Corporate governance in action – where do we stand?

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Corporate governance, as defined by the Cadbury Report,[2] is "the system by which businesses are directed and controlled". According to the Organisation for Economic Cooperation and Development (OECD), it involves "a set of relationships between a company's management, its board, its shareholders and other stakeholders"; and it "provides the structure through which the objectives of the company are set and the means of obtaining those objectives and monitoring performances are determined".[3]

Sound corporate governance practices are essential for attracting investment. Evidence suggests that well-governed companies are able to raise funds at significantly lower costs than poorly managed firms.[4] This reflects the lower level of risk for non-controlling investors. Recent financial scandals confirm that poorly managed firms expose not only investors and shareholders to higher risks but also company's employees, pensioners, creditors, consumers and suppliers.

When assessing a country's compliance with international standards, much attention is posed on the written legislation. Laws on the books are all-important, but especially in early transition countries there can be a gap – the so-called implementation gap – between the rights the law grants on paper and the actual possibility of enforcing those rights or of otherwise having them respected. This is especially true with corporate governance, where usually small, unorganised or anyhow not well-connected investors deal with controlling shareholders who are among the most powerful individuals in the country.

In order to fully assess corporate governance it is therefore essential to look at whether and how the law works in practice. This implies a focus both on the legal actions available to outside investors, i.e. minority shareholders, and on the institutional environment features that may affect their outcome.

The EBRD Legal Indicator Survey (LIS) conducted in 2005 focused on the effectiveness of corporate governance in the EBRD countries of operation:[5] instead of looking at the 'law on the books',[6] it aimed to assess how the law works in practice by taking the perspective of a minority shareholder wishing to find out whether the controlling shareholder abused its control power and, having ascertained abuse, to obtain redress.

A hypothetical case study was developed in order to find out how well minority shareholders of both an unlisted and a listed corporation fare in the context of a typical conflict-of-interest situation between controlling shareholders and outside investors: when the controlling shareholder enters into a sale contract with the corporation and therefore stands on both sides of the transaction. The LIS focus is therefore on self-dealing, which is widely held to be "the central problem of corporate governance in most countries."[7]

The survey's scope broadly coincides with the EBRD's area of operation. In total, the survey covers 26 EBRD countries of operations[8] plus Mongolia.

The case studies

The methodology employed in the 2005 LIS followed on from the successful methodology employed in previous years for EBRD Surveys.[9] These involved working with leading law firms in the EBRD region.[10] These law firms were presented with two broadly similar hypothetical case studies involving a related party transaction. A joint-stock company, Alpha Ltd, is a leading firm in a transition country. Its registered headquarters are 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 minor stake in Beta 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% 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. In the first case study Alfa

Ltd. is an unlisted company, controlled by Beta Ltd. with 76% of the shares, while the minority shareholder Gamma Ltd. owns the remaining shares.

In the second case Alfa Ltd. is a listed company, with Beta Ltd. owning a 56% controlling stake, Gamma Ltd. owning a 12% minority stake and 32% of the capital floating on the market.[11] In both cases, the damage suffered by Alfa Ltd. from the transaction was quantified at €2m.

In this scenario, the minority shareholder is faced with two problems: first it has to find out whether indeed the transaction was entered into and under what terms. Second, once this has somehow been ascertained, it has to obtain some form of redress through a private action in court or otherwise.

An extensive questionnaire was designed to find out how effective each country's legal system is in protecting the minority shareholder's interests in the circumstances outlined above. The questionnaire was sent to the law firms together with the case studies and law firms were asked to respond to it as if they were advising the minority shareholder on how best to protect its rights and preserve the value of its financial investment in the local company. The questionnaire[12] focused on three main areas: the mechanisms by which the minority shareholder can find out whether the transaction had indeed been entered into ('disclosure'); the tools for redress ('redress'); and the 'institutional environment' in which such disclosure and redress tools have to be used.

