The Governance of Privatized Firms: Problems of Power and Control

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Abstract

The corporation is the focal point for the accumulation and exercise of private power. This paper discusses issues relating to who controls the corporation and how it is governed, issues of significant economic, social, and political consequence in transitional economies.

The paper focuses on two closely related principles of corporate governance — accountability to shareholders and adequate disclosure — as these principles have taken hold in the West. These aspects of corporate governance currently are lacking in the debate concerning Central and Eastern Europe and the former Soviet republics. In a broader sense, this paper too is a search for a stronger legal conscience embodied in underlying principles of corporate law essential for newly privatized countries as they continue their journey toward a viable market economy.

Part One focuses on general problems of power and control and accountability to shareholders. Part Two examines mechanisms of control inside the corporation, beginning with financial controls, basic to full and fair disclosure. After a brief comparison of German and United States governance systems, Part Two then discusses an effective model of corporate governance as instituted by leveraged-buyout associations and venture capital funds in the United States. Guidelines for evaluating self-interested transactions by management follow. Part Three examines shareholder participation in governance and control through the annual meeting and proxy contests. A final section reviews difficult issues relating to the protection of rights of minority shareholders.

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Řízení privatizovaných firem: problémy moci a kontroly

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Abstrakt

Korporace je místo, kde se soustřeďuje a působí moc soukromého sektoru. Tento článek diskutuje problémy související s kontrolou a řízením korporace, problémy, které mají významné ekonomické, sociální a politické důsledky v transformačních ekonomikách.

Článek se zaměřuje na dva úzce spjaté principy řízení korporace - odpovědnost vůči akcionářům a adekvátní poskytování informací (adequate disclosure) - tak, jak se tyto pricnipy běžně uplatňují na Západě. Tyto aspekty řízení korporace v současné době chybějí v diskusi týkající se střední a východní Evropy a bývalých sovětských republik. V širším smyslu je tento článek též hledáním hlubšího právního vědomí vyjádřeného v základních principech podnikového práva. Tyto principy jsou pro země, v nichž proběhla privatizace, nezbytné v jejich další cestě směrem k prosperující tržní ekonomice.

První část se zaměřuje na obecné problémy moci a kontroly a odpovědnosti vůči akcionářům. Druhá část zkoumá mechanismy kontroly uvnitř korporace, začíná přitom u finanční kontroly, která je základním předpokladem k úplnému a pravdivému poskytování informací. Po stručném srovnání německého a amerického systému řízení se ve druhé části diskutuje efektivní model řízení korporace ve Spojených státech, využívající převzetí podniku investorskou skupinou (leveraged buyout associations) a rizikových kapitálových fondů. Následují pokyny k vyhodnocování transakcí vedených vlastním zájmem managementu. Třetí část se zabývá účastí akcionářů na řízení a kontrole prostřednictvím valných hromad a soubojů o právo zastupování akcionářů. Závěrečná část shrnuje obtížné problémy týkající se ochrany práv drobných akcionářů.

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PART ONE
ECONOMIC FREEDOM AND ACCOUNTABILITY

1. PROBLEMS OF POWER AND CONTROL

The Corporation - A Complex Legal Idea

The corporation and the means by which corporations are governed increasingly are vital agents for economic as well as social and political change, particularly in transitional economies. The corporation is the focal point for the accumulation and exercise of private power. Who controls the corporation is therefore a significant issue. In the rapidly changing marketplaces of Central and Eastern Europe and the former Soviet republics, key issues after the privatization of enterprises center around power and control as they relate to corporate governance. Effective corporate governance will be an important determinant in the linking of Central and Eastern Europe and former Soviet republics to the West, particularly to the European Union, and to capital markets.

A form of corporate governance is emerging in Central and Eastern Europe and the former Soviet republics driven by the unique historical experience of transition in the area as a whole and then by circumstances peculiar to each individual country. Many changes are underway regarding corporate governance evidenced by the restructuring of enterprises and involvement of Investment Privatization Funds ("IPFs"). Yet important elements are lacking vis-a-vis the West. If the region wants investors and capital from the West, it cannot obtain such capital with the ease and magnitude sought unless Western elements are an integral part of the corporate governance structure. Companies will not raise capital unless they provide information; unless an audit is performed; unless a vital board of directors is in place. Capital markets will play a critical role. Yet it is unclear whether companies know how to run board meetings or shareholders' meetings effectively, or how to protect minority shareholder rights.

The background for this paper was a corporate governance seminar I gave at CERGE (the Center for Economic Research and Graduate Education), Charles University, Prague, in June 1993, hence the particular references to the Czech Republic, though no attempt is made to analyze the many variations in evolving structures of corporate governance in the region as a whole. The paper focuses

on processes operative in the West and important to Central and Eastern Europe and the former Soviet republics, especially in consideration of integration into the European Union.

Corporate governance is a complicated concept to define and analyze. A two-volume study on corporate governance, prepared across a decade of lively debate, was published by the American Law Institute (which brings together some of the best legal minds in the United States to re-examine areas of the law), as *Principles of Corporate Governance: Analysis and Recommendations* ("ALI") (1994). It is significant that the preparation of this restatement of the law of corporate governance took over ten years to prepare with many meetings, several drafts and contributions from scores of leading practising lawyers throughout the United States participating in the debates. The objective of the corporation, as defined by the ALI in the final publication, is to conduct business activities with a view toward enhancing corporate profit and shareholder gain. This definition echoes the theme of U.S. takeover activity in the 1980s of enhancing shareholder values. *The Czech Commercial Code - Part One - Business Companies and Partnerships* states as the corporate objective simply (1) "A business company ... shall be a juristic person (entity) founded for the purpose of undertaking business activities."

An essential first step in understanding corporate governance is to note the characteristics of a "business company" or "corporation" as defined by law. The concept of a corporation as a "juristic person", a separate legal entity as distinct from its members, brings together several significant elements basic to principles of corporate governance. More obvious factors include the permanent existence of the corporation, the power to sue and to be sued in the corporate name, and the ready transferability of shares.

Less obvious attributes are: the political freedom granted a corporation in the right to form a private government, governed by a charter and bylaws; and the limited liability of investors. The fact that an investor, when purchasing a share of stock, risks only what he invests but does not risk becoming liable for debts of the corporation, has major ramifications. By limiting liability for shareholders arising out of their status as shareholders, incorporation makes it possible to accumulate and control large amounts of wealth and power. All debts are the artificial entity's obligations — the corporation's — not the shareholders'. A final factor, relating particularly to the large publicly-held corporation, is the separation of ownership from control and the centralization of management in the board of directors.

These last two last factors of corporate existence — the possibility to accumulate and control great wealth and the separation of ownership and control — are at the root of the problem of accountability. These factors create the need for a bridge to account to shareholders whose wealth is at stake.

Ownership Versus Control

For the past 60 years a seminal work, *The Modern Corporation and Private Property*, co-authored by Adolf Berle and Gardiner Means and published in 1932, heavily influenced the character of U.S. corporate governance. In the publicly-held corporation, the authors argued, given the need of growing enterprises for capital and the subsequent dispersion of stock holdings, the dominant theme was the inevitable passivity of shareholders based on the separation of ownership and control. The increasing complexity of business and the need for specialized management to increase the value of the corporation, widened the split between ownership and control.

