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CORPORATE GOVERNANCE IN ARMENIA: A LEGAL PERSPECTIVE

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Abstract

This paper evaluates the overall efficiency of the public company law framework in Armenia, still a transition economy attempting to develop more extensive capital markets and corporate and securities laws. Both written rules and enforcement issues are evaluated. Against the background of privatization, legal reforms, and consequent institutional development, the paper traces the origins of the legal transformation of the public company law framework in Armenia and compares its legal rules to the OECD Principles on Corporate Governance. The paper argues that though Armenia succeeded in transplanting relatively "good laws" onto its books, their efficiency and enforcement are far from desired. The "self-reinforcing" model of corporate law based on rule-based approach clearly failed to address the fundamental concerns of shareholders in Armenia due to internal inconsistencies and creative circumvention techniques. The paper suggests that Armenia should fundamentally rethink its reform agenda on establishing a wider capital market given the lack of the most basic supporting infrastructure. A viable step forward would be the introduction of an objective-oriented business judgment rule and an intrinsic fairness rule.

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INTRODUCTION

The purpose of this article is to evaluate the corporate governance framework in Armenia by comparing it to the OECD principles on corporate governance. Enforcement issues are also addressed.

Drawing on the law, economics and finance literature as well as empirical evidence, this paper concludes that the corporate governance system in Armenia remains largely ineffective. This is consistent with the views that efficient corporate and securities law regimes can not be transplanted without having an adequate supporting institutional background. Instead of letting a bottom-up trial and error system of legal innovations, the top-down US securities law type of regulation was imposed on a civil law company law regime in Armenia disabling companies from value-enhancing practices rather then enabling them to meet their internal needs and the needs of their shareholders.

The law and finance literature argues that a well functioning securities market requires a nexus of core and supporting institutions such as reputational intermediaries, self-regulatory organizations, state oversight institutions, a well developed body of corporate law and legal enforcement. Given that these institutions are largely absent in Armenia, the paper argues that Armenia should fundamentally rethink whether it is possible to establish a market-based system of corporate finance.

The law and economics literature also argues that minority shareholders should be protected from both majority and management abuse. In Armenia ownership is highly concentrated in the hands of a few and due to shareholder passivity, management effectively controls some companies without having a majority stake. Given flagrant violations, a viable step forward would be the introduction of an objective-oriented business judgment rule and the intrinsic fairness rule to safeguard shareholders from abusive malpractices. The business judgment rule will safeguard minority shareholders from managerial expropriations by setting standards on a principles-based structure of a class of corporate transactions and hence to reinforce the fiduciary responsibilities of the board. The intrinsic fairness rule can serve as an efficient remedy against the majority rents by being sufficiently detailed to provide the judiciary with guidance to determine whether the intent of the law is fulfilled.

Against this background, the rest of this paper is organized as follows: Part I discusses the background, and the legal environment of corporate governance in Armenia. Part II concentrates on a substantive comparative analysis of provisions of the Law on Joint Stock Companies of Armenian with the OECD Principles of Corporate Governance, legal enforcement and compliance mechanisms in the context of the legal framework. Part III analyses the role of stakeholders. Part IV discusses boardroom malpractices. Part V concludes and recommends some doctrinal rules for functional reforms.

I. THE CORPORATE GOVERNANCE FRAMEWORK IN ARMENIA

The purpose of this chapter is to present the background of the corporate governance framework, describe ownership distribution, review the legal system and discuss some efficiency implications of "legal transplants" in Armenia.

A. The Background

1. Privatization

Under the Armenian law, there are two types of joint-stock companies: open and closed, the main difference being the limitation of free circulation of shares of closed joint stock companies. According to the Securities Commission of Armenia (hereinafter referred as SCA), there are 1185 joint stock companies as of January 1, 2002.[1] Only 234 of them are registered with the SCA and listed with the Armenia Stock Exchange as of the end of June 2003.[2] There are 672 companies that declined to register with the SCA despite a legal requirement to do so.[3] The total number of shareholders in listed companies is 135,500 as of mid 2003.[4]

Armenia's privatization program has been carried out with objectives that are at best questionable and at worst misguided. According to the Privatization Program of 1998-2000, the government's goals were rather declarative and unsubstantiated.[5] What has been emphasized was not the role of the State to establish supporting institutions of capital and control but rather simple distribution of the State property to achieve "people's capitalism."[6] At the initial stage of privatization 20% of the state property was distributed to employees through a free voucher privatization scheme. Like Russia, early privatization efforts involved a kind of shock therapy aimed at privatizing industries and freeing markets without any consideration for the establishment of a properly functioning institutional framework. Privatization was aimed at increasing the number of privatized companies by seeing their mere existence as an engine for economic growth and prosperity.[7]

In line with Black, Kraakman & Tarassova's (2000) argument for Russia, Armenian privatization resulted in consolidation of control in the hands of a few

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[1] See THE SECURITIES COMMISSION OF ARMENIA: ANNUAL REPORT (2003) (hereinafter referred to as SC REPORT).

