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Directors' Accountability and Options for Redress by Shareholders, Regulators and Creditors in Eurasia, with particular reference to Azerbaijan

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Corporate governance framework

Azerbaijan permits essentially 3 kinds of corporate entity[1]: a) limited liability enterprise (LLE); b) joint stock company of a closed type (JSC-C); c) joint stock company of an open type (JSC-O).

Only JSCs are required to have a two-tier board structure (supervisory board and management board) and then only where they have more than 50 shareholders. The supervisory board should have a minimum of 3 members[2]. The management board is responsible both to the supervisory board and the shareholders in general meeting.

LLEs are not required to have a two-tiered board structure but may choose to have a supervisory board (though no minimum size is specified) and may, in fact, place another legal entity in charge of management[3].

The law relating to the governance of LLEs is contained primarily in 13 articles in the law *On Limited Liability Enterprises* 1998[4] and 10 articles in the *Civil Code*, 2000[5] (some of which implicitly repeal part of the earlier law). The law dealing with corporate governance in JSCs is contained primarily in 11 articles[6] of the *Civil Code* and 3 brief articles of the law *On Joint Stock Companies* 1994[7] (in part implicitly repealed by the *Civil Code*). Whilst LLEs are somewhat better provided for than JSCs, both lack clarity and detail. One of the difficulties encountered in considering the corporate governance of LLEs and JSCs is that the rules are not uniform and the concept of implicit repeal sometimes leaves it unclear as to whether an older provision is still in force.

The law in general contains no definition of 'director'. The broader term 'officer' is used in various laws and penalties for improper or inadequate performance of duties are imposed on 'officers' not 'directors'. However, the term 'director' is generally used throughout this paper.

In all cases, the shareholders' meeting is the highest body of corporate governance and it is the body exclusively responsible for making changes to the charter and capital, establishing and dissolving management bodies, approving the annual reports and financial statements, approving distributions, the reorganization or winding-up of the enterprise, and electing the auditor or audit committee[8]. In a JSC the election/termination of the members of the executive management board may be delegated by the charter to the supervisory board[9].

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[1] Partnerships, collectives etc. are not dealt with by this paper

[2] *Civil Code*, 2000, Art. 107.3; law *On Joint-Stock Companies*, 1994, Art. 22

[3] Law *On Limited Liability Enterprises* 1998, Art. 37, 38

[4] Arts. 28-39, 48 (the last of these dealing with audits)

[5] Arts. 87-96

[6] *Civil Code*, 2000, Arts. 98-108. In addition, Arts. 120-128 deal with accounting aspects of legal entities.

[7] Arts. 21-23

[8] *Civil Code*, 2000, Art. 91.3, 107.1

[9] *Civil Code*, 2000, Art. 107.1.3

Directors' duties

As the term 'director' is not defined, it is hard to deduce what a director's duties are. Penalties (civil and criminal) are levied on officers for not fulfilling their duties or doing so inadequately. In the vast majority of cases, these penalties are applied to the managing director or, where the matter relates to an accounting or tax offence, the chief accountant. The *Civil Code* 2000 essentially leaves it to the charter (constituting documents) of each company to establish the duties of the directors (though reserving to the general meeting some major matters such as changes to the charter, increase in charter capital, approval of a reorganisation or winding-up of the company, approval of annual statements and the distribution of profits, election of the supervisory board and finance/audit committee, appointment of an external auditor[10]).

The members of the supervisory board of a bank also have certain additional powers e.g. to establish an interest policy, approve unsecured loans above a certain limit, etc[11].

The management board of a JSC must, in theory, provide background information relating to any general meeting agenda item not less than in a prescribed period before the meeting. However, whilst at first sight this seems an enlightened provision, in fact too many pre-conditions make it ineffective: the information must be provided 'in the form prescribed in the charter' (taking no account of what will happen if the charter is silent); a shareholder must request the information (so most boards will provide no information at all); and it is not clear if the information must be provided to all shareholders or, as is the most likely interpretation, just to the shareholder requesting the information. Similar provisions (and pre-conditions) exist with respect to information requests relating to the activity of the company, reports of the supervisory and management boards and, vaguely and unhelpfully, 'other necessary information'[12].

Independence of the Board

Supervisory board members, elected by a general meeting, are, in theory, independent from management and from the audit committee. A supervisory board director may not be a 'representative' of a subsidiary, a public official, in-house legal counsel, a member of the finance/audit committee or a member of the management board[13]. However, the State has the right to appoint board members where it owns at least 25.5% of an enterprise following privatisation[14].

