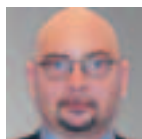




**Assessing the effectiveness of  
corporate governance legislation:  
disclosure and redress  
in related-party transactions**



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In 2005 the EBRD's Legal Indicator Survey assessed the effectiveness of corporate governance legislation in transition countries. In particular, the survey sought to ascertain how well minority shareholders in both unlisted and listed companies would fare in a typical conflict of interest situation.

Effective corporate governance mechanisms protect the interests of investors and other stakeholders in business ventures. These mechanisms are key to a country's financial and economic development. A precondition for the development of capital markets is that outside investors can expect insiders (managers and more often controlling shareholders) not to divert corporate assets to themselves. The law and its enforcement institutions play an important role in preventing insiders' opportunism and, hence, in strengthening investors' expectations.

#### Extensiveness: the assessment

In 2004 the EBRD assessed corporate governance legislation in the Bank's region.<sup>1</sup> It enquired into whether and to what extent corporate governance legislation (the "laws on the books") in each of the Bank's countries of operations complied with the OECD Principles of Corporate Governance. The assessment reported a considerable variation in standards.

Nine countries were given "high" compliance ratings, indicating a sound legal framework in line with the OECD

principles. Ten countries had "medium" compliance, meaning their legal framework was generally in line with international standards despite a number of shortcomings. Four countries received "low" compliance ratings, implying serious shortcomings in their legislation when compared with international standards.

#### Effectiveness: the Legal Indicator Survey

The EBRD Legal Indicator Survey (LIS) conducted in 2005 focused on the effectiveness of corporate governance in the Bank's countries of operations.<sup>2</sup> Instead of looking at the laws on the books, it aimed to assess how the laws work in practice. To achieve this, the survey took the perspective of a minority shareholder trying to find out whether the controlling shareholder had abused its power. The survey also looked at how a minority shareholder could obtain redress.

A hypothetical case study was developed to ascertain how well minority shareholders of both an unlisted and a listed corporation would fare in the context of a typical conflict of interest

situation. In particular, it dealt with a controlling shareholder entering into a sale contract with the corporation. The LIS therefore covered self-dealing, which is widely held to be "the central problem of corporate governance in most countries".<sup>3</sup> In total, the survey assessed 26 EBRD countries of operations as well as Mongolia.<sup>4</sup>

#### Methodology

The methodology employed followed on from previous surveys.<sup>5</sup> Accordingly, it involved working with leading law firms in the region.<sup>6</sup> These law firms were provided with two broadly similar hypothetical case studies involving a related-party transaction (see Box 1).

In the first case study Alfa Ltd is an unlisted company controlled by Beta Ltd. Beta Ltd owns 76 per cent of the company's shares, while the remaining 24 per cent is owned by minority shareholder Gamma Ltd. In the second case study Alfa Ltd is a listed company, with Beta Ltd owning a 56 per cent controlling stake, Gamma Ltd owning a 12 per cent minority stake and 32 per cent of the capital floating on the

### Box 1 A related-party transaction scenario

Joint-stock company Alpha Ltd is a leading firm in a transition country. Its registered headquarters is located in the main business centre within that country. Alpha is co-owned by two companies, Beta Ltd and Gamma Ltd.

Beta Ltd is the controlling shareholder. Its owner is an influential business leader, who also controls another company, Beta Holding Ltd, one of the main conglomerates in the country. Gamma Ltd is an investment company set up by a foreign investor. It owns a minority stake in Alpha Ltd. Alpha's board of directors is composed of three members, all appointed by Beta Ltd. Two of them also sit on Beta Holding's board.

Following an anonymous tip-off from an employee, Gamma has reason to believe that Alpha's directors have sold Alpha's property to a subsidiary of Beta Holding Ltd for 50 per cent less than its true worth.

According to the company's charter, such a transaction – that is, where a director has directly or indirectly a conflicting interest and which exceeds a given value – must be approved by the shareholders' meeting.

Gamma asks for legal advice on what can be done to:

- determine whether the transaction has indeed been entered into
- restore the status quo (by, for example, challenging the validity of the transaction)
- obtain damages for Alpha
- obtain damages for Gamma
- punish Alpha's directors and the majority shareholder (through, for example, criminal sanctions or disgorgement of profits).

stock exchange.<sup>7</sup> In both cases, the damage suffered by Alfa Ltd from the transaction was valued at €2 million.

In the case study scenarios the minority shareholder is faced with two problems:

- It has to determine whether the transaction was entered into and on what terms.
- It has to obtain some form of redress through a private action in court or otherwise.

An extensive questionnaire was designed to establish how effective each country's legal system is in protecting a minority shareholder's interests.<sup>8</sup>

Law firms were asked to respond to the questionnaire as if they were advising the minority shareholder on how best to protect their rights and preserve the value of their financial investment in the local company. The questionnaire focused on three main areas:

- the mechanisms by which the minority shareholder can find out whether the transaction had been entered into (disclosure)
- the tools for redress
- the institutional environment in which such disclosure and redress tools have to be used.

Respondents were asked to provide information on the legal tools available for disclosure and redress and to assess their effectiveness in terms of speed, simplicity and enforceability (see Chart 1). Concerning the institutional environment, they were asked to assess a number of institutional features affecting the enforcement of corporate governance law provisions and standards (see Chart 2). These included the competence of courts and financial market regulators, the availability of previous case law and the presence of arbitration bodies specialising in business law.

### The variables

Measuring the effectiveness of a legal mechanism is a complex process. Several variables should be taken into account and most of them involve subjective judgements by respondents. Speed, simplicity, enforceability and the institutional environment have been used as measures for the effectiveness of disclosure and redress mechanisms.

#### Speed

Speed is the most straightforward factor. In disclosure cases, it refers to the average time between the initial filing of proceedings with the court and the issuance of an executable court order, taking into consideration an appeal by the defendant. In redress cases, it concerns the period from the initial filing of the proceeding to the issue of a court's executable judgement, again taking into consideration an appeal by the defendant.

#### Simplicity

Simplicity relates to the smoothness of proceedings. More precisely, respondents were asked to assess how clear, simple and straightforward the proceedings relating to the available actions were. The guidance offered by judicial precedents in interpreting the law was also considered here, as it simplifies law enforcement by increasing legal certainty.

#### Enforceability

Enforceability relates to the carrying out of the executable judgement in cases where the other party fails to implement it, and extends far beyond corporate governance. Respondents were asked to assess the ease of enforcing a judgement in favour of the minority shareholder.

Measuring the effectiveness of a legal mechanism is a complex process. In the Legal Indicator Survey, speed, simplicity, enforceability and the institutional environment were used to measure the effectiveness of disclosure and redress mechanisms.

### Institutional environment

The institutional environment relates to the capacity of a given legal framework to provide the basic guarantees that are needed for legislation to be effectively implemented and enforced. It includes a number of factors regarding disclosure and redress:

- the perceived reliability of a company's books
- the requirement to have corporate financial information audited
- the presence of international auditing firms in the country<sup>9</sup>
- the perceived independence of statutory auditors
- the perceived degree of competence and experience of courts and prosecutors
- the availability of up-to-date legislation
- the ease with which the defendant can delay the proceedings
- the perceived influence that might be exercised on courts and prosecutors by a powerful defendant.