At the same time, delegation to managers raised a basic problem of managements' discretion to advance their own interests at the expense of the passive shareholders. The objective of corporate governance became the search for ways to bridge the separation of ownership and control by holding managers accountable for their performance and thereby minimizing self-interested managerial behavior.

Monitoring the Corporation

The powers and legal responsibilities of corporate directors and officers derive from corporate law. To be secure, power has to be legitimate, and for power to be legitimate, whether public or private, it has to be accountable. The modern business corporation is accountable according to its constitutional law, just as the government is accountable according to constitutional law. The constitutional law of the business corporation is called the law of corporate governance, which defines the accountability of directors to shareholders and of officers to directors.

Problems of accountability and of monitoring the corporation are as old as the company itself. In the common law, legal duties of corporate directors were established in *The Charitable Corporation* v. *Sir Robert Sutton* decided in 1742, a classic case of the failure of directors to oversee management. As discussed in *Board Games: The Changing Shape of Corporate Power*, Part I, Chapter 1,

the judge noted, "'The loss which ensued from this mismanagement is prodigious.'" Then, as now, the basic question is: who is responsible for management's self-dealing?

The chief executive officer was responsible, but as the facts of the case indicated, he had "run away out of the kingdom in order to avoid justice." The directors however were present; inevitably they were the defendants. The case established the principle that still guides the role of directors: directors are "'most properly agents to those who employ them ... to direct and superintend the affairs of the corporation.'"

Basic principles for effective corporate governance emerge from this case. The law dictates that corporate managerial powers must be exercised honestly and in good faith. Directors are responsible to and accountable to the shareholders of the corporation and are liable for fraud, recklessness, or gross negligence. A director exercises a fiduciary responsibility — this is the "duty of loyalty", which must be exercised with reasonable attention — this is the "duty of care".

According to the Czech Republic's *Commercial Code* Sec. 194 (5): "The members of the Board of Directors shall be bound to exercise their authority with proper care, and to keep in secrecy [secret] confidential information and facts which, if disclosed, may harm the company's interest." In the Czech Republic, this "duty of care", dealt with in court decisions under the civil law during the Czechoslovak First Republic (1918-1938), has yet to be defined further in future cases arising under present company law; future case law ultimately will define the duty of care. But the concept can be made effective only when the duty of care on the part of directors to be responsible and accountable to the shareholders is first recognized as a crucial element in corporate governance and only if a legal conscience prevails supported by a viable judicial system to examine and enforce standards of care and accountability. That is the long-term perspective.

Freedom of Enterprise versus Accountability to Shareholders

The problem of accountability recently was examined in the *Cadbury Report*, a major study undertaken by leading members of the business and government communities in the United Kingdom to analyze problems of corporate governance. The study addressed two central themes: Does the board of directors provide an effective check and balance to management? How to ensure accountability? Issued in December 1992, the *Cadbury Report* is based on the recommendations of the Cadbury Committee on the Financial Aspects of

Corporate Governance, established in the wake of the BCCI (Bank for Credit and Commerce International) and Maxwell scandals.

The *Cadbury Report* defines corporate governance simply as "the system by which companies are directed and controlled." The ALI defines the principles and role of corporate governance as the need to develop a corporate structure that will "... attempt to balance competing values of (i) freedom of enterprise on the one hand and (ii) accountability of directors to shareholders under the law on the other." There is a wide gap between these two definitions. The former articulates half of governance, offering a descriptive, administrative view. The ALI definition articulates both aspects of governance — the need to develop a corporate structure, the administrative leg, and more importantly to address the issues of the free market and profit motive in relation to accountability to shareholders.

The challenge for corporate law, according to the ALI, and hence the building of the very foundation of a strong market economy, is to allow for the development of a corporate structure that gives management the freedom to make use of its expertise to benefit shareholders. At the same time, rules are needed to guard against situations in which management might abuse that freedom to make business decisions that favor itself at the expense of shareholders. Herein lies the crucial challenge for Central and Eastern Europe and the former Soviet republics. To now the restructuring process in the hands of management has taken precedence over principles of disclosure and accountability to shareholders.

Directors and officers are not precluded from becoming involved in other businesses; however they may not use their corporate positions to prevent the corporation from competing with them, use corporate funds for their own businesses, disclose corporate trade secrets to others, usurp corporate opportunities, and so forth. Basically it is the obligation of the director in pursuing any activity to put the interests of the corporation before personal interests.

The responsibilities of directors in governing their companies can be delineated by the following short list of difficult tasks: setting strategic aims; appointing competent management to realize business plans; closely monitoring or supervising management to evaluate performance; reporting fully and fairly to shareholders on management's results. Managers objectives most often are the survival of the firm, its growth, managerial salaries and perquisites, etc. Shareholders are concerned with value maximization, i.e. the highest possible price for their shares.

Vaclav Havel, in expressing his views on the moral responsibility of the individual, inadvertently touched on this central theme of corporate governance — the problem of accountability. According to Havel, as discussed in a *Harvard Law Review* (1990) article, "The Supreme Court 1989 Term - Foreword: Taking Freedom Seriously", the individual's most important freedom is the freedom to assume moral responsibility for the consequences of his actions. Central to that responsibility is a revitalization of responsibility for others and for feelings of community. It should be added to Havel's view, particularly within the context of the economic stakes of the corporation, there also is a need for a coherent set of structural rules to check opportunities for the misuse of power and control. Establishing optimal rules is the first step toward effective corporate governance. The question: what is the right corporate governance model? is discussed in PART II: CONTROL MECHANISMS INSIDE THE CORPORATION - THE CORPORATE MANAGEMENT STRUCTURE.

U.S. Corporate Statutes - "Enabling" Rules

As mentioned, a unique attribute of the corporation is the political freedom granted a corporation manifested in the right to form a private government. This independent entity is governed by a charter, in essence, the corporation's constitution, and bylaws. U.S. state corporation statutes, in prescribing the functions and powers of directors and officers of that private government, simply state: " The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors". Most U.S. state corporation laws are empowering or "enabling" rather than regulatory rules. The rules "enable" private parties to accomplish incorporation on terms which they freely choose.

As pointed out by Judge Ralph Winter of the U.S. Court of Appeals for the Second Circuit, in an article "State Law, Shareholder Protection and the Theory of the Corporation" in the *Journal of Legal Studies* (1977), under contract law private parties will seek the most efficient means of doing business and competing freely. The corporation's charter, as defined in state of Delaware case law, is basically a contract between the state — which grants the right to form a private government — and the corporation, between the corporation and its shareholders, and between shareholders inter sese.

Flexible corporation laws allow for greater flexibility in drafting the corporation's charter and bylaws. In the United States, under the Model Business Corporation Act, (revised through 1991 and adopted by the Committee on Corporate Laws of the Section of Business Law of the American Bar

Association and adopted in substance in more than 35 states), the only information required in the charter to form a standard corporation is the name; the number of shares the corporation is authorized to issue, including the rights and preferences of the shares if more than one class of shares is authorized; the street address of its registered office and the name of its registered agent at that office, and the name and address of each incorporator.

Optional provisions may include the initial directors, a purposes clause, and any provisions not inconsistent with law for managing the business and regulating the affairs of the corporation, its board of directors and shareholders.

