Principal-agent conflict in United States of America and Germany.

Proposals for Uzbekistan

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ABSTRACT

This paper analyzes the principal-agent problem in large publicly held corporations in USA and Germany, the result of this analysis is aimed at providing lessons for the developing Uzbek Model of Corporate Governance. Under my assessment the shareholder–manager relationships are viewed as the core principal agent relationships. The main discussion is around the corporate governance models used in three jurisdictions as well as legal strategies used to mitigate the costs connected with the principal-agent conflict. The thesis starts with defining the source of the principal agent conflict - the separation of ownership and control and its relationship with the agency problem. Further, a discussion starts about a list of common mechanism that are used in both countries to deal with the principal agent conflict. The last chapter starts with an analysis of the Corporate Governance Models of USA and Germany and Uzbekistan and ends with a concluding comparative analysis that provides proposals for the Uzbek Corporate Governance model and asses the fields for improvement.

INTRODUCTION

In our time, big corporations operate in the world market by means of "*an internal system that encompasses policies, processes, people, and which makes sure the needs of shareholders and other stakeholders are met in full*"[1]. This internal arrangement is called corporate governance.

The organization of company's corporate governance is a complex procedure. All companies occasionally face different problems concerning its efficiency. One of the most common issues in corporate governance is the "principal-agent conflict", also known as the agency problem that arises when managers entrusted with certain power from the side of the owners, abuse these powers and use them for their own benefit.

The "agency problem" was identified as a result of the separation of ownership and control in the 18th century by Adam Smith in his work *Wealth of Nations*[2], and subjected to a throughout analysis in The Modern Corporation and Private Property by Berle and Means in 1934[3]. This fact shows that agency problem is not a new issue at all.

The corporations exercise their executive powers through the members of the management bodies. The principal-agent relationship arises as a result of entrustment of these powers to the management of the company from shareholders, who are known as the principals to the directors - the agents of the company. The shareholders, who are the principals, do not take part in management, and provide the management - who are the agents, with the powers to act on their behalf and in their interest. However, since the corporation is

[1] Gabrielle O'Donovan, *Change Management – A Board Culture of Corporate Governance*, (Electronic version, A Mondaq Business ,2003)

[2] Adam Smith, The Wealth of Nations, (London: Methuen & Co., Ltd., 1776)

[3] Adolf Berle, and Gardiner Means, *The Modern Corporation and Private Property*, (New York: The Macmillan Company, 1934)

the one liable for the performance of its obligations, the management bodies may escape personal liability at the expense of company's assets. The difficulty lies in designing the company structure in a way that would not let the directors use company resources for their own good, but would make them responsibly and effectively perform in company's best interest.

The principal agent problem in corporations has developed because of a numerous factors interconnected with the growing size of corporations, that exercised the separation of ownership and control lead to information asymmetries, which in their turn, created possibilities for opportunistic behaviour by the agents. The separation of ownership and control is identified as the root of principal-agent conflict. The separation of ownership and control leads to the entrusted to the directors with certain power to manage the company from the side of the shareholders. This relationship between the directors and shareholder which may lead to the abuse of their managerial powers for their own benefit is in the center of this thesis. The throughout analysis of these cases would give a good ground for future comparative analysis.

Companies use a wide range of different mechanisms in order to minimize the risk of occurrence of the opportunistic behavior of the agents, when they are granted with a power from the owner's side. This is made in pursuit to reduce the transaction costs, often referred to as agency costs that have been identified by Jensen and Meckling (1976) as the sum of the corporation's direct costs for the monitoring expenditures by the principal, the bonding expenditures by the agent and the residual loss.[4] There are legal strategies to mitigate the occurrence of these costs that divide into regulatory and governance strategies that are aimed

[4] Michael Jensen, and William Meckling, *Theory of The Firm: Managerial Behavior, Agency Costs and Ownership Structure*, (Harvard University Press, December 2000; Journal of Financial Economics (JFE), Vol. 3, No. 4, 1976.), p.6

to regulate principal agent problem, by outlining specific internal and external rules or standards of behaviour in the corporations as well as grant certain powers to the owners of the corporations. The examination of these mechanisms and strategies will show their efficiency and fields that they affect. This analysis would help to prevent the possible emergence of the principal agent problem in corporations.

My thesis focuses on the framework of these mechanisms, their practice, efficiency and effect on company's performance in USA and Germany with the main goal of providing possible solutions for the corporate governance in Uzbekistan. The thesis will consist of three chapters that will cover the fundamental elements of principal-agent problem, the nature of agency problem in corporations, as well as mechanisms created to reduce them, the usage of these mechanism in USA and Germany and an analysis of these mechanism for the improvement of the Uzbek Corporate Governance model.

The research method of this thesis is comparative analysis. The main sources are US, German and Uzbek laws. The US and Germany have different corporate governance models. While US has a shareholder oriented approach, Germany is a stakeholder oriented model of corporate governance. What would be important to mention is that Uzbek legal system is a civil legal system and has a lot of similarities with German legal system, however in case of corporate governance laws, interestingly, has a more shareholder oriented approach. In general will be carried out through a text analysis of books, legal studies and online resources. The scope of the thesis will be mostly covered by books on Corporate Law and Corporate Governance. These sources shall provide general understanding of the topics discussed in the thesis as well as present a detailed explanation where needed. All the gathered information will help to provide a decent critical analysis of the topic.

The main objective of this thesis is to produce a critical evaluation and comparative analysis of the methods used by both US and German corporate governance model in solving this issue. First I am going to present the reason of the principal agent conflict - the separation of ownership and control, after that discuss the conflict itself, provide the list of mechanisms that are aimed at reducing the possibility of occurrence of the principal-agent conflicts and the finishing chapter would be the comparative analysis of the three legislations.

In the light of the fact that Uzbek legislation concerning the corporate governance in general is still developing, this analysis in the future can be used as an example for further developments of the Uzbek model of corporate governance, for an example by listing the available ways to avoid the principal agent problem on the early stages.

Chapter I. The source of the principal-agent conflict – the separation of ownership and control

The separation of ownership and control occurs when in large corporations the owners (the shareholders) posses limited or no control over the decisions' made by the corporation's managers. The first reference to the separation of ownership and control, and concerns over its effect, go back to Adam Smith. In The Wealth of Nations, Smith (1776), who wrote about joint stock companies, stated that

the directors of such companies, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. It is upon this account that joint stock companies for foreign trade have seldom been able to maintain the competition against private adventurers.[5]

However, recent interest in the separation of ownership and control is often associated with Berle and Means (1932) who documented the rise of the modern corporation in the United States.[6] While examining the problems of enterprise, one would probably distinguish their three functions: (1) that of having interests in an enterprise, (2) that of having power over it and (3) that of having respect to it.[7] A single individual may fulfill, in varying degrees, one or more of these functions.