The assessment criteria

Measuring the effectiveness of a legal mechanism is a difficult exercise. Several variables are to be taken into account and most of them involve subjective judgements by the respondents. The following have been used as measures for the effectiveness of disclosure and redress mechanisms.

Speed

Speed is the most straightforward factor. With regard to disclosure, it refers to the average time between the initial filing of proceedings with the court and the issuance of an executable court order as assessed by the respondents. In redress cases, it spans 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, and as assessed by the respondents.

Simplicity

Simplicity relates to the smoothness of proceedings and also takes into consideration the guidance offered by judicial precedents in interpreting the law. More precisely, respondents were asked to assess how clear, simple and straightforward the proceedings relating to the available actions are.

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 how smooth the procedure to enforce a judgement favourable to the minority shareholder and to obtain the desired outcome would be.

Institutional environment

The institutional environment relates to the capability of a given legal framework to provide the basic guarantees that are needed for the legislation to be effectively implemented and enforced. It includes a number of factors: with regard to disclosure, consideration was given to the perceived reliability of company books, the requirement to have the corporate financial information audited, the presence of the 'Big Four' auditing firms in the country,[13] and the perceived independence of statutory auditors. With regard to redress, consideration was given to 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 and the perceived influence that might be exercised on courts and prosecutors by a powerful defendant. With regard to both disclosure and redress the '2005 Corruption Perception Index' elaborated by Transparency International[14] was also taken into account.

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 for each country.[15] Secondly, they address a very specific set of circumstances and must be considered within the boundaries of the case studies. Third, assessing effectiveness is by necessity far more difficult and subjective than finding out what the law on the books states in a given country, as one has to deal with hard to measure variables such as courts' competence, simplicity of procedures, ease of enforcement and so on.

Disclosure

The first part of the analysis focuses on how a minority shareholder might find out whether a related-party transaction has indeed been entered into by the company's management on the assumption that the majority shareholder controls the board and no disclosure of the transaction is spontaneously provided to the minority shareholder.

Disclosure is one of the key pillars of an effective corporate governance framework.[16] 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 at large about such transactions.[17] Since the LIS is about 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, as is often the case when assets are siphoned off a company by its dominant shareholder. Therefore, the questionnaire focused on the tools available to minority shareholders who have reason to suspect that a self-dealing transaction has been entered into and on how effective they are in the perception of the respondents, according to the criteria highlighted above (speed, enforceability and simplicity) and to their overall judgement on how likely it is that by using those tools the minority shareholder in our case study can succeed in detecting wrongdoing.

Figure 1: Legal mechanisms available to a 24% minority shareholder in an joint-stock company seeking disclosure

	Requesting access to company books	Questioning the company's auditor	Requesting an independent auditor	Requesting the court to appoint an independent auditor	Requesting an extraordinary shareholders' meeting to question the management	Other action
Albania	✓	✓	✓	✓	✓	
Armenia	✓	✓	✓	✓	✓	✓
Azerbaijan	✓	✓***	✓		✓	
Belarus	✓	✓	✓	✓	✓	
Bosnia and Herzegovina	✓	✓	✓	✓	✓	
Bulgaria			✓	✓	✓	
Croatia			✓	✓	✓	
Czech Republic					✓	✓
Estonia					✓	
FYR Macedonia	✓	✓***			✓	✓
Georgia	✓			✓	✓	
Hungary	✓	✓	✓***	✓	✓	
Kazakhstan	✓	✓	✓	✓	✓	
Kyrgyz Republic		✓	✓	✓	✓****	
Latvia			✓			✓
Lithuania	✓			✓	✓	✓
Moldova	✓		✓	✓		✓
Mongolia*	✓	✓	✓	✓	✓	
Poland			✓**	✓**	✓	✓
Romania				✓	✓	
Russia			✓		✓	
Serbia and Montenegro – Serbia	✓		✓****	✓****	✓	✓
Serbia and Montenegro – Montenegro	✓				✓	
Serbia and Montenegro – Kosovo					✓	
Slovak Republic	✓		✓***		✓	
Slovenia	✓		✓	✓	✓	
Tajikistan	✓			✓***	✓	
Ukraine			✓	✓	✓	
Uzbekistan	✓		✓		✓	

