

## Annex 1.2: Corporate governance

This annex examines the extensiveness and effectiveness of corporate governance laws in the transition countries. Extensiveness – the quality of current laws – may be measured by comparing corporate governance legislation with a well-known international benchmark issued by the Organisation for Economic Cooperation and Development. Effectiveness – how these laws work in practice – can be gauged by the EBRD’s Legal Indicator Survey, which this year focuses on the protection of minority shareholder rights in the context of related-party transactions.

Corporate governance, as defined by the Cadbury Report,<sup>1</sup> is “the system by which businesses are directed and controlled”. According to the 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”.<sup>2</sup>

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.<sup>3</sup> 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 the company’s employees, pensioners, creditors, consumers and suppliers.

### Quality of legislation

This assessment considers the legal extensiveness of corporate governance laws and regulations (laws on the books) based on a checklist covering five aspects:<sup>4</sup>

1. rights of shareholders
2. equitable treatment of shareholders
3. role of stakeholders in corporate governance
4. disclosure and transparency
5. responsibilities of the board.

Legal experts from 27 transition countries were asked more than 140 questions relating to the checklist. Their responses were assessed and scores given for each answer. A weighted average was then calculated to reach an aggregate corporate governance score for each country.<sup>5</sup> Countries were then divided into five categories according to the overall grade assigned (see Table A.1.2.1), ranging from “very high” to “very low” compliance with international standards.<sup>6</sup>

## High compliance countries

Nine countries have a “high” compliance rating, indicating a sound legal framework in line with the OECD Principles. FYR Macedonia has the best compliance rating, followed by Kazakhstan, Hungary and Lithuania. In FYR Macedonia the assessment reveals only minor flaws relating to the role of stakeholders in corporate governance. Hungary and Lithuania introduced a series of improvements in 2002 and 2003 to their company and securities market laws to bring their regulatory frameworks into line with the EU *acquis communautaire* – the main body of EU laws. As a result, only their legislation regarding the rights of shareholders shows some weaknesses. Kazakhstan’s high rating is due mainly to a new Law on Joint Stock Companies enacted in May 2003 and to new accounting and financial reporting rules requiring compliance with International Financial Reporting Standards.

## Medium compliance countries

Ten countries are deemed to have a legal framework generally in line with international standards despite a number of shortcomings. Slovenia has the lowest rating in central eastern Europe and the Baltic states (CEB), with particular weaknesses relating to disclosure and transparency. Estonia’s rating is only slightly better, with deficiencies regarding board responsibility and disclosure and transparency. Croatia must improve disclosure and transparency and also the oversight of auditors’ activities. In Albania and Serbia and Montenegro the assessment reveals some lack of compliance in disclosure and transparency although their overall legal frameworks are improving.<sup>7</sup> In the Kyrgyz Republic there were amendments to the Law on Joint Stock Companies in 2003 and 2004, which have improved the corporate governance framework on disclosure and transparency. However, problems relating to the protection of minority shareholders remain.

## Low compliance countries

Four countries have a “low” compliance rating, implying serious shortcomings in their legislation when compared with international standards. In Bosnia and Herzegovina and in Romania the assessment reveals a need to improve legislation relating to disclosure and

Table A.1.2.1

### Level of compliance with international standards for corporate governance

Very high compliance	High compliance	Medium compliance	Low compliance	Very low compliance
(none)	Armenia FYR Macedonia Hungary Kazakhstan Latvia Lithuania Moldova Poland Russia	Albania Bulgaria Croatia Czech Rep. Estonia Kyrgyz Rep. Serbia and Mont. Slovak Rep. Slovenia Uzbekistan	Bosnia and Herz. Georgia Romania Turkmenistan	Azerbaijan Belarus Tajikistan Ukraine

Source: EBRD Legal Indicator Survey 2005.

transparency.<sup>8</sup> In Turkmenistan, board responsibilities need to be extended and mechanisms for the protection of minority shareholders enhanced. The law does not regulate cross-shareholdings and there is currently no requirement for companies to prepare accounts on a consolidated basis. In Georgia, legislation does not give sufficient responsibility to boards for monitoring conflicts of interest among management, board members and shareholders, including the misuse of corporate assets.

