

## Corporate Governance in Central and Eastern Europe – An introductory review

*Miklós Dobák, Thomas Steger*

Corporate governance from an overall perspective is the structuring of the control mechanisms, monitoring, and organisation of a company or group of companies in a manner that satisfies owners' objectives. Naturally corporate governance does not only keep an eye on the owners' objectives, but on the interests of other stakeholders as well. We may also find numerous other definitions. Several sources define corporate governance as an activity directed at the active management of a portfolio of such assets during the course of which both the shareholders', and the management interests are implemented. A somewhat different approach places the emphasis on a different aspect, saying that the objective of corporate governance is none else than ensuring shareholder value for the shareholders (Monks/Minow 1995). There are approaches that designate the segregation of ownership and management functions as the most important functionality of corporate governance (Sheridan/Kendal 1992).

Researchers and active professionals started examining corporate governance, as a definitive style of managing certain types of organisations primarily during the 1990s. Dozens of recommendations, a large number of studies as well as books have been written to describe the ways in which companies operate from the perspective of corporate governance, how the functionalities of ownership and management are segregated, who the key stakeholders are, furthermore on how control mechanisms are formulated at companies. It is by no means an accident that during the past ten to fifteen years such significant momentum was given to the development of corporate management, as well as to corporate governance. Thus we may conclude that the most important tendencies of this period were the following: the marked segregation of ownership and management functions; the assessment of company performance using market (and also financial market, and stock exchange) methods; moreover the strengthening of shareholders', as well as other stakeholders' influence (Angyal 2001).

It would be a mistake to think, however, that corporate governance issues only appeared in business life during the nineties. Commercial organisations based on capital associations were already well known during the Middle Ages, indeed, after the start of the industrial revolution and the ensuing economic development capital associations became the definitive form for the purpose of

ensuring the additional capital that was required in order to increase the size of enterprises. The unification of family capital with the resources of other capital owners became necessary, and as a result the controllers of family enterprises had to share their management role with their capital partners and their representatives. In this sense the roots go back two to three hundred years even in business life (Angyal 2001).

## **Historic background and roots**

It is worth the trouble to reach back to the roots of corporate governance in order to better understand the current situation even in the countries of Central and Eastern Europe. By the end of the 19<sup>th</sup>, and the beginning of the 20<sup>th</sup> Century capitalist economic conditions were typical in the majority of current Central and Eastern European countries (especially the Czech, Hungarian, Slovenian, and Croatian areas belonging to the Austro-Hungarian Empire, along with Poland). The leading countries in the region possessed legal and institutional systems that allowed for the functioning of various commercial companies. In the most developed countries and provinces of the Habsburg Empire the legal standing of different share companies had been reconciled by the end of the 1800-s with laws concerning commercial companies that were mostly adopted from German legislation. The onset of the 20<sup>th</sup> Century saw the legal regulation of other limited liability companies (e.g. Llc.) in a number of Central and Eastern European countries. All in all we may state that the development of the Central and Eastern European region ran parallel in this respect with the development of the countries in the western part of Europe; the appropriate legal and institutional systems were established, furthermore a role was given to not just commodities and products exchanges, but also regulatory exchanges that influence financial markets (exchange) in the functioning of the economy (e.g. Budapest, Prague). The development of the Central and Eastern European region was significantly defined by the influx, as well as economic impact of Austrian and German capital, and accordingly the adoption of legislation related to this was also quite typical. In summary: we may state that the adopting of German-oriented, continental type commercial company laws was typical in the countries of Central and Eastern Europe from the middle of the 19<sup>th</sup> Century, and this just became the case all the more so during the twenties and thirties.

The situation in Russia and Ukraine along with the countries of Central Asia developed differently. These countries set off on a different track compared to those of Central and Eastern Europe with the creation of the Soviet Union. Pre-1917 corporate governance and market economy initiatives and roots – mostly French in their influence – in Russia and Ukraine were stumped; while systems and institutions similar to those in European countries never really came about in Central Asian and Far Eastern areas. Consequently this part of the world

started showing a completely different type of development than European and market economy development. The Baltic countries, which were still flourishing at the end of the 19<sup>th</sup> Century, and the beginning of the 20<sup>th</sup> later also fell under the zone of influence of the soviet planned economy, and Stalin's dictatorship.

