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PROTECTION OF MINORITY SHAREHOLDERS FROM FINANCIAL TUNNELING: THE CASE OF BOSNIA AND HERZEGOVINA

In this article we examine legal protections against financial tunneling available to minority shareholders in Bosnia and Herzegovina. We analyze legal rules that specifically address the most common forms of financial tunneling in both entities of B&H, their application in practice, and compare them with the adequate protections provided to minority shareholders in comparative laws. Before introducing company law changes in 2008 in Federation of B&H was registered a significant number of cases of joint stock companies delisting and going private. There are indications that those transactions occurred without any compensation given to minority shareholders of those companies. In the article we focus on these cases and use experiences from other transition countries to evaluate the protections offered by entity company laws and propose their future improvements.

Key words: *Minority shareholders. Financial tunneling. Delisting. Preemptive rights.*

1. INTRODUCTION

The development of corporate governance is largely determined by the need to restore investors' confidence in capital markets. Studies have

shown that the nature of corporate governance problem differs significantly in companies that have a controlling shareholder.¹ Bosnia and Herzegovina, as well as other transition economies, is characterized by a relatively high level of ownership concentration, which indicates the presence of the so-called second agency problem i.e. conflict of interest between majority and minority shareholders and the possibility for abuse of minorities' rights.

It is often argued that transition economies should devote more attention to the rules to protect minority shareholders than developed market economies, considering the high ownership concentration and relatively weak non-regulatory restrictions on managers and controlling shareholders, which primarily refers to market efficiency. Unlike the US company law which Black (1990)² marks as "trivial", the shareholders in transition economies in fact have no "exit" option so the law must find separate methods of determining prices for withdrawal from the company.³ There is also the view that corporate law plays a much greater role in transition countries because of its additional educational function.

Substantial expropriation of minority shareholders in those countries was made possible due to the privatization and "imported" regulations that did not correspond to institutional environment of markets in transition. It turned out that some of the problems that led to abuses resulted from the reliance on mechanisms ensuring the implementation of regulations designed for developed economies. Under the conditions of existing great need for protection it is suggested to consider the adoption of mandatory instead of default rules that can be changed by shareholder agreement.⁴ Generally, because of the specific corporate governance issues, it is argued that formal legal rules should not rely on a basis of broad minimum standards, but on binding directives which describe legal behaviour in a simple and clear way.⁵ In particular, the need for strict statutory provisions relating to financial tunneling is highlighted.⁶

¹ L.A. Bebchuk, M.S. Weisbach, "The State of Corporate Governance Research", *The Review of Financial Studies* 3/2010, 948.

² B.S. Black, "Is Corporate Law Trivial?: A Political and Economic Analysis", *Northwestern University Law Review* 84/1990, 542-597.

³ V.A. Atanasov, C.S. Ciccotello, S.B. Gyoshev, "Learning from the General Principles of Company Law for Transition Economies: The Case of Bulgaria", *Journal of Corporation Law* 4/2006, 32, <http://ssrn.com/abstract=770288>, last visited 30 October 2010.

⁴ M. Airaksinen, "Enforcement of Minority Shareholders' Rights", Presentation, OECD/World Bank Corporate Governance Roundtable for Russia, Moscow 2000, 1; G. Avilov *et al.*, "General Principles of Company Law for Transition Economies", *Journal of Corporation Law* 2/1999, 10-11, <http://ssrn.com/abstract=126539>, last visited 30 October 2010.

⁵ U.C. Braendle, J. Noll, "Enlarged EU - Enlarged Corporate Governance? Why Directives Might be More Appropriate for Transition Economies", Research Paper, 2004, <http://ssrn.com/abstract=556703>, last visited 26 November 2009.

⁶ V.A. Atanasov, C.S. Ciccotello, S.B. Gyoshev, 42-43.

Corporate governance system in B&H as a Continental European one is, among other things, characterized by significant ownership concentration⁷, active role of block holders in governing companies, and minor role and importance of capital markets. Illiquid market means less ability to easily exit the investment by selling shares on the stock exchange.⁸ Corporate governance issues specific to transition economies, as recognized by Bobirca and Mićlaus (2007), apply to B&H as well and they involve weak legal system in terms of high court delays and corruption.⁹ The fact of existing immature institutional investors should also be kept in mind.