Source: EBRD Legal Indicator Survey, 2005.
Data on Turkmenistan are not available. Data on Serbia and Montenegro are shown separately in each of three entities for illustrative purposes only.
*** Mongolia is not yet an EBRD country of operation**
**** action available only in the listed joint stock companies scenario**
***** some limitations apply.**
****** action available only in the unlisted companies scenario**

For this purpose, the questionnaire listed five legal tools – see Figure 1 - that may help a minority shareholder find out about whether a self-dealing transaction has been entered into. Respondents were free to add other actions that they would advise the minority shareholder to take.

Minority shareholders generally obtain information about their company at the annual general meeting, where they can verify its results through the annual financial documentation. In several transition countries the legislation and the accounting standards do not require related-party transactions to be registered in the annual report. Minority shareholders cannot, therefore, rely on the ordinary corporate documentation and must use other legal mechanisms to obtain the required information. The most common actions are to request access to company books or an independent audit, to question the company's auditor, or to arrange an extraordinary shareholders' meeting to bring the management to account. As the LIS reveals 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.

As Figure 1 shows, disclosure actions are limited in Estonia,[18] where minority shareholders only have the option to request a general shareholders' meeting to question the management. Alternative mechanisms are available in other countries. In particular, minority shareholders in Poland and Armenia have the legal right to nominate a representative on the board. This should enhance supervision over a company's operations and discourage unethical behaviour by the controlling shareholders and the management.

Central-eastern Europe and the Baltic states (CEB)

Within the CEB region, the survey shows that 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.

As shown in Figure 2, 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.

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 experienced 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 (where the term 'tunnelling' was first used to indicate company asset-stripping activities) related-party transactions must be registered in a specific report "on the relations between interconnected entities". This can provide minority shareholders with useful additional information. 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.

