DEVELOPMENT OF CORPORATE GOVERNANCE
UNDER THE PRIVATIZATION PROCESS IN MONTENEGRO

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1. Introduction

Through privatization ownership and rights are transferred, but not (i) the ways of using these rights, (ii) behaviors that follows transferred rights and (iii) the responsibility. That is the reason why transfer of ownership rights must be followed by development of the new market institutions that can ensure existence of transparency, security and transferability.

No one separate issue of transition has become so discussed by the theoreticians of economic science and creators of economic policy than issue of corporative governance. Transit from planned to market economy cannot be accomplished by universal recipe. But, at the same time, there are nowhere more options than in the case of corporate governance. In western countries foundation and evolution of corporative governance were less spontaneous reactions to market development. In economies in transition corporate governance is necessary in order to stimulate market development. But, not only corporate governance is essential for transition economies, but also economies in transition are of the essence for corporate governance.¹

2. Background Information About the Privatization Process in Montenegro

Privatization in Montenegro began in 1989. under the ex-Yugoslav Law on Social Capital. Inside privatization was dominant type of privatization, but ideological campaign against privatization disabled enforcement of this law in Montenegro (except in few companies).² Montenegrin legislation (Law on Property and Management Transformation) was accepted by the Parliament in 1992. According to this Law, all companies were obligated to go public (and to become corporations), to estimate the value of capital and to define ownership structure. Three governmental funds become owner of the 60% of the estimated capital and workers become owners of the remaining 40%. In June 1996. Privatization Law focusing on the privatization of state capital in the public companies was accepted by the Parliament. The model defined by the law was mass voucher privatization (distribution of shares to all-mature citizens for free). In 1996 two decrees were accepted: Decree on Central Depository Agency and Decree on Privatization Coupons.³


During 2000 several system laws were adopted, such as: Security Law, Law on Banks, Central Bank Law, Foreign Investment Law. At the moment several laws related to the fiscal reform are in procedure of adoption, as well as Enterprise Law, Bankruptcy Law and Public

¹ Colin Mayer, Corporate governance in market and transitional economies
² At first multi-parliament elections in Montenegro the Communist Party won and that was the only Republic from Former Yugoslavia where communists nominally stayed at power.
Procurement Law. Still non-solved issues are: (i) Restitution; (ii) Protection of Minority Owners and (iii) Free Competition Law.

One of the key problems of Montenegrin privatization is how to transit from closed and distributive model of privatization to open and more marketable one? The following table shows the total capital in Montenegro and method of privatization.

<table>
<thead>
<tr>
<th>Category</th>
<th>Value of capital DEM</th>
<th>% Total capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Already privatized</td>
<td>1,971,566,566</td>
<td>21.65</td>
</tr>
<tr>
<td>For International tenders</td>
<td>3,730,664,224</td>
<td>40.98</td>
</tr>
<tr>
<td>For MVP program</td>
<td>2,463,326,475</td>
<td>27.06</td>
</tr>
<tr>
<td>For batch sale privatization</td>
<td>370,704,920</td>
<td>4.07</td>
</tr>
<tr>
<td>For privatization through auction</td>
<td>282,393,371</td>
<td>3.10</td>
</tr>
<tr>
<td>For privatization through insolvency</td>
<td>286,016,791</td>
<td>3.14</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>9,104,672,367</strong></td>
<td><strong>100.00 %</strong></td>
</tr>
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Key principle of the privatization process in Montenegro is privatization through development of the entrepreneurship. That means privatization through new ideas, new management, new products, new market, new organization, and new way of thinking!

3. Market and normative frame as a mechanism of pressure on corporations

Corporate governance is one of the basic elements of market mechanism based on competition. It is directly leans on democracy development and rule of law. Corporate governance depends of cooperation between private and public sector that want to accomplish two aims: competitive market system and democratic society that is based on the rule of law. This is not only relevant for developing countries; it is a universal issue that impacts the openness, credibility and values of one society. Corporative governance depends directly of reliable legal system and norms of business behavior. In this moment in Montenegro, the legal system is improving. Of course, there are a lot of problems, because there still exists the remains of communist thinking. At the same time, standards of business behavior that are not in high level are being development.

The main paradox within the countries in transition, and Montenegro is not the exception, is at the same time basic systematic barrier towards the economic transformation – the most important aspect of transition towards the spontaneous functioning of economy is not possible to initiate with market powers only. The only strong enough power that can initiate market powers in the countries in the region is the state. But, in many countries of the region economic reforms of late communistic period have taken away significant power to the state.

