Corporate Governance Development in a Rapidly Changing Economy: Trends and Challenges in Estonia

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Abstract Implications of the Estonian privatization and the two-tier board model on corporate governance development are discussed. Despite implementing OECD corporate governance guidelines the stock market has still limited role in Estonian economy. The chapter reflects empirical research conducted at the Estonian Business School in the field of corporate governance at different stages of Estonian integration to the European Union and in the change management context. Technology-based new ventures create situations, where entrepreneurs are choosing new owners able to offer smart capital. These examples cannot be fully explained by applying the traditional principal-agent logic. Cases presented by participants of training workshops highlight conflicts between owners with different future vision and difficulties of entrepreneurs to differentiate the role of corporate governance from the daily management of business operations.

1 Introduction

Corporate governance in a small open economy is influenced by many global and regional factors, including economic growth and crisis, integration to the European Union, foreign investments and development trends of the knowledge-based economy. Holistic approach to corporate governance in Central and Easter Europe has to take into consideration macro-level variable implications of the privatization process on the emerging corporate governance practices, clear property rights, institutions and mechanisms that support transparent and growth-enhancing business environment (Hardi and Buti 2012). Estonian society has after the collapse of the Soviet command economy and regaining independence in 1992 accomplished rapid transition to the market economy and integration to the European Union. At present,

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a challenge is to change the structure of the economy towards more knowledge-based products and services and to diminish the role of subcontracting that does not create high added value for owners and sustainable income increase for local workforce.

Present chapter integrates results of several studies that have conducted in Estonia by authors of the present paper and their colleagues during the process of corporate governance development. These studies reflect the institutional framework and regulations influencing the corporate governance but also practical challenges and change trends. The central research problem is how corporate governance regulations and principles can enhance co-operation between owners and managers in small and large business organization facing change management challenges and crises, taking into consideration the role of local and foreign ownership and development of knowledge-based enterprises.

The framework for developing corporate governance in a small open economy is at first analyzed. Section 2 will start from presenting implications of the relatively rapid privatization in Estonia and the two-tier model of corporate governance bodies that has been taken over from the German corporate governance system. Survey results that reflect composition and work practice of supervisory boards and boards are presented. This section also discusses the role of the Commercial Code and implications of the OECD Corporate Governance Recommendations. Section 3 focuses on relations between corporate governance and change management. Change trends in co-operation between owners and managers are analyzed by using data from an expert survey. Special attention is paid to growing small enterprises as the Estonian stock market still has small number of listed companies and exercises quite limited influence on corporate governance practices. Cases of knowledge-based innovative companies are discussed in order to highlight some corporate governance challenges in such enterprises that have born global potential. Finally, the role of corporate governance bodies is linked to crisis management issues in companies.

2 Developing Corporate Governance in a Small Open Economy

2.1 *Privatization and Corporate Governance*

Already in the early stages of privatization in the transition economies of Central and Eastern Europe, Saul Estrin (1994) pointed out the dangers of insider privatization that would not facilitate rapid restructuring of enterprises. Orientation on finding core owners has been stressed among the success factors in Estonian privatization (Terk 2000). Estrin (2002) stressed that only governments in Hungary and Estonia were willing or able to sell an appreciable share of formerly state-owned assets to foreigners. In 1992 Estonian authorities decided to implement the

German 'Treuhand' model for accelerating the process of large-scale privatization and a special body, the Estonian Privatization Enterprise was established. By the beginning of 1995, the period of privatization in Estonia was predominantly over and the first legislative framework related to the operation of corporations in the Western sense had started to develop.

Terk and Elenurm (1996) in case studies of employee-owned enterprises revealed that such enterprises were able to increase operational efficiency. Employee-owners however lacked corporate governance experience and strategic vision in order to decide on long-term investments. A few years after privatization of some transport enterprises to insiders, some employees had retired and insisted on paying out dividends although the need to invest to new vehicles had become even more topical than at the time of privatization.

Jones et al. (2003) have studied the process of ownership change in Estonia after privatization and concluded that ownership change from employees to owners-outsiders has speeded up restructuring of companies. Manager-owned firms have however, according to their research results, displayed better business performance than enterprises owned by domestic owners-outsiders or employee-owned enterprises. Eamets et al. (2008) have studied the development of employee financial participation in Estonian enterprises and concluded that there is no historical tradition of employee share ownership in Estonia and during years after privatization owner-managers and outside owners have become dominant. The discussion on implementing EU regulations that would support financial participation of employees and employee representations in corporate governance bodies of *Societas Europaea,* could however make employee ownership more topical especially in knowledge-based companies.

The ownership structures of Estonian enterprises are relatively concentrated as the result of applying the Treuhand privatization model despite using the privatization process for jump-starting the Tallinn stock exchange. Minority shares of some large privatized companies were sold for the privatization vouchers but these vouchers were tradable and interested investors could start concentrating ownership already at this stage. This privatization practice made the Estonian case different from the so-called Anglo-American system, where ownership is more diffused, and also from the so-called German practice, where the role of banks in corporate governance of industrial companies is very high, as the participation of Estonian institutional investors (banks and other financial institutions, including pension funds) in domestic share trading has also been low. Some features of the Estonian ownership landscape are more similar to the Italian model, as many enterprises are family-owned, but the concentration of domestic outsiders and foreign investors is also high (Hannula 2006, p. 81).