It is worth noting that in B&H still operate two stock exchanges, one in Sarajevo and the other one in Banjaluka, which organize and supervise trade in securities on the regulated markets, accompanied by two institutions responsible for regulation and supervision of issuances, trade and other operations with securities, securities commissions in FB&H and in RS, which each separately keep registers of issuers. Securities accounts are also kept with the entity registers. Shares of almost all companies are traded on the stock exchanges, but only a small number of them belong to segments of the official stock exchange quotation or market.¹⁰

Analysis of the legal protection of minority shareholders against financial tunneling in Bosnia and Herzegovina will show the current state and indicate what is needed for its improvement. The analysis will focus on the open joint-stock companies of a general type that are listed at the exchange. The reason lies in the fact that these companies must solve the second agency problem i.e. protect their minority shareholders.¹¹

⁷ E. Karić, "Kodeks korporativnog upravljanja SASE – Rezultati istraživanja o stanju korporativnog upravljanja u FBiH", Presentation, 4. Međunarodna konferencija Sarajevske berze 2009, 11-12; Z. Jeftić, "Istraživanje o dostignutom nivou korporativnog upravljanja u Republici Srpskoj", Presentation, III Međunarodna konferencija Banjalučke berze 2008, 6.

⁸ D. Tipurić, *Nadzorni odbor i korporativno upravljanje*, Sinergija, Zagreb 2006, 3 etc.

⁹ A. Bobirca, P.G. Mićlaus, "Extensiveness and Effectiveness of Corporate Governance Regulations in South Eastern Europe", *World Academy of Science, Engineering and Technology* 30/2007, 7-12.

¹⁰ According to data from September and October 2010 only 3 companies and all investment funds were included in the quotation at the SASE, and 42 companies and all investment funds at the BLSE. The shares of all other companies were traded at the open market.

¹¹ C. Loderer, U. Waelchli, "Protecting Minority Shareholders: Listed versus Unlisted Firms", *Financial Management* Spring 2010, 35 etc; International Finance Corporation, *Korporativno upravljanje Priručnik za firme u Bosni i Hercegovini*, IFC Sarajevo, Sarajevo 2009, 20.

2. FINANCIAL TUNNELING AND LEGAL MECHANISMS OF PROTECTION

Different forms of abuse of minority shareholders' rights are known in practice, most of them being covered by the concept of tunneling. Johnson *et al.* (2000) define tunneling in the narrow sense as "the transfer of resources out of a company to its controlling shareholder (who is typically also a top manager)"¹². Typically, two types of tunneling are recognized: operational and financial. The operational tunneling includes self-dealing transactions as real transactions through which controlling shareholder or the manager transfers funds out of the company for his own benefit. A wider taxonomy is proposed by Atanasov, Black and Ciccotello (2011) which further differentiates between cash flow tunneling and asset tunneling.¹³

Financial or equity tunneling implies extracting values through financial transactions affecting ownership rights to the share capital, and not the company operations.¹⁴ Atanasov *et al.* (2010) distinguish between the two main forms of equity tunneling: issuance of shares for the purpose of share dilution and freezing out minority shareholders. The first case refers to the issue of new shares (or securities convertible into shares) to insiders at a price that is below market or fair, while the other refers to forced sale of shares to controlling shareholder also at a below market price.¹⁵

As the prerequisites for share dilution are identified: relatively large issuances, disproportionate involvement of existing shareholders in the offering and the issuance of new shares at a price lower than fair price. The dilution also occurs in cases of exercise of options on shares of a company by the managers when it comes to acquiring shares at a price lower than the market price, assuming large compensation packages. The same effect on company will have buying its own shares at a price above the market. Precisely, loans from the firm to insiders, sales of controlling stakes, repurchases of shares from insiders for more than fair value and some equity based executive compensations also represent forms of equity tunneling.¹⁶ Atanasov *et al.* (2007) prove the relationship between the existence of each of these forms of tunneling and the legal regulation,

¹² S. Johnson *et al.*, "Tunnelling", NBER Working Paper Series, Working Paper w7523, 2000, 2 etc.

