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**Role of Boards and Board Culture in Georgia  
George Loladze, Chairman, Georgian Stock Exchange**

# ROLE OF BOARDS AND BOARD CULTURE IN GEORGIA

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## ***I. THE LEGAL FRAMEWORK***

### *1.1. History and Milestones*

#### **1994: Law on Entrepreneurs**

The cornerstone in the Georgian corporate legislation was put in 1994 by adoption of the Law on Entrepreneurs (LoE). Together with other fundamental corporate concepts it defined the governance system of the Georgian joint-stock companies. Advised by German specialists, the two-tier board structure was introduced: the Supervisory Board and the (Board of) Directors.

The *functions (competences)* of the General Meeting of Shareholders (GMS), of the Supervisory Board (SB) and Directors were clearly stated and separated:

- GMS has the competence to take decisions on the most general and strategic issues the list of which is directly stated in the LoE. All other decisions are taken by SB or Directors
- Supervisory Board elected by GMS has the competence to express the shareholders' interests in the periods between GMSs. However, the SB authority is clearly limited to certain strategic decisions and controlling functions over the (Board of Managing)<sup>1</sup> Directors. The Members of SB cannot be Directors at the same time.
- Directors take all other decisions not covered by competences of GMS or SB. They have the right to represent the company with third parties or at court.

As for the *duties* of the Members of SB and of the Directors, they were stated in the general fiduciary duty form.

#### **1998: Law on Securities Market**

In 1998 the Law on Securities Market (LSM), drafted by US advisors, was adopted. Among others, it has introduced the concept of a Reporting (public) company and imposed additional duties on the Members of SB and Directors of such companies. The most significant of these duties is the obligation to sign the Annual, Semi-Annual and Current reports of such companies. In addition, the Members of SB and Directors of a Reporting company have to publicly disclose their ownership in the securities of the company.

#### **1999: Amendments to the Law on Entrepreneurs**

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<sup>1</sup> LoE does not introduce notion of the "Board of Directors" or of the "Managing" Director. However, the number of Directors is not limited and, if not stated otherwise, they should take decisions jointly. Also, though not called so, by their functions Georgian Directors are executive (managing) directors.

In 1999 Amendments to the Law on Entrepreneurs were adopted aiming at harmonization of the “Continental” (German) concepts of LoE with Anglo-Saxon LSM and the best corporate governance and securities market practices. Definition of fiduciary duties of the Members of SB and Directors was slightly modified.

### **2002: Rule on Curators**

In December 2002 the Rule on Rights of the Reporting Companies’ Securities Owners and on Respective Obligations of the Managing Body<sup>2</sup> Members (Rule on Curators) was adopted by the National Securities Commission of Georgia (NSCG). It introduced the concept of Corporate Curators - Members of SB or Directors responsible for protecting certain shareholder rights. This could be considered as the first step in the direction of structuring the Supervisory Board and clarification of the duties of its members in corporate governance issues.

### **2003: Amendments to LoE and LSM**

In July 2003 the Georgian Parliament adopted the Amendments to LoE and LSM by which all joint-stock companies were defined as Reporting Companies<sup>3</sup>. Also, NSCG was granted the authority to supervise and enforce provisions of the LoE related to joint-stock companies. By this the number of companies whose SBs and Directors became subject to stricter and clearer regulation increased from 450 to 1800.

#### *1.2. Competences of Directors and Supervisory Board*

#### **Tasks and competence of the Supervisory Board are the following:**

- a) The Supervisory Board supervises the activity of the directors;
- b) The Supervisory Board may, at any time, demand the reports of the directors concerning the company's activity including the relationships with the affiliated enterprises;
- c) The Supervisory Board may control and check the accounting books of the company as well as its property, in particular the cash-office and the state of securities and goods, it may engage individual members of the Board or experts to execute this activity;
- d) The Supervisory Board calls the general meeting if it is necessary for the company;
- e) The Supervisory Board checks the annual reports, proposals for the distribution of profit, and informs the general meeting accordingly. The Supervisory Board should indicate how and in what volumes it has checked the activity of the Directors of the company during the previous year, what parts of the annual report it has checked up and whether these checks caused significant changes in the final results;
- f) The Supervisory Board may appoint and discharge the Directors, conclude and cancel labour contracts with them;
- g) The Supervisory Board is entitled to represent the Company when making transactions with the Directors and at the decision of the Supervisory Board conduct legal proceedings on behalf of the company against Directors. The Supervisory Board may, in the case of an issue relating to

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<sup>2</sup> Supervisory Board and Directors in the LSM are defined as a Managing Body.