2.2 Two-Tier Model of Corporate Governance Bodies

There are considerable differences between the Anglo-American, German and Japanese corporate governance systems that reflect corporate governance development traditions but also broader institutional context. Many developing and emerging economies are only in the process of developing the most basic market institutions. Kuznetsov and Kuznetsova (2012) claim that large and medium-size companies have failed to gain legitimacy among the vast strata of Russian society. From the corporate social responsibility point of view the Anglo-American theory of corporate governance, which concentrates mostly on the problems of stock ownership, is not exactly adequate in a situation where the ownership structure is in rapid transition and where ownership concentration is in progress.

Development of different types of corporate governance models could be observed in various countries, for example, in Poland the German type and in Russia the Anglo-American type. Slovenian enterprises adopted the German model of corporate governance (Rozman 2006). So did also Czech enterprises with some modifications (Maly 2006). Martynova and Renneboog (2011) point out that the countries of German legal approach and the countries that joined the European Unions in 2004 in principle give more decision rights directly to shareholders. At the same time countries of English legal heritage and the EU 2007 accession countries give more control to trustees and representatives of shareholders in the board of directors but still provide the highest quality of governance standards. Bedo et al. (2011) analysed governance and employment relations in Eastern and Central Europe and stated a key distinction between Ango-American style liberal market economies and coordinated economies in continental Europe. They interpret development of the Baltic countries as moving particularly closely to neo-liberalism.

The stakeholder perspective of corporate governance is strongly represented in the corporate governance practices of the continental Europe but in-depth interviews in 26 Estonian organisations demonstrated that during the rapid economic growth period before the global economic crisis, stakeholder interests and corporate relations with society and environment had not yet been considered important issues in business organisations (Kooskora 2008).

In the German model, governance is assigned to two boards: supervisory board and the management board. Foo and Witkowska (2011) discuss the view that German-Japanese model of more concentrated ownership with active role of such intermediaries as banks and employee-owners may be more appropriate for transition countries than Anglo-American model of dispersed owners. Concentrated corporate ownership can be seen as a tool for active shareholding monitoring and developing closer ties between more active and dominating owners and managers in order to respond to the agency problem. Such trend can however lead to contradictions between controlling versus minority shareholders.

2.3 The Commercial Code

In Estonia the main source of corporate governance rules is the Commercial Code, which entered into force in 1995 and has been amended on numerous occasions since its adoption. The Commercial Code provides for the general corporate governance rules to public limited companies (Aktsiaselts), private limited companies (Osaühing) and for other types of legal entities that can be used for setting up a business. It is commonly understood in Estonia that developing transparent corporate governance with wide opportunities for the investors to control the use of the funds creates a perfect ground for attracting new investments to the country and ensuring continuous economic growth.

The Commercial Code and Estonian corporate governance regulations in general are mainly based on the German version of the Continental corporate governance model. Governance is performed through three main bodies of the company. Corporate governance bodies include general meeting of the shareholders, the supervisory board and the management board. Establishing a supervisory board is compulsory in all public limited companies. The Commercial Code clearly specifies the roles of different corporate governance bodies, assuming that owners of the public limited company are interested to use such legal form to be listed at the stock exchange and are ready to differentiate clearly the role of the supervisory board as the corporate governance body that supervises and strategically directs the management board but is not involved in routine business decisions or in representing the company in daily business transactions.

By establishing a two-tier system, the aim was to bring clarity to the legal landscape in Estonia. Compared to the one-tier system, the roles of managers and owners are more clearly separated in the two-tier system and that played a decisive role in selecting between these two systems. The supervisory board determines the course of action for the company, elects the members of management board and supervises the activity thereof. In order to fulfil its tasks, the supervisory board has the right to examine all the documents of the company and to audit the accuracy of accounting, the existence of assets and the conformity of the activities of the company with the law, the articles of association and resolutions of the general meeting. The consent of the supervisory board is required for conclusion of transactions which are beyond the scope of everyday economic activities. The management board in Estonia at the same time represents the company in business transactions. Every member of the board has the authority to represent the company, whereas in case the articles of association have set forth joint representation, such an arrangement has effect on third persons dealing with the company only if such joint representation is registered in the Commercial Register.

In Estonia members of the management board cannot simultaneously be members of the supervisory board. Entrepreneurs and controlling shareholders in public limited companies have to decide if they prefer to be in the management board as CEO or other management team member in order to accomplish business transactions as representatives of the company that do not need authorization or they

want to be in the supervisory board that elects management board members, sets goals for their activities and accepts or rejects large investment proposals made by the management board.