¹³ V. Atanasov, B. Black, C.S. Ciccotello, "Law and Tunneling", *Journal of Corporation Law* 1/2011, 3 etc.

¹⁴ *Ibid.*, 9.

¹⁵ V. Atanasov *et al.*, "How Does Law Affect Finance? An Examination of Equity Tunneling in Bulgaria", *Journal of Financial Economics* 1/2010, 1 2.

¹⁶ V. Atanasov, B. Black, C.S. Ciccotello, 2011, 9.

showing complementarities of share dilution control and freezing out minority shareholders.¹⁷

National company laws recognize a series of measures aimed at protecting minority shareholders from abuse by the majority ones. The legal and regulatory framework for corporate governance in B&H should be viewed in context of a specific polity. Corporate governance is in jurisdiction of entities that have their own laws and institutions, which resulted in the establishment of two completely separate regimes. Legal sources that directly or indirectly regulate this area include a series of laws and regulations governing companies, securities and capital markets, accounting and auditing etc.¹⁸ It is important to emphasize that the entity laws on companies differ significantly as regard to the board structures and mechanisms to protect shareholders. Still, one might not talk about the existence of regulatory competition between entities in the area of corporate law, most probably due to the participants' current attitude and understanding the role of corporate governance.

When it comes to the companies in FB&H, it is important to note that according to available data, only one of them issued shares through the public offering, which was carried out with the exclusion of preemptive rights of existing shareholders.¹⁹ In RS several companies raised additional capital for development through a secondary public issue of shares, and the first IPO of shares in B&H was registered.²⁰

On the other hand, a period of two years before the recent legislative changes in FB&H was marked by around 50 requests of joint stock companies to change their organizational form into the limited liability company.²¹ This is considered to be the reason why the amendments to the LoC in 2008 prohibit change in the form of open joint stock company for the purpose of protecting investors and improving corporate governance.

¹⁷ V. Atanasov *et al.*, "How Does Law Affect Finance? An Examination of Financial Tunneling in an Emerging Market", EFA Ljubljana Meetings Paper, 2007, 2, <http://ssrn.com/abstract=902766>, last visited 30 October 2010.

¹⁸ Law on Companies in FB&H (further: LoC FB&H), *Official Gazette of the FB&H*, No. 23/99, 45/00, 2/02, 6/02, 29/03, 68/05, 91/07, 84/08, 88/08, 7/09 and 63/10; Law on Securities Market in FB&H (further: LSM FB&H), *Official Gazette of the FB&H*, No. 85/08; Law on Takeovers (further: LoT FB&H), *Official Gazette of the FB&H*, No. 7/06; Law on Companies in RS (further: LoC RS), *Official Gazette of the RS*, No. 127/08 and 58/09; Law on Securities Market in RS (further: LSM RS), *Official Gazette of the RS*, No. 92/06 and 34/09; Law on Takeovers (further: LoT RS), *Official Gazette of the RS*, No. 65/08 and 92/09.

¹⁹ <http://www.sase.ba/DesktopDefault.aspx?tabid=299>, last visited 27 September 2011.

²⁰ BLSE, "Emisija hartija od vrijednosti", Publication, 2010, 6.

²¹ A. Mujanović, "Krhko dioničarstvo: Kapital vrijedan 12,8 milijardi maraka u rukama 333.036 dioničara", 2009, <http://www.liderpress.hr/bih>, last visited 5 May 2009.

Without intention of entering into the analysis of the effects and justification of such a way of preventing companies' delisting, the view that a form of organization should not be imposed to the business and that it is better to have a smaller number of high quality companies listed at the market than more forcefully present issuers seems reasonable²², what is also confirmed by the experiences of other transition economies. At the same time, and again with the same aim, limited liability companies which meet the criteria for an open joint stock company²³ are required to change the form into a joint stock company, otherwise the competent court issues a decision on their liquidation.