We tried to build normative system that define rules of behavior, however, experiences of the developed and developing countries undoubtedly show that there isn’t any better control mechanism than market. Market is that sophisticated mechanism that, from several aspects

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5 Ibid: 155.
controls results of corporation activities. Basic characteristic of market is competition. Namely, market economies have on their disposal:

(i) Laws that regulate role and responsibilities of those who are authorized for corporate governance;
(ii) Market of goods and services that threatens the corporation if it is not efficient to sell its products and services;
(iii) Financial market that enables owners who are not satisfied with work of corporation to sell their shares;
(iv) Constant threats from investor takeover;

That is the reason why the primary task of all reforms is to found and develop market based on free competition!

Practical influence of legal regulations doesn’t depend on what is the subject of regulation, but on the things that can be put on. Problem of the approach basically comes to whether the law should prohibit or issue rules. If we do not have infrastructure that needs to insure that law will be on power, legal regulation is of very small security to owners.\(^6\) Why? Market of goods and services creates pressure only if there is competition. Financial market makes pressure on managers only if it is easy for unsatisfied owners to sell their shares on stock exchange. Investment market creates pressure only if it is easy for investors to take over corporation. Do we have an infrastructure that secures implementation of this system? At this moment infrastructure in Montenegro is building itself, and corporate governance is becoming more and more an important issue. This means that institutions, mechanisms but also the people are important for the process itself.

How to develop mechanisms? The answer is not simple, and it is determined by four elements:

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(i) Transparency – it is not anything new when we say that owners elect directors. Directors represent interest of the owners. At the same time directors make decisions about key problems. Way of decision-making is very important. If the decisions are made in transparent manner owners will be satisfied, especially regarding decisions about selling part of the assets, increasing or decreasing of capital.

(ii) Accounting standards – and their implementation are very important to the countries in transition. In Montenegro creation of the Accounting Law based on the international accounting standards, is in its final phase and it is planned to be introduced on January 1st of next year. This law, and Enterprise Law will define the precise role of independent auditors as well.

(iii) Implementation of the law – although the creation of the law itself is not an easy job, implementation is even more difficult. These are the laws that go into the change of infrastructure, concept and way of thinking, so their implementation must be based on intensive program of training and public campaign.

(iv) Individual responsibility – maybe the most important element of the new system, that leaves behind a system based on collectivism and goes to decision making in tandem with individual rights and responsibilities.

4. Case study Montenegro or how to protect right of majority owners?

Law about ownership and governing transformation from 1992. enabled significant role of Board of Directors. Owners of the capital (state funds and workers) elect members of the board of directors. State funds as owners didn’t have clear strategy of governance that would present to their representatives on the board of directors. On the other side, representatives of the workers had clear requests that were mostly related to regular salary and it’s incensement. In order to protect their positions, managers often accepted requests of the workers representatives, while the representatives of the state on the board of directors tried to postpone the solution of the problem, instead to formulate strategy for problem solving. Basic problem was that problem solving meant interfering with existing structures and relations, and creation of new ones.

Mentioned law created paradox in sense of corporate governance. Let’s take typical scheme of transformation for example. Namely, workers employed in economy received 10% of the shares for free. At the same time, they received rights to buy 30% of the shares with discount plus 1% for every year of working experience. Regardless the fact that very small number of workers decided to start with payments of shares with discount, workers realized their right to govern on the basis of the sum of shares that are undoubtedly their ownership and shares that they had right to buy, but were not yet their ownership (that means, total of 40%). The point of this is that interests of the majority owners were endanger, because not one individual shareholder didn’t have that right. Development fund had 36%, Pension Fund had 18%, and Employment Fund had 6%. This means that problem that was generated by this way of transformation of enterprises was how to protect rights of majority shareholders?

This structure of ownership put funds on one side and workers on the other side. Interests of state funds could be (and were) different. But, in almost every case representative of the funds had to be very careful with representatives of the workers because workers in their portfolio had starting advantage of 30% of shares. Law made possible conversion of shares with discount into free shares (proportion 3 for 1 free share), but this didn’t have time frame. What does this means? This means that workers can still have right to 30% of shares with discount.
At this moment program of mass voucher privatization is implementing in Montenegro. All citizens over 18 years received vouchers (about 2/3 of total number of citizens of Montenegro). Vouchers are exchanged for shares of Development Fund. With this system Montenegro definitely goes into the group of states that paid significant attention to its workers. Why? Because workers received benefits on three basis: (i) free shares in their enterprise – 10%, (ii) shares with discount – 30%, (iii) vouchers that can separately invest into their firm. This means that workers will still have starting advantage of 30% compared with other owners. In case that position of Development fund take privatization investment funds (PIF), the problem still remains.