## Very low compliance countries

Four countries are judged to have corporate governance legal frameworks in urgent need of reform. Tajikistan is rated the lowest among all countries of the region. Its regulations on joint-stock companies do not provide minority shareholders with the necessary safeguards. In Belarus the overall disclosure rules need to be greatly improved.<sup>9</sup> In Ukraine, legislation defining the responsibilities of the board, the rights of shareholders and disclosure and transparency lag well behind international standards.<sup>10</sup> In Azerbaijan, transparency and disclosure requirements are insufficient, encouraging corruption and conflicts of interest.

## Minority shareholder protection

To gauge how the law in each transition country protects minority shareholders – the focus of this year’s Legal Indicator Survey – corporate governance experts in each country were asked to identify the remedies available to shareholders whose rights have been breached. These

remedies exist in the civil procedural framework, which therefore needs to be consistent with the corporate framework.

The experts considered the specific instance of a shareholder with a 24 per cent stake in an unlisted joint-stock company who suspects that a related-party transaction has been entered into by the firm’s management.<sup>11</sup> In the event that evidence of the transaction is established, the experts were asked to assess the extent to which the minority shareholder could use existing laws to obtain redress.<sup>12</sup> Related-party transactions have been identified as a major problem in transition countries and one of the main causes of recent financial scandals in Europe and the United States.<sup>13</sup>

## Disclosure

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 Table A.1.2.2 shows, disclosure actions are limited in Estonia,<sup>14</sup> where minority shareholders only have the option

Table A.1.2.2

## Legal mechanisms available to minority shareholders seeking disclosure

	Access to company books	Access to company's auditor	Independent audit	Court-appointed independent audit	Extraordinary shareholders' meeting	Other actions
<b>Central eastern Europe and the Baltic states</b>						
Czech Republic	No	No	No	No	Yes	Yes
Estonia	No	No	No	No	Yes	No
Hungary	Yes	Yes	Yes	Yes	Yes	No
Latvia	No	No	Yes	No	No	Yes
Lithuania	Yes	No	No	Yes	Yes	Yes
Poland	No	No	No	No	Yes	Yes
Slovak Republic	Yes	No	No	No	Yes	No
Slovenia	Yes	No	Yes	Yes	Yes	No
<b>South-eastern Europe</b>						
<b>SEE-3</b>						
Bulgaria	No	No	Yes	Yes	Yes	No
Croatia	No	No	Yes	Yes	Yes	No
Romania	No	No	No	Yes	Yes	No
<b>SEE-4</b>						
Albania	Yes	Yes	Yes	Yes	Yes	No
Bosnia and Herzegovina	Yes	Yes	Yes	Yes	Yes	No
FYR Macedonia	Yes	Yes	No	No	Yes	Yes
Serbia and Montenegro	Yes	No	Yes <sup>1</sup>	Yes <sup>1</sup>	Yes	Yes <sup>1</sup>
<b>Commonwealth of Independent States</b>						
Armenia	Yes	Yes	Yes	Yes	Yes	Yes
Azerbaijan	Yes	Yes	Yes	No	Yes	No
Belarus	Yes	Yes	Yes	Yes	Yes	No
Georgia	Yes	No	No	Yes	Yes	No
Kazakhstan	Yes	Yes	Yes	Yes	Yes	No
Kyrgyz Republic	No	Yes	Yes	Yes	Yes	No
Moldova	Yes	No	Yes	Yes	No	Yes
Russia	No	No	Yes	No	Yes	No
Tajikistan	Yes	No	No	No	Yes	No
Ukraine	No	No	Yes	Yes	Yes	No
Uzbekistan	Yes	No	Yes	No	Yes	No

Source: EBRD Legal Indicator Survey 2005.

