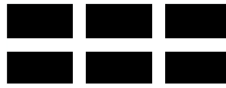

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Factors influencing corporate governance in post-socialist companies: an analytical framework

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Abstract

In explaining the corporate governance performance of post-socialist companies, this article identifies four factors of influence: (1) pressure from majority shareholders, (2) pressure from outside minority shareholders, (3) pressure resulting from internationalization/ globalization and (4) pressure exerted by the state in the form of legal regulation.

If all four factors have an impact on corporate governance performance, their interaction has to be explained. On the basis of research conducted thus far, this article suggests an analytical framework for the examination of corporate governance performance of post-socialist companies.

Case studies of oil and gas firms from Central and Eastern Europe illustrate how the above factors influence a company's corporate governance performance.

Keywords: corporate governance, Russia, Central Eastern Europe, oil and gas industry

JEL codes: G34, L71, M14, P21, P28, P31

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Introduction

This article aims to explain the corporate governance performance of post-socialist companies. Corporate governance is defined here in terms of the shareholder approach, i.e. it deals exclusively with the relations between a company's owners and managers. In this context, corporate governance describes mechanisms which allow all company shareholders fair participation in decision-making and ensure that the management acts in the common interest. The basic components of this definition of corporate governance are accountability of managers to owners, transparency of the company's financial situation and ownership structure, integration of all relevant shareholders into decision-making processes (usually through representation at the company board) and a fair distribution of profits among all shareholders (comprising dividend payments as well as the absence of manipulations, such as asset stripping or dilution of shareholdings, on behalf of a specific group of shareholders). These fundamental elements are present in all four major corporate governance models (i.e., the Anglo-Saxon, German, French and Scandinavian models) commonly identified in the literature (La Porta et al. 1998; Baker/ Wallage 2000). As such, they describe the general rules for company development and investment in a market economy, whereas their concrete design and implementation are influenced by cultural specifics (cf. cultural specifics of corporate governance regulation and implementation e.g., Buck/ Shahrim 2005; Federowicz 2003).

Due to these cultural specifics, the corporate governance of post-socialist companies deserves separate analysis (cf. Berglöf/ Thadden 2000). While a considerable body of literature on the topic exists, the majority of analyses is mostly descriptive (cf. e.g., Goldberg/ Desai 1999; Fox/ Heller 2000; Bushev 2001) and focuses only on single aspects, such as ownership structure (cf. e.g., Yakovlev 2004a; Krivogorsky 2000; Buck et al. 1999; Gray 1996), legal regulations (cf. e.g., Koladkiewicz 2001; Earle et al. 2001; Black/ Kraakman 1996), business culture (cf. e.g., Buck/ Shahrim 2005; Roberts 2004; Buck 2003; McCarthy/ Puffer 2002) or global factors (cf. e.g., Heinrich 2005; Pappe/ Galukhina 2005). A real comparative dimension is therefore still lacking, as is a comprehensive analytical framework to explain corporate governance performance in post-socialist countries.

A recent exception is a project conducted jointly by the Institute for Industrial and Market Studies at the State University Higher School of Economics (Russia), the Center for Comparative Studies (Bulgaria) and Ohio State University (USA), in which a comprehensive framework was developed to explain corporate governance improvements and applied to Russia and Bulgaria (Institute for Industrial and Market Studies et al. 2004). The analytical framework developed in the following section draws on their approach.

A focused comparison is employed to examine aspects of corporate governance and establish causal mechanisms. Due to the impossibility of covering all post-socialist countries in central and eastern Europe and all sectors of any one national economy, the authors have opted to pursue a focused comparison of three countries (Poland, Russia and Ukraine) in the oil and gas sector. Focused comparisons fall between case studies and statistical analysis. They are small N studies concentrating on the intensive comparison of a specific aspect in a small number of countries. This research design seems especially suitable when sufficient reliable data for large N studies are not yet available, as is the case of post-socialist countries. The focused comparison will deliver the data and background information on causal mechanisms for the quantitative research. Therefore, focused comparisons and large-scale samplings are not competitive but complementary (Gerring 2004).