According to Berle and Means (1932) before the industrial revolution the worker who was also the owner of the business, would perform all three abovementioned functions. However, after the revolution the large portion of production in the industries was provided by the entities that have divided the functions by providing that the first two would be

[5] Supra Smith (1776), Book 5, Article 1, p. 34

[6] Eugene F. Fama and Michael C. Jensen, Agency Problems and Residual Claims, (University of Chicago Press: Journal of Law and Economic, 1983), p.6

[7] Berle and Means (1932), supra at p. 112

performed by the owner and third one would be delegated for the hired force – the managers. This has led to the emergence of the system under which the owners as a class were in a position either to manage the entity or separate from it by giving such powers to the management, while at the same time receiving profits of the entities conduct. Meanwhile, the directors as a class were in a position to manage the entity for the owners benefit. In other words the difference between the owners was that they only hold a title – the position, while the managers were the ones taking action. The owners were not expected to act, neither it was their obligations, while the managers primarily role was to act and manage the company. This is the way how under corporate governance, the function of ownership and control were separate. The ownership group are merely owners of legal and factual interests in form of a residual claim, while the control group have legal and factual powers over the company.*”*[8]

The separation of ownership and control is, in its essence, parting the decision management of corporation from the residual risk bearing. While in sole proprietorships both control and management of the firm is possessed by the owner, who manages the day to day business activities of the firm and is the main claimant for the firm's profits, in companies with separation, the claims for profit is an attribute of shareholders (principals), while the decision making process is allocated among the managers (agents) of the company. In the last scenario, shareholders lack control over the firm and are not allowed getting involved into management or policy-making decisions of the company, whereas the managers have no claims for the benefits of the company unless prescribed by the shareholders. In other words, managers control the firm, while shareholders are the owners and recipient of the profit that company generates. This profit is usually referred to as a residual claim, meaning that they

[8] Ibid.

accumulate after all costs and fixed claims have been satisfied by the company in front of all company's stakeholders.

Kraakman in his work "The Anatomy of Corporate Law: A Comparative and Functional Approach" categorizes agency problems that may arise in a firm on the way of their performance into three categories: a) between managers and shareholders, b) between majority and minority shareholders and c) between the company and the other stakeholders (general public).[9] The scope of this thesis will be covering the first category identified by Kraakman. Bhuyan and others further develop the first category and identified that there are three types of principal-agent contractual relationship within the management of a public corporation: a) contractual relationships between the shareholders and the Board of Directors, b) between the Board of Directors and the executives, and c) between the executives and their subordinates.[10] However, this work will be concentrated on the agency problem arising inside the company itself - between the directors and the shareholders.

While this structure is seen as a something positive in view of all benefits that it provides, there is also a cost that every firm has to pay for this separation. Corporate governance has two main functions – establishing and controlling the structure of the company and an attempts to control conflict of interest inside corporation "including those between corporate 'insiders,' such as controlling shareholders and top managers, and 'outsiders,' such as minority shareholders or creditors. These conflicts all have the character of 'agency problems' or 'principal-agent' problems."[11]

[9] Reinier Kraakman, Anatomy *of Corporate Law. A Comparative and Functional Approach*, (Oxford University Press,1st Ed,2004)

[10] Hamid U Bhuiyan and others, Audit Committee in Banks: Current Regulatory Framework and Disclosure Practices in Bangladesh, (*The Cost and Management, 35*(2), 2007), p 5-18.

[11] Supra Kraakman, p 35

Kraakman (2004) provides a good definition for agency problem, he states that "'*agency problem'…arises whenever the welfare of one party, termed the 'principal,' depends upon actions taken by another party, termed the 'agent.' The problem lies in motivating the agent to act in the principal's interest rather than simply in the agent's own interest*."[12]

Another good definition of agency relationship is provided by Jensen and Meckling (1976), who identify it as: "*a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent."*[13]

After analyzing the abovementioned definitions, one can state that while the principal delegates decision making responsibility to their agent, the agent's decisions affect both of them. Jensen and Smith (1985) state that the agency problems that derive from conflicts of interest, between agent and principal, are common to all cooperative activity among all individuals.[14] The root of the agency problem in the case of corporations lies in the separation of ownership and control that has been discussed in the previously. While in the past, before the industrial revolution there were simple sole proprietorships, where the owner was also the manager of his company, since those times they have turned into widely-held corporations, where "*the risk bearing function of ownership and the managerial function of control are separate functions performed by different parties*".[15] Unsurprisingly, these distinct

[12] Ibid., p.21

[13] Supra Jensen and Meckling, p 305-360.

[14] Jensen, M. C., and Smith, W. H. (1985). Stockholder, Manager and Creditor Interests: application of Agency Theory. *Journal of Financial Economics,* p. 3

[15] Pallab K. Biswas, and Hamid U. Bhuiyan, *Agency Problem and the Role of Corporate Governance Revisited*, (Electronic version, October 20, 2008). Available at SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1287185

bodies may clash, in situations where they have conflict of interests. As Biswas provides in his work that Prowse[16] stated:

…shareholders' preferences are to maximize the value of the firm's equity, without regard for the value of its debt. Creditors, on the other hand, prefer to maximize the probability that they will be repaid, which often means the firm taking on less risky projects than the shareholders would prefer to have. Managers prefer to engage in activities that maximize their own return rather than that of outside financiers: this can vary from policies that justify paying them a higher salary (for example, by increasing the size of the firm), to the diversion of resources for their personal benefit, to simply refusing to give up their jobs in the face of poor performance. Even different shareholders may have different objectives. In particular, large shareholders that have a controlling interest in the firm ("insiders") would prefer, if they could, to increase their returns at the expense of smaller, minority shareholders ("outsiders").[17]

The issue of principal agent situation has a complex structure. Generally it is costly to take countermeasures in order to avoid parties from taking self-interested actions. The greed turns on when people are empowered with control over other people's capital and business. The main issue resulting from principal-agent problem is the rise of the company's agency costs. Agency cost, in general is "*a type of internal cost that arises from, or must be paid to, an agent acting on behalf of a principal*"[18]. Consequently, they increase when all of the corporation's bodies act in their own interest.