Note: Data on Turkmenistan are not available. Data on Serbia and Montenegro do not include Kosovo.

<sup>1</sup> Legal mechanism not available in Montenegro.

to request a general shareholders' meeting to question the management. Any decision at such a meeting is adopted by a majority vote, leaving the minority shareholder with very little scope to pursue the action. Furthermore, the law does not provide for a request to the court for action in the case of management obstruction. 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 in Estonia, shareholders will have no other means of further investigation if they judge the information incomplete or incorrect.

Alternative mechanisms are available in other countries. In particular, minority shareholders in Armenia and Poland 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.

### Redress

The various remedies available to minority shareholders whose rights have been breached can be divided into actions before the civil or commercial court, arbitration proceedings and criminal prosecution.

Of the possible actions before the commercial court, filing a suit to challenge the validity of a transaction (render the transaction void) is one of the most common. As Table A.1.2.3 shows, it is available in most transition countries, with the exception of Bulgaria, Croatia, Estonia and Georgia, where only actions for damages are allowed. Another remedy is a liability suit against the company's management. This can be initiated by the shareholder (as a direct liability suit) or on behalf of the company (a derivative suit). In the former case, the plaintiff seeks redress for individual damages while the latter action targets damages suffered by the company. A direct liability suit may not be brought in Bosnia and Herzegovina,

Table A.1.2.3

## Legal remedies available to minority shareholders seeking redress

	Challenge to validity of a 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	Criminal prosecution	Other actions
<b>Central eastern Europe and the Baltic states</b>										
Czech Republic	Yes	Yes	No	No	No	No	Yes	Yes	Yes	Yes
Estonia	No	No	Yes	No	No	No	Yes	Yes	Yes	No
Hungary	Yes	Yes	No	No	No	Yes	Yes	Yes	Yes	No
Latvia	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No
Lithuania	Yes	Yes	Yes	Yes	Yes	Yes	No	No	Yes	No
Poland	Yes	Yes	Yes	No	No	No	Yes	Yes	Yes	No
Slovak Republic	Yes	Yes	No	No	No	No	Yes	Yes	Yes	No
Slovenia	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	No
<b>South-eastern Europe</b>										
<b>SEE-3</b>										
Bulgaria	No	Yes	No	No	No	No	No	No	Yes	No
Croatia	No	Yes	Yes	Yes	Yes	No	Yes	No	Yes	Yes
Romania	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No
<b>SEE-4</b>										
Albania	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No
Bosnia and Herzegovina	Yes	No	No	No	No	No	No	No	Yes	No
FYR Macedonia	Yes	Yes	Yes	No	No	Yes	No	No	Yes	No
Serbia and Montenegro	Yes	Yes	Yes	Yes	Yes	Yes	Yes <sup>1</sup>	Yes <sup>2</sup>	Yes	Yes <sup>1</sup>
<b>Commonwealth of Independent States</b>										
Armenia	Yes	No	Yes	No	No	Yes	Yes	No	No	No
Azerbaijan	Yes	No	Yes	No	No	No	No	Yes	Yes	No
Belarus	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No
Georgia	No	No	Yes	Yes	No	No	Yes	Yes	Yes	No
Kazakhstan	Yes	No	No	No	Yes	No	Yes	Yes	Yes	No
Kyrgyz Republic	Yes	Yes	Yes	No	No	No	Yes	Yes	Yes	No
Moldova	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes	No
Russia	Yes	Yes	No	Yes	Yes	No	Yes	Yes	Yes	Yes
Tajikistan	Yes	Yes	Yes	Yes	Yes	No	No	No	Yes	No
Ukraine	Yes	No	Yes	Yes	No	No	Yes	Yes	Yes	No
Uzbekistan	Yes	Yes	Yes	Yes	Yes	No	No	No	Yes	No

Source: EBRD Legal Indicator Survey 2005.