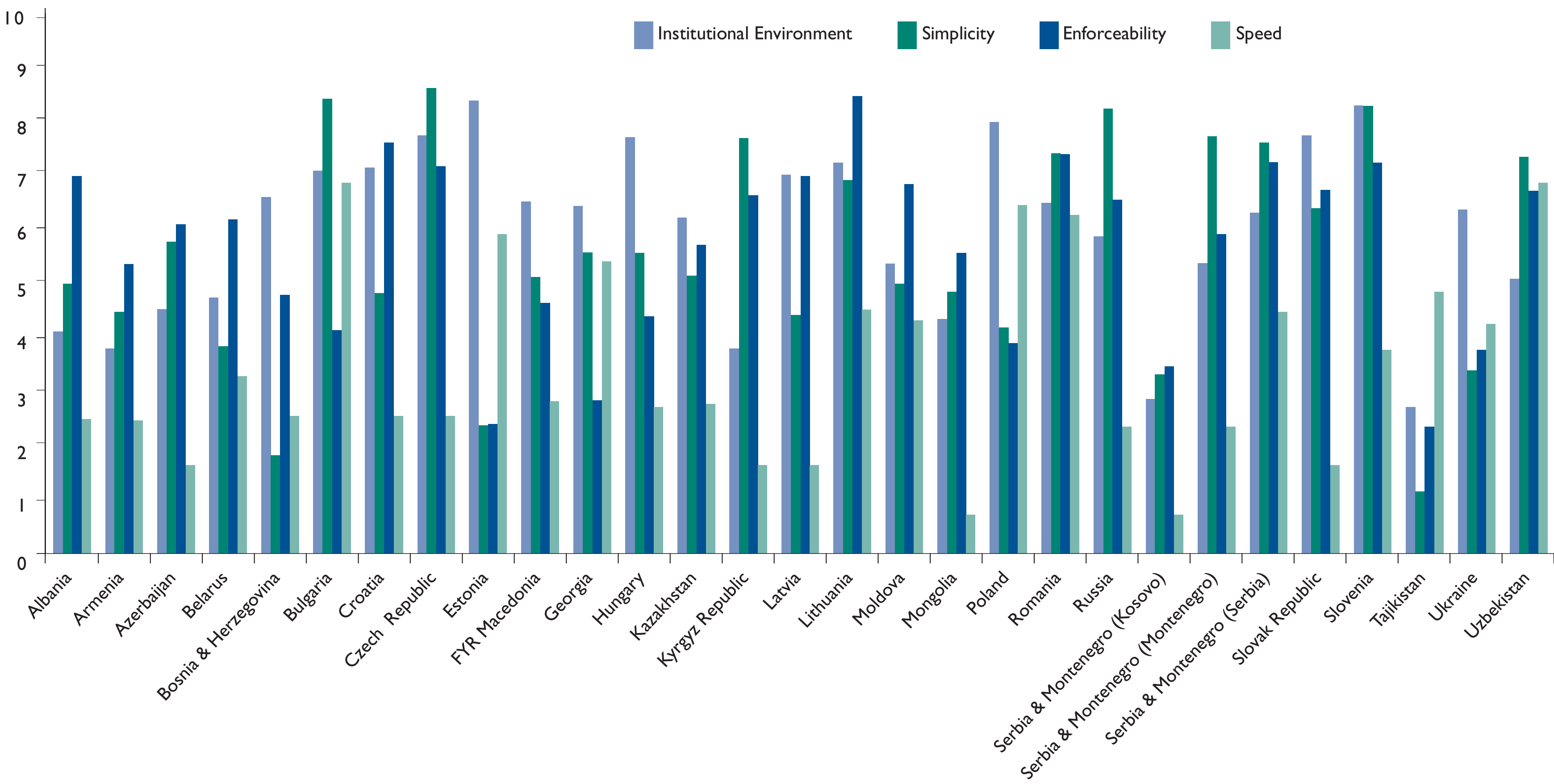
In Estonia, shareholders with a 24% stake in a joint-stock company can request a general shareholders' meeting.[19] This, however, is the only course of action available and the law provides for no enforcement mechanism in case management does not implement the shareholder's request. As a result, minority 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, the situation is similar also in Poland, although a minority shareholder with a stake higher than 20% has, by virtue of law, the right to nominate a representative on the supervisory board.[20] It is doubtful whether the minority shareholder will gain access to information gathered by the supervisory board member appointed by the former, since the latter owes 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 (SEE)

Within the SEE region, a relatively effective framework for disclosure was reported in Bulgaria, Romania and Serbia and Montenegro (Serbia only). 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 & Herzegovina and Kosovo, where procedures are also deemed to be complex and difficult to enforce. The institutional environment is considered especially weak in Kosovo and Albania but

Figure 2: Effectiveness of disclosure in transition countries



Source: EBRD 2005 – Legal Indicator Survey
Note: The chart shows the average between the two case studies for each country regarding the institutional environment and simplicity, enforceability and speed of procedures.
Scores are calculated on a scale of 0 to 10 with 10 being the highest possible score. Data on Turkmenistan are not available. Data on Serbia and Montenegro are presented in three of the regions for illustrative purposes only. Data for Kosovo refers to case 1 only as in case 2 there is no action for minority shareholders to take.

relatively sound in Bulgaria and Croatia.

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

In Kosovo, minority shareholders can only request a general shareholder meeting, but it is likely to be ineffective if the controlling shareholder is hostile. Moreover the legal framework is complex, being a mix of UNMIK (United Nation Interim Administration Mission in Kosovo) regulations and old Yugoslavian law.[21] While UNMIK regulations dealing with corporate governance are limited,[22] there is reluctance on the part of local judges to apply the old Yugoslavian law, which leads to further legal uncertainty.