With regard to both disclosure and redress Transparency International's Corruption Perception Index 2005 was also taken into account.<sup>10</sup>

### Results

The findings of the survey are necessarily limited and must be treated with caution. First, they reflect the views of a limited number of practitioners within each country.<sup>11</sup> Secondly, they address a very specific set of circumstances and must be considered within the boundaries of the case studies. Thirdly, assessing effectiveness is by necessity far more difficult and

subjective than finding out what the laws on the books state in a given country. It deals with hard to measure variables such as courts' competence, simplicity of procedures, ease of enforcement and so on.

### Detecting wrongdoing by a dominant shareholder

The first part of the analysis focused on how a minority shareholder might discover if the company's management had indeed entered into a related-party transaction. The assumption here was that the majority shareholder controls the board and that no disclosure of the transaction was spontaneously provided to the minority shareholder.

Disclosure is one of the key pillars of an effective corporate governance framework.<sup>12</sup> In the context of related-party transactions, disclosure is usually analysed in terms of an obligation to inform the board and/or shareholders and/or the public about such transactions.<sup>13</sup> Since the LIS focused on the effectiveness of the legal framework for corporate governance as opposed to its extensiveness, the case studies assumed that, whatever the disclosure obligations in place, no disclosure had been given on the transaction to the relevant bodies. This, of course, is often the case when assets are siphoned off a company by its dominant shareholder.

Consequently, the questionnaire focused on the tools available to minority shareholders who suspect a self-dealing transaction has been entered into. It also centred on the efficiency of the tools in terms of speed, simplicity and enforceability. In addition, the

questionnaire asked respondents what the probability of successfully detecting wrongdoing by using these tools was.

The questionnaire listed six legal tools that could help a minority shareholder discover whether a self-dealing transaction has been entered:

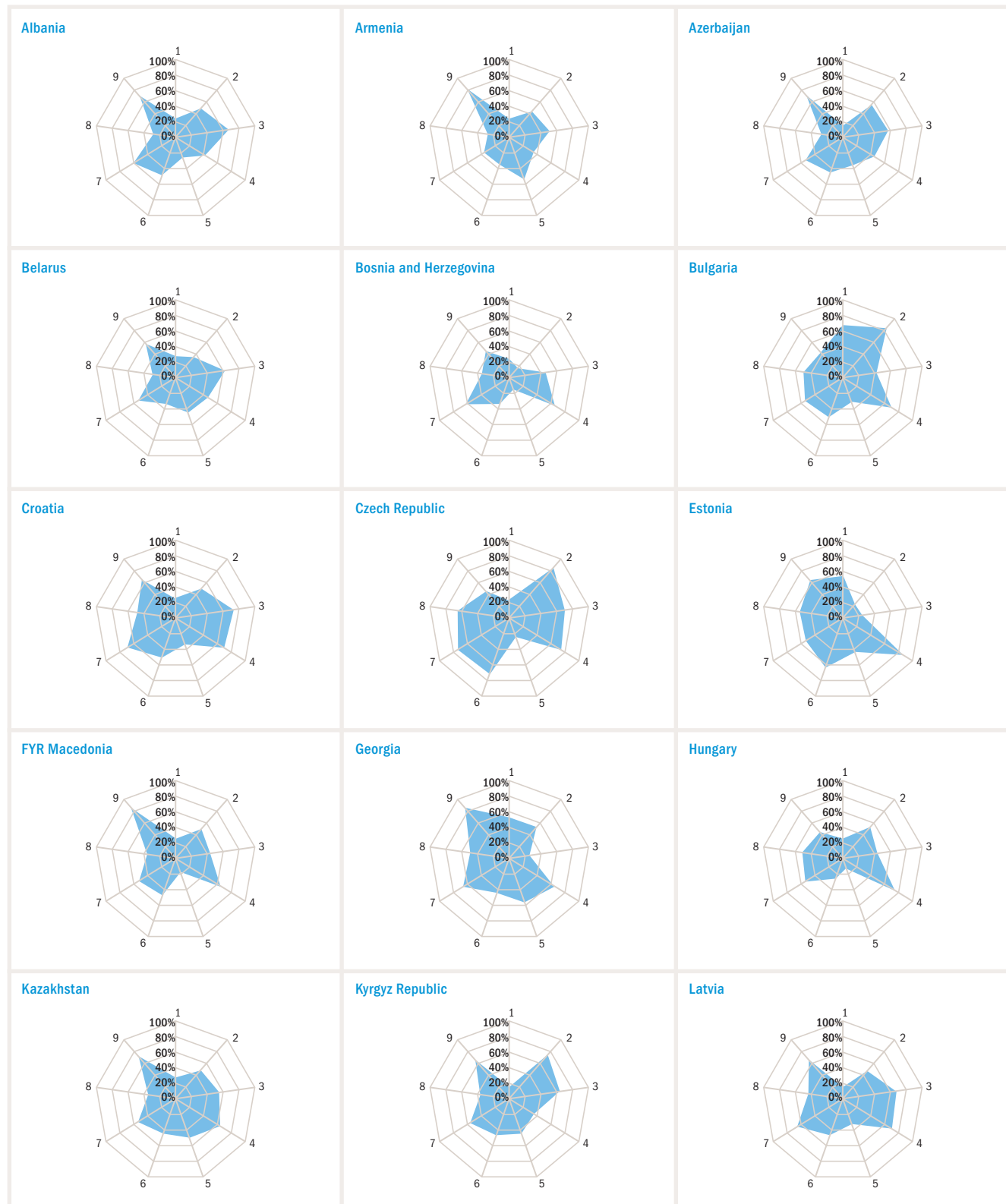
- inspecting the company's books and other corporate documents
- requesting information from the company's auditor
- demanding an independent audit
- asking the court to appoint an independent auditor
- requesting the court or another public body to have an administrator appointed
- calling a special shareholders' meeting to question the company's management.

Respondents were free to add other actions the minority shareholder could take.

As the LIS revealed, only a few countries offer an institutional framework providing minority shareholders with effective mechanisms to obtain disclosure. In many countries minority shareholders face substantial problems and their actions can be easily blocked by majority shareholders.



