

# **Corporate Governance in Azerbaijan**

## **Research Project**

### **REPORT**

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## **1. Essence and Principles of Corporate Governance**

### **1.1. What is Corporate Governance?**

Economic materials usually provide two explanations for the term “corporate governance.” One understanding is defined as the complex relationship between an organisation and the management activities of a joint stock company. On the other hand, corporate governance is also understood as a system regulating the allocation of rights and responsibilities among various parties (managing board, supervisory board, shareholders and employees, etc.).

The corporate form of business is a relatively new phenomenon that has emerged as the result of an evolutionary process. In legal terms, corporation means an organisation of individual bodies.

Being an economic agent, this organisation has certain rights, privileges and obligations that differ from the individual rights, privileges and obligations of each member of the corporation.

There are four peculiarities of the corporate form of business that are more appealing for investors: independence of the corporation as a legal entity, limited liability of individual investors, the possibility of transferring shares owned by different investors to other individuals and centralised management.

The first two peculiarities differentiate corporate responsibility from the responsibilities of individual members. Something owned by a corporation cannot be owned by its members. Responsibility borne by a corporation cannot be the responsibility of those individuals comprising the corporation.

The level of responsibility held by individual investors is limited to the volume of their share invested in the corporation. Respectively, possible losses cannot exceed the share invested.

The spread of corporate governance as a form of business enables investment risks to be diversified for investors. Thus, these individuals are capable of being party to a number of companies at the same time “without placing all of their eggs in a single basket,” meaning without spending all of their money in a single organisation.

Consequently, corporations currently gain their required financial resources on a wider economic scale. They can assume a level of risk beyond the capacity of each individual investor.

Some researchers approach corporate governance as foreign investors obtaining assurances from managers regarding proceeds to be received from invested capital. Finally, in broader terms, corporate governance means an interest record and protection system for investments directed by financial and non-financial investors to corporate activities.

Non-financial investors include service providers (with a specific corporate habit), consignors (providing a corporation with particular equipment) and local governments (representatives associated with taxes and infrastructure)<sup>1</sup>.

Based on the maintained level of access to information and indicators characterising the enterprise, corporate managers are split into two groups: outsiders and insiders. The general meeting of shareholders is used as a means to equalise their capacities. In this way, the outsiders obtain the opportunity to directly monitor corporate activities, as well as participate in discussions concerning future corporate plans. In a word, all issues included in the fate of the corporation as well as the adoption of management decisions fall under their discretion.

## **1.2. Principles of Corporate Governance**

The effectiveness of the accepted model for the joint stock company management influences not only shareholder proceeds, but the general interests associated with company activities.

Therefore, the status of corporate governance standards is not only considered to be an internal affair within individual companies, but also as an important factor affecting the investment environment in the country.

Under current conditions of globalisation, corporate governance methods must be persuasive, clear and understandable not only to nationals, but also to citizens of foreign countries.

As is well known, the member countries of the Organisation for Economic Cooperation and Development (OECD) developed corporate governance principles in 1999. These principles represent a model collection of standards and regulations (principles) aimed at providing assistance to governments of OECD member and non-member countries to assess and improve the legal, institutional and regulatory structure of corporate governance. This collection of principles should be used as a basis for developing a model of corporate governance and the Code of Corporate Conduct in Azerbaijan.

## **2. Corporate Governance Models: International Practice**

Differences between various management systems primarily lead to the concept of a system aimed at insiders and outsiders. Firstly, this allows company shares to be concentrated in the hands of small investors. The means for controlling company activities belong to insiders and, at the same time, winning, procurement and competition for power of attorney and other similar internal management systems play no role.

Control over company activities by insiders is limited to company expansion. This provides other interested parties (i.e. shareholders and employee minority representatives) with the power of substitution. Capital is implemented by shareholders indirectly by means of capital markets. Independent directors, bankruptcy and competition for power of attorney among outsiders is typical of highly disintegrated companies. The level of control cannot be weakened by taking into account the interests of non-shareholder joint parties.

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<sup>1</sup> Hart O.D. Corporate Governance: Some Theory and Implications. *The Economic Journal*, 1995, 105, 140, 430, may p 678-689

Which of these systems is more effective? This is more of an academic question. Insiders are primarily in Europe and Japan, while outsiders have their roots in UK and the USA. These companies prove through their existence that none of these systems has prevailed on the basis of their indicators. In our opinion, the question as to which of these systems is more suitable for transition periods is more interesting.

The following table provides generalised characteristics of the three most widespread models.