Note: Data on Turkmenistan are not available. Data on Serbia and Montenegro do not include Kosovo.

<sup>1</sup> Legal remedy not available in Montenegro.<sup>2</sup> Legal remedy not available in Serbia.

Bulgaria, the Czech Republic, Hungary, Russia and the Slovak Republic. These countries also have no comprehensive definition of related-party transactions in their legislation.

Initiating a derivative suit requires specific legal provisions allowing a shareholder to represent a company in a legal action against the company's management. Such provisions are absent in Armenia, Azerbaijan, Bosnia and Herzegovina, Estonia, Georgia, Kazakhstan and Ukraine. Starting a liability action against the parent company is another option, provided that information on the controlling entity is available. This approach is an option in Albania, Belarus, Croatia, Latvia, Lithuania, Romania, Russia, Serbia and Montenegro, Slovenia, Tajikistan and Uzbekistan.

Parties to a dispute may also pursue their litigation through an arbitration court. Arbitration is available in most transition countries, provided that a specific clause is included in the company's charter or in a shareholder agreement. Criminal prosecution is possible in all transition countries although in some instances (such as Armenia) only a general action for fraud can be initiated. Overall, Bosnia and Herzegovina and Bulgaria appear to have the most limited legal frameworks for protecting minority shareholder rights.

## The application of legislation

The remainder of this annex concentrates on the effectiveness of legislation in relation to disclosure and redress mechanisms available to minority shareholders. The 2005 Legal Indicator Survey examined a particular instance of related-party transaction and assessed the institutional environment in transition countries. A key problem with related-party transactions is that they can be used by controlling shareholders, managers and insiders as a means for extracting private benefits for themselves at the expense of minority shareholders.<sup>15</sup>

Legal practitioners in all 27 transition countries were asked how the corporate governance mechanisms would operate in their respective countries.<sup>16</sup> They were asked to advise a minority shareholder with a 24 per cent stake in a local, unlisted joint-stock company how to access corporate information to see if a related-party transaction had been entered into by the company and how

### Box A.1.2.1

#### A related-party transaction scenario

A 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 with a 76 per cent stake. 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 24 per cent 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).

to obtain compensation if damage had been suffered (see Box A.1.2.1). The effectiveness of legislation was then measured in terms of speed, enforceability, complexity, and the institutional environment (see Chart A.1.2.1).

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

Enforceability relates to carrying out the executable judgement in cases where the other party fails to implement it. Enforcement of the rule of law is the central functional difference between developed market economies and transition countries. Enforcement — more than laws on the books — is key to effective corporate governance.<sup>17</sup> Complexity relates to the smoothness of proceedings and also takes into consideration the guidance offered by judicial precedents in interpreting the law.

The institutional environment includes a number of factors: judicial competence and experience, reliability of corporate books, auditor independence and the

presence of international auditing firms in the country. It also reflects the extent to which outside influences, such as patronage and corruption, might influence the outcome of an action.<sup>18</sup>

The findings of the survey are necessarily limited and must be treated with some caution. First, they reflect the views of only a small number of practitioners. Secondly, they address a very specific set of circumstances and should be considered within the boundaries of the case study.