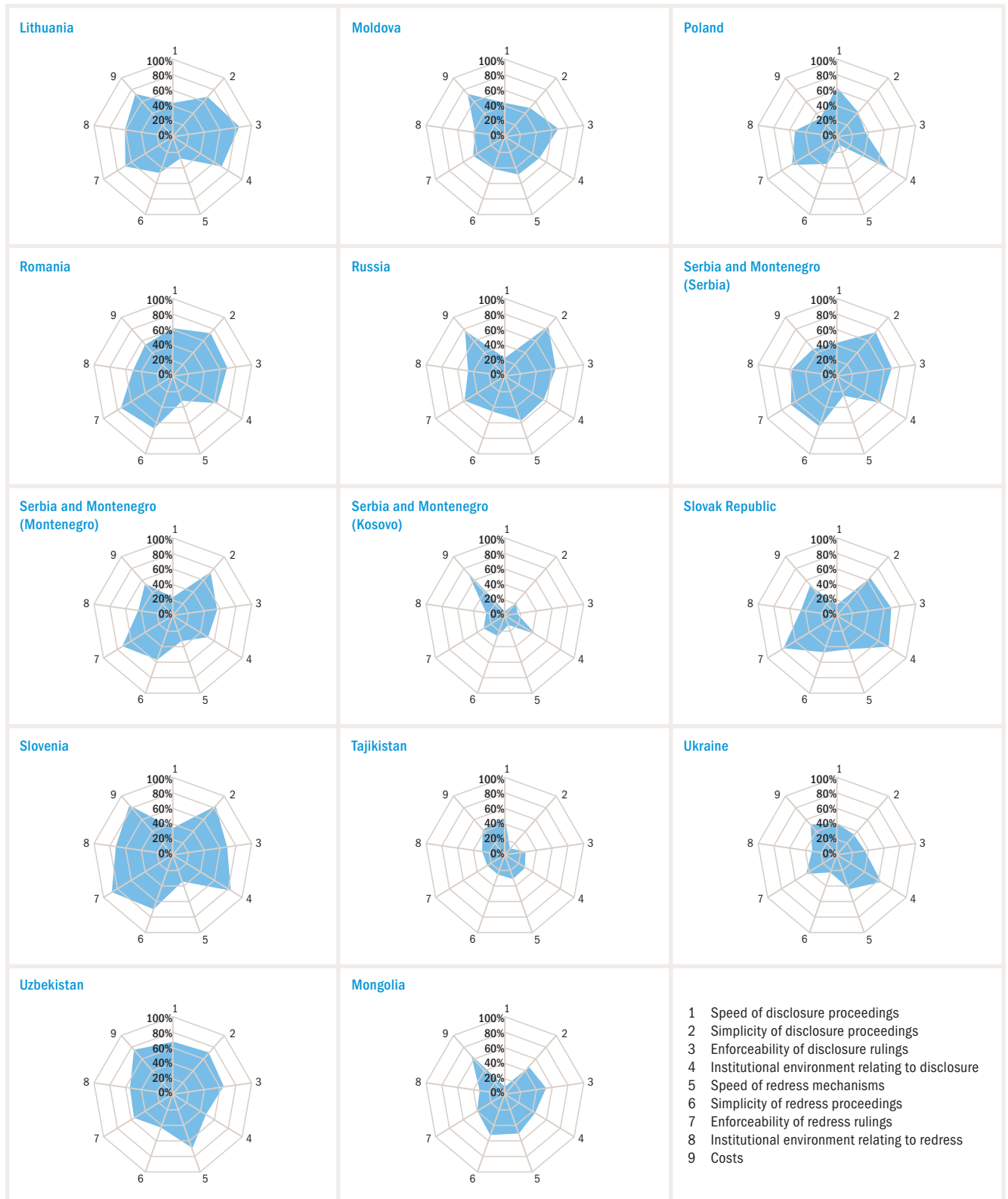
Chart 1 Effectiveness of corporate governance legislation in the case study scenarios



**Notes:** The graphs show disclosure, redress and the institutional environment in the transition countries. The average results from the case study scenarios are shown. Disclosure refers to a minority shareholder's ability to obtain information about their company. Redress refers to the remedies available to a minority shareholder whose rights have been breached. Institutional environment refers to the capacity of a country's legal framework to effectively implement and enforce corporate governance legislation. Costs refer to the estimated expenses a minority shareholder must pay to take legal action.

The extremity of each axis represents an ideal score: the fuller the 'web', the better the corporate governance framework. Data was collected for 26 of the EBRD's countries of operations and Mongolia. Data for disclosure in Serbia and Montenegro (Kosovo) and redress in Tajikistan were not available for the second case study. In both instances, there was no effective action available for minority shareholders to take.

Source: EBRD Legal Indicator Survey 2005.



Only a few transition countries offer an institutional framework which provides minority shareholders with effective mechanisms to obtain disclosure. In many countries minority shareholders face substantial problems and their actions can be easily blocked by majority shareholders.

### Central Europe and the Baltic states

The survey showed that within CEB a reasonable level of effectiveness regarding disclosure can be found in the Czech Republic, Lithuania and Slovenia. Problems have been identified in Estonia and Poland.

Local practitioners reported that procedures are particularly complex in Estonia but generally clear and simple in the Czech Republic and Slovenia. The estimated time needed to obtain a court order varies from a few months in Poland to two or more years in the Czech Republic and the Slovak Republic. While enforceability might be difficult in Estonia, it is considered particularly straightforward in Lithuania and Slovenia. Lastly, the institutional environment is deemed generally sound in all countries, although Latvia displays some weaknesses.

In Slovenia a number of actions are available to minority shareholders. Clear procedures and smooth enforceability are complemented by a sound institutional environment. Courts are considered generally competent and company books are regarded as reliable. Only the time needed to obtain an executable court order (more than one year) appears to be unsatisfactory.

In the Czech Republic the institutional environment is deemed to be sound and procedures are considered clear and simple. Enforceability is generally efficient but can vary substantially depending on the type of action pursued. Only the time needed to conclude proceedings, which can exceed three years, is perceived as a problem.

In Estonia shareholders with a 24 per cent stake in a joint-stock company can request a general shareholders' meeting.<sup>14</sup> This, however, is the only course of action available and the law provides for no enforcement mechanism in cases where management does not implement the shareholders' request. As a result, minority shareholders can only rely on the annual financial documentation presented at the general meeting. Although such documentation is generally considered of good quality, shareholders will have no other means of further investigation should they suspect that the information is incomplete or incorrect.

When looking at the unlisted company case study scenario, Poland demonstrates a similar situation although a minority shareholder with a 24 per cent stake has, by virtue of law, the right to nominate a representative to the supervisory board.<sup>15</sup> It is doubtful, however, whether the minority shareholder will gain access to information gathered by the supervisory board member as they have confidentiality and fiduciary duties to the company. In practice, however, this mechanism allows greater control over a company's operations and might discourage abusive behaviour by controlling shareholders.

### South-eastern Europe

Within SEE a relatively effective framework for disclosure was reported in Romania and Serbia. The average time needed to obtain a court order varies from a few months in Bulgaria and Romania to three or more years in Bosnia and Herzegovina and Kosovo,

where procedures are also deemed to be complex and difficult to enforce. The institutional environment is considered especially weak in Albania and Kosovo, but relatively sound in Romania.

In Bosnia and Herzegovina several courses of action are open to a minority shareholder but none have realistic prospects of enforcement should the controlling shareholder refuse to cooperate.

In Kosovo minority shareholders can only request a general shareholder meeting, but this is likely to be ineffective if the controlling shareholder is hostile. Moreover the legal framework is very complex, being a mix of United Nation Interim Administration Mission in Kosovo (UNMIK) regulations and old Yugoslavian law.<sup>16</sup> While UNMIK regulations dealing with corporate governance are limited,<sup>17</sup> there is reluctance on the part of local judges to apply the old Yugoslavian law, which leads to lower legal certainty.

In Albania the average time needed to get a court order is about six to eight months, although a defendant has several means of delaying the procedure. Procedures are not considered particularly complex or difficult to enforce. However, the institutional environment is weak. Company books are considered generally unreliable, statutory auditors are usually unable to act independently and courts are inexperienced in corporate cases.

### Commonwealth of Independent States

All CIS countries display substantial shortcomings in the legal framework for disclosure. Procedures are deemed very long in Azerbaijan, the Kyrgyz Republic and especially complex in Tajikistan. Enforceability is considered a problem in Georgia, Tajikistan and Ukraine, and the institutional environment is particularly poor in Armenia and Tajikistan.

Tajikistan appears to have the least effective legislation. There are no specific law enforcement proceedings, and court executors do not have the necessary enforcement authority, particularly against a powerful defendant. This is further undermined by the overall weak institutional environment. The reliability of corporate information is limited, statutory auditors are not independent and courts are inexperienced in corporate cases.