<sup>3</sup> Before, only those, which had more than 100 securities-holder or those traded at stock exchange were deemed as Reporting Companies.

responsibility of its members, appeal against Directors without the decision of a General Meeting;

h) The functions of the directors shall not be delegated to the members of the Supervisory Board.

The following activities should be performed exclusively with the consent of the Supervisory Board:

- a) Purchase or disposal of more than 50-% of other companies;
- b) Purchase, disposal, pledging or leasing of real estate or rights similar to them, as well as renting out a production unit or cessation of its activities;
- c) Formation and liquidation of the branches;
- d) Planning of annual budget, designing of planned balance sheet, profit & losses plan and of an investment plan, the assessment of obligations proceeding from long-term legal relationships;
- e) Investments or divestments, the amount of which individually or during one fiscal year exceeds 10 % of the book value of a Company's total property as of the end of the last year;
- f) Taking of credits and loans in a higher amount than fixed by the Supervisory Board;
- g) Guarantying credits and loans if they are outside the routine economic activity. Such guarantees shall not be issued to the directors and the Supervisory Board members;
- h) Starting new type of business activity or cessation of existing one;
- i) Determination of general principles of the economic policy;
- j) Determination of the principles of participation of the managers in the profits and other related relations as well as the granting of pensions to them;
- k) Appointment and discharge of trade representatives (procurators);
- l) Allowing the shares and other securities issued by the Company to be admitted for trading on a stock exchange, if such admission imposes additional material expenses on the Company by law.
- m) Making decisions on buying back its own shares in the cases provided for in this law, unless otherwise defined by law.

The management and representation of the company shall be duty of the Directors. The authority of the Directors shall be determined by the instructions approved by the Supervisory Board. If such instructions do not exist, the general principles of management shall apply. The Directors represent the joint stock company at the Court and in other relationships.

### *1.3. Eligibility. Positive qualifications and restrictions*

No positive qualifications are stipulated either for Directors or for Members of SB. As for restrictions:

A person can be restricted by NSCG to be appointed as a Director or a Member of SB for a certain time period, for violations of fiduciary duties being at the position of a Director or of a Member of SB.

A Member of SB of a company may not at the same time be a Director or an executive officer of the same company.

#### *1.4. Board Structure*

For Joint Stock Companies (JSC) the two-tier board – the Supervisory Board and (managing) Directors – is mandatory. There may be even one (managing) Director. Directors cannot be members of the Supervisory Board.

For Limited Liability Companies (LLC) introduction of the Supervisory Board (the second tier) is possible but usually not compulsory. Establishing of the Supervisory Board is mandatory for LLCs, where more than 50% of shares belong to the state, Charter Capital is higher than 30,000 lari and annual turnover is higher than 100,000 lari. In such cases, the rules concerning the Supervisory Board of joint-stock companies shall apply.

Establishing of Supervisory Board is mandatory for LLCs if requested by shareholder(s) owning at least 20% of the Charter Capital.

#### *1.5. Composition of the Boards (Size, qualifications, labour representatives, committees)*

For (managing) Directors – there are no restrictions on the number of Directors.

For the Supervisory Board – it shall consist of not less than three and not more than twenty-one members. At the same time, the number of members must divide by three.

No specific qualification is required to be a Director or a Member of SB.

2/3 of Supervisory Board members are elected on general grounds by the general meeting, while 1/3 may be elected from the company staff (the rule of electing the Supervisory Board members from the company staff is to be determined by special voting instructions adopted by the general meeting). The owner(s) of not less than 20% of the Charter Capital have the right to have at least one representative at the Supervisory Board.

No Supervisory Board committees are required by Georgian legislation.

The concept of Independent Director (Independent Member of the SB) is foreign to Georgian legislation.

There is no limitation on the number of Supervisory Boards where a person can be a Member.

#### *1.6. Nominating, Election and Removing of Supervisory Board Members*

In general, there are no nominating rules. However, in cases when the general meeting of shareholders decides to elect 1/3 of Members of SB from the company staff, procedure for (nominating and) electing the Supervisory Board members from the company staff shall be determined by special voting instructions adopted by the general meeting.

The general meeting of shareholders is authorized to elect representatives of the shareholders to the Supervisory Board as well as remove them from the Supervisory Board at any time. Any member of the Supervisory Board may leave it at any time.

If after six months from the date a member left the Supervisory Board a new member is not elected, the regional court on the territory where the company is located may, by declaration of a shareholder or a (managing) Director or a member of the Supervisory Board appoint a new Member, unless otherwise provided by the company charter.