2.4 Supervisory Boards and Management Boards in Practice

In 2007 researchers of the Estonian Business School and the Estonian Institute of Future Studies conducted survey that included 373 companies randomly selected by the Estonian Statistics Bureau (Alas and Tafel 2008). In one third of all domestic companies in the sample, the company belonged 100 % to the CEO or top management team and to their closest family members. The majority of management boards had one or two members (38.5 % and 22.2 % respectively), 14.5 % had three members and 10.3 %, four members. Management boards meet 1 or 2 times per month, on average 1.5 times per month. In 11 % of cases the supervisory board formed a special committee for dealing with issues such as compensation or remuneration for members of the top management team, strategy, finances, issues connected with purchasing raw materials, investments, evaluating assets and changing top managers. As much as 44 % of supervisory boards had three members that possess voting power on the supervisory board. Only 11 % of them were elected by the employees. In foreign firms, most of the supervisory board members are foreign residents. Thirty-seven percent of supervisory board members have the job of CEO or a similar top executive role in some other company. Sixty-five percent of supervisory board members had no business ties to the firm. It can be concluded that at least part of them can be seen as independent supervisory board members. Although supervisory board meetings on average take place 4 times per year, formal board decisions are also made outside regular face to face board meetings using phone meetings, e-mails and faxes instead. In 35 % of companies, the work of board members was compensated, but only 15 % had explicit rules for compensating their work. Contributions by the supervisory board was assessed to be the most significant in controlling business results and business decisions, followed by the function of replacing top management if needed. The survey results highlighted that conflicts in the supervisory board arise most often in discussions about what is best for the firm (Tafel-Viia and Alas 2009).

2.5 Implementing OECD Corporate Governance Principles

Trying to develop a system of good corporate governance in new EU member states is made difficult by problems such as complex corporate ownership structures, vague and confusing relationships between the state and financial sectors, weak legal and judicial systems, absent or underdeveloped institutions and scarce human resource capabilities (Tafel et al. 2006).

OECD has contributed to developing corporate governance in Estonia already in 1990s (Gerndorf et al. 1999) although Estonia was invited to join OECD only in 2007. The major stock market index in Estonia was originally TALSE (derived from the Tallinn Stock Exchange name), now renamed as OMX Tallinn. The OMX has been from 2008 integrated with NASDAQ.

Only 13 companies were listed in the main list of the Tallinn Stock Exchange as of March 2013. Secondary list comprises companies that do not meet quantitative admission requirements (free float, capitalization). In the secondary list 3 companies were listed. Tallinn Stock Exchange is one of the OMX Nordic Exchanges, which also operates Helsinki Stock Exchange and Stockholm Stock Exchange.

The role of the Tallinn Stock Exchange in the market for corporate financing changed during the economic crises at the end of 1990s, where large Scandinavian banks took over the majority ownership stake in the leading Estonian banks, former Hansapank and Eesti Ühispank have been now fully integrated as 100 % owned subsidiaries to Swedish Swedbank and Svenska Enskilde Banken corporate structures. After gaining the full corporate control Estonian subsidiaries of these international banks were withdrawn for the Tallinn Stock Exchange in 2008. On September 20, 2008, the shares of Saku Õlletehase AS (Saku Brewery) were delisted from the Tallinn Stock Exchange after the Carslberg Group had acquired shares of other shareholders. TeliaSonera Group delisted Eesti Telekom in 2010 after acquiring the stake of Estonian state and minority shareholders in this company that offers wide range of telecommunication services.

Bistrova and Lace (2012) have studied the influence of high quality corporate governance on firms financial performance in Central and Eastern European listed companies. Twenty-one assessment criteria based on best practices recommended by stock exchanges in the region were grouped into four major categories: supervisory board, management team, investor relations and information transparency. Estonian, Latvian, Lithuanian and Slovakian companies obtained in their research high scores mainly thanks to high stability of their management teams and logical organisational structures compared to Czech and Slovenian companies. However, in the whole region, when comparing 25 % of the best and 25 % of the worst companies from corporate governance perspective, researchers discovered that companies with the best corporate governance ratings, delivered below average profitability. The only financial ratio, which was better in the best corporate governance companies, was the equity ratio. These companies followed conservative capital management policy having higher than 45 % of equity ratio in their total assets. Companies that by the corporate governance criteria were among 25 % worst performers, had in average 35 % equity ratio. Bistrova and Lace (2012) see as one explanation that utility companies that cannot offer huge growth try to attract potential investors by demonstrating excellent corporate governance. But they do not exclude the possibility of the earnings manipulation in their sample.

Due to the liberal economic policy and high involvement of investors from more advanced Nordic countries in large and medium-sized Estonian companies, the current legislation with its low level of regulation frequently gives advantages to majority shareholders. In order to avoid machinations and manipulations, corporate

governance practices need to be improved, especially where it concerns the protection of small shareholders (Steger et al. 2006). In companies partly controlled by foreign investors that could mean developing the regulations that deal with transfer pricing between large foreign corporate owners and their Estonian subsidiaries. In smaller enterprises that are controlled by the local capital it assumes clarification of the role of larger block owners that are simultaneously top managers.

