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Corporate Governance and Informal Institutions: Experiences of BRICS Economies

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The article attempts to explore the divergence between corporate governance on paper and on the ground in non-Western societies. In doing so, it excavates the role of informal institutions in the practice of corporate governance. Through a comparative study of BRIC economies, the article argues that variables pertaining to informal social norms (articulated in the histories and cultures of societies) are crucial to explaining the emergence of rather peculiar models of corporate governance.

I. By way of a Prologue

In an exploratory study, Morck and his co-authors observed an interesting correlation.[1] They divided the world's billionaires into two categories: *billionaire heirs* (who inherited most of their wealth) and *self-made billionaires* (entrepreneurs) and compared the rate of growth of GDP per capita with billionaires' wealth. They found that a rate of growth of GDP per capita is higher if *self-made billionaires'* wealth is larger as a fraction of GDP. The research also revealed that if the wealth of *billionaire heirs* as a fraction of GDP is larger, the rate of growth of GDP per capita is smaller (in addition to lower innovation and higher political rent seeking). Therefore, there is a highly significant relationship between the growth of an economy and manner in which control and concentration over its capital assets is done.

While self-made billionaires reflect institutions of a society that encourage entrepreneurship, billionaire heirs exemplify the structural problems within a society in which elites have a significant influence over public policy and institutions like capital markets. There is a non-

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1 Randall Morck, David Stangeland & Bernard Yeung, *Inherited Wealth, Corporate Control, and Economic Growth: The Canadian Disease, in* Concentrated Corporate Ownership (Randall Morck ed., Univ. of Chicago 2000). Also circulated as National Bureau of Economic Research working paper 6814 (1998).

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trivial literature on the impact of these elites on the corporate and economic performance of a country.[2] However, an institutional perspective of how corporate governance norms need to be reconstructed due to this impact is missing.[3] My paper is an effort in this direction.

In most of the developing world, and indeed in Brazil, Russia, India, China and South Africa (hereinafter BRICS), it is common to observe controlling family owners using pyramidal structures, cross shareholding, and super voting rights to maintain command over many listed companies[4] (in China, concentration of ownership lies in the hands of State). Such concentrated ownership leads to a divergence of interest between controlling and public shareholders,[5] thereby resulting in inefficient resource allocation in the firms. In most BRICS countries, a huge portion of the corporate sector lies in the hands of a few wealthy families.[6] These families, though under the framework of Western norms of corporate governance, will in reality, choose to curtail information, restrict monitoring exercises and engage in activities that will undermine advancement of property rights and capital markets.[7] These elites, through their political connections, may also erect welfare-reducing informal institutions and distort capital market function and corporate governance. This situation is particularly acute in countries where information dissemination is low and the legal system is dysfunctional.

Several studies have produced eloquent illustrations with regard to corporate governance in developing countries that embrace market reforms through a period of institutional change.[8] This paper adds to

2 For earlier reviews, see Philippe Aghion, Eve Caroli & Cecilia Garcia-Penalosa, *Inequality and Economic Growth: the Perspective of the New Growth Theories*, 37 (4) J. ECON. LITERATURE 1615 – 60 (1999); *see also* Ross Levine, *Financial Development and Economic Growth: Views and Agenda*, 35 (2) J. ECON. LITERATURE 688-726 (1997).

3 *See, e.g.*, Steve Sauerwald & Mark W. Peng, *Informal Institutions, Shareholder Coalitions, And Principal–Principal Conflicts*, ASIA PACIFIC J. MGMT. 1-18 (2012).

4 Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Corporate Ownership around the World*, 54 J. FIN. 2 (1999).

5 This, in contemporary literature is termed as principal-principal conflict, also known as tunneling. *See* Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Tunneling*, 90 AM. ECON. REV. 22 (2000); *see also* Sauerwald & Peng, *supra* note 3; *see also* Michael N. Young et al., *Corporate Governance In Emerging Economies: A Review Of The Principal–Principal Perspective*, 45 (1) J. MGMT. STUD. 196–220 (2008).

6 *See* Rafael La Porta, Florencio Lopez de Silanes, Andrei Shleifer & Robert Vishny, *Investor Protection and Corporate Governance*, 58 (1-2) J. FIN. ECON. 3–27 (2000) (authors contend that concentration of ownership is symptomatic of weak investor protection).

7 This behaviour, termed as 'economic entrenchment' is comprehensively discussed in Randall Morck et al., *Corporate Governance, Economic Entrenchment and Growth*, NBER Working Paper No. 10692 (2004).

8 *See* Berglöf Eric & Ernst-Ludwig von Thadden, *The Changing Corporate Governance Paradigm: Implications For Developing And Transition Economies*, *in* THE WORLD BANK 135-162 (Boris Pleskovic& Nikolas Stern eds., Annual World Bank Conference on Development Economics 1999, 2000).

the ongoing discussion by observing the effects of the institutional variables on the corporate governance norms in developing countries. Although few studies have indeed made efforts in this direction,[9] three crucial insights crystallise from my analysis, which have hitherto been less developed. First, the apparent failure of corporate governance structures in developing world is not a result of poor enforcement or lack of expertise (which could be addressed rather quickly) but due to unavoidable interaction between formal and informal institutions that overlap incongruently in existing practices of governance. Secondly, BRICS economies, while very different from each other, share a common thread of each possessing a unique evolution of corporate entities that require a customised approach to suit their particular needs and scope. Thirdly, there is a crucial need to account for national culture and historical trajectory when determining the various processes that characterise governance practices in a country.

The rest of this paper is divided into three sections. Section II presents dominant corporate governance theories and their modelling principles. It also clarifies the role of corporate governance in economic growth. In Section III, I undertake brief and comparative case studies of four BRICS economies to coagulate institutionally determined structures of corporate governance in these countries and what lessons can be taken from them.

II. Corporate Governance: the what and why

A. *Standard Architecture*

At the most basic level, corporate governance is a framework for assuring suppliers of capital a return on their investment.[10] It is about investors of a company making sure that managers of that company do not steal their capital. This simple design is of immense practical importance. Unless suppliers of finance are not assured of their returns *ex post*, they will not make the investments *ex ante*. Investor protection is therefore crucial for economic growth.[11] Not surprisingly therefore, corporate governance is the skeleton over which capital markets of any country grow.

However, creating such a framework may not be easy. While it would

9 *See infra* note 66

10 Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. Fin. 737 (1997).

11 *See, e.g.*, Jamal I. Haider, *Investor Protection and Economic Growth*, 103 Econ. Letters No. 1 (2009).

appear that investors (principals) and managers (agents) can simply sign a contract *ex ante* detailing roles, responsibilities, and the sharing of profits, in reality it is impossible to foresee all future contingencies. Therefore, such contracts are essentially and inherently incomplete in nature. The dominant theoretical construct of corporate governance which emerges from the 'incomplete contracts' view was developed and reconstructed in several studies, notably by Coase (transaction cost),[12] Jensen and Meckling (agency theory),[13] Williamson (asset specificity),[14] Aghion and Bolton,[15] and Hart[16] at multiple levels.

In order to address the 'incomplete contract' problem, it may be natural to consider a contract that gives all residual control rights of the firm with principals or owners/shareholders. Unfortunately, this is not possible because the whole point of separation of ownership and control is that owners hire managers in the first place because the former need the latter's specialised human capital to generate returns on their investments.[17]

The agency problem deals with the alignment of principal's interests with agents. The black box of the agency problem therefore throws open an extensive web of conflicts of interests. Corporate governance is an effort to align the interests of various parties. This is done through carving out formal institutions to design executive compensation plans, stock options, direct monitoring by boards, shareholders' rights, appointment of independent directors, prohibitions against insider-trading, capital markets regulations, markets for corporate control, general body meetings, etc. That corporate governance is pivotal for economic growth cannot be emphasised enough. Several studies have noted this[18] and, recently, powerful academic work (with some critiques)

12 Ronald H. Coase, *The Nature Of The Firm*, 4 ECONOMICA 386-405 (1937).

13 Michael Jensen & William Meckling, *Theory Of The Firm: Managerial Behaviour, Agency Costs And Ownership Structure*, 3 J. FIN. ECON. 305-360 (1976); *see also* Eugene Fama & Michael Jensen, *Separation Of Ownership And Control*, 26 J. L. & ECON. 301-325 (1983); Eugene Fama & Michael Jensen, *Agency Problems And Residual Claims*, 26 J. L. & ECON. 327-349 (1983 b).

