

CORPORATE GOVERNANCE IN LEBANON: AN EMPIRICAL INVESTIGATION*

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Abstract

In this paper, we examine the board composition of the largest three companies, two of which are the first to be privatized and find that the oversight function of corporate boards has not yet been fully utilized. We also analyze the state of corporate governance in Lebanon using the five principles of corporate governance, namely: protection of shareholder rights, equitable treatment of shareholders, protection of stakeholder rights, timely and accurate disclosure and transparency, diligent exercise of the board of directors' responsibilities. We try to highlight Lebanon's potential challenges given its recent experience in the privatization of the mobile telecommunication services, and its current and proposed institutional and regulatory reforms as laid out in the Paris II conference. We also examine the organizational determinants of the governance arrangements in privatized firms based on the experiences of other emerging economies.

Keywords: Corporate Governance, Board Independence, Shareholders' Rights

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Introduction

Beginning 1990s, many developing countries have begun to undertake large-scale privatization in an attempt to achieve economic reform. Through the sale of state-owned enterprises to private investors, governments of developing countries have sought to adopt a market-based economic system aiming to secure enterprise efficiency and accountability while reducing budget constraints and removing enterprise-level decisions from the potential influence of interest-group politics. Unfortunately, such transfer of title has been insufficient to ensure the anticipated economic reform. Governments of developing countries have failed to recognize the importance of promoting good corporate governance in attracting private investment that in itself is fundamental to the success of newly-privatized enterprises. In the absence of an adequate governance system, developing countries have found themselves incapable of convincing potential local and foreign investors that the money they might invest in newly privatized enterprises will be handled responsibly by corporate managers.

Several studies examine the effect of corporate governance mechanisms in improving post-privatization performance of state owned enterprises (Shleifer & Vishny, 1997; Dyck, 2000; Boubakri, Cosset, Guedhami, 2001). These researchers, among others, have found that there is a positive association between post-privatization performance and foreign ownership. They also document performance gains with more private control and cash flow rights, more qualified Board-of-Director members and managers, large and sophisticated local capital market, more legal protection of shareholders' rights and higher quality of law enforcement. Other researchers focus on the role of capital markets and argue that effective competition can actually resolve the associated problems with corporate governance (Boubakri et al, 2001). Dornbusch (1992) and Boubakri et al (2001) among others document the effect of competition on post-privatization performance and found that the extent of competition, as represented by trade liberalization, is positively related to post-privatization performance improvements. Khemani, Shyam and Leechor in a recent working paper find that competitive markets are usually accompanied by high governance qualities.

The Lebanese economy is dominated by family-owned businesses that do not support transparent corporate culture and protocol, which in turn define the roles and responsibilities of those charged with conducting corporate decisions; such a situation presents further challenges to newly-privatized enterprises as effective controls on managerial behavior are nonexistent thereby enforcing the same problems that privatization is supposed to mitigate. In addition, the country's legal institutions suffer from political interference and limited enforcement capabilities and as such legal regulations seem vague and ill-defined. Notwithstanding the problems of clear corporate control and legal accountability, the Lebanese market does not support the concept of a developed and efficient financial market that can in a sense substitute the corporate and legal deficiencies and provide some kind of discipline to corporate behavior. Illiquidity and lack of investment incentives have made it difficult for companies to raise additional capital, for dissatisfied owners to liquidate their holdings at reasonable exit prices (equity prices have already tumbled to below fair value) and for outside takeover threats to acquire those inefficient firms. It may be some time before the above mentioned disciplining mechanisms mature in Lebanon to serve as effective external controls of corporate activity.