[2] See THE SECURITIES COMMISSION OF ARMENIA: SEMI-ANNUAL PERFORMANCE IN FIGURES (2003).

[3] See THE SC REPORT, supra note 1. The charter capital of these companies exceeds five million Armenian Drams (about $8,000 USD) that makes them qualify for registration with the Securities Commission.

[4] See id.

[5] See THE GOVERNMENT OF ARMENIA: DECREE ON THE STATE PROPERTY PRIVATIZATION THROUGH DIRECT SALES (1998); DECREE ON THE STATE PROPERTY PRIVATIZATION THROUGH AUCTIONS (1998); DECREE ON THE STATE PROPERTY PRIVATIZATION THROUGH OPEN SUBSCRIPTIONS (1998); DECREE ON STATE PROPERTY PRIVATIZATION THROUGH TENDER OFFERS (1998). http://www.privatization.am/old/start/start%20legal.html

[6] See JOSEPH STIGLITZ, WHITHER SOCIALISM? (1994)

[7] See THE GOVERNMENT OF ARMENIA THE LAW ON PRIVATIZATION PROGRAM 1998-2000, supra note 5.

individuals particularly skilled at engaging in bribes and other forms of theft.[8] The auction process was heavily corrupted and independent of the methods of privatization. Potentially profitable companies ended-up in the hands of government connected persons. This pattern of ownership acquisition and concentration resembles early experiences of some transition countries. Unlike Russia, complicated systems of corporate control through a myriad of affiliated and off-shore companies were not established in Armenia.[9]

In line with Coffee (1999), it can be argued that privatization in Armenia was conducted in a non-market fashion and in an institutional vacuum which precluded any alignment of interests of shareholders and managers.[10] Coffee writes that "…managers do not either contract with shareholders or pledge a reputational capital that they have carefully built up over years of service; rather, managers and shareholders are thrown together as legal strangers."[11] Systemic shortcomings of privatization per se coupled with a high level of political corruption and lack of domestic capital resources were key elements in the failure of privatization in Armenia.

2. *The Stock Market*

Efforts aimed at establishing market-based finance in Armenia also largely failed. This should not come as any surprise. Regulation and supervision of a market-based system is much more complex, multi-layered and costly than a bank-based system. It requires active participation of market intermediaries or gatekeepers such as accounting firms, investment banks, law firms, ratings agencies and stock exchanges as well as a well-developed legal system with well-trained lawyers and judiciary. It also requires voluntary and mandatory self-regulatory organizations to control the intermediaries. Armenia lacks the most basic infrastructure for the efficient functioning of its securities market. Apart from some basic laws and a relatively powerful regulator, other supporting layers are non-existent in Armenia. Trade in government bonds dominates the market amounting to 91% of total transactions.[12]

B. Concentration of Ownership and Market Capitalization

Ownership is highly concentrated though the data is somewhat unreliable and contradictory. Table 1 below demonstrates the concentration of ownership in the top ten listed companies along with number of shareholders.

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[8] This is very similar to the Russian experience that has evidenced a pronounced tendency towards the concentration of ownership and control up to 75 percent. See Bernard Black, Reinier Kraakman & Anna Tarassova, *Russian Privatization and Corporate Governance: What Went Wrong?,* 52 STANFORD LAW REVIEW 1731 (2000); Tatyana Dolgopyatova, *Corporate Control in Russian Companies: Models and Mechanisms,* Moscow Higher School of Economics WP 1/05 (2002); Tatyana Dolgopyatova, *Development of Corporate Sector and Evolution of Shareholder Ownership (translated from Russian),* Moscow Higher School of Economics WP 1/04 (2003).

