Foreign Direct Investment and Corporate Governance in Emerging Markets: Poland's Search for a Workable Model

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European International Business Academy – Athens, December 2002

September 4, 2002

Abstract: This paper is at once a description of Poland's corporate governance system and an analysis of the challenges facing that country's equity markets. Drawing on the experiences of three important companies, the paper argues that Poland's corporate governance issues and potential remedies go well-beyond international and national proposals for codes of conduct and standards of good corporate governance. It concludes that the main challenge for Poland is creating a corporate governance framework, despite the long rupture in its capital market history, and developing a coherent set of attitudes about desperately needed foreign direct investment.

"Experience, however, shews, that the fancied or real insecurity of capital, when not under the immediate control of its owner, together with the natural disinclination which every man has to quit the country of his birth and connexions, and intrust himself with all his habits fixed, to a strange government and new laws, check the emigration of capital. These feelings, which I should be sorry to see weakened, induce most men of property to be satisfied with a low rate of profits in their own country, rather than seek a more advantages employment for their wealth in foreign nations."

David Ricardo, *On the Principles of Political Economy and Taxation*, 136-137.

I. Introduction.

Poland, for many reasons, has been the focal point of discussions about central Europe's progress toward developing economic and political institutions alone the lines of its western neighbors. Its size, population, history, and geographic position make that country essential to hopes of integrating central European countries into the European Union. One of the many issues facing Polish economic and political leaders is developing a system of corporate governance that will help attract sufficient domestic and foreign capital for continued economic growth and integration. This piece is designed at once to assess Poland's progress since 1991, when the Warsaw stock exchange reopened, and to suggest that the persistent corporate governance conflicts that remain are more issues involving ambivalence about foreign ownership of Polish assets rather than straightforward problems of corporate governance. It takes as a given the propensity of transnational firms to demand of national governments the right to treat their assets as interchangeable components in a network designed to optimize the economic value of the whole, rather than the parts. As Raymond Vernon succinctly characterized competition in many industries, multinational behavior, and the potential conflicts:

> When mature multinationals are at war (in competition, our note), those who shape the strategy of the enterprise usually see it as a global war, with share-of-global-market as the telling measure of success. From their viewpoint, every unit in the enterprise is involved in the global face-off, irrespective of its location. Decisions to open or close plants, to introduce new products or retire old ones, to raise prices in a market or lower them, are likely to be framed by their effects on the global position of the firm. Those decisions can be expected at times to vary from the decisions of a stand-alone firm confined to a single market. Sensing that

> possibility, government officials, labor representatives, and other nation-bound interests are frequently wary of the durability of the multinational's presence and uncertain how it is likely to behave in the national economy.[1]

The Warsaw exchange is central Europe's largest by volume, but it has never been an extraordinary performer. Moreover, recently Poland's growth rate has declined to 1% and unemployment has reached 18%. Some observers attribute these economic difficulties to problems in Poland's corporate governance system – the means by which any society determines "the direction and performance of corporations."[2] Recently, too, the exchange has been rocked by a series of shareholder conflicts. Criticism of corporate governance practices has been focused on foreign firms such as Michelin, of France, and ING, of the Netherlands. Minority domestic investors have accused these firms of realizing profits offshore as well as railroading domestic investors. Some of these conflicts can be best explained by the growth of private Polish pension funds, which have been organized along Anglo-Saxon lines and which invest a substantial amount of their assets in domestic equity securities. They have been leading a fight for the rights of minority shareholders.

Nonetheless, large shareholders dominate most companies listed on the Warsaw exchange. Moreover, most of the state companies recently privatized were sold to foreign companies. Ownership patterns resemble continental European patterns rather than American or English less concentrated form. Historical, this ownership configuration gave rise to much of the attention that corporate governance receives and many of the proposals for reform in developed and developing markets. Several groups have put together new codes of best practice, which are designed to protect the interests of minority shareholders, improve accountability of companies, and maximize shareholder value. Although these codes are non-binding in Poland, as in most European countries, firms will be expected to use them or explain why they do not. Those firms that do not comply are expected to sell at a discount to those that do. Foreign and even some domestic shareholders fear, however, that more stringent requirements for big

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[1] Raymond Vernon, *In the Hurricane's Eye* (Cambridge, Mass.: Harvard University Press, 1998) 14.
[2] Robert Monks and Nell Minow, *Corporate Governance* (Cambridge, Mass.: Blackwells, 1995) 1.

foreign investors will discourage foreign investment in Poland and thereby dampen the market.[3]

The history of Poland's corporate governance system and its stock market highlights two special problems in the control of corporations in that country, which may have more general implications for other emerging markets. The first is that not only do some key elements of its corporate governance system stem from pre-Communist regulations, which were substantially formed prior to the advent of complex transnational corporate entities. The absence of private property, especially share capital, from 1945-1985, stunted the development of interpretive regulation or common law to bolster or refine the initial laws. For example, the original law governing the responsibility of boards of directors stipulates that the board is responsible for the interests of the company, without stipulating how that interest is to be defined and how to resolve conflicts between competing interests in the corporation. Polish law, for example, lacks a body of precedent, which might help balance various stakeholder interests and define a "prudent man," as is the case in the U.K. or the U.S. Second, like most emerging markets, Poland desperately needs foreign capital. The series of privatizations and preference for some dispersed local shareholding in Poland have left many companies listed on the Polish stock exchange with one major foreign shareholder and many local ones. This ownership structure has, almost inevitably, left a major and uncomfortable cleavage between the interests of large and small shareholders.