2.6 The Corporate Governance Recommendations

In Estonia, the Corporate Governance Recommendations approved by the Financial Supervision Authority (2005) and introduced at the Tallinn Stock Exchange in 2006 follow the principle "comply or explain". Recommendations deal with arranging general meetings of shareholders in order to exercise shareholder rights, management board and supervisory board's composition, duties and charge, cooperation between management and supervisory boards, publication of information, and financial reporting and audit. Equal treatment of all shareholders, avoiding conflicts of interests and transparency are stressed in recommendations. In these recommendations public limited companies listed on the stock exchange are also asked to disclose their CEO compensation schemes. CEO compensation in non-listed enterprises is, however, a field that so far has been reflected mainly in general salary surveys that do not disclose links between components of the executive compensation package and specific corporate governance practices. Public discussions about compensation packages of board members have in recent years focused on companies, where the state is the main shareholder. In 2012 chairman of the Estonian Air management board Tero Taskila was dismissed after failing to implement his ambitious expansion strategy. The supervisory board and also the Ministry of Economy and Communications were criticized for accepting the contract that allowed to pay to Taskila 33,000 € guaranteed monthly salary that was higher than salaries paid to Estonian president and prime minister.

A survey among representative of companies listed at Tallinn Stock Exchange and a sample of investors Raadik (2008) revealed that issuers were 2 years after introducing the corporate governance recommendations to the stock exchange quite well informed about their essence. Many investors, even regular ones, were at the same time not aware about content of recommendations and potential benefits of related company reports for making sound investment decisions. In recent years information about recommendations has become more widespread but following or not following principles of this document has still not become a topical issue when discussing the quality of corporate governance.

The OECD report on corporate governance in Estonia (2011) reached a positive overall view on Estonia's corporate governance framework. The report mentions among weaknesses a small listed market that tends to be dominated by core, controlling shareholders. Investors are not active, and stock market mechanisms play a limited role in providing incentives for good corporate governance. OECD

experts suggest that Estonia's voluntary corporate governance recommendations should be reviewed to consider making some provisions mandatory, while clarifying more the nature of reporting requirements and their enforcement. Provisions to protect "whistle-blowers" informing about irregularities in corporate governance and provisions about developing codes of ethics could be added. Authors of the report also insist on more specific reporting requirements related to company objectives, to the independence, qualifications and remuneration of board members.

3 Corporate Governance and Change Management

3.1 Cooperation Between Managers and Owners

Good corporate governance should not be seen as a static system but as a change management framework. Changes in corporate strategies and adaptation to crises situations create moments of truth, where conflicts between owners and managers or between owners themselves can lead to new development visions but sometimes to delays in restructuring companies or in initiating new profitable business projects.

The classical organization development (OD) approaches do not pay much attention to possible conflicts of interest between owners and their representative corporate governance bodies versus company managers. Although aligning the strategic priorities of the wider circle of stakeholders inside and outside organizational boundaries has become more integrated into organizational development programs during recent decades, conflicts between the strategic views of owners and managers are not the key focus of OD initiatives. The same applies to the learning organization concept that identifies systemic archetypes (Senge 1990) inhibiting sustainable strategic solutions, but does not specify the roles of managers and owners in dealing with the underlying mechanisms enabling the organizational learning process. In the emerging market economy context, however, it would be especially important to understand the functions and dysfunctions of owners in the organizational learning process, as the first learning challenge for many inexperienced owners is to clarify their identity in this new role.

Interaction between owners and managers has to be understood in order to predict the results of organizational change processes. A survey by Cvelbar (2007) in Slovenia on the effectiveness of management turnover as a corporate governance mechanism presents evidence that the supervisory board in not an efficient corporate governance mechanism for changing underperforming managers. Furthermore, representatives of owners in the supervisory board do not protect the interests of the shareholders better than representatives of employees and managers. This conclusion can be related to specific features of the Slovenian heritage of employee ownership, which is also reflected in its present corporate governance practices.

Beside the owners' control function, no lesser importance can be attached to their "soft" mechanism – their role in defining the vision, mission, values, etc. of the organization – in other words, the motives behind establishing the organization. Although the visionary role of the top management and his/her management team is essential, it can be argued that the business vision starts from the owners (Alas et al. 2010a).

3.2 Change Trends in Corporate Governance Practices

The Estonian Business School and the Estonian Institute for Future Studies have studied co-operation between executives and owners by interviewing experts that represent the main business sectors in Estonia and have long, more than 10 years of experience in both roles. The interviewees had the most extensive experience as owners and managers in the following business sectors: banking, real estate, wholesale and retail, logistics, energy, hotels, publishing, telecommunications, information technology, food processing and clothing. Results of this study indicate the main corporate governance change trends between the 1990s of the last century and the first decades of this century, and on the other hand, differences between companies based on foreign and domestic capital. Local Estonian owners in 1990s were looking for developer-type managers that sometimes took over the strategic role of owners. When owners moved later towards preferring maintainer-type of top managers for more mature markets, this indicated a change towards less radical organizational changes. Recent economic crisis has forced some block owners to be more actively involved in company down-sizing decisions.

The interviews provided evidence that in the context of a transition economy, the managers do not often trust the strategic visions offered by owners that were successful as entrepreneurs during the earlier stages of economic transition. Managers are skeptical about the abilities of many owners as strategists, especially if the business environment has changed and the original business success model might not be sustainable. They tend to share the view that becoming an owner in a transition economy was more often the result of being in the right place at the right time rather than an indication of more entrepreneurial competence than they themselves possess. The central problems causing stress among the managers were, first, the issue of the managers being left out of possible strategic decision-making by the owners, and, secondly, the owners' excessive interference in operations, which would obstruct the manager's opportunities to operate according to an established strategic plan. According to the managers, the owners are remote and less informed, but often do not acknowledge it and start interfering. It was claimed to be especially frequent if the owners have been earlier operating as managers in the same sector. Approximately half of the interviewed managers considered more long-term, clearer and complex strategies necessary. The owners were described as immediately addressing numbers in the strategy discussions instead of conceptual debates and quickly descending to the level of next year's business plan.