[9] See e.g. Andrei Yakovlev, Pavel Kuznetsov & Alexander Fominykh, *Identification of Informal Business Groups for Tax Purposes (translated from Russian),* Moscow Higher School of Economics WP 1/02 (2002). See also Alexander Radygin & Ivan Sidorov, *Russian Corporate Economy: A Hundred Years of Solitude?* (*translated from Russian),* 5 VOPROSI EKONOMIKI 45 (2000).

[10] See John Coffee, *Privatization and Corporate Governance: The Lessons from Securities Markets Failure,* 25 JOURNAL OF CORPORATE LAW 1 (1999).

[11] See id.

[12] See THE SC REPORT, supra note 1.

Table 1: Market Value and Ownership Concentration of Top Ten "Traded" Companies*

Companies	Number of shareholders	Top three ownership ratio
Hayelectomashin	7474	57.7♣
Yerevan Jewelry Factory	1448	80♣
Hayagrobank	2683	68.3
Armen-Carpet	1584	80♣
Yerevan Jewelry Factory-1	1149	80♣
Hayeconombank	1154	60
Almast	783	63.3
Ardshinbank	3000	77
Aviahamalir	1222	42.5
Armenian Development Bank	70	59.1

* This table is based on the data of the Securities Commission data.

♣ Indicates a single individual holding. The data is not available on the 2nd and 3rd largest holdings.

The SCA estimated that as of the end of 2002, market capitalization was about 10 million USD while the ratio of market capitalization to GDP was about 4.5%. However, this is an arbitrary estimate given the fact that there is almost no public trading, and thereby, no reliable market valuation for companies. The numbers rather reflect book values of listed companies. [13]

C. Overview of the Legal System

In general, Armenia follows a French Civil Law tradition. The corporate governance framework is regulated by two major legal acts. The first is the Law on Joint Stock Companies, hereinafter referred as JSCL, which is of civil law origin.[14] The second is the Securities Exchange Law, of common law origin (hereinafter referred as SEL). The SEL established the SCA to regulate and oversee the market. It laid out the regulatory background for registered issuers, disclosure and transparency requirements, and the powers of the regulator. In an effort to strengthen the regulation and monitoring of

[13] For a link between market valuation and legal protection, see Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Investor Protection and Corporate Valuation*, NBER WP No w 7403 (1999). See also Bernard Black, *Does Corporate Governance Matter? A Crude Test Using Russian Data*, 149 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 2131 (2001). Using a variety of correlation tests, Black finds a positive correlation between valuation and governance ranking.

[14] The JSCL incorporates most of the elements of the Russian Law on Joint Stock Companies drafted by Black and Kraakman in 1996. See Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARVARD LAW REVIEW 1911 (1996); BERNARD BLACK, REINIER KRAAKMAN & ANNA TARASSOVA, GUIDE TO THE RUSSIAN LAW ON JOINT STOCK COMPANIES (1998).

registrars, the Central Depository Agency (hereinafter referred as CDA) was established as a fully self-regulated organization in charge of maintaining corporate registrars.

Table 2 provides a short overview of the general legal and regulatory framework of company law in Armenia and emphasizes respective enforcement and regulatory bodies.

Table 2: Legal and Regulatory Framework of Company Law in Armenia*

Legal and Regulatory Framework	Enforcement/Regulatory Bodies
Company Law Framework • Civil Code • Arbitration Act • Audit Act • Joint Stock Company Law-Stock Corporation Act • Limited Liability Companies Act • Bankruptcy Law	• Courts (General Jurisdiction and Commercial Courts)
Securities Law • Securities Exchange Act • Restated Rules Regulating the Stock Market	• Securities Commission • Courts
Stock Exchange Listing Rules • Listing and Delisting Rules of the Armenian Stock Exchange • Listing Rules of the Securities Exchange Act	• Securities Commission • Courts

* Author's own classification.

D. Law and Economics of Legal Transplants

There is wide-spread recognition that law and its enforcement matter for development of active securities markets. In line with the argument of law matters, La Porta, Lopez-de-Silanes, Shleifer & Vishny's (LLSV) construct indices of shareholders' and creditors' rights to measure the level of minority shareholder protection and relate it to wider corporate governance, finance and securities law considerations.[15] LLSV observe that a higher level of ownership concentration acts as a substitute for weak investor protection, and, thereby, ownership concentration is an institutional response to weak

