Property Rights in Context: Privatization's Legacy for Corporate Legality in Poland and Russia

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More than a decade after the collapse of state socialism in the East Bloc, the region displays many striking and intriguing contrasts in national trajectories. This paper focuses on one such contrast: the remarkable distinctions between Poland and Russia in the area of corporate governance. In the 1990's Russia's corporate governance became notoriously conflictual. In any number of privatized firms, management refused to share power and profits with shareholders, sometimes via flouting the law, at other times by simply manipulating it. Legal experts asked "what went wrong" and sought "corporate governance lessons from Russian enterprise fiascoes."[1] The state of corporate legality in Poland, by contrast, drew far more flattering academic depictions.[2] Practitioners shared academics' impressions. Surveys by the EBRD, as well as other systematic cross-country comparisons, generally rated Poland far above Russia in terms of the effectiveness of its commercial and corporate law.[3] The enormous, almost laughable gap in what constituted major corporate governance scandals in each country is a telling indicator of the same divergence. In Poland, one large firm set off a firestorm of investor criticism for failing to disclose it had given another firm an option to buy shares in an attractive telecom assets at a low price.[4] A firm in which this was the most serious governance problem would have been a paragon of good corporate behavior in the Russian market of the 1990's. For many Russian outsider shareholders, discussing the quality of disclosure would have been a

[1] Black, Kraakman, and Tarassova 2000; Fox and Heller 2000.
[2] For instance, Glaeser, Johnson, and Shleifer 2001
[3] Pistor, Raiser, and Gelfer 2000.
[4] Piotrowicz 1998.

luxury: they were more concerned whether they would in fact be allowed to attend shareholders' meetings.[5]

These contrasts, I argue below, resulted from the way privatization structured relations among shareholders in privatized firms, and relations between these shareholders and stakeholders in the privatized firms (i.e., managers, employees, suppliers, and customers).[6] In Russia, privatization was carried out in a way that strongly discouraged negotiation both among stakeholders and among potential shareholders of the corporations created from them. Division of property thus became a zero-sum game, with large rewards for displacing other claimants. These large rewards led to frequent contestation of the property rights granted by corporate shares. In Poland, by contrast, privatization and the transition to corporate form generally could occur only after potential shareholders and stakeholders had reached a bargained agreement. The allocation of property rights was part and parcel of a larger accommodation about the future of the firm—a positive-sum game, and one in which contesting property rights would risk the gains from cooperation.[7] Thus, in Poland the form of privatization ensured that those in a position to challenge shareholders'

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[5] Black, Kraakman, and Tarassova 2000, 1771; Sprenger 2000.

[6] For a different perspective on how privatization strategies in the two countries affected property rights, see Goldman 1999.

[7] This argument is influenced especially by Spicer, Kogut, and McDermott 2000; Kogut and Spicer 2002; {McDermott, 2004 #1232}; and Ellerman 2001. Polish privatization involved a number of variants capable of encompassing the specifics of these accommodations. unlike Russia which practiced something very much like "institutional monoculture" in its privatization format. On "institutional monoculture" see Evans' contribution to this symposium. Compare also the discussion of the difficulties of formalizing property rights in Scott 1998.

property rights were embedded in relationships that encouraged them not to do so.[8] In Russia, the form of privatization made such accommodations impossible, and set the stage for intense and long-running struggles over property rights.[9]

Thus, this article offers contrasts in how privatization embedded property rights as an answer to the empirical puzzle of contrasting corporate governance experiences in Poland and Russia. The theoretical significance of this argument is the evidence it provides for an "economic sociology of law" (ESOL) approach to the legal grounding of property rights. As Richard Swedberg notes, "From a sociological perspective it is ... obvious that many factors other than the law determine why people engage in the behavior prescribed by the law. The extent to which it is the law, rather than some other factor that determines the behavior in question, has therefore to be decided in each particular case."[10] The ESOL resonates with several other schools of thought that likewise direct attention to the interests, resources, and options that affect actors' decisions to invoke, obey, or manipulate law. Thus one might also term this an "old institutional economics," "legal realist," or "critical legal studies" approach to law.[11]

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[8] I use "embedded" in the sense of Granovetter 1985 and Somers 1993.

[9] There is something of a consensus linking conflictual Russian corporate governance to the form of privatization. Black, Kraakman, and Tarassova 2000; Fox and Heller 2000; Pistor 1997; Shleifer and Treisman 2000; Spicer, Kogut, and McDermott 2000. Where the present article differs is in its focus on identifying a configuration of factors that made property rights subject to contention, rather than presuming Russian managers' propensity to steal as a given inevitably requiring enforcement.

[10] Swedberg 2003, 8.

[11] For a classic text of the "old institutional economics" that makes these points see Commons 1957. "Old institutional economics" was closely allied with the school of "legal realism" within studies of the law Fried 1998, and the arguments of both schools have more recently been taken up in the Critical Legal Studies movement Kennedy

Scholars in these traditions recognize that law operates in a dual context: in a context of legal facts (e.g,, who owns what) and of contextual factors (what other relations, options, and interests owners have).[12] For instance, the attitude of managers to shareholders' rights will depend not only on the laws governing these rights, but also on the legal facts of stock ownership and such sociological factors as where the firm intends to acquire capital or with whom it needs to cooperate.[13] These points about the importance of context enable a thoroughgoing challenge to various new-institutionalist arguments that link security of property rights primarily to the commitment and capacity of state bodies to enforce them, to the normative legitimacy of the law, or to coordination equilibria in a game-theoretic framework. The ESOL argument also enables a clarification of the politics of corporate property rights that strengthens the case made by historical institutionalists for an understanding of institutions as imperfectly self-contained processes unfolding over time.[14]

However, discussion of implications for politics and other institutionalist approaches will be postponed to the conclusion. The body of the paper first explicates on a general level how the intersection of legal facts, contextual factors, and laws on the books shapes the practical effects of law. I also argue that certain combinations of these factors are unstable even given powerful enforcement commitments, prompting

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1993. For Swedberg's approach, which draws parallel ideas from Weber, see Swedberg 2003.

[12] Commons 1957, 65-67.

[13] Rapaczynski 1996. Or, in another example, as Granovetter notes, firms may decline to enforce contracts against partners whose future cooperation they need Granovetter 1985.

[14] Thelen 1999, 383-384.

evolution in legal facts or contextual factors. In the second section, I describe the privatization experiences in the two cases, arguing that unlike Poland's privatization, Russia's established an unsustainable combination of stock ownership patterns (legal facts), interests of and relations between shareholders (contextual facts), and corporate laws.

The third section demonstrates that this unsustainable combination promoted enormous dynamism and conflict in Russian corporate governance. The contentious use of "loopholes" designed to force the transfer of property rights and alter the legal facts had a central role in these conflicts. In Poland, by contrast, the persisting legacy of privatization created far less conflict and corporate property transfers took the more familiar form of voluntary purchase and sale. The conclusion returns to the theoretical implications of these contrasting developments. In particular, it discusses how understanding the context of the legal facts of property changes one's view of the politics surrounding property rights.

I. Contextualizing Property Rights: Legal Facts, Sociological Facts, and Laws

Adopt good laws, and enforce them: such, in a nutshell, is the program of what has been termed the "new" law-and-development movement, which promotes the strengthening of legal institutions as a path to growth.[15] This movement reprises arguments dating at least to the 18th century that link stability of property rights to investment and thence to growth. More recent support for such this position comes from the huge literature in the New Institutional Economics, corporate governance, and related fields. Characteristic of this approach is an emphasis on enforcement. Enforcement should work to cow the shifty, and thereby embolden the thrifty, who invest and trade. Unpunished malfeasance should have the opposite effects.[16] Thus, state capacity to ensure impartial and consistent enforcement of commercial law that underpins the predictability businesses need to invest and promote growth.

These arguments, I argue in this section, may be logically impeccable but they are sociologically naïve. The emphasis on enforcement obscures the crucial question of how hard the state has to work to ensure law-consistent action in the realm of property rights. Are the laws securing property ones people behave consistently with for reasons of their own, or is the threat of enforcement necessary? In discussions in many areas of legal policy, such as those surrounding drug prohibition, this question is manifestly central, and oft-posed. But it has had little impact on discussions of property rights. I argue that when property laws are flouted, or subverted, this does not necessarily imply a "weak state;" it may merely imply an effort to strike an unsustainable balance between legal facts, contextual factors, and the laws on the books.

