ASECU South-Eastern Europe Journal of Economics 2 (2009) 205-227 SEEJE

REFORMS OF CORPORATE GOVERNANCE AND TAKEOVER REGULATION: EVIDENCE FROM SERBIA

KSENIJA DENCIC-MIHAJLOV
University of Nis*

Abstract
Good corporate governance is considered one of the building platforms upon which economic success is based. The challenges of corporate governance in Serbia, which is moving toward EU membership, are particularly serious. Takeover regulation is an important corporate governance external mechanism, and the attempts to improve its provisions have a significant impact on the wider corporate governance system. Having reviewed recently released investigations on the legal extensiveness and effectiveness of corporate governance regulation in Serbia, we analyze significant interventions that were made in corporate and security legislation in Serbia last years. We indicate the privatization process as a primary, and concentration of ownership, low liquidity of the equity market, distortion of the key functions of the capital market and de-corporatisation as consequent key factors of corporate governance reform. We show that recent reforms include the reinforced role of the stock exchange and security commission in monitoring of companies' governance, as well as the improved regulatory framework, particularly in the field of takeover activity. The mandatory bid rule, principle of equal treatment of shareholders, squeeze-out and sell-out rules, are the regulatory devices created in the Serbian takeover regulation to achieve two main aims — a well-functioning market for corporate control and protection of the interests of minority shareholders. However, we indicate that the takeover regulation itself provides the possibility to evade the enforcement of the provisions regarding mandatory rules, both when parties to bid are obliged to activate the rule application and in the price determination process.

Keywords: corporate governance, reform, takeover, rule, shareholders, mandatory bid rule, squeeze-out, sell-out.

JEL classification: G 34, K 22

* *Corresponding address:* Faculty of Economics, Trg kralja Aleksandra 11, 18000 Nis, Serbia, e-mail: ksenija@eknfak.ni.ac.rs

I'm grateful to Professor Axel Haller, Professor Dejan Malinic and two anonymous referees for useful suggestions and valuable comments on a previous draft of this paper. Usual disclaimer applies.

Introduction

Corporate governance has been a very attractive and dynamic research area over the past decade, but also the field of dynamic changes of legislation, internal corporative rules and norms. The role of corporate governance in economics and capital markets has increased in Europe with the adoption of the common European currency, free flow of capital, goods, services and people within the EU, the process of globalization, privatization of state-owned enterprises and with increased merger and acquisition activity realized by European corporations and stock exchanges.

In developed market economies corporate governance has been an important policy issue for more than a decade, while the transition economies have viewed the corporate governance debate as a policy priority since the late 90s (e.g. Brada, 1996; Walsh and Whelan, 2001; Berglöf and Pajuste, 2003; Puffer and McCarthy, 2003; Pop, 2006; Klapper, *et al.*, 2006; Stringham *et al.*, 2008; Melkumov, 2008). Starting in the mid 1990s, the corporate governance debate within transition economies revolved around specific privatization issues and initial efforts in the move toward responsible corporate governance included legislative, judicial and corporate initiatives to provide investors with more disclosure and transparent information (Bobirca & Miclaus, 2007).

In attempting to establish a market-based economy in the post socialist period, like other transition economies, Serbia has faced serious challenges in creating an economic system, forming institutions and establishing incentives in order to improve economic performances. Corporate governance, as a set of processes by which corporations are directed and controlled, has been recognized as a crucial part of the reform process. The challenges of corporate governance in Serbia, on its way toward EU membership, are particularly serious. In its corporate governance quality Serbia lags behind developed European countries, partly owing to former legal and regulatory deficiency and partly owing to the self-management system's inheritance. Reformers in the Serbian government as well as foreign investors view corporate governance as a key factor in developing and improving the investment climate in Serbia. Thus, there are three main factors – economic (investors interest protection), political (EU accession) and globalization process – that press Serbia to build and ensure a regulatory regime and corporate governance practice that would provide a sufficient level of market efficiency and transparency.

Takeover regulation is considered to be an important element of corporate governance. Changes in takeover regulation affect the level of investor protection, the development of the capital market and the market for corporate control, but they also cause changes in ownership and control (Yarrow, 1985, Hirshleifer and. Titman, 1990, Burkart, 1999, Bebchuk and Ferrell, 2001, Berglöf and Burkart, 2003, Goergen *et al.*, 2005). Reforms of takeover regulation in this way constitute an important channel through which a corporate governance system can progressively develop.

The paper reviews recently released investigations of the legal extensiveness and effectiveness of corporate governance regulation in Serbia. The aim of the paper is to present and critically analyze significant interventions that have been made in corporate and security legislation in Serbia in recent years and point to the crucial factors of the reform course and key enforcement problems. We show that recent reforms include the reinforced role of the stock exchange and security commission in monitoring of companies' governance, as well as the improved regulatory framework. Employed privatization methods, mandatory listing requirements imposed by the privatization regulation and fragmented privatization process have had as consequences: accelerating concentration of ownership, de-corporatisation of successful Serbian companies and increasing numbers of low-quality shares on the unregulated stock market, low liquidity of the equity market, insignificant role of institutional investors in corporate governance, distortion of the key functions of the capital market. We identify all these factors as essential in the field of transitional reform of corporate governance. As takeover regulation is an important corporate governance device, the attempts to improve its provisions have a significant impact on the wider corporate governance system in the Republic of Serbia. The mandatory provisions imposed by the new Serbian takeover regulation are to achieve two main aims - a well-functioning market for corporate control and protection of the interests of minority shareholders. We emphasize that the new takeover regulation gives a more flexible framework for squeeze-out and sell-out right activation and consequently leads to a higher number of squeeze-outs and sell-outs. On the other hand, we indicate that the takeover regulation itself provides the possibility to evade the enforcement of the provisions regarding mandatory rules, both when parties to bid are obliged to activate the rule application and in the price determination process.

The paper is organized as follows. In the following section we give an overview of the recently released investigations of the legal extensiveness and effectiveness of corporate governance laws and regulation in Serbia. Section 2 contains an analysis of the recent developments in the corporate governance regulatory framework in Serbia, identifying key problems in this field of transitional reform. Section 3 provides an evaluation of the takeover regulation reform and discusses its impact on the Serbian corporate governance system. The final section of the paper contains our conclusions.