Development of an analytical framework

Under the socialist system, corporate governance in the sense of the shareholder approach was a nonentity, as all large companies were state-owned and -controlled. Accordingly, there were no corporate governance regulations in place when the socialist system disappeared, nor were there state agencies capable of controlling private companies.

The newly established corporate governance institutions in the three countries examined here were strongly influenced by the German corporate governance model. Companies in Poland, Russia and Ukraine have a two-tier board system despite a strong US influence (especially in Russia) during the process of institution building; this model better fits their ownership structure. Contrary to the Anglo-American configuration, where companies owned by a large group of small private shareholders dominate, ownership structures in post-socialist economies are characterized by large blockholders.

At the beginning of this decade up to 65% of all Russian companies were more than 50% owned by one shareholder. The average share of the largest shareholder was approximately 40% (Dolgopyatova 2003; Radygin et al. 2004). In Poland today, 36% of listed companies are more than 50% owned by one shareholder and the average share of the largest shareholder is 45% (Dzierżanowski/ Tamowicz 2004). In Ukraine, this share in privatized companies is also 45% (Akimova/ Schwödiauer 2004). Accordingly, most companies have a majority shareholder that monitors and controls the management.

If we define corporate governance as the way a company behaves towards its owners, changes in a company's corporate governance performance impact first and foremost the owners, i.e. shareholders. The distinction between majority and minority shareholders is therefore critical.

The post-socialist institutional environment in the early stage of transformation gave company owners – majority shareholders (outsiders) and managers-owners (insiders) alike – little incentive to restructure their firms or maximize their value. As long as ownership rights were insecure, owners tended to withdrew cash from their enterprises through fictitious expenses or outright theft at the expense of minority shareholders, instead of reinvesting. Within short time horizons, the owners diverted cash flows to offshore accounts and shell corporations, concentrated losses among subsidiaries held by outsiders (rather than evenly distributing them between the insider-owned holding company and the subsidiaries), and delayed the payment of dividends (Desai/ Goldberg 2000).

Even owners interested in the long-term performance of their enterprises did not necessarily strive to improve corporate governance. Under the socialist central planning system, enterprises externalized business functions to government ministries and other organizations. Accordingly, owners had to rectify the enterprises' lack of resources and capacities. In the weak post-socialist institutional environment at the outset of transition period, concentration of ownership was a necessary precondition for restructuring measures to secure full control over a company, thus enabling the owners to benefit from the successful reconstruction and increased competitiveness. To secure this control, the owners used informal practices (including violations of shareholders' rights) to increase their stake and to dilute the minority shareholders' shares. During corporate restructuring, the owners again utilized informal methods, such as centralizing the cash flows generated by subsidiaries in a holding company, thereby violating the interests of the corresponding shareholders. This enabled the owners to bring the various business functions under a single controlling mechanism within the administrative framework of the firm (Adachi 2006; Yakovlev 2004b, 148-155; Iji 2003).

Only when owners with an interest in long-term profitability had (in their own assessment) secured property rights in a consolidated enterprise, were they likely to be interested in good corporate governance to attract finance and business partners or to enter new markets.

Minority shareholders, on the contrary, have an interest in improved corporate governance when they suspect that company management is trying to disadvantage them by manipulating corporate information and financial statements. However, outside minority shareholders can only translate this interest into improved corporate governance when they have the means to put pressure on the company board. In the literature on corporate governance, three groups of shareholders are deemed especially likely to enforce improvements in corporate governance behavior; financial institutions, such as banks or investment funds; strategic investors with a strong minority shareholding; and foreign investors, normally outsiders who therefore rely on good corporate governance to obtain attractive returns on their investments. In this sense, a company's ownership structure is linked to its corporate governance performance.