A supervisory board member of a bank may not be a supervisory board member of more than one other company or a supervisory board member or employee of another bank. A member of a bank's management board may not also be a member of the management board of another company, a close relative of another member of the management board or a public employee[15].

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[10] *Civil Code*, 2000, Arts. 91.3, 107.1,126.4

[11] Law *On Banks and Banking*, 1996, Arts. 23

[12] Law *On Joint-Stock Companies*, 1994, Art. 13

[13] Law *On Joint-Stock Companies*, 1994, Arts. 22-24

[14] Law *On the Privatisation of State Property*, 2000, Art. 7; Resolution of the Cabinet of Ministers No. 92, 10 May, 2001, *On Approving the Participation of Representatives of the State in the Management Bodies of Joint-Stock Companies Established on the Basis of State Enterprises where the State Continues to Own a Controlling or Blocking Share*, Art. 2 which delegates the responsibility of appointing the representative to the Ministry of Economic Development; see also Statute *On the Reorganisation of State Enterprises into Joint-Stock Companies*, 1996, sec. 7.11

[15] Law *On Banks and Banking*, 1996, Arts. 23, 25

No restriction is imposed by law on the length of the term of a member of the supervisory board. However, as far as executive management in LLEs is concerned, members are elected at the general meeting of participants for a period not exceeding 4 years[16].

Management of both LLEs and JSCs may be collegiate, in the form of an executive management board, and/or it may consist of one person, who may be independent of the owners or a representative of (one or more of) the owners[17].

Appointment of the executive management board is made by the participants/shareholders in general meeting except that, in a JSC, this aspect may be delegated to the supervisory board[18].

Directors' qualifications

Other than for banks and insurance companies, neither a director of the supervisory board nor an executive manager need possess any special qualification nor does a prior criminal record disqualify him from such a position.

1. Finance/Audit committee and external auditors

JSCs are required to have a finance/audit committee that is independent of its supervisory and management boards. The committee audits the financial statement of the company and the shareholders may not approve the financial statements unless the committee has expressed an opinion on them[19]. A JSC-O must have an external auditor (independent of the company or its shareholders) and the audited annual report and balance sheet must be published for the public record (how this is to be achieved is not specified but it is usually done through publication in a newspaper)[20].

An LLE may have an audit committee (or a sole auditor) but is not required to do so. A founder may be part of the audit committee (but not if s/he is also managing the company) and the management of the company is required to provide information[21]. An LLE is required to appoint an independent external auditor[22].

A legal entity with a balance sheet value of AzM 5 bn or turnover of AzM 2.5 bn must produce a statement of affairs, outlining important transactions during the year and reflecting the business of the company together with, where possible, a prognosis for the coming year[23].

Directors' remuneration

A company with a closing balance sheet value of AzM 5 bn or turnover during the year of AzM 2.5 bn must have its accounts and notes to the accounts audited. The notes must state the compensation received by members of the supervisory board and of management. The provisions here are commendably detailed – the accounts are required to show the total cost of all managerial staff (including insurance premiums) and the remuneration of members of the supervisory board. Payments for professional services provided to the company (including services on behalf of other companies)

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[16] Law *On Limited Liability Enterprises* 1998, Art. 34. There is an argument, however, that the 4-year limitation no longer applies after the introduction of the *Civil Code*

[17] *Civil Code*, 2000, Art. 91.1, 107.4

[18] *Civil Code*, 2000, Art. 91.3, 107.1.3

[19] Law *On Joint-Stock Companies*, 1994, Art. 24

[20] *Civil Code*, 2000, Art. 99.2, 107.6

[21] Law *On Limited Liability Enterprises* 1998, Art. 39

[22] *Civil Code*, 2000, Art. 91.4

[23] *Civil Code*, 2000, Art. 125

by management must be separately identified. Compensation or pensions paid by an associated legal entity must also be shown[24]. It is not, however, clear whether the law requires only the totals to be given or remuneration for each director/executive to be separately itemised.

These provisions could go some way to protecting shareholders from undeclared payments being made to directors and executives. Unfortunately, the provisions seem to be ignored, even by major accounting firms, in the conduct of audits.

General meetings

LLEs are required to hold an annual general meeting within 4 months of the end of the year[25]. A special meeting of a JSC or an LLE may be convened upon the requisition of shareholders representing at least 10% of votes[26]. Certain powers are reserved exclusively to the general meeting of shareholders in both LLEs and JSCs (see above)[27].