[15] See Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Law and Finance*, 106 JOURNAL OF POLITICAL ECONOMY 1113 (1998). The antidirector rights score includes i) ability to vote in abstentia, ii) no legal requirement to deposit shares prior to proxy voting, iii) availability of cumulative voting , iv) availability of legal mechanisms against perceived oppression against minority shareholders, v) availability of preemptive rights vi) below or above 10 percent threshold for calling extraordinary general meeting of shareholders. The creditors rights index includes i)the absence of automatic stay in the reorganization to prevent secured creditors to collect collaterals, ii) rights to collateral in reorganization, iii) availability of creditor consent for filing for reorganization, iv) management control while pending for reorganization.

monitoring. A higher level of antidirector rights is associated with a higher level of external finance[16] and "dispersion of ownership goes together with good shareholder protection."[17]

An extensive body of literature, argues that not only law matters but also design and enforcement of a system of law are of paramount importance. Gilson (1996) for example, argues that any reform measure makes sense only in the framework of a country-specific institutional environment.[18] In line with Pistor (2000), it can be argued that the process of legal reform in Armenia has been mostly associated with the transplantation of Western statutory law.[19] The US common law tradition in securities market regulation was "implanted" in Armenia without much thought and consideration. While this might have been seen as a welcome move towards vitalization of its capital market, consistent with Berkowitz, Pistor & Richard (1999), [20] imported rules without substantiated local back-up have note offered a value enhancing regime for shareholders in Armenia. In line with Pistor, Raiser & Gelfer (2000),[21] legal transplants resulted in an above the world average measure of minority shareholder protection in Armenia without any statistically significant relationship with the market capitalization.

Armenia has followed "a wholesale reform of corporate and securities laws" based on the principle of "legal transplants." Mere transposition of "good foreign laws," however, failed to establish a good system of corporate governance. Following Black & Kraakman's (1996) recommendations for Russia, Armenia intended to create a "self-enforcing model" of corporate law to regulate procedural aspects in great details rather than its substantial dimensions given generally inefficient courts.[22] Nevertheless, poor enforcement and creative circumvention techniques virtually eliminated most, if not all, benefits associated therewith.

E. Summary Remarks

The corporate governance system is an unstable and transient phenomenon is Armenia. On the one hand, there is a high degree of ownership concentration, shareholder passivity, relatively active bank finance. These are some of the characteristics of a bank-based system. On the other hand, Armenia has enacted US- type securities regulation and has committed itself to develop a strong securities market. Nevertheless, it has so far

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[16] See Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Legal Determinants of External Finance,* 52 JOURNAL OF FINANCE 1131 (1997).

[17] See Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 65 JOURNAL OF FINANCE 471 (1999).

[18] See Ronald Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 WASHINGTON UNIVERSITY LAW QUARTERLY 327 (1996).

[19] See Katharina Pistor, *Patterns of Legal Change: Shareholder and Creditor Rights in Transition Economies*, 1 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 59 (2000).

[20] See Daniel Berkowitz, Katharina Pistor & Jean-Francois Richard, *Economic Development, Legality, and the Transplant Effect,* Columbia Law and Economics Working Paper No. 195 (1999). http://papers.ssrn.com/sol3/papers.cfm?abstract_id=183269; Eric Berglof & Ernst von Thadden, *The Changing Corporate Governance Paradigm: Implications for Developing and Transition Economies,* Annual World Bank Conference on Development Economics (1999).

[21] See Katharina Pistor, Martin Raiser & Stanislav Gelfer, *Law and Finance in Transition Economies*, Working Paper 2000 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=214648

[22] See id.

failed to establish the basic supporting elements. Market intermediaries, gatekeepers, self-regulatory organizations, various types of investor groups, directors' associations and bodies related to the stock exchange, business, industry and academic associations are either non-existent and/or passive. Markets for corporate control are still non-existent and unregulated. The stock exchange is characterized by almost no trading and liquidity.

Against this background, Armenia should fundamentally rethink its reform agenda on establishing a "wider capital market framework" in the country. It might opt for a bank-based system which is much simpler and less costly to regulate vis-à-vis a market-based system given the fact that it suffices to set a crude minimum capital ratio and to have some weighting of the asset specific risks. It also requires a limited group of supervisors.