The owners in their interpretations set apart the businesses, with which they were actively connected, either as authors of the business idea or sometimes because of personal interest, and where they view the manager's role primarily as the executive and implementer. They displayed a different attitude towards the enterprises, which have achieved stability and whose owner/founder has turned his attention to other business projects. In these cases the CEO was expected to show initiative, which would help to retain or restore the growth trend. Managers were in this situation seeking for a greater strategic decision-making role in enterprises with multiple owners, whose expectations regarding its development need not coincide and some of whom had, in the CEO's opinion, accidentally become owners.

There are different mechanisms used by domestic and foreign owners to influence organizational change. Owners in foreign-owned companies may accomplish their corporate governance functions through the supervisory board, but if the subsidiary in a transition economy is part of a larger transnational corporation, they may prefer to use the chain of command linking functional units of the corporate headquarters to management board of their overseas subsidiary. In this case the role of the supervisory board tends to be rather formal. In practice the interference of foreign owners in a more regulated and reporting-based compared to unforeseen actions by local owners. The results of the interviews enable us to conclude that local owners in Estonia can be often described as interfering owners that try to be involved in the daily management of the management board but are not enough focused on long-term strategic objectives supported by incentive schemes for top managers that should be developed by representatives of owners in the supervisory board. Foreign owners, especially strategic foreign owners, impose many more instructions on top managers and much greater formalized restrictions on the top manager's freedom of action than Estonian owners. In fact, involvement of larger transnational corporations on the Estonian business landscape has resulted in more detailed procedures and reporting rules.

In recent years the need for more innovative, high value-added business models has emerged as a result of economic convergence with the European Union. It can be anticipated that development towards a knowledge-based economy may in future again lead to higher demand for developer-type managers, especially as partners for risk capitalists that invest into high tech ventures.

3.3 Corporate Governance Challenges in Small Growing Enterprises

Redefining the role of owner-entrepreneur in the business growth process of a small enterprise is an essential issue in the corporate governance discourse. In addition to different aims of managers and owners, asymmetric information can also lead to conflicts between these two roles. These reasons are reflected in the research that

sees separation of ownership and control as a reason decreasing business performance (Andres 2008).

Ramdani and Witteloostuijn (2012) have used data from the World Bank Enterprise Surveys that also included Estonia among 51 countries in other to establish the likelihood of firm bribery depending on the shareholder-manager relationship. They have found that the principal-owner gender and the equity share of the largest shareholder have significant impact on likelihood of trying to bribe public officials in order to get some advantages for owner's business. A conclusion based on samples from all countries is that male principal-owners are more likely to be engaged in bribery than female principal owners. The effect of separation of ownership and control was not established but enterprises where the largest shareholder has large equity share have lower bribery likelihood.

Information about firm bribery cases in Estonia has been mainly linked to state procurements, where large construction companies have been involved, and transactions for exchanging plots in Natura 2000 environment protection areas to land in city areas that are interesting for real estate developers.

In Estonia formal procedures of setting up a company are not too complicated. A limited liability company (Osaühing), the typical legal form for a start-up company, can be registered by filling in online application at the Company Registration Portal http://www.rik.ee/en/company-registration-portal without physically visiting public notary or the Commercial Register's office. Identity of the applicant-company founder is proved with the help of ID-card or by using an online banking link.

Our group work during training workshops for entrepreneurs have however revealed several cases, where founders of a new venture did not anticipate growth-related challenges for corporate governance when they were in hurry to register their limited liability company. They used the standard statutes template and made only minimalistic agreement between founders that did not specify how to solve situations, where one of founding partners wants to exit the company or there is no consensus how to invest for company growth. When using the standard statutes template, such founders did not discuss which articles should be customized in order to set the qualified majority requirement for some strategic decision. Insufficient regulations in the company statutes and missing agreements between founders usually lead to conflicts if company is in crisis but also at some stage of rapid business growth. Rapid growth usually assumes additional investments. Often additional owners are needed in order to expand to foreign markets. When making growth-related decisions, situations where consensus-seeking does not succeed have to be regulated beforehand.

Cases of participants discussed during training events have also indicated that involving relatives and friends to key positions in growing companies have often lead to conflicts if these persons appear to have limited management skills for a larger company. Family-owned businesses have in Estonia better track record in gardening and retailing compared to knowledge-intensive business fields.

In Estonia the number of portfolio investors and serial entrepreneurs is still limited and for this reason owners that have hired a managing director for their growth enterprise tend to have difficulties in differentiating their governance role as

the principal form the management of daily operations that they should delegate to the managing director as their agent. Many experienced entrepreneurs started their first business during the collapse of the Soviet command economy are now close to the retirement age. They do not want to be involved any more in daily business. Their first business success experience 20–25 years ago is however based on such interpretations of the principle "trust but control", where control was accomplished through direct observation of employee activities and the owner was constantly generating ideas for using new "windows of opportunity" as an early mover. Such experience drives owners to interfere to daily operations instead of defining long-term priorities and resources for company value growth.