These conditions do not seem to be very attractive for investments (not to domestic or foreign investors). Logic of buying the social peace is surpassed logic of business. Social issues are not to be solved without sound economic basis. On this way, social aspect of transition became big barrier for economic aspect, and economic aspect defines future development. That is why model of mass voucher privatization was supplemented with two models: batch sale and international tender. They included mostly big firms which shares potentially can be vary fast on the stock exchange and where share of the workers capital is much smaller, which gives opportunity to potential investors. In these enterprises it possible to answer common question: how to protect rights of minority shareholders?

5. Creation of new institutions predicted by law in Montenegro

Creation of new institutions that are capable to deal with financing, monitoring and controlling of enterprises is precondition of successful development of economy in transition. Without them, corporate sector will not be established. Basic issues that are emerging are: (i) how to establish institutions, (ii) which reforms are necessary to perform in existing institutions, and (iii) which model of corporate governance and control would best suit transition of Montenegrin economy. There are several different mechanisms that are in practice in market economy conditions. These mechanisms are planed by new Enterprise Law and Securities Law and include: (1) protection of ownership rights, (2) board of directors, (3) corporation takeover, (4) proxy and (5) liquidation.

- **Protection of Shareholders’ Rights** - In the mass voucher privatization dominated by insiders, who are in a much better position to exercise their shareholders rights than outsiders, the problem becomes even more complicated. Laws provide the same rights to all shareholders but *de facto* shareholders are in a very different position in such companies. Therefore the only long-term solution is transformation of the quasi public companies into private or public companies.

It is expected that 1/3 to 1/2 citizens will transfer vouchers to firms, and the rest will be transferred to funds. Question of rights of shareholders in Montenegro, especially in those firms that are in the list for mass voucher privatization, includes solving of 30% shares that were ownership of the workers but are not yet paid off. Right to decision making is derived from ownership right, not from potential right to ownership, especially when that

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7 In large number of countries only with few enterprises is traded on stock exchange (in UK there are 2,000, in USA 6,000, in Germany only 650 and in France 440 companies are traded on stockexchange).

8 Domestic and experts of USAID worked on creation of these laws.
potential right is not timely limited. Another problem is related to judiciary that still reacts very slowly on problematic issues that are generated from the debtor-creditor relations. Solving the issues of ownership rights, and all other rights that are generated from ownership rights in this moment gains priority in further transition in Montenegro. Why? Because in this way we build a system in which investors (domestic and foreign) have trust.

- **Board of directors** are most direct way of corporate governance. That’s why the question of electing members on to board of directors is very important. Montenegrin firms have to be reconstructed in order to be profitable, and a lot of questions that are related to members of the board of directors will arise: insiders vs. outsiders, question of conflict of interests, misuse of information, etc. Generally, successful functioning of the board means solving the problem of corporation without transferring responsibilities to other mechanisms of governance. People with managerial skills are in deficit in Montenegro. This can potentially make conflict between owners and managers, mostly related to expectations of the results.

- **Quorum** – From different reasons (lack of education, political reasons etc) it is evident that one part of the population will not participate in the process of mass voucher privatization, so they can make some obstructions in the period after the finishing of auction\(^9\) when it would be necessary to call assembly of the shareholder company. In the process of finding a solution it was our attempt to avoid a situation where, because of absence of shareholders that do not want to participate in decision making process, that means that they do not want to use right that is theirs on the basis of shares ownership (and they don’t want to sell those shares) it is not possible to have session of the assembly. Therefore, the proposed law gives three possibilities for the assembly session.\(^10\)

- **Corporation take over** – Take over happens when potential buyers think that unsuccessful activities of the enterprise are more consequence of bad decisions of the managers that it is the result of bad business circumstances. Many people

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\(^9\) Different from the other countries that implemented mass voucher privatization, Montenegro has only one auction.

\(^10\) Article 30: A quorum at a general meeting shall consist of shares representing at least half of the total voting shares, either in person, or by proxy. If this meeting does not attain the required quorum, a repeat meeting may be called within 30 days of the original meeting, at which the quorum shall consist of shares representing at least thirty three percent of total voting shares, either in person, or by proxy. If the repeat meeting does not attain the required quorum, a third meeting may be called within 30 days of the repeat meeting at which no quorum is required, and the meeting shall have the right to adopt resolutions on all the items of the agenda irrespective of the number of shares represented. If the consent of shareholders holding shares of a certain class is necessary for the adoption of a resolution, the decision may be adopted by the shareholders of the respective class, provided that the meeting is attended by shareholders who hold more than half of the shares of said class. The procedure for calling a general meeting shall be valid for convening the repeat meeting. Notice of any repeat meeting must be given in the manner prescribed in Article 31 except that only 10 days notice is required.
see takeover as a means that provides respect of the interest of the shareholders from the side of management.\textsuperscript{11}