**Table**

**Comparative Characteristics of Corporate Governance Models**

<b>English-American Model</b>	<b>Japanese Model</b>	<b>German Model</b>
<b>General Characteristics and Features</b>		
- existence of large number of non-affiliated shareholders; - property dispersal; - preference to financing by shareholders.	- large share of affiliated companies among shareholders; - <b>keiretsu</b> -type cross holdings; - non-formal concentration of property.	- long-term property of banks in corporations; - long-term investments by corporations into their other <b>non-affiliated</b> companies; - formal concentration of property (family control through majority ownership); - bank financing preferred.
<b>Primary Parties</b>		
- management; - directors; - shareholders.  Principle for establishing relationship: <b>power balance</b>	- lead creditor bank and core keiretsu (unofficial control of corporate managers); - affiliated company is corporate shareholder; - managers; - government. Principle for establishing relationship: <b>establishing mutual relationship.</b>	- commercial banks (shareholder and creditors); - corporate shareholders.  Principle for establishing relationship: <b>direct control (realistically) and social partnership (formally)</b>
<b>Primary Shareholders</b>		
- increase of share of non-bank financial institutions and corporations; - liberal share of individual shareholders; - small share of foreign investors.	- increase of share of banks, insurance societies and corporations.	- increase of share of banks, pension funds and corporations; - small share of individual shareholders; - liberal share of foreign investors.
<b>Board(s) of Directors Composition</b>		
- Unitarian Board of Directors include <b>independent</b> directors (tendency towards increase in number).	- Board of Executive Directors includes <b>affiliated persons</b> (executive directors, departmental managers), as well as retired officers; - “outsider” representatives are included in a few cases.	- <b>bicameral</b> management: - executive body (management – corporate officers); - supervisory board (affiliated – independent shareholders and <b>employees</b> ).
<b>Legal and Institutional Frameworks</b>		
<i>In USA:</i> - laws of states; - rights and obligations of corporations, “corporation-shareholder” and “shareholder-shareholder” relationship; <i>In UK:</i> - parliament; - collegium for securities and investments.	- ministries responsible for industry policy; - Securities Department of Ministry of Finance and Stock Exchange Control Committee (imitation of U.S. legal regulation mechanism after war).	<i>On federal level:</i> - joint stock companies, stock exchanges, groups, trade laws, regulations for managing joint stock companies.  <i>On local (“lands”) level:</i> - regulation of exchanges.

<b>Information Disclosure Requirements</b>		
- highly developed harsh and detailed legislation; - financial information submitted quarterly; - personal information on rewards (payments); - information regarding all shareholders having shares in excess of 5%; - significant role of exchanges.	- relatively low rigidity requirements; - financial information submitted for six months; - cumulative information on rewards (payments); - information concerning 10 major shareholders.	- relatively low rigidity requirements; - financial information submitted for six months; - cumulative information on rewards (payments); - information regarding all shareholders with shares exceeding 25%; - information concerning Supervisory Board members and shares not disclosed.
<b>Mechanism for Mutual Relationship Between Parties</b>		
<b>In general:</b> - based on dispersal of ownership and management (control).  <b>In technical terms:</b> - simple and accessible mechanism; - shareholders receive information on general meeting, annual report and voting bulletin via post; - right to vote through power of attorney.	<b>In general:</b> - weak influence of non-independent (non-affiliated) shareholders on corporate activities due to specific composition of shareholders; - voting problems of foreign shareholders and institutional investors.  <b>In technical terms:</b> - simple mechanism; - accessibility of annual reports and meeting materials for all shareholders; - right to vote through power of attorney.	<b>In general:</b> - dispersal of control and management (bicameral board). legislation allows: - - <b>limitation</b> of shareholder rights during voting (number of votes may be less than number of shares); - regulations (provisions) for shareholder proposals profoundly developed (intended for small investors). <b>Impediments:</b> - most of shares are of “due bearer” type (not registered); therefore, documents sent to shareholders are first provided to depositary bank, which delivers them to shareholders; - one should either attend a meeting or be represented by his/her depositary.
<b>Actions of a Corporation to Obtain Concurrence of Shareholders</b>		
<b>Mandatory:</b> - election of directors and assignment of auditors, as well as options, reorganisation, merger and controlling block of share- purchasing plan; - right to business proposals. <i>In UK also:</i> - size of dividends.	<b>Usually:</b> - payment of dividends, allocation of funds, Board of Directors elections and assignment of auditors, as well as capital change, amendments to articles of association, funds paid to directors and auditors when resigned, top limit of payments to be made to directors and auditors. <i>Since 1981 also:</i> - right to business proposals (commercial code), however, not encouraged.	<b>Usually:</b> - payment of dividends, allocation of funds, supervisory board elections and assignment of auditors, ratifications of executive body and supervisory board resolutions for a fiscal year, as well as capital change, amendment to articles of association, mergers, top limit of payments; - right to proposals is commonly used.