1. The assessment of the legal extensiveness and effectiveness of corporate governance laws and regulation in Serbia

According to a recently released investigation significant improvements in corporate governance have occurred in Serbia in the first few years of the 21st century. On the basis of three governance indicators (voice and accountability, regulatory quality and control of corruption), Kaufmann (2005) reports on significant changes in corporate

governance that took place in Serbia in the short 1996-2004. However, according to Kaufmann, in the same period, no changes have been observed in three other dimensions of governance – government effectiveness, political instability and violence and regulatory burden.

In the EBRD (*The European Bank for Reconstruction and Development*) project on corporate governance sector assessment[1], twenty seven European countries have been assessed according to changes in corporate governance legislative reform during 2003. The level of compliance of specific legislation with international standards and best practices is defined by the EBRD as *extensiveness* ("law on the books"). *Effectiveness* is, on the other hand, a measure of the "law in action". It estimates how the legal regimes work in practice, as opposed to the quality of the law on the books. Corporate governance effectiveness is a more adequate measure since the changes in the national legislation do not illustrate the effectiveness of the new corporate laws. It depends both on the voluntary compliance rate and on the effectiveness of legal institutions that are charged with enforcing the law.

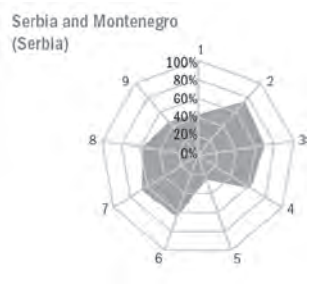
In the EBRD report the countries were rated from "A" – representing a very high compliance level of the corporate governance system measured against OECD (*The Organization for Economic Co-operation and Development*) "Principles of corporate governance", to "E" – representing a very low compliance level of the corporate governance system. According to the assessment results, Serbia improved its 2002 rating score and was rated in 2003 with medium compliance. In Serbia the corporate governance sector assessment reveals some lack of compliance in disclosure and transparency although the overall legal framework is improving and is generally in line with international standards.

The survey conducted by the EBRD aimed at assessing the corporate governance "law in action" measured the effectiveness of disclosure and redress mechanisms (see Figures 1 and 2). Serbia has a relatively effective framework for disclosure, and redress characterized by relatively simplified disclosure and redress proceedings, and by satisfying enforceability of disclosure and redress rulings. Major weaknesses consist in low speed of disclosure proceedings and redress mechanisms.

With respect to the institutional environment, Serbia has the most effective legislation in the South-Eastern European region (together with Romania) characterized by a developed statutory background, acceptable level of competence and experience of prosecutor and the use of precedents by lawyers. The major weak points stressed are inadequate reliability of company's books, competence and experience of market regulator as well as weak institutional integrity.

1. Available at: http://www.ebrd.com/country/sector/law/corpgov/assess/report05.pdf

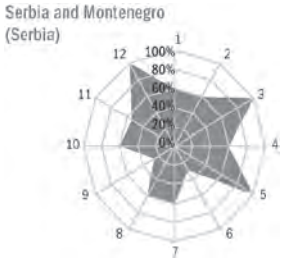
Figure 1. Effectiveness of corporate governance legislation in Serbia according to factors such as disclosure and redress mechanisms and the institutional environment[2]



Factors:

1. Speed of disclosure proceedings
2. Simplicity of disclosure proceedings
3. Enforceability of disclosure rulings
4. Institutional environment relating to disclosure
5. Speed of redress mechanisms
6. Simplicity of redress proceedings
7. Enforceability of redress rulings
8. Institutional environment relating to redress
9. Costs

Figure 2. Effectiveness of corporate governance legislation in Serbia according to factors such as disclosure and redress mechanisms and the institutional environment[3]



Factors:

1. Reliability of company's books
2. Independence of statutory auditors
3. Statutory background
4. Competence and experience of courts
5. Competence and experience of prosecutor
6. Competence and experience of market regulator
7. Impartiality of market regulator
8. Impartiality of courts
9. Institutional integrity
10. Possibility for defendant to delay proceedings
11. Availability of precedents
12. Use of precedents by lawyers

The main findings of FSAP (*The Financial Sector Assessment Program*), a joint project by the World Bank and the International Bank for Reconstruction and Development (IBRD), are that even though Serbia has made good progress in macroeconomic stabilization, much work remains to be done on the corporate governance framework. The crucial weaknesses identified are: unsatisfactory transparency of ownership, financial reporting, board responsibilities, minority shareholders protection in capital dilution and takeovers, weak institutional capacity, unregulated sphere of investment

2. Source: EBRD Legal Indicator Survey 2005, Focus section: Implementing Corporate Governance Framework.

3. Source: EBRD Legal Indicator Survey 2005, Focus section: Implementing Corporate Governance Framework.

funds operation. Since November 2005, when the FSAP report was released, corporate governance framework in Serbia has been improving steadily.

2. Corporate governance in Serbia: recent developments in regulation framework and key problems in practice

Serbian corporate governance was an area largely unexplored by academics both from the standpoint of its main mechanisms and comparative law perspective with other European countries. Over the past few years, corporate governance in Serbia has been, directly or indirectly, the subject of more intensive reform and economic analysis (see: Begovic *et al.*, 2003; Zivkovic and Djeric, 2003; Zivkovic, 2004; Dencic-Mihajlov, 2006; Jolovic, 2007; Miskic, 2008).

Many factors have resulted in a limited interest in corporate governance reform and impede the efficacy of internal and external corporate control mechanisms:

- A high number of companies in Serbia is still owner-controlled and not-listed on the Belgrade Stock Exchange, the only organized stock exchange in Serbia. Of 2250 registered companies at the Serbian Central Securities Depository and Clearing House (SCDCH),[4] shares of 1852 companies are quoted on the national stock exchange. Since all these companies do not fulfill the listing requirements of the exchange market, they are listed on the lowest market level – free stock exchange market.[5] Only 31 companies' shares are subjected to continual trade at the Belgrade Stock Exchange.[6] The information that up to now only three Serbian companies met criteria to be listed on Listing A (Prime Market) of the Belgrade Stock Exchange (Tigar ad. Pirot, Enegroprojekt holding ad. Beograd, Soja Protein ad. Becej) and only one company to be listed on the Standard Market (Listing B) of the Belgrade Stock Exchange (Alfa Plam ad. Vranje), illustrates the activity of the Serbian regulated capital market, as well as the insider domination and low

4. Information acquired on 14/10/2008 from the Serbian Central Securities Depository and Clearing House web site: http://www.crhov.co.yu

5. The unregulated or free stock exchange market is a market fully regulated by the internal regulations of the Belgrade Stock Exchange. There are no special criteria for inclusion of shares on the unregulated market, while for inclusion of shares on the Prime and Standard Market the criteria are defined by the Exchange Listing and Quotation Rules. The decision on the admission/exclusion of a security from the unregulated market is made by the Managing Director of the Exchange. The securities are to be traded on the free stock exchange market (a) when the issuer does not fulfill any longer the requirements for the listing on the Prime or Standard Market, or (b) by the decision of the Managing Director of the Exchange upon the request of the issuer on the inclusion of securities on the unregulated market.