### **Socialism: the hegemony of state ownership - experiments and utopias**

Following the Second World War, however, the countries of Central and Eastern Europe became a part of the soviet sphere of influence as well. In just a few years state ownership became totally dominant in these Central and Eastern European countries, which also meant that for this period the role of corporate forms, and that of capital associations on the whole ceased to exist. It is interesting to note at the same time that in some Central and Eastern European countries (e.g. in Hungary) laws concerning share companies were not abolished<sup>1</sup>, as an insignificant number of companies which proved impossible to fully nationalise because of various political and international reasons continued to exist – mostly as exceptions to the rule –, and pre-World War II investors were allowed to keep a small ownership stake. (Tungsram in Hungary was an example of this, in which General Electric has a small stake, and accordingly the company by law operated in a share company form in Hungary, in fact, however, its complete corporate governance was in line with what was referred to as the socialist major company management system.) All in all we must conclude that during the nationalisation of the fifties and sixties corporate governance in the western sense was discontinued in the Central and Eastern European countries, and naturally – according to the aforementioned – these solution forms also disappeared completely in the Soviet Union.

At the turn of the sixties and the seventies, however, developments interesting from the perspective of our topic took place. First of all the co-operative movement, and the framework of co-operative ownership allowed for the formulation of certain personal, also at least partially capital unification forms, and enterprises. Various forums started to operate, such as: general meeting, presidium, in which it is possible to find certain governance elements, if only in a very limited way (Angyal 2001).

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<sup>1</sup> This is also interesting because at the end of the eighties, but before the change of the political system, during the period referred to as soft-socialism, the reformist economic policy-makers of those times took these laws out of the desk drawer (primarily in Hungary and Poland), “dusted them off”, and utilised them to formulate corporate governance structures in which they attempted to implement concern and holding company governance elements.

The formulation and operation of trusts and combines in the Central and Eastern European countries, as well as the Soviet Union and the German Democratic Republic is also interesting from this perspective. These organisations basically constituted a multi-level group of companies, in which various legally independent (as single legal entities) organisations operated under the unified management of a trust or combine headquarters. We may consider this to be a peculiar form of today's operative concern control, in which ownership, and operative management functions certainly were segregated to some extent. Compared to unified socialist national major companies, as they were called (where the strategic and operative management tools, along with ownership rights were in the hands of top-level managers, the latter as a result of appointment by functional and industry ministries), in the case of trust companies the trust management companies carried on more definite ownership and strategic control, while delegating a part of the operative management burden to the heads of trust member companies. This operation did not take place according to the laws on association either in today's or pre-World War Two sense of course, rather with the creation of state legislation, as well as direct state intervention. (Bühner et al. 2002)

As of the beginning of the seventies, and especially at the start of the eighties we witnessed a number of further experiments in the countries of Central and Eastern Europe. Answers to the economic irrationality of socialism as it existed, as well as to the means of doing away with its efficiency problems, were sought in the decentralisation of responsibilities within major companies, and also in the creation of various units with independent accounting, moreover in the applying of the limited opportunities of private enterprise within the framework of the socialist major company. Different types of enterprise models came about, especially in Poland, Hungary, and Yugoslavia, where a number of concepts about how state-owned companies may be made market-oriented and efficient also came to light. The biggest part of solutions, however, was more on the utopia side than anything else, and did not constitute a radical breakthrough, since the demolishing of state ownership, and the establishing of market-based and efficient privately owned structures continued to be unheard of.

During the second half of the eighties, referred to as the times of "soft dictatorship" (especially in Poland and Hungary), we witnessed another experiment, whereby quasi concerns and holding companies built from various subsidiaries were created. Interesting experiments were also performed in certain Central and Eastern European countries using the self-governance models applied in Yugoslavia, as a result of which different governance bodies, such as for example company councils, were established and operated. The appointment for example of the company's director fell in the purview of these bodies.

The appearance of foreign capital starting from the second half of the eighties had the impact of accelerating changes, as the existing legal and institutional systems did not provide adequate room for its movement (Balaton et al. 1990).