The broad language of the Model Business Corporation Act allows draftsmen to place in the charter provisions believed to be sufficiently important to be of public record or subject to amendment only by processes that apply to amending the charter, namely shareholder approval.

Thus although state laws impose few mandatory restrictions upon the discretion of corporate management, restrictions can be written into the corporate charter. In transition economies, given the formative stages in the evolution of laws governing corporations and financial institutions and practices, the corporation's charter presents a readily available means, through the power of the corporation itself, to guard against possible adverse actions. For example, the charter may require supermajority voting that would serve to protect shareholders that are not in control. (See PART THREE, the section PROTECTING AGAINST OPPRESSION OF MINORITY SHAREHOLDERS BY MAJORITY OR CONTROLLING SHAREHOLDERS).

The bylaws of a corporation generally set forth self-imposed rules and regulations necessary for the corporation to function effectively and typically may be amended by the board of directors acting alone. In the event of a conflict between the charter and bylaws, the higher authority, the charter, prevails. Bylaws impose rules governing matters such as shareholders annual and special meetings, voting, proxies; the number of directors, their election, resignation, removal, and vote required for action; the powers and duties of executive officers. These intra-corporate rules define the rights and obligations of directors, officers and shareholders as they relate to the administrative affairs of the corporation. The focus is on internal control.

2. EXTERNAL CONTROLS OVER THE CORPORATION

Market Forces as a Monitoring Device: Rules of Disclosure

In the West, monitoring is facilitated by many external as well as internal factors that are less developed in Central and Eastern Europe and the former Soviet republics. That corporate governance not only concerns the corporation as a separate entity but also the corporation in its relation to market forces and developed capital markets is best illustrated by the merger activity in the United States in the 1980s. The takeover surge and active market for corporate control gave rise to an intense period of restructuring and boardroom upheavals. Large-scale mergers, hostile takeovers, leveraged buyouts, and corporate restructurings greatly enlarged the scope of the board's decision-making agenda. The issues no longer were decisions regarding month-to-month functioning of the corporation but could involve the final question of whether that corporation would continue to exist. The corporate takeover radically transformed the directors' role in the power structure of the U.S. corporation.

In general the process of monitoring the corporation in the West is supported by well-established accounting procedures; a long record of corporate performance against which to measure present actions of management; as well as many other factors relating to developed capital markets and specialized financial institutions that evaluate and assess corporate performance.

One of the most important and most pervasive factors is disclosure. In the U.S, rigorous standards of disclosure are mandated by the federal government. The Securities and Exchange Act of 1933, protects against fraud and misleading statements, mainly in the initial distribution of securities by the issuer, by imposing stringent registration (and prospectus) requirements. The Securities and Exchange Act of 1934, which deals primarily with the secondary distribution of securities, also establishes extensive reporting requirements. Felix Rohayton, a former partner of the investment banking house of Lazard Freres, has referred to disclosure as "a great innovation making United States markets the best".

The specificity of the rules is clearly illustrated by a leading U.S. case, *SEC* v. *Texas Gulf Sulphur*. The case involved "insider trading", an insider's use of confidential corporate information to trade in the company's stock, which violates not only the federal securities acts but also the director's common-law duty of loyalty to the corporation. Brought in federal court by the Securities and Exchange Commission (SEC) against Texas Gulf Sulphur Company and certain of its officers and directors, the executives were charged with conduct that violated Rule 10b-5 of the SEC Act of 1934.

The rule addressed the issue of the use of insider information for personal profit stating: "It shall be unlawful for any person.... (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order [that] ... the statements made... [will not be] misleading... in connection with the purchase or sale of any security."

The SEC Rule 10b-5 proscribes not only affirmative misrepresentations and half-truths; it also proscribes a failure to disclose "material facts". If the information would affect the assessment of the value of the securities, it should be considered "material." The executives in the Texas Gulf Sulphur case, who issued an ambiguous public statement about a possible ore strike and then bought shares of the company's stock as well as rights to buy stock in the future, took from other shareholders the difference between the stock price before and the stock price after news of the ore strike. The court applied the rule that a director or officer may not use confidential company information for his own benefit and the gains were returned to the corporation.

The development and enforcement of meaningful rules of disclosure presents a major challenge to the legal and financial architects of Central and Eastern Europe and the former Soviet republics. To date the lack of adequate disclosure is one of the weakest links in the chain of effective corporate governance and well- functioning capital markets.

Outside Financial Control through Covenants in Debt Instruments

Given the lack of extensive disclosure regulations, sophisticated accounting practices, scores of security analysts, and developed capital markets in Central and Eastern Europe and the former Soviet republics, outside controls through instruments that give creditors influence over management are especially important. Though an external force, managerial behavior can be constrained directly by means of controls on the enterprise arising through debt financing.

In addition, in the Czech Republic, for example, the fact that most of the major IPFs were organized by commercial banks raises potential conflicts of interest insofar as the banks are acting as both owners and creditors. IPFs exercise ownership rights in firms in which they are majority shareholders by obtaining a seat on the board. Outside controls through covenants in debt instruments can mitigate potential conflicts relating to board decision-making.

The most frequent means of outside controls over the corporation as they appear in lending documents in the U.S. were investigated by Professors Clifford Smith

and Jerold Warner of the University of Rochester in a now classic article on financial contracting published in the *Journal of Financial Economics (1979)*.

The covenant appearing most often related to further indebtedness: over 90 percent of the agreements reviewed contained restrictions on the board's ability to issue additional company debt. Issuing new debt was subject to aggregate dollar limitations or was prohibited unless the company maintained certain minimum prescribed financial ratios.

Over a third of the lending documents restricted merger activities and placed constraints on the board's ability to dispose of the company's assets. Covenants required that the company not "otherwise than in the ordinary course of business, sell, lease, transfer, or otherwise dispose of any substantial part of its properties and assets ...." Certain covenants permitted the disposition of assets only up to a fixed dollar amount.

Approximately 25 percent restricted the payment of dividends. Dividend covenants act as a restriction on the payment of dividends financed by issuing debt or by the sale of existing assets, either of which would reduce the coverage on, and thus the value of, the debt. Such dividend restrictions, however, are not outright prohibitions on the boardroom decision to pay dividends. Shareholders are permitted to have any level of dividends, so long as the payment of those dividends is financed out of new earnings or through the sale of new shares. The board's decision on the distribution of dividends rests for the most part on the corporation's financial statements, the basis of disclosure and the audit.

PART TWO
CONTROL MECHANISMS INSIDE THE CORPORATION - THE CORPORATE MANAGEMENT STRUCTURE

1. FINANCIAL CONTROL: THE DIRECTORS' FINANCIAL STATEMENTS AS THE BASIS OF THE REPORTING SYSTEM AND THE AUDIT - GUIDELINES FROM THE CADBURY REPORT

Disclosure - Financial Information

Insofar as capital markets require the flow of correct and relevant information, when information issued by corporations is incorrect or otherwise unreliable, costs are added and uncertainty is introduced to the market's pricing functions. Effective financial reporting rules limit the scope for uncertainty and manipulation as well as managerial discretion.