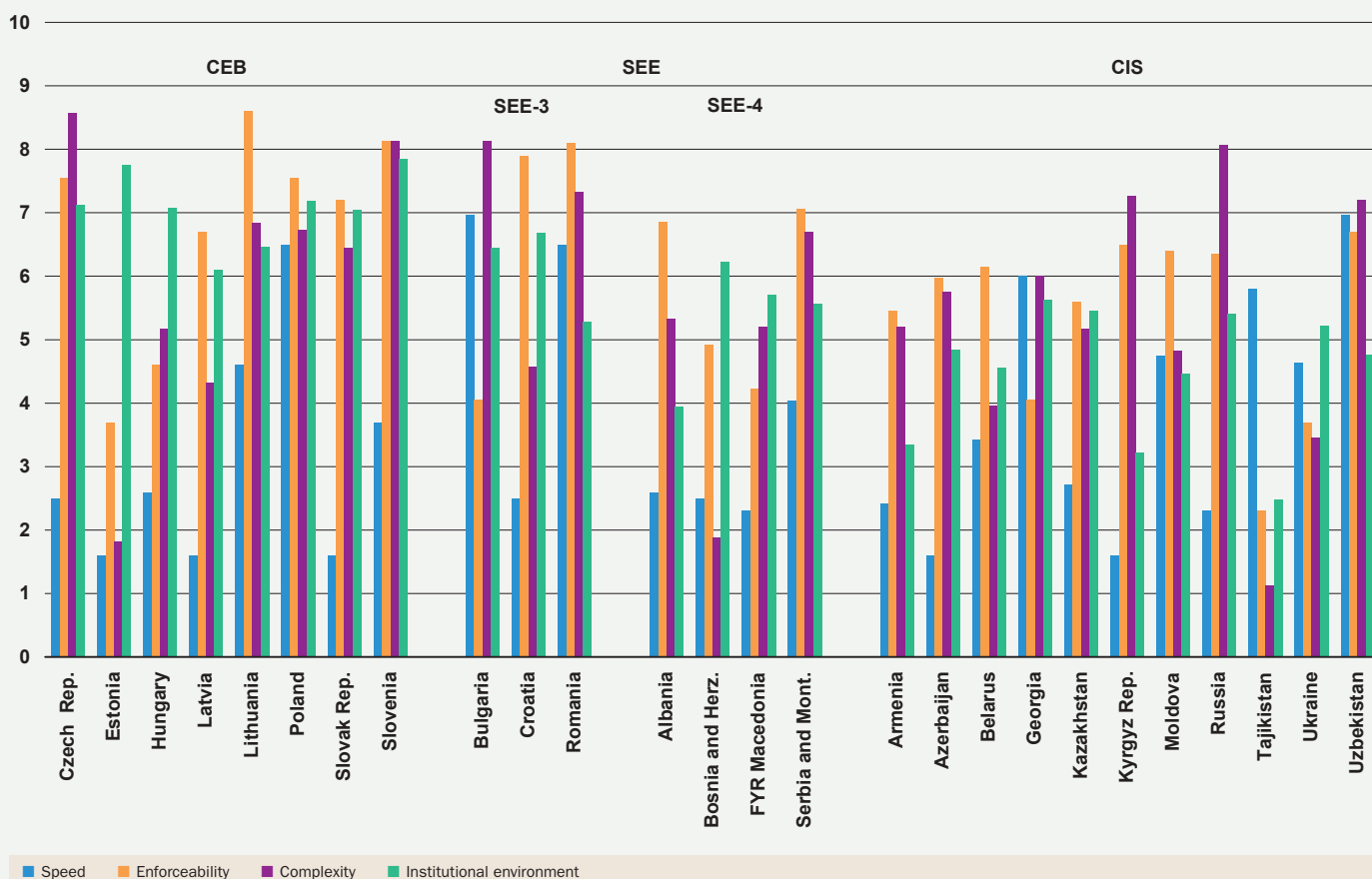
## Effectiveness of disclosure

The first part of the analysis concentrates on how a minority shareholder might find out whether a related-party transaction has indeed been entered into by the company's management if the majority shareholder controls the board and does not spontaneously provide the requested information.

Disclosure is one of the key pillars of an effective corporate governance framework. As the Legal Indicator Survey reveals, only a few countries offer a legal system that 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.

Chart A.1.2.1

## Effectiveness of disclosure to minority shareholders



Legend: Speed (blue), Enforceability (orange), Complexity (purple), Institutional environment (green)

Source: EBRD Legal Indicator Survey 2005.

Note: The chart shows the scores for each country regarding the speed, enforceability, the complexity of procedures and the institutional environment. 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 do not include Kosovo.