6. Information acquired on 14/10/2008 from the Belgrade Stock Exchange official web site: www.belex.co.yu

protection of external shareholders/investors. Table 1 gives some indication of the Serbian capital market development during the last 5 years. The growth of the number of firms is increasing due to the privatization regulation in force. It implies mandatory listing of the privatized companies. Rational consequence of such an obligatory listing for a group of the most successful Serbian companies is fast concentration of ownership and withdrawing from the capital market (de-corporatisation). On the other hand, an increasing number of low-quality companies continue to be open and traded on the free stock exchange segment of the market.

Table 1. The development of the Serbian capital market

Year	2003	2004	2005	2006	2007
Number of Companies	355	431	900	1204	1552
Market Capitalization (US$*)	1417.41	3280.6099	5408.7035	10985.0128	22306.8221
Total Vol.-Stocks (US$*)	536.875288	435.0145	584.8951	1334.8456	1436.0071
Total Vol.-Stocks (# Shares*)	16.314457	16.2243	19.173	22.1135	20.1191
Avg. Daily Vol.-Stocks (US$*)	2.1	1.7059	2.3118	5.3824	11.9667
Avg. Daily Vol.-Stocks (# Shares*)	0.063	0.0636	0.0758	0.0892	0.1677
Total Vol.-Bonds (US$*)	177.702205	154.1842	137.579	200.3666	173.0724
Total Vol.-Bonds (# Shares*)	154.922485	124.4637	110.6584	158.6827	129.9827
Monthly Avg. Turnover Ratio	0.163	0.0111	0.009	0.0101	0.0107

* in millions
Source: http://www.feas.org

- While institutional investors are to play a significant role in the process of corporate governance, they have stayed on the margins of the capital market - pension fund due to a slow reform of the pension system, while investment funds became a part of the market in the later phase of the transition process. According to the SCDCH data, Pension and Share funds have a 6% share in the ownership structure of all registered Serbian companies. However, banks play an important role in corporate governance, participating heavily in corporate financing and delegating their officers to companies' managing and supervisory boards. A strong dependency on banks derives from the high debt/equity ratios and less developed capital markets.
- Listing of companies in Serbia has not been market-motivated, in the sense of collecting capital to finance development and improve market and competitive position of companies. The privatization process in Serbia, in all its modalities (sale of capital or transfer of capital free of charge), has been followed by the incorporation of socially or state-owned capital of Serbian enterprises. Shares issued in the

privatization process have been introduced, by the Law on Privatization[7], into the secondary market — the Belgrade Stock Exchange. In this way, instead of being market-oriented, the listing of companies in Serbia was mandatory, imposed by the privatization regulation.

- All listed companies are still securing needed funds through loans from commercial banks, while the collection of the additional capital in the primary market by the initial public offers is something of an exception on the Serbian capital market. In addition, there is no corporate debt market in Serbia at present (nor a municipal bond debt market).
- Limited interest in corporate governance reform is partly caused by the fact that many large Serbian companies are still state-controlled (telecommunications, railways, electricity and water suppliers). The main problem that is linked with state ownership results from the remaining influence of the state in corporate decision-making through a nexus of subsidies, regulatory favors and tax arrears provided in exchange for residual control rights. The Law on Right to Shares Free of Charge and Pecuniary Compensation Available to Citizens in the Privatization Process[8] was enacted in 2007. According to the Law, members of the society who meet the basic criteria (18 years of age, Serbian citizenship, no past participation in the privatization process) have been given the right to register for receipt of shares free of charge in the largest and most successful public enterprises (NIS-Petroleum Industry of Serbia, Telecom Serbia, Elektroprivreda Serbia, JAT Airways, Belgrade Airport and Galenika Pharmaceuticals) and pecuniary compensation. Even though the public response was highly positive (several million natural persons requested to become new shareholders and to have the right to sell their shares on the Belgrade Stock Exchange), the process of share distribution (and consequently their trading on the stock exchange), has not yet begun.
- The ownership concentration is a consequence of a selected mass privatization model, low GDP per capita, incompatibility of the main laws that regulate the privatization process, etc. Concentration of ownership in Serbian enterprises undermines the liquidity of the equity market and distorts its main functions — it doesn't operate as a financial intermediary but as an ownership transfer mechanism (see: Zivkovic, Jolovic, 2009). Trading in shares declines and the companies are "withdrawing" from the capital market, which has as a consequence a decreasing number of high quality shares on the market. The capital market becomes shallow. Ownership and control are relatively closely held by identifiable and

7. Article 59 of the Law on Privatization (Serbian Official Gazette No. 38/2001, 18/2003, 45/2005)

8. Serbian Official Gazette No. 123/2007

cohesive groups of insiders who have longer-term stable relationships with the company (i.e. families, banks, groups of managers). Unsatisfactory protection of minority investors, with an entrenched position of incumbent enterprise managers (who retain effective control rights even where privatization has shifted ownership to outsiders) have been accompanying effects of the low liquidity of the equity market and the market for managers.

The aforementioned factors of a limited interest in corporate governance reform could be analyzed as direct or indirect consequences of the Serbian privatization regulation and the privatization process based on it. The privatization process started in the 1990s and went through three phases. The first phase of privatization started in 1990 with the federal regulation.[9] Privatization was not mandatory, and permitted only the transformation of social property (not state-owned property). The model was workers and managers buy-out based, with relatively high discount for share acquisition. Up to 1994 some 40% of Serbian firms were subject to the privatization transformation. Because of the insider privatization model, this wave of privatization did not do anything to change the corporate governance within the firms. Under the second law on privatization, the Law on Property Transformation enacted in 1997[10], a free share transfer was possible in respect of up to 70% of the total capital of firms, and available both to the employees and other citizens. The law was also voluntary, the results were lower than expected (only 10% of the capital was privatized by the end of 2000), and the implementation was terminated in 2001. In the third privatization phase, with the Law on Privatization enacted in June 2001, the insider model is abandoned and privatization is made obligatory. The state is given a greater role in ensuring the course and the success of the process (via Ministry for Privatization, Agency for Privatization, Share Fund). There are two models of privatization: sale of capital[11] and transfer of capital free of charge. Sale can be realized by public tenders and public auctions, whereas assets can be transferred to workers and citizens.[12] Shares issued in the privatization process are to be freely tradable on the secondary market via the stock exchange. What are the results of the privatization process thus

9. The regulation of the Federal Republic of Yugoslavia - the Law on Enterprises in 1988 and the Act on Financial Operations and the Law on Social Capital in 1989. It was followed by the law on conditions and procedures to transform collective property into other forms of property (Serbian Official Gazette No. 48/91, 75/91, 48/94, 51/94) adopted by the Serbian parliament.