Equally important are internal controls whose existence and efficacy will determine the post-privatization performance of state-owned enterprises. According to Dyck (2000), a well known internal control mechanism is the corporate board, which is charged with overseeing and controlling corporate management on behalf of owners. Lebanon's experience with corporate boards and their effectiveness as a control mechanism is not well known because of the lack of transparency. According to the U.S. State Department: "transparency has never been strong in Lebanon". Nevertheless, we attempt to shed some light on the efforts needed to create an effective corporate board capable of promoting managerial accountability. The oversight function of corporate boards requires the presence of independent directors who don't have a relationship to either the company's business or the company's management. As such, directors will be able to pass independent and objective judgments on corporate activities, which are in essence defined by shareholders and formulated by the board itself, and ensure management's accountability of company's performance and results. Of course, to be able to pass informed judgments, directors need to have open information flows with management. In addition, to ensure a genuine governance process, the board should be accountable for its actions to shareholders.

Based on the above discussion, it is clear that ensuring effective governance controls is a vital yet a complex task in the privatization of state-owned

enterprises. Lebanon, like many other developing countries, should consider instituting and raising corporate governance standards concurrently with privatization. We draw from the limited empirical evidence in the newly privatized telecommunication industry.

The paper is organized as follows: In section 2, we investigate the role of corporate boards in Lebanon and their effectiveness in serving as an internal monitoring mechanism. Section 3 covers the impact of competition on corporate governance measures and the limited empirical evidence in Lebanon. Section 4 summarizes the different approaches to effective corporate governance. In section 5, we address issues as to what can Lebanon do to attract external financing and fulfill the promises of its planned privatization program.

Corporate Boards

The board of directors is an elected body charged with effectively representing shareholders' interests. The board's principal responsibilities, as characterized by Fama and Jensen (1983), center on ratifying management decisions and on overseeing management performance. The legal authority grants the board expansive authority to fulfill its responsibilities. However, Borokhovich, Parrino, and Trapani (1996) argue that the board does not always use its authority to advance shareholders' interests. Brennan (1995) states that the so-called principal-agent or agency problem arises from the impossibility of perfectly contracting for every possible action of an agent whose decisions affect both his own welfare and the welfare of the principal. Arising from the agency problem is therefore how to induce the agent to act in the principal's best interests. The problem then becomes how to align the incentives of individual board members with those of shareholders to ensure that the board's decisions and actions benefit shareholders' interests.

Several researchers have studied the degree of alignment between shareholders' and directors' incentives. Fama and Jensen (1983) argue that effective corporate boards would be composed largely of outside directors who tend to be major decision-makers in other companies. Outside directors are expected to be more closely aligned with outside investors' interests and to exercise effective decision control on top management since reputational concerns provide them with the sufficient incentive to do so: the value of their human capital is directly related to the strength of their reputations as decision control experts. Boycko, Shleifer and Vishny (1996) document that the presence of large outside investors is conducive to efficiency. Of course, such a finding is based on the premise that large outside investors would not provide their capital unless they secure certain control rights through their representatives on the

board. Hermalin and Weisbach (1988) also document that firms typically add outsiders to their board following poor performance as outsiders are perceived as more likely to enact changes that improve firm performance. Rosenstein and Wyatt (1990) report a positive and significant stock price reaction when an outsider is named to the board, implying that the market expects the outsider to benefit shareholders. However, such a market reaction does not seem to be consistent for both large and small firms. In larger firms, the stock price increase is found to be insignificant. Lin, Pope, and Young (2000) attribute such a finding to the degree of existing agency problems between large and small firms and to the characteristics of the appointee. They find that smaller firms tend to have relatively fewer existing outside directors and usually focus on appointing outsiders with significant product or technology relevant experience and with no other board seats, and affiliated directors with strong monitoring incentives. Similarly, Filatotchev and Zhukov (2000) found that poor firm performance in Russia stimulated increased outside investment and hence the introduction of outside board members. Whether the appointment of outside directors actually enhances firm performance is a question that has not yet found a definite empirical answer. Agrawal and Knoeber (1996) find that the proportion of outside directors on company boards is negatively related to firm value. However, Hermalin and Weisbach (1991) find no apparent relationship between board composition and firm value. Further research into the role of outside directors has raised a couple of interesting conclusions. Denis (2001) highlights the important role of outsiders in boosting performance during times of crisis; outsiders' role seems to be insignificant in the day-to-day running of a business. Hermalin and Weisbach (2001) document that the power of outside directors is dependent upon the performance of the incumbent CEO. If the CEO is of high quality then outsiders would have little power in controlling and disciplining top management. Mace (1986) and Lorsch and MacIver (1989) find that the effectiveness of outside board members depends on whether the CEO dominates the director nomination process. In such a case, outside directors would be selected based on their inclination to support top management's decisions.