While electing members of the Supervisory Board, shareholders may agree to use the cumulative voting method. But it is not mandatory.

According to LOE, members of the Supervisory Board are elected for four years, but their authority shall be prolonged until the next regular meeting is called. However, change of controlling shareholder(s) or if a new shareholder (or a group of shareholders acting in accord) acquires 20 or more percents of common shares, initiates respective changes in the Supervisory Board. Holders of 20% or more of voting shares have the right to have at least one representative in the Supervisory Board. However, it is unclear from the legislation, how this can be achieved in practice if controlling shareholders refuse to appoint such representative at the GMS.

There are no rules defining whether all board members should be re-elected at the same time or staggered terms are allowed. In most cases they are elected at the same time.

#### *1.7. The Chairman of the Supervisory Board*

The Chairman (the Deputy-Chairman when the Chairman is absent) calls the meetings of the Supervisory Board and determines the agenda. The Chairman or the secretary of the Board meeting prepares the minutes.

The Chairman of the Supervising Board chairs the general meeting of shareholders. In case of Chairman's absence the Deputy-Chairman heads the meeting.

Since Members of SB cannot be Directors at the same time the Chairman of SB cannot be simultaneously the CEO.

#### *1.8. Board Meetings*

The Chairman (the Deputy Chairman when the Chairman is absent) calls the meetings and determines the agenda. The minutes are to be prepared by the Chairman or the secretary of the meeting.

The meetings of the Supervisory Board are to be held not less than once in a quarter. The notification is to be sent in writing, with the intended agenda, not later than eight days prior to the meeting. The members of the Supervisory Board may be represented by other members of the Board. One member may represent one other member only.

The Supervisory Board is authorized to make decisions if at least half of its members are present or represented. If the Supervisory Board is not authorized to make decisions the Chairman (or the Deputy Chairman in the absence of the Chairman) may call a new meeting within not less than 8 days, which shall be authorized to make decisions only if at least 25% of the members Supervisory Board are present or represented. If the Supervisory Board is still not authorized to make decisions, the Chairman (or the Deputy Chairman in the absence of the Chairman) may within not less than 8 days call a new meeting, which shall be authorized to make decisions regardless the number of attendees

#### *1.9. Board Remuneration*

General Meeting of Shareholders decides on the Supervisory Board remuneration

The Supervisory Board executes contracts with Directors. It also is authorized to determine the principles of participation in profits for the Directors and other managers as well as of granting pensions to them;

### *1.10. Access to Information*

The Supervisory Board may control and check the accounting books of the company as well as its property, in particular the cash-office and the state of securities and goods. It may engage individual Board Members or experts to carry out this activity.

The Supervisory Board may, at any time, demand the reports of the directors concerning the company's activity including the relationships with the affiliated enterprises;

### *1.11. Fiduciary Duties*

The members of the Supervisory Board and (managing) Directors should take all the efforts in conducting company's activity in good faith, with care that a person of ordinary prudence would exercise in similar circumstances, and in a manner that they believe to be in the best interests of the company. If they do not fulfil their obligations, they are jointly and severally responsible to the company for the damages incurred. Abovementioned persons must prove that they did not infringe on their obligations.

If the NSCG finds that a Member of the Supervisory Board or a Director of a Reporting Company is involved in the activity restricted by NSCG rules and he/she got any benefit from such activity at the expense of shareholders, and such activity caused damages to the company or its shareholders, the NSCG may request from such a Member of the Supervisory Board or a Director to compensate the damages to the company and its shareholders.

NSCG may adopt rules specifying the fiduciary duties of the members of the Supervisory Board and Directors of the Reporting Companies. Recently NSCG had adopted such rule – *The Rule on the Rights of Shareholders of the Reporting Companies and the Respective Duties of the Members of the Managing Body*. The basic provisions of this rule are described in the Section 1.13.

### *1.12. Reporting Requirements*

All joint-stock companies and companies that had issued public securities (those held by more than 50 security holders or traded at a stock exchange) are deemed as Reporting Companies<sup>4</sup>. Such companies shall file Annual, Semi-Annual and Current reports with NSCG and the stock exchange where their securities are traded. The Annual and Semi-Annual reports shall contain basic financial and corporate information as prescribed by NSCG rules. Submission of the Current report is required if material event takes place in the company. The event is deemed material if a reasonable investor or potential investor would consider it important in a decision to buy or sell securities. Such reports shall be submitted within 15 days after the material event takes place.

The CEO, the Financial Director and the majority of Supervisory Board members shall sign the reports. Every person who signs the reports shall be liable for material misstatements or omissions contained therein.