10. Serbian Official Gazette No. 32/97.

11. The sale model implies that up to 70% of the capital must be sold on either tender or auction, and the remaining 30% will be transferred to employees or citizens but only upon the completion of the sale of the 70%. Public tenders are employed for big and strategic firms, while smaller and medium-size enterprises, are planned to be sold in public auctions.

12. For more information on the privatization phases in the Republic of Serbia see Hadzic, 2002.

far? The transformation of social/state ownership into public-traded companies and re-configuration of the stock exchange, have not accelerated trading on the secondary market, nor the development of the financial market. On the contrary, the lowering of the trading level and the liquidity of the stock market, the concentration of the ownership initially dispersed by the employed methods of mass privatization and the transformation of the public-traded companies into private ones, have had an adverse impact on both the quality of corporate governance and takeover practice.

Serbia has drawn interest from foreign investors attracted by the possibilities offered by an undeveloped market with high potential of growth. This interest has begun with acquisitions in banking sector, and has been intensified by the realization of considerably high returns on the stock market in the last quarter of 2006 and beginning of 2007. However, a development of the financial and real sector had to be accompanied by the development of a regulatory and institutional framework that would ensure judicial and corporate initiatives to provide investors with more disclosure and transparent information. Therefore, in Serbia, as in most countries of Central and Southeast Europe, significant interventions and reconstructions have been made in corporate and securities legislation in recent years. Significant progress has been made in promoting private sector development, bringing down inflation, deregulation, improving public administration. The condition of relative disorder and discriminatory regulation, which was encountered in the period of mass privatization in Serbia, has been changing rapidly during the last few years (Živković, 2004).

After two years of preparation, in June 2006, the Government of the Republic of Serbia enacted several laws which are to regulate in a more efficient way the sphere of corporate governance, financial and accounting management and the activity of the capital market. This package of laws — consisting of a law on takeovers, a law on investment funds, a law on accounting and audit, a law on investment funds and a new law on securities and other financial instruments (Serbian Official Gazettes No. 46/2006, 47/2006) — is harmonized with European standards. The law system in Serbia now regulates the corporate sector and capital markets in a consistent way with the comparable regulation of the developed European countries (see Table 3). However, there are opinions that the above laws were adopted too late, at the end of the privatization process, when "strong" domestic and foreign investors had already acquired all the positive effects of buying undervalued Serbian companies.

Table 2. Serbian company and securities law framework

LEGAL/REGULATORY FRAMEWORK	Enforcement bodies
Company law framework	
Company Law, Serbian Official Gazette No. 125/2004 *Law on Business Registry*, Serbian Official Gazette No.55/2004, 01/2005	***Commercial Courts***
Company law framework	
Law on Bankruptcy Procedure, Serbian Official Gazette No. 84/2004 *Labor law*, Serbian Official Gazette No. 24/2005 *Insurance Law*, Serbian Official Gazette No. 55/2004, 70/2004, 61/2005, 85/2005 *Law on investment funds*, Serbian Official Gazette No. 46/2006	***Commercial Courts***
Securities Laws / Regulation	
Law on Securities and Financial Market, Serbian Official Gazette No. 47/2006 *Law on Takeovers*, Serbian Official Gazette No.46/2006	***Commercial Courts/ Securities Commission***
Stock Exchange Listing Rules	
Listing and Quotation Rules of Belgrade Stock Exchange, announced on the Belgrade Stock Exchange web page on 03/07/2007 *Rules on Confidential Information*, adopted by the Belgrade Stock Exchange on 20/04/2006	***Belgrade Stock Exchange***
Financial Reporting Regulation	
Law on Accounting and Auditing, Serbian Official Gazette No. 46/2006	***Commercial Courts/ Ministry of Finance/ National Commission for Accounting***

The Company Law, largely based on EU practice, represents a significant advance in comparison with the previous Law on Enterprises. This law, that establishes the regulatory basis for establishing the relationship between shareholder and management structure, incorporates issues such as 1) scope, implementation and protection of shareholders rights, 2) structures, obligations and liabilities of the managing bodies, 3) judicial and other forms of protection. The Company Law introduces improvements in the provisions relating to corporate governance, business combinations, corporate form conversion, disclosure requirement, and company liquidation outside bankruptcy. Another enhancement is the possibility of open and closed joint stock companies' existence. The provisions relating to limited liability companies have been simplified. Along with the improvements in regulation dealing with the operation of companies, the procedures for registration of new companies and filing of companies' documents have been much improved by putting into force the Law on Business Registry in January 2005.

The Law on Securities and the Financial Market links directly the activity of financial markets with corporate governance elements by including provisions relating to: 1) the obligation of public companies to keep the public informed about the company's activities, 2) the responsibility to provide true and accurate data in the prospectus and 3) the issue of insider information and their abuse (Šeskar, 2006).

A particular progress in regulating corporate governance practice using external mechanisms is made by enacting the Law on Takeovers which is discussed in detail in the next section.

The general conclusion is that the quality of the corporate governance legal framework is improving, but its implementation is lagging behind. Serbia has developed a solid institutional environment that can generally offer an effective legal framework. However, good "laws on the books" have not been sufficient to guarantee the effectiveness of a system, i.e. the existence of implementation gaps (that diminishes the confidence of foreign investors in the legal system as a whole) is obvious. Accordingly, though Serbia still needs to upgrade its corporate, banking and stock market legislation, the main effort should be focused on the implementation and understanding of the benefit of this legislation in practice, in order to provide an explicit signal for investors that are essential for the development of their financial markets.