The remainder of this paper is divided into six parts. The first will review the literature on corporate governance and emerging markets. The next will discuss the history of Poland's capital markets and corporate governance legislation. Part four recounts three case studies, which highlight problems in Poland's corporate governance system. Part five discusses the shortcoming of two recent attempts to reform the corporate governance system in Poland. The last section will attempt to tie together our evidence and conclusions.

This paper will argue two points. The first is that many of Poland's current corporate governance difficulties stem from vague legislation about the proper

[3] "Corporate governance in Poland: Minority protection," *The Economist*, May 4, 2002, p.80.

responsibility of boards and the absence of a history of regulations or common law that might aid those most directly involved with the governance of firms. Second, as is the case in many emerging markets, the Polish problems with corporate governance stem from a great need for foreign capital, a desire to keep some shareholder control in domestic hands, and fundamental requirements of multinational companies to place all subsidiaries, even partially owned ones, in an integrated, seamless transnational system.

II. Foreign Direct Investment and Corporate Governance in Emerging Markets.

While most existing literature on corporate governance has studied exclusively U.S. and other OECD firms (see Shleifer and Vishny, 1997; and Maher and Andersson, 2000, for comprehensive surveys), a growing and substantial literature in finance and public policy argues that corporate governance poses a special problem for emerging markets. The very notion of emerging market is for some tied to equity investment.[4] According to the International Finance Corporation (IFC), for example, emerging markets are those economies where incomes are low- to middle (high income begins at USD 9,361 per capita) and which have a low ratio of investable market capital to Gross National Product. Eighty-one countries, including Poland, are classified as emerging.[5]

Not surprisingly, increases in market capitalization have been accompanied by increases in foreign equity investment in emerging markets. Until fairly recently the preferred form of emerging market investment for foreigners was with debt. The 1990s witnessed a veritable revolution in emerging market foreign investment patterns. Foreign investment in the Czech Republic, Hungary and Poland has grown from USD 5.2 billion in 1990 to USD 11.3 in 1996, but the change in its composition is even more striking. The equity portion of portfolio investment in the three countries climbed from USD 68 million in 1990 to 1.3 billion in 1996; net foreign direct investment (FDI) climbed tenfold in the same period. Annual net foreign direct investment in Poland alone, for example, climbed from USD 89 million in 1990 to 2.7 billion in 1996. During the same period,

[4] We will make no distinction here between emerging and transitional economies. In the text, the two terms will be used identically.

[5] Data from *Emerging Stock Markets Factbook*, quoted in Levich.

FDI and equity portfolio investment grew from just over ten percent of net inward investment to approximately 70% in the region.[6]

Very recently, Richard Levich (2001) has argued that, despite the enormous growth of equity and debt investing in capital markets and the opportunity for superior returns offered to investors by emerging markets, that investment still remains a small part of emerging markets' Gross National Products (GNP). Although emerging market equity capitalization has grown from USD 67 billion in 1982 (32 stock exchanges representing, representing 2.5% of world capitalization) to USD 3.0 trillion in 1999 (81 emerging market exchanges, 8.5% of world capitalization), market capitalization in emerging markets represents between 30-40% of emerging markets' GNP compared with 70-80% in developed markets.[7] Moreover, according to Levich, emerging markets still represent a large continuum of conditions. "Some markets are maturing and on course toward converging into and integrating with the world of mature, developed financial markets. Markets in other countries are almost non-existent or deserving of the 'frontier' label given by the IFC to markets one step below emerging."[8] Poland's capital markets are or, perhaps better put, aspire to be among those that have converged.

Levish also raises another issue that is important for our discussion. Although the gains from trade in goods and services are proportional to the differences in factor conditions (relative prices, technology, etc.) among the trading nations, general institutional and corporate governance weaknesses more specifically discourage investors and lesson the ability of emerging markets to exploit the gains from trade. If this is the case, he suggests that those countries, such as Poland, should outsource corporate governance activities like listing and audit to countries with more experience and credibility.

The importance for emerging markets of developing effective corporate governance institutions has been underscored by Klapper and Love (2002) and others. Building on the work of Easterbrook and Fischel (1991) and Black and Gilson (1998), who have shown that many laws to protect shareholders have been undermined by

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[6] Dorothy Meadow Sobol, "Central and Eastern Europe: Financial Markets and Private Capital Flows," in *Capital Flows and Financial Crises*, ed. Miles Kahler (Ithaca: Cornell University Press, 1998) 188.