Disclosure as it relates to financial control raises two key issues: (i) What kind of information is required? and (ii) Who presents it? The independence of the accountant is crucial. The central task of the audit/financial reporting is to ensure that an adequate flow of information exists to evaluate effectively management performance in relation to the corporation's strategic and financial goals.

Financial statements also are the basis for board decisions on the distribution of dividends. In the U.S. most states have limited the source of dividends to legally prescribed funds defined in terms of earned surplus, net profits or earnings, non-impairment of capital, insolvency, or some combination. Directors often are made liable by statute for dividends paid out of funds that are not legally available.

Financial Controls

Boards set financial policy and oversee its implementation by establishing and applying financial controls within the company and by reporting on activities and progress of the company to shareholders. The process of financial reporting is to be guided by the principle that the view presented should be true and fair including:

- A balanced assessment of the company's financial position will deal with setbacks as well as successes.
- Boards will aim for the highest level of disclosure that can be attained without damaging the company's competitive position, a line often difficult to draw. As stated earlier, the *Czech Commercial Code* Sec. 194 (5) requires that: "The members of the Board of Directors shall be bound to exercise their authority with proper care, and to keep in secrecy [secret] confidential information and facts which, if disclosed, may harm the company's interest."

Audit - Outside Assessment

Given the separation of ownership from management, directors are required to report to shareholders by means of the annual report and financial statements sent to shareholders. The role of auditors is to provide shareholders with an external and objective check on the directors' financial statements which form the basis of the reporting system. The audit essentially assures that the financial statements are free of material misstatements.

A primary concern also is to ensure that an appropriate relationship exists between auditors and management whose financial statements they are auditing. Shareholders require auditors to work with management; yet auditors must remain objective and committed to principles of accountability to shareholders. An essential first step is the development of effective accounting standards.

In Central and Eastern Europe and the former Soviet republics professional objectivity means that strict professional requirements must be in place and observed to practice as an auditor. To ensure accountability, it also is necessary that there be legal recourse, an established right to sue auditors and to limit the power of broad disclaimers.

Directors' Responsibilities

To clarify for shareholders the boundaries between the duties of directors and auditors, a brief statement of the directors' responsibilities for the accounts should appear in the report and accounts (as a counterpart to a statement by the auditors about their reporting responsibilities) covering the following points:

- Legal requirement for directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the

company as at the end of the financial year and of the profit and loss for that period;
- The responsibility of directors for maintaining adequate accounting records, for safeguarding the assets of the company, and for preventing and detecting fraud and other irregularities;
- Confirmation that suitable accounting practices, supported by reasonable estimates, were used in preparation of the financial statements;
- Confirmation that applicable accounting standards were followed, subject to any material departures disclosed in notes to the accounts.

Since accounts are prepared on the assumption that a corporation is a going concern (and to guard against the sudden collapse of companies without apparent warning) directors should satisfy themselves that it is reasonable to make the assumption that the corporation is a going concern, for e.g., by preparing an adequate cash flow forecast. In a well-functioning system, the auditor takes an active role in testing going concern assumptions.

2. U.S. AND GERMAN CAPITAL MARKETS AND GOVERNANCE STRUCTURES: A COMPARISON

Ownership in Capital Markets

Whereas auditing and accounting principles tend to be uniform in the West, which legal system ultimately predominates and actually takes root with regard to corporate law, management principles and shareholder rights is a matter of real consequence not only for the new market economies themselves but for Germany and the United States as well. As reported in *The Wall Street Journal*, not only does the "battle" for influence in transition economies pit the civil-code traditions of continental Western Europe against the common law of the Anglo-Saxons, but it sets German banks, "representing an outdated financial system," against the U.S. and British investment houses, and Germany's "conservative boardroom culture against America's rough-and-tumble capitalism of proxy fights, hostile takeovers and junk bonds."

The Czech commercial law as it relates to companies is based on the German model though in the Czech Republic, as well as elsewhere in Central and Eastern Europe and the former Soviet republics, insofar as the practical functioning of boards is concerned elements are borrowed from both the U.S. and German models. Moreover many factors in emerging markets force idiosyncratic adaptations that depart sharply from both. One such factor are the IPFs.

According to Professor John Coffee in his paper, "Investment Privatization Funds: The Czech Experience" (1994), IPFs are cited for their role as a corporate governance solution to the problem of the dispersed ownership of shares. The effectiveness, however, of the IPFs as corporate monitors is not yet clear. They are viewed from the U.S. perspective as similar to mutual funds with power over capital markets, emulating the U.S. model, although given the lack of liquidity it would be difficult to compare levels of activity in portfolio management with
U.S. funds.

Alternatively, Czech IPFs are seen as bank-dominated entities, extending the reach of the banking system into the governance of the privatized enterprise, supposedly the German model. In the first wave, the largest Czech financial institution, Ceska Sporitelna, the Czech Savings Bank, also founded the largest IPF. In actuality neither view is correct. What is apparent is the great diversity of the IPFs, not only with regard to decision-making as to how to invest voucher points, but additionally how each monitors companies in which they do have a stake.

Papers by Colin Mayer and Julian Franks (1992) discuss differing structures of corporate governance between Germany and the United States, based in part on differing capital markets. Thus U.S. ownership in capital markets is characterized by a large number of listed companies - 6,000 in 1986 (New York Stock Exchange "NYSE" and NASDAQ, the over-the-counter market, combined). As witnessed by the takeover era of the 1980s in particular, it is a liquid capital market where ownership and control rights are frequently traded. There are few intercorporate equity holdings, i.e. share stakes held by other companies. Moreover there is a reluctance on the part of U.S. companies to take a minority position. All or nothing strategies prevail.

In the U.S., greater reliance is placed on external control through the takeover process and also more recently on "relational investing". To now, there has been only a weak relation between corporate performance and the likelihood of executive dismissal. A high level of executive dismissal, however, is associated with takeovers. Insofar as control is allocated on the basis of the highest bids, the U.S. system allows for greater flexibility in corporate control: whoever attaches the highest value to the corporation can seize control simply by bidding for ownership.

The German capital market, on the other hand, is smaller, with few listed companies - 450 in 1986. Capital markets are illiquid, i.e. ownership and control is infrequently traded. Because of large concentrated owners and the type

of ownership, Germany does not have an active U.S. takeover control market. The highly concentrated shareholder structure is characterized by complex systems of intercorporate holdings. Nor are the banks necessarily the large shareholders; less was borrowed as companies prospered and banks sold their equity positions.

Concentrated ownership is in the hands of other German industrial companies and family trusts. Nevertheless banks act as custodians and can cast proxy votes blocking a minority.

Governance Structure - The German Insider System

The primary distinction between Germany and the United States as to ownership determines the way in which companies are controlled. The distinction is reflected in differences in the corporate governance structures of the insider (German model) and the outsider (U.S. model) systems and the conduct of the two systems in restructuring. The German corporate control system has the following characteristics:

- Supervisory and management boards.
- Representatives on supervisory boards are chosen to meet a need for a particular expertise or because of an institutional affiliation, e.g. the representative of a large bank.
- Election to the supervisory board is for a particular period (5 years in the first instance) and during that period it is difficult to remove members without good reason. The supervisory board comprises representatives of shareholders and employees who traditionally vote with management.
- The supervisory board's primary function is to select new members of the management board and to monitor management and evaluate its investment plans. The supervisory board also provides a natural forum for supervisors to meet without management. However, in the normal course of events, the supervisory board intervenes little in the activities of management. During periods of financial difficulty the supervisory board will evaluate restructuring plans proposed by management, but even then, management is replaced only when there is clear evidence the restructuring plan has failed.
- Members of the executive board also are elected for a specified period (5 years) and dismissal occurs only in the event of financial failure. Members are rotated regularly.