II. SHAREHOLDER RIGHTS

This section analyzes the details of shareholder rights and their enforcement in Armenia by comparing and contrasting them with the OECD Principles on Corporate Governance (hereinafter referred as Principles).[23]

A. Ownership Rights

In line with the Principles, the JSCL provides that companies should maintain a shareholder registrar to keep track of all shareholdings, and record any change in ownership title through acquisition or sale. The registrar of shareholders shall maintain information on every registered person (a shareholder or a nominee). The registrar of companies with more than 50 shareholders should be maintained by the CDA. Any transfer of shares should be registered within three days after the CDA is notified thereof.

At the request of the company, shareholders and/or their proxies as well as authorities, the CDA should release information on changes in shareholders' (proxies') personal accounts and classes of corporate securities. Any shareholder who alone or in concert with others possesses 10% of shares can get a list of names of participants in the general meeting of shareholders. The JSCL does not secure any access to detailed breakdown of ownership with names and respective shareholdings.

The SCA reports that almost 55% of registered issuers have been involved in gross violations in maintaining their registrars.[24] Though ownership is established only upon the registration with the CDA, only 29% of companies have their registrars maintained by the CDA as of the end of 2002.[25] In 58% of companies shareholders have been refused registration of their ownership title by managers.[26]

B. Information Rights

According to the Principles, all material matters regarding the corporation, including its financial situation, performance, ownership, and governance of the company must be timely and accurately disclosed.[27]

The JSCL and the SEL regulate the information content of disclosure in Armenia. While the former mandates annual reporting and sets forth corresponding information requirements, the latter requires disclosure of financial and operating data quarterly, semi-annually, and annually.

1. Information on Corporate Performance

It is a widespread practice to have formal statements on corporate performance that don't allow for appropriate monitoring and valuation despite the legal requirement to

[23] See ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT PRINCIPLES ON CORPORATE GOVERNANCE 1999 (hereinafter referred as OECD PRINCIPLES). (www.oecd.org/daf/governance/principles.htm).
[24] See THE SC REPORT, supra note 1.
[25] See id.
[26] See id.
[27] See OECD PRINCIPLES, supra note 23.

do so. The board generally sends out only very limited financial and accounting information, if any, to shareholders prior to the general meeting. Though the CEO is responsible for truthfulness of financial and accounting information, timely submission of the annual report, and dissemination of financial and statistical reports to its shareholders and creditors, lack of enforcement for malpractice virtually haven't had any deterrent effect.

2. Information on Ownership Composition

In general, ownership and control structures are not transparent to shareholders in Armenia. The JSCL requires neither ownership composition nor attached rights vis-à-vis other owners to be disclosed in annual reports. There is also no obligation to disclose shareholders' agreements under the current law. It is not legally binding to disclose the identity, compensation, and equity ownership of directors.

Though it is mandatory for listed companies to disclose changes in company ownership and control structures, this requirement is largely neglected. Shareholders do not have a right to access the ownership composition data with the CDA.

3. Information Requirements: Accounting and Auditing Principles

The JSCL gives an option between using an internal auditor (account inspector) or an external auditor. The requirement is consistent with the Principles that any external auditor can not have a material interest either with the company or any of its shareholders. Any external auditor should be appointed by the general meeting of shareholders while the board decides on her remuneration. Companies must keep their accounting records in line with the applicable legislation and with the International Accounting Principles.

It is formalistic for the audit committee to approve the annual report, the annual balance sheet, and the profit and loss statement before the board submits them to the approval of the general meeting of shareholders. Moreover, the requirements of auditor independence have been largely neglected. It is a wide-spread practice to have unaudited statements.

C. Participation and Voting Rights

The Principles stipulate that shareholders have the right to participate, be sufficiently informed, and decide on fundamental corporate changes such as amendments to the statutes, authorization of additional shares, and extraordinary transactions.[28] In Armenia, shareholders are entitled to participate and vote in the general meeting of shareholders in proportion to their holdings both personally or in absentia. Extraordinary general meetings might also be called by any shareholder who alone or in concert with other shareholders possesses 10% of voting shares of the company.