## Central eastern Europe and the Baltic states

Within the CEB region, the survey shows that legislation in the Czech Republic, Lithuania, Poland and Slovenia is perceived as having a reasonable level of effectiveness regarding disclosure. However, there are major problems in Estonia. 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, Estonia and the Slovak Republic. Local practitioners reported that procedures are particularly complex in Estonia but generally clear and simple in the Czech Republic and Slovenia. While enforceability is a substantial obstacle in Estonia, it is considered particularly straightforward in Lithuania and Slovenia. Lastly, the institutional environment is deemed generally sound in all countries although Latvia has 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 experienced and company books are regarded as reliable. Only the time needed to conclude an action — often exceeding one year — is deemed too long for obtaining disclosure.

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 Lithuania the length of proceedings can vary from six months to two years depending on the type of action.

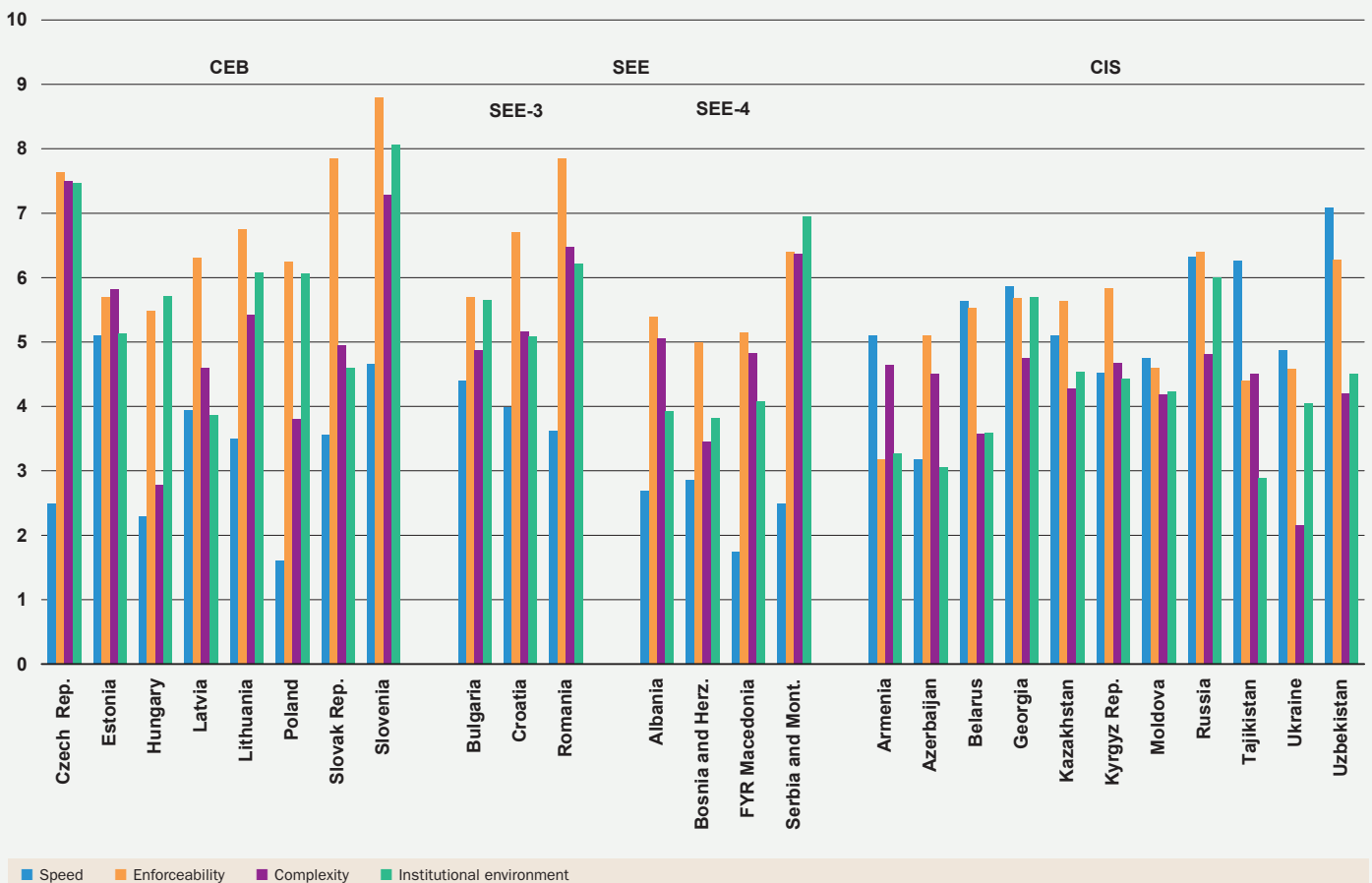
## South-eastern Europe

In south-eastern Europe (SEE) a relatively effective framework for disclosure was reported in Bulgaria, Romania and Serbia and Montenegro. 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. Procedures are also deemed complex and difficult to enforce in the latter country, especially if the defendant refuses to collaborate. The institutional environment is considered especially weak in Albania but relatively sound in Bulgaria and Croatia.

In Bosnia and Herzegovina, several courses of action are open to a minority shareholder but these do not have realistic prospects of enforcement if the controlling shareholder refuses to collaborate. 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.

Chart A.1.2.2

## Effectiveness of redress for minority shareholders



Speed Enforceability Complexity Institutional environment

Source: EBRD Legal Indicator Survey 2005.

Note: The chart shows the scores for each country regarding the institutional environment, the complexity of procedures, enforceability and speed. 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 do not include Kosovo.

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

In the Commonwealth of Independent States (CIS) there are substantial shortcomings in the legal framework for disclosure in all countries. Tajikistan has the least effective legislation. Procedures are deemed very long in Azerbaijan and the Kyrgyz Republic, and especially complex in Tajikistan. Enforceability is considered a problem in Georgia, Tajikistan and Ukraine, and the institutional environment particularly weak in Armenia, the Kyrgyz Republic and Tajikistan.