[7] Levich. Clearly emerging markets have even outpaced the growth in total world market capitalization, which increased from USD 3.0 trillion in 1980 to USD 36.0 trillion in 1999.

corporate bylaws that permit a high degree of opt-out from national laws. Klapper and Love argue that firms in emerging markets with good corporate governance systems tend to outperform those without. Using the Credit Lyonnais Securities Asia corporate governance rankings of corporations and markets, they found that companies with high rankings tended to have higher Tobin's-Qs and higher return on assets, and that corporate commitments to good corporate governance were even more important in countries with weak legal protections.

Some studies have focused on the particular configuration or mechanisms of corporate governance and their relationship to company performance. Claessens and Djankov (1999a, 1999b) found that companies in the Czech Republic, for example, with concentrated ownership, foreign ownership, and ownership by non-bank investment funds were more profitable and had higher labor productivity than those that did not. Gibson (2000) looked at whether the ease of replacing CEO's in emerging market companies influenced company performance.

In short, given the dependence of emerging markets on high levels of foreign equity investment and the likelihood that foreign investors will seek out countries with good corporate governance environments, the issue of what kind of systems to have and how to build them is crucial for Poland and other emerging markets.

III. The Warsaw Stock Exchange – Some history and facts.

Founded in 1817, the Warsaw Stock Exchange (WSE) or Commercial Exchange functioned through most of the first part of the nineteenth century. Like most of the early exchanges in Europe and America, it traded mostly bonds and a few equity securities. Not all securities were traded through the exchange. Nevertheless, by the second half of the century, buying and selling equity shares became the main activity at the stock exchange. Between World War I and II, the Polish stock exchange operated smoothly and ran several subsidiary exchanges throughout Poland – in Katowice, Cracow, Lodz, Poznan and Vilnius. After World War II, when a planned economy was introduced in Poland by the Communist governments imposed by Soviet Union, the WSE ceased to operate.

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[8] Levich, 3.

In 1989, with the beginning of the transformation from a planned to a market economy and from communism to democracy, the new Polish governments started to reintroduce institutions necessary in a modern society. In October 1990, the French and Polish governments signed a cooperative agreement to develop the Warsaw Stock Exchange. In April 1991, the Warsaw Stock Exchange was re-established in the form of a joint stock company and trading began, at first only once a week. Five companies were listed at this time – Tonsil SA, Prochnik SA, Krosno SA, Kable SA and Exbud SA. By the end of 1991, there were nine companies quoted with a total market value of 100 million Polish zloty. (Table 1 shows growth of WSE in some details.)

The WSE developed naturally over time. In 1993, it became totally computerized and parallel markets in derivatives and other instruments were created. In 1994, share options were introduced and traded; trading instruments was extended throughout the workweek, and the WSE became a member of the World Federation of Exchanges. Continuous trading was introduced in 1996. By 1997, the WSE's market capitalization reached over USD 10.0 billion, representing 100 quoted companies. The American Committee of Exchanges and Securities recognized the WSE as a designated international market, thus confirming that the WSE had attained, at least, U.S. standards for corporate governance and control in the eyes of American regulators. By 1998, market capitalization exceeded USD 20.0 billion. With new securities and options introduced and traded each year, the WSE is considered the most sophisticated and largest exchange in the CEE region (See Figure 2).

By the end of 2001, two hundred thirty companies were quoted on the WSE, representing three main sectors: manufacturing (138 companies), financial services (25 companies), and other services (51 firms). Their ownership structures are very different and difficult to characterize, since in many cases they evolves over time. Nevertheless, we can group them by their origins. Fifty-two companies were first listed on the stock exchange by the Polish State Treasury. After the first nine companies were put on the market in 1991, the State Treasury added an average of five companies per year, until the very end of the 90s when the pace slowed down considerably. As late as 1998, the State Treasury privatized through public offerings five companies – Polish Telecom was the largest placement. In both 1999 and 2000, in contrast, only one company per year was privatized in this manner. (In 1999, for example, PKN Orlean, Poland's largest petrochemical company.) The second significant group of companies at the stock exchange is former state-owned companies that were privatized through private placement, management buyouts (MBOs) or initial public offerings (IPOs) on the WSE, but to a limited number of shareholders. (**Does this make sense? Is this really a public offering?)** The third group of companies is firms that participated in the program of National Investments Funds. Their shares were placed on the WSE by investments funds. The largest group, however, sixty-four companies, is private companies on the WSE. These firms were generally formed in the beginning of 90s and listed on the stock exchange by their original owners as a means of getting capital for further expansion. The majority of placements occurred in the 'good years' of 1998 and 1999.