3.4 Corporate Governance Development as Learning by Doing

New private ventures were created by local entrepreneurs for the first time experiencing the role of private owners. That has resulted in learning by doing processes, where corporate governance and strategic management practices are shaped by the changing institutional framework and business environment but also by conflicting priorities and role models of managers and owners at different stages of the transition to the market economy and internationalization of the Estonian corporate structures. Since the year 2000 retained earnings in Estonia have been exempt from profit taxation. The aim has been to stimulate investments through availability of internally accumulated funds. Frankel (2012) has presented this taxation rule as one example of new approaches that small countries can teach to the world. Such taxation has supported organic growth on new ventures that have growth potential, need to re-invest their profit and have consensus of majority owners to follow long-term growth strategy. Management does not have motivation to manipulate profits downwards in their financial accounting statements in order to decrease profit taxation of company as only dividend payments are taxed.

Hobdari et al. (2010) have used a representative sample of Estonian enterprises for analysing liquidity constraints of business organisations. They have concluded that firms owned by insiders, especially by non-managerial employees, are more prone to be liquidity constrained in their investment rates than other ownership structures.

A typical situation that has inhibited strategic efforts in many locally owned growing ventures is that founder-owners of the limited liability company keep jobs in the management hierarchy that do not correspond to their competencies in a growing company. The question when it is the right time for an entrepreneurial owner to pass his managerial tasks to a professional manager is also topical in advanced market economies. In a new market economy one could however more often find cases, when in the role of owner-founders of a new company or partners in the privatization process were friends or persons that happened to be at the right

place in the right time. Management jobs were distributed as a compensation for commitment of founders and following the need to fill in the gaps in the management team at the first stage of company development. New strategic challenges of growing companies and more fierce business competition have revealed mismatch between being one of important owners and at the same time a bad performer compared to other members of the management team. During recent years a solution in many companies has been that all key owners, including excellent and bad management performers, give up their membership in the management board and move to the supervisory board. That will distance them more clearly from the operations management and set the supervisory board to the role of the team that has to assess the performance and strategic ideas of non-owner managers without the tough job of assessing the managerial performance of other owner-founders of the company. However, supervisory boards are at present a voluntary governance body for limited liability companies and many entrepreneurs in growing medium-sized companies prefer to avoid the two-tier corporate governance bureaucracy if possible.

Business opportunity exploitation includes business concept development, business planning and business creation (Ardichvili et al. 2003). Growth opportunities mean also business risks. The mainstream theory of corporate governance views one of the main problems of agency relationship in frequent risk aversion of the executive managers and too short-term interests, at least as compared to the owners. In advanced market economies the owners have dispersed their risks between the various objects of investment but the manager has invested his entire human capital in the enterprise where he works, meaning that his risks are not dispersed. He has significantly more to lose than the owners-shareholders. Several reasons allow presuming that such managerial risk mechanism need not dominate in Estonia. A special survey carried out by the Estonian Business School established that in case of approximately 40 % of the surveyed enterprises, the manager desired a higher level of risk than that accepted by the owner when assessing new business opportunities. In other words, the above problem of agent relationship was not observed. The risk aversion of top managers could be observed more in case of enterprises owned by domestic rather than by foreign capital, in case of very young and very old managers and less in case of middle-aged managers (Elenurm et al. 2008).

3.5 Corporate Governance in Innovative Knowledge-Based Ventures

Mainela and Puhakka (2011) suggest that international new venture emergence assumes an entrepreneurial process that involves four major elements that link networks to international business opportunities: venture drafting, resourcing, learning & creation and finally legitimizing the emerging venture. The “blue ocean” concept (Kim and Mauborgne 2005) explains business opportunities of

value innovations that focus on new markets and on new ways of satisfying client needs not yet discovered by competitors stacked in fierce competition in existing "red oceans". The innovative entrepreneur faces the choice of developing in his/her entrepreneurial venture core competences sufficient for implementing a value innovation or relying on complementary core competences of business partners and customers as co-creators of changes. A challenge for knowledge-based new ventures is to integrate technological, international marketing and governance competencies of entrepreneurs and risk capital provides.

Research on relationships between export activities, local managers' independence and decision-making in five new member states of the European Union that used the data set of 434 foreign-invested firms in Poland, Hungary, Slovenia, Slovakia and Estonia demonstrated the positive impact of foreign investor's ownership and control over strategic decisions on the export intensity (Filatotchev et al. 2008). Allen and Aldred (2011) criticized Nölke and Vliegenthart's (2009) view that Central and East European market economies are mainly in the role of assembly platforms based on innovations that are made at transnational corporation's headquarters and then transferred to CEE subsidiaries. They present a more optimistic vision of the role of these subsidiaries in using the tacit knowledge for innovation and stress the benefits of spillover from the foreign-owned subsidiary to host-country firms that try to move to higher value-added activities in international networks. Allen and Aldred (2011) also raise the question about the role of banks in financing investment and export activities under different corporate governance models. They argue that in the German and other co-ordinated market economies banks provide "patient capital" for long-term strategic initiatives of client companies, have more detailed understanding of the investment and strategic decisions of companies and are represented in company supervisory boards. At the same time banks are reluctant to support strategies that aim to offer new products to new markets and prefer to support incremental up-grading of products. In liberal market economies such as USA and UK, company managers feel more the pressure of owners to attain short-term business targets of institutional investors.