### **Changing the political and economical system: the road to a market economy**

The big boom ultimately came about at the very end of the eighties, and the start of the nineties, at the time of political changes. The countries of Central and Eastern Europe show quite a varied picture, however, in this respect, since in Poland and Hungary for example legislative regulatory efforts that allowed for functioning in various corporate forms were initiated even before the political transformation (i.e. the first free elections of 1990), while in the other countries, and subsequently in the Soviet Union too, this type of legal regulatory activity only began after the political changes, and ultimately these made the establishment of western-style corporate governance structures possible. The fact that in a good number of Central and Eastern European countries (and perhaps in the Baltic Republics too) it was possible – at least in part – to reach back to earlier, pre-World War Two legislation is an interesting phenomenon from this aspect, along with the possibility to utilise the experience of former lawyers and company court justices who were still alive during the drafting of the new laws. This of course was typically untrue for most of the CIS member states, where whole generations had died since the years between 1917 and 1920.

All in all, nonetheless, the adoption of western practices took place in the whole region. The countries involved turned their attention to various models. The Anglo-American type, along with the German continental solution, were the two most influential, with French corporate governance practices receiving less emphasis.

It would be a mistake, however, to examine the transformation of the region from just the corporate governance perspective. This was only one element of transformation in this period. The decisive element in the Central and Eastern European countries, and the Soviet Union, of course, was the transformation connected to the changing of the ideological and political system: the creation of a parliamentary democracy, the development of democratic institution systems, the establishing of constitutionality on the whole.

The establishing of a market economy was the second very significant feature of the transformation, along with the creation of an institution system that conforms to it; as well as the consistent carrying through of liberalisation. (This practically was greatly influenced by the IMF and the World Bank). The institution system for the market economy, liberalisation, and the establishing of exchanges necessary for money market operations came about in Central and

Eastern European countries predominantly on Anglo-Saxon, American models and designs (Szalai 1999). What is very interesting, however, is that the formulation of legislative and institutional structures connected to corporate governance, along with the adapting of models shows less Anglo-American orientation: it is rather the continental and German corporate governance legislation, as well as philosophy that have become characteristic of Central and Eastern European countries. This in part has historic reasons, but for that matter the relatively greater role of German and Austrian capital also supported this tendency in the region. The formulation of institutional and legislative structures connected to corporate governance cannot be separated from the commencing of privatisation, and the creation of private property.

Apart from the changing of the political system, and liberalisation that served the purpose of establishing a market economy structure, privatisation was therefore the third significant element that most impacted corporate governance issues. At the same time in every one of the Central and Eastern European countries, as well as in the former member states of the Soviet Union, privatisation occurred during a period in which the collapse of markets was uniformly characteristic, along with extraordinarily weak corporate efficiency and profitability, a multitude of resource structure related problems, and a capital market functioning in an improperly developed manner. These problems were typical in the whole of the region, and thus the privatisation process was connected to a whole range of turn-around problems in Central and Eastern Europe, as well as the former countries of the Soviet Union in a rather interesting way. (e.g. Stark 1992, Frydman et al. 1993a and 1993b, Kornai 1993). On an ideological level, the need to terminate the monopoly of state ownership and to formulate an ownership structure that conforms to the functioning of a market economy was more-or-less accepted in the whole region, of course. The countries of Central and Eastern Europe, however, took different paths in the selling of their state owned property (along with the asset valuation connected to this); having decided on different durations for transitional state asset management tasks, as well as on different proportions of permanent state ownership. Furthermore, at the start of the nineties there were also serious differences between these countries as to their approach to who are “good proprietors”. (Clark/Soulsby 1999, Balaton 2000). Socialist planned economies transforming into capitalist market economies was a phenomenon as yet unseen in world history. No prior experience related to this was available, nor any models. Thus we may perhaps consider it natural that each of the countries experimented with different solutions, mostly because of political, and social reasons, as well as influences. Apart from radical solutions seeking real owners, all forms of employees’ ownership, bonuses, community and municipal ownership also cropped up. We can surmise that one of the most exciting questions of the beginning of the nineties was how to find the various roads “in search of owners” in the countries of Central and Eastern Europe. This naturally

also meant that economic rationality was enforced together with political and power struggle irrationality. Ownership conditions formulated at that time, however, determined the subsequent competitiveness, as well as the economic structure of each of these countries for quite a long time indeed.

The turn of the eighties and nineties was an unusually exciting period because of the extraordinarily strong interaction between corporate governance and privatisation; another aspect of this was that in almost every one of these countries the question of whether the most important legislative regulations, and laws connected to corporate governance constitute *ex ante* or *ex post* regulation, caused a serious dilemma. In other words: should drafted legislation and laws to be codified regulate privatisation as well or should they instead reflect the status quo of established practices? Is there perhaps a need for a separate corporate governance act and model for the transition period?