However, this link is by no means absolute. It has been claimed that financial institutions in post-socialist countries play no relevant role in corporate governance issues, as they are underdeveloped and themselves badly regulated (Estrin/ Wright 1999; Dittus 1996; Frydman et al. 1996). For Ukraine, an empirical study grimly concludes that no ownership structure has succeeded in changing corporate behavior there (Estrin/ Rosevear 2003); similar skepticism has been voiced about Russia (Peng et al. 2003; Krivogorsky 2000). Contrary to the argument above, in Russia's case, it is asserted that strong outside minority shareholders often lead to the deterioration of corporate governance as majority shareholders and management alike, try to oust troublemakers by underhanded means. Though ideas about the causal mechanism vary, all studies focusing on ownership structure examine the position of outside minority shareholders as an explaining variable for a company's corporate governance performance.

Improvements in corporate governance may also result from cultural learning. In the post-socialist cases, where the domestic economies were initially marked by the absence of corporate governance regulations, the main source of learning was activity on foreign markets characterized by higher corporate governance standards. When a company wants to enter a foreign market, it must strive to adapt to the foreign business environment, potentially including the adoption of foreign corporate governance standards. In other words, the more important foreign markets become to the company, i.e. the more the company becomes internationalized[1], the likelier it is to at least partly assume foreign corporate governance practices (Pappe/ Galukhina 2005; Heinrich 2005 and 2004; Walsh/ Whelan 2001). Accordingly, internationalization is another possible explaining variable.

Finally, the state can intervene in corporate governance in order to improve the investment climate and fight criminalization of the economy; financial manipulations associated with bad corporate governance are usually fraudulent and often used to avoid taxes. Accordingly, the state can create legal regulations, which, if enforced, could foster good corporate governance.

[1] Here internationalization refers solely to a company's efforts to enter foreign markets and to find partners abroad. It does not include co-operation with foreign companies on the domestic market. First, in this instance the foreign partner and not the domestic company is forced to engage in cultural learning. Second, if the foreign partner acquires a share in the domestic company, this will be covered by the ownership structure.

In summary, there are four factors which can influence corporate governance performance, in the form of pressure exerted by: (1) majority shareholders, (2) outside minority shareholders, (3) internationalization/ globalization and (4) the state (via legal regulation).

Case studies

The four factors influencing corporate governance performance will be illustrated by cases studies of major oil companies in post-socialist countries. Russia's Yukos exemplifies the strategic impact of majority shareholders and the effects of internationalization. Ukraine's Ukrnafta illustrates the role minority shareholders can play, and Poland's PKN Orlen demonstrates the effects of legal regulation. All companies are listed at the stock exchange.

For purposes of comparing these companies, corporate governance performance will be measured with an index which comprises all relevant aspects according to the shareholder approach: (1) disclosure of financial information; (2) transparency of ownership structure; (3) management and supervisory board structure; (4) dividend payments; and (5) violations of shareholders' rights (cf. e.g., Heinrich 2006). An index value of –0.5 represents the worst corporate governance possible; the maximum score is 1.6. The latter indicates a governance level considered normal by western legal standards. A detailed description of the index, along with the index values for 15 post-socialist oil and gas companies, can be found in Heinrich et al. (2005).

Yukos – Company consolidation and internationalization

Yukos was founded as a fully state-owned oil company in 1993; its privatization started in 1995. In December 1995, the Rosprom-Holding of Bank Menatep, controlled by Mikhail Khodorkovsky, acquired a 78% share of the company, enabling the bank to increase its shareholding to 85% in the following year. The privatization auctions were manipulated in favor of Rosprom, leading to repeated allegations of corruption and establishing Khodorkovsky as one of Russia's leading oligarchs (Allan 2002; Pleines 2000).