Table 1. WSE development

Source: 10 years of WSE, *WSE Publications* , Warsaw 2001

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Total market capitalization in Polish zl (bn)	0,3	2,0	9,1	9,4	20,1	37,7	53,6	96,1	134,6	103,4
Number of companies quoted	16	22	44	65	83	143	198	221	225	230
WIG	1040,7	12439	7473,1	7585,9	14342,8	14668	12795,6	18083,6	17847,6	15821,2

Note: the ratio of zloty/USD in 1992 was…., and in 2001 was about 4zl=1USD

Table 2. Approximate market capitalization (December 2001, in bn USD) and number of quoted companies (December 2000) at selected stock exchanges in Europe
Sources: 10 years of WSE, WSE Publications, Warsaw 2001; *Statistical yearbook 2001 of WSE* , WSE Publications, Warsaw 2002

Bratislava	Ljublana	Praque	Budapest	Vienna	Warsaw	Lisbon	Oslo	Dublin	Athens
1,5	4	9	11	25	25	46	70	75	85
10	155	62	65	110	225	110	220	90	310

IV. A Short history of corporate governance in Poland.

Corporate governance in Poland is regulated mainly by that country's Commercial Code. Established in 1926, the Polish Commercial Code lay dormant during the communist regime but survived as a legal instrument. In 1989, it was reactivated as national law and proved surprisingly effective in regulating the development of Polish private companies and markets.

In January 2002, a new, more modern version of the Code was introduced. The new code contains several provisions relevant to corporate governance. It strengthened the powers of shareholders and supervisory boards, spelling out their competencies, responsibilities, and procedures. It also made the powers of shareholders more precise. Changes in company bylaws, the approval of financial statements, and the election of members of both the supervisory and management boards, for example, must be decided at shareholder meetings. Most of these decisions can made by a simple majority of all voting shares; only major decisions, such as those about changes in a company's capital structure, such as creating new shares or issuing bonds, require a qualified majority of at least 75% of votes. This qualified majority can be higher if stipulated by company bylaws. Like Germany, Poland vested the primary responsibility for the ongoing monitoring of company performance, operations, and managers in a separate supervisory board. As clearly stated in the Commercial Code, however, the supervisory board's responsibility is to work in the interest of the company, not shareholders. The supervisory board of the joint stock company must meet at least four times per year.

At the beginning of the 1990s, discussions about corporate governance were dominated by the daunting issue of who should serve on supervisory boards. With the plans to privatize over 7000 state-owned firms in the 1990s, demand for board members was enormous. As discussed, the state had four major ways of privatizing companies: public placement on the WSE; sale to a single foreign or local investor; placement the National Investment Funds – a voucher system for mass privatization that included 512 companies – and, finally, employee and management buy-outs. The first stage usually was 'commercialization' of a company, which meant transformation of a state-owned enterprise into a joint stock company owned 100% by the State Treasury. Such a company had to have a supervisory board. Typically, two members were worker representatives, but other positions had to be filled by external experts. At the later stage, all or part of the state's shares were sold by the Treasury, but even at the initial stages of the privatization process the demand for responsible supervisory board members grew substantially.

While demand was growing quickly, supply of qualified board members was constrained. There was a clear problem of finding board members who were capable and knowledgeable enough to monitor companies. The problem was further complicated by the necessity to replace old executive and management boards with individuals who were not tainted by the old system. From 1989 to 1991, over 40% of the managers of state-owned companies were replaced.

The state agency responsible for privatization (The Plenipotentiary Department for Ownership Changes) set out to create future members of managing boards with special training programs. A special Foundation for the Development of Capital Markets was established. It started a four-week education program, which concluded with a complex series of exams. A cadre of teachers was recruited for the program from international experts, including university professors from economics, legal and business disciplines.

Those who passed the exams entered a pool, from which members of the boards were chosen by the Ministry of Privatization, later renamed the Ministry of State Treasury. From 1991-1993, at the early stages, when the capital market was just taking shape, the process of appointing board members was not very political. The norms of professionalism and independence for supervisory board members were widely accepted and respected, even by politicians, as indispensable elements of the development toward a market economy.

Over time, however, the norms of professionalism and independence were diluted by two major factors. The first was the return to power in 1993 of the former communist party, renamed Social Democrats. The former communists were used to *nomenklatura* system, the common practice of requiring the approval of national, regional, and local Communist Party Committees before allocating posts. Posts on supervisory boards became valuable possessions to be distributed in a controlled way to party members and other political cronies. The second was the growing sophistication of international funds, local investors, and powerful state-owned companies (especially banks and insurance firms) about how they could use the system to manipulate capital markets. They discovered new possibilities for investing in capital markets and influencing the fates of companies. Positions on supervisory boards increasingly became important elements in these maneuvers. Seats on boards needed to be secured and controlled by people who would perform in accordance with the wishes of particular shareholders. These two factors led in the late 90s to a growing number of corporate governance problems in Poland.