In Russia requesting an internal audit of the company's financial documentation is regarded the most effective action. The procedure is clear and the time usually limited to five months, although it is easy for the defendant to delay the proceedings. In addition, enforcement can be problematic due to several deficiencies in the Russian court system.

In Armenia, similarly to Poland, minority shareholders holding at least 10 per cent of the shares have, by virtue of law, the right to nominate a representative to the supervisory board.<sup>18</sup> As in Russia, requesting an internal audit is considered the most effective action among those available. However, reliability of auditing in Armenia might be an issue as the limited presence of international auditing firms in the country suggests.

- a liability suit against the company holding the majority stake (and/or its subsidiary on the other side of the transaction and/or its directors) on behalf of the company
- a direct liability suit against the company holding the majority stake (and/or its subsidiary on the other side of the transaction and/or its directors) for damages incurred by the minority shareholder
- an action against the counterpart to the transaction to obtain the disgorgement of the profits made out of the transaction.

The questionnaire also asked whether enforcement mechanisms other than civil courts were available (for example, criminal prosecution, national or international arbitration, action before the securities regulator and the stock exchange). Once again practitioners were free to supplement this choice with additional remedies.

Once an abusive related-party transaction has been detected, the legal framework must offer effective mechanisms for minority shareholders to obtain redress.

In Georgia asking the court to appoint an independent auditor and/or calling a general shareholders' meeting to question the company's management are judged to be the best mechanisms to obtain disclosure. Nonetheless, such procedures are quite complex and might be very difficult to enforce.

In the Kyrgyz Republic several courses of action are available to minority shareholders but the procedures are likely to last more than one year. Furthermore, given the weak institutional environment, the outcome of any action is unpredictable. Company books are considered unreliable and may therefore be useless even if disclosure is obtained.

### Redress mechanisms

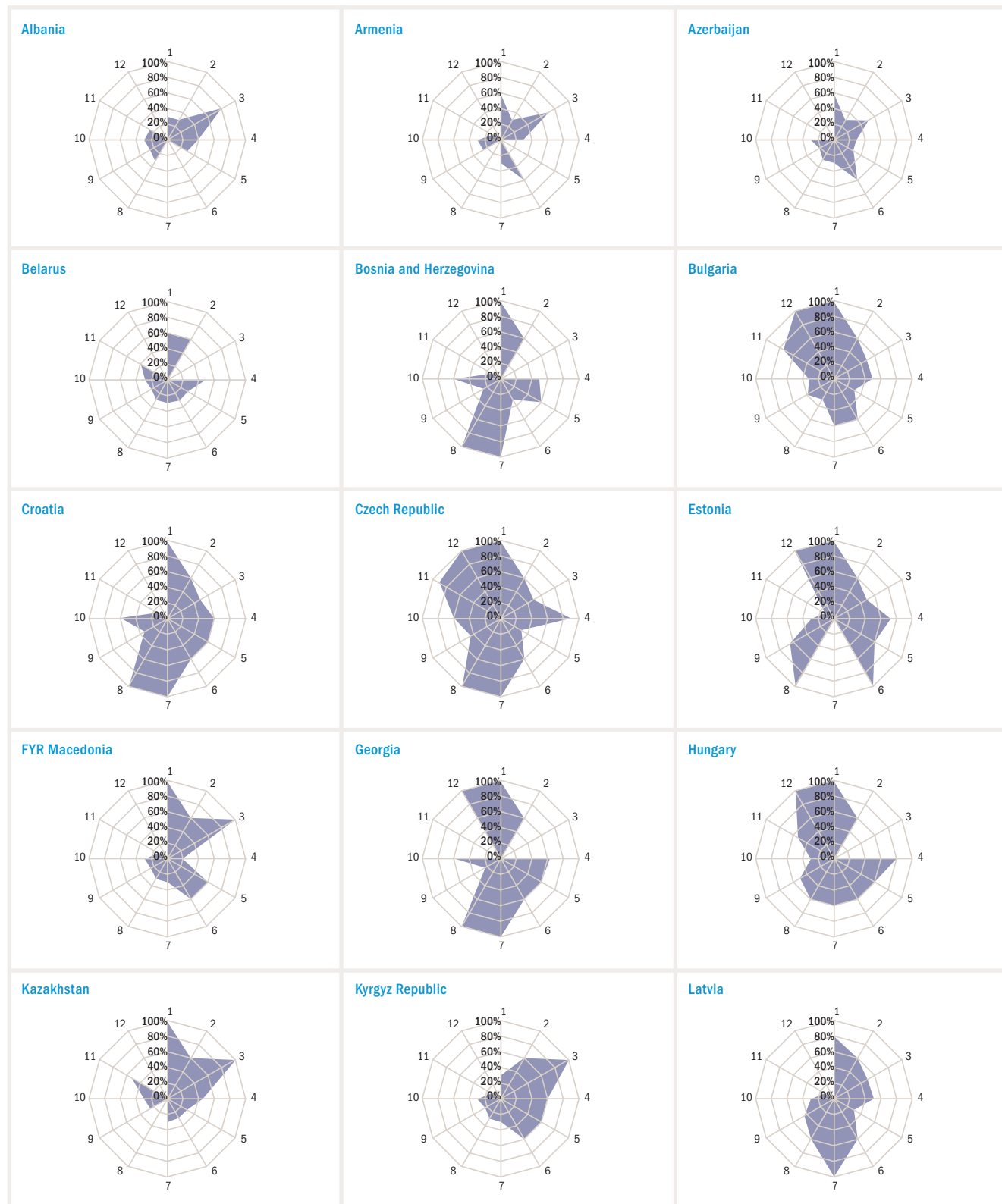
Once an abusive related-party transaction has been detected, the legal framework must offer effective mechanisms to obtain redress. Local practitioners were asked to indicate what legal remedies were available to the minority shareholder in the case study scenario. A choice of possible remedies was listed in the questionnaire, including:

- a challenge to the validity of the transaction, that is to say rescission
- a liability suit against the company's directors on behalf of the company (a derivative suit)
- a direct liability suit against the company's directors for damages incurred by the minority shareholder

For each of the remedies the usual questions on availability, speed, simplicity and enforceability were posed. Respondents were also asked to assess the costs of the legal remedy they deemed to be most effective. More specific questions were also included with regard to civil and criminal actions.

In general, it can be observed that in all transition countries except Bosnia and Herzegovina, Bulgaria<sup>19</sup> and Estonia, minority shareholders have several options for legal action. Unsurprisingly, however, the effectiveness greatly varies from action to action and from country to country. In many instances minority shareholders can face endless delays and enforcement difficulties.