Rosprom over-stretched the financial capacities of Yukos through the acquisition of additional assets (including the Russian oil company VNK) and asset stripping. Consequently, a serious conflict with minority shareholders in Yukos production subsidiaries arose, namely with American investor Kenneth Dart. Low oil prices and the Russian financial crisis of 1998 brought the company to the brink of bankruptcy. A planned merger with Sibneft, another major Russian oil company, was cancelled.

In 1997, Bank Menatep pledged a 30% stake of Yukos to procure a loan from Standard Bank (South Africa), West Merchant Bank (Germany) and Daiwa Bank (Japan/ UK). When the bank was unable to meet its liabilities in the wake of the 1998 financial crisis, the Yukos stake was claimed by its creditors. However, shortly after a debt-for-equity swap agreement with the lenders was reached, the Yukos supervisory board decided to double the company's share capital, thus diluting the stake to be surrendered to the banks. In 1999, Standard Bank acquired the shareholdings of its partner banks. The Russian investment bank Troika Dialog alleged the existence of a personal link between Standard Bank and Yukos and concluded that Standard Bank was securing internal control of Yukos.[2]

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[2] Troika Dialog (1999) *Bulletin on Corporate Governance Actions*, 23 June and 1 December.

The ownership structure of the company remained opaque from 1995 to 2001; only nominal shareholders were released, mostly off-shore front companies with unknown owners. Only in 2002, when Yukos' major shareholder, the Group Menatep, disclosed its ownership structure did it become public knowledge that Yukos' president Khodorkovsky was its largest shareholder. Though the practice of disclosing only nominal shareholders was in line with Russian regulations, it provoked considerable criticism from the Russian public and foreign investors due to the impossibility of finding the ultimate culprit for the company's malpractice.

In the second half of the 1990s, Yukos was characterized by significant violations of corporate governance standards. American investor Kenneth Dart was deprived of his share in Yukos subsidiary profits through transfer pricing. In addition, minority shareholders witnessed the dilution of their stakes through the emission and sale of new shares to company insiders. Yukos was also accused of asset stripping via transfer pricing and of illegally transferring shares to offshore companies. Yukos was indisputably intransparent and discriminated heavily against minority shareholders.

Upon Bank Menatep's collapse during the financial crisis, chairman Khodorkovsky transformed himself from banker to oil magnate as he turned his attention to re-building Yukos. The oil market began to improve, and the post-devaluation environment was looking favorable for export-oriented businesses. 1999 became a turning point in the company's history; the company started to adopt a more investor-friendly stance. Major elements included the payment of dividends, the publication of financial reports in international accounting standards, the election of independent directors to the company board and an end to the above-mentioned discrimination against minority investors.

Table 1: Yukos' economic performance 1997-2004

	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Total crude oil production (mt)	35.6	44.6	44.5	49.6	58.1	69.5	80.8	85.7
Oil exports (mt)	9.1	13.3	17.9	22.4	30.1	35.5	43.0	34.0
Net sales (US$m)	4,619	2,480	2,110	8,948	10,135	11,373	13,349	22,100
Net profit (US$m)	171.6	- 1,735	254.2	3,331	4,006	3,065	N/A	N/A

Note: Due to back claims by the tax administration resulting in long-lasting court proceedings, Yukos could not present final financial results for the years 2003 and 2004.

Sources: Yukos company information.

By the end of 2000, the reduction of corporate debts was almost completed. Yukos was also able to secure control over its production subsidiaries that year. The management was thereafter able to focus on a long-term business strategy (Mazalov 2000; Reznikov 2000). In a globalised sector like the oil industry a long-term business strategy nearly automatically entails internationalization. Since the Russian government keeps domestic energy prices artificially low, the Russian oil and gas industry receives nearly all of its profits from exports (Smirnov/ Posvyanskaya 2003). As the sale of oil products directly to the end consumer offers considerably higher profits than the sale of unrefined products at the border, Yukos soon developed an interest in entering the EU downstream market. Yukos saw investments in post-socialist EU candidate countries as an entry ticket into the EU downstream market. Major acquisitions included stakes in a

Croatian pipeline project, in Lithuania's premier oil company and in Slovakia's oil pipeline operator (Pleines 2006).