[16] Stephen Prowse, *Corporate Governance in East Asia: A framework for analysis*, (The World Bank, 1999), pp 115-116

[17] Supra Biswas, (2008), p 1

[18] Investopedia,(2011). Agency costs.

Chapter II. Mechanisms and strategies for regulating and preventing agency problems

In the beginning, it was stated, that corporation is a nexus of contractual relationships. The relationships that involve delegation of powers or a promise to perform from one party to another are subject to agency problem. There is no standard format for creation of ideal contracts. In the end, the possession of asymmetric information may persuade the agent to take the risk and gain some extra profits out of corporations "pocket". My thesis is focused on the agency costs arising from the relationship between shareholders and managers that have been viewed by Jensen and Meckling as the core relationship, where agency costs arise[19]. Further, I am going to analyze the ways to resolve these agency problems that arise in the firms between the owners (principals) and managers (agents) of the company.

The problem lies in insuring that the agent acts in the best interest of the principal, rather than for his personal benefit. Principals better than anyone else understand the nature and consequences of this problem. That is why they take specific measures in order to detect and prevent agency costs. In relation to the way of control and mitigate agency problems there is a large number of studies, where scholars provide different strategies to achieve this goal. One of the most recognized universal works that provide a number of legal strategies that control or mitigate the agency problem is Reinier Kraakman's "The Anatomy of Corporate Law".[20] In the author opinion the law plays an important role in reducing agency cost.[21] He provides a set of legal strategies that are comprised of "regulatory" and "governance" strategies that regulate the opportunistic behavior of managers.[22] Kershaw (2009) in his work provides a comprehensive analysis of a wide range of legal strategies that both may come

[19]Supra Jensen and Meckling at p. 6

[20] Kraakman, supra (2004)

[21] Ibid.

[22] Ibid.

both as a benefit or regulatory norms on the basis of Kraakman's analysis.[23] In contrast, Professor Biswas in his paper provides that strong model of corporate governance is a mechanism that reduces divergence between the interests of the agent and the principal: "*corporate governance is ... the widest control mechanism used for efficient utilization of corporate resources. It is a hybrid of internal and external control mechanisms with a view to achieving efficient utilization of corporate resources. Corporate governance and monitoring mechanisms are manifold and generally comprise external control mechanisms as well as internal control mechanisms*".[24] Marks, in general, provides strategies that are reflected in the works of all abovementioned authors.[25] Further I am going to describe the mechanism and strategies provided Kraakman while contrasting and adding views of other scholars.

2.1 Legal Strategies

As discussed above, according to Kraakman, law plays an important role in reducing agency cost. When trying to resolve the agency problems he advices to turn to legal strategies that would help "*to enhance disclosure by agents or facilitate enforcement actions brought by principals against dishonest or negligent agents*"[26]. In matters like agency problem, the law turns to normative legal strategies. These legal strategies are in essence the means of controlling the behavior of manager and protecting the interests of the owners. Marks (2009) in his work also addressed the corporate law. In his approach he explained that one of the mechanisms to regulate the agency problem would be the specification and enforcement of

[23] David Kershaw, *Company law in context: text and materials*, (Oxford University Press, Oxford, UK. ISBN 9780199215942, 2009)

[24] Biswas, supra (2008), p.9

[25] Stephen Marks, *Separation of Ownership and Control*, (Electronic version, 1999) Available at: http://encyclo.findlaw.com/5630book.pdf, p 705

[26] Kraakman, supra at Chapter 2, p. 22

managerial duties[27]. In his point of view, this could be achieved by imposing obligations that could be put into practice through specific enforcement mechanisms in legislative, administrative, judicial or contractual ways by the means of corporate law. These enforcement regimes are given in 2 categories: private and public. Private in a form of private right of action and public in a form of government enforcement.[28] Private enforcement – gives a right for a private right of action – "the right to sue alleged violators of the law". In other words the corporation may sue the offenders under private law e.g. under law of contract, labor law or corporate law. Public enforcement – is an enforcement mechanism created by the government for the public good. Governmental enforcement can be in a form of acts that may impose specific duties upon managers or employees in general (e.g. duty of care).

Both of these scholars state that in the agent principal problem situation one of the main ways to solve it would be by the means provided by the (corporate) law. While Marks has simply identified that there is an enforcement regime with 2 categories of the agency problem, Kraakman has gone much further than that. He identified that these "legal" strategies can be divided into two categories: regulatory and governance strategies.[29] While the regulatory strategies are prescriptive in their form usually in the form of statutory requirements, in other word they are meant to protect the principal directly, the governance strategies have more of an indirect nature. In my point of view, this scheme of strategies created by Kraakman is core in the field of reducing and mitigating agency costs. Consequently, both of these strategies will be described coherently.

[27] Marks, supra (1999), p. 703

[28] Ibid.

[29] Kraakman, supra at Chapter 2, p.23

2.1.1. Regulatory Strategies

The **regulatory strategies** are dogmatic in their nature. In other words, they explicitly formulate the terms and conditions of the agent-principal relationship as well as formation and dissolution of this contractual relationship.[30] It is assumed that the principals better than anyone else understand the nature and consequences of this problem. That is why the general type of these strategies restrains the managers from certain decisions or dealings, which in principals eyes, would harm the company's wealth.

The regulatory strategies formulate rules and standards.[31] While these rules and standards are aimed to directly control the core of agency relationship, they perform their duties differently. Given strategies form rules that regulate the managers behavior in a way, that would prevent possible misconduct and standards that outlines the procedure that has to be considered by the court after the occurrence of the misconduct[32]. The rules strategy creates a code of rules that regulate complex relations within the company. The standards strategy creates discretion for adjudicators to determine ex post, whether violations have occurred or not. While rules can be easily drafted and enforced within the company, the validity of standards requires close examination by the court that must be convinced about the legality of the accusations. To conclude it can be said that rules and standards—regulate the terms on which the principal-agent relationship develops internally.

[30] Ibid.

[31] Ibid.