U.S./U.K. Governance Structure

The law in the U.S. and U.K. provides for a unitary board, which allows for closer scrutiny and faster and more direct intervention. The chairman is primarily responsible for the working of the board, including:

- the board's balance of membership, subject to board and shareholder approval;
- ascertaining that all relevant issues are on the agenda of board meetings and that independent directors receive thorough information on issues arising at board meetings. Though independent directors lack the executive directors' in-depth, inside knowledge of the company, both require equal access to information.

Given the importance of the chairman's role, the *Cadbury Report* recommends that the chairman's function should be separate from that of the CEO, arguing that a clearly accepted division of responsibilities at the head of a company helps to ensure a balance of power and authority.

Thus in the U.S. and U.K., the board as a whole is the final authority. However executive directors, analogous to management directors serving on German boards, and independent directors, analogous to directors serving on German supervisory boards, contribute in different ways to its work. Independent directors means that apart from their directors' fees and shareholdings, they should be independent of management and free from any business or other relationship which could interfere materially with the exercise of independent judgment. Independent directors review the performance of executive/management directors and are required to take the lead where potential conflict of interests arise, e.g. directors' pay, or boardroom succession or the sale of the company. The most important committees, to be composed of independent directors, are the compensation and audit committees. Committees also provide a forum for independent directors to meet without management.

To encourage an attitude of a long-term investor, researchers suggest that all independent directors be required to take the director's fees in stock, with transferability restricted for 5 or 10 years. Executive directors' pay should be subject to the recommendations of a compensation committee made up wholly of independent directors and based on ability and performance. Researchers have found that direct ownership of shares is by far the most effective incentive device for manager motivation. According to empirical evidence, a 5% stake works well; at some point further increases are actually detrimental to managerial performance. Shareholders are entitled to a full and clear statement

of executive directors' compensation, i.e. full disclosure as to present and future benefits and how they are determined.

3. THE PROVEN MODEL OF CORPORATE GOVERNANCE: THE LEVERAGED-BUYOUT ("LBO") ASSOCIATION AND VENTURE CAPITAL FUND

The Basic Problem with Present Boards

Professor Michael Jensen of the Harvard Business School in a paper on the modern industrial revolution and the failure of internal control systems (1993), provides a model of corporate governance by signaling weaknesses of present boards and strengths drawn from LBO and venture capital fund structures. Most importantly the board of directors, which has final responsibility for the functioning of the firm, sets the rules for the CEO. The job of the board is to hire, compensate, and fire the CEO, and to provide high level counsel. In the U.S. few boards in the past decades have done this job well in the absence of external crisis. A competent board will provide early warning of impending crises and take action to redirect corporate strategy.

Board Culture - an Important Component of Board Failure

The great emphasis on politeness and courtesy in the boardroom has been at the expense of truth and frankness. CEOs do not seek criticism, thereby continuing the cycle of ineffectiveness - of rewarding consent and discouraging conflict. CEOs have the power to control the board. In the U.S., most independent directors are CEOs of other large companies (63% of outside directors are CEOs of other companies) who would most likely monitor as they would want to be monitored by their own boards. Typically, independent directors are chosen by management and see themselves as "serving at the pleasure of the CEO-Chairman" or what one steel industry referred to as "the parsley on the fish."

Information Problems

In the U.S., the CEO almost always determines the agenda and the information given to the board, which limits the ability of board members to contribute effectively to monitoring and evaluating the CEO and the company's strategy. Moreover the board requires expertise to provide input into the financial aspects of planning - especially in forming corporate objectives and assessing factors

which affect corporate value. In the U.S., such financial expertise is generally lacking on today's boards.

Lack of Management and Board-Member Equity Holdings

Many problems arise from the fact that managers typically own tiny fractions of their firm's equity and few independent directors own substantial equity, e.g. the average CEO of the 1,000 largest U.S. firms (measured by market value of equity) holds 2.7% of the firm's equity (1991). As mentioned above, to force new board members to recognize from the outset that their decisions affect their own wealth as well as that of remote shareholders, boards should require that new members invest in stock of the company. A recent trend in the U.S. to pay some board-member fees in stock or options is a move in the right direction.

Oversized Boards

Keeping boards small can help improve their performance. When boards get beyond seven or eight people they are less likely to function effectively and are easier for the CEO to control.

Democratic Political Model

Also according to Professor Jensen, suggestions to represent various constituencies on the board are likely to make the process even weaker, illustrated by the inefficiency of representative political democracies whether at local, state or federal level.

Commonly debated is the question whether there is a broader constituency than shareholders — for example, employees — and whether that constituency should be represented on the board. Professor Henry Hansmann, of the Yale Law School, states in a paper on worker participation and corporate governance (1992) that in the U.S. though employee stock ownership is common, of the 1,000 public corporations with the largest employee stock ownership, only four had a worker representative on the board. In the rest of the world too, where there is employee ownership, there is virtually no employee control or significant participation in control for the following reasons: employees differ in age, the part of plant they work in, and their value to the company and therefore have different objectives.

Separate CEO and Chairman

An independent Chairman, at a minimum, should be given the rights to initiate appointments to the board, board committee assignments, and (jointly with the CEO) setting the board's agenda, all conditional on ratification by the board.

Need for Active Investors

Individuals or institutions that hold large debt and/or equity positions in a company and actively participate in its strategic direction are important to a well-functioning governance system. CEOs can recruit large block investors to serve on the board, even selling new equity or debt to induce their commitment to the firm. In recent U.S. history, LBO associations and venture capital funds are the pre-eminent examples of active investors. (See PART THREE, SHAREHOLDER PARTICIPATION IN GOVERNANCE AND CONTROL).

Governance Structures in the LBO Association and Venture Capital Fund Models

Governance structures of LBO associations and venture capital funds provide a blueprint for managers and boards who wish to make their top-level control systems more efficient. Evidence from LBOs indicates that cash flows increase by 96% from the year before the buyout to three years after the buyout. LBO and venture capital funds have similar governance structures and both have been successful in resolving the problems of:

- slow growth or the declining firm faced by the LBO associations; and
- meeting the needs of high entrepreneurial firms whereby venture capital funds work closely with the company to build value.

The corporate governance structure has certain predominate characteristics:

- High equity ownership on the part of managers. Equity becomes concentrated in the hands of managers (over 20% on average) and the board (about 12% -15% on average).
- Board members who are mostly the LBO association partners or the venture capitalists.
- Small boards of directors (of the operating companies) typically consisting of no more than eight people.
- CEOs who are typically the only insider on the board.
- CEOs who are seldom the chairman of the board.

LBO associations and venture funds solve many of the information problems facing typical boards of directors. As a result of the due diligence process at the time the deal is done, both the managers and LBO and venture partners have extensive and detailed knowledge of all aspects of the business. In the period thereafter boards have frequent contact with management, often weekly or even daily during times of difficult challenges. This close involvement provides a model for the director's role: "to direct and superintend the affairs of the corporation."