The starting point for an effort to move beyond an exclusive emphasis on enforcement is Wittgenstein's demonstration that any action is consistent with an arbitrarily large number of rules. For instance, in a stopping at a red light I might be

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[15] Rose 1998. Cf. Messick 1999; Upham 2002. On the older law-and-development movement, which was closely linked to modernization theory, see Tamanaha 1995.

[16] For an example pertaining to Russian corporate governance, see Fox and Heller 2000, 1725.

obeying any of the following rules: (1) always stop at red lights; (2) stop at red lights except when I'm running late; (3) stop at red lights except on January 1st, 2010; (4) stop at red lights when it would be dangerous not to; and so on and so forth.[17] For social scientists this argument contains an important lesson about the rules set out in law: actions consistent with a law need not be motivated by that law—by respect for its provisions or fear of those charged with enforcing it.[18] For instance, when I choose to stop at a red light at a busy intersection, the desire to avoid a crash might loom larger in my considerations than the fear of a traffic fine. Just because I am acting consistently with a legal rule does not mean the law's authority and sanctions played any part in my decision. Thus, one needs to distinguish the broad category of law-consistent action, motivated by anything whatsoever, from its subset, the narrower category of law-motivated action, motivated by the law's authority or sanctions. I refer to the multiple possible motivations underlying law-abiding action as the *potential embeddedness of law*.[19]

The notion of the potential embeddedness of law relativizes the significance of enforcement capacity by emphasizing that fear of legal punishment is only one of the

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[17] Kripke 1982.

[18] For an important discussion of the multiple reasons rules are invoked, on an example of traditional rather than legal rules, see Bourdieu 1977, 33-52. See also Swedberg 2003, 8. Scholars sometimes argue that people's beliefs about the normative validity of law influence laws effectiveness (North 1990, 6; Cooter 1997). However, this modification does nothing to address the distinction between law-consistent and law-abiding behavior. Law is still obeyed because it's the law. Indeed, in Cooter's game-theoretic analysis, normative commitment to the law is modeled as an increase in the payoff to obeying it, which is structurally equivalent to an increase in the cost of enforcement. Thus, there is no contextual "embeddedness" of law-consistent behavior.

[19] Woodruff 2000, 442. Compare Granovetter 1985; Somers 1993.

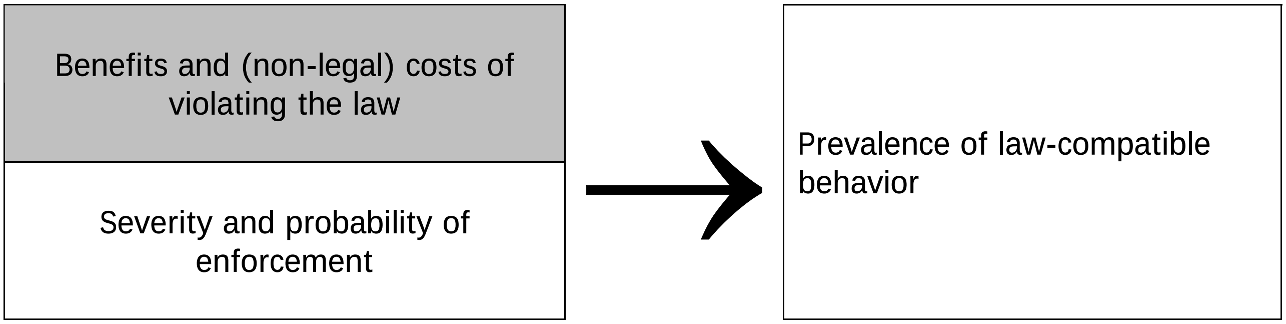
motives that can inspire behavior consistent with law. Many businesspeople refrain from illegal deceit, as a number of scholars have noted, because they desire to reap the rewards of a reputation for fair dealing.[20] More generally, there may be extra-legal costs that deter violations of the law. By the same token, the magnitude of the gains available from violating the law are an obvious stimulation to violate it.[21] Even a small chance of mild punishment might deter a violation that yields little benefit. This point is obvious enough when one compares the prevalence of violation of two different laws in the same jurisdiction. That drivers will exceed the speed limit more readily than they will drive on the wrong side of the road does not primarily reflect the greater severity and probability of legal punishment for the latter. The concept of "state capacity to deter violation of the traffic laws," which superficially seems extremely specific, is actually too general to capture the reasons people obey or violate particular traffic laws.

To speak of a general state capacity to enforce contracts and defend property, without considering the value and context of the rights the state is protecting, is just as senseless as speaking of a state capacity to deter violations of the traffic laws. The argument about how situational incentives (costs and benefits of violating the law in some specific instance) contribute to law-compatible action is expressed in Figure 1.

Figure 1

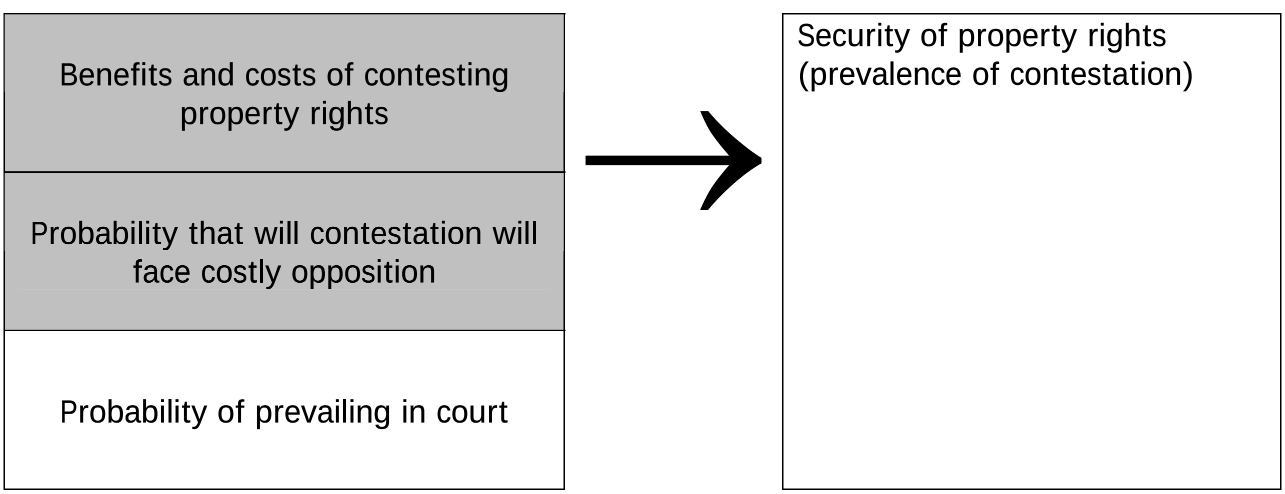
[20] Klein 1997 includes many relevant papers. However, it is still an empirical questions when reputational concerns mandate law-abiding behavior and when they do not. See Sinyagina-Woodruff 2003.

[21] Swedberg 2003, 8, 11. This is a problem with game-theoretic accounts of law-conforming behavior, which seem invariably to model the potential material payoffs to violating the law as the same in all circumstances. See, for instance, Cooter 1997.



Traffic laws, however, are a poor metaphor for the laws securing property rights. Property rights are rights to invoke the state's backing to compel people to behave in certain ways: to pay debts, to allow shareholders to participate in the governance of a corporation, to refrain from trespass, etc. One can violate a traffic law all by oneself, on a deserted road; but property rights are claims people assert against one another. Thus, the relevant decision is whether to contest property rights claimed by someone else, either via litigation or simply by taking actions that negate these claimed rights. It is the chance of having one's way in such a contestation, through prevailing in court or simply by the other side conceding the rights in question, that must be weighed against costs and benefits (see Figure 2).