**Source:** Радыгин А. Д. Регулирование норм корпоративного управления в России и ЕС: ограничения, возможности и перспективы унификации. (Radygin A. D. Regulation of Corporate Governance Standards in Russian and EC: Limitations, Opportunities and Unification Perspectives) Экономика переходного периода. Сборник избранных работ. 1999-2002. ИГПП, М., 2003, 960 с. (стр.831-833) (Economics of Transit Period. Collection of Selected Works. 1999-2002. IGPP, M.m 2003, 960 p. (pp 831-833))

### **3. Corporate Governance in Azerbaijan: Evolution Characteristics and Problems**

#### **3.1. Evolution Characteristics of Joint Stock Companies in Azerbaijan**

Based on Article 98.6 of the Civil Code of the Azerbaijan Republic, the legal status of a joint stock company is determined according to this code. It should be noted that there are numerous

provisions in the Law on Joint Stock Companies that do not contradict the standards specified in the code regarding joint stock companies. These provisions remain in legal force. Therefore, references will be made as necessary to sections not contradicting the code due to the significant regulatory role of this law in company activities.

According to the code, any company with authorised capital allocated for a certain quantity of shares with the objective of gaining profit will be considered to be a joint stock company. Company shareholders are not responsible for its obligations and only bear risks for damages associated with company activities to the extent of the value of their shares.

As is evident, the primary feature making a joint stock company different from other corporate bodies is the allocation of its authorised capital to certain shares. Based on applicable legislative acts, all commercial entities have authorised capital.

However, only joint stock companies have capital composed of shares. It is no coincidence that the right to issue shares is granted only to joint stock companies based on legislation.

One of the primary features characterising a joint stock company is that it can only formalise the rights of its members through shares. Shareholders may leave the company through the transfer, sale or alienation of his/her shares in another manner. This means that claiming property relevant to their share in the company is unjustified.

Based on Article 99.1 of the Civil Code, when parties of a joint stock company alienate their shares without the consent of the other shareholders, then it is considered to be an **open joint stock company**. Such a joint stock company may implement open subscription to and the free sale of its issued shares.

Based on Article 98.3 of the Civil Code, a joint stock company may be established by forming a new company according to this code or reorganising (merger, split-up, spin-off, transformation) an existing corporate body while considering the regulations/limitations specified in the code.

According to the aforementioned, all joint stock companies currently operating in our country may be conditionally split into **two large groups** based on the way that they have been established:

- Those founded on a common basis;
- Those founded as a result of reorganising enterprises.

It should be noted that a small group of joint stock companies currently operating in our country include companies established on a common basis. These are mainly joint stock commercial banks, some insurance organisations and others.

Founding the first group of joint stock companies is governed by Articles 98.9, 98.10 and 98.11 of the Civil Code, as well as the Law on Joint Stock Companies. One of the interesting points here is the numerical composition of joint stock company founders.

According to Article 98.5 of the Civil Code, a joint stock company may be established by a single body or, in cases where all of the company's shares are obtained by a single shareholder, it may be composed of a single body.

The minimum number of joint stock company founders has been determined differently in similar legislative acts in foreign states.

For example, this indicator may not be less than two persons in Italy, three in Switzerland, five in Germany and Turkey and seven in the UK, France and Japan; in Holland, Sweden, Finland, Russian, Estonia and most states in the USA, a company may be founded by a single individual.

In addition to considering possible cases where joint stock companies are founded by a single body with the purpose of subsequently selling shares (temporarily concentrating all of the shares in the hands of a single body), it should be noted that a company consisting of a single shareholder should be typical for such corporate bodies. This type of situation contradicts the nature of a joint stock company as its essence is supported by principles of collectivity.

As has been noted, the second group of joint stock companies are established as a result of mergers, entries, split-ups, spin-offs or transformations of a corporate body (or bodies) operating in any organisational and legal form. The primary feature of such an establishment is that the founded company is considered to be the legal successor of the corporate body (or bodies).

It should be noted that the absolute majority of existing joint stock companies in our republic have been established as a result of the reorganisation of state-owned enterprises.