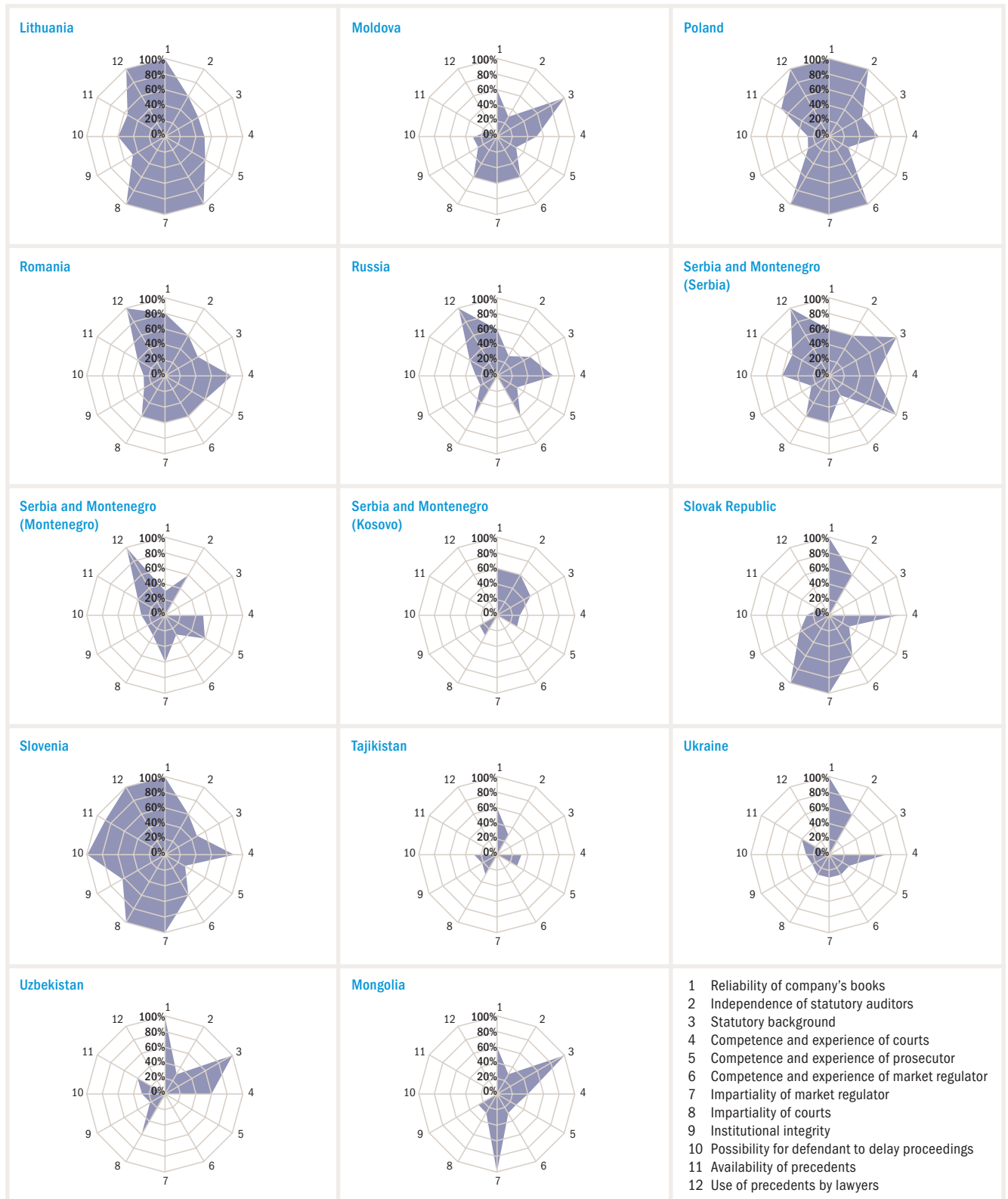
Chart 2 Institutional environment affecting corporate governance in transition countries



**Notes:** Institutional environment refers to the capacity of a country's legal framework to effectively implement and enforce corporate governance legislation. Statutory background relates to whether a comprehensive, clear and well structured definition of related-party, self-interested, self-dealing or conflict of interest is provided by the country. In particular, whether this definition covers transactions in which the director or the dominant shareholder has an indirect interest (for example, the party to the transaction is a dominant shareholder's subsidiary). Institutional integrity refers to the level of corruption

within a transition country, as determined by Transparency International's Corruption Perception Index 2005. This index is measured on a scale from 1 to 10, with 1 being the most and 10 the least corrupt environment. The extremity of each axis on the graph represents an ideal score: the fuller the 'web', the better the institutional environment. Data was collected for 26 of the EBRD's countries of operations and Mongolia.

Source: EBRD Legal Indicator Survey 2005.



In most transition countries, minority shareholders have several options for legal action. Unsurprisingly, however, the effectiveness of these options vary greatly from action to action and from country to country. In many instances, minority shareholders can face endless delays and enforcement difficulties.

### Central Europe and the Baltic states

Among CEB countries, the Czech Republic and Slovenia appear to have the most effective mechanisms for redress while the framework is somewhat weaker in Hungary, Latvia and Poland. The estimated time needed to obtain an executable judgement varies across the region from about one year in Estonia to two or more years in the Czech Republic, Hungary and Poland. Local practitioners reported that redress procedures can be particularly awkward in Hungary and Poland, but are generally straightforward in the Czech Republic and Slovenia. Enforcement can be problematic in Hungary, yet is considered simple in Slovenia.

Survey results for Slovenia confirm that the corporate governance framework is as effective for redress as for disclosure. The Czech Republic similarly has a sound institutional environment with effective enforcement and clear procedures. The only relative weakness in both countries is the time needed for concluding an action (often exceeding two years).

In general, the situation in Estonia concerning redress is better than for disclosure. Only the direct liability action against the company's management is available, but it is considered reasonably effective. The proceedings are not particularly complex and the burden of proof required to a minority shareholder not particularly heavy. However, as evidenced before, obtaining disclosure in Estonia might be a problem.

### South-eastern Europe

Romania and Serbia have the most effective legislations in the SEE region regarding redress. Major weaknesses are evident in Bosnia and Herzegovina and Kosovo. The average time needed to obtain an executable judgement is likely to vary from 18 months in Romania to more than five years in Serbia and Kosovo.

Challenging the validity of a related-party transaction is the only legal remedy available in Bosnia and Herzegovina and its effectiveness is limited. Courts have a backlog of cases and, despite strict time limits set by law, the complex legal proceedings can drag on for several years. Legal effectiveness is further undermined by a weak institutional environment.

In Bulgaria procedures are not particularly smooth and this can lead to enforcement difficulties. The time required to reach an executable judgement can be up to two years and the defendant can easily delay the process further.

In Romania and Serbia and Montenegro minority shareholders can choose between several different procedures which are generally deemed to be clear and enforcement does not appear to be an issue. However, while in Montenegro the time needed to conclude proceedings is generally limited to three years, courts in Serbia are not bound by any mandatory deadlines and the procedures can last up to 10 years.

### Commonwealth of Independent States

As with disclosure, the legal framework for redress is deficient in all CIS countries. Enforceability is a problem across the region, and procedures are deemed particularly complex in Ukraine. Also, the institutional environment has significant flaws in all countries. The time needed to obtain an executable judgement is generally short, but in many instances it is reported easy for the defendant to delay the proceedings.

In Azerbaijan the available mechanisms are considered relatively effective although the procedure can be complex.<sup>20</sup> Enforceability is usually not a substantial problem, and the time needed to conclude the action is limited to 18 months. The major obstacles can be the ease by which the defendant can delay the proceedings and courts' bias in favour of powerful defendants.

In Russia challenging the validity of the transaction is reported to be the most effective action, but enforcement of court decisions can be problematic.

Armenia, Belarus and Tajikistan appear to have the least effective legislation, the lowest degree of judicial competence and perform badly in terms of enforcement of court decisions.