V. Three Cases Studies.

The case of Polifarb Debica:

Polifarb Debica, a major producer of paints and lacquers, became a public company in 1997 as part of the National Investment Funds (NIFs) privatization program. The basic goal of the program was to enable as many adult citizens as possible to participate in the privatization process. Between November 1995 and November 1996, every adult in Poland received one NIF certificate, which could be convert later into the shares of NIFs (one share in each of the 15 funds) or could be sold on the secondary market. About 26 million people participated in this heavily advertised program that embraced 512 medium-sized firms whose ownership was distributed among 15 NIFS operating as joint stock companies. While the shares of the NIFs were listed on the WSE and at first were owned by eligible citizens, most of those citizens sold those shares soon after the creation of the NIFs. Each fund took up a sizeable holding, amounting to 33% of the shares of 33 firms, and smaller holdings in other companies participating in the program. Up to 15% of the shares in each company was distributed free of charge to those companies' employees and 25% was retained by the State Treasury. In accordance with the Law on National Investment Fund trading in NIF shares began in June 1997, and the Funds started also to list some of their controlled companies on the Stock Exchange. By the end of 1998, the shares of 21 companies were publicly traded. [9]

[9] Warsaw Stock Exchange , Fact Book 1999, WSE Publications, Warsaw 2000, p. 35-37

Polifarb Debica, one of these companies, faced with the possibility of a merger with one of its major competitors. The largest block of its shares was held by XI NIF, one of the NIFs. XI NIF decided to sell its 32%-stake to a "strategic investor," a Swedish firm, Alcro Beckers AB, at a premium price. The strategic investor decided immediately to increase its stake and announced a tender offer to buy all the shares sold on the stock exchange, offering 89 zl. per share. To many investors, this offer seemed ridiculously low, because the company's shares were selling at 115 zl. at this time. Therefore, Alco Beckers decided to buy a second significant block of shares controlled by the state (25%) paying the same high price it had paid for the XI NIF's shares, which by this time represented a substantial premium over the normal WSE price. By 1999, the Swedish investor controlled 54,6% of the shares and was actively buying more shares on the stock exchange.

It also decided for the first time in the history of the Warsaw Stock Exchange to use juridical means to force minority shareholders to sell their shares. Meanwhile, the company's performance deteriorated. Although in 1997 the firm had handsome profits, in 1998, sales went down by 2% and it posted an accounting loss. Its share price went down steadily from 135 zl to 50 zl. Nevertheless, once again the Swedish investor offered to buy shares at 42 zl per share, an offer that for obvious reasons was not welcomed as its price on the market was 50 zl. The supervisory board, controlled totally by AlcroBeckers AB, which already owned more than 75% of shares, decided to appoint a special auditor to value the company. The auditor established a final price per share of 57 zl. The tender offer for the 219,000 outstanding shares was accompanied by the announcement that company would be de-listed in September 2000. Minority shareholders were simply informed that they had to indicate by August 2000 at what bank accounts they wanted money transferred for their shares. Despite public outcries, minority shareholder criticism, and the threat of law suits, Polifarb Debica ceased to be a public company, and a month later was de-listed from WSE.

Stomil Olsztyn SA:

Well publicized in Polish and French press, the conflicts between a strategic investor in a large Polish tire producer, Stomil Olsztyn SA, offer another good illustration of Poland's problems with foreign investors. In the late 1990s, Campagnie Financiere Michelin bought 59,2% of the shares of Stomil shares. Problems with the minority investors erupted in the middle of 2000. Five minority shareholders, the investment funds Pioneer and Union Investment, DWS Poland, AIG and the pension fund OFE PZU together controlled over 20% of the outstanding shares. They accused Michelin of stripping out profits from Poland to France, using transfer pricing for exported tires and heavy licensing fees. They also argued that Michelin prevented them from accessing information about the financial operation of the company, which the company was required to do in accordance with transparency rules for public firm. In order to fight for their rights, the minority shareholders gained one seat on the supervisory board using a provision of the Commercial Code, which allows bloc voting for supervisory board members. That is, a group of minority shareholders, who together own 20% of a company's shares and who are not satisfied with the list of board candidates provided by the company, can demand to have one candidate reserved for each minority block of 20%. With over 20%, minority shareholders managed to put one representative on the five-person board.

Michelin denied the accusations and, at the shareholders meeting, blocked the minority shareholders proposal to choose a BDO, a local but respected auditor for several listed firms, as a special auditor to analyze the relevant transactions in detail. Michelin argued that the company's regular auditor, Arthur Anderson, could perform the required audit. Anderson's analysis found that Michelin did not treat Stomil Olsztyn any differently than it other European subsidiaries. This conclusion was supported by KMPG and PWC, two other accounting firms to which the executive board of Stomil Olsztyn turned for help. Nevertheless, the minority shareholders did not accept these conclusions, since Anderson was Stomil's and Michelin's overall auditor. Anderson's vested interests in serving its client, they argued, prevented the auditor firm from revealing the true facts. In June 2001, Michelin, partially under the pressure of public opinion, proposed using a joint team of Andersen and BDO as auditors, but minority shareholders still demanded a separate BDO audit. They also obliged their only representative on the supervisory board, in accordance with special regulations in the Commercial Code, to perform a personal analysis of the financial transactions of the executive board. But executive board members refused to allow individual supervisory board members to perform any audit, as long they were unwilling to sign a special confidentiality clause, which the minority shareholder categorically refused to do.