[32] Ibid. p. 23-24

The possibility to manage the conditions on which principals' collaborate with agents is viewed as a second set of regulatory strategies available by the law.[33] The law can utter conditions required for both **entry and exit** prospects in principal agent relationship.[34]

The entry strategy is important part of director's selection, in other words it helps principals to screen out those agent with tendency to or possible opportunistic goals. It allows you to have a better understanding of the agent's experience, his past employments in the public capital market, as well as makes it possible to ask agents to reveal the forecast of their future performance as the company's manager. This is a requirement imposed by the outside investors, who "want some form of systematic disclosure to obtain an adequate supply of information".[35] Thus it can be said that "entry" strategies are sort of a filter that screens different people or organizations before they become part of a corporation. The exit strategy is an approach used ex post the revelation of the agency problem[36]. Logically, when the misconduct on the agents' side will be revealed, he will be released from his position. However, this scheme is applicable in cases where the agent has benefited by using the corporation and by damaging all major principals in the corporation. However there are situations, where the decision that the manager is about to make, may benefit most of the shareholders, while leaving the others in vain. The exit strategies will reimburse the losses faced by such principals. There are two kinds of exit strategies: first one is investment withdrawal that doesn't usually lead to agent's removal and the second one is the right to transfer that allows to get rid of inefficient agent.[37]

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[33] Ibid. p.24

[34] Ibid.

[35] Ibid.

[36] Ibid. 25

[37] Ibid.

The best example of withdrawing the value of investment in corporate field is the practice of awarding an “appraisal right” to principals who dissent from certain major transactions[38]. This right allows for the principals who acquired significant loss because of a transaction that he disagreed upon, to claim the value of their shares prior the value-reducing decision made by the agents. The principals may also sell their stock before the disputed transaction, as well as creditor, who may ask the corporation to repay the loan, before engaging into performance that can be viewed as risky by them.

The shareholders right to transfer or freely sell their shares on the market is the second type of exit strategy.[39] This strategy is the outcome of transferability – one of the core characteristics of the corporation. On the one hand, transfer rights may lead to a loss, since the principal buying the shares, will get inside information about the agency problem inside the corporation and therefore will propose a lower price for the shares.[40] On the other hand, the transfer right allows removing the agent, who is the cause of the agency problem and as a consequence eliminate the future agency costs from this source.[41] The transfer right provides a chance for takeovers from other companies as well as concentration of a controlling portfolio of shares into hands of one active shareholder. While the minor shareholders have no or small incentives to maintain strict management monitoring because of its costs, an active shareholder, on the contrary, would be able to benefit from the takeover. When the takeover procedure is initiated, the active shareholder or the new group of principals may remove the whole managerial team with a new one.

[38] Ibid.

[39] Ibid.

[40] Ibid.

[41] Ibid.

The possible transfer of control right to a new group of shareholders or into hands of one active principal that would result in the job positions of the active managerial team is an effective mechanisms for disciplining management

2.1.2. Governance Strategies

Corporate governance, in general, is a combination of internal and external control mechanisms for efficient use of corporate resources[42]. Principal-agency conflict, as we already, know is a factor that may significantly harm the companies wellbeing. Consequently, effective internal and external mechanisms of corporate governance are the natural mechanism for mitigating and avoiding agency costs. Various scholars one way or another include corporate governance as mechanism of reducing agency risks.[43]

The governance strategies are the second form of the legal strategies proposed by Kraakman.[44] While describing Kraakman's regulatory strategies we could see that they are focused on resolving agency costs that arise between the parties on the level of contractual relationships. In contrast, the governance strategies have more of an indirect nature that concentrates on the corporate governance and hierarchical basics of the principal-agent relationship.

Under governance strategies he includes 1) appointment right, 2) decision Right and 3) incentive strategy.[45] David Kershaw's work is literally based on the classification provided by Kraakman.[46] Marks in his work overlaps with Kraakman. He describes the following

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[42] Biswas, supra (2008), p.9

[43] Biswas, Kraakman, Kershaw, Marks

[44] Kraakman, supra at p.26

[45] Ibid. p. 26 -27

[46] Kershaw, supra

mechanisms: 1) the alignment of the managerial financial incentives, 2) market for corporate control, 3) corporate governance structure and oversight, 4) shareholder empowerment and 5) business failure as the means of mitigating agency costs.[47] Biswas explicitly states that "corporate governance" is the ultimate control mechanism for mitigating the consequences of separation of ownership and control.[48] Under the control mechanism he includes the board of directors and committees, 2) ownership concentration, 3) managerial ownership and compensation, 4) dividends and market for corporate control.

After studying works of all the above mentioned scholars, I came to a conclusion, that they all overlap and converge to an opinion that corporate governance is one of the major ways of controlling agency costs. That is was not an unexpected finding, since the agency principal is a universal problem. Further I am going to prove my point of view by comparing their judgments where appropriate. Same as before, the core structure will be based on Kraakman's categorization of the strategies for mitigating agency costs with additions from works of other scholars. This approach has been chosen by me so that there would be no need for a constant repetition of the same strategies provided by the scholars.

First strategy described by Kraakman is the **"appointment right",** that is a consequence of delegated management. This delegated management allows the shareholders to indirectly control the corporation with help of appointment rights through means of voting for appointment and removal of corporation's directors for the board of directors. The appointment rights or the right to select or remove directors and other important employees is the fundamental mean of protection of the shareholders interests.[49]

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[47] Marks, supra (1985), p. 698

[48] Biswas, supra (2008), p. 9

[49] Kraakman, supra at p. 26

The analysis of BoD plays a big role in the analysis of all other scholars as well. Furthermore, the size and the composition of the board of directors are also described as corporate governance mechanisms.[50] While large board of directors may seem as an effective monitoring mechanism, decreasing the size of the BOD is believed to lead to an increase in performance, since small boards need less time for communication as well as for adoption of important decisions.[51] Since, sometimes time is a more important factor compared to a throughout analysis.

Next important point would be the Board composition.[52] The Board composition has two important components that are need to be analyzed. First one is the amount of non-executive directors and the second one is the roles of Chief Executive Officer and the Chairman of the Board. The role of non-executives as outside directors who are not engaged into the executive management, backed up with their expertise and knowledge in specific areas is to provide objective independent advices as well be a mean of knowledge in the board, thus decrease the information asymmetry.

"Decision right" is the next form of governance strategy. Decision right is the rights that allow principals to intervene into the firm's management and initiate, alter, sanction or veto certain managerial decisions.[53] This strategy is also a consequence of delegation of managerial power to the board of directors. The same strategy is proposed by all other scholars. Marks stated that "*shareholder empowerment reduces the separation and gives*

[50] Ibid.

[51] Biswas, supra (2008), 9

[52] Ibid.