3. Takeover regulation as an external corporate governance device

Takeover regulation mitigates conflicts of interests related to transfers of corporate control. It also impacts the agency problems between management and shareholders, minority and majority investors, and other stakeholders. In this way, it plays an important role in corporate governance system. The shape of the role depends on other characteristics of the governance system such as ownership and control (Goergen and Renneboog 2001, 2003; Goergen *et al.* 2005). In a system with dispersed ownership, the primary corporate governance role of takeover regulation is to restrain opportunistic managerial behavior. Hostile takeovers target poorly performing firms and replace poorly performing management. Examples of measures stimulating takeover activity are the squeeze-out rule, the break-through rule, and limitations on the use of takeover defense measures.

In a system with concentrated ownership, takeover regulation functions as a corporate governance device aiming at protecting minority shareholders' interests. The concentration of ownership and control is seen as an alternative mechanism that mitigates the conflict of interests between management and shareholders. Although there are a number of standard company law techniques to resolve conflicts between the large shareholder and minority shareholders, takeover regulation plays an important role, as it can provide minority shareholders with an 'exit on fair terms' opportunity. Provisions such as the sell-out right, the mandatory bid rule or the equal treatment principle, ensure such exit opportunities for minority shareholders.

Activity on the Serbian market for corporate control is regulated by the law on takeovers, the company law, the law on the securities market and other financial instruments regulation and accompanied directives and rules. The Serbian takeover law is fully harmonized with the Directive on Takeovers (2004/25/EC) adopted by the EU parliament and Council in April 2004. The Law regulates the requirements and procedure for takeover of joint stock companies, the rights and obligations of the participants in the takeover procedure, and the supervision of implementation of the joint stock company takeover procedure. Before the enacting of the law, takeover activity had been regulated by the two system laws (the Company Law[13] and the Law of Securities and Other Financial Instruments' Market[14]) and the rules on the content and form of takeover bids.[15] Such regulation produced all the features of the early transition process: accelerated ownership concentration, low corporate governance quality and low protection of minority shareholders (Zivkovic, 2004).

Serbian takeover regulation is an important corporate governance device, and recent attempts to change its provisions have a significant impact on the wider Serbian corporate governance system. The Serbian Security Commission (SSC) is designated as the competent authority to supervise the application of the new takeover law and the relative directives. This Law is applied to takeover of joint stock companies with their registered office in the Republic of Serbia, if the shares issued by such companies are traded on a regulated securities market in the Republic. Joint stock companies whose shares have not been traded on the regulated market within the three months preceding the announcement of the takeover bid may not be the subject of the takeover. Under the old takeover regime, the subjects of takeover were also the companies whose shares have not been traded on the regulated market (privatized companies with dispersed ownership), which were opening the possibility of taking over shares under the price significantly lower than the fair (market) value. Consequently, the main function of the takeover mechanism in the corporate governance system had been distorted.

The new legislation of takeover activity brings a higher level of minority shareholders protection and equal status for all the owners in the acquisition process in the Serbian market for corporate control. The Law introduces provisions relating to sell-out and squeeze-out right, the establishment of an equitable price in mandatory bids as well as the creation of an adequate "playing field" that guarantees the proper information to all the participants in the bid. The aim of the takeover regulation reforms was primarily to improve the efficiency of external monitoring of the market for

13. "Službeni glasnik RS" br. 125/2004.

14. "Službeni list SRJ" br. 65/2002 i "Službeni glasnik RS" br. 57/2003 i 55/2004.

15. "Službeni glasnik RS", 102/2003, 25/2004, 103/2004, 123/2004.

corporate control, to improve minority shareholder protection and finally to increase shareholders' (particularly foreign shareholders') confidence and their willingness to invest.

As discussed above, the regulatory devices in the Serbian takeover regulation available to achieve two main aims — a well-functioning market for corporate control and protection of the interests of minority shareholders — are the mandatory bid rule, the principle of equal treatment of shareholders, squeeze-out and sell-out rules, and the one-share-one-vote principle. In the following we analyze those provisions in the Serbian takeover regulation and discuss the application of each device as well as its consequences for corporate governance in Serbia.

3.1 The mandatory bid rule and the principle of equal treatment of shareholders

The importance of a mandatory bid rule derives from the fact that it offers the minority shareholders an opportunity to exit the company on fair terms. Since the acquirer may attempt to exploit private benefits of control at the expense of the minority shareholders, the role of the mandatory bid rule is to protect the minority shareholders by providing them with the opportunity to exit at a fair price. The rule requires the acquirer to make a bid to all the shareholders once a certain percentage of the accumulated shares have been achieved. The mandatory bid rule usually also determines the price of the takeover bid. Depending on the national regulation, the price must not be lower than the highest price paid for the shares already acquired by the bidder or must not be lower than a certain percentage of the average share price of the previous 12 months (e.g. 75%).

Another function of the mandatory bid rule, as Burkart and Panunzi (2003) show, is to reduce the likelihood of value-creating takeovers. The rule makes control transactions more expensive and thereby discourages bidders from making a bid in the first place. Even though there are several ways to reduce these costs (by increasing the threshold above which the acquirer has to make a mandatory offer, or by allowing the bid price to be lower than the highest price paid for any of the shares previously accumulated), any change to the rule increases the likelihood of the minority shareholders' expropriation. Finally, in the multiple bidder contest, the mandatory bid rule may lower the winning bid price (Bergström *et al.*, 1997; Cornelli and Felli, 1998).

The provisions concerning mandatory bids are set out in Article 6 of the Serbian takeover law. Article 6 (1) obliges any person who acquires the shares of the target company, and combined with the shares it already holds, has more than 25% of the total number of votes attached to the voting shares of the target company, to make a bid for the outstanding shares of the target company. The acquirer who accumulated more than 25% of the total number of the shares has to notify, without delay and at the same time, the organizational form of the regulated market in which the shares of the target company are traded, the Commission, and the target company.

Under the Law, the proposed price in the takeover bid may not be lower than the price at which the acquirer has acquired the voting shares. It can be calculated in two ways: (*i*) it cannot be lower than the average weighted price of shares in the period of three months preceding the announcement of the takeover bid; (*ii*) if the last market price of shares of the target company on a regulated market on the working day preceding the takeover bid announcement date exceeds the average three-month price, the acquirer is obliged to offer such a price.