- **Proxy** – Interested sides can vote that they do not trust existing management. Every share counts for one vote, and shareholder can transfer right to vote in his name (proxy) to another person. The optimal solution for the period of process of privatization and certain time after that in the first phase of the post privatization period is direct voting of the owners of the shares. This is not possible all the time, it is necessary to determine the question of proxy so that it is clear, transparent and easy to transfer rights to decide the persons who are authorized by owners of the shares.\textsuperscript{12}

- **Liquidation** – Investors are capable to control behavior of corporation through possibility of bankruptcy. As long as corporations regularly payoff capital and interests, control of activities is in the hands of shareholders and management. But, if the company cannot answer to its entire obligation, control goes into hands of creditors. Insolvency is not the best possible way of control. What is important is that mechanism of liquidation is well-known, easy to implement and effective from the standpoint of institutions that are included in the process. The proposal of Bankruptcy Law in Montenegro coordinates this problematic with best practice from the region.

One of the big problems is related to implementation of suggested legal solutions and on public campaign. Concept of ownership rights will certainly have an influence on the speed of acceptance of new rules, but in the situation where there is a high percentage of population that do not have basic knowledge about market functioning, a public campaign has a very important role.

6. What next?

Expectations about fast market discipline and introducement of corporate behavior in Montenegro are much more connected with privatization investment funds, than with individual owners of securities. Whether the funds, as owners, will provide effective control mechanism remains to be seen. It is to early to precisely define interests of funds themselves.


\textsuperscript{12} Article 26. of the Company Law: A shareholder shall have the right to authorize another person to vote for him as his proxy at the general meeting or perform other legal acts. The authorization of a shareholder must be certified. The auditor of the company may not act as proxy. The proxy shall present his authorization at the meeting. The person responsible for recording shall record the proxy in the list of registration at the meeting. When the Republic of Montenegro or a municipality owns shares, the rights of such shares shall be exercised by the authorized official or persons designated to exercise such rights.
Being owner of majority of shares at the same time creates certain problems. If that owner is the only owner in the company, sometimes is very difficult to control and replace him.

Regarding financial institutions, banks, especially new ones, could be in the position to provide financial resources and control of not successful firms. They are the key player of economic development of many economies, and in the absence of efficient securities market, they should play central role in financing and restructuring. Nevertheless, in order to play their role, existing banks must be fundamentally reconstructed themselves. A large number of banks in Montenegro suffer from great loses that are a consequence of their earlier loans. A large part of those loans has lost their meaning, which makes these banks insolvent. Under these circumstances transformation of privatization investment funds into investment funds becomes significant.

Bank restructuring, foundation of investment funds and creation of effective regulation system is essential for the success of this phase of transition process. At the same time, it can be concluded that banks in Montenegro do not have expertise or the experience to actively monitor corporate results. It is questionable if they have a motive. Knowledge in the area of estimation of credit liability and monitoring of loan users are still deficit; ability to estimate corporative results in market ambient is still rare; it is still to be expected the development of managerial capabilities. This means that privatization funds, domestic and foreign investors when talking about large enterprises, can have significant role in further development of knowledge, capabilities and skills.

One of the primarily tasks of further implementation of privatization process should be creation of market structures in which enterprises will function. Restructuring of the economy will provide competition that is as equally important as selection of right governing system.

Reform of government sector in Montenegro (concept of micro state) will encourage domestic and foreign investors. This does not mean that state is disappearing from the scene in the part of implementing reforms in corporative sector, in the sense of creating adequate legal and regulatory environment. Clear rules that protect investor and avoid systematic risk are especially important. Competition on the market of products is essential characteristic of effective systems of corporate governance and good regulation is especially important on those product markets where there is not enough competition.

Regulatory priorities for the development of the transparent and fair market in the framework of mass voucher privatization are:

- Protection of the shareholders rights in the privatized companies. This is essential in mass privatization dominated by insiders.
- Protection of small investors on privatization funds which accumulated most of the vouchers and become most important institutional owner.
- Protection of small shareholders in the ownership consolidations process following mass voucher privatization.
- Protection of investors trading on the public market with shares of public companies.
Literature:

1. Colin Mayer, “Corporative governance in market and transitional economies”
9. John C. Coffee and Jr. Shareholders “*The Strain in the Corporate Web*”