When it comes to experiences of other countries, some significant conclusions on protection of minority shareholders from financial tunneling in specific conditions of a market in transition derive from the case of Bulgaria. New regulations that were introduced in that country brought positive changes while dropping out reliance on market prices, courts and actions of minority shareholders. The first key change considered compulsory creation of warrants when issuing shares, which as long-term call options on the company's shares are publicly traded on the stock exchange. Another key legislative change related to introducing the institute of fair value along with the detailed rules on calculating the selling price at freeze-out tender offer. It is also required that majority of minority shareholders approve the conditions in a mandatory tender offer. The third key change involved the establishment and strengthening of the central regulatory body.²⁴

3. LEGAL PROTECTIONS FROM DILUTIVE EQUITY OFFERINGS IN B&H

Atansov *et al.* (2010)²⁵ classify the rules that seek to limit the dilution of shares into three groups: preemptive rights, rules on the minimum share price during issue and rules on approval of minority shareholders, which is usually required for the larger share issuances or issuances above a certain percentage of share capital.

Preemptive rights are means to protect shareholders from dilution of their rights by issuing shares to favored investors and / or at prices

²² V. Trivun *et al.*, "Izmjene Zakona o privrednim društvima FBiH", VIII Među narodni seminar "Korporativno upravljanje Novosti u međunarodnim standardima, za konodavstvu i praksi Bosne i Hercegovine", Revicon, Dubrovnik 2008, 91

²³ LoC FB&H, Article 107.

²⁴ V.A. Atanasov, C.S. Ciccotello, S.B. Gyoshev, 2 etc.; V. Atanasov *et al.*, (2010), 13 14.

²⁵ V. Atanasov *et al.*, (2010), 8 9.

lower than the market prices. Those are rights of existing shareholders to acquire new shares of the company in proportion to the nominal value of the shares they hold.²⁶ For transition economies it is recommended to include preemptive rights in case of any new issuances, with the possibility of limitation or exclusion of those rights only in certain cases requiring a majority or a qualified majority vote of shareholders.²⁷

In order to protect shareholders who do not vote in favor of the limitation or exclusion, it is recommended to grant the so-called rights of participation that would enable them to participate in the offer of shares or purchase additional shares at a price from the main offer. It is important to provide a simple procedure for exercising preemptive rights. Due to dependency on the financial capabilities of the holders of rights, their transferability and organized public trading in the form of warrants are considered to be significant determinants of their effectiveness.²⁸

Preemptive rights are established by the laws in both entities of B&H and may be excluded or limited in a single issue only by the general meeting's decision (in RS at the proposal of management board), which in FB&H must be adopted by a majority vote of the total number of voting shares. For example, for adopting such a decision in Croatia at least 3/4 of share capital votes represented at the meeting is needed. The Law in RS does not prescribe a special majority for making such a decision, but requires a written report stating the reasons for the limitation or exclusion including the rationale for the proposed issue price. The management board in RS may restrict or exclude preemptive rights in the issue of authorized shares according to the LoC. Comparatively, in Serbia preemptive right may be limited or excluded in the founding act and statute of the company. A substantial drawback is the fact that in FB&H, those rights are not transferable. In RS they can be transferred by a contract.

In FB&H preemptive rights also exist in the case of issuance of convertible bonds and bonds with a preemptive right. Effective deadline for exercise of these rights determined by the law is relatively short.²⁹ Companies in RS have an obligation to inform all shareholders of its intention to issue shares, including how to use preemptive rights to be de-

²⁶ M.S. Vasiljević, *Kompanijsko pravo: Pravo privrednih društava Srbije i EU*, Pravni fakultet Univerziteta u Beogradu, Beograd 2007³, 317.; R. La Porta et al., "Law and Finance", *Journal of Political Economy* 6/1998, 1128.

²⁷ In case of voting on the limitation or exclusion of preemptive rights, future buyers and related parties should be excluded from voting. The rules should also be applied to cases of issuance of convertible securities and stock options. See G. Avilov *et al.*, 26-27.

²⁸ V.A. Atanasov, C.S. Ciccotello, S.B. Gyoshev, 24.