Technology-based companies from a small open economy already at early growth stage have a challenge to obtain credibility among international clients. Regio is a company in Tartu, second largest city in Estonia located at the southern part of the country. Their aim is to become a premium provider of location-based solutions in the Eastern Hemisphere for telecom, transport and infrastructure sectors. Regio has four fields of activity: mapping, geospatial data, geographical information systems and mobile positioning. Regio was founded in 1990. As a matter of fact their first business action started even earlier, in 1989, when Regio as an university spin-off (having unique combination of roots from Tallinn Pedagogical University and Tartu University) was the first to publish the map of Estonian roads that was not deliberately distorted. Due to security considerations of Soviet authorities it had not been possible to publish non-distorted maps before the Soviet empire started to collapse. The evolution of the company since 1990 has gone through different corporate governance stages: at the beginning an university spin-off, then an employee-owned company, followed by the venture capital-fuelled

company stage, after that being part of an international stock exchange listed technology corporation, and finally, management buy-out. In the years 1994–1998 Regio team was involved in developing Estonian geoinformatics standards and development concepts. It was a period of stable sales growth, many innovative ideas and "club spirit". This led the founders of the company to the logical conclusion that all "club members" (i.e. employees) should become also shareholders. However, as shares were given free of charge to employees and the share distribution was the sole discretion of founders without clear criteria, Regio did not become a typical partnership. In order to get resources to speed up sales and profit growth and to transform Regio from the "club" to a "normal company", the Baltic Small Equity Fund was involved in 1998 as an investor. The risk capital owners remained fairly passive, but the fund was of great help when it came to negotiating in the second round of financing. Risk capital could open doors to new contacts and networks. Regio management understood that it is not possible to finance mobile technology sales all over Europe only by using the Estonian capital. The problem was not only about limited capital, it was also about image. They started to think how to use the image of Finland as an innovative country to enter the global technology market from a unknown country at the edge of Europe. It was decided to sell Regio to a Finnish company Done Corporation that had been listed at the Helsinki stock exchange. The crises however hit both information and mobile technology sectors at the global scale in the year 2000 and the Finnish parent company soon faced bankruptcy. Regio management offered to the trustees of the bankrupt's estate management buy-out solution and in 2002 Regio again became an independent company owned by Estonian capital. Although Done Corporation was not sustainable, being part of this venture gave to Regio credibility to offer its services to Ericsson and other large international customers. This client capital appeared to be valuable for business growth and international recognition of Regio services after 2002. Regio case demonstrates that the role of ownership structures in accessing global markets. Technology-driven companies need smart capital but also ownership structures that enable co-operation with large international customers and integration to some international value chain for developing and applying advanced technologies. Traditional principal-agent thinking does not reflect fully such situations. In high-tech companies entrepreneurs-developers in the role of managers are actively looking for new owners that would add value to their venture.

During the first decade of the twenty-first century development of technology-based start-up firms has raised some new corporate governance issues. Estonians were active in developing Skype internet phone application. Although Scandinavians had the key role in commercializing Skype and selling it to eBay, Estonian developers also received substantial capital gains from this transaction. Ambient Sound Investments (ASI) was established in 2003 as an equal partnership by four founding engineers at Skype Technologies to hold a minority stake in Skype. At the end of 2005 ASI sold its stake to eBay and now operates as a private investment vehicle. Today they are a team of about ten people managing 100 million Euros of the partners' assets and growing an independent investment vehicle spanning multiple generations. They consider themselves more as a "family trust' than a

typical venture capital firm" Although ASI partners themselves have strong track record of building cutting-edge P2P networks, they declare that they are not constrained by a particular industry focus and are ultimately free to invest in the best people and ideas from different business fields. However, so far they have demonstrated investment skills mainly in such fields, where understanding internet and telecommunication technologies has enabled them to represent smart capital in these particular fields. In September 2012 ASI, together with co-investors the Estonian Development Fund and Caplia Invest announced that they had successfully realized the exit of one of their first risk capital investments, Modesat Communications, assets of which were acquired by Xilinx, a World leader in the programmable logic devices sector. The deal entailed the sale of substantially all of Modesat's assets (http://www.asi.ee/company).

The case of Ambient Sound Investments demonstrates how technology-driven developers can move to the role of risk capitalists. But it also draws attention to the need to prepare entrepreneurs in start-up ventures for presenting the potential of their team to potential risk capitalists and for co-operation with more than one smart capital provider in order to access global markets and to find the right position in the global value chain.

3.6 Corporate Governance and Crisis Management

Crisis challenges the public's sense of safety, values and appropriateness (Sapriel 2003). The failure to manage crisis effectively leads to even more risk-laden eventualities for the organization and its stakeholders (Ulmer et al. 2007). Earlier research on the Swedish financial crisis of the early 1990s and later has demonstrated that severe results of crisis for companies were caused by overconfidence, control illusion, and herd mentality but also by shortcomings in management and corporate governance (Fromlet 2012).