Ultimately it took the countries of Central and Eastern Europe, along with the former republics of the Soviet Union until the end of the nineties – along different paths and with alternate solutions – to reach a point when the legislative regulation related to corporate governance started to near completion. It was not only legal regulations and laws impacting direct corporate operation that were created, but also other, related legislation that determine corporate governance to a great extent. Consider for example the laws on money market (stock exchange) operation or those on accounting. All of these together went to ensure that the legal foundations of corporate governance were created in the region. The level of consistency among these legal regulations is of course a problem entirely unto itself. The reason for this being that the biggest part of financial market laws were drafted in these countries with the help of English and American consultants – that is to say, if you prefer, with an Anglo-American orientation –, while corporate laws and the legislation directly connected to them are mostly German in their origin. The reconciliation of this situation is still being done to this very day, and should be more-or-less complete with the legal harmonisation of the EU's *acquis communautaire*. (In this regard, by the way, there are significant discrepancies and different approaches among the EU member states as well).

The influx of foreign capital to the region greatly accelerated corporate governance related legislation and legal practices. In this respect there were significant differences between the Central and Eastern European countries, the Baltic States, and the former members of the Soviet Union until the middle of the nineties. Of the capital invested in the Central and Eastern European countries some 90% was directed to Hungary, the Czech Republic and Poland, and this was also significantly more than what was invested in the former Soviet Union. Foreign (primarily Scandinavian) investment in the Baltic countries can also be considered significant. This capital did not just assume the form of technology and management know-how, of course, but it needed its own room

to move, therefore it also constituted an influence on corporate governance practices, as well as legal regulations. As a result, however, of a relatively well-balanced portfolio being typical in the Central-Eastern European countries at the middle of the nineties as concerns the nationality of capital (approximately 33% Anglo-American, 33% German-Austrian, 33% other), the area saw the arrival of different corporate governance philosophies with equal gravity. Obviously an American investor has different ideas about the operation of a board than does a German; a German investor would give a different role to a supervisory board than would an American (seeming as how the supervisory board is an unknown corporate governance category in the USA, it is primarily the independence of the non-executive members of the board that constitutes a guarantee to the owner). The ensuing shakedown and the adjustment of legislation to at least partially fit investors' requirements continues to this very day in the countries of Central-Eastern Europe, and they all managed to establish a basic structure that is acceptable to all foreign investors.

## **Current state**

What can be said about the current state of corporate governance in Central and Eastern Europe? In fact, a large number of authors dealt with diverse aspects of this topic within recent years. It is not possible to discuss all of them here. Instead, we try to elaborate some features which emanate from the literature. Of course, we do not claim to deliver a complete or a generally valid picture. However we should give a subjective and somewhat provocative overview of what we considered the most outstanding current problems of the topic.

### **A problematic legal and business environment**

In most countries, the legal framework for corporate governance must be considered still at a premature level. Although great efforts have been made in institution building, this alone is far from being sufficient, especially as it is often used for mere imitation of western models and for disguising real processes (Peev 2002). Several authors report in detail about the weaknesses of the institutional framework in diverse countries of the region (Fox/Heller 2000, Gros/Suhrcke 2000, Bloom et al. 2003) which, in respect to corporate governance, hinders the enforcement of property rights and enables corruption to flourish. On the level of "soft" law, considerable progress has been made in developing codes for good corporate governance in most countries. However they must still be considered as being of little relevance to the actors concerned (Hartz/Steger 2003).

Consequently, the inadequate legal framework also hinders the development of a functioning financial sector (Fink et al. 1998), constraining investments both from domestic sources as well as from abroad (Pistor et al. 2000). In addition to this, stock markets and markets for corporate control barely play a role (Peng

2000). In a more general perspective, it becomes obvious that the transformation imposed from above reinforced rather than undermined the dominance of politics over economics even in the field of business (Martin 2002). In many countries, business culture is dominated by traditional values and habits rather than by the widely propagated Western “best practices” (McCarthy/Puffer 2002). Moreover, “hidden”, informal activities must be considered direct reactions of business actors to an adverse environment of exaggerated taxes, bureaucratic corruption and an inactive court system (Johnson et al. 1999).