[53] Kraakman, supra at p.26

shareholders more say in management".[54] Biswas also considered the "decision right" under "ownership concentration"[55]. However, none of them has seen it as a major strategy when to fight the managerial opportunism. Biswas has seen this strategy as a "theoretically" available option, while Kraakman sees it as a not effective method when compared with other governance strategies.[56] According to Kraakman, "*this disparity is a logical consequence of the fact that the corporate form is designed as a vehicle for the delegation of managerial power and authority to the board of directors. Only the largest and most fundamental corporate decisions (such as mergers and charter amendments) require the ratification of shareholders ex post under existing corporation statutes, and no jurisdiction to our knowledge requires shareholders to initiate managerial decisions."*[57] In other words, this governance mechanism in its nature is contrary to the core characteristic of the corporation – "the delegated management", which enhances the corporate performance by delegating certain type of decisions for different groups of managers and absence of need for their constant monitoring.[58]

Next governance strategy is the **"incentive strategy".** The incentive strategy is different in its nature from all the previous strategies, because its main goal is to induce the agent, rather than provide the principals with powers, that would shield him from the agents' misbehavior.[59] There are two incentive strategies: reward strategy and trusteeship strategy.

[54] Marks, supra (1985), p. 708

[55] Biswas, supra (2008), p. 11

[56] Kraakman, supra at p. 26

[57] Ibid.

[58] Kraakman, supra at p. 11-12

[59] Ibid., p. 26

The **reward strategy's** main goal is to remunerate the agent, who is working in the best interest of the principals.[60] There are 2 ways the principals in corporations reward their loyal and committed agents. First one is directly connected with the principal's returns from corporation's performance. This form is called "sharing rule". This rule is a common form of a reward strategy. This form is believed to strongly motivate the corporations agents, since their salaries and extra benefits are directly connected to the principal's income. As a result the agent would be willing to work in the share value maximizing way that would increase the dividends paid to the shareholders. The higher the income, the higher is the agent's fee.

Marks widens this approach. In his point of view, different financial instruments like warrants[61], may provide managers with incentive to work in a share value maximizing way.[62] It is proposed to mix the warrant mechanism with the standard corporate governance incentives with the goal of creating even more attractive incentives. Biswas provides that incentives "*in the form of accounting-based bonuses, stock option grants, stock appreciation rights, or restricted stock can reduce a variety of agency problems*."[63]

The second reward mechanism is the **pay-for-performance (trusteeship strategy)** regime. This form can be seen as an opposite of the "sharing rule". In this form an agent is paid for successfully advancing her interests, without sharing his principal's returns.[64] This form is less popular, since it may benefit different members of the corporation even in the times of the corporations default or may even become its direct cause.

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[60] Ibid.

[61] A derivative security that gives the holder the right to purchase securities from the issuer at a specific price within a certain time frame

[62] Marks, supra (1999), p. 707-708

[63] Biswas, supra (2008), p. 12

[64] Kraakman, supra at p. 27

The trusteeship strategy is the next form of the incentive strategy, which it quite distinct from those considered above. The main goal of trusteeship strategy is the elimination of the conflict of interest before the actual decision, transaction or dispute.[65] In order words it ensures beforehand that the agent who could act opportunistically would not be rewarded afterwards. The main incentive in this strategy is not money, as in the previous strategies, this time it is more about reputation within the company as well as pride for the job done well. These kinds of agent that have this type of incentives are more likely to manage for the good of their principals.

After discussing the universal mechanisms for regulation of the principal-agency conflicts, further I will proceed by providing an analysis of corporate governance models in United States of America and Germany and will present examples how many and to what extent these mechanism are put into practice .

[65] Ibid.

Chapter III. Analysis of the Corporate Governance Models in USA, Germany and Uzbekistan

Business corporations have a fundamentally similar set of legal characteristics and basically face similar set of legal problems in all jurisdictions. The five core structural characteristics of the business corporations are: (1) legal personality, (2) limited liability, (3) transferable shares, (4) centralized management under a board structure, and (5) shared ownership by contributors of capital.[66] In virtually all economically advanced jurisdictions, there is a basic statute that provides for the formation of firms with all of these characteristics. It is important to draw attention to the fact that in large market economies, almost all major businesses implement a legal form that holds all five basic characteristics of the business corporation.[67] The main purpose of corporate law is to present to the business enterprises a legal form that holds all these five core attributes.[68] Kraakman proposes reaching this goal "*by making this form widely available and user-friendly—i.e., by altering background property rights and providing off-the-shelf housekeeping rules—corporate law enables entrepreneurs to transact easily through the medium of the corporate entity, and thus lowers the costs of business contracting*".[69] In general, all developed countries have a specific statute or law that provides a possibility to create a corporation under these underlying principals. The owners of the corporations are the ones, who decide whether to implement all core characteristics or will exclude one or more of them.[70] However, it is advised to include all of the characteristics since they harmonize and make the corporation suitable for organizing productive activity.[71]

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[66] Kraakman, supra at p. 1

[67] Ibid

[68] Ibid p.2

[69] Ibid

[70] Ibid p.5

[71] Ibid

Nonetheless, nothing is perfect and these characteristics also have a number of drawbacks such as agency problems that will be discussed in this thesis.

Jensen (2003) identifies the corporations as "*a legal entity that serves as a nexus for a complex set of explicit and implicit contracts among disparate individuals*"[72]. This view helps to see the corporations not just as if they were legal persons; it shows that the performance of an organization is a combination of balanced behavior of a complicated contractual system comprised of "*maximizing agents with diverse and conflicting objectives*".[73] In other words the behavior of the organization is the reasonable behavior of a market.

In theory of organizations, the individual agent is the basic unit of analysis when examining the "equilibrium behavior" of these complex contractual systems. According to Jensen and Smith, "*in such a theory the exogenous variables are individuals' preferences and opportunity sets, including the impact of the contracting technology on opportunity sets. The structure of contracts, the forms of institutions, and the firm's investment, financing, dividend, insurance, accounting, production, and marketing policies are all endogenous, that is, determined within the system*.[74] However, for our analysis, first of all, we need to examine the core characteristics of the corporate governance models of the corporations in each jurisdiction.

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[72] Michael C. Jensen, A Theory of the Firm: Governance, Residual Claims, and Organizational Forms, (Harvard University Press, 2003), p. 136

[73] Jensen, M.C., "Organization theory and methodology"(1983) [online] Available at : <http://www.imamu.edu.sa/Data/abstract/management/acc/ORGANIZATION%20THEORY%20AND%20METHODOLOGY.pdf>

[74] Jensen and Smith, supra(1985), p 2

3.1 Corporate Governance Models

Worldwide developments have resulted in two leading approaches to the organization of corporate boards: the outsider model or the Anglo-Saxon one-tier board model and the insider or Continental European two-tier board model.[75] While the outsider model of CG is typical for common law countries, the insider model is a feature of the continental civil law countries. Further, I will discuss all three models of corporate governance with while emphasizing on the use of the mechanisms discussed in the previous chapter. The assessment of the strengths and weaknesses of the models would provide valuable lessons for the developing Uzbek model.