Meanwhile, Michelin was also steadily buying shares of the company, increasing its stake. It finally announced a tender offer for all the outstanding shares at a price of 24,5 zl. per share. The investment funds holding minority positions considered this offer much too low and accused Michelin of illegally attempting to exceed the 75%-threshold, at which the French company could decide the fate of the company at will. The large minority investors also announced that they would not sell their stakes to Michelin, thereby, effectively preventing the French company from gaining total control over the company.

In the beginning of October 2001, minority shareholders scored two victories over Michelin. The court fined the company's CEO for not allowing individual board members to perform an analysis of selected transactions. In accordance with minority shareholders demands, the court also stipulated that Stomil Olsztyn had to use BDO as the auditor for checking the French company's transfer pricing mechanisms. The ruling was supported by the President of the Securities and Exchanges Commission, whose responsibilities included monitoring the performance of capital and commodities markets in Poland. He characterized the decision as an example of how minority investors' rights would be respected in Poland and global companies prevented from running firms any way they wanted, even if those companies were majority shareholders.

The new audit performed by BDO found that Stomil Olsztyn was selling tires to the Michelin subsidiaries at lower prices than to other buyers, thus transferring profits out of Poland. The French company persisted however. Its reaction was quick and decisive. In January of 2002, jointly with Stomil Olsztyn, the French company sued BDO for false accusations, using the PWC and KPMG opinions to show that the BDO report was seriously flawed. Michelin also sued separately minority investors for controlling over 25% of shares and conspiring to vote those shares jointly, which is forbidden by law without specific permission from the Polish Securities and Exchange Commission. With accusations flying back and forth, enormous amounts of press coverage of the conflict and an ensuing deadlock between the participants; Michelin finally proposal to negotiate a settlement. The various shareholders agreed to withdraw their pending suits against one another. Minority investors agreed to stop their representative's efforts to monitor the individual performance of the executive board members. They also agreed to talk with Michelin about the possibility of selling their shares, on condition that those who decided to keep their shares in the company would be treated in accordance with "good principles" of corporate governance, specifically demanding that new principles of corporate governance should be part of the agenda of the next shareholders meeting and that the results of the decision should become part of company's bylaws. In April, Michelin voted to choose Deloitte and Touche as a company auditor and agreed that that the new auditing firm should also investigate the issue of transfer pricing.

Elektrim SA:

Elektrim SA, a huge conglomerate operating mainly in the telecommunication industry and power segment but with large stakes in dozens of privatized companies in many industries ranging from textiles and consumer goods to cement, was a darling of Warsaw Stock Exchange. Its share price increased 7000% between 1992, when it became public company, and 1997, making it one of the largest companies on the stock exchange in terms of market capitalization and the most heavily traded. Its early investment in a 34,1% position in PTC (Polish Digitial Telecummunication), which established Poland's largest mobile phone network, Era GSM, seemed to ensure that Elektrim would be a powerhouse in Polish economy.

The first signs that there was something amiss with Elektrim's corporate governance and management came in 1998, when the company's secret contract with Kulczyk Holding (owned by a well known Polish financier) to sell it 6,5% of its shares in PTC at a very low price (valued by analysts to be worth USD 165 million) came to light. The news propelled the company's share prices into a free fall. The CEO was dismissed, and, finally, Kulczyk Holding agreed, for USD 25.0 million fee, to release Elektrim from the contract.

The newly appointed president was a foreigner, U.S. trade investment manager, Barbara Lundberg. Her appointment was well received by the press and by international investments funds that had a controlling interest in Elektrim SA. Almost immediately, she embarked upon a large-scale expansion drive. During the first three months of her tenure, the company invested USD 1.1 billion in new and promising areas of telecommunication and Internet technologies. Additional capital requirements were met by issuing USD 440.0 million in convertible bonds, which were readily bought by international the investment funds Eastbridge and Acciona. The string attached to the deal, however, was a clause calling for the immediate conversion of the bonds into cash if the company's share price fell below 64 zl.

Moreover, Elektrim's partner in PTC, the conservative Deutsche Telecom, was surprised by the announcement of an Elektrim alliance with French firm, Vivendi, which invested hundreds of millions of dollars for a 49% stake in a Elektrim subsidiary that controlled that company's holding in PTC. From that moment on, Elektrim was in constant conflict with its former ally, Deutsche Telecom, a conflict that eventually resulted in court suits with international repercussions. At the end of 2000, Elektrim's management board unexpected decided to sign a letter of intent with Deutsche Telecom, giving the German company a slight chance to take over a controlling stake at PTC. Vivendi made a counteroffer, and executive board started to play one investor off against the other. The resulting tug of war between the investors led to alternating attempts to try to get rid of the CEO and existing management board, or conversely, to support them, depending on how they were leaning at any given moment. In March 2001, when it looked as if Deutsche Telecom had persuaded several supervisory board members to vote to dismiss the existing management team, three out of seven members of the supervisory board announced that they would resign immediately. According to the company's bylaws, board meeting required a five-person quorum. The trick worked. The CEO was saved until the next shareholders meeting, where a new supervisory board, with two Vivendi representatives and five from financial investors, were chosen. The new supervisory board dismissed the CEO, but because there was no consensus around a new candidate for this post, it was temporarily delegated to the President of the Supervisory Board, Waldemar Siwak. (Polish commercial law allows for such a contingency in an emergency situation, but only on a temporary basis. The law, however, does not stipulate the duration of what is meant by 'temporary.')