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) and procedures are not deemed 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 (CIS)

All CIS countries display substantial shortcomings in the legal framework for disclosure. Procedures are deemed long in the Kyrgyz Republic, and especially complex in Tajikistan. Enforceability is considered a problem in Georgia and Tajikistan, and the institutional environment particularly weak in Armenia, the Kyrgyz Republic 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. Corporate information is generally unreliable, statutory auditors not independent and courts inexperienced in corporate cases.

In Georgia, asking the court to appoint an independent auditor and/or calling a general shareholders' meeting to question the company's management are deemed to be the best mechanisms to obtain disclosure. However, such procedures 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.

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

In Armenia, similarly to Poland, minority shareholders holding at least 10% of the shares have, by virtue of law, the right to nominate a representative on the supervisory board.[23] As in Russia, requesting an internal audit is considered the most effective action among those available but reliability of auditing in Armenia might be an issue, as the very limited presence of international auditing firms in the country suggests.

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 menu of possible remedies was listed in the questionnaire – see Figure 3. Respondents, again, were free to add further remedies.

The questionnaire also inquired into whether enforcement mechanisms other than before civil courts were available (criminal prosecution, national or international arbitration, and – for case two only – action before the securities regulator and the stock exchange). Once again, practitioners were free to add further remedies.

For each of the remedies the usual questions on availability, speed, simplicity and enforceability were made.

In general, it can be observed that in all transition countries except Bosnia & Herzegovina 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.

Central-eastern 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 somehow 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 and Latvia to two or more years in the Czech Republic, Hungary and Poland. Local

Figure 3: Legal remedies available to a 24% minority shareholder seeking redress

	Challenge the validity of the transaction	Derivative liability suit	Direct liability suit	Derivative liability suit against the parent company	Direct liability suit against the parent company	Action against the parent company's subsidiary	National arbitration	International arbitration	Action before the Market Regulator	Action before the Stock Exchange	Criminal prosecution	Other actions
Albania	✓	✓	✓	✓	✓	✓	✓	✓			✓	
Armenia	✓		✓			✓	✓***	✓***	✓**		✓	
Azerbaijan	✓		✓					✓			✓	
Belarus	✓	✓	✓	✓	✓	✓	✓	✓			✓	
Bosnia and Herzegovina	✓						✓***	✓***			✓	
Bulgaria	✓**	✓		✓**		✓**			✓**		✓	
Croatia		✓	✓	✓	✓		✓				✓	✓
Czech Republic	✓	✓					✓	✓			✓	✓
Estonia			✓				✓***	✓***			✓	
FYR Macedonia	✓	✓	✓			✓				✓**	✓	
Georgia			✓	✓			✓	✓			✓	
Hungary	✓	✓				✓	✓	✓	✓**		✓	
Kazakhstan	✓		✓		✓		✓***	✓***	✓**	✓**	✓	
Kyrgyz Republic	✓	✓	✓				✓	✓	✓**		✓	
Latvia	✓	✓	✓	✓	✓	✓	✓	✓	✓**	✓**	✓	
Lithuania	✓	✓	✓	✓	✓	✓	✓***	✓***	✓**	✓**	✓	
Moldova	✓	✓	✓		✓	✓	✓	✓	✓**		✓	
Mongolia*	✓	✓		✓	✓	✓	✓	✓	✓**		✓	
Poland	✓	✓	✓				✓***	✓***			✓	
Romania	✓	✓	✓	✓	✓	✓	✓	✓	✓**	✓**	✓	
Russia	✓	✓		✓	✓		✓	✓	✓**	✓**	✓	✓
Serbia and Montenegro – Serbia	✓	✓	✓	✓	✓	✓	✓				✓	✓
Serbia and Montenegro – Montenegro	✓	✓	✓	✓	✓	✓	✓				✓	
Serbia and Montenegro – Kosovo	✓		✓		✓		✓	✓			✓	
Slovak Republic	✓	✓					✓	✓			✓	
Slovenia	✓	✓	✓	✓	✓	✓	✓		✓**	✓**	✓	
Tajikistan	✓****	✓****	✓****	✓****	✓****						✓	
Ukraine	✓		✓				✓	✓			✓	
Uzbekistan	✓	✓	✓	✓	✓				✓**		✓	