14 OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES (1975); *see also* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985).

15 Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach To Financial Contracting*, 59 REV. ECON. STUD. 473-494 (1992).

16 OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE (1995).

17 This idea of separation of ownership and control was first identified in the seminal work of Berle-Means. *See* Adolf Berle & Gardiner Means, The modern corporation and private property (1932).

18 *See, e.g.*, Utpal Bhattacharya & Hazem Daouk, *The World Price Of Insider Trading*, 57 (1) J. FIN. 75–108 (2002); *see also* CIPE (2002, May) (Instituting corporate governance in developing, emerging and transitional economies, a handbook.).

has emerged from seminal LLSV literature.[19] The authors showed empirically the relationship between the law on one side and economic growth, the development of markets, and the governance of firms on the other. Most importantly, they developed tools to compare institutional environments. Understanding institutional environments is crucial to understanding how formal laws (dis)engage with a society's goals and aspirations.[20]

B. *Need For Reconstruction With Institutional Variables*

The formal character of law emphasises the importance of 'law on paper.' However, societies across their path-dependent evolutionary trajectory develop social norms and customary modes of behaviour in business (and non-business) transactions. Sometimes these informal norms not only bypass formal laws but also erode them. The impact of these very norms and informal governance mechanisms on corporate governance has not yet been rigorously explored.[21] Institutions consist of rules of the game[22] and there is a crucial need to understand both formal and informal institutions to balance the contractarian approach of corporate governance. A more nuanced, culturally and politically informed, theory of how corporations ought to be run, feeding themselves from the institutional endowments of a country, is the new research agenda.[23]

Norms are entrenched deep within the cognitive abilities of humans, who are hard wired in accordance with the institutions that they grow up in. This hard wiring is not easy to replace. If transplanting policies were so easy, societies would not have diverged in their economic indicators. After all, the knowledge of best practices should yield the best practices everywhere. But this is rarely seen in practice. Every society develops and evolves in a unique fashion. This is predominantly dictated by the historical path taken. The particular path develops unique thought-frames in the minds of population which continue to go

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19 LLSV literature is an acronym for series of papers, two of which are: Rafael La Porta *et al.*, *Legal Determinants Of External Finance*,52 J. FIN. 1131-50 (1997); Rafael La Porta *et al.*, *Law and Finance*, 106 J. POL. ECON. 1113–1155 (1998).

20 In many other studies, institutional determinants of corporate governance regulations were seriously modeled. Mark W. Peng & Yi Jiang, *Institutions behind family ownership and control in large firms*, 47 (2) J. MGMT. STUD. 253–273 (2010); *see also* Rafael La Porta *et al.*, *And Corporate Governance*, 58 (1–2) J. FIN. ECON. 3–27 (2000).

21 *See* Sauwerwald & Peng, *supra* note 3.

22 DOUGLASS. C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE (1990); *see also* Gretchen Helmke & Steven Levitsky, *Informal Institutions And Comparative Politics: A Research Agenda*, 2 (4) PERSPECTIVES ON POL. 725–740 (2004).

23 *See* Peer C. Fiss, *Institutions And Corporate Governance, in* THE SAGE HANDBOOK OF ORGANIZATIONAL INSTITUTIONALISM 389-410 (R. Greenwood *et al.*, eds., 2008).

in the direction it has already started, creating path-dependent institutions in which switching costs are too high. Many of these institutions may be inefficient, but path dependency fossilize them into the social fabric.[24] The extent to which to take an example, welfare enhancing formal laws are able to weed out inefficient informal norms is an open question but it is clear that it will be a long process.

In their business and non-business transactions, non-Western economies are bound more by the customary norms than the rule of formal law. Developing countries are characterised by personal relationships being the hinge around which trade, credit and insurance linkages revolve.[25] With thinly practiced institutions of contract and property rights, reliance is largely based on social identities like caste, kinship, ethnicity, language, or any other means of group identity. Informal social networks at a political level enter and undermine the regulatory space of even formal legal structures through 'back door deals'[26] and affect well-intended regulatory interventions.[27]

It is these informal institutions that resist the functional convergence of corporate governance norms around the world. The shareholder-focused corporate governance model was touted for long to be the ideal case to be followed by the world. It was said that this model would act as a converging point for most corporate governance models in the world.[28] Yet substantial diversity remains and it is unlikely that such convergence is going to be possible in the near future.[29] It has also been shown that similarities in formal laws and financial regulations have not been able

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24 For an interesting and early illustration, see Paul David, *Clio and the Economics of QWERTY*, 75 Am. Econ. Rev. 332 (1985).

25 *See, e.g.*, Kaivan Munshi & Mark Rosenzweig, *Why is Mobility in India so Low? Social Insurance, Inequality and Growth*, NBER Working Paper No. 1485 (2009); *see also* Kaivan Munshi & Mark Rosenzweig, *Traditional Institutions Meet the Modern World: Caste, Gender and Schooling Choice in a Globalizing Economy*, 96 Am. Econ. Rev. 1225 (2006).

26 *See* Navroz Dubash, *Regulation through the back-door: Understanding the implications of Institutional Transplant*, Jerusalem Papers in Regulation and Governance, Working Paper No. 42 (2012).

27 For impact of political connections on stock market valuations, *see* Raymond Fisman, *Estimating The Value Of Political Connections*, 91 Am. Econ. Rev. 1095-1102 (2001); Simon Johnson & Todd Mitton, *Cronyism and capital controls: Evidence from Malaysia*, 67 J. Fin. Econ. 351-382 (2003); on corporate bailouts, *see* Asim I. Khwaja & Atif Mian, *Do Lenders Favor Politically Connected Firms? Rent provision in an Emerging Financial Market*, 120 (4) Q. J. Econ. (2005); for access to credit, *see* Mara Faccio, *Politically connected Firms*, 96 Am. Econ. Rev. 369-386 (2006).

28 Henry Hansmann & Reinier Kraakman, *The End Of History For Corporate Law*, 89 (2) Geo. L. J. 439-68 (2001).

29 *See, e.g.*, Toru Yoshikawa & Abdul A. Rasheed, *Convergence Of Corporate Governance: Critical Review And Future Directions*, 17 (3) Corp. Governance: An Int'l Rev. 388-404 (2009); *see also* Ruth V. Aguilera & Gregory Jackson, *Comparative And International Corporate Governance*, 4 (1) Acad. Mgmt. Annals 485-556 (2010).

to translate into similar trends in financial development.[30] This is, again, largely explained by the interaction between formal and informal models of governance. Institutional change is never a result of changing scripted laws. On the contrary, it lies more certainly at the dynamic confluence of formal and informal norms.[31]

There is a need to identify and incorporate the already existing local norms that have emerged as endogenous solutions to agency theory into the standard governance model.[32] Norms will always co-exist with scripted laws. Ignorance of their inevitable interactions, complementarities, receptivity and substitutability will only render an incomplete picture when trying to understand societies where norms are deeply entrenched. Informal modes of behaviour are amorphous rules spread through a particular society. Once a new law is scripted formally, it crystallises a certain mode of expected behaviour. While these crystals are important to lend some co-ordinating points of transactions in a society, we fail to notice that these crystals are scattered on the existing amorphous bed of informal norms. Hence, filtering through informal norms is an inescapable process of arriving at formal laws and their implementation. If the crystals are not attractive enough, societies will choose to remain in their amorphous and fluid state.

III. Institutional Structures of Corporate Governance in BRIC Countries

A. BRICS Economies

Studies have shown that firms may benefit through their cognisance of informal institutions.[33] This is particularly true when formal institutions are weak or absent,[34] exactly the case in emerging economies like BRICS.[35] These economies are in societies that are in a state of

30 John Armour, Simon Deakin, Viviana Mollica & Mathias Siems, *Law And Financial Development: What We Are Learning From Time Series Evidence*, 6 Byu. L. Rev. 1435-1500 (2009).

