

SUMMARY OF KEY ARTICLES BY PROFESSOR REINIER KRAAKMAN

Reinier Kraakman is a professor of corporate and company law at Harvard Law School. He was involved in the Company Law in Russia and the Enterprise Law in Vietnam. This summary provides the main structure of two recent articles (written with co-authors). One, from the Stanford Law Review, July 2000, is "Russian Privatization and Corporate Governance: What Went Wrong?". The Second is from the Georgetown Law Journal, January 2001, "The End of History for Corporate Law".

Russian Privatization: What Went Wrong?

In Russia and elsewhere, proponents of rapid, mass privatization of state-owned enterprises (ourselves among them) hoped that profit incentives unleashed by privatization would soon revive faltering, centrally planned economies. In Russia, this revival did not happen. We offer here some partial explanations.

First, mass privatization is likely to lead to massive self-dealing by managers and controlling shareholders unless (implausibly in the initial transition from central planning to markets) a country has a good infrastructure for controlling self-dealing. Russia accelerated self-dealing process by selling control of its largest enterprises to crooks, who transferred their skimming talents to the enterprises they acquired and used their wealth to further corrupt the government and block reforms that might constrain their actions.

Second, profit incentives to restructure privatized businesses and create new ones can be swamped by the burden on business imposed by a combination of (among other things) a punitive tax system, official corruption, organized crime, and an unfriendly bureaucracy. Third, while self-dealing will still occur if state enterprises are not privatized, since self-dealing accompanies privatization, it politically discredits privatization as a reform strategy, and can under-cut longer-term reforms. A principal lesson: developing the institutions to control self-dealing is central to a successful privatization of large firms. In other words, the quality of government, accounting, and law enforcement has a major influence on the success of economic laws and policies. Initial conditions (i.e. institutional quality) matters more and privatization per-se matters less than thought in 1990. Economic revolutions tat destroy existing

institutions before new ones can be built are likely to run into trouble, as those without scruples can take advantage of the resulting institutional vacuum.

The End of History for Corporate Law

This article argues that in the 150 years since public corporations that were not royal monopolies were developed, there have been several major types of corporate governance. The key aspects of a corporation were: (a) it was a legal “person” or entity that could enter into contracts; (b) there was limited liability for owners and managers; (c) it was shared ownership by owners of capital; (d) management was delegated under a board of directors and (e) shares were traded and transferable. Even with these similarities, there were variations on the basis or standard model that stipulated that the corporations was to be run by managers for the benefit of its shareholders.

The alternatives to shareholder-control have been:

1. Control by Corporate Managers (Some large firms in Holland, 50's US)
2. Control or Influence by Labor (Germany)
3. Control or Influence by the State (Japan, Korea, France)

The article argues that all three alternatives have lost their attraction in rich economies. The point is not that corporations should serve shareholders instead of society. It is that the corporations' best contribution to the overall society is achieved by making corporate managers strongly accountable to shareholders rather than labor, government, or even themselves. Nor does this view suggest that workers, pensioners, consumers or the environment should be ignored by the law or the corporation. Rather, the key insight is that it is easier to protect the legitimate rights if others can be handled outside of corporate law. Creditors are a special group in that their interests are partially within corporate law, but mainly in bankruptcy law rather than normal governance. It is also necessary to treat all shareholders alike so that non-controlling shareholders are not abused by insiders.

The manager-oriented model argues that professional managers would best serve as technocratic guardians or fiduciaries if given wide discretion. The collapse of

conglomerates in the 1970's and 1980's largely destroyed the attractiveness of this argument.

The state-oriented model has many levers of control that lie outside of corporate law, but corporate law plays a role by weakening shareholders rights. The main levers of control, such as bureaucratic discretion in granting loans, licences, foreign exchange, or other legal benefits have been discredited as too costly, inefficient, and corrupt-friendly. The historical record with Thatcher, Mitterand, the collapse of the Soviet Union, and the decade-long stagnation in Japan have all undermined the appeal of this model.

The reasons why the standard model is now so widely preferred are several:

Logic shows that the shareholder rights are harder to protect than others, so giving them control is necessary to protect their rights. Having rights, they have a reason and a way to make the firm create more value than others do.

Experience has shown that companies run along these lines are more successful. In lists of major global corporations, about 70% are run along US/UK shareholder lines, and many of those in Europe or Japan are moving in that direction.

Competition, especially in new firms or in new product markets, has tended to reveal an advantage to shareholder firms. In large, established markets other models may have an advantage for some period because they over-invest and accept low returns.

In rich countries, the wide diffusion of equity ownership has created a broad economic and political class supporting their interests.

Although there are questions concerning the speed of convergence, accounting standards, insider self-dealing, or empire building, and related issues, they are not serious. Badly run firms tend to be undervalued relative to their assets and potential profitability. Some group (even insiders) are likely to buy up the poorly-run firm and run it better - in the interest of the new shareholders.

The prediction is that the shareholder model will continue to become as dominant in Europe and developed Asia as it is in North America.