## Other enforcement mechanisms

The effectiveness of corporate governance mechanisms depends not only on courts but also on other public and private enforcement institutions.<sup>21</sup> Private enforcement institutions include arbitration courts and stock exchanges. In addition, pressure exerted on insiders' behaviour by the media,<sup>22</sup> shareholders' associations or embassies may also have a positive effect when either listed companies or foreign investors are involved.

### Arbitration

As an alternative to actions before the court, local practitioners were asked to assess the availability and effectiveness of national and international arbitration procedures, according to the same variables considered above. In order to assess the availability of arbitration,

In Hungary proceedings are complex and enforceability may be difficult. In Poland the enforceability of the award is generally simple and straightforward, but the procedure may take up to three years.

With respect to SEE, the survey revealed an uneven situation throughout the region. Practitioners in Bulgaria revealed the exclusive competence of courts on the issues described in the case studies. Meanwhile in Bosnia and Herzegovina the law on civil procedure allows for the formation of "ad hoc arbitration" which is not deemed applicable to the scenario under analysis. In Albania arbitration is considered a valid alternative to the weak judicial environment. Contrastingly, in Kosovo arbitration is felt generally ineffective since general enforcement mechanisms are limited and their effectiveness highly unreliable.

### Action before the stock exchange<sup>24</sup>

The survey found that, for a minority shareholder in a listed company, an action before a stock exchange to obtain enforcement of the relevant provisions in the listing rules is available in seven countries.<sup>25</sup> Local consultants reported the action to be quite effective in Romania and Slovenia. In FYR Macedonia, Kazakhstan and Russia it can also lead to positive results, while substantial doubts have been raised about its effectiveness in Latvia. Procedures are considered complex especially in Kazakhstan and Russia and particularly long in FYR Macedonia and Russia.

### Action before the market regulator

All countries in the EBRD region have a securities market regulator. However, an action before the regulator to obtain administrative sanction or some other

The effectiveness of corporate governance mechanisms depends not only on the civil courts, but also on other enforcement institutions, such as arbitration courts and stock exchanges.

respondents were asked whether a provision in the company's charter would suffice to start arbitration proceedings or whether instead an agreement among the disputing parties would be necessary.

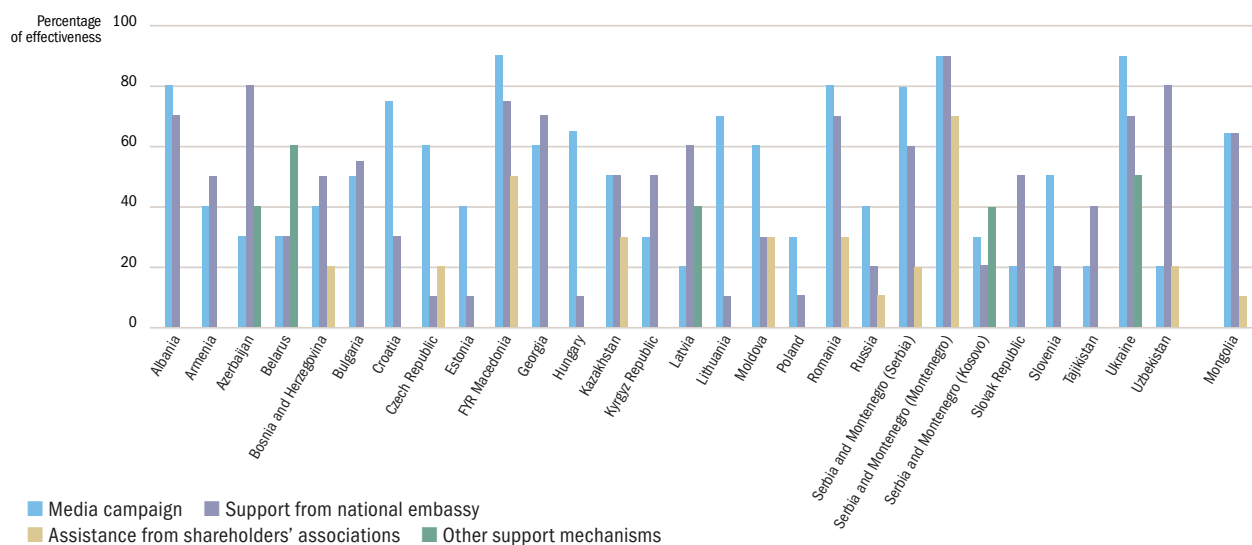
In CEB, arbitration for this type of situation is generally available in all countries, but some limitations apply. In Estonia and Lithuania a specific agreement must be concluded with the other party before starting the procedure, thereby limiting the effectiveness of this possibility.<sup>23</sup>

Finally, arbitration for this type of dispute in the CIS is not an effective option. In Tajikistan, although arbitration is in theory available, its lack of enforceability renders the option unrealistic. In Uzbekistan the courts settle all disputes between national entities. International arbitration is available in case one party is foreign and a specific agreement between the parties is concluded. In Moldova and Russia arbitration for this type of situation is considered relatively effective, although proceedings can be quite complex and the enforceability of the award can be problematic.

enforcement action against the company's directors or dominant shareholders is feasible in only 12 countries.<sup>26</sup>

In Armenia, Georgia, Hungary and Uzbekistan the action is considered quite ineffective, while in Bulgaria, Lithuania, Romania and Slovenia it can produce a positive outcome. Enforceability of the market regulator's decision is relatively smooth in Georgia, Hungary, the Kyrgyz Republic, Lithuania and Mongolia, while difficult in Russia and Kazakhstan. The length of the procedure is an issue especially in Armenia, Georgia, the Kyrgyz

Chart 3 Effectiveness of mechanisms supporting corporate governance legal actions



Note: Scores range from 0 to 100%, with 100% indicating the most effective support mechanism.

Source: EBRD Legal Indicator Survey 2005.

Republic, Lithuania, Moldova, Mongolia and Uzbekistan, yet it can be particularly fast in Hungary and Slovenia. The procedure is held to be smooth in Bulgaria, Lithuania, Moldova, Romania and Slovenia and complex in Armenia, Georgia, Hungary, Russia and Uzbekistan.

The market regulator is deemed to be highly competent and experienced especially in Estonia, Lithuania and Poland.

### Support for action

The survey also asked whether the plaintiff should consider other support mechanisms for their actions. In several countries a media campaign was considered to be a good support for the action, with particularly high ratings in Albania, FYR Macedonia, Montenegro, Romania, Serbia and Ukraine. Requesting support from the national embassy – bearing in mind that the minority shareholder in the case studies was a foreign investor – was instead considered helpful especially in Azerbaijan, FYR Macedonia, Montenegro and Uzbekistan.

Only in FYR Macedonia, Montenegro and Romania (for listed companies only) was support from a shareholders' association judged to be helpful (see Chart 3).