It was assumed, incorrectly, that the Board would find a new CEO in short order. The President of the Supervisory Board remained as CEO until February 2002, changing hats occasionally, as it were, from his supervisory duties to performing his duties as a member of management board.

Neither the supervisory board nor the executive board halted the free fall of Elektrim SA, in spite of an emergency sale of assets and a deal made with Vivendi, in which the company sold a control over its most valuable asset, PTC, for Euro 491.0 million euro in cash. In December, with the company's shares of the company at a record low, bondholders demanded immediate conversion of bonds into cash. Management offered to pay no more than 60% of the value of the bonds in installments, triggering another round of conflict. Bondholders demanded that the company file for bankruptcy, but the court refused to start the process. An extraordinary meeting of the shareholders resulted in another overhaul of the supervisory and management boards. New supervisory board members were chosen, four representing Vivendi and four representing the aggressive BRE Bank, which had rapidly acquired a large bloc of shares. A new CEO, Maciej Radziwił, was asked to prepare a rescue plan for Elektrim SA.

VI. The cases and Poland's new codes of good corporate governance practices.

As discussed, 1999-2001 was a very turbulent period for the Polish stock exchange. Conflicts among shareholders, aggressive behavior of investments funds, unexpected breaches of trust by former allies, unfair treatment of minority investors, all combined to create employment for hordes of lawyers, whose imaginative ideas and interpretations resulted in hundreds of ways to bend corporate governance law. As illustrated by these cases, some of the most important conflicts in corporate governance were tied to inherent conflicts between multinational investors, whose interest in Polish firms is a function of how well they fit into a network of multinational subsidiaries, and Polish investors, who wish to maximize their in-country returns. In all three cases, foreign investors were willing to use legal and extra-legal methods to avoid the costs of dealing with the interests of independent third-party shareholders. Their behavior implied a belief that their large ownership interest in Polish firms put them above or at least outside the norms of corporate governance strictures, even those that are commonplace in their own country. Whereas in their country of incorporation transnational firms have a legal as well as economic interest – that is, a need to attract small shareholders to help keep share prices high, and, thereby, equity costs low – in other countries, minority share holders are considered an informational and behavioral constraint on multinational flexibility. Even in situations where local minority shareholding is considered an effective way of avoiding host country political risks, transnational firm would still generally prefer 100% ownership of subsidiaries, to avoid costly and embarrassing conflicts over information and intercompany pricing. Poland's corporate legislation, or more precisely privatization, policies contributes to these conflicts by encouraging needed foreign investment, discouraging 100% ownership, and offering little in guidance for resolving the ensuing inherent conflicts. By law 15% of all privatized companies had to be held by workers, although most foreign companies have been able to buy them out. The state also kept a sizeable portion of the shares of privatized companies for the express purpose of enforcing agreements with foreign shareholders. Although there are no statutory limits on 100% foreign ownership, the privatization procedures ended up leaving sizeable minority shareholdings in worker and government hands, adding at the very least transaction costs for those foreign firms which wanted to move to 100% ownership.

A new code of commercial law, introduced in January 2002, made little improvement in this situation, and two initiatives to develop special codes of good corporate governance practices surfaced. The first was developed by Warsaw Forum on Corporate Governance and has the institutional support of Securities and Exchange Commission and Warsaw Stock Exchange. The second was developed by Research Institute of Market Economy from Gdansk. While both share the same goal – to improve the integrity and behavior of shareholders and managers – they differ in some respects.

The very detailed Warsaw Forum code stipulates that dominant investors have special rights as they take larger risks. Minority rights should be protected but not at the cost of the dominant investors. It promotes the idea of independent directors in the supervisory board and proposes that the most important decisions about the fate of the company cannot be made without their consent. The proposal also calls on supervisory board members to treat the interests of all shareholders and company as equally important. Other issues treated in detail by this code are the preparation and execution of shareholders meetings, and supervisory and executive board procedures and organization.

The second project, developed by Research Institute of Market Economy, is more hostile to foreign investors. Its fundamental assumption is that all shareholders are equal and dominant shareholders should not leverage their position in order to attain special profits. Oddly, it recognizes that dominant shareholders will control, by virtue of their absolute majorities or large minority stakes, voting on major issues such as dividend policy. This project also specifies good practices for supervisory board operations and proposes that at least two board members should be independent and that they should have supplementary voting powers for decisions relating to minority shareholders. Finally, the project covers a lot of broad but important issues, such as limitations of poison pill mechanisms, manipulations of new shares issues (e.g., with limiting rights to buy them) and treatment of other company stakeholders.

In short, neither the new codes nor Polish governmental legislation come close to providing principles and mechanisms for resolving the conflicting interests of international and domestic investors.