According to Article 98.8 of the Civil Code, when privatising state-owned enterprises, particularities of establishing joint stock companies are specified by legislation related to the privatisation of the enterprise. Establishing companies in such a manner is governed by the Regulations on Reorganisation of State-Owned Enterprises into Joint Stock Companies approved by the law of the Azerbaijan Republic dated November 29, 1996.

According to this act, even if a decision on reorganisation has been made by the President of the Azerbaijan Republic or Ministry of Economic Development (previously, State Property Ministry), the latter always acts as a founder.

The possibility of establishing joint stock companies has also been provided for in Article 88.1 of the Civil Code. In accordance with the requirements of the article, the number of parties of a limited liability company cannot exceed the limit specified by legislation. Otherwise, it is reorganised into a joint stock company within a year. Moreover, if the number of parties has not been reduced to the limit specified by legislation, it faces liquidation on a court basis.

### **Joint Stock Companies Established on the Basis of Large and Medium Sized Enterprises**

	1997	1998	1999	2000	2001	2002	2003	2004	Total
Subtotal	407	547	111	104	220	97	40	10	1536
Volume of authorized capital, bln AzM	1015.8	924.7	1087.9	393.5	1805.7	103.7	46.5	x	

**Source:** State Statistics Committee and Ministry of Economic Development

Joint stock companies established as a result of the reorganisation of state enterprises may also be split into two groups:

- Enterprises whose shares are completely held by the state despite having been reorganised into a joint stock company; in other words, government corporations. These include joint stock companies such as Azerenerji, Azersu, Azerigaz, Aznefkimyamash, etc.;
- Wholly or partially privatised enterprises whose shares were put up for sale on a privatisation basis after having been reorganised into a joint stock company.

As noted, medium and large scale state enterprises are privatised by being reorganised into joint stock companies. In this case, part of these enterprises is privatised under individual projects and through investment competitions in accordance with Sections 4.1 and 4.5 of the Second State Programme. Besides enterprises being privatised in these ways, shares of other small and large scale enterprises are sold according to the following proportion:

- a) 15% - Directed to concessional sale for labour collective;
- b) 30% - Directed to cash auction;
- c) 55% - Directed to specialised voucher auctions.

Points attracting attention during the establishment of joint stock companies on the basis of privatisation:

1. Due to the implementation of privatisation by allocating privatisation vouchers among the public, the shares have been allocated to thousands of small investors.
2. Using various legal and illegal methods, company managers have succeeded in obtaining large volumes of shares enabling them to control the activities of their organisation.
3. The majority of small shareholders have half-forcibly and half-willingly sold their shares at trifling prices to holders of large blocks of share.
4. In most cases, investors show no interest in shares put up at cash auctions. These parts of shares remain wholly or partially with the state, etc.

Research has revealed that a portion of the share of 970 enterprises privatised in 1997 to 2000 remained with the state for various reasons. It became known that 25 to 30 percent of the share of 212 enterprises (22 percent of all enterprises), 30 to 35 percent of 563 enterprises (58 percent) and 20 to 25 percent of 31 enterprises (4 percent) have remained at the state's disposal.

In other words, investors have not taken interest in obtaining these shares. This means that 20 to 35 percent of the shares of 83 percent of joint stock companies established through privatisation during that period have remained with the state. The shares of 94 of these enterprises have practically not been sold.

As a result, a particular property structure has been generated in Azerbaijan. Thus, the decisive block of shares is owned by corporate managers. Small blocks are owned by employees.

Although the state holds a sufficiently large block of shares in joint stock companies, this ownership is formal and agencies managing state-owned property do not actually interfere with their activities. Instead, these shares are managed according to the will of large shareholders with a major portion of the shares. The property rights of shareholders with small portions of the shares, as well as their rights in all areas related to social activities, are violated. It becomes almost impossible for outside investors to obtain shares. Accordingly, shareholder capital becomes "concentrated." This is also confirmed by the outcome of an opinion survey conducted among managers of 120 joint stock companies.

It becomes obvious from the responses provided to the question, *What portion of company shares has been concentrated in the hands of shareholders?*, that up to 50 percent of shares at 24 companies (20 percent), up to 80 percent at 83 companies (69.2 percent) and more than 80

percent of all shares at the rest of the 13 companies (10.8 percent) have been concentrated in the hands of a single body. More than half of the shares at 93 (80 percent) of the 120 enterprises involved in the survey have been bought by a single investor.

In such situations, the unanimous response of five individuals on the managing board to the question, *How many persons does the managing board of a joint stock company include?*, arouses interest. This is because it is obvious that both the managing board and supervisory board at these companies are formal entities.