### How much does it cost to obtain redress?

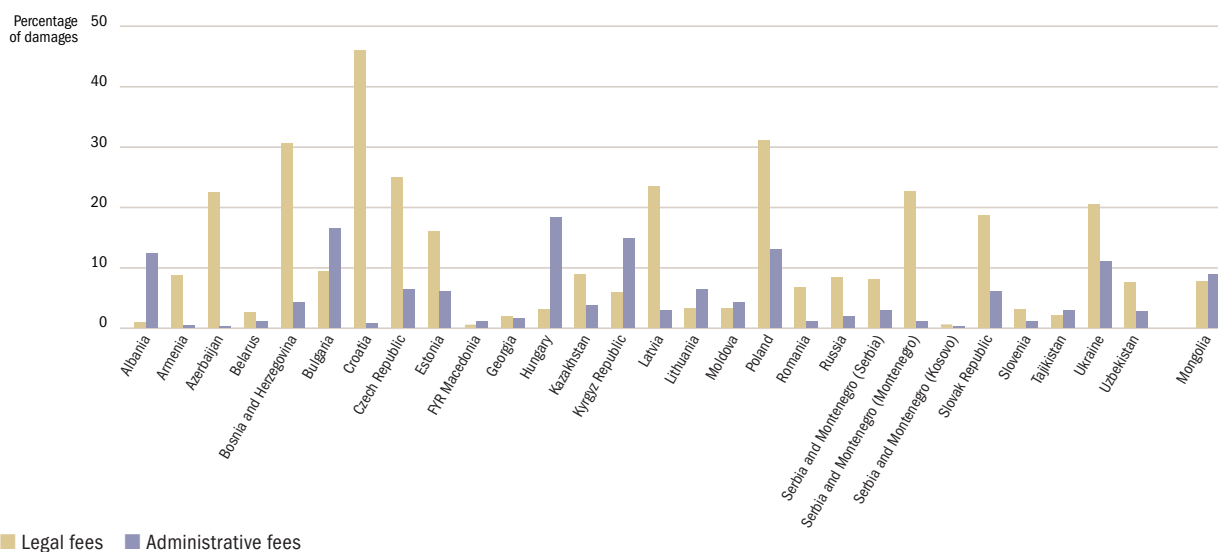
Practitioners were asked to assess the expected costs of the legal action they deemed most effective in obtaining redress. A few questions were also designed to learn about the rules on attorney's fees in shareholder suits. Especially in publicly listed companies, the prospect of having to pay lawyer's fees as well as the winning defendant's fees provides a great disincentive to shareholder suits.

Ideally, countries should allow for "no win – no fee" agreements, as seen in the US and Japan. Under this agreement, a shareholder bringing a *bona fide* suit should not have to pay their lawyers' fees (contingency fees) or the defendants' fees if they lose the case. This principle ensures that minority shareholders bringing an action

against insiders' wrongdoing will not have to compensate the defendant should their case be unsuccessful. However, as most countries in the survey do not have this rule, minority shareholders rarely challenge insiders' behaviour in court. As a result, laws protecting minority shareholders are under-enforced and less effective.

Estimating legal costs is a difficult exercise as it depends on a number of circumstances, several of which are unpredictable. Bearing this in mind, the survey evidenced that in CEE legal costs were estimated to be less than 5 per cent of the damage suffered by the plaintiff in Hungary, Lithuania and Slovenia while at the other extreme, more than 20 per cent in Croatia, the Czech Republic, Latvia and Poland. In SEE legal costs were estimated in a range of less than 2 per cent in Albania and FYR Macedonia to more than 20 per cent in Bosnia and Herzegovina and Montenegro. In the CIS the costs were put at less than 3 per cent in Belarus, Georgia and Tajikistan and at more than 20 per cent in Azerbaijan and Ukraine.<sup>27</sup>

Chart 4 Costs associated with legal actions taken by minority shareholders



**Note:** Estimated costs are shown as a percentage of the damages suffered by the plaintiff in the case study scenarios.

Source: EBRD Legal Indicator Survey 2005.

Apart from lawyers' fees, administrative fees and costs should also be considered as they have to be advanced by the plaintiff when filing the suit. The survey discovered that administrative fees are particularly high in Albania, Bulgaria, Hungary, the Kyrgyz Republic and Poland.

According to the survey, in six of the CEB countries (Croatia, Estonia, Latvia, Lithuania, the Slovak Republic and Slovenia), three countries in SEE (Albania, Bosnia and Herzegovina and FYR Macedonia) and nine countries in the CIS (Azerbaijan, Armenia, Georgia, Kazakhstan, the Kyrgyz Republic, Russia, Tajikistan, Ukraine and Uzbekistan) it would be possible to conclude an agreement between the law firm and the plaintiff so that the latter would not have to pay the law firm if the action was rejected.

In all CEB and SEE countries and in six CIS countries (Azerbaijan, Kazakhstan, the Kyrgyz Republic, Moldova, Tajikistan and Ukraine), the plaintiffs must pay the defendants' fees if they lose the case. Likewise, the defendants must pay the plaintiffs' fees if they lose the case. In two of the CEB countries (Hungary and the Slovak Republic), three countries in SEE (Bosnia and Herzegovina, Romania and Serbia and Montenegro – Serbia and Kosovo only) and in Belarus in the CIS, lawyers are not allowed to agree with the client a share in the damages awarded.

Finally, class actions are available in Latvia, Lithuania, the Slovak Republic and Slovenia in CEB, Romania in SEE, and Georgia, the Kyrgyz Republic and Russia in the CIS.<sup>28</sup>

## Conclusion

The 2005 Legal Indicator Survey confirms that related-party transactions remain an issue for concern in all transition countries. The degree to which minority shareholders can obtain effective disclosure or redress is limited, and well below what could be expected when looking at the laws.

Disclosure and redress are inextricably linked. This is because an action for redress can only be initiated when evidence is secured. The assessment reveals that requesting a general shareholders' meeting is the most common action provided by law to minority shareholders, but it is unlikely to produce any disclosure when the company is controlled by a powerful

The prospect of a minority shareholder having to pay their lawyer's fees, as well as the defendant's legal fees should their action be rejected, provides a great disincentive for shareholders trying to obtain redress.

Even excellent laws can suffer from poor implementation. This undermines the usefulness of legal provisions and diminishes the confidence of foreign investors in the legal system as a whole. Most transition countries need to upgrade their commercial laws to standards that are generally acceptable on an international level.

shareholder. In cases of obvious misconduct, criminal proceedings are available by law in all countries in the region, but the vast majority of contributing practitioners expressed serious doubts as to the experience and competence of prosecutors in corporate cases.

Three main conclusions can be drawn. First, countries that have developed a solid institutional environment can generally offer an effective legal framework. Nevertheless, as demonstrated by the issue of disclosure in Estonia, this alone is not enough to give minority shareholders adequate protection against abusive behaviour by controlling shareholders. The sound environment needs to be coupled with a corporate governance framework in line with international standards and with an effective civil procedural framework.

Second, consistent with previous studies on shareholder and creditor rights in transition countries, the survey shows that new EU member states and candidate countries,<sup>29</sup> while displaying a better institutional environment, do not systematically outperform other transition countries with regard to the effectiveness of disclosure or redress mechanisms.

Finally, even excellent laws can suffer from poor implementation.

This undermines the usefulness of legal provisions and diminishes the confidence of foreign investors in the legal system as a whole – in particular, in its ability to uphold contractual rights. Most transition countries need to upgrade their commercial laws to standards that are generally acceptable at an international level. Even more importantly, they must make those laws fully effective, particularly through strengthening their court systems, tackling corruption and adopting appropriate measures to strengthen the rule of law.