31 Hicheon Kim, Heechun Kim & Robert E. Hoskisson, *Does Market-Orientated Institutional Change In An Emerging Economy Make Business-Group-Affiliated Multinationals Perform Better? An Institutional-Based View*, 41 (7) J. Int'l Bus. Stud. 1141-60 (2010).

32 Masahiko Aoki, Corporations In Evolving Diversity: Cognition, Governance And Institutions (2010).

33 John C. Coffee, *Do Norms Matter? A Cross-Country Evaluation*, 149 (6) U. Pa. L. Rev. 2151–2177 (2001).

34 Mike W. Peng *et al.*, *The Institution-Based View As A Third Leg For A Strategy Tripod*, 23 (3) Acad. Mgmt. Perspectives 63–81 (2009).

35 Mike W. Peng, Dennis Y. L. Wang & Yi Jiang, *An Institution-Based View Of International Business Strategy: A Focus On Emerging Economies*, 39 (5) J. Int'l Bus. Stud. 920–936 (2008).

institutional flux. Hitherto disengaged with world economy, the BRICS nations possess an immense potential for a new growth order of the world. While each of the member countries of BRICS is distinct in substance and aesthetics, their differences from the West is the group's commonality. BRICS are characterised by the existence of deeply entrenched norms and informal institutions in their societies, largely shaped by a distinct pattern of path dependency and complex history. Each of these countries had their own twist with historical narratives, punctuated by colonisation, communism, socialism and the transition towards capitalism. Each of these countries, therefore, has developed endogenous norms to address their unique challenges and those norms come from within their social milieu.

In the following part of this section, I will undertake a brief comparative study in order to excavate the silences of informal institutions and how these silences affect the structure of corporate governance in BRICS countries. Not touching South Africa is not an oversight but rather a conscious decision to keep my focus on BRIC for a variety of reasons. First, South Africa is fairly new entrant (joining the BRICS league during the end of 2010).[36] Secondly, it represents a comparatively low proportion of total GDP of the BRICS economies (USD390 bn, as compared to close to USD 2000 bn for Brazil, Russia and India each and USD8000 bn for China).[37] This suggests that impact of corporate governance norms may not have a sizeable impact in South Africa. Thirdly, and perhaps most importantly, a study of corporate governance in South Africa is fairly straightforward. Its corporate governance code is based on three seminal reports by Judge Mervyn E. King (called King's Report), which came out in three volumes, in 1994, 2002 and 2009.[38] The code has been internalised in both regulations of security exchange and company's act with a high rate of compliance,[39] obviating my need to delve deeply into institutional structures.

A. *China: Vestiges Of Socialist Control*

China is one of the most interesting cases to study not only owing to

36 Nasreen Seria, *South Africa is asked to join as a BRIC Member to boost Emerging Markets*, Bloomberg, (Dec. 24, 2010).

37 IMF, World Economic Outlook (2012).

38 For an overview, see South African Institute of Chartered Accountants, The King Report on Corporate Governance (2010), *available at:* https://www.saica.co.za/TechnicalInformation/LegalandGovernance/King/tabid/626/language/en-ZA/Default.aspx

39 Collins G. Ntim, Kwaku K. Opong, Jo Danbolt, Dennis A. Thomas, *Voluntary Corporate Governance Disclosures By Post-Apartheid South African Corporations*, 13 (2) J. Applied Acct. Research 122 - 144 (2012).

its mammoth share in world trade today but also the incredible pace at which this economy has grown. China's institutional endowments date back through centuries but it is pertinent for my work to focus on the second half of the last century. The institutional determinants need a more thorough analysis[40] and what follows is suggestive of important factors.

Post-1949, China embraced centrally planned and bureaucratically managed industrial instruments to run the economy.[41] State-owned enterprises (SOE) were the sources of production.[42] The SOEs were neither independent industrial units nor did they have legal status. They were merely extensions of state bureaucracy falling under the line Ministries (which in turn, fell under the State Council). Ministries and their agents dictated the SOEs on matters related to both production target and price. The entire proceeds from sales were remitted to the line Ministry system, from where wages and working capital were distributed back to the SOE for the next period. Credit was doled out by the state-controlled banking system, which again had no monitoring incentive. These SOEs were characterised by (a) no owners, (b) no incentive structure, (c) no pursuance of profitable activities but only adherence to State's commands, (d) no monitoring, (e) no profit accounting but only cost accounting, and (f) no need for using balance sheets since growth was not on the agenda.[43] Needless to mention, with no corporations existing, corporate governance was not heard of, even remotely.

Slowly it became clear that SOEs were inefficient and wasteful.[44] With Deng Xiaoping's policy, China began on a bold policy reform, which permitted enterprises that received foreign investments, to partner with SOEs for project specific purposes[45] and created an incentive culture. As the institutional heaviness of previous decades was enormous, these changes took place through policy principles rather than corporatisation or under statutory law.[46] Corporatisation took place in the 80's with the pressure of raising capital. It led to a few SOEs adopting the shareholding

40 Qiao Liu, *Corporate Governance in China: Current Practices, Economic Effects and Institutional Determinants*, paper prepared for CESifo Economic Studies Conference (2005).

41 For a detailed study, see BARRY NAUGHTON, GROWING OUT OF THE PLAN: CHINESE ECONOMIC REFORMS, 1978-1993(1995).

42 SOE's closest Chinese translation is 'owned by all the people – system enterprises' (*quan-min-suo-you-zhi-qi-ye*). This means that structure was largely consistent with orthodox Marxist ideology. This ideological choice fit well with addressing the ravages of wars (against Japan, and the Civil War) that had transpired recently then.

43 Nicholas C. Howson & Vikramaditya Khanna, *The Development of Modern Corporate Governance in China and India*, *in* CHINA, INDIA AND THE INTERNATIONAL ECONOMIC ORDER 513-576 (M. Sornarajah & J. Wang eds., 2010).

44 NICHOLAS R. LARDY, CHINA'S UNFINISHED ECONOMIC REVOLUTION(1998).

45 *See* YASHENG HUANG, SELLING CHINA: FOREIGN DIRECT INVESTMENT DURING REFORM ERA (2003).

46 Howson & Khanna, *supra* note 43.

system enterprise. However, this reform did not dilute any of the state's absolute control over the resulting corporate entities.[47]

During the mid-90's, a paradigm shift began to be observed. The new reforms were very different from those in the 1980's in terms of intention and content and included issues such as the establishment of goals for a market economy and the rapid growth of foreign and private enterprises.[48] Most SOEs were converted into limited liability companies with share capital, articles of association, and regulatory space for board of directors.[49] In addition, modern principles of independent directors, rights of shareholders, and executive compensation were charted while regulating capital market issuance.[50]

These reforms did compel LLSV literature to give a perfect score to the shareholders' rights index in China,[51] yet looting seemed widespread in the corporate sector of the country.[52] Using measures listed in the existing literature, it has been found that China's laws and institutions are significantly less developed than most Western and even many non-Western nations. The legislative system has been described as infused with 'chronic disorder'[53] and 'chaos.'[54] Corporate fraud and underhand dealings are a widespread norm too.[55] The corporate market has often been called a 'dysfunctional halfway house'[56] where the poor quality of listed firms is a serious problem.

I contend that explanations rest on a heavy institutional endowment that China received in legacy. One of these institutions was the state's involvement in industrial units. This has percolated until this day. The state maintains absolute control over strategic and key industries (defence, power, telecom, oil/petrochemical, coal, civil aviation, shipping), possesses a controlling stake in basic and pillar industries

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47 *Id.*

48 Major events in this period include the enactments of the Company Law in 1994, the Labour Law in 1995, the Securities Law in 1999, and especially the Rules on Corporate Governance of Listed Companies, promulgated by China Securities Regulatory Commission (CSRC) in 2002.