Source: EBRD Legal Indicator Survey, 2005.
Data on Turkmenistan are not available. Data on Serbia and Montenegro are shown separately in each of three entities for illustrative purposes only.
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****** available only in the unlisted joint stock companies scenario**

practitioners reported that redress procedures can be particularly awkward in Hungary, but are generally straightforward in the Czech Republic and Slovenia. Enforcement can be problematic in Hungary but 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 although, as evidenced before, obtaining disclosure in Estonia might be a problem.

South-eastern Europe

Romania and Serbia and Montenegro (Montenegro and Serbia only) have the most effective legislations in the SEE region regarding redress. Major weaknesses are evident in Kosovo and Bosnia & Herzegovina. 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 & 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.

Bulgaria also offers only one course of legal redress in the unlisted companies scenario, the derivative suit; in addition, procedures are not particularly smooth and can lead to enforcement difficulties.

The time required to reach an executable judgement can be anything 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 appears not to be an issue. However 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 several countries. Surprisingly, however, according to local practitioners the time needed to obtain an executable judgement is generally short when compared to other regions.

In Azerbaijan the available mechanisms[24] are considered relative effective, although the procedure can be complex. Enforceability is usually not a substantial problem and the time needed to conclude the action 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. Arbitration procedures are available but they can be complex and the award difficult to enforce.

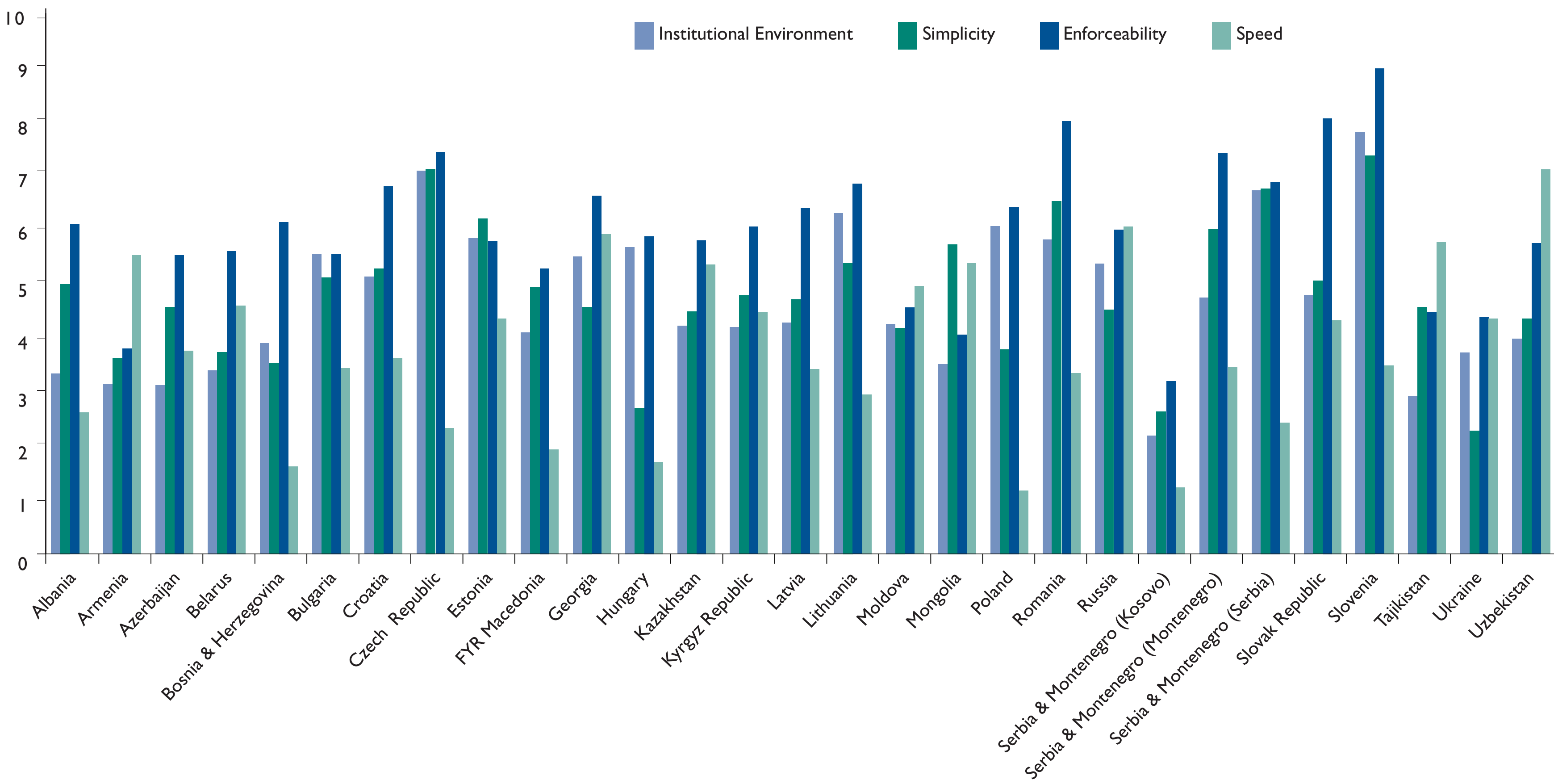
Armenia, Belarus and Tajikistan appear to have the least effective legislation, the lowest degree of judicial competence and to perform badly in terms of enforcement of court decisions.