Figure 2



Probability and severity of legal enforcement against contestation		

A simple state-capacity argument for the prevalence of secure, which is to say uncontested, property rights focuses on laws, courts and enforcement: With clear laws applied evenhandedly and without corruption, those mulling illegitimate contestations will not embark on them, especially if unsuccessful contestations are punished. Again, this superficially plausible argument, presented in the unshaded cells, ignores the value of the property rights that the state is seeking to protect (which affects the issues shown in the shaded cells). Just as law-compatible action stems from the joint effect of enforcement and extra-enforcement considerations, the failure to contest property rights (allowing them to be secure) stems from the joint effect of legal and extra-legal considerations. Were I to form a corporation tomorrow to capitalize on the commercial implications of my social scientific research, I doubtless could be sure that no one would contest my ownership of this corporation, even if the legal system's ability to defend property was notoriously weak: why steal something of such risible value?

Establishing that the security of claimed property rights (i.e., how broadly they are accepted) is a product of situational considerations still leaves open the question of how best to describe these situational considerations. As suggested earlier, these are usefully divided into three parts: laws on the books, legal facts, and contextual factors. The latter two categories require some explication. By *legal facts* I mean the set of facts about the world relevant to the implementation of laws. For instance, while the law might state that contracts will be enforced, that any two particular parties had signed a contract with particular provisions would be a legal fact. *Contextual factors* are those that shape the costs and benefits of accepting a given set of legal facts and their law-driven consequences in a particular context. These costs and benefits will have multiple sources. Some are purely sociological: what relationships will be hurt or helped by accepting or challenging particular claims of property rights?[22] Some are transparently material: what are the costs of contesting claimed property rights, and what are the potential payoffs?[23] Others are determined by situational bargaining power: are there alternatives to remaining exposed to the power of others' property rights, and how attractive are these alternatives?[24]

A single legal provision can intersect with any number of configurations of legal facts and contextual factors. The laws says debts must be repaid, but one creditor might take a harsh line with deadbeat debtors due to pressing obligations, where another will forbear in expectation of an economic upturn. To take an example closer to present concerns, many have argued that managers who hold stock themselves will be more respectful of shareholder property rights. In short, when one observes that property rights are rarely challenged, this is not necessarily testimony to the authority of the law and the impartiality and power of its enforcers. It could equally reflect a configuration of legal facts and contextual factors that make challenging property rights unattractive. By the same token, prevalent challenges to property rights do not

[22] Granovetter 1985.
[23] Cf. Swedberg 2003, 2, 8.

necessarily reflect corrupt and ineffectual authorities defending illegitimate laws: *a priori*, there is no reason not to seek the explanation in a lack of property-supporting embedded relationships or in high payoffs to successfully contesting property rights. Indeed, as I will argue below, just these factors explained the conflicts surrounding Russian corporate governance over the last decade, as well as their dynamism.

An implication: paths of change and loci of conflict

Before turning to the case material, it is helpful to explore the implications of the argument that law-consistent action derives from a configuration of legal and situational factors for institutional change. When a table wobbles, one can stabilize it by making one leg longer or the other three shorter. Likewise, if it is a configuration of elements that renders property rights unstable, there should be multiple paths to stability. Change in the laws and their enforcement is only one possible path—and for actors pursuing their advantage in local contexts, sometimes a rather distant one. This is especially so in a civil-law system like Russia's, where courts have limited authority to extend or modify laws through precedents, making rules harder to change. By contrast, changes in legal facts or contextual factors do not require moving the massive machinery of the nation-state.[25]

Highlighting struggles over the definition of legal facts as a route to institutional change is one of the ways that an economic sociology of law improves on an

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[24] This last point is especially central to the OIE-Legal Realist-Critical Legal Studies line of thinking Commons 1957, 65; Hale 1952; Kennedy 1993, 87.

[25] Kennedy 1993, 93 notes that legal tactics "are constantly invented by smart people looking for ways to modify the balance of power without a change in the intractable, large, general determinants of strength."

enforcement-centered view of property rights. When actors pursue their interests through struggle over the definition of the legal facts, legal rules can become a factor of uncertainty rather than certainty. This so because actors will canvass the massive body of the law seeking rules that give the substantive changes in the legal facts they need, whatever the implicit or explicit reasoning behind the rule. A brief exposition of this argument, adapted from Karl Llewellyn (a central figure in legal realism), illustrates the kinds of frictions likely to arise when actors find powerful material or contextual reasons to challenge legal facts.[26]

Llewellyn argues that statutes implicitly or explicitly depict “situation-types” involving a specification of relevant actors and their motives.[27] In considering whether a given situation ought to be brought under a legal provision, judges weigh how adequately the provision depicts the motivations of the actors involved. When the motivations implied in legislation fail to match those operative in practice, judges often experience the outcome of applying the provision as unjust. In Weberian terms, formal rationality gives an unwelcome substantive result; Llewellyn describes this as a violation of the “fireside equities,” i.e., of the judge’s intuition for what a fair decision would be.[28]

Llewellyn’s discussion of the abuse of legal remedies for failure of a shipment of goods to conform to specification provides an example. The situation-type (recall that this refers to relevant actors and their motivations for invoking a law) is one where a

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[26] The account that follows is thoroughly influenced by Stinchcombe 2001, 76-99, which gives a pellucid reading of Llewellyn 1960.

[27] I have not been able to locate a precise definition of situation-type in Llewellyn; my definition as “actors and motives” is abstracted from his uses of the term on 212, 271-272, 426-428 and elsewhere.

buyer and a seller have agreed to a transaction where the seller undertakes to deliver goods of a specified quality and the buyer agrees to pay a definite price. The law makes provision for the buyer to refuse delivery when the goods are not as promised. Refusal of delivery is allowed in order that buyers may be confident they will get what they pay for. However, courts saw a number of cases in which buyers chose to claim that goods did not conform to quality for a different reason: the price of the goods in question had gone down. Thus, actors reacted to a change in contextual factors (the price of goods) by contesting legal facts (the quality of the goods).

Because the law offered no straightforward way to disallow non-acceptance of goods on such motivations, judges sought other, technical grounds to disallow them (in Llewellyn's phrasing, judges were "trump[ing] the sharper's ace" by invoking a legal rule irrelevant to their real concerns, just as the buyers were).[29] Fireside equities were driving decisions. As an appeals-court judge noted, "it would seem at least possible that [the decisions in lower courts on such a case] were influenced not a little by their natural desire to prevent purchasers on a rapidly falling market from escaping from a bad bargain, by taking advantage of a variation from the terms for which they in fact cared nothing."[30]

This example illustrates nicely how when applying a legal rule to a situation, one is also offering a depiction of the motivations of the parties that may or may not be accurate. When a rule is invoked for reasons other than the motivations implicitly or

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[28] Llewellyn 1960, 274.
[29] Llewellyn 1960, 123.
[30] Quoted in Llewellyn 1960, 123n158.

explicitly embodied in it, we may term the rule a "loophole" or "technicality." In the sort of cases just discussed, buyers were exploiting non-conformance to the agreed terms as a loophole to avoid their agreed-upon obligations. Judges sought other loopholes to force them to uphold these obligations.[31] The search for loopholes undermines the predictability of laws: because this search may conceivably involve a huge body of rules, it becomes difficult to predict which rules will be relevant.

Legal development does not necessarily get bogged down in an endless hunt for rules that adventitiously justify particular substantive outcomes in particular cases. When situations repeat, sometimes it is possible to find, or create, a single rule that consistently gives the desired substantive outcome in a situation-*type*, rather than just a particular case. Llewellyn even asserts that situation-types generally imply some "immanent law" or "singing rule" with these features, a rule which talented judges can uncover.[32] Such loophole-closing does increase legal certainty, by fitting rules to the circumstances in which they are invoked, and producing substantive results that accord with most judges' sense of the fireside equities. As Stinchcombe's reading suggests, an indicator that legal certainty (or "reasonable regularity," the phrase Llewellyn prefers) has been achieved is that "hard cases" stop reaching the stage of appeals, since what

[31] Compare Llewellyn 1960, 274 on "bad law."