Creditors started demanding improvements in corporate governance after their experience with written-off debts during the Russian financial crisis of 1998. The aforementioned improvements helped Yukos to attract foreign finance. Improved corporate governance was also a major prerequisite for investments in post-socialist EU candidate countries, as governments there suspected Russian companies as possible agents of Russian attempts to re-establish Soviet hegemony.

As a result of substantial corporate governance improvements Yukos became the most successful Russian oil company in terms of increase in production and share price. In 2003, it again announced a merger with Sibneft. However, Khodorkovsky's subsequent attempts to engage in politics in opposition to Russia's President Vladimir Putin led to the destruction of the company by state agencies from 2003 to 2005. Tax claims served to confiscate Yukos' major production unit and charges of economic crimes were used to put the company's leading owners and managers, including Khodorkovsky, in jail (Tompson 2005).

There is a razor-sharp contrast between the company's egregious corporate governance in the 1990s and its adherence to virtually all major corporate governance rules since 2002. The corresponding values of the corporate governance index are indicated in Table 2. This contrast can be explained by a shift in the majority shareholder's strategy. In the second half of the 1990s, Menatep tried to gain control of all Yukos subsidiaries and unite them into a vertically-integrated holding structure. To this end, it had to get rid of the minority shareholders. The best way to achieve that aim was to deny them their share in profits through asset stripping, i.e. through transfer pricing, and to dilute their share (Adachi 2006; Iji 2003).

Table 2: Yukos' corporate governance index 1997-2004

	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Index value	0.4	0.2	0.0	1.0	0.8	1.4	1.4	1.4

Once this aim was achieved, Khodorkovsky, the majority owner cum self-appointed manager, developed a long-term business strategy. In the oil industry, such a strategy would entail focusing on exports and expansion into export markets. Accordingly, the development of a long-term business strategy automatically meant internationalization. This reinforced the improvements in corporate governance, as the harrowing experience of 1998 had made foreign partners more demanding in terms of corporate governance performance (Heinrich 2005).

Ukrnafta – The power of minority shareholders

In 1992, the year of Ukrainian independence, the Ukrainian State Property Fund initiated the reorganization of the oil and gas sector. After more than one year of administrative proceedings, Ukrnafta was established as a national oil and gas company. A plan for its privatization was finally agreed upon in January 1995. By summer 1995, 8.6% of Ukrnafta shares were sold to its workers and 3.4% to Ukrainian citizens. However, the progress of the company's privatization was hampered by parliament's decree, in full disregard of the existing privatization law, that some of Ukrnafta's subsidiaries could not be privatized due to their national importance. However, after 1996, major stakes in Ukrnafta were sold (Pleines 1998).

20% of Ukrnafta shares were sold at stock markets, of which 6% were offered in Germany and the United States in the form of American Depository Receipts (ADRs). In addition, stakes adding up to 10% were sold to financial investors. Consequently, Ukrnafta's minority shareholders included Alfa Nafta (part of the Russian Alfa Group), Privatbank, Ukrsibbank and affiliated companies, such as Copland Industries S.A., Watford Petroleum Ukraine, Occidental Management Co. Ltd. and others. The state retained an absolute majority of shares in Ukrnafta, which were transferred to the national oil and gas holding company Naftohaz Ukrainy. In the late 1990s, the management of the effectively state-controlled oil company engaged in asset stripping and did not develop any long-term business strategy (Prudka 2001).

However, by 2001 Privatbank and Ukrsibbank had jointly gained control of 41% of Ukrnafta, mainly through companies registered in Cyprus. In 2002-2003, Ukrsibbank transferred full control over the stake to Privatbank.[3] Privatbank, controlled by Igor Kolomoysky, had become one of the largest holdings in the country in the wake of privatization (Maskalevich 2003). As a consolidated and powerful minority shareholder, Privatbank demanded an end to asset stripping and a say in the company management. It thereby confronted the state, represented through Naftohaz Ukrainy, as majority shareholder.