In response to the question, *Are there cases when shares held by small shareholders are sold?*, 58.3 percent (70 persons) of those questioned provided positive responses, while 19.2 percent (23 persons) of the answers were negative. 22.5 percent (27 persons) of the respondents answered, *I do not know*. The frankness of this response is clear as there is no doubt that a person managing a company has exact information in this regard. The same is seen regarding answers to the question, *Who obtains the shares of small shareholders?*, as 50 managers (41.7 percent) responded that they do not know who obtains the shares sold.

In response to the question, *Do outside individuals show interest in company shares?*, 45 respondents (37.5 percent) answered *yes*. 36 respondents (30 percent) answered *no*. The remaining 39 respondents said, *I do not know*.

Responses provided to the question, *Are you interested in increasing the number of shareholders and arranging mass share sales?*, demonstrate the level to which individuals are prepared, particularly businessmen in our country, to corporate activities.

Only 28 (23.3 percent) of 120 persons said that they were willing. The remaining 92 persons (76 -- *no* and 16 -- *I do not know*) directly or indirectly noted that they were not at all interested. The logical deduction from the answers to this question is demonstrated in the responses to the question, *Is the company preparing to issue additional shares?*, to which only nine persons (7.5 percent) responded positively. 92 persons (76.7 percent) said that they were not preparing to issue additional shares and the remaining 19 persons (15.8 percent) provided indefinite answers.

It is seen from the survey question, *Are the company's shares being bought and sold at the stock exchange?*, that the shares of only 25.8 percent (31 entities) of companies have been placed on the stock exchange.

Only 23 respondents (19.2 percent) answered the question, *Were dividends paid to shareholders over recent years?*, that, regardless of the amount, dividends were paid to shareholders. Although 23 persons answered, *I do not know*, it can be stated with absolute certainty that dividends were not paid to shareholders in the remaining 97 companies (80.8 percent), including those 23 persons. This is due to a lack of candour among these 23 persons. The company management definitely knows whether dividends have been paid. They simply stated, *I do not know*, instead of, *no*.

It is seen from the answers to the question, *Have funds been allocated from company profit for production expansion?*, that the situation in more than half of the companies (55.8 percent or 67 companies) involved in the survey is deplorable. Funds have been allocated for production expansion in 32 companies (26.7 percent). The remaining 13 persons partially answered the question, which shows that little funds were allocated for this purpose.



62.5 percent (75 persons) of respondent company managers are pleased with existing laws in this sphere regarding the management of joint stock companies, 30.0 percent (36 persons) are partially satisfied with these laws, while the remaining 19 persons (7.5 percent) are dissatisfied.

Similarly, from the answers to the question, *Are you satisfied with the protection statement for shareholder rights and shareholder participation in the management process in the Law on Joint Stock Companies and actual operating mechanisms?*, it also becomes evident that 62.5 percent of managers are content with the laws and 19.2 percent (23 persons) are dissatisfied. Shareholders with liberal share portions should have provided us with such an answer.

The question, *Are all shareholders able to familiarise themselves with the company's articles associated with you being a shareholder?*, was responded to negatively by 10 persons (8.3 percent).

The question, *Are all shareholders given the opportunity to become familiar with the annual financial statements of the joint stock company?*, was negatively answered by 16 persons (13.3 percent). 22 and 20 persons, respectively, answered, *I do not know*. As is seen, these confirm that the rights of ordinary shareholders are violated.

By generalising the opinions of the survey respondents, we can conclude that a lack of transparency and accountability in the activities of joint stock companies is still a problem.

Thus, the answers of the majority of respondents, which is 100 (83.3 percent) of 120 persons to the question, *Is the closing balance of the joint stock company published in the press?*, was negative. Only 16.7 percent (20 entities) of the companies have published their annual closing balances.

While dealing with the issue, *Whether all information provided for by law related to the company's activities is submitted to state statistical offices*, which is another element of accountability and transparency, it becomes evident that not all companies submit the requested information to statistical offices. This is the case with 34 companies (28.3 percent) of those questioned.

Numerous points in the survey are confirmed by the results of inspections conducted by the State Securities Committee at individual joint stock companies. Thus, according to information received from the SSC, the committee conducted inspections at relevant companies based on letters of complaint concerning the violation of shareholder rights at joint stock companies.

These inspections revealed that a number of requirements of the existing legislation have been violated by company management and general shareholder meetings have not been held. The inspections also identified that, although some joint stock companies had profits against annual returns, dividends have not been paid to shareholders. Based on the requirements of the State Securities Committee, shareholder rights have been restored and these violations have been eliminated.