[32] Llewellyn 1960, 122. This process requires that judges have substantial flexibility in deducing decisions from extant law. That they do is a key legal realist argument; Llewellyn 1960, 129, cf. 75-76 argues that judges regularly have a "choice among [a] plethora of correct doctrinal possibilities."

generates appeals are precisely those cases in which the desire of judges for a substantive outcome has to be backed up by vulnerable legal reasoning.[33]

In the example considered above, Llewellyn does not say how, or whether, judges came up with a rule that made it clear that buyers could not use nonconforming goods as an excuse to return to the market for a better price, but this would have been the final stage in his process. Stinchcombe terms the process of forging rules that give substantively desirable results in classes of cases a “trajectory of improvement.” The intellectual possibility for such a trajectory—leaving aside all practical matters—depends on the recognizing that particular loopholes are being invoked on similar motivations in similar situations. Thus, stability in the workings of a legal rule depends on regularity in the sort of situation in which it is applied, regularity in terms of the motivations of the parties. *By itself* a rule on what allows a buyer to reject a seller’s shipment as not up to snuff does not create predictability for the seller—if the market situation determines how intensively the buyer will look for grounds for rejection, or the kinds of remedies the buyer will seek. How much certainty the rule gives depends on how stable the market situation is, and how well the law is able to recognize and sanction efforts to exploit a technicality for commercial advantage. In some circumstances—such as purchases of unique goods not elsewhere available—the rule’s predictability might well be completely adequate.

Thus, the trajectory of improvement argument reflects the ESOL approach by recognizing the interplay between legal facts and contextual factors in determining the

[33] Stinchcombe 2001, 80, 95.

significance and effectiveness of legal rules. The need for a trajectory of improvement stems from the fact that enforcement of rules uncovered in a search for loopholes and technicalities may *decrease* the predictability of law and thereby the security of property rights. This facially paradoxical conclusion illustrates how radically the ESOL approach enforcement-centered, state capacity view. One cannot focus solely on the resources for law enforcement when actors are actively seeking to turn the law against itself. In other words, law can not only be violated: it can also be made vague.[34] The Llewellyn-Stinchcombe argument thus provides a useful indicator for distinguishing between corporate governance conflict traceable primarily to weak enforcement and that stemming primarily from an unsustainable configuration of legal and contextual factors. In the latter case, much of the conflict ought to center around the use of loopholes, and development will take not the form of improvement in enforcement, but of modifications in rules. Below, I demonstrate that corporate governance practice in Russia had these features. First, though, I turn to the privatization policies that gave rise to them.

Privatization in Poland and Russia

If we take the overwhelmingly shared impression that legal certainty of shareholder rights in Poland has been far greater than that in Russia as accurate, the forgoing suggests we look to the different contexts in which shareholder property rights

[34] This in and of itself is a challenge to any game-theoretic understanding of law (e.g. Cooter 1997), which requires that actions be definitively legal or illegal.

were exercised to explain why.[35] The privatization programs in Russia and Poland "embedded" the corporate law governing privatized enterprises differently, an outcome that reflects distinctions in how these programs reacted to the existing relational context of state-owned enterprises. The programs had different ways of addressing the interests of stakeholders: those in existing, ongoing relationships to the enterprises subject to privatization, for whom these relationships constituted a form of property or investment which they wished to preserve. In Poland, the dominant forms of privatization allowed stakeholders to achieve negotiated, locally appropriate recognition of their stakes as part of the privatization process. Importantly, these negotiations involved structuring the relational context in which the post-privatization property rights would operate.[36] Russia's privatization employed the shortcut of converting stakeholders to stockholders according to standardized procedures. The allocation of property rights to stakeholders thus was detached from discussion of the substantive character of their relations, and indeed promoted fragmentation of these relations.[37] At the same time, Russia's privatization offered outsiders a share of ownership in privatized enterprises, without providing for (indeed, discouraging) pre-privatization negotiation between outsiders and insiders. The upshot was an allocation of property rights carried out without a simultaneous restructuring of relational context. This

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[35] For documentation on the Poland-Russian contrast, see the first paragraph of this article.

[36] For important insights on this point, in the context of a discussion of implications for entrepreneurship and restructuring, see Spicer, Kogut, and McDermott 2000.

[37] Cf. the contrast between Poland and the Czech Republic in Spicer, Kogut, and McDermott 2000 and McDermott 2001.

disjuncture created, for reasons explained below, massive incentives to contest the legal events possession of corporate stock authorized.

For these arguments, I offer two sorts of evidence. First, I describe the course of privatization in Poland and Russia, demonstrating that the ability of stakeholders to achieve negotiated, locally appropriate legal recognition of their stakes existed in Poland, but was absent in Russia. Second, I demonstrate that the pattern of conflicts over property rights and the evolution of the legal situation in Russia are consistent with a poor match between the laws relevant to stockholder property and the practical situations in which it was embedded, distortions created by the form of privatization. All evidence, including the pattern of legal change, indicates that such conflicts were far more infrequent in Poland. Most dramatically, the form of corporate acquisitions differed drastically between the two countries. In Poland, corporate acquisitions took the form of negotiated purchases of shares. In Russia, however, corporate acquisitions, with great regularity, involved intense conflict in the legal arena and around it.

On the eve of privatization, it would have been hard to predict that privatized enterprises would have such distinct relationships to the law in the two countries. In both Poland and Russia, crucial choices regarding the form of privatization were made in an extraordinarily difficult economic atmosphere in which the state seemed to have little real control over the enterprises it nominally owned. Reforms in the 1980’s had destroyed what coherence the planned economy had attained, leading to a loss of both macroeconomic and microeconomic control mechanisms. The macroeconomic context involved roaring inflation, fed in part by a disorganized banking system in unsteady transition from its status as an organ of accounting and planning under the command economy. On the microeconomic level, in both countries, industrial enterprise insiders—workers and managers—had gained substantial autonomy from higher-level planning and management agencies. This autonomy was regularly used for what has been termed “nomenklatura” or “spontaneous” privatization, in which state managers transferred assets and cash-flows to new legal entities. An effective summary of the situation was that the state “did not really own the assets it needed to privatize” and “various ‘stakeholders,’ including the managers, the employees, and the local governments, exercised substantial control over the allegedly public assets and could stop privatization if they wanted to.” [38]

What differentiates the two cases is the *reaction* to these circumstances of macroeconomic and microeconomic disarray by the liberals in charge of economic policy at the transition’s outset. Roughly speaking, Polish reformers focused more on the macroeconomy, and found themselves in a long political stalemate over privatization to restore microeconomic control. Privatization went forward slowly, effectively on a case-by-case basis, with stakeholders granted a de facto veto over how privatization occurred. Veto rights were not property rights, however: reformers were not willing to “to support preferential privatization to … inside groups associated with the Communist regime.”[39]

[38] These quotations, referring to Russia, are drawn from Boycko, Shleifer, and Vishny 1995, 13; for similar pictures see Clarke and Kabalina 1995; McFaul 1995; Radygin 1995. On the parallel situation in Poland, see Orenstein 2001; Levitas 1994.

[39] Orenstein 2001, ?.

Russian reformers, quite aware of the Polish impasse on privatization, made the opposite choice.[40] When plans to privatize without insider preferences met political opposition, reformers created a program that would neutralize the resistance of stakeholders by turning them into stockholders. Even with outsiders excluded, they argued, stockholders would have an interest in maximizing the value of their property, which would manifest itself in firm restructuring and political support for capitalism. Fast privatization would also help make the end of the planned economy irreversible.

Privatization in Russia

Russian politicians, with the aid of outside advisors sophisticated in economics, designed the country's rapid and comprehensive initial wave of privatization (1992-1994) with several aims in mind. First, they felt that enterprises' managements were engaged in destructive asset-stripping, and wanted to forestall this by giving managers some *de jure* control, so that there would be an incentive for enterprise adjustment. Second, they wanted to offer incentives to "stakeholders" within the enterprise to support privatization, or at least not oppose it, by giving them privileged access to shares. Third, reformers hoped that despite the imperfections of economic legislation and the weakness of its enforcement, the new group of private property owners would become a constituency for property rights, pushing the state to strengthen them.[41]

[40] At the time Russia's privatization program was being designed, conventional wisdom was the Czechs' voucher privatization had successfully avoided the privatization stalemate dogging Poland. For the Russian reformers' close attention to the Eastern European experience, see: Rosett and Liesman 1995; Anonymous 1992; Boycko, Shleifer, and Vishny 1995, 83.

[41] Boycko, Shleifer, and Vishny 1995.