3.1.1 USA

As Berle and Means have stated, the main feature of the American largely held entities is the separation of ownership and control. While the shareholders own the corporation they do not manage it.[76]

The US outsider corporate governance model has a **shareholder oriented structure**. The regulations provide that the corporations should have the one-tier board model. The US Model Law states that all corporate powers shall be exercised by the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction and subject to the oversight of its board of directors.[77] In this model, executive

[75] Roberto García-Castro and others, A Cross-National Study of Corporate Governance and Employment Contracts, (Business Ethics: A European Review, Vol. 17, Issue 3, 2008) pp. 259-284. Available at SSRN: http://ssrn.com/abstract=1140817 or http://dx.doi.org/10.1111/j.1467-8608.2008.00535.x

[76] Supra Berle and Means

[77] Model Business Corporation Act, chapter 8, sbuchapter A, § 8.01, Available at: https://users.wfu.edu/palmitar/ICBCorporations-Companion/Conexus/ModelBusinessCorporationAct.pdf

directors and nonexecutive directors operate together in one organizational layer - the Board of Directors.

The Shareholder are the owners of the residual claim of the company, but do not manage the corporation's affairs. This is a direct result of the separation of ownership and control, which has significantly weakened the shareholders position both directly and indirectly. Directly in a form the statutory assignment of the **decision making** authority to the board. Under the Delaware Code - the **shareholders rights are limited** to the election of directors, and approval of charter or bylaws amendment, mergers, sales of large stock of assets and voluntary dissolution. Indirectly by providing disclosure requirements, shareholder communication rules and insider trading rules that discourage the shareholders to try boosting their powers.[78] However, it is important to state that the **Board of Directors is elected by the shareholders**, who can select and remove the officers as their representatives on the Board.

The regulatory doctrine- is a legal doctrine that is concerned with the principal agent conflict in USA is the concept that directors owe fiduciary duties to the shareholders. Directors are reasoned to be fiduciaries of the corporation because their relationship with the company and its shareholders is one of trust and confidence. Generally, these fiduciary duties include the duty of care and the duty of loyalty, however it is important to discuss the duty of disclosure as well.[79] The duty of loyalty concerns with the fiduciary duty of loyalty that directors owe to the corporation in relation to the absence of the conflicts of interest from the directors side.[80] A breach of duty of loyalty may be considered an act of the director that leads

78 Bainbridge, Stephen M., The Case for Limited Shareholder Voting Rights. UCLA Law Review, Vol. 53, pp. 601-636, 2006; UCLA School of Law, Law-Econ Research Paper No. 06-07. Available at SSRN: http://ssrn.com/abstract=887789, p. 616

79 Corinne Ball, Marilyn Sonnie and Anna F. Triponel, Advice for Corporate Directors, (Electronic Version, Available at SSRN: http://ssrn.com/abstract=1558020, 2009), p 5

80 Ibid, p. 17

to the misuse of company assets, confidential information or opportunities in his own favor at the cost of damage to the company. The duty of care is an expectation for the director to behave in good faith in corporation's best interest while exercising care with prudent business judgment.[81] The breach of duty of care may result in damages for a negligent act. The duty of disclosure[82] requires from the directors to disclose relevant information in order to prevent the occurrence of the conflict of interests between him and the shareholders. In other words, in case, where the director might have any conflict of interest regarding his proposals or actions he is making he is obliged to inform shareholders about it.

There is a wide range of incentives mechanisms available in US Corporate Governance model for the enhancement of the director's loyalty. However, it is still fully the decision of shareholders whether they want to use them or not. Those include but are not limited to different bonuses, pay for performance, stock option rights and stock appreciation rights. These mechanisms are aimed at improving the director's incentives to maximize the share value of the company.

3.1.2 Germany

Germany has an insider or Continental European model of corporate governance. In its statutes the German law has adopted mandatory model for public corporations[83] that separates the management and control by a two tier structure. The German Insider model of corporate governance has a **stakeholder oriented structure**.

[81] Ibid, p. 7

[82] Ibid, p. 52

[83] Stock Corporations Act,(BGB),(Federal Law Gazette, 1965, Vol I, p.1089), §30

The difference between the one tier and two tier board system lies in the additional organizational layer that can be found in German model. This layer has been designed to separate the executive function (day-to-day management) of the board from its monitoring function(supervision).The management board is usually composed of executive managing directors who run the business for the company. The role of the supervisory board is not that easy to outline. While it's main objective seems to be the supervision of the management board and appointment and removal of its member. However it is important to note that the supervisory board is entirely composed of non-executive directors, who usually play an additional role of improving the networking between the stakeholders of the company by representing the employees, the government and banks. The supervisory **board cannot be directly involved** into the day-to-day management, however, when the company's constitutional documents may add specific actions to be subject to the supervisory board approval.

Another interesting feature of German corporate governance model is the way the **supervisory board members are elected**. German law states that the Supervisory Board members are supposed to be **appointed by the shareholders and employees equally**. This is so called labor co-determination that is specific to Germany. Historically the labor co-determination is an instrument of preventing social conflicts, promotes networking and interest balancing within supervisory board.[84] The appointment and dismissal of the Management Board members as well as it's remuneration is the Supervisory Boards responsibility.

[84] Hopt, Klaus J. and Leyens, Patrick C., Board Models in Europe - Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy. ECGI - Law Working Paper No. 18/2004; European Company and Financial Law Review, pp. 135-168, 2004; Company & Securities Law Review, Vol. 1, pp. 217-245, 2005; VOC 1602-2004: 400 YEARS OF COMPANY LAW, Ella Gepken-Jager, Gerard van Solinge, Levinus Timmerman, eds., Deventer (Kluwer), 2005. Available at SSRN: http://ssrn.com/abstract=487944 or http://dx.doi.org/10.2139/ssrn.487944, p. 7

Regulatory strategies used in Germany to regulate the conflict of interest between the managers and the company are not as clearly defined compared to the American model, however it is possible to see the interrelation between them. First of all, in German law directors owe duties not to the shareholders, but to the corporation itself.[85] They are perceived as organs of corporation, rather than agents. The directors are liable to the company in case if the company has incurred damages because of his actions in form of a negligent or intentional breach of a contractual or statutory duty owed to the corporation. The German Law outlines that in the conduct of business a director should act with care that is expected from a diligent and conscientious manager.[86] This can be compared to the duty of care that is found in the US Model. The German duty of loyalty isn't as developed as in the US model. Self-dealing under German law is prohibited, unless expressly allowed by the shareholders.[87] Concerning the duty of disclosure, there are no specific guidelines in the German law for the directors to disclose any sort of personal interest.[88]