Questions of directing and overseeing the affairs of the corporation and issues of board culture are far more complex when dealing with corporate governance in Central and Eastern Europe and the former Soviet republics. Where there are Western partners, the problem of creating an effective board involves considerable cultural adaptation. It is necessary to create unique methods of decision-making that draw on Western know-how and at the same time recognize the local culture and corporate environment and find ways to foster the emerging and strong entrepreneurial spirit. This must be accomplished against a culture of secrecy, a dramatic lack of disclosure and little understanding of rights of shareholders. In drawing new lines of board decision-making and accountability these are factors that should be addressed, together with a practical vision of strategic development based on compatible views of risk.

4. SALE OF THE COMPANY - SELF-INTERESTED TRANSACTIONS BY MANAGEMENT

The Need for a Special Committee

Though self-interested transactions by management are a governance problem faced in most jurisdictions, in Central and Eastern Europe and the former Soviet republics, instances of self-interested transactions by management are often the rule rather than the exception. For example, as pointed out in a speech by Jiri Heubner of the EBRD, in the Czech Republic ensuring fairness to shareholders may be complicated by the fact that several "privatized" companies still have majority ownership in the hands of the National Property Fund which shares are available for further privatization through a management buyout. Unlike in the U.S. where all of the company's shares are purchased in the LBO, under certain circumstances in the Czech case, management would be buying a majority of shares. Problems arise when some managers would implement their management buyout by offering the purchased shares in their company as a security for a bank loan. By taking advantage of a majority control or two-

thirds control in the company, they may force the company to repay their personal loan, thereby using company profits for their own benefit and discriminating against minority shareholders.

In the U.S. the following guidelines were developed to protect the interests of all shareholders. The need for independent directors to meet the requirement that directors place the shareholders' interests ahead of their own is especially important when insiders have a stake in a buyout proposal. Concern about self-interested transactions by management is best met by having a special committee of outside directors as exclusive representatives of shareholder interests act as the decision-making body, with its own investment bankers and lawyers.

Guidelines

The following rules to guide the special committee are taken from the chapter, "On the Block: Management Buyouts and Open Bidding", *Board Games: The Changing Shape of Corporate Power*:

"- Independent Directors. The decision-making process should be guided by directors who have no interest in the buyout proposal and who, to the extent feasible, have no material financial relationship to the company. The decision-making process itself should be calculated to render an informed decision, consistent with the primary objectives of shareholders. Minutes should reflect the nature and scope of its discussions....

- A Fair Price. In determining what is a fair price, a foremost consideration is whether a present sale is opportune — may the company be worth substantially more later? The measure of valuation is also critical. The following factors are usually paramount: the company's value if sold as a going concern to a third party; its liquidation value; its value in a standard leveraged buyout; and its value on a restructured basis....Whenever possible, the committee or its representatives should seek by negotiation to improve the price and other terms of the proposal.

- Feasibility. Will the shareholders actually realize the payoff that a proposal promises? The feasibility of the transaction is affected by the financing, time to consummation, and viability of the surviving entity as a going concern. Whether the company will be undercapitalized or incapable of meeting its contemplated debts as they mature has to be considered.... If it is later proved that there were deficiencies in these respects, unpaid

creditors or a trustee in bankruptcy may seek to recover payments made to shareholders in the transaction...."

The special committee of outside directors acting as the exclusive representatives of shareholder interests in effect becomes the agent of the shareholders and can deter an unfair outcome.

PART THREE
SHAREHOLDER PARTICIPATION IN GOVERNANCE AND CONTROL

1. ACCOUNTABILITY OF BOARDS TO SHAREHOLDERS

Communication Through the Annual Report and the Annual (General) Meeting

The most general means of communication with shareholders is through the annual report. Basically the report includes a message to shareholders on overall performance, specific information profiling the company's objectives for the past year and recent accomplishments, a listing of directors and officers and most importantly, financial statements presenting net sales, net earnings and dividends per common share, accompanied by the auditor's report and a discussion and analysis of the figures.

The report of the independent accountants will state that the financial statements are the responsibility of the company's management and that their responsibility is to express an opinion on these financial statements based on their audits. Generally accepted auditing standards require that the independent accountants plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. The report will state that an audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements and also assessing the accounting principles used and significant estimates made by management.

One criticism of corporate governance in Central and Eastern Europe and the former Soviet republics is the uncertainly of how shareholders meetings should be run. In the U.S. corporations are required to hold annual meetings primarily to elect directors; generally, advance written notice to shareholders, who are

entitled to be represented in person or by proxy, is required. To transact business a quorum, as dictated by the bylaws, must be present and unless there is a greater requirement, action is taken by majority vote.

In order to conduct an orderly meeting, certain simple procedural rules generally are observed. The following pragmatic list from Balotti and Finkelstein's, *Delaware Law of Corporations and Business Organizations*, highlights basic procedures in effect in the U.S. including:

- "The business of the meeting will be taken up as set forth in the Agenda and questions and comments are confined only to that item in the Agenda that is before the meeting for consideration;....
- Questions not related to an Agenda item are discussed during the "Discussion of the Annual Report;"....
- Shareholders should confine comments to one subject at a time to give other shareholders an opportunity to speak on that subject;....
- Shareholders' comments and criticisms are welcome but the purposes of the meeting will be observed. The Chairman will stop discussions that are irrelevant to the business of the company, proposals related to the conduct of the company's ordinary business operations, or comments that in substance repeat statements made by other persons;....
- Nominations from the floor for membership on the Board will only be accepted if the person nominated has consented in writing to the nomination and agreed to serve if elected."

Relationship Investing - Institutional Shareholders as Active Owners

Institutional investors act increasingly as corporate monitors, active owners in contrast to the Berle/Means concept of the inevitable passivity of shareholders based on separation of ownership and control. Professor Michael Jensen in "Corporate Control and the Politics of Finance", *The Journal of Applied Corporate Finance* (1991), defines "active investors" as "one who holds large equity and/or debt positions and actually monitors management, sits on boards, is sometimes involved in dismissing management, is often closely involved in the strategic direction of the company and, on occasion, even manages." This approach gives companies what has been referred to as "patient capital", freeing management to focus on long-term planning and investment in projects that may pay off in the future. U.S. investors are looking to dispel the stigma as traders.

Thomas Wyman, Chairman of S. G. Warburg & Co., Inc., retired Chairman of CBS, Inc. and on the board of General Motors, commenting on his tenure on the General Motors board points to recent shifts in corporate governance. "For years

we were shown many slides at board meetings. We believed in the success of the company. At shareholder meetings, a few individuals challenged the board during that one day. Then the company lost $7 billion. No one drove the Toyotas that did not rattle. The outside directors met alone and changed the course of the company. And now institutional shareholders managing billions of dollars are confronting boards charging: 'You are not making enough money' and they are voting their shares."