They did all they could to make privatization a rapid process. Once the privatization law was passed in the summer of 1992, presidential orders soon followed implementing the distribution of vouchers for use at auctions of property, and mandating legal transformation of enterprises into corporations. Over 22,000 enterprises were registered as corporations by June 1994; of these, nearly 15,800 had been privatized.[42]

Russia's privatization law offered three options for privatization, each of which gave insiders what have been called "colossal" benefits, but no detailed say over the shape of the process.[43] The most popular option, chosen in 73% of cases, was "Option 2." This allowed workers and managers to purchase 51% of the shares, at 1.7 times their largely meaningless "book value," determined mechanically by reference to Soviet-era nominal values. In another 25% of cases, "Option 1" was chosen; this option gave 25% of the stock as nonvoting shares to the workers, with another 10% available at around a third less than the book value.[44] Internal distributions of shares were also conducted as voucher auctions. Thus, the distribution of shares among stakeholders reflected not the substantive character of their stakes, but the number of vouchers they could mobilize. Since insider stakeholders in these auctions were competing with one another for a fixed number of shares, explicit negotiations that would link shareholding to the nature of stakes were practically out of the question. Naturally enough,

[42] Boycko, Shleifer, and Vishny 1995, 98, 106.
[43] Radygin 1995, 43;
[44] Boycko, Shleifer, and Vishny 1995, 75, 78; Radygin 1995, 39.

managers' control over firm cash flows gave managers excellent chances in these internal auctions.

Having chosen to give controlling blocks of stock to insiders they felt were extremely unlikely to do a good job of restructuring, the privatizers focused on making sure that shares could be traded after privatization, and opening the road to at least some outsiders. Where Polish insiders that had privatized their firms through leasing-style arrangements regularly formed "closed" joint-stock companies, with existing shareholders eligible to buy further shares, this corporate form was practically eliminated as an option for privatizing Russian firms.[45]

The fate of the shares not distributed to insiders varied. In general, the official intent was to have 29% sold at public voucher auctions, with the remaining 20% (under Option 2), held for future sale by the state.[46] Voucher auctions were a major way that outsiders could acquire stock; efforts of insiders to rig auctions to their own benefit and block outside purchasers were notorious, but not always successful.[47] Remaining state shares were slowly parceled out in a variety of ways over time, including via "investment tenders" that linked their purchase to a commitment of additional investment in the firm.[48]

No form of privatization pursued in Russia involved discussion of the allocation of property rights between suppliers and customers, or of how to maximize the value of

[45] On Poland, see below; for Russia, see Boycko, Shleifer, and Vishny 1995, 75. Very few firms found a way around this ban.

[46] Radygin 1995, 64; Boycko, Shleifer, and Vishny 1995, 75, 78

[47] Radygin 1995, 67.

[48] Radygin 1997.

enterprises as “going concerns.” Indeed, the procedures for privatization promoted isolation of stakeholders from one another, and conflict between them. Internal auctions transformed stakeholders into competitors. And because of the extremely cheap distribution of control in each privatized entity, privatization’s design had a fragmenting effect: more valuable subunits of “going concerns” had every reason to split off if they could. Even existing integrated enterprises experienced intense conflicts over whether subdivisions would be privatized jointly or separately, as some subdivisions had the legal right to do. Participants in longer supply chains had even fewer chances to come to a negotiated decision about the degree of their legal integration. Efforts at joint privatization of technologically linked enterprises, forwarded by descendants of Soviet sectoral ministries and production associations, were resisted by privatization authorities, who could usually count on the backing of individual enterprises that would prefer to be privatized alone.[49]

Not all large firms underwent voucher privatization. Most notoriously, some of the most valuable energy and metals-producing firms were sold for a pittance to Moscow-based bankers, in an effort to build a coalition that would back Yeltsin’s re-election as president in 1996.[50] As in voucher privatization, allocation of property rights happened without negotiation between stakeholders. The situation was programmed for conflict between outsiders with no stake in the firm beyond their stockholdings, and

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[49] Boycko, Shleifer, and Vishny 1995.

[50] This interpretation may be considered undisputed, since it has been offered by Anatolii Chubais, who designed and managed the auctions. *MK-Daily*, 23 September 1998, 2; as translated by the Federal News Service, supplied by DowJones News Retrieval.

insiders whose de facto control was threatened. Though in most cases in the outsiders were indeed able to consolidate the control they had won through the loans-for-shares plan, it was in no case a trivial task.

Privatization in Poland

Privatization in Poland did not set the stage for long-running insider-outsider conflict centered around stock ownership. Polish Communists had retreated from their claim to domination in the face of economic pressure and popular mobilization by the Solidarity workers' movement. Although it was intellectuals close to Solidarity who launched the economic reforms, they rejected the movement's longstanding advocacy of worker control.[51] This led to sharp conflicts in the Sejm, Poland's parliament. In 1990, the upshot was a compromise privatization law that provided for three forms of privatization (although no provisions were made for implementing one of these, mass privatization for free vouchers distributed to citizens).[52] Some privatization was also carried out using socialist-era bankruptcy provisions.[53] It wasn't until 1993 that legislation implementing mass privatization was enacted, at a time when the original reformers had already been voted out of office. Implementation did not begin until 1995.[54]

The hallmark of the most widespread privatization methods in Poland was a *simultaneous transformation of legal form and social substance*.[55] In other words,

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[51] Orenstein 2001.
[52] Orenstein 2001.
[53] Blaszczyk et al. 1999, 3-5.
[54] Blaszczyk et al. 1999, 3-5.
[55] Cf. McDermott 2001.

changes in legal status were directly connected to negotiated reorganizations of the social environment in which law would be implemented.[56] Particularly important was that in the vast majority of cases commodification of stock was permitted only on terms acceptable to insiders. Furthermore, when outsiders did receive an opportunity to buy into privatized firms, this was done either on terms decided by insiders or in a way that gave outsiders an overwhelming dominance in shareholding. Because there were so many ways privatization took place, space considerations prevent a full review. However, a couple of examples give the flavor.

Direct privatization. This method of privatization encompassed roughly a third of all privatized enterprises. Although it consisted in three subtypes, around two-thirds of these privatizations took the form of installment purchases (usually termed leases) of the assets of the former SOEs. The SOE was legally dissolved, and its assets transferred to a new company formed by the SOE's employees, who had to commit to buy at least 20% of the assets. After all the payments had been made, the assets became the property of the new company.[57] The procedure was voluntary, and could *only* happen after a vote of the employee council.[58] The valuation placed on SOE

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[56] For a key early perspective on this joint transformation, see Levitas 1994, who argued that enterprise insiders "are trying to wean themselves away form the state by simultaneously redefining the ownership structures of their firms, their productive profiles, and the markets in which they expect to function."

[57] Kozarzewski, Krajewski, and Majak 2000, 38. Some leasing arrangements apparently did not terminate with property transfer, though it is unclear how many. Kozarzewski, Krajewski, and Majak 2000, 38. See also Levitas 1994, 107-108.

[58] Kozarzewski, Krajewski, and Majak 2000, 38. This changed after passage of a new law that came into force in 1997; which allowed outsiders to initiate privatization, and also tried to promote the inclusion of more outsiders in the new joint-stock company created out of the dissolved SOE. However, by this point at least 80% of all

assets was regularly such that it was beyond the means of the company's employees, meaning that outsiders had to be involved. However, it was the newly organizing firm that both located buyers and determined "which of these buyers to let into the process. ... [Outsiders were] usually drawn from the network of the firm's suppliers and buyers."[59] The approving authorities included the SOE's "founding body," often an arm of local government, which brought another stakeholder into pre-privatization negotiations.

Survey research suggests that the nearly 90% of new enterprises formed in this way employed corporate charter provisions restricting the sale of shares to outsiders. These restrictions did not block them, however, from issuing new shares to allow additional outsiders to buy into the company—presumably, when this was a legal form that suited both bodies.[60]

Mass privatization. Poland's version of mass privatization involved a complex two-tier procedure in which Poles were given certificates for shares in 15 newly created investment funds, which in turn were allocated shares in the 512 state enterprises (about 11% of all privatized enterprises) participating in this program. For present purposes, the important point is that participation in the program was subject to veto either by management or by the employees council. Though of course this did not preclude subsequent conflict between insiders and outsiders, the procedure left high-

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direct privatizations had been accomplished. Blaszczyk et al. 1999, 307; Dabrowski 2001, 140; Kozarzewski, Krajewski, and Majak 2000.