49 Howson & Khanna, *supra* note 43.

50 *Id.*

51 La Porte *et al.*, *supra* note 19.

52 *See for e.g.*, Yi Zhang, *Law, Corporate Governance, and Corporate Scandal in an Emerging Economy: Insights from China*(2007), *available at:* http://ssrn.com/abstract=957549; *see also* Ming Jian & T. J. Wong, *Earnings Management and Tunnelling through Related Party Transactions: Evidence from Chinese Corporate Groups* (2003), *available at:* http://ssrn.com/abstract=424888

53 *See* Perry Keller, *Sources of Order in Chinese Law*, 42 AM. J. COMP. L. 711 (1994).

54 *See* RANDALL PEERENBOOM, CHINA'S LONG MARCH TOWARD RULE OF LAW (2002)

55 *See, e.g.*, Steven Shi & Drake Weisert, *Corporate Governance with Chinese Characteristics*, 29 CHINA BUSINESS REV. 40 (2002).

56 STEPHEN PAUL GREEN, CHINA'S STOCK MARKETS: A GUIDE TO ITS PROGRESS, PLAYERS AND PROSPECTS 118 (2003).

(auto, IT, construction, steel, chemicals), and expresses the necessary influence in other industries.[57] Private ownership of Chinese companies has only recently been made legal and even now, ambiguities remain towards the enforcement of private ownership rights.[58]

Even then, the private sector growth in China has been faster than the state and listed sectors and provides most of the country's economic growth.[59] This only suggests that there are several effective alternative financing channels and governance mechanisms such as those based on trust and relationships which contribute to this growth.[60] Such informal institutions therefore act as substitutes for formal laws that have a weak enforceability index. This idea is most illustratively shown in the concept of *guanxi*. *Guanxi* is a term used for informal connections that private businesses develop when formal legal infrastructure is missing.[61] For decades it has formed the cornerstone of private businesses in China and is deeply pervasive even today.[62]

Since the Chinese government can practically appropriate any private asset as it deems fit, the real corporate governance issue in many cases is misappropriation by the state and not by the agent. It is fascinating to look at how several informal institutions have evolved to specifically deal with the problem of securing one's private assets against the state. These informal institutions build legitimacy of private firms while uncertain legal rights of ownership abound.[63] They do this by developing relations with government officials, taking over ailing state-owned enterprises, donating services to local communities and, most important of all, concealing the private nature of their ownership.[64] Disguising a business is known as 'wearing a red hat.' During the first decade of reforms, many so-called collective enterprises were actually privately held companies (in some localities, as high as 90% of the collective enterprises were privately owned and managed). Local party officials were complicit

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57 *Id.*

58 *See, e.g., China's Murky Ownership Rules: Who owns what?*, ECONOMIST, (July 7, 2011)

59 Franklin Allen, Jun Qian & Meijun Qian, *Law, Finance And Economic Growth in China*, U. PA. INST. L. & ECON. RESEARCH PAPER 3-21 (2004).

60 *Id.*

61 Exhaustive work has been done on Guanxi. *See, e.g.*, THOMAS GOLD, DOUGLAS GUTHRIE & DAVID WANK, SOCIAL CONNECTIONS IN CHINA: INSTITUTIONS, CULTURE AND THE CHANGING NATURE OF GUANXI (2002); *But see* Lin Jun, Steven X. Si, *Can guanxi be a problem? Contexts, ties, and some unfavorable consequences of social capital in China*, 27 (3) ASIA PACIFIC J. MGMT. (2010).

62 Interestingly, internet-based social networking companies/websites are facing tough times in deeply embedded social networking of guanxi. *See LinkedIn, others face challenges against China 'guanxi,'* SOUTH CHINA MORNING POST, (March 10, 2013).

63 David Ahlstrom, Garry D. Bruton & Kuang S. Yeh, *Private firms in China: Building legitimacy In An Emerging Economy*, 43 J. WORLD BUS. 385-399 (2008).

64 *Id.*

in sanctioning such arrangements.[65] The depth of this informal institution was so deep that even when private entrepreneurs started to get invited to join the Communist Party, they continued to wear the 'red hat' because "there remained political criticism of private entrepreneurs," 'spiritual pollution,' 'bourgeois liberalisation,' and harassment by tax collectors and bureaucrats.[66] In a way, therefore, Chinese society evolved adaptive informal institutions for the private ownership of companies.[67]

Gaining legitimacy to own a private enterprise also propelled the growth of such firms in geographical localities where such firms already existed. This was done through the taking over of ailing state-owned enterprises, using long standing relations or clan ties, building reciprocal relations through gifts and reception hosting, establishing liaisons with foreign firms whose legitimacy was already accepted, and many other such *guanxi* techniques.[68] This also means that Chinese family-owned firms rely on informal sources of finance such as family networks.[69] Therefore, underground credit institutions have thrived, even with their high interest rates.[70]

Indeed, the new story of China's corporate governance cannot be carved by overlooking the manner in which delicate private ordering has taken place as a response to the institutional structure of state intervention in businesses.

B. *India: Family Matters*

Indian corporate governance reforms are also developments of recent decades. An important difference from China however, is that while in India the impetus was on developing local industry before focusing on foreign direct investment (FDI), China began attracting FDI before implementing domestic economic reforms.[71] As a result, while China has outpaced India in growth, very few Chinese firms are considered internationally competitive, as opposed to India, which boasts of several globally competitive firms. India and China have sufficient dissimilarities

65 *See* David L. Wank, *The Institutional Process Of Market Clientelism: Guanxi And Private Business In A South China City*, 147 THE CHINA Q. 820-838 (1996); *see also* Y. HUANG, SELLING CHINA: FOREIGN DIRECT INVESTMENT DURING THE REFORM ERA (2005).

66 Saul Estrin & Martha Prevezer, *The Role Of Informal Institutions In Corporate Governance: Brazil, Russia, India, And China Compared*, 28 (1) ASIA PACIFIC J. MGMT. 41 (2011).

67 Kellee S. Tsai, *Adaptive Informal Institutions And Endogenous Institutional Change In China*, 59 WORLD POL. 116 (2006).

68 Estrin & Prevezer, *supra* note 66.

69 Meghana Ayyagiri, Asili Demirgüç-Kunt and Vojislav Maksimovic, "Formal versus Informal Finance: Evidence from China," World Bank, Policy Research Working Paper 4465 (2007)

70 Lihui Tian, *Does Government Intervention Help The Chinese Automobile Industry? A Comparison With The Chinese Computer Industry*, 31 (4) ECON. SYSTEMS 364 (2007).

71 Howson & Khanna, *supra* note 43.

with each other, the most important of which are: (a) a very high element of heterogeneity prevailing in India compared to China, and (b) a democratic government in India as opposed to single-party rule in China.[72] Owing to their peculiar institutional endowments, the trajectory of corporate governance reforms in both these countries diverged markedly.

Organised forms of business entities existed in India for thousands of years in varying structures that resembled guilds and cooperatives (and also modern corporations in some senses),[73] but they were relatively fragmented until the advent of the British Raj.[74] There was an active stock market from 1875, and the beginning of 1866, during which time several statute-governed securities, trust activities, corporations and banks were effectuated.[75] Later, the devastation of competitors like China and Japan in World War II led India to take the lead and it began establishing well-functioning stock markets, an active manufacturing sector, several formal institutional scripts, and a banking infrastructure by the time of its independence in 1947.[76]

Post-independence, India developed the socialist structure of its economy.[77] This was characterised in the government's successful efforts in the nationalisation of industries, banks and insurance services and the removal of private firms and competition from large sectors of the economy. Coupled with the institutionalisation of what is known as *license raj*, where approval from a series of bureaucratic arms of government becomes a barrier to entry for many Indian entrepreneurs, Indian business transactions were heavily regulated by the state.[78] There were large trade barriers to both FDI and foreign competition through tariffs and other such policies. The primary source of capital was debt through several state-owned Development Finance Institutions (DFIs) which were poorly governed and had inefficient monitoring systems.[79]

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72 *Id.*

73 Vikramaditya Khanna, *Economic History of Organisational Entities in Ancient India*, U. MICH. PROGRAM IN L. & ECON. DISCUSSION PAPER 05 (2011)

74 *Infra* note 90.