VII. Conclusion.

Much has been written recently about the nature, extent, and advisability of globalization. Some of that discussion relates to the themes of this piece. What is often missing in debates about global investment, especially as it relates to that which preceded World War I, is an analysis of the type of investment not just the amount, and the implications of these changes for corporate governance, especially in emerging markets. Whereas it is clearly true that transnational labor flows are clearly below those before WWI, and that trade and investment flows as a percent of output have only recently, if at all, exceeded pre-1914 levels, the type of trade and capital flows have augmented corporate governance problems. (Kobrak, 2000) For many emerging markets today, for example, capital imports are only a small fraction of what they were in the late 19th

century.[10] Although labor mobility was greater in the late 19th century than now, despite higher costs (in relative terms) and greater difficulty of transportation, and although virtually the whole world was brought into an international trading system voluntarily or through colonial occupation, most would agree with Stephen J. Kobrin, when he wrote:

> There is no question that the late-twentieth-century world economy differs significantly from that of a century ago in many respects. First, it is broader in terms of the number of national markets encompassed (albeit to varying degrees) as constituent units. Secondly, it is *deeper* in terms of density and velocity of interaction, of flows of trade and investment, than it was prior to 1914.[11]

Our era's "internationalization," in comparison with that of the late 19th century, represents a change of kind rather than degree, which raises profound corporate governance policy issues for national and supranational bodies. In 1914, there were only 350 foreign-owned production facilities in the world. In contrast, from 1959 through 1967, over 5000 were established.[12] This trend has intensified in the last decades of the 20th century. Foreign owned companies' share of American manufacturing, for example, grew from less than 6% of that country's total production in 1977 to approximately 20% in 1991.[13] Foreign trade in the 19th century was much more between third parties and shipments of finished, semi-finished, or raw materials. Today many more cross-border transfers are components of a complex, networked production process that go well beyond the simple packaging or finishing steps performed by foreign subsidiaries in the 19th century. By the early 1990s, approximately 60% of all foreign trade was in the form of intercompany shipments. Nearly 40,000 transnational companies with total sales of USD 5.5 trillion account for roughly one-third of world production.[14]

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[10] Harold James, *The End of Globalization: Lessons from the Great Depression* (Cambridge, Mass.: Harvard University Press, 2001) 12.
[11] Stephen J. Kobrin, The Architecture of Globalizaiton: State Sovereignty in a Networked Global Economy," in *Governments, Globalization, and International Business*, John H. Dunning, ed. (Oxford: Oxford University Press, 1997) 147.
[12] Alice Teichova, et al. *Multinational Enterprises in Historical Perspective* (Cambridge: Cambridge University Press, 1986) 364.
[13] Rose Marie Ham and David C. Mowery, "The United States of America," in *Governments, Globalization, and International Business*, John H. Dunning, ed. (Oxford: Oxford University Press, 1997) 286.
[14] Kobrin, 147.

Moreover, whereas foreign investment before 1914 was mostly in the form of debt secured by assets, today's investments are in the form of portfolio or large equity investment. While disputes about corporate investment and, in general, the use of free cash flows occur between bondholders and managers, they are more rare and more narrowly focused than those between shareholders and managers.

The growth of foreign direct investment and large portfolio investment entail separate, but interrelated problems. Both managers of firms and of portfolios view their investments as part of an integrated whole. Internationalism today differs yesterday from the globalization of today like the difference between inviting guests to your house for dinner or to live with you, if we might make an analogy. Businesses are run as integrated wholes, rather than distinct production or distribution centers. A requirement of this integration is that goods, services, capital, labor and other inputs and outputs pass across borders with virtually no impediment (transaction cost) or risk, like those who live with you, there is no need to make a date to get together or to cross town for dinner, your dinner partner is just there, with all the attending advantages and disadvantages.

Moreover, while some theorists argue that corporate governance convergence is an inevitable outgrowth of globalization, it is arguable that the last hundred years has witnessed the reverse, a de-convergence of corporate governance systems. Before World War I, most major industrial countries relied on bank-based corporate governance systems like that of Germany today. The British political model of political respect for private property and laissez-faire economic management was widely adhered to, though with increasing reluctance. Countries outside of the major industrial nations were either subservient colonies or docile client states, with little independent local power to influence how corporations would behave in the geographic jurisdictions. Indeed, there were far fewer nations, a more relevant point for our discussion of Poland, to have national systems of corporate governance at all. (Whitley, 1999)

Neither the reforms suggested in Poland nor the codes of conduct suggested by the Cadbury Commission or the OECD address the key issues in Poland. They fail to address the specific conflicts caused by transnational firms' interest to optimize their international subsidiary networks with the national interests of countries and minority shareholders to protect their financial as well as social concerns. The conflicts illustrated by these case studies suggest that the problems of Polish corporate governance go well beyond the standard issues treated by good practice codes of corporate governance. Those corporate governance issues are a reflection of a deep-seeded ambivalence about foreign control of domestic assets and the inability of international bodies and national governments in many emerging and developed economies to create corporate governance policies that simultaneously address the economic necessity of encouraging foreign investment with the political necessity of protecting local autonomy and social values.

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