According to Ukrainian legislation, 60% plus one share must be registered for a general shareholder meeting to take place. Privatbank and Ukrsibbank, which gained two of eleven seats on the supervisory board at the September 2000 general shareholder meeting, seized the opportunity to block subsequent shareholder meetings in order to pressure for a total of five seats, which would have meant a veto position on key issues (where a 60% quorum is required). Consequently, company operations requiring approval at general shareholder meetings, such as the adoption of long-term strategies, the creation of joint ventures or dividend payments, could not take place. Accordingly, attempts by the new management to develop a long-term business strategy failed. The stalemate also prevented any improvements in corporate governance.

Table 3: Ukrnafta's economic performance 1997-2004

	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Oil production (mt)	3.0	3.0	3.0	2.9	2.8	2.8	2.9	3.0
Gas production (bcm)	2.2	2.6	2.7	2.7	2.6	3.3	3.3	3.4
Net sales (US$m)	560	538	344	538	486	384	556	822
Net profit (US$m)	163	57	56	182	182	84	167	254

Sources: Ukrnafta (www.ukrnafta.com); Dragon Capital (www.dragon-capital.com); InvestGazeta (www.investgazeta.ua); MFK Investment Bank (www.mfkgroup.com).

The government's attempt to resolve the conflict by reducing the legally required quorum for a general shareholder meeting from 60% to 50% was rejected by parliament. At the extraordinary general meeting of Ukrnafta shareholders in March 2003, an agreement was finally reached between the state as majority shareholder and Privatbank

[3] Information on the ownership structure is based on information provided by the company (www.ukrnafta.com, only available in the Ukrainian version) and by MFK Investment Bank (www.mfkgroup.com).

as minority shareholder with some veto powers. Privatbank received four of eleven seats on the supervisory board and its candidate, Ihor Palytsya, was appointed head of the management.

In spring 2005, the new Ukrainian leadership, which saw Privatbank as an ally of the former regime, launched legal investigations into its acquisitions in a new attempt to neutralize Privatbank's influence in Ukrnafta. However, the initiative to reduce the legally required quorum for a general shareholder meeting from 60% to 50% was again rejected by parliament in October 2005.

Table 4: Ukrnafta's corporate governance index 1997-2004

	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Index value	0.2	0.2	0.6	0.6	0.4	0.4	1.0	1.0

In summary, Ukrnafta was characterized by bad corporate governance in the late 1990s, when the largely uncontrolled management engaged in asset stripping. As with Yukos, the conflict with minority shareholders did not boost the company's corporate governance performance (or its economic performance). However, in contrast to Menatep, the Ukrainian state (as majority owner) did not revert to illegal means to remove of the unwanted minority shareholders; it settled for a stalemate instead. However, when a compromise was finally reached in 2003, corporate governance improved remarkably as transparency measures (primarily intended to prevent asset stripping) and fair participation in decision-making (meaning adequate representation at the company board) were now being demanded bilaterally to safeguard interests.

PKN Orlen – The power of laws

Established in 1999 through the merger of Centrala Produktów Naftowych and Petrochemia Plock, PKN Orlen is Poland's largest oil and petrochemical company. In 1999 and 2000, 72% of PKN Orlen was sold on the Warsaw Stock Exchange and in the form of Global Depository Receipts (GDRs) on the London Stock Exchange. The state retained a blocking stake of over 25%. In 2002 and 2003, two bigger minority shareholders emerged. The Kulczyk Holding acquired a 5.69% stake and the Commercial Union obtained 5.04%.[4]

Consequently, the state remained the largest owner with veto powers, but lacked a majority stake. Apart from the stakes of the two smaller minority shareholders, most of PKN Orlen's shares were on free float at stock exchanges. As small portfolio investors tend to be passive, the three major stockholders had more voting power than their share would suggest. Like the two companies presented above, PKN Orlen was subjected to stricter corporate governance rules and controls due to its listing on the stock exchange. However, whereas the rules in Russia and Ukraine existed mainly on paper, enforcement in Poland was considerably better (Heinrich et al. 2005).