75 RADHE SHYAM RUNGTA, THE RISE OF BUSINESS CORPORATIONS IN INDIA 1851-1900 (1970).

76 RAJESH CHAKRABARTY, THE FINANCIAL SECTOR IN INDIA: EMERGING ISSUES (2006).

77 This is oversimplification of economic policies, which were more mixed in nature and complex in scope. *See, e.g.*, Omkar Goswami, *India: The Tide Rises Gradually*, *in* CORPORATE GOVERNANCE IN DEVELOPMENT: THE EXPERIENCES OF BRAZIL, CHILE, INDIA AND SOUTH AFRICA (Charles P. Oman ed., 2003).

78 Overall, the stifling of industrial growth could be attributed to Industries (Development and Regulation) Act, 1951 and Industrial Policy Resolution of 1956. *See* Rajesh Chakrabarti, William L. Megginson & Pradeep K. Yadav, *Corporate Governance in India*, 20 (1) J. APP. CORP. FIN. 59, 62 (2008).

79 For a brief summary, see Howson & Khanna, *supra* note 43.

While capital markets existed, the institutional structure was weak and a general equity culture was lacking. Modern elements of corporate governance were not in place and neither were disclosure requirements, making ownership structures and related party transactions, fairly opaque.[80] Indeed, by the time India liberalised its economy in 1991, the industrial and corporate sectors had become woeful.

The reforms of 1991 opened up the economy by reducing trade barriers, selling sick SOEs, creating incentive structures in DFIs and easing the *license raj*. Subsequently, the Securities and Exchange Board of India (SEBI) was created in 1992 and it slowly took over the responsibility of regulating the many domestic stock markets in India.[81] Capital strapped industries were waiting for these moves, and consequently, Confederation of Indian Industries (CII) drafted its first corporate governance code in 1998.[82] This was followed by SEBI's incorporation of Kumar Mangalam Birla Committee, which submitted its recommendations on creating corporate governance standards for India which ultimately led to changes in the listing agreements of stock exchanges.[83] The most important of these recommendations was incorporated as Clause 49, in 2000. Clause 49 details out the mandatory (and non-mandatory) guidelines for corporate governance in India, notably on independent directors, external auditors, board meetings, and disclosure obligations.[84]

Yet, the Indian corporate landscape did not reach close to its Western counterpart, in that it developed traits of economy that are characterised by concentrated ownership of family groups (rather than the State, as in China). Such a structure inherently thwarts any governance effort that rests on the foundation of principal-agent conflict because the real conflict is between majority and minority owners. Therefore, while the rules look impressive on paper, the reality is that little information or decision-making power reaches minority shareholders, leaving them without recourse. The family owned businesses show a lack of transparency or public disclosure, little professionalism as regards the appointment of Board of Directors, pervasive corruption, insider trading, inconsistency in dividend payments, misappropriation of bank funds, fly-by-night-businesses, price manipulation, and non-performing

80 *Id.*

81 *Preamble*, The Securities and Exchange Board of India, *available at:* http://www.sebi.gov.in/sebiweb/stpages/about_sebi.jsp

82 Howson & Khanna, *supra* note 43.

83 Report of the Kumar Mangalam Birla Committee on Corporate Governance, (May 7, 1999).

84 *Corporate Governace*, NSE India, *available at:* http://www.nseindia.com/getting_listed/content/clause_49.pdf

assets.[85] That is why corporate governance reforms in India could not arrest the tendency of Indian firms getting involved in several frauds, most notably, the Satyam scandal that rocked corporate India in early 2009. The Chairman of the company and his family owned approximately 5% of the company's shares.[86] The Chairman was reported to have falsified the accounts in order to show bloated, fictitious cash assets,[87]which resulted in a fall of share prices by 70% and wiped out the shareholders' wealth overnight.[88] Satyam had meticulously followed relevant regulations of corporate governance practices and yet it emerged as the 'Enron of India.'[89]

Let us try to understand institutional variables that amount to the creation of family-owned businesses. Over the previous century, in India, the concentration of ownership started rather slowly, with only Tata and Birla as the two dominant family-owned business houses.[90] The 1950's saw the Goenkas and Khaitans rise to become members of the elite club through a transfer of assets.[91] During the *license raj*, the Ambanis, who had learned the art of playing with the game of licenses, grew to prominence.[92] Most corporate families in post-liberalisation period also had their genesis during the *license raj* when business-government relationships were deeply entrenched in the way corporate transactions took place.

The institution of the *license raj* created incentives for rent seeking activities.[93] When approvals from government became key for either initiating a venture or expanding an existing business the importance of social networks rose. As these social networks grew in the form of

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85 S.K. Verma & Suman Gupta, *Corporate Governance And Corporate Law Reform In India*, 25 IDE Asian Law Series Inst. Dev. Econ. (2004).

86 A company with promoters possessing merely 5% of shares may look like a company not governed by family, but Indian corporate governance norms confer some distinct role for promoters, thereby ensuring that even in companies like Satyam, promoters, "continued to wield significant powers in the management of the company despite a drastic drop in their shareholdings over the last few years." *See infra* note 106.

87 *Satyam Chief Admits Huge Fraud*, The N. Y. Times, (January 8, 2009).

88 *See infra* note 106.

89 *Satyam accounting scandal could be 'India's Enron'*, The Telegraph, (January 7, 2009)

90 *See* Tarun Khanna& Krishna Palepu, *The Evolution of Concentrated Ownership in India: Broad Patterns and a History of the Indian Software Industry*, *in* A History of Corporate Governance around the World: Family Business Groups to Professional Managers (Randall K. Morck ed., 2005).

91 *Id.*

92 *Id.*

93 Marianne Bertrand, Paras Mehta & Sendhil Mullainathan, *Ferreting Out Tunneling: An Application To Indian Business Groups*, 117 (1) Q. J. Econ. 121–48 (2002); *see also* Tarun Khanna, *Business Groups And Social Welfare In Emerging Markets: Existing Evidence And Unanswered Questions*, 44 (4–6) Eur. Econ. Rev. 748 (2000); Tarun Khanna & Krishna Palepu, *Emerging market business groups, foreign intermediaries, and corporate governance*, *in* Concentrated corporate ownership 265–94 (Randall Morck ed., 2000a).

underhand dealings between politicians and businessmen, future transactions were built on existing networks, feeding on their preceding networks, creating an inescapable circle. The rigid structures of the economy left much space for the market to operate outside the networks. But due to the lack of institutions to fill those voids, new groups began entering the space,[94] which also increased social welfare. Indeed business groups controlled by families are shown to be socially beneficial when legal institutions are weak[95] and scholars have noted how the emergence of large shareholding is a response to the weak protection provided for external shareholders.[96] Large business groups 'overcome financing obstacles, creating internal capital markets and enable different firms within [them] to compete for funds.'[97] In doing so, they develop informal norms of practice different from the western form of corporations and therefore need a different approach to corporate governance.

In such situations, informal networks of kinship, family and castes become most reliable. India presents a case where such ethnic ties substitute for raising credit, providing insurance, and transacting with implicit and unwritten contracts.[98] Historically, Indian business communities have predominantly emerged from three business groups;[99] Gujaratis, Marwaris[100] and Parsis, and, even now, the emerging capitalists are mainly family groups.[101] Khanna and Palepu observe these dynamics but also add that corporate ownership has also changed frequently[102] which is an interesting observation that merits a more detailed and separate study. Little doubt however remains on the dominance of family controlled firms in India. According to a study conducted by global financial services major Credit Suisse, two out of every three listed companies in India are family-controlled, making it the country with the highest presence of family businesses in Asia.[103]As many as 663 out of 983 listed Indian firms are family businesses and they account for

94 Estrin & Prevezer, *supra* note 66.

95 Mike W. Peng& Yi Jiang, *Family ownership and control in large firms: The good, the bad, the irrelevant – and why*, 840 William Davidson Institute Working Paper (2006); *see also* Pursey Heugens, J.H. Van Oosterhout & Marc van Essen, *Meta-analyzing ownership concentration and firm performance in Asia: Towards a more fine-grained understanding*, 26 (3) Asia Pacific J. Mgmt. 361-609 (2009).