In 2008, 67 interviews were conducted in Estonian companies in order to study crisis management in Estonia. The companies were from various industries, with different sizes and ages – 20.6 % of the companies had 1–10 employees, 16.2 % had 11–25 employees, 16.2 % had 26–100 employees, 20.6 % had 101–500 employees, 25.0 % had more than 500 employees. According to industry, 25.0 % were from production, 25 % from trade, 11.8 % from consultation, 8.8 % from banking, 1.5 % from telecommunications, 2.9 % from entertainment, 7.4 % from the public sector, 2.9 % from repair and transport and 4.4 % from services companies. In 35.3 % of companies the top manager of the company answered the questions. The content analysis was done using interviews in order to find types of crisis that companies have faced. Almost half (41.8 %) of the crises in companies in 2008 were connected to human resources, reputation and economics were both crises for 23.9 % of companies (Alas et al. 2010b). Even in 2008 lack of qualified labor was seen among main situations, where crisis management is needed in a company and deteriorating global financial situation and market demand was not seen as the

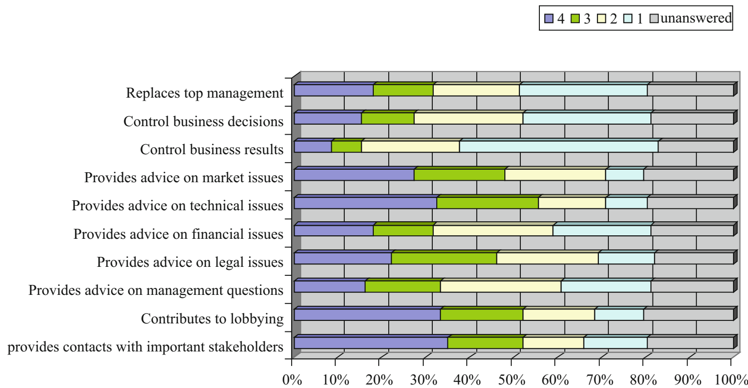

Fig. 1 Contributions by the supervisory board to different issues (1 = significant contribution . . .4 = does not deal with this)

main determinant of crisis management. Only a few companies had adopted a profound proactive crisis management strategy at that time. Figure 1 indicates the contribution made by the supervisory board. Most attention was paid to the firm's business results, next came business decisions and then replacing the top management.

After 7.5 % GDP growth in 2007, Estonian GDP declined 4.2 % in 2008 and 14.1 % on 2009. In 2010 there was moderate growth 3.3 % and in 2011 Estonian GDP growth was the highest in the European Union, 8.3 % (Eurostat 2013). Owners in an economy so dependent on international markets should be able to forecast risks created by decline of foreign markets and make sound decision for strengthening the capital base of the company in order to be prepared for sharp sales decline.

Main banks in Estonia belong to Nordic banking corporations and remained well-capitalized during the financial crisis. Estonian government did not need to bail out banks. Estonian policy makers and public opinion have during the global financial crisis and euro crisis become more aware of the contribution good corporate governance makes to financial market stability, investment and economic growth. As companies play a pivotal role in our economies and we rely increasingly on financial institutions to manage personal savings and secure retirement incomes, good corporate governance is important to broad growing segments of the population.

4 Conclusions

Estonian privatization process in general supported involvement of foreign investors in shaping the corporate governance landscape and facilitated restructuring of companies. There is no strong historical tradition of employee share ownership in

Estonia and as the result during years after privatization the dominance of owner-managers and outside foreign and domestic owners has mainly directed changes in the corporate governance practices. When discussing protection of small shareholders, challenge is the dominance of large block owners that simultaneously are top managers.

The German two-tier corporate governance model has been implemented already in 1990s through the Commercial Code but its application in many small and medium-sized companies has been rather formal as owners have preferred more the role of "hands-on" decision makers and considered two-tier system too slow and complicated for executing their functions in ownership and management. Managers at the same time do not trust the strategic visions of owners that were successful as entrepreneurs during the earlier stages of economic transition. It will take time before a larger number of active owners will emerge that are prepared to implement their ownership functions through corporate governance tools, without desire to be involved in daily management operations. Training and coaching both owners and managers for co-operation can help to align the corporate governance legal framework and practices of boards and supervisory boards. Aligning perceptions concerning reasonable business risks and strategic teamwork both for growth and crisis governance are essential fields of such development activities that also enable action research on corporate governance problems and development priorities. Anticipating future crisis situations are among important skills for professional owners and investors.

A future research field is holistic study of the influence that the global financial crisis has had on corporate governance in Estonia as in a country, where the banking sector did not need any bailout and many companies were able to cut their costs in order to react to the rapid decline in the export demand.

Technology-based new ventures that have to gain credibility at global markets face situations, where the ownership structure influences their credibility for large international customers. Smart capital creates new opportunities but also new challenges for entrepreneurs in Estonia and in other rapidly changing economies. This is an avenue for future research in order to develop new corporate governance approaches for knowledge-based economies.

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