In Tajikistan 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 generally weak

institutional environment. Corporate information is considered reliable for only a minority of companies, statutory auditors are not generally thought to be independent and courts are inexperienced in such 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 the best mechanisms to obtain disclosure. However, such procedures are quite complex and 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 a 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.

### Effectiveness of redress

Once evidence of a related-party transaction has been secured, the legal framework must offer effective mechanisms to obtain redress. Local practitioners were asked to assess the complexity, enforceability and speed of the available actions before the commercial court, arbitration bodies (national and international) and criminal prosecution authorities. The results are shown in Chart A.1.2.2.

In all transition countries except Bosnia and Herzegovina and Bulgaria (see Table A.1.2.3), minority shareholders have several options for legal action. However, the effectiveness varies from country to country. In many instances, minority shareholders can face endless delays, long procedures and enforcement difficulties.

## CEB

Among CEB countries, the Czech Republic and Slovenia appear to have the most effective mechanisms for redress while Hungary, Latvia and Poland show flaws. 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. It should be noted that in all transition countries the first-instance judgement can be appealed (with the effect of suspending its execution). Regarding complexity, 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 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).

## SEE

Romania and Serbia and Montenegro have the most effective legislation in the SEE region regarding redress. Major weaknesses are evident in Bosnia and Herzegovina. The average time needed for obtaining an executable judgement varies from 18 months in Romania to more than five years in Serbia and Montenegro.

Challenging the validity of a related-party transaction is the only legal remedy available in Bosnia and Herzegovina. 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 — the derivative liability suit may sometimes have a positive outcome but the procedure is unclear 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 clear and enforceable. While in Montenegro the time needed to conclude proceedings is generally limited, courts in Serbia are not bound by any mandatory deadlines and the procedures can last up to 10 years.