96 *See* La Porta et al., *supra* note 20.

97 Estrin & Prevezer, *supra* note 66.

98 For an earlier study, see Helen B Lamb, Studies on India and Vietnam (1976); *see also* Damodaran.

99 Gita Piramal, *Long shadows of the past*, The Econ. Times (India), (August 18, 1989).

100 *See, e.g.*, Tom Timberg, The Marwaris (1978); *see also* Gurcharan Das, India Unbound: From Independence To The Global Information Age (2000) (noting how by 2000, Marwaris controlled half of industrial assets in India).

101 *See* Harish Damodaran, India's New Capitalists, (2008).

102 Khanna & Palepu, *supra* note 90.

103 *India has highest share of family businesses in Asia*, Indian Express, (November 4, 2011).

half of all corporate hiring.[104] Additionally, family businesses in India account for close to 50% of the total market capitalisation.[105]

Therefore, it is not surprising that the Satyam lapses took place at two levels: first, at the level of external auditing, and second, at that of the oversight by independent directors.[106] This is an example of how social networks develop informal yet powerful norms in corporate governance. Satyam's promoters were perhaps able to, through their social capital, select external auditors or independent directors who would be *obedient* to them or, after having appointed them, create influential networks to subvert value creation. This pervasive form of corruption[107] is euphemised as 'returning favours', an inherent characteristic of most societies and definitely of India. India does suffer from a gaping schism between legal institutions on paper and those in reality.[108] Notably, India, like other BRICS economies, reflects the need for an 'insider approach' to corporate governance but has unfortunately transplanted the 'outsider model' from the West.[109]

C. Brazil: Institutional Inertia Of Colonization

Brazil's corporate governance exhibits heterogeneous practices evident in improving corporate governance quality yet remaining low in the last decade.[110] Therefore, even when minority shareholders have right to representation on the boards of many firms and alternate approach to address financial statement accuracy in form of *fiscal board* exists, through an extensive survey of Brazil's corporate governance, Black *et al* found that formal institutional strength is weak at some levels.[111] The boards of most Brazilian firms are comprised almost entirely of insiders or representatives of controlling family or group, with the controlling shareholders ensuring control through shareholder

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104 *Id.*

105 *Id.*

106 Umakath Varottil, *A Cautionary Tale of the Transplant Effect on Indian Corporate Governance*, 21(1) NAT'L. L. SCH. INDIA REV. 1-49 (2009).

107 There is a difference between pervasive and arbitrary corruption, where former seems to have certain element of certainty, which gets incorporated into cost calculations of companies leading to rather insignificant impact on governance. The real problem is arbitrary nature of corruption. *See* Seung H. Lee & Kyeungrae K. Oh, *Corruption in Asia: Pervasiveness and Arbitrariness*, 24 (1) ASIA PACIFIC J. MGMT. 97-114 (2007).

108 Franklin Allen, Rajesh Chakrabarti, Sankar De, Jun Qian & MeijunQian, *Financing Firm in India*, 3975 WORLD BANK POLICY RESEARCH WORKING PAPER (2007).

109 Varottil, *supra* note 106.

110 Da Silveira, Alexandre de Miceli, Ricardo P. C. Leal, Andre Luis Carvalhal-da-Silva, & Lucas Ayres B. de C. Barros, *Evolution and Determinants of Firm-Level Corporate Governance Quality in Brazil* (2007), working paper, *available at*: http://ssrn.com/abstract=995764 last accessed on 22 March 2013.

111 *See infra* note 136.

agreements.[112] The study also showed that most firms have no independent directors[113] and that financial disclosure badly needs to catch up with world standards.[114] Various studies assessing Brazil's corporate governance in 1990s concluded the absence of IPOs, and decline in trading in Bovespa due to low investor protection.[115]

Owing to its chequered history, building a general case is complicated for Brazil. But there are distinct punctuations in country's historical narrative, reflected in manners of asset control – that has only permeated in time to corporate control.[116] While sweeping generalisations are avoidble, the idea that certain informal institutions simply trickled down through time from colonisation is not unfounded. Colonisation witnessed a slave-holding regime that exploited land for the cultivation of sugar and coffee. For several hundred years, the moral codes of a slave society developed the seeds of paternalism in the social soil.[117] The deep-rooted impact of the institutions of big landlords of sugar plantations is studied by Gilberto Freyre, who, in primarily attempting to demystify problems of miscegenation in Brazil, showed the reflections of patriarchy in the formation of Brazilian society.[118] In a more radical 'rediscovery of Brazil,' Caio Prado, Junior perceives a sense of colonial pasts in contemporary times.[119] The last phase of the imperial regime flagrantly exposed the fact that 'emperor's personal power'[120] was particularly instructive to the climate that continued even after the abolition of slavery in 1888. This happened through the temporal percolation of the rural segment's privileges and political strength.[121] This structure of economic power translated into political power after the promulgation of the Republic in 1889 as the 'power of oligarchies remained in democratic institutions as the regional political parties were still

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112 *See infra* note 136.

113 *But see also* Marcos G. L. Dutra& Richard Saito, *Conselhos de Administração: Análise de sua Composiçãoem um Conjunto de Companhias Abertas*, 6(2) Revista de Administração Contemporânea 9-27 (2002) (another detailed survey, which finds little use of cumulative voting although shows that 20% of directors are independent).

114 *See infra* note 136.

115 Antonio Gledson De Carvalho, *Governança Corporativa no Brasilem Perspectiva*, 37(3) Revista de Administração 19-32 (2002).

116 Erica Gorga, *Culture and Corporate Law Reform: A Case Study of Brazil*, 27 U. Pa. J. Int'l. Econ. L. 803-905 (2006).

117 *Id.*

118 Gilberto Freyre, The Mansions and the Shanties: The Making of Modern Brazil, (Harriet de Onís, trans., 1963). *See also* D. Cleary, Race, Nationalism and Social Theory in Brazil: Rethinking Gilberto Freyre(1999). A brilliant scholar of Brazilian literature, Roberto Schwarz, also has undertones of the institutions of slavery and social classes of the time, getting reflected in his work.

119 Caio Prado Júnior, Formação do Brasil contemporâneo., Vol. 1. Editôra Brasiliense, (1945)

120 *See* Sérgio Buarque de Holanda, O Brasil monárquico: do Império à República. Difel, (1985)

121 *See* Sérgio Buarque de Holanda, Raízes do Brasil Editora Companhia das Letras, (1995).

dominated by traditional families.'[122] To make matters worse, laws introduced during the founding of the Republic were unsuitable for the Brazilian institutional context and remained so to a long time. Indeed, the transplanted formal legal order needs to augur well with the cultural context of the host country, the failure of which results in institutional imbalances.[123] When immigrants who had accumulated some capital noticed the demand created by wars and depression to set up industries, they realised that they needed to tie up with ruling elites even while they disagreed with their ideologies.[124] This was possible through an extensive web of social networks that was created by the oligarchies and bourgeoisies which ultimately established a system of paternalistic government.

The sources of corruption and bureaucratically dense system of governance have roots in colonial Brazil and noted scholars have observed how such a patrimonial system has maintained its presence in the political economy of the country.[125] Brazilian elites were savouring the fruits of paternalistic attitudes and internalising elements of patrimony. Earlier, land was a symbol of status. When corporations began replacing land for assets, families continued to own companies just like they owned lands.[126] Even until this day, entrepreneurs are more concerned about controlling an asset rather than enhancing its value.[127] These patrimonial relationships coupled with traditional ownership structures were crucial factors in gaining privileges on which the ownership of asset depended.[128] Personal relationships came to dominate organisations rather than institutional mechanisms and investments in relationship outweighed investing in tangible resources, hurting corporations' growth in value. This also means that the conversion of an organisational status from being wholly owned to publicly listed was a very hard thing to do. Controlling shareholders are not amenable to change. When independent directors have personal relationships between owners, who are also managers, it leads to the dilution of formal corporate governance norms. Indeed, studies have shown a high degree of ownership and control concentration and a fairly low number of

122 *See infra* note 136.