[59] Levitas 1994, 108-109; McDermott 2001.

[60] Kozarzewski and Woodward 2001, 22.

visibility, government backed outsiders with a dominant share of the outstanding stock.[61]

Privatization's legacy for corporate legality

State socialism built an economy of idiosyncracies.[62] As the system approached its demise, each enterprise operated according to an accretion of particularistic bargains with planners and ministerial supervisors over such things as norms for material use and allocation of capital to different purposes. This diversity of local situation, of production and its organization, of course persisted after privatization. Nevertheless, the distinct forms of privatization in Poland and Russia did produce characteristic patterns in the relationship between corporate stock as a legal form and the social substance underlying it—the day-to-day routines and interactions that make a firm a "going concern."

In Poland, all evidence suggests that insiders' veto on privatization generally meant that outsiders could acquire firms only when insiders felt that had something to gain from it. There was regularly an option to privatize as a closed corporation with nonfungible shares, which many employee-manager buyouts adopted. True, some firms' poor financial situation left them faced with an unpleasant choice between outright liquidation and a bank-led reconciliation plan that could involve a reassignment of property rights through debt-for-equity swaps. But even in such cases the deals were negotiated on the basis of mutual gains for creditors and debtors, not as a zero-

[61] Rapacki 2000; Blaszczyk and Woodward 2001.
[62] Woodruff 2000, ?.

sum division of property.[63] In short, property rights were transferred to outsiders when insiders were willing to accept the legal consequences.

In Russia, by contrast, outsiders received shares only through tenacious efforts by central government officials over the objections of enterprise managers.[64] Outside shareholders represented a threat to the nearly total control managers had over enterprise finances.[65] Stakeholder-shareholders (i.e., workers) could be kept in line through their other dependencies.[66] But outsiders were simply new claimants for the firm's earnings, who could conceivably be backed by the courts or bring other resources to bear. Given the extremely cheap valuations the privatization process put on Russian firms,[67] managers had every reason to purchase as many shares as they could to secure their control over their enterprises. Surveys in the immediate aftermath of privatization suggested that insiders in the median firm controlled 52% of the stock, and that general directors, on average, aspired to have 69% of the stock controlled by insiders.[68] They also took other measures to prevent outsiders from acquiring stock or exercising the legal rights it was supposed to afford. Thus, unlike in Poland, allocation of stock resulted not from acquiescence of the firm's *de facto* owners when they were able to turn it to their advantage, but over the objections of these owners.

These contrasting histories explain why Russian privatization set the stage for regular, systematic frictions between legal facts and contextual factors. On the side of

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[63] McDermott 2001
[64] Boycko, Shleifer, and Vishny 1995;Radygin 1995; Frye 1997.
[65] Boycko, Shleifer, and Vishny 1995, 117.
[66] Clarke and Kabalina 1995.
[67] Boycko, Shleifer, and Vishny 1995, 117-120.

legal facts, the distribution of stock shares set up insiders as majority and outsiders as minority owners. Contextually, these outsiders did not share any network relations with the insiders. Another important element of context was material interest: corporate stock's market value was extremely low. For insiders, this meant that sales were senseless since they brought little reward and might threaten effective control.[69] For outsiders, finding a way to force management to share profits would greatly increase the value of stock holdings, setting the stage for conflict.

Polish privatization did not create these legal and contextual features. Insiders were minority shareholders, not majority ones. Outsiders were often drawn from existing networks and in any event had to negotiate with the insiders, who could veto their participation. Finally, the extremely low valuations stemming from the voucher process were avoided in a situation where firms were sold rather than distributed.

In sum, Russian privatization created an unsustainable combination of legal facts, contextual factors, and laws. Polish privatization did not. Although one could try to give evidence for this proposition in a number of ways, including describing the incredible prevalence and intensity of corporate conflicts in Russia. Others, however, have done this.[70] Instead, I will focus on an indicator directly related to my argument on the impact of tensions between contextual and legal factors: actors' use of legal

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[68] Blasi, Kroumova, and Kruse 1997, 193-194.

[69] Wintrobe 1998.

[70] Black, Kraakman, and Tarassova 2000; Fox and Heller 2000. Although both studies draw some useful links the difficulties of corporate governance to privatization, neither suggests that other ways of embedding or contextualizing the relations between insiders and outsiders would have avoided the issue.

"loopholes" to change legal facts in the context of zero-sum legal battles.[71] Although it is more difficult to prove the absence of a phenomenon than its presence, I also offer brief contrasts to Poland that suggest the absence of parallel developments there.

Russia: Exploiting the legal definition of value as a loophole

This section details the way the configuration of legal and contextual factors created by Russian privatization—a fissure between insider and outsider shareholders, with the former unwilling to share net revenues or sell their stakes in the firm at low prevalent prices—prompted a search for loopholes. These loopholes had the effect of resolving conflicts by forcing one side to surrender stock in return for legally determined, but inadequate, compensation. The elimination of competitors' ownership claims left both *de jure* and *de facto* control in one set of hands. The first example is a case history that illustrates in some detail the use of such a loophole to resolve contestation over property rights. The second example chronicles the emergence of an industry devoted to debt-for-equity takeovers, which used bankruptcy law to contest the property rights of manager-shareholders unwilling to sell.[72]

Case: The Conflict at the Volgograd Factory of Drilling Machinery.[73] This conflict, which centered around a factory with around 30% of the Russian market for oil-drilling machinery, pitted minority shareholders with 43% of the outstanding stock against

[71] An alternative to exploiting loopholes to solve the mismatch between legal and contextual factors would be to seek to change the latter—embedding shareholding relations in other forms of cooperation. This also took place: for an insightful analysis, see Pappe 2000.

[72] For discussions, see Radygin 2002; Deriabina 2002; Volkov 2002.

[73] Based on press reports and the text of relevant laws available from the Emerging Markets database at www.securities.com.

majority shareholders with 51%. The majority shareholders, who controlled the factory's management, were a Volgograd-based banking group called NOKSS. The outside shareholder, initially, was the United Machinery Group (known by its Russian acronym as OMZ), a holding company that controlled much of the rest of oil-drill market. OMZ, having acquired its shares apparently through door-to-door purchases from workers who had received them in privatization, spent more than a year trying to reach an arrangement with management and the majority shareholders regarding representation on the firm's board and division of its profits. Eventually, OMZ turned over 40% of its shares to MINFIN, a company specializing in aggressive efforts to enforce legal claims. MINFIN, for unclear reasons, split these shares among two smaller partnerships.

Russian corporate law allows minority shareholders controlling more than 30% of outstanding stock to call an extraordinary shareholders meeting; the quorum for such a meeting's decisions to be binding is 50%. Representatives of the majority shareholders failed to appear at the scheduled meeting (held on the morning of January 1st, 2001). In the event that a quorum is not present, the law allows calling of a second meeting twenty days later, with a quorum of only 30%. MINFIN called such a meeting, and elected a new general director and a new chairman of the board. The new general director (a business-school student, as was the chairman of the board) did not try to take control of the factory's day-to-day operations, though he did make an effort to enter the plant grounds and was stopped by security. He also asked for the plant's seal (required for binding documents). Denied, MINFIN had a new seal produced, and tried, at least formally, to win control over the firm's bank accounts.

The majority shareholders declared the MINFIN-organized shareholders' meetings illegitimate, claiming they had not been properly notified. They then took two further, more dramatic actions. One of these was to arrange for the arrest of the alternative general director and board chairman for "forging" the company's seal on official documents. The arrest was carried out by Volgograd policemen, who traveled to Moscow to make the arrest and then transferred the two students to pretrial detention in Volgograd. They were fairly quickly released with a pledge to appear for trial.