The Members of the Supervisory Board and the Directors of a Reporting Company shall provide reports regarding percentage of the company's securities in their beneficial ownership (and any changes therein) to the NSCG and the stock exchange where the company's securities are traded.

### *1.13. Corporate Curators*

The Members of the Supervisory Board and Directors of a Reporting Company shall ensure protection of rights of company's securities holders. Protection of each type of right shall be supervised by at least one personally liable Member of the Board or a Director (hereinafter – "The Curator").

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<sup>4</sup> See footnote 2 on page 2.

The company Charter or any other internal act shall identify the Curators. This not done, all members of the Supervisory Board and all Directors are deemed responsible for the protection of the security holders' rights.

To protect the rights of the security holders, the respective Curator shall:

- a) Ensure that registration of the facts related to the ownership rights on the securities is timely, reliable and secure. In this regard he/she is responsible for the relations with the securities registrar and, in accordance with the fiduciary duty principles, control its activities.
- b) Ensure dissemination of the annual, semi-annual and current reports of the company, as well as the reports of the Directors and Supervisory Board members on the beneficial ownership of the securities, with regularity, in the form and scope prescribed by legislation, in particular:
  - publishing in such a periodic media, which is distributed at the whole territory of Georgia;
  - posting the information regarding preparing (adopting) of the reports not later than the next day after filing such reports with the NSCG and for the period such reports are kept by the company, at the visible place in the offices of the company. During working hours such reports shall be readily accessible for acquaintance, making abstracts or copies to any securities holder;
  - providing to the registered holders of securities by mail or via courier.
- c) Ensure, personally or together with the other members of the Managing Body, orally or in written, provision to the security holders, upon request, adequate comments (clarification) regarding activities of the Managing Body of the company, as well as on the past, current and expected activities of the company, purchase, sale or pledging of company assets and on other events information on which was requested. If Curator considers provision of such information as damaging to the commercial interests of the company, he/she shall justify this adequately, first of all providing NSCG's confidentiality statement regarding the information. Besides, the comments (clarification) provided to one or several security holders shall be made public in a manner prescribed by paragraph b);
- d) Ensure calculation and distribution of dividends and funds due after the company liquidation to all security holders in accordance with the Georgian legislation.

The Curator together with a Director (if the Curator is not a Director) shall ensure:

- Calling of the General Meeting of shareholders in a manner and time prescribed by the Georgian legislation;
- Organization of issuance/cancellation and recording of proxies as set by legislation;
- Accessibility of the General Meeting minutes and decisions (indicating shareholders participating in voting and number of votes given) furnished in the prescribed form, to the securities holders, upon request;
- Calling of the Extraordinary General Meeting of shareholders or refusing to call such meeting with appropriate justification, in accordance with the article 53.3.3 of the LOE.

If the company receives an appeal from a securities holder or a potential investor regarding violation, by some reason, of his/her legitimate right, the corresponding Curator shall, in reasonable time-period, investigate and redress the violation and eliminate its reasons or, if needed, address the NSCG or the court,

when the violation can not be eliminated. The Curator shall inform in writing the appealing party about the measures taken, immediately but not later than in 15 days after receiving of the appeal, if not stated otherwise by law. The measures taken shall be timely and effective. If it is stated in the appeal that in the appellant's opinion his/her rights are infringed due to the Curator, the latter shall immediately inform the Supervisory Board about this and act in accordance with its directions, taking into account the time-period for responding to the appellant prescribed by this paragraph.

In case of absence of a Curator the sphere of his/her supervision shall be transferred to a Director, Chairman or Deputy Chairman of the Supervisory Board by appropriate company act, for a period of absence of the Curator.

#### *1.14. Related Party Transactions and Insider Trading*

There are practically no provisions in Georgian legislation regulating related party transactions in Supervisory Board or Directors' context<sup>5</sup>. Only in the Article 9.8 of the Law on Entrepreneurs we have somewhat "archaic" clause related to this issue:

"Directors or other authorized representatives shall not be granted with credits from the company's property that is necessary to ensure the Charter Capital. If the credit is nevertheless granted it should be returned regardless of all of the other agreements."

As for insider trading, the LSM clearly regulates it. According to the law, an *insider* is any person who, by virtue of his membership in the managing body<sup>6</sup> of a reporting company, his holdings in the capital of such company, or based upon his access to such information by virtue of the exercise of his employment, profession or duties, possesses inside information. Other persons obtaining inside information that evidently originated with an insider shall be likewise considered insiders. Inside information means non-public material information relating to one or more reporting companies or any of their Publicly Held Securities.