1. Participation Rights

While the law is in basic compliance with the Principles in terms of written rules, in practice it does not give an opportunity to shareholders to participate effectively in general meetings and be informed of the rules, including voting procedures that govern

[28] See id.

general meetings. This is due to low level of enforcement and procedural inadequacies. The notification rarely includes the draft annual report, the opinion of the control committee, information on new board members, and amendments to the charter, if any. Fifteen-day notification period established by the law is clearly not sufficient to ensure sufficient participation in the general meeting. This legal loophole has systematically led to many decisions being adopted without a shareholder vote. The SCA reports that as of the end of 2002, 30% of companies violated the law in calling a general meeting of shareholders.[29] As of the end of 2001, 94% of companies violated notification rules and procedures, 67% compiled the list of shareholders eligible to participate in the meeting with violations, and 53%of companies did not call any general meeting at all.[30]

2. *Voting Rights*

Though the JSCL is somewhat consistent with the Principles stating that shareholders should be able to vote on fundamental corporate decisions in person or in absentia, and weight should be given to votes whether cast in person or in absentia, participation in the general meeting in Armenia is impaired by unclear procedures for proxy voting. It remains increasingly difficult in practice because of rudimentary requirements attached to a power of attorney given to proxies. The proxy can exercise the right to vote only if she is given a power of attorney by the shareholder in charge. The former retains the power to vote personally even if the proxy (ies) has been initially authorized to vote.

The situation is also exacerbated by the fact that distribution of competences and voting thresholds between the general meeting and the board creates ample room for manipulations. There are some very crucial issues delegated to the board. For example, the board is authorized to increase the equity capital and conduct share repurchase without the approval of the general meeting. This might lead to share dilution which might turn especially harmful for minority shareholders.

Another example is related party transactions. They are subject to two tier regulation. If the company has less than 500 shareholders, the transaction can be approved by the board. Otherwise, it must be submitted to the approval of the general meeting of shareholders. Related party transactions are just consolidated with other transactions in the annual report. Though large transactions require supermajority voting, according to the SCA 24% of companies violated the voting procedures while involved in such transactions.[31]

D. Dividend Rights

It is a rare practice for Armenian companies to pay out even approved dividends. A systemic shortcoming is in the fact that even if a decision is made to approve and pay out dividends, there are no clear-cut legal deadlines to do so. It is the discretion of the board to set time limits. Thus, the payment of dividends can be unduly and indefinitely postponed.

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[29] See THE SC REPORT, supra note 1.
[30] See id.
[31] See THE SC REPORT, supra note 1.

Dividends are approved by the general meeting of shareholders by a simple majority of participating votes. The board and only the board is authorized to make such a proposal to the general meeting. Interim dividends, if any, may not be greater than 50% of the dividends paid out at the end of the previous financial year. Annual dividends, if any, may not be greater than the limit proposed by the board and less than the interim dividends that have already been paid out. Under an insolvency regime, the company can not pay any dividends.

E. Equitable Treatment of Shareholders

Though the JSCL stipulates that within any class shareholders have the same voting rights, in contrast to the Principles, the corporate governance framework does not ensure equitable treatment of all shareholders including minority and foreign shareholders.[32] There are two types of shares envisaged by the law: common stock and preferred stock. The law allows up to 25% of preferred stock in the charter capital. As of today, no preference shares have been issued in Armenia. Except for a very narrow range of issues defined by the charter, preferred stock does not carry any voting rights.

Shareholders are subjected to managerial and majority abuse in Armenia and their ability to obtain effective redress for violation of their rights is significantly impaired.[33]

F. Legal Redress

The ability to seek legal redress is an inefficient remedy due to very low sanctions for serious violations on the one hand, and by the inefficient and inexperienced judicial system on the other. Generally, there are many inconsistencies between the procedural and substantial provisions of many laws, which give rise to conflicting interpretations. There is also general mistrust of the courts as they are not regarded as impartial institutions. Judges lack experience and precedents to deliver timely and impartial adjudications.

Nevertheless, the law is consistent with the Principles insofar it provides that shareholders can seek legal redress either in general jurisdiction courts or in commercial courts. Shareholders can apply to a court to invalidate decisions of the general meeting, if these decisions have been adopted in violation of the law. Any shareholder alone or in concert with others who possesses 1% of shares can sue the company for any fraudulent action and be compensated for incurred losses as a result thereof.

G. Summary Remarks

Armenia scores six on the six point scale of La Porta, Lopez-de-Silanes, Shleifer & Vishny's (LLSV) shareholders' "antidirector rights" score.[34] This is consistent with Pistor, Raiser & Gelfer's (2000) finding that transition economies show above the world average level of minority protection rules primarily due to legal transplants.[35] In line with LLSV ownership concentration can be seen as an institutional response to monitoring in

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[32] See OECD PRINCIPLES, supra note 23.
[33] See id.
[34] See Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, supra note 15.
[35] See Pistor, Raiser & Gelfer, supra note 21.