What is the application of the mandatory bid rule in Serbia? The Law itself provides the possibility of evading the enforcement of the provisions regarding mandatory bids: (*i*) when parties to bid are obliged to launch mandatory bid, and (*ii*) in the price determination process. The most serious deficiency of the mandatory bid rule in the Serbian Takeover Law refers to the categories of the rule derogation. Even though the exemptions from the obligation to announce the takeover bid are described in detail (Article 8), the mandatory bid rule is not fully comprehensive, which makes its implementation and its protective function more difficult. Another problem that works against the contribution of the mandatory bid rule is definition of the "concerted parties" (Article 4 and 5). The Law provisions about parties acting in concert should be examined more carefully at the implementation stage, since they give plenty of scope for evading the mandatory bid rule.

The principle of equal treatment is established as one of the most important principles of corporate governance regulation. In the case of takeover regulation, its significance is even higher, since the possibilities of disruptions of the minority shareholders' rights in the control transfers transactions are far-reaching. According to the principle, the majority shareholder, the management, and other constituencies are required to treat all shareholders within each individual class of shares equally. The function of the equal treatment principle in takeover regulation is similar to the mandatory bid rule — both of them focus on protecting minority shareholders. More precisely, the equal treatment principle requires an acquirer to offer minority shareholders the chance to exit on terms that are at least as favorable as those offered to the shareholders who already sold their shares. The combination of the mandatory bid and the equal treatment principle increases the costs of an acquisition and reduces the price that a bidder is able to offer to the controlling shareholder (Davies and Hopt, 2004).

The principle of equal treatment is declared to be a general principle of the Serbian Takeover Law. According to Article 2 all shareholders of the target company are equal in the takeover procedure. Minority shareholders may sell their shares to the acquirer under the same conditions as the majority shareholders. The importance of

the principle is also underlined in the Serbian Code on corporate governance[16] (Articles 11 to 13).

3.2 The squeeze-out and sell-out rights

At the European level, Directive 2004/25/EC requires the EU Member States to provide majority shareholders the squeeze-out right and minority shareholders the sell-out right in a takeover transaction. The right to squeeze out minority shareholders allows a bidder who has acquired a very large part (90%-95%) of the share capital to acquire the outstanding shares. Forcing minorities out of the company liberates the bidder from costs and risks which the continued existence of minorities could bring. Possibility to squeeze-out makes takeover bids more attractive since full ownership is more valuable to them than a majority ownership. On the other hand, provided that the majority shareholder owns 90% (95%) of the equity capital, the remaining minority shareholders have the right to require from him to buy out their shares at the fair price (sell-out right). The main argument behind the sell-out right is that it prevents the abuse of the majority shareholder dominant position (blocks the extraction of private benefits at the expense of the minority shareholders).

The role of squeeze-out and sell-out rights in corporate governance depends on the main characteristic of the governance system–ownership structure. In continental European countries most companies have controlling shareholders whereas in the Anglo-Saxon countries companies with a widely dispersed ownership structure dominate. Since both types of ownership structure exist in both corporate governance systems, takeover regulation should offer a framework for efficient corporate restructuring, reduction of agency conflicts and protection of minority shareholders (Goergen *et al.*, 2005).

Squeeze-outs discourage the free-riding problem and thus enhance value-increasing takeovers (Yarrow, 1985; Burkart and Panunzi, 2003). Goergen *et al.* (2005) agree that the squeeze-out right mitigates Grossman and Hart's (1985) potential free-riding behavior of minority shareholders and allocates a larger share of the takeover gains to the bidder. On the other hand, sell-out rights offer minority shareholders a larger part of the benefits and they discourage bids and the takeover market. Both measures mitigate the conflicts of interest between the majority and the minority shareholders. Van Der Elst. and Van Den Steen (2006) point to the other arguments that support the introduction of a squeeze-out and sell-out rule in the takeover regulation:

- The obtaining of the exclusive control over a company offers a number of advantages to the majority shareholder: (*i*) simplifies the organization of general share-

16. "Službeni glasnik RS", No. 1/2006

holder meetings, (*ii*) enables the majority shareholder to pay off the debt used for acquisition financing by selling the assets of the company.

- Minority shareholders can use the sell-out rights in circumstances where they judge that the board of directors of a group of companies does not sufficiently respect the interests of their subsidiary.
- Taking the full control over the company allows going private (target delisting) and thus eliminates the costs of public ownership which are considered significant.
- The transfer of losses and profits in a group of companies is allowed according to some tax regulations only if a 100 per cent control of the subsidiary is achieved.
- Finally, the squeeze-out right enhances legal security. In some jurisdictions the supervisory authority compelled the majority shareholder *ex post* to share the control premium with the minority shareholders. This *ex post* approach creates legal insecurity and can distort the proper functioning of the market.

Serbian legislation provides majority shareholders the squeeze-out right and the minority shareholders the sell-out right in the post-takeover period. The Serbian Company Law incorporates provisions such as squeeze-out right (Article 447) and sell-out right (Article 448). The same field of post-takeover activity is covered by the Article 34 and 34 of the Serbian Law on Takeovers. Unlike Directive 2004/25/EC on takeover bids, the Serbian squeeze-out regime does not require the squeeze-out to be preceded by a takeover bid. The right to squeeze-out (Law on Takeovers, Article 34) is available to a majority shareholder who acquired at least 95% of shares of a Serbian joint-stock company in a tender offer. In the squeeze-out case, the majority shareholder must compensate the minority shareholders under the terms previously offered in the takeover bid.

The analysis of the admissibility of the squeeze-out right application indicates that the legislator has determined quite rigorously the extent of this right. First, the threshold is set at 95% of shares of a joint-stock company which is the upper limit defined by the Directive. Second, the possibilities for activating the squeeze-out right are significantly limited, since the squeeze-out procedure can be activated following previously realized tender offer (and following the terms of the tender offer). Finally, the bidder is obliged to offer the target shareholders the highest price (market price, or the price he was paying for shares in the year preceding the tender offer announcement or the price achieved during the last two years if he acquired in that period at

least 10% of target firm's shares and that price is higher than the price from the tender offer - the Law on Takeovers, Article 22).[17]

The sell-out rule is a provision in the Serbian Law on Takeovers aimed at protecting the remaining minority shareholders who have right to demand the controlling shareholder to buy their shares under the terms from the takeover bid (Article 35). In the sell-out case, the minority shareholders inform the controlling shareholder of the number and the class of shares they offer to sell. The majority shareholder is, in that case, obliged to pay per share the price equal to the amount he has given for the last share with which he acquired 95% of shares. The sell-out provision is introduced in the Serbian takeover legislation, while it is more an exception than a rule in the EU member states' legislations, indicates the legislator's attitude towards the protection of the minority shareholders' interests.