Germany has a somewhat different approach to the director's incentives. While these incentives can be implemented there as well, the general view is that the maximization of director's incentives is not viewed as an objective Germany's corporate governance.[89]

3.1.3 Uzbekistan

[85] Theodor Baums, Personal Liabilities of Company Directors in German Law, (7 Int. Company and Commercial L. Rev. 318, 1996), p.5

[86] Ibid, p.6

[87] Supra 82, BGB,§181

[88] Supra 84

[89] Theodor Baums and Kenneth E. Scott, T*aking Shareholder Protection Seriously? Corporate Governance in the United States and Germany*, (American Journal of Comparative Law, Vol. 53, ECGI - Law Working, 2005) Paper No. 17/2003; Stanford Law and Economics Olin Working Paper. Available at SSRN: http://ssrn.com/abstract=473185 or http://dx.doi.org/10.2139/ssrn.47318

Uzbekistan is a country with civil legal system and has most of the characteristics of an insider model of corporate governance that can be found in Germany. However, while the German Corporate Governance model is affected by representation from the side of employees, the government and the investors, in Uzbekistan the governmental influence is vast because of its block holding presence in all of the strategic spheres of the economy. We may say that Uzbek Insider Model of Corporate Governance is **state-oriented structure.**

Under Uzbek law joint stock companies (public companies) are governed by **General Meeting**, **Supervisory Board** and the **Executive body (board)**.

The supreme management body of joint-stock companies is the **General Meeting of Shareholders**.[90] The General Meeting has **authority** to make changes in the founding documents of the company, restructure or liquidate it, increase or decrease the capital of the company, as well as appoint and dismiss the Members of the Supervisory Board at its own will.[91] Under the decision of general meeting of the shareholders to the members of supervisory council of company during fulfillment by them of the responsibilities can be paid compensation and (or) to be compensated costs, connected to fulfillment of functions of the members of supervisory council. The sizes of such compensations and indemnification are established by the decision of general meeting of the shareholders.[92]

The **Supervisory Board**[93] exercises overall management not covered by the exclusive competence of the general meeting. The supervisory board **has authority**: to determine the

[90] LAW OF THE REPUBLIC OF UZBEKISTAN, About joint-stock companies and protection of shareholder rights, (No. 223-I, 1996), art. 64

[91] Ibid, art. 65

[92] Ibid, Art. 65

[93] Ibid, Art. 81

priority objectives of the company, to prepare the agenda of GM, to increase the charter fund by increasing the par value of stocks within the limits and categories of "authorized" stocks, to determine the amount of executive compensation, to recommend the remuneration for the members of the audit commission (internal auditor) or external auditor ,to recommend the amount of dividends and to submit various proposals to the GM to decide on the activities in the competence of the GM. These matters cannot be delegated to an executive body. Members of an executive body may not be elected to the supervisory board.

The Executive Body[94] manages all of the company's day-to-day activities through a sole executive body in a form of a Director (chief executive officer) or a collective executive body in a form of Directorate (Board). The Executive Body of any form is acts in the name and on behalf of the company, however only within the scope of authority delegated by the General Meeting of Shareholders or the Supervisory Board. Further authority may be provided by the Companies Charter. The Director and members of the Directorate may incur joint and several liability for their actions.[95]

The executive body of company has the **authority** over all questions of a management of the current activity of company, except for questions, referred to the exclusive competence of general meeting of the shareholders or of supervisory council. According to the Uzbek law, the **appointment and dismissal** of the executive body is fully in hands of the General Meeting of Shareholders, however, the Charter of the Company may delegate such power to the authority of supervisory board.

[94] Ibid, Art. 87

[95] Ibid, Art. 88

Concerning the regulations, the fundamental principles of corporate governance in Uzbekistan are stipulated in the Law «On joint-stock companies and protection of shareholders' rights». In addition, a number of Presidential decrees, such as Decree of the President of the Republic of Uzbekistan **"On measures on cardinal enlargement of share and impact of private sector of economy of Uzbekistan"** of 24.01.2003. № УП-3202 and Government resolutions, such as Resolution of cabinet of Ministers of the Republic of Uzbekistan **"On measures on perfection of corporate governance in privatized companies"** of 19.04.2003. № 189 have been adopted aiming to improve corporate governance in joint-stock companies. Overall, they provide different duties for the directors. For an example the Model Provisions on the supervisory board of the joint stock society states that the Director of the Supervisory Board must inform the Shareholders in case where there is a chance of occurrence of the conflict of interests.[96] The supervisory board members are not eligible to use the assets of the company in their own interest[97], as well as obliged to carry out their duties in good faith and in a matter the deem to benefit the company.[98] However, the main fiduciary is the executive body of the corporation, whose duties are listed in his or their employment contracts.

The incentives strategy was popular in the beginning of the 1990 after the collapse of the Soviet Union. The government had a positive attitude towards the denationalization of the various government owned companies. Nevertheless, after a short period this strategy was said to be ineffective, and the percentage of shares available for the employees was reduced to 25%. Nowadays, the denationalization of the companies is in the past, moreover the newly

[96] Attachment I, (Resolution of the Cabinet if Ministers of the Republic of Uzbekistan,№189, 2003), Art. 26

[97] Ibid, art 29

[98] Ibid, art 30

created joint-stock companies are not allowed to provide shares for the employees, in general there is a tendency to provide shares for the overseas investors.

3.2 Comparative Analysis

Broadman more than a decade ago stated in his paper "Competition, Corporate Governance and Regulation in Central Asia: Uzbekistan's Structural Reform Challenges", that "in Uzbekistan the state owned enterprises are being transformed into joint-stock companies that account for 45 percent of all registered firms in the private sector."[99] Unfortunately, despite the movement away from the government ownership structure inherited from a long past as a Soviet Republic, even nowadays the State holds shares in thousand of enterprises, including all strategic enterprises in which it hold a large block of the shares.