123 Daniel Berkowitz, Katharina Pistor & Jean-Francois Richard, *Economic Development, Legality, and the Transplant Effect*, 47 EUR. ECON. REV. 165 (2003).

124 Gorga, *supra* note 116.

125 *See, e.g.*, RAYMUNDO FAORO, OS DONOS DO PODER (THE OWNERS OF POWER)(1958).

126 Gorga, *supra* note 116.

127 KORN FERRY INTERNATIONAL & MCKINSEY & COMPANY, AN OVERVIEW OF CORPORATE GOVERNANCE IN BRAZIL (2001).

128 Gorga, *supra* note 116.

firms with good corporate governance practice.[129]

Overlaying nineteenth century institutions into present times is a possible reductive argument and I want to allay fears about the apparently simplifying tone. Indeed, disruptions in previous century with industrialisation have much to inform. Bresser-Pereira's work in this regard is evaluative as he emphasizes the importance of the growing Brazilian economy not just through market-orientation but through Latin America orientation[130] He also illustrates how the import-substitution model of industrialisation, the emergence of new classes of industrialists, workers and a bureaucratic middle class, the economic and political crises of 60s, all informed the conflicts and influences between traditional agrarian ideologies of coffee planters and the industrialising policies of the mid-twentieth century in Brazil.[131] Therefore, while there were discontinuities in the institutional carry-over through twentieth century, the inefficient state[132] with myopic policies, heavy regulation and culture of clientelism in politics[133] did little to insulate old institutions from the newly developing economy.

Using historical dimensions to explain present-day Brazil is an idea supported by Brazilian economist, Celso Furtado.[134] He explains the history of Brazil using the centre-periphery model where Brazil is at the periphery.[135] Its economic performance and policies were dependent on that of the economies at the centre: Europe and the U.S. That government's intention to address challenges in the corporate sector were also driven by borrowing formal institutions, (which tended to be crippling), which does not seem surprising. Since the adoption of Brazil's corporation law in 1940, the financial markets of Brazil have been tightly regulated. For example, the government ran the stock exchanges, brokers were civil servants, and brokerage fees were fixed.[136] Liberalisation took place after a 1964 military coup and a new corporation law allowed for private stock exchanges and broker-dealers to operate. But then

129 André Luiz Carvalhal da Silva & Ricardo Pereira Câmara Leal, *Corporate Governance Index, Firm Valuation and Performance in Brazil*, 3 Braz. Rev. Fin. 1 (2005).

130 Luiz Carlos Bresser-Pereira, Economic Crisis and State Reform in Brazil: Toward a New Interpretation of Latin America (1996).

131 *See, e.g.*, Luis Carlos Bresser-Pereira, Development and crisis in Brazil, 1930-1983 (1984).

132 Bresser-Pereira, *supra* note 130.

133 Bresser-Pereira, *supra* note 130.

134 Celso Furtado, Economic Growth of Brazil (2007).

135 Celso Furtado, Desenvolvimento e Subdesenvol vimento (1961). Celso Furtado, O Mito do Desenvolvimento Econômico (1974). Celso Furtado, O Capitalismo Global (1998). Celso Furtado, Teoria e Política do Desenvolvimento Econômico (2000). *See also*, Ricardo Bielschowsky, *The Economic Growth of Brazil: a masterpiece of structuralism ECLAC*, 9(4) J. Pol. Econ., 38-55 (1989).

136 Bernard S. Black, De Carvalho, Antonio Gledson & Erica Gorga, *An Overview of Brazilian Corporate Governance*, Cornell L. Fac. Pub. Paper 101 (2008), *available at:* http://scholarship.law.cornell.edu/lsrp_papers/101

again in the 1970s, the government intervened to create incentive structures by doling out tax incentives to firms that went public and to investors who purchased shares in public companies. This intervention increased the number of publicly listed firms, but the firms' main motive was to extract tax benefits. Hence, while the firms went public, they enjoyed tax benefits and returned to private ownership later.[137]The system was dysfunctional and eventually resulted in the collapse of the Rio de Janeiro Stock Exchange. In response, the government made frantic efforts to create an entire set of corporate governance codes and listing agreements in order to avoid such catastrophes in the future.

Heavy regulation in Brazil is coupled with an inefficient judiciary, associated with corruption, nepotism and politicisation.[138] Companies in the formal economy are forced to adhere to formal laws which have huge transaction costs. This creates a culture of informality that aims to get around the rules rather than adhere to them. Indeed, by some estimates, while dominant shareholders in Organisation for Economic Cooperation and Development (OECD) countries extract almost no private benefit, the value of this extracted benefit is 65% of firm equity in Brazil.[139] The institution of oligarchies stemming from a patrimonial system of managing organizations has remained like a bedrock. Corporate governance in Brazil cannot be reformed unless there is a due recognition of the sources for the identity of these institutions.

Although the role of informal institutions in shaping the direction of policy has remained fairly important, corporate governance structures have improved to a certain extent.[140] The creation of Novo Mercado in 2000 is an example.[141] In fact, Bovespa's success after Novo Mercado encouraged countries like Turkey and Romania to adopt the model, albeit with limited success.[142] The *new market* encourages companies by

137 *See infra* note 140.

138 Augusto Zimmerman, *How Brazilian Judges undermine the Rule of Law: A Critical Appraisal*, 11 INT'L TRADE & BUS. L. REV. 179-217 (2008).

139 Alexander Dyck & Luigi Zingales, *Private Benefits Of Control: An International Comparison*, 59 (2) J. FIN. 537-600 (2004).

140 Bernard S. Black, Antonio Gledson De Carvalho & Joelson Oliveira Sampaio, *The Evolution of Corporate Governance in Brazil*, 12-22 NW. L. & ECON. RESEARCH PAPER (2012); *see also* M. LUBRANO, CORPORATE GOVERNANCE IN BRAZIL: OBSERVATIONS ON 2000–2007 AND COMPARISONS WITH OTHER LATIN AMERICAN AND BRIC MARKETS (2007); Y. LUO, GLOBAL DIMENSIONS OF CORPORATE GOVERNANCE (2007).

141 Indeed, between 2002 and 2008 Bovespa companies' market capitalisation increased by more than 700%, and average daily volume grew about ten times. *See*, Gonzalo A. Chavez& Ana Cristina Silva, *Brazil's Experiment with Corporate Governance*, 21 (1) J. APPLIED CORP. FIN. 34-44 (2009).

142 Melsa Ararat, & B. Burcin Yurtoglu, *Different Approaches to Differentiating 'Better Governed' Companies: Market Segmentation in BOVESPA and Rating Based Indexing in ISE* (2007), *available at*: http://ssrn.com/abstract=989806, last accessed on 22 March 2013.

making the members adopt corporate governance practices in addition to those required by the law. This is, unlike a top-down government decree, a self-regulating and incentivising structure which works much better in societies characterised by an uncomfortably paternalistic past. In fact, India's story is not different, where corporate governance reforms were initiated by industry itself, rather than the government.

D. Russia: Domination Of Oligarchs

After the collapse of Soviet Union in the 90's, Russia had a peculiar stint with privatisation. The entire process was influenced by the heavy import of institutions from the West, including governance codes for corporations. However, the last two decades have seen a massive violation of shareholders' and foreign investors' rights and an increase in fraud that has intermittently plagued a deeply corrupt Russian corporate sector.[143] This change is most notably apparent in Russia's 1998 financial crises[144] and frauds that have intermittently plagued a deeply corrupt Russian corporate sector.[145] Interestingly, Russia's corporate governance reforms brought the scripted laws very close to OECD standards, but these formal institutions were ineffective in practice[146] due to the informal modes of governance that were in conflict with the formal legal framework.[147]

Russia had a tumultuous yet rapid[148] economic transition from centrally planned structures to free market. During the 1990s, the major focus of lawmakers was to privatise state-owned assets. But this was done without adequate legislative reforms which triggered acute conflicts.[149] Most enterprises fell into the hands of a few, who became enormously rich. Appropriating state-owned assets by way of criminal activities and by virtue of administrative positions became the key factor

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143 *See* Andrei Yakovlev, *Evolution of Corporate Governance In Russia: Government Policy Versus Real Incentives Of Economic Agents*, 16 POST COMMUNIST ECONOMIES387 (2004); *See also* Olga Lazareva, Andrei Rachinsky & Sergey Stepanov, *A Survey of Corporate Governance in Russia*, 103 NEW ECONOMIC SCHOOL WORKING PAPER (2007).