Table 3. Realization of squeeze-out and sell-out rights in Serbia

	Period before enacting the Law on Takeovers (31.11.04–10.06.2006)		Period after enacting the Law on Takeovers (11.06.06.–08.05.2008)		Total	
	Number	%	Number	%	Number	%
Successfully ended takeover bids	137	100,00	267	100,00	404	100,00
Total number of realized squeeze-outs and sell-outs	13	9,49	123	46,07	136	33,66
• Number of squeeze-outs	12	8,76	116	43,45	128	31,68
• Number of sell-outs	1	0,73	7	2,62	8	1,98
Ended takeover bids without triggering squeeze-out and sell-out rights	124	90,51	144	53,93	268	66,34

Source: Malinic, Dencic-Mihajlov (2008)

The enforcement of the squeeze-out and sell-out provisions triggered a wave of squeeze-outs and sell-outs in Serbian companies during the period 2005-2008. Malinic and Dencic-Mihajlov (2008) show in their empirical study that the squeezing-out process (that protects the interests of the majority shareholders) is far more common in Serbian corporate practice than the selling-out process (that is in the function of minority shareholders' protection). This practice, however, rather limits than en-

17. Prior to the enforcement of the Law on Takeovers, the price in the tender offers was set at the level of market, estimated or book value. The consequence of such a choice was often a price that is not optimal for the target shareholders, neither for the minority shareholders who are obliged to sell their shares in the squeezing-out procedure.

hances flows on the capital market. It diminishes the importance of the takeover mechanism as a corporate governance device aimed at protecting minority shareholders' interests.

The squeezing-out and selling-out processes have been significantly intensified following the enforcement of the Law on Takeovers, when 46.07% of successfully ended takeover bids have been completed by triggering squeeze-out or sell-out rights. Malinic and Dencic-Mihajlov (2008) show that 100% ownership over the target company is an important motive behind tender offer announcement and squeeze-out realization on the Serbian market (in 61.7% of the realized tender offers which resulted in majority ownership of over 95%, majority shareholders used the opportunity to squeeze-out minority shareholders).

In comparison to the realization of the squeeze-out right by the majority shareholders, minority shareholders rarely exercise their sell-out right. Even though the activating of the sell-out right in Serbian corporate practice is uncommon, the introduction of this rule is very important since it provides a higher level of minority shareholders' protection.

Conclusion

Corporate governance, as a set of processes by which corporations are directed and controlled, has been recognized as a key factor in developing and improving the investment climate and ensuring a sufficient level of market efficiency and transparency both from the standpoint of the Serbian government and domestic and foreign investors. The establishment of a satisfactory level of corporate governance framework in Serbia is closely related to reform in the area of takeover activity. Both corporate governance and takeover regulation and practice in Serbia underwent significant changes at the beginning of this century. Major improvements and changes, as discussed in the paper, encompass the following:

- The company law introduces improvements in the provisions relating to corporate governance, business combinations, corporate form conversion, disclosure requirement, and company liquidation outside bankruptcy. The procedures for registration of new companies and filing of companies' documents have also been improved by putting into force the law on the business registry.
- The Serbian legislation on takeovers, investment funds, accounting and auditing and securities and the financial market, regulate the corporate sector and capital markets in a consistent way with the comparable regulations of the developed European countries.
- Particular progress in regulating corporate governance practice using external mechanisms has been made by enacting the Law on Takeovers, which is fully

harmonized with the Directive on takeover bids (2004/25/EC) adopted by the EU Parliament and Council in 2004.

- The new legislation on takeover activity results in a higher level of minority shareholders' protection and equal status for all owners on the Serbian market for corporate control. The law introduces provisions relating to sell-out and squeeze-out rights, the establishment of an equitable price in mandatory bids as well as creation of an adequate "playing field" that guarantees the proper information to all the participants in the bid.
- The importance of the mandatory bid rule in the Serbian takeover regulation rests upon its protecting role, since it offers the minority shareholders an opportunity to exit the company on fair terms. However, the effectiveness of the rule has been undermined as the law provides the acquirer with the possibilities either to evade the mandatory bid launching process or to deviate from the process of the price determination.
- In comparison with the previous takeover regulation, the new Law on Takeovers gives a more flexible framework for the squeeze-out and sell-out right activation and consequently leads to a higher number of squeeze-outs and sell-outs. Both rights are interpreted restrictively and in relation with the tender offer process. Triggering the squeeze-out right appears to be one of the motives for a tender offer even in the situations when the bidder already holds a controlling stock of shares. Even though the activating of the sell-out right in Serbian corporate practice is uncommon, the introduction of this rule is very important since it provides a higher level of minority shareholders' protection.
- Finally, the effectiveness of the takeover mechanism in the Serbian corporate governance system is greatly influenced by how proactive and prescriptive an approach the Serbian Security Commission takes.

Serbia has developed a solid institutional environment that can generally offer an effective legal framework. However, good "laws on the books" have not been sufficient to guarantee the effectiveness of a system. Many factors are "responsible" for the existence of implementation gaps: less developed capital market, remaining influence of the state over corporate decision-making, uncompleted privatization process, high concentration of ownership in privatized companies, modest activity of the institutional investors, low educational level of managers in the field of corporate governance, non-existence of effective sanctions for abuses and criminal acts. Accordingly, though Serbia still needs to upgrade its corporate, banking and stock market legislation, the main effort should be focused on the implementation and understanding of the benefit of this legislation in practice, in order to provide explicit signals for domestic and foreign investors that are essential for the development of its capital market.

References

Bebchuk, L., and A. Ferrell, 2001, "A New Approach to Takeover Law and Regulatory Competition", *Virginia Law Review* 87, 1168.

Berglöf, E. and M.C. Burkart, 2003, "European Takeover Regulation", *Economic Policy*, Vol. 36.

Berglof, E., and A. Pajuste, 2003, "Emerging owners, eclipsing markets? Corporate governance in central and Eastern Europe", Mimeo, Stockholm School of Economics.

Bergström, C., Högfeldt P., and J. Molin, 1997, "The Optimality of the Mandatory Bid Rule", *Journal of Law, Economics and Organization* 13, 433-451.

Bobirca A., and P.G. Miclaus, 2007, "Corporate Governance: a South-Eastern European perspective", Munich Personal RePEc Archive, Paper No. 3272

Brada, J., 2006, "Corporate governance in transition economies: lessons from recent developments in OECD member countries", OECD Working papers, Vol. 4, No. 49.