### **Ambiguous international influence**

Since Central and Eastern Europe has been exposed to considerable external influences during all the years of transformation, corporate governance must be considered based on this background as well. The picture here is bifurcated: On the one hand foreign banks and international institutions are highly needed for bank privatisation (Fink et al. 1998) and foreign strategic investors, namely multinational enterprises, play a considerable role in the development of corporate governance, especially in a later stage of transition (Mygind 2001). Due to the fact that foreign direct investments are first of all directed to the fast reforming countries (EBRD 2002) a strong influence of the diverse actors from abroad and their models and concepts is not surprising. On the other hand, imposed changes are often questionable in quality. Under the surface, traditionally inherited models and behaviours may persist whereas adaptation to classic Western patterns is just for rhetorical purposes due to external prescriptions and pressure (Martin 2002, McCarthy/Puffer 2002).

### **Heterogeneous company landscape**

On the enterprise level a large variety of corporate governance configurations can be found which also can be considered the result of different forms of privatisation (Mallin/Jelic 2000, Mygind 2001). Among them, however, several institutions can be found which proved to have fairly problematic impacts on the overall business landscape, namely the huge financial industrial groups in Russia (Fox/Heller 2000) or the “crony” communist-capitalist networks in Bulgaria (Peev 2002). They constitute the peak of an iceberg of fuzzy firm boundaries and obscure networks of firms, managers and bureaucrats (King 2001). No wonder that in these circumstances abusive take-overs and fraud methods, e.g. tunnelling, are not seldom found (Bloom et al. 2003, Klinkhammer 2003). Besides this, direct links between the state and firms remain close in most countries and state capture must be considered still highly problematic in several of them (Hellman/Schankerman 2000).

### **Shareholders with “unequal sticks”**

The question about firm ownership is of great interest from a descriptive (who are the ruling shareholders?) as well as from a normative point of view (which owner would be best for the firm?). As far as the latter question is concerned several authors pointed out that concentrated ownership (especially in co-operation with strategic investors) could enforce control of acting managers and improve company performance (Hashi 2000, Schwarz 2000). However, the state is still the main player in the ownership structure of companies in most CEE countries (Mallin/Jelic 2000). Besides, and often functioning as “unholy alliance”, a lot of (old) managers came into power through obscure and often abusive privatisation methods (Fox/Heller 2000, McCarthy/Puffer 2002). Employee ownership was widespread at the beginning of transformation and is considerably declining with increasing need for thorough restructuring and financial resources (Mygind 2001). What remains are the minority shareholders who are most often in a very weak position, as transparency and protection of shareholder rights are widely lacking, and who, as a consequence, fail to fulfil their control task with regard to the ruling internal groups (Schönfelder 1999, Jesover 2001).

### **The arena of actors: Managers, financial institutions and employees**

It is important to stress here that the power of management is not first and foremost based on ownership but on control of collective assets – Martin (2002) speaks about “politicized managerial capitalism” which seems to be much more similar to Japan than to the USA. Being the winners of privatisation they often managed to keep their dominant positions. Particularly in Russia, the preponderance of insider dominated boards is just slowly changing (McCarthy/Puffer 2002). Even the removal of poorly performing CEOs’ is often hindered by insider ownership (Muravyov 2002) because supervisory boards lack or – where they exist (e.g. in Slovenia) – still face some problems as concerns developing balancing power (Mihelcic 2003). With the old managers, old values and attitudes also persist such as the widespread paternalistic leadership style (Mygind 2001) and the company providing significant welfare benefits to its employees (Martin 2002).

The situation of banks is still problematic in many countries of Central and Eastern Europe because their privatisation is uncertain in many places, capitalisation remains often inadequate and multiple (political) pressures hinder independent development (Fink et al. 1998, Mallin/Jelic 2000). So, strong tendencies towards imprudent banking must be identified in many places. Nevertheless, banks will play a more and more important role for future corporate governance in the region, although a lot of work is still to be done as privatisation alone will definitively not be enough.

Employees and unions experience a somewhat opposite tendency. Though initially in a fairly advantageous position (e.g. in Poland they were even given veto rights over the method of privatisation - Mallin/Jelic 2000) they had to face a considerable decrease of power in recent years (Steger 2003). While the number of employee-owned companies has considerably reduced and employees more and more find themselves in the position of minority shareholders, there is even a relatively lower aspiration for participation to be identified (Mygind 2001). The countries of Ex-Yugoslavia with still relatively high employee influence (and ownership) are to be considered exceptions with an insecure future anyway.

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