Armenia. However, in contrast to the LLSV, higher level of antidirector rights is not associated with higher level of external finance in Armenia.[36] Moreover, minority shareholder protection rules didn't result in dispersion of ownership. This can be largely attributed to an inefficient and inexperienced judiciary system.

III. THE ROLE OF STAKEHOLDERS

In general, the degree of participation of stakeholders in the corporate governance process in Armenia is limited. In contrast to the Principles, stakeholders are not given adequate performance-enhancing mechanisms for participation in the corporate governance of companies.

As far as employees are concerned, then there is no legal requirement for employee communication, consultation, and representation in the board. Employees are subjected to managerial discretion without any efficient mechanism of legal redress.

Creditors are seemingly empowered with significant leverages by the Bankruptcy Law in case of a default.[37] Bankruptcy proceedings can be initiated for any overdue claim of at least 30 days which exceeds one million Armenian Drams (about 1,500 USD). Any reorganization or liquidation procedure requires creditors' consent and is subjected to judicial review. Secured creditors have rights to collect collateralized property. Creditors can participate in the management of the debtor and propose a trustee for debtor monitoring and management to the court for approval. They have to be informed periodically on key decisions and their recommendations should be taken into consideration by the trustee.

Nevertheless, the Bankruptcy Law is cumbersome and full of conflicting interpretations. Though it provides both for reorganization and liquidation for the debtor, due to substantial and procedural contradictions, the only way out so far has been liquidation of companies. It has usually taken years for courts to decide bankruptcy cases.

In general, on the four point scale of LLSV's "creditors' rights," Armenia scores the highest score of four.[38] A higher creditors' rights score is consistent with the LLSV hypothesis that poor countries have stronger creditors rights compared with rich countries.[39] Despite the fact that Levin (1999)[40] finds that a higher score of creditors' rights is statistically and significantly associated with a greater level of development in financial intermediation, the level of development and expertise in financial intermediation in Armenia is very low, if any, at all.

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[36] See Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, supra note 16.

[37] Currently, a new bankruptcy code is being considered by the Parliament.

[38] See LLSV, supra note 15.

[39] See id.

[40] See Ross Levine, *Law, Finance, and Economic Growth,* 8 JOURNAL OF FINANCIAL INTERMEDIATION 8 (1999).

IV. THE ROLE OF THE BOARD

This part analyzes the board structure, its operations and its efficiency implications in Armenia.

A. Board Structure

The JSCL envisages two types of board structures depending on the number of shareholders. It is obligatory for companies with more than 50 shareholders to have a two-tier board structure. The executive body of the company may be represented by a CEO or a management body letting the charter to make the choice. Companies with more than 500 shareholders must separate competences of the board and the executive board/CEO. In practice, however, there is no real separation.

B. Board Membership and Elections

The board has to have at least three members. Any shareholder alone or in concert with others who possesses 10 % of voting shares can be included in the board without a shareholder vote. Companies with more than 500 shareholders should employ cumulative voting for board election.[41] The general meeting can dismiss board members. The board should be dismissed in its entirety, if it is elected by cumulative voting.

Nevertheless, cumulative voting as a minority protection mechanism has largely failed due to boards' unwillingness to employ it. Many companies do not have formal boards and these boards are not elected during general meetings by cumulative voting.

C. Board Functions

Board functions are fully in contradiction with the Principles. In contrast to the Principles, the JSCL entrusts the board with managerial powers to carry out day to day management of the company which impairs its monitoring and integrity.

The board is also in charge of appointing and dismissing the management board, and determining the terms, conditions and amounts of executive compensation. The law is silent as to whether the board should set corporate performance targets and monitor the implementation of corporate strategy. The law is also silent as to how the board should fulfill key functions of ensuring integrity of accounting and financial reporting, putting a system of risk management, financial control, and general due diligence. It does not spell out how the board should select executives and monitor their performance. There are no obligations for the board to oversee executive succession planning. Legal provisions on the auxiliary committees to the board of directors such as audit, nomination, and remuneration committees are absent.

[41] A cumulative voting system is designed to provide fair minority representation on the board. In this system, shareholders cast as many votes as there are board seats. Shareholders are not limited to giving only one vote to a candidate. Instead, they can distribute their votes among competing candidates as they wish. They can put multiple votes on one or more candidates. For example if there are three candidates to be elected, shareholders can cast one vote for each, three votes for one or any combination in between. Candidates win by a simple majority of votes.