144 *See, e.g.*, UNCTAD & UNECE, *The Russian Crisis*, (October 16, 1998), *available on*: http://www.unece.org/press/pr1998/98gen12e.html (last accessed on March 10, 2013).

145 Yakovlev, *supra* note 143.

146 *Id.*

147 Ruta Aidis, Saul Estrin & Tomasz Mickiewicz, *Institutions, Networks and Entrepreneurship Development in Russia: A Comparative Perspective*, 23 (6) J. BUS. VENTURING 656-672 (2008).

148 Chen refers to it as 'big bang.' *See* Aimin Chen, *Corporate Governance in Russia and Some Points of Comparison with China*, 42 (3) CHINESE ECON. 41-59 (2009).

149 Yakovlev, *supra* note 143.

characterising the transition.[150] Financial manipulations and heavy influence by key position holders enriched themselves immensely, right under the government's nose.[151] Huge assets were transferred outside the country in capital flight. Most state enterprises were privatised and sold off to *insiders* which developed a new social class called the 'oligarchs.'[152]

By the late 1990s, both federal and regional authorities were under the control of oligarchic capital and the state was practically captured by private interests.[153] While there are signs of improvement[154] through strict and expansive laws, the oligarchs, through the concentrated Financial Industrial Groups (FIGs)[155] have created a culture of rent-seeking[156] that stifles entrepreneurship.[157] The old elite in Russia was hugely incompetent[158] and this weakness of the state was carried through the economic transition.[159] In the absence of a counter-elite of resistance,[160] elites usually develop a tendency to destroy the existing public institutions and to inject private interests in the institutional vacuum thus created. This is exactly what happened in Russia: the elites took over businesses using formerly state-owned property and made money on residual structural distortions.[161] This process gave rise to what has been termed transformational rent.[162] The elites carved out relationships between the government and businesses, where decisions at the federal level could guarantee a company millions of dollars in

150 Sheila Puffer & Daniel McCarthy, *The Emergence Of Corporate Governance In Russia*, 38 (4) J. WORLD BUS. 284-298 (2003) (Authors talk about a category of people called *nomenklatura*, business-government elite, in addition to oligarchs. Powerful financial industrial groups like Menatep, Onexim, Inkombank and Alfa were results of this phase.); *see also* Aidis *et al*, *supra* note 147.

151 Privatisation took place through a voucher system, which was manipulated in favour of those who were already holding positions of responsibility. *See* Saul Estrin& Mike Wright, *Corporate governance in the Former Soviet Union: An overview of the issues*, 27 J. COMP. ECON. 398-421 (1999).

152 DAVID E. HOFFMAN, THE OLIGARCHS: WEALTH AND POWER IN THE NEW RUSSIA (2002).

153 Andrei Yakovlev, *The Evolution Of Business-State Interaction In Russia: From State Capture To Business Capture*, 58 EUR.-ASIA STUD.1033 (2006).

154 *Id.*

155 Saul Estin, Svetlana Poukiakova& Daniel Shapiro, *The Performance of Business Groups in Russia*, 46 (3) J. MGMT. STUD.393-420 (2009).

156 ANDREI SHLEIFER& DANIEL TREISMAN, WITHOUT A MAP: POLITICAL TACTICS AND ECONOMIC REFORM IN RUSSIA (2000).

157 *See* Aidis *et al.*, *supra* note 147.

158 Yakovlev, *supra* note 153.

159 Notice that this is a major difference between Russian and Chinese experience. The strength of the State never diminished or subverted in China.

160 Yakovlev, *supra* note 153.

161 For further details, see Olga Kryshtanovskaya & Stephen White, *From Soviet Nomenklatura to Russian Elite*, 48 (5) EURO.-ASIA STUD. 11 – 33 (1996).

162 DAVID M. WOODRUFF, PROPERTY RIGHTS IN CONTEXT: PRIVATIZATION'S LEGACY FOR CORPORATE LEGALITY IN POLAND AND RUSSIA (2003).

extra profits from the state budget.[163] Such possibilities provided strong incentives for corruption, bribery and violence and also strengthened the positions of the elite.

During these winds of change, an interesting phenomenon occurred concurrently. Those who had limited access to capital and influence took the course of adopting free entrepreneurship.[164] Therefore, outside the state-capture model of governance, the space for regional level entrepreneurship was occupied by local entrepreneurs who worked at a distance from the state. This gave Russia its characteristic dichotomous corporate structure: one born out of close integration (and capture) of the state, and the other as free entrepreneurship. The free entrepreneurship model was a result of (a) a weak (and captured) state, (b) tax evasion,[165] and (c) the rising demands of business. This also produced a unique administrative model for governance of the economy which based itself on informal control over private businesses. This was a marked shift from the governance structure of FIGs.[166] This institutional change is specifically associated with Russia, and, therefore, the surgical treatment needs to be customised accordingly.

Although the incessant rent-seeking and macroeconomic de-stabilisation established a strong state in the last decade, a by-product of the process was the emergence of bureaucratic consolidation. This, unfortunately, had a tendency to suppress and capture businesses. The conflicts that emerged later were most evidently manifested in the Yukos fiasco.[167] Such chaotic times resulted in fairly weak norms of corporate governance that are still followed in Russia. Large concentrated owners do not have complementary goals towards minority shareholders, because of "asset-stripping, capital flight, tunneling of benefits out of the firm, and through abuses by the Russian government in its involvement in business affairs and in its use of the rule of law vis-à-vis large oligarchic shareholders."[168] The Russian example is typical of erstwhile socialist economies which demand tailored solutions. These solutions need to incorporate variables emanating from institutional perspectives which are locked in the history and culture of Russian society.

163 Yakovlev, *supra* note 153.
164 *Id.*
165 *Id.*
166 *Id.*
167 *See* MARTIN SIXSMITH, PUTIN'S OIL: THE YUKOS AFFAIR AND THE STRUGGLE FOR RUSSIA (2010).
168 Estrin & Prevezer, *supra* note 66.

CONCLUSION

The honeymoon period is over. It is high time that the economic juggernaut that BRICS has become in the current global context, take stock of their individual governance infrastructure and examine the underlying deficiencies. With great tenacity, these countries have survived the recent financial crises by attracting huge foreign reserves, catapulting at an unimaginable growth rate, and sustaining their forward momentum through active participation in world trade. However, they have also suffered from high levels of corruption, rent-seeking tendencies, corporate frauds, inefficient information systems, an unpalatable inequality and their relatively low ranks on the Human Development Index. Having flirted with Western imports of regulations in general and corporate governance norms in particular over the last two decades, it is time that the reconfiguration of the existing regulatory determinants begins. Institutional variables have powerful explanatory power in this regard. From rigorous empirical research, the new architecture of governance needs to be designed.

While this article attempted to briefly explore how institutions in corporate governance are formed, a much deeper analysis needs to be undertaken. I am far from suggesting normative principles. Yet I hope I am not undertaking a thoughtless probe. There is an element of undeniable logic in viewing governance systems through an institutional lens. I am emphasising, why it could be an answer to the problems that non-Western societies are plagued with. I am proposing factors that are crucial in producing a stable and efficient form of governance for corporations. The power of corporations has grown considerably in the last few decades and channeling this unabated rise of power needs to be orchestrated skillfully.

As a concluding thought, I have sought to suggest that understanding the form and substance of the interaction between formal and informal institutions is incomplete without understanding the social identity, politics and historical evolution of previous institutions. Designing new institutions therefore, needs to navigate across disciplines and take important clues from Sociology, Anthropology and Political Science. This does not only need more receptivity from lawyers, economists and management professionals alike but also a proactive approach by policy makers to include several disciplines in the construction of a comprehensive theory that alternative paradigms of institutional design can be based upon.