Conclusion: Overall, the current status in the evolution and management of joint stock companies and corporate governance in Azerbaijan is characterised by the following factors:

#### **1. Aspects Generated from Selected Privatisation Model and Practice:**

- “Inevitable shareholder” syndrome, lack of shareholder knowledge (actually, no knowledge) in economic areas related to the joint stock company and corporate governance;

- During an enterprise's privatisation process, managers obtaining a major portion of shares or individuals interested in the enterprise through corruption and other forms of violations, causing the enterprise to come under their control;
- Mass violation of the rights of shareholders having a small portion of shares due to the numerous gaps and conflicting points in legislation related to protecting the rights of small investors and the management of joint stock companies;
- The half-forceful, half-willing removal of the shares of small shareholders by major shareholders and the concentration of shares;
- Managing companies in accordance with the interests of or directly by the shareholders possessing major portions of shares;
- Formally conducting general company meetings and excluding small shareholders;
- Conflict of interests of major and small shareholders, widespread occurrence of cases where shareholders possessing major portions of shares change the organisational and legal form of the company by liquidating it.

## **2. Factors Related to Legal Environment:**

- Poor development of legislation and normative basis governing the activities of joint stock companies and corporate governance issues;
- Weakness of judicial and legal (control over application and execution of laws) infrastructure due to corruption in the judicial system and law enforcement bodies;
- Unstable system for protecting and enforcing property rights (it has been proved in practice that the weaker the protection of property rights in a country, the wider the occurrence of share concentrations);
- Low level of contract "culture" and discipline.

## **3. Issues Related to Poor Growth of Market Institutions (as well as Infrastructure) and Lag in Reforms:**

- Unavailability of an embodied bankruptcy institution;
- Poor development of securities market and low level of liquidity;
- Recent evolution and poor development of financial institution systems (investment funds, pension funds, etc.);
- Limited financial capacities of joint stock companies and low level of capitalisation;
- Dominant position of major companies, particularly especially large state enterprises and the monopolisation problem;
- Unavailability of a clearly developed and sustainable policy in the reforms area.

## **4. Factors Related to Historical and Cultural Traditions and Level of Socio-Economic Development:**

- Unavailability (or obliteration) of corporate ethics and cultural traditions;
- Lack of modern management skills by those managing the company;
- "Transparency" problem of emitters, as well as company management, etc.

## **4. Improvement Trends for Corporate Governance Practice in Azerbaijan**

Certain progress has been observed over recent years in terms of improving individual trends of organisational and regulatory principles of corporate governance in Azerbaijan, as well as the establishment of an appropriate legislative basis. The Law on Civil Code which protects investment operations, foreign investments, investment funds and the securities market has been adopted. Agreements for the mutual protection and support of investments have been signed with a number of countries. These legislative documents make provisions related to the basic rights of

shareholders, the powers and activities of management bodies at joint stock companies, the principles and rules for disclosing information to shareholders and investors, the issuing of securities and turnover of issued securities and establishment of a securities market and party activities.

Despite the aforementioned, many activities must be conducted to gain the confidence of local and foreign investors in the corporate governance standards applied in Azerbaijan.

The main reasons for the high level of investment risks at Azeri companies are the result of non-compliance between individual areas of legislation governing corporate relationships, the unavailability of financial sanctions applied for legal violations and ambiguity enabling various interpretations of existing legislative norms. Activities have been conducted with the purpose of establishing a universal area regulating the attraction of investment to the Azerbaijan Republic and corporate governance.

The disclosure of information to shareholders and creditors regarding the activities of the Board of Directors and management, as well as reforms in the reporting system, are among the main dictates of the day. According to commonly accepted corporate governance practices, new management mechanisms must be created, the activities of company management bodies improved, mechanisms for estimating market the value of enterprise property and shares advanced, and transparent and coherent criteria established for making agreements larger and more interesting.

#### **4.1. Necessity for Development of Code of Corporate Conduct**

The Code of Corporate Conduct ensures that the parties have a balance of interests in the corporate process and that high ethical standards are complied with during company activities.

The primary objective of such a code is to determine quality corporate governance criteria and corporate governance improvement trends in Azerbaijan. At the same time, the code must provide methodological support to companies whose relevant structural elements of corporate governance and management operations are evolving.

As a rule, in such a code, the attention focuses on realising shareholder rights, the evolution and activities of the Board of Directors, transparency in company activities and information disclosure. The Code of Corporate Conduct is not a collection of directive and normative regulations. It is a proposal that includes rules, principles and standards expressed as norms recommended for implementation.

