taxation rules make profits costly and also encourage making informal profits as well as transferring capital abroad. It seems that company law has very little to do with actual corporate governance. With company law the legislator can transplant the formal system of norms into Russian society. Courts, of course, have a new role to control and help to plant new

business culture. Their role should, however, not be exaggerated. A lot depends on the managers, who are in the core of Russian corporate governance. They have the power to start to restructure, which would be in the shareholders' long-term interests. Many shareholders, however, are also employees who do not wish to lose their jobs. Also a high burden of social responsibilities, which the companies have difficulties to get rid of, hinder restructuring.

Even if western economic theory does not fit into Russian concepts, it can still give new approaches to Russian company law. The logic of economic organization is different in Russia. Profits are costly and transaction costs are saved often with illegal methods. Restructuring has been postponed due to "an agreement" between managers and their workers. The latter helped the former to keep the enterprises in their control in order to maintain their jobs. Managers owe a lot to the workers and are therefore still reluctant to increase unemployment. The agreement to keep things running as much in the old way as possible maintains a virtual economy. It cannot, however, last forever. Old style management will bankrupt the enterprises sooner or later. Managers still have an opportunity to survive, if they have managed to channel most of the profitable production to new companies. Old companies are actually more profitable than is shown. Since formal profits are costly, production is channeled to the informal sector. Managers can "suck the company dry" before they become bankrupt. Officially they do not cheat the workers in this way but maintain their jobs as long as possible. Company law has rules for sanctioning losses, which are deliberately caused to the company. Running the company into bankruptcy can also be sanctioned. It is, however, obvious that such rules can only be exceptionally used. Producing profits informally and double bookkeeping fulfills the definition of deliberately running a company to bankruptcy. It is, however, too common in Russia. In principle, exceptional personal liability of managers for losses has an exceptionally fertile soil in Russia.

Virtual economy networks diminish uncertainty with experienced methods. Asset specificity is involved in a simple way — scratch my back and I will scratch yours. Managers' self-seeking has no control.

Russian company law is a transplant, which does not meet with the current aims of companies functioning within a virtual economy. The forms of companies resemble German counterparts but also contain remnants from the socialist past. Transplanted company law introduced new models for governance structures, but old administrative methods prevailed on the side. Modern corporate law is structured for market control and rests on the assumption that ownership and control are divided and that shareholders have become moving investors. In Russia, shareholders are not the core of the company. The core is the majority of the shareholder managers, who are able to control the company effectively. The market does not govern them, because the framework of a virtual economy does not force to restructure or even make a profit. Shareholders are not investors. Insider shareholders only want to secure their position.

Because of insider privatization Russian companies are more closed than the law would allow. Information is given reluctantly, since companies do not compete for shareholders and good investors. However, there is a learning process going on. Some managers may understand the need for restructuring. The change is vested in small enterprises. Russian economy is, however, dominated by big privatized enterprises. The

state should encourage entrepreneurship, but the managers of big privatized enterprises are a significant lobby group, which can keep the economic policy favorable for them. The unholy alliance of the government circles and the oligarchs keeps supporting unhealthy monopolistic enterprises.

Privatized former state enterprises have not emerged through contractual relations with private owners as economic theories explain firms, but have been created by state authority and now continue their life in a new private property form because of the will of the state. They are some kind of hybrids between administrative units of state bureaucracy and capitalist firms. On the other hand, there are also "new" small and medium sized enterprises, which have been started during the last ten years and which have been private from the beginning.

On the one hand, the development has been path-dependent but on the other hand, it has produced unwanted results. Modern company law is not perfect for a virtual economy, where it can be misused, neglected and ignored. The development also proves that the rationality of the legislator is bounded. No one can possess the required information and knowledge about the changing environment of Russian business. Russian company law regulation is not created to answer the immediate needs of current business, but for the future. In this way the legislator attempts to speed up the learning process towards a market economy. However, there always lies a danger in this kind of teaching of businessmen. In the worst scenario, law loses its authority completely.

7 Recommendations

Even if company law of modern market economies does not completely fit into the Russian environment it is, however, the only possible way to continue developing company law. For foreign investors it is easier when the regulations of company law are international.

There are some weaknesses in Russian company law, which should not be difficult to correct. For example, the requirements on companies to publish information should be tightened to ensure transparency. The equality of shareholders should be protected more efficiently by abolishing excessive formalities, which enable managers to make shareholders silent. The liquidation of a company without informing creditors should be made impossible. The provisions of the Civil Code should be made consistent with the later drafted Joint Stock Company Law and the Law on Limited Liability Companies.

An audit commission or an auditor should also be made obligatory in smaller limited liability companies. This would not make management more complicated but would protect creditors' interests. Management of close limited liability companies should not be made too flexible because it may encourage fraudulent business.

The development, which in European countries seems to go towards more flexible company law rules, does not fit into the Russian environment that has no effective control of managers. Flexible rules, which give managers more power, would only be used to keep minority shareholders silent in the absence of effective market control, which enables flexibility in more developed countries. On the other hand, there are

formal rules that enable managers to silence minority shareholders, which should therefore be abolished. The control of managers is important in the Russian business environment.

Corporate governance should be studied and should be able to find its place as the most important issue of company law. Such development requires a change in legal thinking. Company law developed out of the law of obligations and used to be part of the doctrine of juristic persons also in Germany in the 19th Century. The development towards separate company law occurred with the development of a market economy. The old fashioned legal positivism and conceptualist standpoint hinders the development of Russian law to reach the needs of a modern market economy. The most effective way in the long term is to educate legal scholars and university teachers.

Since it is the managers who are at the core of developing corporate culture, they should also be educated. This may be a difficult and complicated task because on the one hand Russian managers have to adapt to the environment of a virtual economy. On the other hand, Russian managers should start to think in terms of a market economy. Only investing in restructuring can save Russian companies in the long term. Responsible managers have realized this fact even if they have to work daily with problems, which are due to a virtual economy.

The problems with the management of companies are tightly connected with the attitudes of the managers. They should be able to understand that the shareholders have their rights, which cannot be neglected. Transparency is also in the long term the best policy for any company. Russian enterprises need strategic investments and not typical western portfolio investments. However, western investors, who are ready for strategic investments, might have experience in running companies and ideas for developing a Russian company to an internationally competitive level. Even if Russia is, in itself, a huge market area, globalization is a fact that even Russian companies cannot escape. On the other hand, it is understandable and acceptable that Russia wants to protect its own industry against competition during the transition period. There should, however, be better means available than hiding and distorting information with the help of company law rules.

Even if corporate culture is not developed in the courts, they are important as a final resort in solving disputes. Judges, therefore, also need training and education. Even if there are specialized commercial courts (arbitration courts) in Russia, the general level of knowledge of the changing business environment is not one of the strongest among Russian judges. The attitude that lawyers teach businessmen should be exterminated completely. Lawyers and businessmen should be able to work together and understand the interests and objectives of one another.

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