

Corporate Governance: An Antidote to Corruption

Examples/lessons learned in Bulgaria and transition countries

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The phenomenon referred to as corruption comprises the sundry forms of abuse of power (economic, political and administrative) which all result in obtaining personal or collective benefits to the detriment of the rights and lawful interests of an individual, groups or the whole society. Corruption hinders development virtually everywhere, thus harming the social, political, and economic life of any society. It distorts choice, increases costs of products and services, promotes unproductive investment, contributes to decline of living standards and undermines democracy and societal integrity.

Corruption is not solely a disease; it is rather a symptom. It indicates poor governance - both in public administration and business. Lack of transparency, discretionary power and low accountability are considered as the three main causes for corruption worldwide. Corruption in transitional context is also a response to the institutional gaps that meets new demands of people and firms.

Existing corruption in business-to-business relationships is a symptom of poor corporate governance. A full range of examples of corporate governance failures that are associated with corruption, fraud and cronyism in support of the hypothesis outline above could be found in the Asian and the Russian economic crises of the late 1990s.

Corporate governance problems in the context of transitional or developing countries go beyond the classical problems that result from the separation of ownership and control. Following the new institutional economics approach, the effectiveness of a particular corporate governance system is interdependent with the set of institutions (regulations, contracts and norms) which create self-governing firms in the economy. Among the core issues to address in the attempts to build sound corporate governance in transition countries we should mention transparency of financial and performance information, conflicts of interest, procedures for bankruptcy, property rights, contract enforcement, etc. It is also absolutely necessary that the public and private sector cooperate in order to develop a set of rules which would establish the ways in which companies govern themselves.

Good corporate governance is a counterbalance to corrupt practices in the private business. Sound corporate governance practices attack the supply side of corrupt relationships by raising transparency, reducing discretionary power, and holding decision-makers accountable. In the course of corporate governance reform new norms, trust and integrity are built which limit the space for corrupt activities.

On the basis of the Bulgarian experience, we could say that good corporate governance can provide effective instruments in the fight against corruption - instruments which are equally applicable in other countries within the context of transition to a competitive market economy and increased importance of civil society in political and social affairs. The numbers used in it are courtesy of Vitosha Research (www.online.bg/vr) - a major Bulgarian polling agency which has conducted multiple surveys on corruption and corporate governance.

1. Transparency Reduces Fraud and Corruption

In addition to creating direct obstacles to legitimate actions, shortcomings in transparency have indirect adverse effects by providing room for unjustified discretionary behavior. Lack of adequate disclosure has been widely regarded as a major factor which brought about the Asian crisis a few years ago. The following examples demonstrate that low disclosure standards induce or permit fraud and corruption regardless of the time and place: A small shareholder of a Bulgarian company was informed of facts showing that the management was not trying to maximize shareholders value - it was targeting private gain instead. This shareholder wanted to convene a general assembly meeting (GAM) to discuss the evidences she had, to obtain further information and eventually undertake remedy measures together with the other shareholders. The law provides that someone holding at least 5% of the capital could litigate a case against the management. The company management, however, rejected the idea of convening a GAM claiming that only shareholders of more than 10% have the formal right to convene a meeting; on the top of that it refused to make available the list of all shareholders on record. In addition, the Central Depository,

which has all this information, was not willing to cooperate. Thus, the small shareholder had either to bribe the Central Depository or leave the corrupt behavior with no reaction.

In another case a GAM of a company was held at a hotel. The announcement, however, did not include detailed information about the exact place of the meeting at the hotel, so representatives of the holders of more than 34% of the capital couldn't attend in spite of being on the premises of the hotel. As a result, capital increase was voted in their absence, their holdings were diluted and they lost blocking power.

Another case which attracted public attention was holding a GAM of state-owned enterprises in the course of the privatization process which increased the number of shares owned required to elect members of the board. This decision was not disclosed properly and made it impossible even if a private investor acquired more than 50% (in some cases up to 66%) to make changes in the board of directors and the management of the company against the will of the government. Further appointments of new board members were possible only after extensive negotiations involving corrupt practices. After a strong negative public response to this the government was forced to pull back.

Disclosure of information exerts a disciplining effect in corporate governance provided that the information disclosed is available to investors in a fast, easy and inexpensive manner. Unfortunately, most of the public companies in Bulgaria do not comply with the transparency requirements (This conclusion was reached by Vitosha Research on the basis of a study in 2000 of 268 listed companies with authorized capital over BGN 200,000 (response rate of 59%).

Serious problems exist with the disclosure of management and board members remuneration - only a few companies do this properly. Virtually no disclosures of conflict of interest exist. In a broader context, even the statutory requirement of publishing annual financial statements (balance sheets, income statements and cash flow statements) is often violated. Access to disclosed information is rendered difficult for a number of reasons: information is not consolidated; much of it is not submitted in an electronic version; low awareness of the requirements for access to public information in general, etc.

2. Discretionary Power Creates Incentives for Corruption

Discretionary power is manifested in all areas of corporate actions: convening general assembly, capital increase, nominating board members, contracts, etc.

If we come back to the first case mentioned, shareholders ultimately managed to get together and demanded to convene a general assembly meeting. If the management does not respond positively within a month, then the court can convene this meeting. At the time of the case it was not specified in the law within what timeframe the GAM had to be held and the management convened the meeting with a delay of one year, thus preventing earlier resolution of the issue in spite of the court decision.