*Corporate Conduct practice must ensure real opportunities for shareholders to implement their rights.* To that end:

1. Reliable and effective techniques must be ensured to enable shareholders to realise their property rights, as well as freely sell their shares.
2. Shareholders have a right to participate in managing the joint stock company by adopting decisions on important issues related to company activities at general company meetings. The following must be ensured to realise this right:
  - Information on holding general shareholder meetings should provide possibilities for shareholders to prepare for participation;
  - Conditions should be created for shareholders to familiarise themselves with a list of persons having the right to attend the general meeting;

- Venue, date and time of the general meeting should be set in such a manner that they have a real opportunity to attend; no difficulties should be created to prevent shareholders from attending;
  - Shareholder rights related to calling of a general meeting and making proposals for the meeting agenda should not be accompanied by unjustified and inappropriate provisions complicating the process;
  - Each shareholder should have an opportunity to realise his/her right to vote in a manner that is simple and suitable for him/her.
3. Possibility to participate in the joint stock company profit should be ensured. To that end:
    - Transparent and understandable mechanism should be established to determine the amount of dividends and their payment;
    - Sufficient information should be provided to form a precise system for paying dividends and conditions and rules for these payments should be established;
    - Possibilities to confuse shareholders regarding the company's financial status while paying dividends should be eliminated (responsibility for these attempts should be accounted for);
    - Rule should be determined for the payment of dividends to ensure that their purchase is not accompanied by unjustified complications;
    - Implementation of punitive measures for executive bodies should be provided for in cases when announced dividends have been paid untimely or incompletely.
  4. Shareholders should have the right to obtain complete and precise information regarding the company on a regular and timely basis. To realise this right:
    - During preparations for the general shareholder meeting, shareholders should be provided with detailed and comprehensive information on each issue on the agenda;
    - All necessary information for evaluating the results of company activities over a year should be included in an annual report provided to the shareholders;
    - Position for company secretary should be established and his responsibility should be to provide comprehensive information to shareholders about the company on a regular basis.
  5. Shareholders should not abuse their rights. Actions taken by shareholders to cause damage to other shareholders or the company are not allowable.

#### **4.2. Measures for Corporate Governance Information Support**

The transparency and correctness of financial statements are among the main factors determining corporate governance quality.

Most shareholders are forced to use financial (accounting) statements as their main source of financial information. Therefore, financial statements should be developed and submitted while taking into consideration shareholder requirements. Investors making risky capital expenditures are concerned about investments and income gained from investments. They need correct and unbiased information to make decisions on the purchase, sale and storage of securities. At the same time, shareholders are interested in data enabling the company's capacity to be assessed for dividend payment.

In addition, financial statements represent the results of management activities or resources assigned to them. In order to make economic decisions, users (investors, shareholders, etc.) are interested in assessing management activities and responsibilities. These decisions include those related to storage or the sale of shares and other securities, as well as resigning and reassigning management.

It is no secret that the statements made by Azeri enterprises are not satisfactory; most business-related information is kept secret. It can be noted with a high level of probability that the information is incorrect. As a result of the unavailability of precise standards for accounting and financial statements, shareholders not participating directly in the company's management are not able to obtain correct information regarding company activities.

In such cases, executive bodies provide reports only to key shareholders who have a decisive block of shares. Other shareholders are not able to obtain correct information and, as a result, cannot make justified economic decisions. Legislation requires mandatory auditor inspection of annual financial statements, but because the legislation does not provide for responsibilities for infringements, these requirements are not taken into consideration by the management of joint stock companies and other open-type companies.

As a rule, auditor inspections of annual financial statements are formal. The reason for this is that the company management is not interested in clarifying the existing situation and the auditor does not wish to lose his/her client.

On the other hand, in circumstances where accounting and financial statement standards aimed at satisfying investor information demands are not available, even the best auditor service is not capable of providing an opinion representing the company's real status.

In such a situation, instead of fulfilling the duties of an independent arbitrator, the auditors involuntarily become the executors of the will of company managers.

Another point needs to be noted. Company managers in Azerbaijan try to snatch control of the organisation under their leadership rather than attract investments to the company.

Moreover, business and fiscal accounting have been separated in developed countries. This is why the company management is not interested in concealing real profit.