It shall be unlawful for any insider, and any person who knowingly receives inside information from an insider, to:

- a) acquire or dispose of, for his own account, or the account of a third party, either directly or indirectly, Publicly Held Securities of the reporting company or companies to which that inside information relates;
- b) disclose inside information to any third party unless such disclosure is made in the normal course of the exercise of his employment, profession or duties;
- c) recommend to or procure a third party, on the basis of inside information, to acquire or dispose of Publicly Held Securities.

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<sup>5</sup> However, LOE partly addresses the related party issue in regard of shareholders. According to the Article 53.4, shareholders may use their voting right in their personal interests except in the cases where the decision relates to the contracts with them or the approval of their report.

<sup>6</sup> See footnote 2 on page 2.

### *1.15. Consequences of Breach of duty*

#### ***Civil***

The Supervisory Board members and (managing) Directors, if they do not fulfill their obligations, are jointly and severally liable to the company for the damages incurred. Abovementioned persons must prove that they did not infringe their obligations.

If the NSCG finds that a Member of the Supervisory Board or a Director of a Reporting Company is involved in the activity restricted by NSCG rules and he/she got any benefit from such activity at the expense of shareholders, if such activity caused damages to the company or its shareholders, the NSCG may request from such a Member of the Supervisory Board or a Director to compensate the damages to the company and its shareholders.

In case the company has creditors and their claims were not satisfied by the company due to damages caused by violation of fiduciary duties by Directors or Members of the Supervisory Board, company's refusal concerning the demands for regressive compensation or, the compromise of the company shall be void if such compensation is necessary in order to meet the creditors' claims. This rule is not applicable if a person responsible to compensate is insolvent or, in order to avoid bankruptcy and bankruptcy proceedings he/she makes a deal with his/her creditors. If the compensation is necessary to meet the creditors' claims, the obligations of the managers are not terminated because they had acted to perform the partners' decisions.

#### ***Administrative***

Below are number of administrative sanctions against Directors and Supervisory Board Members related to violation of their duties defined by LSM:

Related to violations of public offering of securities:

- Violation of Public offering rules – penalty of up to GEL 10,000 imposed on the Members of the Managing Body who had signed the Prospectus.
- Omission of the material facts or providing materially wrong information in the Prospectus – penalty of up to GEL 10,000 imposed on the Members of the Managing Body who had signed the Prospectus;
- Failure to amend Prospectus with corrected information - penalty of up to GEL 1,500 imposed on the Members of the Managing Body, who failed to amend the prospectus.

Related to rules of circulation of public securities:

- Failure to dematerialize public securities issued by a reporting company - penalty of up to GEL 1,500 imposed on the Members of the Managing Body
- Failure to select a licensed securities registrar for maintaining proper recording of securities - penalty of up to GEL 1,500 imposed on the Members of the Managing Body;
- Failure to report the selection of a licensed securities registrar – penalty of up to GEL 400 imposed on the Members of the Managing Body.
- Insider trading - penalty of up to GEL10,000.

Related to violations of reporting requirements by reporting companies:

- Failure to prepare or present requested reports by a reporting company - penalty of up to GEL 2,000 imposed on the Members of the Managing Body;
- Signing of wrong or misleading reports by members of the managing body – penalty of up to GEL 2,000 imposed on the Members of the Managing Body;

Related to violations of reporting requirements related to beneficial ownership of reporting company securities by a member of Managing Body:

- Failure to report such beneficial ownership – penalty of up to GEL 1,500 imposed on the member of the Managing Body.

### ***Criminal***

The range of violations subject to criminal sanctions against members of Managing Body is quite broad. Here we just list most of them:

- Fraud
- Misappropriation or plundering
- Encroachment on property
- Illegal entrepreneurial activity
- Legalization of illegal income
- Monopolistic activity and restriction of competition
- Illegal use of trademarks
- Falsification
- Production, import or realization of goods dangerous for human health or life
- Production, keeping, realization or transportation of excise goods without excise marks
- False advertisement
- Violation of accounting rules
- Illegal activity during bankruptcy proceedings
- Violation of accounting rules during bankruptcy proceedings
- Non-reporting of bankruptcy
- Illegal receiving of credits
- Violation of customs rules
- Tax evasion

- Misuse of the authority
- Commercial bribery
- Related to violations of public offering of securities:
  - Deliberate Public offering of securities without Prospectus or with a terminated Prospectus, which caused significant damages – is punishable by a penalty or by up to two (2) years of reformatory works or by up to three (3) years of imprisonment;
  - Deliberate omission of the material facts or events in the Prospectus – is punishable by a penalty or by one (1) to three (3) years of imprisonment.