The second action proved to be of more enduring significance. According to law on joint-stock companies, companies' board of directors were allowed to take decisions on stock splits or on stock consolidations. The majority shareholders used this provision to carry out a consolidation of the company's nearly 190,000 outstanding shares into four shares. Because the two MINFIN partnerships held less than 25% of the shares each, they were not entitled to one of the four new shares in the company. Instead, the law specified compensation based on the *board's* determination of reasonable value for the outstanding shares.[74] The board paid the minority shareholders around $400,000. By contrast, MINFIN had some time earlier publicly offered $7 million for an additional 25% of shares in the company (whose annual sales were around $30

[74] The price was supposed to be that a "uncoerced buyer" would pay; evaluation was supposed also to "take into account" public quotations of the stock's price—none in this case—as well as what an uncoerced buyer would pay for the entire outstanding capital stock. The latter provision appears designed to capture the possibility of an

million). The two shares actually issued in the consolidation went to the existing majority shareholders, who then started proceedings to convert the firm into a private partnership. MINFIN then pursued suits and regulatory appeals contesting the consolidation, losing in the local courts, winning once in at a higher-level court in Moscow, and finally losing on a second appeal. It continued to claim (to no apparent avail) that the board taking the consolidation decision was not legitimately elected. The majority shareholders were left with full control over their property.

It's worth noting that this provision of the law had been on the books since early 1997, but seems to have first been exploited in this way in 2001. The notion that this was a poorly drafted law is thus too simple. If the pattern of motivations were different, this provision of the law might be entirely unoffensive. It was particular circumstances—the particular struggle over control and division of firm profits—that led to the *search* for this loophole.

Debt-for-equity takeovers. The minority shareholders in the case just described announced their willingness to purchase the firm in question, but they were not able to come to an agreement on the price. This situation was very typical. Firms intent on industrial acquisitions—especially the largest Russian business groups—found pursuing them through stock purchase very difficult. This led to a search for loopholes that would force insider shareholders to part with their shares.

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undervaluation due to the presence of a control bonus, but it did not offer any detail on how this control bonus was to be calculated.

Acquisition specialists found a solution in exploiting the secondary debt market to as a mechanism to achieve debt-for-equity hostile takeovers.[75]. Would-be acquirers bought up the outstanding loans of a target firm from its creditors. Because they were not entrenched insiders, creditors were willing to sell. Acquirers then used the court system to try to enforce these debts in a way that would give them control over the assets of the target—ideally, by compensating debts with "undervalued" stock, though the mechanisms were many. Thus, these were debt-for-equity hostile takeovers.

Because assets were the target, creditors would often seek ways to prevent targeted debtors from paying off their outstanding obligations, since this would leave the creditor only with money and not the more valuable assets. Legal provisions designed to protect minority shareholders—by giving them the right to challenge certain company decisions—were one way that hostile acquirers could prevent loan repayment from taking place. Another was to push the target firm into bankruptcy proceedings, during which it would be run by a court-appointed administrator, who could often be convinced to interfere with the repayment of debts that had led to the bankruptcy in the first place.

The search for legal mechanisms that could force debt-for-equity exchanges created an entire bankruptcy industry, devoted to facilitating hostile takeovers. These became a key basis for the rapid expansions of the biggest business groups after the August 1998 crisis, a time when high export commodity prices and weak domestic ones gave these groups an especially strong position. These hostile takeovers were

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[75] For discussions of the prevalence of these mechanisms and examples of their

sometimes quite hostile indeed. The high stakes attached to various legal events—such as payment or nonpayment of debt—created strong incentives to contest them. Sometimes, as these contests were pursued in different jurisdictions, conflicting rulings would be issued, creating a situation of multiple legal realities, often degenerating into physical confrontation as different parties tried to enforce their version of the legal facts.

The empirical developments just surveyed illustrate the distance between law and the situation-types in which it was being invoked. In the case of the conflict at the Volgograd factory, the legal provision for consolidation of shares of stock was turned the purpose of expropriating minority shareholders. In the debt-for-equities hostile takeovers, laws postulating a situation of creditors seeking to recover debts were likewise inserted into conflicts between insiders and would-be acquirers. The most dramatic illustration of the split between the law's implied situation-type and that of its practical application was the phenomenon of creditors seeking to avoid being repaid.

The Polish contrast. Proving the absence of contested shareholder property rights in the Poland case is a more difficult task than documenting their prevalence in Russia. However, the available record of how firm acquisitions have proceeded displays no parallel conflicts. Consider the history of the Elektrim conglomerate, which until 2001 was one of the country's most prominent and successful business empires. Elektrim began as a state trading firm coordinating imports and exports for industries offering supplies and services related to electricity generation and transmission. After

use see Radygin 2002; Deriabina 2002; Volkov 2002.

being privatized itself, Elektrim used its export revenues to fund a large number of acquisitions in Polish industries—at one point, it owned controlling or substantial stakes in over 100 firms. It was able to purchase dominant stakes in many of these firms through the privatization process, after offering wage, employment, and investment guarantees. More strikingly, it was able to use sales of minority stakes in enterprises it had acquired to fund further acquisitions.[76] This strategy would have been completely unimaginable in the Russian context, where majority owners scorned the desultory receipts available on the stock market, and would have had a hard time finding sufficiently large blocks of shares to purchase with these receipts in any event.

Elektrim management did sometimes find itself in conflicts with shareholders. In late 1998 the company revealed that it had failed to disclose an obligation to sell an asset cheaply. Regulators' reaction to this incident has been cited as an indicator of the effectiveness of Polish securities law enforcement.[77] And the Polish SEC did indeed levy a fine of $133,000 against the firm, and instruct prosecutors to inquire into possible criminal consequences. Nevertheless, compared to the $150 million in market capitalization the firm lost in the aftermath of the scandal these factors seem relatively trivial. Immediately after the scandal broke, and well before the enforcement action, the firm's CEO was in London seeking to reassure investors. His fairly quick subsequent resignation (despite a assertion of legal innocence), and replacement by a new manager who began a forceful campaign to reassure investors are further signs of the crucial influence of the market. Given that Elektrim was trading at a very large price-to-

[76] Michaels 1995.

earnings ratio of roughly 40 before the scandal, there was a great deal of wealth to be lost by angering investors.[78]

The contrast to the behavior of large Russian firms in the same period could not be more striking. Their disregard for shareholders was manifest. But the costs for angering shareholders were correspondingly low. When in March 1999 the Russian oil conglomerate Yukos used a dubious court order to exclude minority shareholders from a meeting in which assets were diverted from the firm, it was trading at P/E ratio of around 4, one tenth of Elektrim's.[79] It no longer had anything to lose from offending stockholders.

Evidence suggests that such situations of an enormous split between the market price of stock and its value to majority owners were infrequent in Poland. Indeed, a study of the premia investors pay for large blocks of shares on the Polish stockmarket revealed them to be "substantially lower than in well developed markets."[80] Debate over the amendments to the bankruptcy law in 2002-2003 in no way echoed the Russian discussions of bankruptcy as a mechanism of property transfer. Instead, discussions focused on more familiar creditor-debtor issues, and resolving collective

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[77] Glaeser, Johnson, and Shleifer 2001.

[78] Elektrim appoints outsider 1999; Poland's Elektrim appeals to Polish SEC over fine 1999;Laidlaw 1998;Michaels 1998;Warburg Dillon Read 1999. Elektrim eventually failed for unrelated reasons.

[79] On the incident see Black, Kraakman, and Tarassova 2000, which also describes the abysmal valuations of Russian firms in this era but describes them solely as consequence, not cause, of poor corporate governance; for the P/E ratio see Troika Dialog Research 2000.

[80] Trojanowski 2002

action problems of creditors.[81] These developments all suggest that the characteristic situation in which Polish corporate and bankruptcy law operates does not involve the particular incentives to contest shareholders' property rights found in Russia.

Conclusion: from sociology to politics

This article has presented an "economic sociology of law" argument about the ways in which Russian and Polish privatization shaped the subsequent destiny of corporate governance in the two countries. By enabling embedded relations among stockholders, and avoiding a huge undervaluation of stock in the course of privatization, Poland created contextual factors that supported the legal facts of ownership. Russian privatization procedures isolated shareholders from one another and involved extraordinarily low stock valuations, a set of contextual factors that set the stage for long-running, zero-sum conflicts over the legal facts of stock ownership.