In the Czech Republic, the IPFs are well situated to act as corporate monitors, but their incentives to monitor vary widely. According to Professor John Coffee of Columbia Law School writing on IPFs in the Czech Republic (1994), insofar as a major bank may control a large IPF, the goal may be to restrain the pace of restructuring to avoid bankruptcy or increase unemployment, even in light of otherwise more favorable alternatives. The private funds, on the other hand, neither funded nor managed by a large Czech or commercial savings bank, must succeed solely as fund managers. Yet there is uneven performance in their monitoring of companies including accusations of insider trading and self-dealing.

In the United States, under the "Wall Street rule", when shareholders are dissatisfied with management's performance, they sell their stock. As pointed out by Professor Coffee, it would be difficult for the IPFs to operate under the "Wall Street Rule" given the lack of liquidity. In addition, even if IPFs could sell those stocks in their portfolios that were not performing adequately, it could be difficult finding and purchasing better performing stock in sufficient quantity. The trading that does occur is primarily off the market. Generally, trading among IPFs is often with the objective of consolidating the portfolios of each IPF in "swap" transactions in order to entitle the IPF to a seat on the board. Small stakes in other companies are likely to be swapped for positions in companies where the IPF is already a substantial holder. In the short-run the most promising role, in terms of corporate governance in the region as a whole, is for the IPFs to consolidate their holdings and act as active investors, particularly with board representation.

Impact of institutional Investors on Proxy Contests - Armstrong World Industries ("AWI")

In the United States active ownership may culminate in a proxy contest. The proxy contest traditionally has been a means of participating directly in corporate governance through the power of the shareholder vote. In the U.S.,

now that hostile takeovers are no longer popular, there is renewed interest in actively using shareholder voting — proxy fights — as a means of control.

Diverse goals are sought in proxy initiatives or challenges to the board through the voting process. These goals, as reported by the Institutional Voting Research Service in a Client Advisory Letter, dated May 1990 range from:
- acquiring the corporation;
- selling or restructuring the firm;
- replacing the current board of directors with a new board and hence new management;
- monitoring whereby dissidents seek to elect one or several representatives to the board to assess and possibly redirect management strategy. Unlike the first three, these contests involve no transfer of control and no abrupt change in corporate strategy. An outside representative or representatives are placed on the board who can investigate management policies and guard shareholder interests.

The case of AWI illustrates a classic minority board contest. First City Financial Corporation Inc. ("First City") controlled by Samuel, William and Hyman Belzberg, sought to place four outside representatives on AWI's 13 member board. The Belzbergs launched a proxy fight: four directors were up for renomination. The Belzbergs nominated four outstanding people from the business and academic communities.

The Shareholder Committee for Responsible Corporate Governance of Armstrong World Industries, (the "Committee") sent to AWI shareholders a Proxy Statement in Opposition to the Board of Directors of AWI, Annual Meeting of Shareholders, April 30, 1990, proposing the election of the committee's nominees to AWI's board. The objectives of the committee called for the following:
- Maximizing shareholder value;
- Directing the company's resources to focus on its core businesses;
- Paying larger dividends to shareholders;
- Cutting corporate waste by reassessing the company's expenditures;
- Tying management compensation more closely to the price of the company's stock so as to align the interests of management with those or the shareholders whom they serve;
- Improving communication between shareholders and the board by establishing a Shareholder Advisory Committee to more effectively solicit views of shareholders; and

- Reducing barriers to the acquisition of the company in the belief that an efficient market for corporate control promotes better management of a company's business.

The committee's nominees were elected to the board and thereafter worked toward board consensus to realize their objectives.

The proxy contest is illustrative of a useful tool for Central and Eastern Europe and the former Soviet republics of self-enforcement, what Professor Black of Columbia Law School and Professors Kraakman and Hay of Harvard University (1994) describe as the reliance in corporate law on actions and decisions by direct participants rather than on regulators or judges. Though in the U.S. proxy contests also are subject to government regulation, the initiative comes from the "insurgents" — direct participants — often supported by institutional investors as active owners. Insofar as shareholders elect the board to be their representatives, which in turn selects management, the ongoing review process for corporate decision-making is one of representative democracy. The proxy contest provides the opportunity to challenge a board that may have become ineffective in representing shareholder interests.

2. THE MEANING OF CONTROL AND THE MINORITY SHAREHOLDER

Definition of Control - Control is given a specific definition by the ALI, derived in part from the U.S. federal Securities Code and a section of the Investment Company Act of 1940. As stated in Part I, Section I of "Principles of Corporate Governance":

"(a) 'Control' means the power, directly or indirectly, either alone or pursuant to an arrangement or understanding with one or more other persons, to exercise a controlling influence over the management ... of a business organization, through the ownership of or power to vote equity interests, through one or more intermediary persons, by contract, or otherwise.

(b) A person who, either alone or pursuant to an arrangement... with one or more other persons, owns or has the power to vote more than 25% of the equity interests in a business organization is presumed to be in control of the organization, unless some other person... owns or had the power to vote a greater percentage of equity interests."

Squeeze-Out Mergers

A squeeze-out is the use of corporate control to eliminate minority shareholders from the enterprise or otherwise deprive minority shareholders of business income or some other advantage.

Squeeze-out mergers are a 20th century innovation in corporation law permitting the elimination of minority shareholders. The ability to squeeze out minority shareholders in order to obtain 100% of the equity of a corporation is a basic condition of the current market for corporations. Without such a device, acquisitions of the whole equity interest in public companies would usually be impossible and would always be more expensive.

Thus the alternative to permitting a squeeze-out merger would be the unanimous consent of all shareholders or a continuing minority which probably could be reduced over time. Unanimous consent would be difficult to obtain, since shares may be held by incompetents, lost, or held by shareholders not willing to cooperate. Unanimous consent invites oppression by a minority shareholder: the last shareholder to consent could demand and receive an extortionate price for his consent.

Squeeze-out mergers most frequently occur as the second step in a unitary acquisition of a corporation in a takeover. The first step is the acquisition of a controlling block of stock from large shareholders, in open market purchase, or through a tender offer. Squeeze out mergers also are essential for purely "going private" transactions where management insiders or controlling shareholders want to eliminate public shareholders.

Fiduciary Duty Owed Minority Shareholders

It is generally agreed that directors and officers stand in a fiduciary relationship to the corporation. Many modern cases and some statutes in the U.S. acknowledge that this fiduciary duty is owed to minority shareholders as well as to the corporation, particularly in squeeze-out cases. Also there is a growing recognition that controlling shareholders stand in a fiduciary relationship to the corporation and to minority shareholders.

Appraisal Rights in Squeeze-out Mergers - "Fair Price" and Determining Value per Share

The issue of the squeeze-out merger was raised in a leading U.S. case, *Weinberger* v. *UOP, Inc.* (Delaware 1983). The action was brought as a class action on behalf of minority shareholders who received cash in a squeeze-out merger for their shares of UOP, Inc. following the acquisition by Signals Companies, Inc. of 50.5% of UOP's outstanding shares pursuant to an agreement with UOP concluded a few years before the squeeze-out merger. The purchase price at that time was $21 per share paid in cash - a 50% premium over the $14 per share price at which UOP's common stock had been trading on the New York Stock Exchange immediately before the announcement of the transaction.