## **II. THE ROLE OF BOARDS IN PRACTICE**

### *2.1. Soviet “Routine” Mentality*

To understand the role of the Supervisory Boards in Georgia today, one should realise that, like in many post-communist countries, people’s mentality here practically did not change. This is true as for general public, so for the government officials, employees (which in many cases are shareholders at the same time) and for Directors and Supervisory Board members as well.

According to this (Soviet) mentality Director(s) are ‘bosses’ to whom the (practically unlimited) management power is delegated by ‘Decision Makers’. If in Soviet time ‘Decision Makers’ were respective Communist Party officials now a Dominant Shareholder is understood in such role. In Soviet times there also existed various Employee Committees, Trade Union Committees, etc. “elected” by employees but strictly according to Directors’ or communist officials’ “recommendations”. Common understanding was that these committees were nominal and membership there was just a “honorary duty”, without any real obligations or rights.

The current attitude to Supervisory Boards’ and its members’ role is most easily understood using the concepts of the Evolutionary Theory of Economic Change<sup>7</sup>. According to this theory enterprises (including their staff and managers) are continuing their “routine” activities according the “routine” schemes notwithstanding fundamental changes in the legal, political and economic environment. Primarily this is caused by inertia of the people’s mentality, which is most difficult to change.

Respectively, by this ‘routine’ mentality, to the post-communist Supervisory Boards are attributed formal ‘honorary’ functions of the above Committees - without any rights or duties. And one should stress again, that this virtual picture is in the minds of all and every – Directors, employees, shareholders and members of the Supervisory Board themselves!

Due to the described phenomenon, members of Supervisory Boards in Georgia could be classified in two groups. The first group are those members who are Dominant Shareholders themselves (or their fully authorised representatives - indicated in many cases just informally). The second group are those appointed by the Dominant Shareholder formally, just to meet some legal requirements e.g. on the necessary number of Supervisory Board members, or on some other matter. Such breakdown of Supervisory Board members fully reflects the abovementioned virtual role of the Board. The first group is considered as a ‘decision-maker’ – but not due to their Board membership but because they are the Decision-Makers (or directly associated with Decision-Makers). As for the second group – they are not taken seriously by anybody,

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<sup>7</sup> Nelson R.R., Winter S.G., 1982; *An Evolutionary Theory of Economic Change*. Cambridge, the Belknap Press of Harvard University Press.

thus stressing insignificance of the Supervisory Boards once again. In many cases companies are functioning in a way that the employees even have no idea about the existence of the Supervisory Boards (but of course, they know the Directors and the Dominant Shareholders).

Certainly, all the abovementioned well explains difficulties and complexities related to the implementation of the legislation described in the first chapter. The details of such reality are described below.

## 2.2. *Why a Supervisory Board Meets At All?*

Supervisory Board meetings take place quite irregularly. As a rule, Boards convene on special occasions, like appointment (removal) of a Director or approval of an extraordinary transaction. Certainly, these meetings are quite formal - just stamping the decision being already taken by a Controlling Shareholder.

It is interesting to analyse, why even these meetings take place.

Case 1. Appointment of Directors, Trade Representatives (Procurators) and creation of branches. To legitimise such appointments or branch creation, these should be registered in the State Enterprise Register with a district court and the courts request abstract from the Supervisory Board meeting at which respective decision was made.

Case 2. Approval of extraordinary transactions. Oftentimes, contractors signing (or notaries notarising) an agreement request consent of the Supervisory Board for the transactions requiring such consent by law or the company inner regulations. Really, if such consent is absent, by law, the company may declare the transaction void within 18 months after execution of the agreement.

It is clear that in both cases the demand for the Supervisory Board meetings (and the Board activities – in general) comes from outside the company. As for other responsibilities of the Board, if there is no clear demand to uphold these, in most cases they are just neglected.

Let's look closer, who may be the source of such demand. For this, first of all, we shall briefly review what are the prescribed Board responsibilities (apart from those described in Cases 1 and 2). According the Law on Entrepreneurs (see section 1.2):

- a) The Supervisory Board supervises the activity of the directors;
- b) The Supervisory Board may, at any time, demand the reports of the directors concerning the company's activity including the relationships with the affiliated enterprises;
- c) The Supervisory Board may control and check the accounting books of the company as well as its property, in particular the cash-office and the state of securities any goods, it may engage individuals or experts to execute this activity;

Demand for the supervision and control described in points “a”-“c” can come only from the company shareholders. Since the Directors are practically appointed by (direction of) a Dominant Shareholder and the Supervisory Board Members all are fully controlled by the Dominant Shareholder (in the absence of the mandatory cumulative voting for election of the Supervisory Board members), such demand may originate only from minority shareholders. However, minority shareholders either have no idea about such duties of SB members, or have no tools to practically prove a breach of this duty in the absence of formal guidelines for such ‘Supervisory’ or ‘Controlling’ activity. Such guidelines are not required by law, while companies have no incentives for their creation on a voluntary basis.