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[4] All ownership figures are from PKN Orlen's annual reports.

Table 5: PKN Orlen's economic performance 1999-2004

	1999	2000	2001	2002	2003	2004
Total crude oil processing (mt)	12.5	13.1	12.9	12.5	11.7	12.2
Net sales (US$m)	3,347	4,285	4,156	4,540	6,917	7,958
Net profit (US$m)	237.9	207.7	91.8	113.1	266.0	651.9

Source: PKN Orlen company data.

This difference is clearly demonstrated by PKN Orlen, which became the subject of a scandal caused by machinations similar to those observed at Yukos and Ukrnafta. An important actor in this scandal, Jan Kulczyk, was the man behind the Kulczyk Holding and, according to the mass media, Poland's most influential businessman. He acquired important assets in Poland's privatization auctions and promoted his business through contacts with leading politicians at the regional and national levels (Schoenman 2005; Grzeszak 2004).

When he became a minority shareholder in PKN Orlen, the company was heavily shaken by political scandals. In 2004 a parliamentary commission was established to examine possible irregularities at the firm. The allegations included donations to foundations headed by the Polish president's wife. Another parliamentary commission was set up to investigate allegations that Kulczyk negotiated with the Russian secret service to promote Russian business interests in the Polish oil industry. In the Czech Republic it was alleged that the prime minister had been bribed to favor PKN in the privatization of Unipetrol.

In 2004, Kulczyk Holding's president was appointed head of the supervisory board of PKN Orlen, although the holding officially controlled less than 6% of the company. However, after criticism from the Polish prime minister, he was replaced by the government's candidate after just 20 days in office. Since then the government has used its blocking share to hand-pick the head of the company management. In September 2004, a deputy finance minister was appointed (Heinrich et al. 2005).

Although scandals have tarnished the company's image and hampered the realization of an ambitious strategy to create a regional, vertically integrated oil company in central eastern Europe, PKN Orlen's corporate governance has been on a consistently high level, especially when compared to Yukos and Ukrnafta. The company has published its financial information in international accounting standards, disclosed its ownership structure and paid dividends. No violations of shareholders' rights are in evidence. Overall, PKN Orlen has been characterized by good corporate governance performance, particularly in its disclosure standards, as indicated by the index values in Table 6.

Table 6: PKN Orlen's corporate governance index 1999-2004

	1999	2000	2001	2002	2003	2004
Index value	1.2	1.2	1.2	1.2	1.2	1.4

This can be seen as a result of a stricter enforcement of legal regulations related to corporate governance (Hashi 2003), forcing the company to ensure a high level of transparency in financial reporting and ownership disclosure (Brody et al. 2005; Patel et al. 2002). This moreover prompted state organs to investigate allegations of manipulations and violations. Though the parliamentary committees established to examine PKN Orlen are unlikely to clarify all issues, public attention and pressure helps

to ensure certain minimum standards of conduct for politicians and businesspeople alike (Federowicz/ Sitek 2006).

Conclusion

Earlier, we singled out four factors influencing corporate governance performance. As there is no single explaining factor for corporate governance performance, but rather a combination, a more complex framework is necessary to explain it. On the basis of research conducted so far (Heinrich et al. 2005), the following analytical framework is suggested:

In the socialist system, corporate governance did not exist in the western sense; all large companies were state-owned and state-controlled. Accordingly, there were no corporate governance regulations in place, when the socialist systems disappeared, nor were there state agencies capable of controlling private companies. At the same time, internationalization was very limited; economic co-operation was largely restricted to centrally planned socialist economies within the CMEA (Council of Mutual Economic Assistance) trading area. Export activities mostly fell under the stewardship of state ministries rather than individual companies.