A few years later, Signal eliminated the UOP public minority in a cash squeeze-out merger, also at $21 per share, the subject of the case. The facts were as follows:

- The closing price of UOP's common stock on the day of the merger was announced at $14.50 per share.
- The UOP board obtained an opinion from Lehman Brothers (investment bankers) that the $21 per share price was a fair price for minority shareholders. The fairness opinion, common in going-private transactions, is obtained for several reasons: to gather expert information about fairness; to protect majority shareholders and directors legally; and to enlist director and minority shareholder support for the transaction.
- Signal management had made a feasibility study concerning the possible acquisition of the balance of UOP's outstanding shares. The study concluded that it would be a good investment for Signal to acquire these shares at "any price up to $24 each." This fact was not disclosed to the independent board members of UOP or to the minority shareholders in the proxy statement for approval of the merger.

The complaint alleged that the squeeze-out transaction was unfair to UOP minority, claiming the stock was worth $26 at the time minority shareholders approved the merger. The $26 figure was based on a comparative analysis of premiums paid over market prices in 10 other tender offer-merger combinations and the projected cash flow for several years.

On appeal the Delaware court held: In the future, the appraisal remedy set forth in Delaware Corporation Law would be the exclusive remedy available to shareholders in squeeze-out mergers, with certain limited exceptions involving fraud or breach of fiduciary duty. Under Delaware law minority shareholders in a merger are entitled to a fair price for their shares, neither less nor more.

Minority shareholders are not entitled to negotiate for a top price with the power to stop the merger. (The issue was settled years back when Delaware eliminated the requirement of unanimous consent for mergers.) Courts could consider proof of value by any method generally considered acceptable in the financial community. Evidence could be considered of premiums paid in comparable tender offer and merger cases and discounted cash-flow data.

The Court held that fairness in a squeeze-out merger requires a fair price and fair dealing. The failure to disclose the top price undermined fair dealing.

3. PROTECTING AGAINST OPPRESSION OF MINORITY SHAREHOLDERS BY MAJORITY OR CONTROLLING SHAREHOLDERS

High Vote for Shareholder Action

The most effective way of protecting a minority shareholder against a squeeze-out is to include in the charter (or bylaws) a provision requiring a high vote for shareholder and director action. The high vote requirement gives a minority shareholder a veto over corporate decisions. For example, if a favorable vote of holders of 85% of the shares outstanding is required for shareholder action, a person or group holding 20% can prevent shareholder approval of any objectionable resolution.

Under modern U.S. corporation statutes, shareholder approval is required for fundamental corporate acts. Statutes in about half the states in the U.S. require a supermajority vote (two-thirds) of all shares entitled to vote for approval of fundamental corporate changes such as mergers, consolidations, sale of substantially all the corporate assets or voluntary dissolution. In other states these changes require approval of holders of only a simple majority of shares entitled to vote.

Almost all states permit a corporation, by amendment of its charter, to increase the vote otherwise required for shareholder action. Regardless of whether a state statute fixes a two-thirds vote or a simple majority vote, a corporation’s charter can specify, e.g. an 80% vote and thus give a veto to any shareholders holding more than 20% of the corporation’s stock.

Supermajority Voting Requirements to Fend Off Hostile Tender Offers

Supermajority voting requirements were popular in publicly held corporations in the U.S. (particularly in the 1980s) whose managements were seeking to fend off hostile tender offers. These measures are often directed at two-step tender offers. The bidder makes a tender offer for a controlling block (but less than all) of a company's shares. The bidder then uses its newly acquired majority position to implement a fundamental corporate change, such as a merger, which will force out minority shareholders on terms that may be considerably less favorable than the per share price paid in the tender offer.

To block this type of takeover, a supermajority requirement for shareholder action is combined with a "fair price" provision. e.g. a corporation's charter may require that a merger must receive the approval of a supermajority of shareholders (sometimes 80% or higher), unless the merger gains the approval of independent board members or provides shareholders a "fair price." The term is defined as providing so generous a price that the bidder either drops the two-step acquisition or negotiates with the corporation's board of directors.

Preventing Amendment of the Corporation's Charter

If high vote requirements are placed in the corporation's charter (or bylaws), the corporation must prevent amendment of the charter or bylaws to reduce the required vote. Clauses designed to safeguard minority shareholders' rights must be "back-stopped" by high vote requirements for charter (and bylaw) amendment or some other device to prevent majority shareholders from first removing the protective clauses from the charter (and bylaws) and then squeezing-out the minority.

Inserting Voting Requirements in the Corporation's Charter

Given the rationale that articles of incorporation are publicly available to original and subsequent investors, as well as others doing business with the corporation, certain U.S. state corporation statutes mandate that, to be valid, high vote requirements must be inserted in the corporation's charter, e.g. New York State - NY Bus Corp Law secs. 616(a)(2), 709(a)(2). Bylaws, on the other hand, are adopted and changed by the board of directors without prior notice to or participation by the shareholders.

Criticism: Blocking Changes in Control

Critics argue that high vote requirements for shareholder action on mergers and other fundamental corporate actions discourage hostile takeover attempts. Thus instead of providing protection for the minority and other non-management shareholders, high vote requirements may be disadvantageous to them if they want to dispose of their shares at the highest possible price.

An Efficient Market Economy - Free Choice by Participants

Many U.S. economists and lawyers believe that corporations and their shareholders benefit from flexible corporation laws that leave the maximum amount of discretion to the draftsmen of corporation charters and bylaws. They argue that corporations should be permitted to eliminate the concept of a statutory or court-imposed right to fairness for minority in squeeze-out transactions if the corporation so chooses. Instead these corporations should be allowed to specify in their charters rules that should govern minority rights in squeeze-out transactions. In the words of Judge Ralph Winter of the U.S. Court of Appeals, "free choice by participants is the fundamental axiom of an efficient market economy."

On the other hand, corporate laws in transition economies, as argued by Black, Kraakman and Hay (1994), based on mandatory self-enforced, relatively simple rules could protect minority shareholders against opportunism of controlling insiders by requiring a supermajority shareholder vote for a wider range of important business decisions than in U.S. statutes. These would include for example decisions to issue significant amounts of new equity or for the purchase of major assets.

Moreover, shareholder voting should be combined with a mandate that a certain proportion of the directors on company boards be independent. Approval of decisions where there are conflicts of interest, as in management buyouts, would be vested exclusively in their hands and made subject to maximum disclosure. The shift toward enabling laws could proceed over time with the emergence of effective capital markets founded on adequate disclosure and the decisions of sophisticated investors.

CONCLUSION

Perhaps there will be two stages in the evolution of corporate governance in Central and Eastern Europe and the former Soviet republics. Stage one involves the present restructuring by management in the absence of disclosure. Ideally stage two would driven by principles of accountability to all shareholders and full disclosure guiding free choice in the restructuring process. Recognition and enforcement of these principles will benefit a market economy linked with an integrated Europe. Quoting Harvard University economist, Professor Jeffrey Sachs, from an article appearing in *The Wall Street Journal*: "'We are in the midst of one of history's greatest expansions of market capitalism.'" One way to hasten the integration of Central and Eastern Europe and the former Soviet republics into the European Union and global capital markets, and to reduce the costs of capital and increase its availability, is to base corporate governance on principles of adequate disclosure and accountability to shareholders. Only then can the region foster confidence in capitalism and in the privatized firm. To ignore these issues is to impair the basis of the large corporate enterprise and market capitalism as we know it today.

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