## CIS

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 Kazakhstan, Ukraine and Uzbekistan. Also, the institutional environment has significant flaws in all countries. Surprisingly, however, the time needed to obtain an executable judgement is generally short (with the exception of the Kyrgyz Republic).

In Russia, challenging the validity of the transaction is reported as the most effective action but the enforcement can be problematic. Courts are not very experienced in corporate cases and a powerful defendant can easily delay the procedure. Arbitration procedures are available but they can be complex and the award may be difficult to enforce. Armenia and Tajikistan are considered to have the least effective legislation, judicial competence and enforcement capacity for minority shareholder redress.

## 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 in terms of prevailing legislation. Although the law in some countries reflects internationally recognised principles — for example, in Armenia and FYR Macedonia — its effectiveness is deficient in most of the region. Conversely, Slovenia, which is rated the lowest among CEB countries in terms of extensiveness of legislation, has the most effective laws. In particular, the country has built a sound institutional environment for corporate governance despite legislative priorities focusing in recent years on the adoption of the EU *acquis communautaire*, which does not specifically address the issues of minority shareholder protection.

In cases of related-party transactions, disclosure and redress are closely 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 shareholder. Requesting an external independent audit is a far more effective solution, especially when the "big four" auditors are present in the country and when the law adheres to international accounting and auditing standards. 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.

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.

## Endnotes

- 1 *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.
- 2 Preamble of the *Principles of Corporate Governance* (OECD).
- 3 See, for example, La Porta et al. (1999).
- 4 The assessment is based on legislation in force as of 30 September 2003. In some cases, footnotes provide indications of new legislation enacted after that date. The checklist is available at [www.ebrd.com/country/sector/law/corpgov/assess/check.pdf](http://www.ebrd.com/country/sector/law/corpgov/assess/check.pdf). The checklist is based on the OECD *Principles of Corporate Governance* issued in 1999. The Principles were revised in 2004.
- 5 Questions in the checklist were given a weight according to their importance. A preliminary score was then finalised, taking into consideration the country's overall efforts in improving the corporate governance-related legal environment, promoting good corporate governance understanding and practice, and other ongoing related reform initiatives.
- 6 The 2004 corporate governance assessment is available at [www.ebrd.com/country/sector/law/corpgov/assess](http://www.ebrd.com/country/sector/law/corpgov/assess)
- 7 In Serbia and Montenegro a new company law was enacted in 2005, substantially improving the existing legal framework. However, corporate governance legislation differs in Serbia, Montenegro and Kosovo. In Albania a new law establishing auditing standards is due to enter into force in 2006 and will create a new National Accounting Committee.
- 8 The Romanian framework was improved in 2005 with the enactment of new provisions aimed at harmonising national law with EU legislation. However, it is too early to evaluate whether these provisions have addressed the failings identified in the assessment.
- 9 In 2005 an amendment to the Law on Joint-Stock Companies was enacted, partially improving the corporate governance framework.
- 10 On 1 January 2004 the Civil Code and the Commercial Code entered into force, substantially amending the existing legal framework. However, the new legislation is not always coherent and may create legal confusion.
- 11 A related-party transaction can be defined as a business deal or arrangement between two parties who are linked by a special relationship prior to the deal. For example, a business transaction between a major shareholder and the corporation, such as a sales contract, would be deemed a related-party transaction.
- 12 Remedies are based on the assumption that the controlling shareholder is not collaborating with the minority shareholder.
- 13 See, for example, OECD (2004a and b).
- 14 In Estonia the legislation provides that the court may only consider a request to appoint an independent auditor from shareholders holding at least 25 per cent of the company's shares.
- 15 See also OECD (2004b).
- 16 Among others, the following law firms contributed to and supported the 2005 Legal Indicator Survey: 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 and Montenegro); 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).
- 17 See Berglöf and Claessens (2004).
- 18 When considering disclosure, the institutional environment index consists of 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 and the perceived independence of statutory auditors. When considering redress, the institutional environment index consists of 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.

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