Conclusion

The 2005 LIS 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 in terms of prevailing legislation. Although the law in some countries is in line with international principles – for example, in Armenia – its effectiveness is deficient. Conversely, Slovenia, which is rated low among CEB countries in terms of extensiveness of legislation,[25] has the most effective laws. This mirrors the findings of the 2004 EBRD Legal Indicator Survey on insolvency, in which Slovenia scored poorly on quality but highly for effectiveness. The country has built a sound institutional environment for corporate governance despite legislative priorities having in recent years been focused on the adoption of the EU *acquis communautaire*.

When considering related-party transactions 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

Figure 4: Effectiveness of redress in transition countries



Source: EBRD 2005 – Legal Indicator Survey
Note: The chart shows the average between the two case studies for each country regarding the institutional environment and simplicity, enforceability and speed of procedures. Scores are calculated on a scale of 0 to 10 with 10 being the highest possible score. Data on Turkmenistan are not available. Data on Serbia and Montenegro are presented in three of the regions for illustrative purposes only. Data for Tajikistan refers to case 1 only as in case 2 there is no action for minority shareholders to take.

minority shareholders, but it is unlikely to produce any disclosure when the company is controlled by a powerful shareholder. Requesting an external independent audit is a far more effective solution, especially when the law adheres to international accounting and auditing standards. In case 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.

Two main conclusions may 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 illicit 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. Secondly, 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 internationally. 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.

References

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Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Shleifer and Robert Vishny (1999), 'Investor protection: Origins, consequences, reform', World Bank – Financial Sector Discussion Paper No. 1, September 1999.

Notes:

1. The article expresses only personal opinions. Substantial contributions for this article were provided by Prof. Luca Enriques – University of Bologna, Italy.
2. 'The Financial Aspects of Corporate Governance', known as the Cadbury Report, was the first code of corporate governance to advocate disclosure of compliance with a code of best practices by listed companies. The code, sponsored by the London Stock Exchange, the Financial Reporting Council and the accountancy profession, was developed by a committee chaired by Sir Adrian Cadbury in response to financial scandals in the late 1980s and early 1990s
3. Preamble of the 'Principles of Corporate Governance' (OECD).
4. See, for example, La Porta et al. (1999).
5. The initiative was funded by the Italian Government.
6. For an assessment of the legislation ('laws on the books') concerning corporate governance, see www.ebrd.com/country/sector/law/corpgov/asses s/index.htm
7. See Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, 'The Law and Economics of Self-Dealing', mimeo, 2005, 34 (emphasis in the original). Djankov et al's paper similarly devises a case study involving a self-dealing transaction and uses responses from practitioners in a number of jurisdictions to analyze the treatment of self-dealing transactions across the globe.
8. The EBRD countries of operations are 27, geographically divided in three regions: Central Europe and the Baltics (CEB): Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia; South-eastern Europe (SEE): Albania, Bosnia and Herzegovina, FYR Macedonia, Serbia and Montenegro (SEE-4); Bulgaria, Croatia, Romania (SEE-3 EU candidate Countries); 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 (e.g Serbia, Montenegro and Kosovo) for illustrative purposes only.
9. The results of previous Legal Indicator Surveys are available on the EBRD website:
   LIS on insolvency (www.ebrd.com/country/sector/law/insolve/insolass/lis/index.htm) and
   LIS on enforcement of charges (www.ebrd.com/country/sector/law/st/facts/ecs.htm).
10. Among others, the following law firms 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 Bratonov Lawyers' Partnership (Bulgaria); Wolf Theiss (Croatia and Serbia, Montenegro and Kosovo); Linklaters (Czech Republic, Poland and Slovak Republic); Luiga, Mugu & Borenius (Estonia); Mgaloblishvili, Kipiani, Dzidziguri (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 o.p., d.n.o.i. (Slovenia); Akhmedov, Aziziv & Abdulhamidov Attorneys (Tajikistan); Lynch & Mahoney law offices (Mongolia).

[11] For those countries where there is no active stock exchange, Alfa Ltd. was to be considered a large open-type company with numerous minority shareholders.

[12] The questionnaires were sent out in early June 2005. Answers were received between July and September 2005. Before treating the data, a number of additional questions and requests for clarifications were sent to the respondents in order to clarify their answers. In some cases conference calls were held with local practitioners.

[13] The underlying intuition is that the presence of the Big Four is a proxy of the quality of the audit profession. Cf. OECD, Corporate Governance in Eurasia: A Comparative Overview, 29 (underlying the importance of having well-trained accountants for a country's corporate governance); Bernard S. Black, 'The Legal and Institutional Preconditions for Strong Securities Markets', 48 UCLA L. Rev. 781, 793-94 (2001) (including "[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).

[14] See ww1.transparency.org/cpi/2005/cpi2005.sources.en.html.

[15] In some instances, one single practitioner within the leading law firms to which the questionnaire was sent answered the questionnaire, in others it was a team of practitioners.

[16] See OECD Principles II and V.

[17] See e.g. Djankov et al., supra note 1.

[18] In Estonia the legislation provides that the court may only consider a request to appoint an independent auditor from shareholders holding at least 25% of the company's shares.

[19] In case the request is refused, the shareholding require to petition the court for the appointment of an independent auditor is 25%.

[20] Differently from the unlisted company case study, in the listed company scenario, minority shareholders can also request an independent audit, or request the court to appoint one.

[21] According to UNMIK Regulation 24/199 – as amended - on the 'Law Applicable in Kosovo', 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 March 22, 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 March 22, 1989 which is not discriminatory (…) the court as an exception, shall apply that law.

[22] 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 and Administrative Direction 2002/22 implementing UNMIK regulation 2001/6 on business organisations

[23] See Davit Karapetyan, 'Shareholder Rights: Theory and Practice in Armenia', 7 (2002), available at www.oecd.org/dataoecd/41/42/2096900.pdf.

[24] Two actions are available in Azerbaijan: challenging the validity of the transaction and the direct liability suit against the company's management.

[25] See EBRD 2004 corporate governance assessment in www.ebrd.com/country/sector/law/corpgov/assess/index.htm

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