A few privatization funds exercised their discretionary power provided by the Commercial Code to convene general assembly meetings at locations difficult to reach (for example villages in the mountains where no public transportation exists) or even abroad. These meetings usually resulted in dilution of shareholder value for those who could not attend as a result of the capital increase voted at the meetings. In this respect 11.6% of the public companies in Bulgaria admit to have increased their capital at least once in disregard of proportional participation of all shareholders.

One privatization fund, known among investors and the public for the worst corporate governance record in Bulgaria, used the provision for allowing a shareholder with 5% of the capital to file a court case against a company solely for blackmail of the management and the controlling shareholders. It also used the lack of clarity in terms of holding general meetings to take over the management by not allowing the majority shareholder to attend the meeting. Further, it obtained that these illegitimate decisions were registered with the court with the help of insiders and started siphoning off the company. The problem was ultimately resolved after the diplomatic involvement of a foreign government (the majority shareholder was a foreign investor) and the media putting pressure on the judicial system.

Presently, a number of Bulgarian public companies suffer because controlling shareholders siphon off funds to their own private companies. For example, a public company strikes a sweetheart deal (often regarding advertising, consulting or even supply of raw materials or distribution of goods) with a company wholly-owned by controlling shareholders. Under the present law this is not totally illegal. The only regulation concerning conflict of interests is included in the Commercial Code and relates to the exercise of the voting rights at the general assembly meeting. Thus, shareholders or their representatives are prevented from voting on resolutions for claims against the major actors in such practices or initiating actions for enforcement of these actors liability to the company. Another important area where discretionary power exists is the nomination of board members. It often results in nepotism, cronyism and low representativeness. At present, there are no rules or criteria concerning who should serve on

boards, nor the balance between internal and external directors. For example, participation of government representatives at boards where the government has no shares is an indicator of (possible) corrupt practices or unnecessary politicizing of purely economic decisions.

In a number of cases representatives of the government which was holding shares in the company voted explicitly in favor of a private majority shareholder, against the interests of their principal and the mandate they had received. In most cases these people have not been held accountable for their actions.

3. Low accountability and responsibilities feed corruption

Even when decisions, relevant information and behavior are transparent corruption would still widely exist if the people involved are not accountable for their actions. Accountability is shaped by the legislation and enforced by the judicial system. The judicial system in Bulgaria, however, is usually slow to act. Still a missing element of the puzzle is the self-control of private business exercised, for example, through companies regulations of their management and employees conduct.

The Commercial Code and the Law on Public Offering of Securities do not spell out the responsibilities of the governing bodies and fail in this respect to draw a distinction between public and private joint-stock companies. Presently, the liability of the members of governing boards is limited to three month compensation. Sanctions are possible only in cases of failure to comply with the reporting requirements with regard to the commercial register and the requirements of the State Securities and Exchanges Commission.

Internal control is a valuable tool to prevent corrupt behavior. There is a clear lack of understanding of how boards should be structured and different committees (on compensation, appointments, etc.) should be formed. To date, 75.8% of the public companies in Bulgaria have no auxiliary committees in their managing bodies; if such committees exist, their efficiency is assessed as low. Moreover, the institution of outside directors has not yet been established.

The capital market usually plays the role of an external disciplining mechanism for managers and directors, but as it is underdeveloped in Bulgaria it cannot adequately perform this role. Self-regulation within the private sector (for instance, through Codes of Best Practices) can probably be a substitute for the lack of an effective checks and balances system.

4. Building trust and new institutions can curbs corruption

Corruption has flourished in the transition context and due to the inefficiency of the existing institutions. It is the lack of trust in these institutions and their inadequacy to the new needs of individuals and firms what accounts for the existing situation; for this, effective strategies to curb corruption should work toward improving the existing institutions and building new one ones which could be up to the challenge. These new institutional forms can be country-specific - the Corporate Governance Initiative (CGI) (www.csd.bg/cgi) in Bulgaria represents a good example of effective strategy of public-private partnership in combating corruption, a coalition in which the Center for the Study of Democracy has played a key role.

CGI adopted a strategy of assisting in the elaboration and the implementation of practical and policy instruments which would bring trust, accountability, transparency and sound business practice in a transition economy, promoting public awareness of best corporate governance standards and their practical importance for economic growth and social progress, setting up a framework for policy dialogue between private and public sector institutions with the goal of introducing sound corporate governance structures and procedures.

CGI proposed a number of institutional innovations as tools in combating corruption. They include:

- Endorsement by private business of a Best Practices Code. This Code would address the public expectations of equal treatment of shareholders, including protection of minority shareholder interest; design a clear mechanism for management and control focusing on the responsibilities and motivation of governing bodies (boards); set clear standards on disclosure and dealing with conflict of interest; adequately address the issue of transparency of business activities and disclosure of corporate information.
- Establishment of an institution for intermediation and non-judicial settlement of corporate governance disputes. This institution would ensure confidentiality, free access, speed, quality and cost efficiency.

The paper has been published in Shkolnikov, A (ed), 2002, Corporate Governance: An antidote to Corruption, CIPE, Washington, pp 33-36.