Bristow, S., 2005 "Corporate governance in Bulgaria – an outsider's perspective on recent developments", in *Proceedings from the conference "Bulgaria and the European Union – challenges for business education"*, Slunchev Bryag, Bulgaria.

Burkart, M. and F. Panunzi,. 2003, "Mandatory Bids, Squeeze-out, Sell-out and the Dynamics of the Tender Offer Process", ECGI – *Law Working Paper* No. 10/2003, available at SSRN: http://ssrn.com/abstract=420940

Burkart, M., 1999, "Economics of takeover regulation", SITE Working Paper 99/06, Stockholm School of Economics.

Commission of the European Communities 2007, Report on the implementation of the Directive on Takeover Bids, Brussels.

Cornelli, F. and L. Felli, 1998, "How to Sell a (Bankrupt) Company", White Center Working Paper No. 18-98, Wharton School, University of Pennsylvania.

Davies, P. and K. Hopt, 2004, Control Transactions, in *The Anatomy of Corporate Law*, R. Kraakman, P. Davies, H. Hansmann, G. Hertig, K. Hopt, H. Kanda, and E. Rock, Oxford University Press, 157-191.

Dencic-Mihajlov, K. 2006, "Corporate governance in Serbia: an overview of recent developments", *Facta Universitatis*, Series Economics and Organization, Vol.3, No 2, 169-177.

Dencic-Mihajlov, K. and D. Malinic, 2007, "Squeeze-out and sell-out rights: rationales and objectives for regulation", Proceedings of the Conference "Contemporary Challenges of Theory and Practice in Economics", Belgrade, September 2007., Section *Accounting and Business Finance and Financial Market Development*, Faculty of Economics, University of Belgrade, 1-10.

Goergen, M. and L. Renneboog, 2001, "Strong managers and passive institutional investors in the UK", in *The control of corporate Europe*, F. Barca and M. Becht (eds.), Oxford University Press, 259-284.

Goergen, M. and L. Renneboog, 2003, "Why are the levels of control (so) different in German and UK companies? Evidence from initial public offerings", *Journal of Law, Economics and Organization* 19, 2003, 141-175.

Goergen, M. *et al*. 2005, "Corporate Governance Convergence: Evidence from Takeover Regulation Reforms in Europe", *Oxford Review of Economic Policy*, Vol.21, No. 2

Grossman, S.J. and Hart O. (1980), "Takeover bids, the free rider problem, and the theory of the corporation", *Bell Journal of Economics* 11, 42-64.

Hadzic, M., 2002, "Rethinking privatization in Serbia", *Eastern European Economics*, Vol. 40, No. 6, 6-23.

Hirshleifer, D., and S. Titman, 1990, "Share Tendering Strategies and the Success of Hostile Takeover Bids", *Journal of Political Economy* 98, 295-324.

Kaufmann, D., Kray, A., Mastuzzi, M., 2005, "Governance matters IV: Governance indicators for 1996-2004.", *World Bank Policy Research Paper* 3630, Washingon DC.

Klapper, L., Laeven L. and I. Love, 2006, "Corporate governance provisions and firm ownership: Firm-level evidence from Eastern Europe", *Journal of International Money and Finance* 25, 429-444.

Melkumov, D., 2009, "Institutional background as a determinant of boards of directors' internal and external roles: The case of Russia", *Journal of World Business,* Vol. 44, Issue 1, 94-103.

Nenova, T., 2006, "Takeover Laws and Financial Development", World Bank Policy Research Working Paper 4029.

OECD, 2003, "White paper on corporate governance in South Eastern Europe", Paris.

OECD, 2004, "Principles of corporate governance", Paris.

Papadopoulos, T,. 2007, "The mandatory provisions of the EU Takeover Bid Directive and their deficiencies", *Law and Financial Markets Review*, November 2007, 525-533.

Pop, D., 2006, "M&A market in transition economies: Evidence from Romania", *Emerging Markets Review* 7, 244-260.

Puffer, S., McCarthy, D., 2003, "The emergence of corporate governance in Russia", *Journal of World Business* 38, 284-298.

Serbian Official Gazettes No. 55/2004, 84/2004, 125/2004, 01/2005, 24/2005, 01/2006, 46/2006, 47/2006.

Seskar, L., 2006, "Corporate Governance in Serbia", 6th South East Europe Corporate Governance Round Table, Istanbul, Turkey.

Stringham, E., Boettke, E.,Clark, J.R., 2008, "Are regulations the answer for emerging stock markets? Evidence from the Czech Republic and Poland", *The Quarterly Review of Economics and Finance* 48, 541-566.

Van Der Elst, C. and L. Van Den Steen, 2006, "Opportunities in the M&A aftermarket: squeezing out and selling out", Financial Law Institute, Working Paper Series, Universiteit Gent, WP 2006-12.

Walsh, P., Whelan C., 2001, "Firm performance and the political economy of corporate governance: survey evidence for Bulgaria, Hungary, Slovakia and Slovenia", *Economic Systems* 25, 85-112.

web-sites: http://www.ebrd.com, www.belex.co.yu, http://www.srrs.co.yu

Weil, Gotshal & Manges L.L.P., 2002, "Comparative study of corporate governance codes relevant to the European Union and its member states", Final report and Annexes I-III, European Commission, Brussels.

World Bank, IBRD, 2005, "Financial sector assessment program", Project No. SeCM2005-0581, November 2005.

Yarrow, G.K., 1985, "Shareholder Protection, Compulsory Acquisition and the Efficiency of the Takeover Process", *Journal of Industrial Economics* 34, 3-16.

Živkovic, B., 2004, "Corporate governance quality and corporate control market amidst transition", *Proceedings from the III International Belgrade Stock Exchange Conference*, Belgrade Stock Exchange, Belgrade, 79-91.

Živković, B., Djerić, A., 2003, "Korporativno upravljanje i razvoj tržišta kapitala" in Dabić, S. (eds.), *Posletranzicioni procesi*, Beograd: Savez ekonomista Srbije, Podgorica: Savez ekonomista Crne Gore.

Živković, B., Jolović, A., 2003, "Privatizacija i evolucija finansijskog tržišta u Srbiji", Sientific Society of Economists, Working Paper, www.ekof.bg.ac.yu/centri/nde/2009/01/Zivkovic_Jolovic.