In a JSC, the management board should provide shareholders with a report on the affairs of the company as well as with reports of the management and supervisory boards[28].

Restrictions on effective corporate governance

In the context of a well-developed legal system, the absence of detailed provisions about corporate governance might be thought to be advantageous. This provides a great deal of flexibility to the founders of a company to have the form of corporate governance that permits effective management. However, in the CIS, where judicial review and enforceable remedies do not normally favour the small shareholder, perhaps greater prescription, or at least recommendation, would be helpful. Nonetheless, some of the greatest problems associated with corporate governance are caused by poor drafting of the limited amount of legislation that we have.

A classic example of this is the quorum provision of the law *On Joint-Stock Companies* 1994 that states that a general meeting is quorate where at least 60% of shareholders with voting rights are present (Article 21.1). This has proved a significant hindrance both to effective corporate governance of JSCs and to the process of privatization.

Conflicts of interest

In an LLE, management may not enter into transactions (including loans) with the enterprise for personal gain unless consent is obtained in a general meeting. The receipt of commissions from, or acting on behalf of or in the interests of a third party in relation to the LLE is prohibited. Carrying on business in competition with the enterprise is also prohibited. The charter may impose other restrictions[29] but no special conflict of interest protection is provided for shareholders of JSCs – there are no requirements (other than of the very ill-defined nature referred to in the next section) to disclose transactions with directors.

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[24] *Civil Code*, 2000, Art. 124.3

[25] Law *On Limited Liability Enterprises* 1998, Art. 31

[26] Law *On Joint-Stock Companies*, 1994, Art. 14; law *On Limited Liability Enterprises* 1998, Art. 32.2

[27] *Civil Code*, 2000, Arts. 91.3, 107.1,126.4

[28] Law *On Joint-Stock Companies*, 1994, Art. 13

[29] Law *On Limited Liability Enterprises* 1998, Art. 36

Disclosure of shareholders

Companies which are required to produce notes to their accounts (see above) must reveal in those notes shareholdings in excess of 25% and whether any 'connected person' (a term which is undefined) together hold more than 25%. The notes should also show legal and economic links with other companies and significant business transactions with such companies[30].

On the face of it, this is a broad all-encompassing provision that should force full disclosure. However, the very breadth of the provision means that it is hardly, if ever, complied with. And, in any event, the law permits an enterprise not to report such information if it is of a confidential nature or might, if revealed, cause damage. No qualification is made or any definition given of 'damage' so any enterprise appears free to avoid applying it by invoking confidentiality[31].

Conclusion

The overall residual impression of the law relating to corporate governance in Azerbaijan is that intentions have clearly been good. However, the practice is patchy to say the least and there is no evidence that the law is enforced – some of the biggest culprits appear to be state-owned enterprises.

Good corporate governance ultimately depends on trustworthy, ethical directors, which is not something that can readily be legislated for. However, three matters are nonetheless critical for aiding good corporate governance:

1. Clear definitions and guidance as to directors' duties and procedures for performance. The situation would be helped if, where the law lacks definition or is vague, to rectify this by more acceptable legislative drafting. Though the law in Azerbaijan is admirably flexible in that it is not overly prescriptive, it unfortunately leaves it to companies to adopt rules without guidance as to what is good practice (something similar to Table A of the English Companies Act would have been helpful).

2. Disclosure: good corporate governance must be seen to be practised, which is best done through good disclosure standards. The Civil Code prescribes some very good requirements but fails to enforce these or have any effective enforcement mechanism. Furthermore, although the Code sets out disclosure requirements for remuneration, it does not require specific disclosure of transactions with directors or companies of the directors are shareholders.

3. Good company secretarial practice: much of what constitutes good governance involves close adherence to procedures. This has been alluded to in point 1. above. However, having good procedures laid down in law is not in itself sufficient. A company, particularly a larger one or one with more than a handful of shareholders but also a closely held company, needs to follow corporate procedures laid down, for example, for calling board/shareholder meetings, circulating notices/agendas, doing so in good time, minuting resolutions etc. This is best handled through a formal company secretariat that can be held accountable for failure of procedure. Azerbaijan's laws make no reference to company secretariats, which is a major failure of legislative drafting.

[30] *Civil Code*, 2000, 124.4

[31] *Civil Code*, 2000, 124.5