This factor as well as an underdeveloped legal environment and weak supporting infrastructure, including financial management systems and immature capital markets are a direct result of poor corporate governance. According to Broadman lines of authority for corporate governance are ill-defined, not only in SOEs and State "*"trade associations", but also in privatized firms, engendering weak external and internal disciplines on corporate performance, and little effective separation between government and business."*[100] Overall, the current legal and regulatory framework of corporate governance in Uzbekistan is thought to be structured in accordance with international standards and is aimed at providing all conditions for implementation of worldwide corporate governance principles in joint-stock

[99] Harry G. Broadman, Competition, Corporate Governance, and Regulation in Central Asia: Uzbekistan's Structural Refore Challenges, (The World Bank, 1999), p. 1

[100] Ibid, p.1, p.9

companies. The regulatory strategies in general impose rules and standards within the corporation with a goal to secure the shareholder from the manager's misbehavior and provides ways to deal with agency problem after its occurrence. Nevertheless, compared to the US and German regulations that have already forgone all the fundamental changes, the main legislative act is still not as direct and concrete as it should be. The regulations are is under constant change and was amended numerously by different bodies through the decree's of the President or the decisions of the Cabinet of Ministers. While on the one hand one may see the multilayer system of control, as a good device for monitoring in theory, the presence of obvious mistakes in legislation for years, shows the irrelevance of some provisions and prove this assumption to be wrong. At the same time it creates an unstable, overly scrutinized and time consuming process of control over the entities activities.

Compared to the other two legal systems the terms of entry and exit lay directly in the hands of the General Meeting of Shareholders. The GM chooses the Supervisory Board and all the executive bodies are chosen by the supervisory board through shareholders consent.

Concerning the corporate governance strategies implemented in Uzbekistan, we can see that there is a major difference compared to the US and Germany. While the separation of ownership and control has been one of the most important factors in both systems, whereby the shareholders would delegate their powers to some extent to the Boards, in Uzbekistan this separation almost does not exist. The Shareholders General Meeting is the main managerial power within the company and exercises the high level of decision right. Furthermore, although by the law, it can delegate certain powers to the Supervisory Board, in reality this never happens.

The Supervisory Board is elected by the General Meeting, and afterwards the shareholders representatives in the Supervisory Board. Compared to the highly developed principles of fiduciary duties in US model and a less developed, but still efficient German perspective, the fiduciary duties are vaguely outlined under Uzbek Corporate Governance. While there is a list of duties imposed on the Supervisory Board and Executive Body, the main fiduciary is still the Executive Body. Although in regulations it is clearly stated that the Supervisory Board represents the company and should act in its best interest, in reality the Supervisory Board is not employed directly by the company, but are rather the representatives of different shareholders who can influence the decisions on the conclusion of major transactions that only some of the shareholders are interested in. This fact alone may lead to the occurrence of the conflict of interest.

CONCLUSION

Corporate law identifies the separation of ownership and control as a root of principal-agent problem. While this separation was a progressive innovation which leads to creation of large publicly held firms, which Jensen even calls "*an awesome social invention*"[101], where a number of owners and investors were able to gather large amount of capital for production purposes, it is also the reason for the existence of the principal agent problem. The modern hierarchical structures of complex corporations in USA and Germany have created a various agency relationships and distinct bodies that bear diverse responsibilities and have different opinions and goals. Unsurprisingly, these distinct bodies may clash, where they have conflict of interests. These clashes create agency costs that damage the corporation's welfare. The main source of the agency cost is seen the consequence of the separation of ownership and control – the asymmetrical information, that allows the agents to manipulate for their own interest and create transaction costs for the company. However, while in theory this is true for both USA and Germany the situation is different in Uzbekistan. The shareholders in Uzbek Corporate Governance Model have excessive amount of decision right that limits if not removes completely the level of separation between the management and control. While this results in a reduction of its main drawback: the agency problem, it also has a disadvantage. Through this strategy shareholders are limiting one of the most advantageous characteristic of a modern corporations and the benefits that it provides.

The Uzbek Model, in general, positions itself as the creditor oriented model, however as it was discussed before, in most of the cases the government is the main creditor. There is clearly a need to shift away from overly protectionist approach toward corporate governance within the Republic. There is a need for privatization of many fields of the business sector, in

[101]Supra 4, Jensen and Meckling (1976), p. 71

order to achieve better results and boost the economy in general. This can be achieved through diffusion of the governments influence on the business sector by clearly defining the line of authority with the corporations and widening the separation between the government and business in general.

Simultaneously it is required to provide more independence of the internal organs of the corporation through the separation of ownership and control. Simply removing the governmental influence is not enough, the sales of the governments shares would only result into the emergence of new big controlling shareholders that would exercise high level of decision right. The Supervisory Board and the Executive should be acting in the best interest of the Company and the society as a whole as it is prescribed by the Law and not look for loopholes in legislations to continue working in the best interest of separate shareholders.

This can be achieved through a legal reform that would revise all the regulatory and corporate governance strategies and would as well remove all the present decades old mistakes in the legislation. The improvement of corporate law in general would create a strong first line of defense for the shareholders' interests. In my point of view the governance mechanisms can be seen as superior tools for diminishing agency costs as well as decreasing the possibilities of opportunistic behavior from the manager's side. The above discussed "appointment right" effectively controls the adverse selection problem in the Board of Directors and also mitigates other agency problems that may arise in the board. This strategy allows them to shape the structure, composition and power of the board, in a way, that they see as the most efficient.

The incentives mechanisms are somewhat promising mechanisms for reducing agency costs, since they address the main reason of managerial opportunistic behavior – the money. As has been discussed above, the incentives have a different approach towards agency problem. Their goal is to stimulate the agent, rather than provide the principals with powers, that would shield him from the agents' misbehavior. By reintroducing the incentives mechanism in the Uzbek Model of Corporate Governance the agency costs will fall since this would provide an opportunity for the Directors to gain an extra reward for their good performance and consequently owners of the company will improve managers' loyalty and increase in managerial performance. The better is the managers' performance; the higher is the firm's share value.

Although, there is no perfect framework that would fully eliminate the principal-agent problem in case of the implementation of the separation of ownership and control in Uzbek Corporate Governance Model, the most efficient structure that would be advantageous for both principals and agents would be a blend of most of the abovementioned mechanisms, a combination of both internal and external corporate governance mechanisms used in both USA and Germany. Though, this is a matter of a change in the state policy of Uzbekistan that would lead to political reforms that might lead to significant changes within the country and would result in a boom that the government wishes to avoid. However, the amount of the information, sources and their analysis on the efficient separation of ownership and control is enormous. I truly believe, that under the right influence and reasonable transitional period, this step by step conversion, might lead to a creation of well a functioning hybrid system of corporate governance model.

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