²⁹ LoC FB&H, Articles 213-215 and 223; LSM FB&H, Article 23 (2); LoCC, Article 308; LoC RS, Articles 203, 207-208 and 235.

terminated on the section day. The provisions on preemptive rights also apply to convertible bonds. In addition to ordinary shareholders, the rights to acquire shares of a new issue have holders of warrants and convertible bonds, and preferred shareholders for shares of the same class. Comparatively, in Croatia and Serbia legal provisions on the preemptive rights appropriately apply when disposing of its own shares.³⁰

Another means of protecting shareholders from dilution is a requirement for issuing shares at a price not lower than their market value i.e. price regulation, which provides some protection against the issuance of shares to insiders or related parties at very low prices. In case of using the concept of market value its precise definition is extremely important. *The General Principles* provide the following definition: “the price at which a seller and a buyer, having full information about the property’s value and not obliged either to sell it or to buy it, would agree to sell and buy.”³¹ Some jurisdictions require a detailed explanation of the necessity to increase the capital and the criteria for calculating the price of shares being issued. The limitations of this mechanism are recognized in terms of illiquid markets prone to manipulation.³²

In FB&H preemptive rights represent the only mechanism for protection from share dilution. There are no provisions on the minimum price requirements except that the price of shares being issued cannot be lower than its nominal value.³³ Unlike the FB&H, the Law in RS establishes requirements regarding the selling price of the issue in order to exercise the preemptive rights.

As an alternative legal strategy Atanasov *et al.* (2007)³⁴ consider requesting approval of minority shareholders for related party transactions, which includes the case of a share issue to the controlling shareholder without preemptive rights. In some jurisdictions a qualified majority of shareholder’s votes is required when deciding on changes in equity capital, large issuances of shares etc.³⁵ The approval of a class of shareholders whose rights will be impacted by the decision is usually required.³⁶

Concerning the minorities’ approval, it should be noted that the Law in RS recognizes the cases when a shareholder cannot vote at the meeting, and one of them includes deciding on the exclusion of preemp-

³⁰ LoCC, Article 233 (2); LoCS, Article 213 (3).

³¹ G. Avilov *et al.*, 26.

³² V. Atanasov *et al.*, (2007), 11.

³³ LoC FB&H, Article 130.

³⁴ *Ibid.*, 10.

³⁵ G. Avilov *et al.*, 27 etc.

³⁶ Technical Committee of the IOSCO in consultation with the OECD, “Protection of Minority Shareholders in Listed Issuers”, Final Report, OICV IOSCO 2009, 21 22.

tive rights in an issue of shares by a way of private offering in which he and / or related party is the buyer. The Law in FB&H contains no specific provisions on related parties and transactions approval,³⁷ so in the case of issue of new shares to the controlling shareholder, managers or related parties with the exclusion of preemptive rights no approval of minority shareholders would be required.

4. LEGAL PROTECTIONS FROM FREEZING OUT MINORITY SHAREHOLDERS IN B&H

The institute of squeeze-out or freeze-out is linked to the institute of takeover of open joint stock companies and regulated by the EU Thirteen Directive.³⁸ The offeror who acquires 90–95% of voting shares of the target company is entitled to purchase shares of the remaining shareholders at a fair price which will be considered as the one from the public offering. There is a tendency of providing this right as a general and not only in the case of a takeover by way of a public offer.³⁹

As possible means to protect minority shareholders from freezing out at excessively low price Atanasov *et al.* (2010)⁴⁰ state the appraisal rights, rules on minimum pricing, fiduciary duties, and requesting price approval of minority shareholders or regulators. It is possible to demand that the purchase price cannot be lower than the market price before the release of an offer to buy shares. However, this mechanism provides little protection in terms of an inefficient, illiquid and prone to manipulation market. Another way of determining the price includes the use of liquidation value or the value of discounted cash flows in calculating fair value of the shares. Greater protection can be achieved if combining those two ways of calculating with the requirement for the use of a higher price.⁴¹

It has been shown that in transition economies the application of mandatory bid rule increases acquisition costs and affects companies in a way that they leave the stock exchange quotation.⁴² A particular problem

³⁷ V. Trivun *et al.*, “Transakcije sa povezanim osobama: pojam i reguliranje”, XIV Međunarodni simpozij “Računovodstvena profesija u funkciji unapređenja poslovanja”, Neum 2011.