An economic sociology of law approach can improve one's account of the politics of making property rights secure. In particular, the ESOL approach avoids the assumption that only a strengthening of state commitment and/or capacity to enforce property rights will make them secure. This assumption can take various forms. In the context of a game-theoretic analysis, the issue of state capacity is frequently analyzed using an argument about the potential feedback between the prevalence of violation of law and the state's ability to contain it. The implication is that either the state collapses in a downward spiral of lawlessness that increasingly overwhelms authorities, or law-abiding behavior by the many makes containment of the law-violating few ever

[81] More power to the creditors 2003.

simpler.[82] A similar argument regarding Russia is that the absence of effective regulation after privatization fostered the spread of majority owners willing to flout minority property rights, since such owners were able to extract more from the firms under their control.[83] The prevalence of such unscrupulous majority shareholders means that Russia “needs a serious, top-down effort to control corruption, organized crime, and self-dealing [by corporate insiders],” and even "selective renationalization and reprivatization."[84]

Other analyses emphasize not state capacity to secure property rights but rather the political will to do so. One technocratic version links good corporate governance to “strict enforcement of securities law by a highly motivated regulator,” arguing that the secret to Poland’s success was reliance on a regulator handsomely rewarded for enforcement, rather than weak courts without such incentives.[85] Alternatively, the requisite political will might be sought among property owners. Some of those closely involved with Russian privatization, for instance, argued that the political clout of the outside shareholders created by privatization would successfully prod the state to secure corporate legality, an expectation that proved unfulfilled.[86]

Both the arguments from feedback loops and those from political will posit an unmediated interaction between state and society, taking conflict over corporate

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[82] Sachs 1994; Johnson 1997; Roland 2000.

[83] Black, Kraakman, and Tarassova 2000, 1735. Note that this argument portrays the division of firm revenue as a zero-sum process.

[84] Black, Kraakman, and Tarassova 2000, 1798.

[85] Glaeser, Johnson, and Shleifer 2001, 853.

[86] Boycko, Shleifer, and Vishny 1995, 128; Black, Kraakman, and Tarassova 2000, 1753; Shleifer and Treisman 2000, 38.

property rights as a given. The ESOL approach recognizes property rights as situated in concrete social and economic interactions, which may or may not be marked by conflict. By transcending a binary approach to law-consistent behavior (law-abiding or law-violating equilibria; presence or absence of political will for enforcement), it makes possible the mapping of more intricate trajectories of legal and political change.

Such a trajectory has unfolded in the Russian case. An unstable configuration of legal facts and contextual factors gave rise first to an effort to use loopholes to alter the legal facts. But changing patterns of property distribution eventually prepared the ground for new laws that would increase the security of property.[87] The trajectory is especially clear in the case of debt-for-equity takeovers. In the fall of 2002, Russia passed new legislation weakening the rights of creditors and minority shareholders while strengthening those of owner-managers.[88] The new bankruptcy code, in particular, contained many provisions designed to hinder forced debt-for-equity exchanges. These provisions force creditors to try vigorous measures to collect debts before initiating bankruptcy proceedings, and allow firms in bankruptcy proceedings to exit them by repaying outstanding debts. Furthermore, management and the creditors must jointly agree on the bankruptcy administrator, from a list proposed by an independent association of qualified administrators, making it less likely that the administrator will be willing to shift assets from management. Related legislation

[87] Boone and Rodionov 2001 described the process of business conglomerates' consolidation and argued that big business was embracing law as a means of stabilizing property rights. For a vigorous counterargument, based however on evidence predating the most recent legal changes, see Barnes 2003.

[88] See Andreev 2002; Medvedeva, Timofeev, and Iukhnin 2003.

regulating commercial courts now makes it harder for minority shareholders to interfere with management decisions than previously.

It was representatives of big business, *who had used debt-for-equity takeovers to expand*, that did the most to give the new laws the form they took.[89] For instance, when President Putin vetoed the initial version of the bankruptcy bill, passed by parliament in the summer 2002, he did so in part to include longstanding suggestions of big business lobbyists to eliminate provisions preventing firms from paying their debts when able to do so.

The position of big business, a number of observers plausibly suggest, reflected the fact that displacement of the entrenched insiders created by privatization was all but complete. The vast bulk of the country's most valuable private enterprises had been subordinated, both de facto and *de jure*, to a handful of conglomerates run by Russia's richest and most powerful.[90] These empires grew based on their ability to disturb the flow of controllable legal events that constitutes the exercise of property rights. Their behavior during the debate on the new bankruptcy law suggested that as the new owner-managers, they were not eager to see others repeat their accomplishments.[91]

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[89] Medvedeva, Timofeev, and Iukhnin 2003 describes the preparation of the bill. For an example of the intense interest of the country's largest business lobby in the bill, see Rossiiskii soiuz predprinimatelei i promyshlennikov 2002; Liubimtseva 2002.

[90] Dolgopiatova 2002, 1-90.

[91] Medvedeva, Timofeev, and Iukhnin 2003 describes the multiple interests involved, noting that while some big businesses wished to secure extant acquisitions, others opposed the law in hopes of maintaining their ability to acquire new assets through bankruptcy. Also: author's interview with Tatiana Medvedeva, Moscow, June 2003; author's interview with Aleksei Iukhnin, Moscow, June 2003. For a vigorous

From an ESOL perspective, it is entirely intelligible that in line with changes in the legal facts of property, conglomerates would shift from manipulating extant laws to destabilize others' property rights to promoting legislative change stabilizing their own. However, this transition does not fit easily with approaches highlighting the impact of feedback effects or political will on enforcement. For instance, relying on equilibrium arguments and feedback effects, one scholar asserted in 2000 that "the relative irreversibility created [by mass privatization] has locked the Russian economy in an inefficient situation where interest groups who gained most from mass privatization (the famous oligarchs [phrase in original]) have become so powerful as to block further reform such as tax reform, government reform, stronger law enforcement, and stronger security of property rights."[92] Yet, just three years later, the "famous oligarchs" have become among the most active promoters of all the values mentioned.

In a defense of historical institutionalism, Thelen has argued for a conception of politics "as a dynamic process that frequently produces unintended consequences as different, ongoing processes interact. Perspectives that conceive of change as the breakdown of one equilibrium and its replacement with another do not capture this well."[93] Explaining institutional order through equilibrium fetishizes stability and eviscerates investigation into the roots and forms of change. One can add that the modeling of institutions in a game context, which requires a self-contained description

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argument against the position that big business is embracing law to stabilize its property, based however on evidence predating the most recent legal changes, see Barnes 2003.

[92] Roland 2000, 337. For a similar, but more influential formulation see Hellman 1998.

of actors' interests and options in an indefinitely repeated game rules out investigation of "the contingent temporal alignments and simultaneous movement of relatively independent institutional orderings that riddle political action."[94] The arguments presented above suggest that these historical-institutionalist points apply as much to economic institutions as to straightforwardly political ones, and to the interactions between the two categories of institutions as well. Incompatibilities between legal facts, contextual factors, and law can touch off evolutionary processes that eventually give rise to demands for legislative reform.

In Russia, this took place only after a reconfiguration of context made it feasible for law to be an effective tool in constraining action. The process by which demands moved from society to politics was mediated through the local arenas in which the meaning of law was determined.[95] This causal pathway is quite unlike the reformers' presumption that shareholders automatically would become a coalition for the strengthening of property rights once they had been granted them.

Thus, a decade after privatization, the outcome in Russia is tending toward a reconciling of law and context. In a "trajectory of improvement," loopholes that destabilized property rights are being closed. Former villains of corporate governance are now its heroes as they seek to convert their vast holdings into the liquid currency of

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[93] Thelen 1999, 383-384, drawing on Orren and Skowronek 1994.

[94] Orren and Skowronek 1994, 321. For similar points in the context of economic institutions, see Woodruff 2000.

[95] Cf. Kennedy 1993, 95. For a similar dynamic local struggle to national struggle dynamic in contention over the definition of Russia's legal means of payment, see Woodruff 1999, 110-202. For related points in a comparative corporate governance context see Roe 1996; Skeel 1998.

market capitalization.[96] Although an ESOL approach makes sense of these developments, it also cautions against reflexively celebrating them. As Weber and many of the other authors here mobilized have emphasized, law is only superficially a neutral instrument: "conditions of formal freedom are officially available to all; actually, however, they are accessible only to the owners of property and thus support their very autonomy and power positions."[97] Put differently, law stabilizes distributions of property and bargaining power arising from social and economic resources.[98] It in no way provides security for the justice of these distributions.

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[96] Whalen 2002; Chazan 2002.
[97] Quoted in Swedberg 1998, 102.
[98] Kennedy 1993.

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