Consequently, in the early years of reform, most post-socialist companies were characterized by bad corporate governance and a low level of internationalization. In Russia and Ukraine, the lack of functioning corporate governance regulations and state control clouded most of the 1990s. At the same time corporate governance problems hampered the development of domestic companies and limited their business to the home market.

In line with the thesis that as a company becomes more integrated into global markets, it increasingly adopts international standards of business conduct and ethics (thereby transforming its business behavior), improvement in the corporate governance of central and eastern European companies correlates to internationalization. As pressure from global partners mount, internationalization leads to improved corporate governance. Meanwhile, improved corporate governance promotes internationalization as a company attracts more foreigner investors.

Most central European countries improved their corporate governance in line with their internationalization by the mid-1990s. For some major Russian companies, this process started after the financial crisis of 1998.

Although internationalization is the dominant factor explaining improvements in the corporate governance of central and eastern European companies in the early 1990s, the three other factors which generally influence corporate governance performance came into play later.

Domestic regulation of corporate governance issues and enforcement markedly improved in all post-socialist countries. In the central European countries, this was demanded or even supervised by the European Union prior to their accession. In Russia and Ukraine, important improvements in corporate governance regulation were achieved in 2000 to 2002. Further improvements in corporate governance may be due to national legislation, such as the adoption of international accounting standards, soon to be compulsory in both countries.

As legal protection of minority shareholders is weak in law and even weaker in practice, especially in post-Soviet countries, corporate governance improvements forced through by minority shareholders have remained the exception.

Instead, the strategy of majority shareholders has had a strong influence on corporate governance performance. However, there are intervening variables. Only when they had consolidated ownership rights legally and de facto did majority owners embark upon long-term business strategies whit the requisite improvements in relations with other shareholders, thus leading to improvements in corporate governance. If the strategy of majority shareholders is oriented towards long-term profitability, its positive impact on corporate governance performance is strengthened if the degree of internalization is high. However, if the position of minority shareholders is strong, they may potentially neutralize the majority shareholders' strategy. At the same time, the presence of weak minority shareholders has provoked violations at their expense, thus leading to worse corporate governance, especially in the late 1990s.

This leads to the following main working hypotheses:

> *(H1) A company's corporate governance is good if legal regulation is good, i.e. the quality of related laws and the degree of their enforcement are high.*

Hypothesis H1 describes the situation in the central eastern European countries like Poland. The big and established companies, like PKN Orlen, are unlikely to risk legal proceedings. Although illegal manipulations naturally take place, they are exceptional. Still, there is considerable room for improvement. Whether companies merely fulfil the legally required minimum standards or aim higher depends on the other three factors.

> *(H2) A company's corporate governance is good if the strategy of majority shareholders is oriented towards long-term profitability and there is no conflict with strong minority shareholders. The impact of this constellation on corporate governance is strongest when internationalization is high.*

Hypothesis H2 describes the situation in former Soviet Union countries like Russia and Ukraine. As the minimum standard set by legal regulations is very low (mainly due to lack of enforcement) the actual corporate governance performance of companies in these countries can differ dramatically. The main explaining factor for these differences seems to be the strategy of majority shareholders. In the oil and gas industry a strategy of long-term profitability automatically leads to internationalization. Accordingly, there is a strong link between strategy and internationalization, which both promote better corporate governance.

As the current experience of Russia demonstrates, a remarkable improvement in corporate governance is possible under hypothesis H2 (cf. e.g., Kochetygova et al. 2004; Judge/ Naumova 2004; Heinrich 2005). However, this improvement depends on the will of the majority shareholders, and it can be reversed at any time. Moreover, the state has very limited control over these factors and therefore cannot really influence corporate governance. As the example of Ukraine indicates, where corporate governance performance has not improved, economic growth alone is not enough to ensure better corporate governance (Sidenko/ Kuziakiv 2003).

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