³⁸ Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, *Official Journal of the European Union* L 142, 30. 04. 2004., Articles 15-16.

³⁹ M.S. Vasiljević, 379 etc.

⁴⁰ V. Atanasov *et al.*, (2010), 9.

⁴¹ V. Atanasov *et al.*, (2007), 12-13.

⁴² E. Berglöf, A. Pajuste, “Emerging Owners, Eclipsing Markets? Corporate Governance in Central and Eastern Europe”, *Law and Governance in an Enlarged European Union* (eds. G.A. Bermann, K. Pistor), Hart Publishing, Oregon 2004, 308 etc.

with its implementation is the issue of determining a fair price, due to which this remedy can completely lose its protective function.⁴³

It should be added that in some jurisdictions shareholders who voted against certain significant decisions or refrained from voting at the general meeting have the right to withdraw from the company by selling their shares to the company at the market value which is to be determined according to the certain rules. If the company does not redeem the shares or does that at a price they consider to be lower than the market price, the shareholders generally have the right to initiate proceedings before the competent court.

In FB&H the general meeting's decisions on the adoption or approval of the issue of new shares, bonds convertible or with preemptive rights to shares of the company, on the limitation or exclusion of preemptive rights, and on the change of form, division, merger and acquisition to another company or *vice versa*, will be considered a significant change in the company or shareholders' rights, which activate the provisions of Art. 255 of the LoC on minority protection pursuant to which, shareholders under certain conditions have the right to ask the company to redeem their shares. Exceptions are the cases of restructuring or reorganization of companies with majority state capital.

Share redemption is made at a fair market value for the period from the date of publication until the date of the meeting, whereby the important issue of the means of determining the fair market value of shares for a relatively short period is not regulated. Unlike the RS, where the company has a period of 30 days starting from the receipt of the shareholders' request to make the payment, the adequate period in FB&H is 3 months. In addition, if the total nominal value of shares in the request is greater than 10% of equity, and the total fair market value greater than the sum of the reserves and retained earnings, a company from FB&H shall carry out the obligations only to amount of specified limits in that period while for paying the remaining part has a further period of 6 months. In case of company's failure to fulfill its obligations, shareholders have the right to lodge a complaint to the competent court.

In the RS, a minority shareholder has the right to demand redemption of shares in the event of reorganization in terms of status changes and changes of legal form.⁴⁴ The company is required to redeem the shares at their market value which is calculated on the date of adoption of the decision, without taking into account any expected increase or decrease in value as its result. The market value is the average price that is regularly published on the stock exchange or another regulated market in the period immediately preceding the date for which it is determined,

⁴³ V.A. Atanasov, C.S. Ciccotello, S.B. Gyoshev, 43.; G. Avilov *et al.*, 30.

⁴⁴ LoC RS, Articles 330 and 435 436.

which is not shorter than 3 or longer than 6 months. In case the shares are not traded regularly or a regulated market does not exist, the market value is determined based on the estimated value of the company's capital applying appropriate methods. If he considers the amount paid to be less than the market value of shares or the company fails to make the payment, the shareholder has a right to approach the competent court according to the Law.

5. CONCLUSION

The paper explores the legal protections from financial tunneling available to minority shareholders in B&H. We start with the concept of financial tunneling and various measures of protection as defined by Atanasov et al. (2007, 2010), considering the experiences of individual countries in transition.

In the second part of the paper we analyze the provisions specifically targeted at the most common forms of financial tunneling in B&H including the available data on their application in practice. Prior to the recent legislative changes in FB&H a significant number of cases of joint stock companies changing the form into limited liability companies was registered which basically means their delisting. For comparison purposes we consider some of the adequate comparative solutions.

In terms of protection from share dilution we observe some major deficiencies in solutions of the LoC FB&H. The entity laws do not ensure a public trade of preemptive rights. The rules on the determination of share price in cases when they have a right to require redemption are not defined in favor of minority shareholders in FB&H, while minority shareholders in companies with the majority state capital do not even have the right to demand redemption.