- d) The Supervisory Board checks the annual reports, proposals for distribution of the profit, and informs the general meeting accordingly. The Supervisory Board should indicate how and in what volumes it has checked the activity of the Directors of the company during the previous year, what parts of the annual report it has checked up and whether these checks caused significant changes of the final results;

In most of cases Supervisory Board checks the annual reports formally. It is very seldom that it informs the GMS about the details of its controlling and checking activity. Again, only minority shareholders may request the provision of more precise report of the Board's controlling/supervisory activity (of course, if they are aware of such a duty of the SB members). However, even in case of the request, it is very difficult to prove the violation of the fiduciary duty by the Supervisory Board members and to demand compensation of damages to the company caused by such violations.

- e) The Supervisory Board is entitled to represent the Company when making transactions with the Directors and at the decision of the Supervisory Board conduct legal proceedings on behalf of the company against Directors. The Supervisory Board may, in the case of an issue relating to responsibility of its members, appeal against Directors without the decision of a General Meeting;

Of course, in such exceptional cases the SB will convene and execute all needed formalities.

According to the law, the following activities should be performed exclusively with the consent of the Supervisory Board:

- f) Planning of annual budget, designing of planned balance sheet, profit & losses plan and of an investment plan, the assessment of obligations proceeding from long-term legal relationships;
- g) Determination of general principles of the economic policy;

If "f" and "g" takes place, it is not a big deal to approve them at the Supervisory Board meeting. However, the problem is that in most cases there is no planning or determination of the general principles of the economic policy at all. And since this is not requested by law it is hard to interpret as violation of fiduciary duties by SB members or by Directors.

- h) Starting new type of business activity or cessation of existing one;
- i) Determination of the principles of participation of the managers in the profits and other related relations as well as the granting of pensions to them;

If "h" and "i" happen without SB approval, Directors are under potential threat of being sued for damages if such take place. So it is in the interests of Directors (if they know about such norm) to get SB approval.

### *2.3. Professionalism and Informed Decisions*

There are no legal requirements for professional qualification of Directors or SB members. In practice, their awareness about even basic corporate governance principles is very low. As for specific duties - as it was stated above - only upon the request/advise of a lawyer in connection with an extraordinary event (including appointment/removal of a Director) the SB formally convenes and takes a decision.

In the absence of specific legal requirements or guidelines for making informed decisions, most of decisions, as a rule, are based on the instructions of a Dominant Shareholder and – to a lesser degree - on common sense.

There is no statistics on the profile of Directors or SB Members. By expert estimates only 1-2% of them may be legal professionals, about 5% - financial professionals, about 70% former industry leaders (“Red Directors”) or former government officials.

Today, especially, after adoption of the Rule on Curators (See Section 1.1), the duties and responsibilities of the Board members became more specific. Penalties for violation of the duties are strict enough. So, without well-trained competent candidates for boards most of joint-stock companies’ boards may be left without members. Hence, there is clear need in training courses, schools of directors, etc.

#### *2.4. Strategy Setting and Monitoring*

As it was described above, the strategy setting and monitoring takes place in very rare cases. Most of the Supervisory Boards never used to be involved in these activities even formally.

#### *2.5. Transparency and Reporting*

There are no special transparency requirements for SB or Directors’ decisions. However, if the decision implies or triggers any material fact/event, the latter is subject to reporting in the Current Report and in a respective Annual or Semi-Annual report for the Reporting Companies (see Section 1.12).

Though Georgian legislation envisages administrative sanctions against Directors and SB members for violation of the reporting requirements, NSCG, soon after its creation in 1999 started with extensive awareness campaign among the Reporting Companies rather than full-scale application of the above sanctions. But gradually it became stricter. Despite the positive trend, statistics below show that filing of reports is still not satisfactory: the Annual report for 2002 was presented by 274 of 447 reporting companies and the Semi-Annual report for 2003 was presented by 230 of 456 companies.

After legal changes of July 2003, which declared all joint-stock companies (about 1800) as Reporting ones, even more efficient educational and enforcement steps shall be taken to practically enforce the legal requirement. This is not an easy task.