## Notes

- <sup>1</sup> The assessment was financed by the government of the United Kingdom. The assessment refers to legislation in place on 30 September 2003. The results are available at: [www.ebrd.com/country/sector/law/corpgov/assess](http://www.ebrd.com/country/sector/law/corpgov/assess).
- <sup>2</sup> The initiative was funded by the Italian government. See: [www.ebrd.com/country/sector/law/corpgov](http://www.ebrd.com/country/sector/law/corpgov).
- <sup>3</sup> See S Djankov, R La Porta, F Lopez-de-Silanes and A Shleifer (2005), *The Law and Economics of Self-Dealing*, p. 36 (emphasis in the original), available at: <http://post.economics.harvard.edu/faculty/shleifer/papers/>. The Djankov *et al.* paper similarly devises a case study involving a self-dealing transaction and uses responses from practitioners in a number of jurisdictions to analyse the treatment of self-dealing transactions across the globe.
- <sup>4</sup> The EBRD has 27 countries of operations, geographically divided into three regions: central Europe and the Baltic states (CEB): Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia; south-eastern Europe (SEE): Albania, Bosnia and Herzegovina, Bulgaria, FYR Macedonia, Romania, Serbia and Montenegro; Commonwealth of Independent States (CIS): Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan. For the LIS, data on Turkmenistan were not available. Results for Serbia and Montenegro are represented separately (Serbia, Montenegro and Kosovo) for illustrative purposes only. Mongolia, which is not yet an EBRD country of operations, was also surveyed.
- <sup>5</sup> The results of previous Legal Indicator Surveys are available on the EBRD web site. The LIS on insolvency is available at: [www.ebrd.com/country/sector/law/insolve/insolass/lis/index](http://www.ebrd.com/country/sector/law/insolve/insolass/lis/index) and the LIS on enforcement of charges is available at: [www.ebrd.com/country/sector/law/st/facts/eecs](http://www.ebrd.com/country/sector/law/st/facts/eecs).
- <sup>6</sup> The following law firms, among others, contributed to and supported the 2005 LIS: Studio Legale Tonucci (Albania and Romania); Chadbourne & Parke LLP (Azerbaijan, Belarus, Kazakhstan, Kyrgyz Republic, Russia, Ukraine, Uzbekistan); Advokat (Bosnia and Herzegovina); Spasov and Bratnov Lawyers' Partnership (Bulgaria); Wolf Theiss (Croatia and Serbia, Montenegro and Kosovo); Linklaters (Czech Republic, Poland and Slovak Republic); Luiga, Mugu & Borenius (Estonia); Mgaloblishvili, Kipiani, Dziridzuri (MKD) Law Firm (Georgia); Ormai es Tarsai CMS Cameron McKenna (Hungary); Sorainen Law Offices (Latvia); Lideika, Petrauskas, Valiunas & Partners (Lithuania); Law Office Polenak (FYR Macedonia); Turcan & Turcan (Moldova); Colja, Rojs & partnerji (Slovenia); Akhmedov, Aziziv & Abdulhamidov Attorneys (Tajikistan); Lynch & Mahoney law offices (Mongolia).
- <sup>7</sup> For those countries where there is no active stock exchange, Alfa Ltd was imagined as a large open-type company with numerous minority shareholders.
- <sup>8</sup> The questionnaires were sent out in early June 2005. Answers were received in June-July 2005. Before treating the data, a number of additional questions and requests for clarifications were sent to the respondents.
- <sup>9</sup> The presence of the "big four" auditing firms is a proxy for the quality of the audit profession in the country. The importance of well-trained accountants for corporate governance is discussed in OECD (2004), "Corporate governance in Eurasia: a comparative overview", available at: [www.oecd.org/dataoecd/18/63/33970662.pdf](http://www.oecd.org/dataoecd/18/63/33970662.pdf). B S Black (2001), "The legal and institutional preconditions for strong securities markets", *UCLA Law Review* 781, Vol. 48, pp. 781-855, includes "[a] sophisticated accounting profession with the skill and experience to catch at least some instances of false or misleading disclosure" among the "core institutions that control information asymmetry" and hence among the preconditions for strong securities markets.
- <sup>10</sup> See: [ww1.transparency.org/cpi/2005/cpi2005.sources.en.html](http://ww1.transparency.org/cpi/2005/cpi2005.sources.en.html).
- <sup>11</sup> In some instances questionnaires were answered by just one practitioner within a leading law firm. In other instances, the questionnaire was addressed by a team of practitioners.
- <sup>12</sup> See OECD Principles of Corporate Governance, Principles II and V.
- <sup>13</sup> See, for example, Djankov *et al.*, *supra* note 3.
- <sup>14</sup> In case the request is refused, the shareholding required to petition the court for the appointment of an independent auditor is 25 per cent.
- <sup>15</sup> In contrast to the unlisted company case study, the listed company scenario allows minority shareholders to request an independent audit or request the court to appoint one.
- <sup>16</sup> According to UNMIK Regulation 24/1999 on the law applicable in Kosovo (as amended on 27 October 2000 by Regulation 2000/59), the applicable law is composed by "the regulations promulgated by the Special Representative of the Secretary-General (...) and the law in force in Kosovo on 22 March 1989. In case of a conflict, the regulations shall take precedence. If a court (...) determines that a (...) situation is not covered by the [above mentioned] laws but is covered by another law in force in Kosovo after 22 March 1989 which is not discriminatory (...) the court as an exception, shall apply that law."
- <sup>17</sup> UNMIK Regulation 2001/6 on business organisations; Regulation 2001/30 on the establishment of the Kosovo board on standards for financial reporting and regime for financial reporting of business organisations; Administrative Direction 2002/22 implementing UNMIK regulation 2001/6 on business organisations.
- <sup>18</sup> See D Karapetyan (2002), "Shareholder rights: theory and practice in Armenia", OECD, available at: [www.oecd.org/dataoecd/41/42/2096900.pdf](http://www.oecd.org/dataoecd/41/42/2096900.pdf).
- <sup>19</sup> In Bulgaria actions available to minority shareholders in the unlisted company scenario are limited to the derivative suit.
- <sup>20</sup> Two actions are available in Azerbaijan: challenging the validity of the transaction and a direct liability suit against the company's management.
- <sup>21</sup> See E Berglöf and S Claessens (2004), "Enforcement and Corporate Governance", World Bank Policy Research Working Paper No. 3409, <http://ssrn.com/abstract=625286>, 20.
- <sup>22</sup> *Id.*
- <sup>23</sup> A specific provision in the company's charter was not considered enough.
- <sup>24</sup> In the EBRD countries of operations, the stock exchange is reported to be inactive in Albania, Armenia, Kosovo and Tajikistan. In Belarus there is a functioning stock exchange but it is generally limited to hard currency transactions and government papers, while there are only a few joint-stock companies listed.
- <sup>25</sup> The action is available in FYR Macedonia, Kazakhstan, Latvia, Lithuania, Romania, Russia and Slovenia.
- <sup>26</sup> The action is available in Armenia, Bulgaria, Georgia, Hungary, Kazakhstan, the Kyrgyz Republic, Latvia, Lithuania, Moldova, Romania, Russia, Slovenia and Uzbekistan.
- <sup>27</sup> The estimate has been calculated taking into consideration the likely legal fees stated by law firms compared with the average damage suffered by the minority shareholders in the two case studies.
- <sup>28</sup> Defined broadly as a lawsuit brought by one or more plaintiffs on behalf of a large group of others who have an identical claim (for example, an action filed by one shareholder on behalf of other shareholders).
- <sup>29</sup> See, for example, K Pistor (2004), "Patterns of legal change: shareholder and creditor rights in transition economies," *European Business Organization Law Review*, Vol. 1, No. 1, pp. 59-110, available at: [ssrn.com/abstract=214654](http://ssrn.com/abstract=214654).

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