Notwithstanding the role of outside directors in promoting the boards' effective monitoring role, several researchers have gone further to examine the relationship between board size and corporate value. Jensen (1993), Yermack (1996), and Eisenberg, Sundgren and Wells (1998) document that corporate boards become less effective as they grow in size. Larger boards tend to lose their decisiveness and their ability to be critical of one another. However, Faccio and Lasfer (1999) find that such an inverse relationship does not seem to hold in the U.K.

From what has been summarized so far, it is important to emphasize that no matter what the structure or size of the board is, quality monitoring of top management necessitates the separation of decision making and decision control and as such calls for the existence of truly independent outside directors.

Board of Directors: The case of Lebanon

In Lebanon, separation of ownership and control has not yet been fully realized. The commercial code, specifically Article 153, does not provide for the separation of the roles of the chairman of the board from those of the general manager: the board's chairman is responsible for executing the duties of the general manager unless he/she appoints one on his/her behalf. Such a situation makes the task of effectively monitoring management's decisions very difficult. The situation becomes even worse upon examining the characteristics of the board of directors. The concept of truly independent outside directors does not seem to have been utilized yet. The commercial code does not provide for a clear and enforceable definition of an independent outside director to guarantee board independence. The code only requires boards to have a minimum of three directors. Notwithstanding the board's lack of independence, board members in Lebanon don't effectively practice their control roles; they seem to lack the ability and the will to view and examine companies' conditions. In the absence of adequate empirical evidence, we attempt to shed light on the nature of the board of directors in Lebanon by focusing our analysis on the largest three companies in Lebanon: Solidere and the two mobile telecommunication companies, Cellis and Libancell.

Examining Cellis's board composition, it is evident that Cellis is serious with regard to instituting a truly independent board of directors. Even though the Lebanese commercial code allows boards to have a minimum of three directors, Cellis' board consists of nine members including six outsiders and three insiders. Examining the board's voting rights, it is clear that the company complies with the one share one vote concept reflecting the equitable treatment of shareholders' voting rights.

As for Libancell, the current board of directives has been active since October 9, 2002. It is evident that Libancell does not share Cellis its concern about board independence. Effectively, the board consists of three corporate insiders. This represents a clear disregard to the concept of board independence. Not only that, but Libancell seems to challenge the basic standard of one share one vote. Looking into Libancell's internal bylaws, we find that the rules allow shareholders owning shares for a period of at least two years to have two votes for every share. Such practice calls for the preferential treatment of some investors over others and hence challenges the

concept of equitable protection of shareholders' voting rights.

As representatives of the Lebanese corporate sector, Cellis and Libancell show that the Lebanese corporate sector has not yet fully developed the true function of corporate boards.

Solidere, The Lebanese Company for the Development and Reconstruction of Beirut Central District S.A.L., is a private joint-stock real estate company formally established, by virtue of Law 117 (dated 1991), on May 5, 1994. The objective of the company is to reconstruct and develop the Beirut Central District (BCD) area.

Solidere's share capital is composed of two types of common stock:

Type A shares which are issued to property owners in the BCD and individuals or corporations in exchange for their real estate property contributions.

Type B shares which are issued to investors (Lebanese, Arab and foreign) against their cash subscriptions.

Solidere seems to treat all of its shareholders equally. Besides securing equitable rights to its shareholders, Solidere seems to provide adequate protection for its minority shareholders. Article 17 of the company's bylaws states that "no individual or corporation can own, directly or indirectly, more than 10 percent of the total capital of the company". Any contract or agreement in violation of the 10% ownership limit is considered legally void and is subject to disciplinary sanctions based on law 117, dated 1991. To further protect minority shareholders, Article 26 grants any shareholder, regardless of his/her ownership stake, the right to sue the board of directors in case of any evidence of inequity, fraud, deceit or violations to the internal bylaws.