#### *2.6. Cumulative Voting. Independent Directors*

Cumulative voting is not mandatory by law. This far no cumulative voting case has ever been reported.

There is no independent director concept in Georgian legislation. However, by law, every Director or SB member shall serve in the best interests of the whole company rather than of any (dominant or minority) shareholder. However, as stated many times, virtually the whole board is constituted from the people fully loyal to a Dominant shareholder.

Though, by law, the owner(s) of not less than 20% of the Charter Capital have the right to have at least one representative at the Supervisory Board, due to collision in legislation (see section 1.6) practical implementation of this norm is very rare.

#### *2.7. Conflicts of Interest and Related Party Transactions*

As the Georgian legislation practically does not address directly these issues<sup>8</sup> the role of Supervisory Boards in this regard is not visible at all.

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<sup>8</sup> Related party transactions are covered by the Georgian Law on Entrepreneurs only in case such a party is a (large) shareholder – not a Director, SB member or company officer.

As for insider trading, it is the most difficult to trace violation even at the developed markets. As a rule, an unnatural pattern (trend) in a security's trading activity triggers investigation, which eventually may result in revealing of illegal insider trading. In the countries like Georgia, with absolutely illiquid markets, it is practically impossible to catch an unnatural trend - in the absence of any trends! That's why, though majority of transactions actually are of insider character it is impossible in practice to qualify them as such from the legal standpoint.

### *2.8. Supervisory Board Committees*

Due to absence of legal requirements and described nascent stage of the Board culture there exist practically no SB committees.

### *2.9. Supervisory Board Members' Remuneration*

As a rule, SB members are not compensated at all. This once again indicates the nominal or honorable character of this position rather than duty of high responsibility.

### *2.10. Directors Associations and Institutes of Directors*

There are no professional associations of Directors (SB members) of any Institutes of Directors in Georgia.

## **III. WHAT SHALL BE DONE**

### *3.1. Stronger tools in minority shareholders hands*

Below is incomplete list of necessary steps, which may heighten the influence of minority shareholders on the SB and Directors' performance:

- Introduction of the mandatory cumulative voting for SB election by law;
- Introduction of mandatory number of Independent Supervisory Board Members (equivalent of Independent Directors in one-tier board systems).
- Introduction of legal provisions regulating conflicts of interest and related party transactions for Directors and SB members, as well as board procedures for handling related party transactions for all other related parties.
- Shareholder education.

### *3.2. Better enforcement mechanisms*

Enforcement of principles declared in legislation still suffers from many loopholes. Below are some areas which should be addressed to this end:

- Clarification/specification of SB member duties by law, e.g.
  - How they execute their functions (further specification of procedures);
  - What happens if they fail to conduct any standard procedure (like regular SB meetings);
- Transparency/reporting requirements for SB meetings and SB decisions.

Further training of judiciary and lawyers in general is absolutely necessary to better acquaint them with peculiarities of the complicated corporate governance mechanisms.

### *3.3. Director (SB member) professionalism*

Without creation of the pool (critical mass) of professional Directors/SB members there are no prospects for the development and spreading of best board practices. The following can facilitate this process:

- Organizing different training courses for directors (SB members). There are no doubts that the Institutes of Directors are the most adequate form for institutionalization of such courses.
- Creation of Independent Directors Association (Code of Ethics, Directors' track record and rating, etc)

### *3.4. Demand Mechanisms for the best Corporate Governance practices*

The most efficient way for improving Supervisory Boards' performance is to stimulate demand for best corporate governance practices. In the developed countries the main source of such demand are capital markets. Capital markets request good corporate governance and the good corporate governance enhances interest in capital market. This dialectic link is indissoluble. And this is the principal foundation for efficient functioning of the corporate mechanism.

However, in countries like Georgia, this principal link is broken. Capital market is stagnant, while there are thousands of joint-stock companies with complicated corporate structure. The reason put shortly is that there is a stick, but no carrot. To restore the needed balance, appropriate incentives are required. When these are introduced, the above broken link will be restored and mandatory requirements and their enforcement will be only complementary to the basic voluntary compliance with the best corporate governance practices.

Together with principal policy decisions to be made by the government for implementation of the above (which is beyond the scope of this article), below is the list of measures that can facilitate this process:

- Introduction of the National Code of Corporate Governance (Including guidelines for Directors and SB;
- Including the Code compliance requirement in the Georgian Stock Exchange Listing rules.
- Introduction of the National and International system of rating in Corporate Governance (CG Scorecards, etc.).