The following are suggested to eliminate the aforesaid problems:

- Accelerate the transition of the financial statements of the Azerbaijan Republic to international standards;
- Define administrative and criminal responsibilities for the non-disclosure of information (concealment of true information);
- Bring company managers who failed to comply with legislative requirements related to auditing annual financial statement to administrative responsibility;
- Bring auditors and auditing organisations who provided incorrect opinions regarding company financial outcomes to administrative and financial responsibility;
- Provide free access to all information regarding the open joint stock company to registered shareholders and to others at an appropriate price.

#### **4.3. Separation of Corporate Dispute from Labour Disputes**

Presenting a corporate dispute as a labour dispute on behalf of a person holding a unified executive body position to snatch corporate control may be a serious legal issue.

For example, a claim may be submitted on behalf of the general director (as an employee) to a district (city) court regarding the restoration of violated labour rights and, according to the court's decision, the resolution made by the general shareholder meeting regarding the resignation of the general director may be cancelled. The court may issue such a decision based on labour legislation.

Such a situation contradicts key legislative principles regarding corporate bodies. In corporate law doctrine, the persons performing the functions of executive bodies are conventionally treated as hired managers promoting the internal investor policy. Labour legislation applies to managers, however, issues related to employment or resignations are governed by corporate legislation.

Based on existing procedural legislation, all cases related to labour disputes are initially referred to district (city) courts. As a result, it is possible that the general director could be forced to resign from his position based on a resolution made by the supreme management body of the corporate entity at a general shareholder meeting. He may appeal to the district (city) court to restore his/her position. Thus, existing legislation does not exclude the appeals of members of executive bodies to district (city) courts regarding labour rights violations.

Appropriate amendments should be made to the labour code and code of civil procedure to resolve the aforesaid problem.

1. Election, assignment to relevant positions, termination of powers of persons included in the company's management bodies should be governed only in accordance with the Civil Code or accordingly adopted legislative acts and organisation's articles of association.
2. Election, assignment to relevant positions, suspension of activities of persons included in the company's management bodies and disputes related to any responsibilities should be referred to a jurisdiction of economic courts. These disputes should be considered in accordance with civil legislation.

#### **4.4. Protection of Shareholder Rights**

The following should be implemented to protect shareholder rights:

1. To guarantee registration of investor's property rights:
  - Develop and approve standard contract conditions with registered shareholders on a legislative basis;
  - Define administrative and criminal responsibility for infringing upon any regulations related to registration.
2. In order to prevent infringements of regulations related to general shareholder meetings:
  - To govern all indefinite issues through legislation (e.g. if when distributing a voting bulletin, the shareholders receive the bulletin after the meeting, this should be interpreted as a serious violation providing the shareholder with the right to leave the company);
  - To empower the State Securities Committee of the Azerbaijan Republic to inspect procedures for disseminating information and publishing resolutions in a manner provided for in legislation related to holding shareholder meetings.
3. Development of legislation on depriving managers of powers, thereby causing damage to the organisation under his/her leadership and its founders.
4. Making amendments to legislation with the purpose of simplifying the general director resigning from his/her position.

#### **4.5. Inclusion of Mandatory Regulation of Corporate Disputes Prior to Court**

Existing procedural legislation enables dishonest parties to corporate relationships with the intent of implementing control over a corporate body by keeping judicial processes a secret from the opposing party. As a result, interested parties are deprived of the opportunity to attend judicial proceedings. In cases where there are court claims, they obtain information after the relevant decision has been made and become effective.

A standard should be included in corporate legislation regarding mandatory prior notification to parties about decisions to appeal to court to prevent such cases. In these cases, shareholders and a joint stock company will have the opportunity to participate in court reviews. According to existing procedural legislation, courts will not review cases until evidence has been submitted confirming the fulfilment of this condition.

#### **4.6. Judicial Remedy for Shareholder Rights**

If at least one disputing party is a physical body without individual owner status, then according to Item 25.1 of the Code of Civil Procedure, disputes arising from civil relations are weighed on a civil basis in district (city) court.

Accordingly, any claims made by physical bodies or shareholders related to protecting their rights are only considered by general jurisdiction courts. The professional level of these courts is relatively low for considering these types of cases.

Thus, economically ineffective conditions are generated. Disputes of economic content with at least one party being a physical body without individual owner status remain beyond the jurisdiction of economic courts.

Accordingly, it is recommended for disputes arising in companies to be referred to economic courts. Otherwise, problems related to the effective resolution of corporate disputes will not be solved. Experience shows that any dispute belonging to this category of cases is eventually associated with the ownership of certain blocks of shares.

At the same time, a programme should be implemented to teach the key concepts of corporate governance to judges as a lack of business experience leads to a literal application of laws.