D. Board Responsibilities

According to the law, members of the supervisory board and the management body must act in the best interest of the company, exercising their rights and fulfilling their duties with regard to the company in good faith and reasonableness. Nevertheless, there are no definitions and practical guidelines as to what constitutes acting in good faith and reasonableness means.

Though the board is collectively and individually liable for any damage caused to the company by its actions or the absence thereof, no derivative suit can be brought against the interested person by shareholders. The law does not clarify either what triggers a legal response: violations by the interested party, a representative or an intermediary thereof. Any board member who voted against or abstained from the vote on the interested transaction is discharged of any and all liabilities.

CONCLUSIONS

In general, company law does not work effectively in Armenia. This stems from tensions between written laws vs. legal enforcement as well as institutional incompleteness. Though Armenia transplanted relatively "good laws," its legal system is both inefficient and lacks legal clarity. The judiciary lacks experience and expertise to deal with commercial cases in Armenia. Substantial and procedural aspects of many laws give conflicting interpretations. Armenia lacks the most basic infrastructure to have an efficiently functioning capital market and its capital market reform agenda should be critically reconsidered.

Commentators have long agreed that there is no best model of corporate governance. Each system reflects national legacies in law and finance as well as local needs. While diversified ownership provides diversification of opportunities and efficient distribution of risk over the investor base, it endows managers with significant discretionary power to pursue corporate strategy. Controlled ownership effectively curbs the managerial power but yet introduces another type of agency problems between controlling and non-controlling shareholders.

One can copy the formal legal regime of a relatively well functioning system. Nevertheless, a more viable way forward would be to consider "adjusted flexible transplantation." This will require legal reform, judicial reform and enforcement reform.

Legal reform is needed to establish a clear-cut delineation between the powers of the board and those of the general meeting of shareholders. All issues that might potentially create conflicts of interest and violate minority rights such as repurchase of own shares should be in the exclusive competence of the general meeting.

Board members should be made liable both to the company and shareholders. Shareholders should be empowered to bring derivative suits to seek legal redress in the case of perceived or actual violations of standards of good faith and reasonableness.

Judicial reform should reinforce the fiduciary responsibilities of the board through duty of care and duty of loyalty. Such an objective can be met through the introduction of doctrinal rules such as a business judgment rule[42] and an intrinsic fairness rule. These rules should be backed up with an extensive judicial review practice. Such measures will reflect the key role played by insiders in corporate governance process in Armenia.

The business judgment rule will effectively reinforce the fiduciary responsibilities of managers while giving them enough freedom to act. It can be the standard of application to business and strategic decisions. The intrinsic fairness standard can apply to direct dealings with the corporation: any transaction between the controlling shareholder and the corporation. The rule subjects the controlling shareholder to prove that any transaction between her and the corporation is intrinsically fair. If the standards of the

[42] The business judgment rule is a rule granting directors immunity from liability if their actions have been executed in good faith, using sound business judgment and exercised with reasonable care. Section 4.01(a) of the American Law Institute's Principles of Corporate Governance reads: "A director or an officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.…" See THE AMERICAN LAW INSTITUTE: PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1994).

business judgment rule and intrinsic fairness rule are met, then consequently there will be no need for substantial legislating in this area. As a result, double-sided agency problems between minority shareholders and the board on the one hand and minority shareholders and majority shareholders on the other hand will be addressed more efficaciously.

It has been amply demonstrated that the rule-based standards clearly failed to address the fundamental concerns of corporate governance in Armenia because the intention of legal rules has been effectively circumvented. Given that the business judgment and intrinsic fairness rules are largely principle-based standards, they might provide little guidance to inexperienced judiciary to exercise professional judgment in Armenia. Hence, policy makers could develop standards on principles of corporate law by clearly stating the intention of the standard as well as fleshing it out with sufficient details to make it operational and ensure its consistent application. In applying a given standard of business conduct, judges should be required to concentrate on whether a given business decision or a transaction meets the objective of business conduct and the intention of the law.

Finally, to improve enforcement, the state should take proactive and radical measures to enhance both the quality of judges and efficiency of adjudication. Until a trained, skilled, unbiased and uncorrupted judiciary is in place to adjudicate such disputes and enforce their outcomes, no meaningful progress can be made in Armenia.

With these reforms Armenia would have a more effective and value enhancing system of corporate governance that can curb minority shareholder abuse and promote better financial institutional development.