As to the issue of separation of ownership and control, Solidere seems to join many other Lebanese companies in its disrespect to such a concept. Article 28 of the company's bylaws grants the chairman of the board the right to assume the responsibilities of the general manager; he/she represents the company in cases of litigation and is responsible for executing the board's decisions and for running the company's day-to-day operations. Article 28 also gives the board's chairman the right to appoint one or more general managers to aid him/her in running the company. The appointed general manager, however, carries his/her duties under the chairman's name. Further, the chairman also is granted the right to appoint a consultancy committee involving individual board members or outside independent personnel. Nevertheless, the ideas and opinions of such committees are not binding upon either the chairman or the board of directors.

Article 18 of the company's bylaws specifies the structure of the board of directors; it states that the board should consist of 12 members, at least two thirds of which should be Lebanese nationals.

Upon further examination of the structure of the board and characteristics of board members, it is evident that Solidere is not serious with regard to establishing a truly independent board. First, the bylaws do not call for the existence of truly independent directors. As such, the ability of the board to truly oversee management is questioned. Moreover, the bylaws do not provide for the full disclosure concerning each board member. In the absence of such information as the member's background, current activities and how his/her independence is perceived, shareholders would not be able to cast fully informed votes with regard to their representative board of directors. Notwithstanding the ineffectiveness of the board's oversight function, the company's bylaws call for shareholders to appoint one or more independent auditors to continuously monitor the company's operations. Such auditors have the right to look into all financial and legal documents. The auditors should present an annual report to shareholders during general assembly meetings covering the company's financial conditions and the feasibility of distributing dividends. The board of directors is obligated to present to the independent auditors information about profits and losses 50 days prior to the general assembly meeting.

The independent auditors can call for a general assembly meeting whenever they think it is necessary and upon the demand of a group of shareholders representing at least 20% of the company's capital.

In addition to what has been previously presented, Solidere's bylaws seem to institute the basic structure for communication and disclosure. Periodic information is communicated by the board of directors to shareholders and to the appointed independent auditors.

Article 56 of the company's bylaws grants every shareholder the right to look into the company's budget, profit and loss statements, list of shareholders, board of director's report and independent auditors' report 15 days prior to general assembly meetings. The company's existing system of communication and disclosure, in our opinion, fails to provide a sound disciplining mechanism. It is true that the disclosure of the independent auditors' report gives the impression of proper discipline; however, we believe that the presence of independent auditors only provides accounting discipline and as such they are not enough in disciplining all of the board's decisions, especially those concerning the company's long-term financial management and strategic practices. Ensuring such a discipline requires the presence of non-executive independent directors with the required skills and knowledge in such fields. Perhaps the recent failures of reputable audit firms in disciplining companies stand as a proof of the importance of independent directors.

From what has been presented so far, Solidere seems to institute the basic form of a corporate governance system. However, we believe that it still lacks high quality corporate governance measures. As such, the ability of Solidere to attract capital, especially from external sources, would be limited.

Corporate Governance, Competition and the Telecommunication Industry

Shleifer and Vishny (1997) argue that markets play a major role as a control mechanism in promoting effective corporate governance. The market's disciplining function is secured primarily through promoting effective competition. Competition places pressure on corporations through the product, financial and investment markets to seek out and implement competitive practices and strategies focused on operational efficiency and on promoting accountability and transparency in business decisions.

Lebanon, similar to other developing countries, lacks the business environment that fosters effective competition. We attempt to shed light on the nature of domestic competitive practices in Lebanon by focusing the analysis on the mobile telecommunications industry.

The mobile telecommunication industry was introduced to the Lebanese market in 1994 through the use of two 10-year BOT contracts with two private consortiums: Cellis and Libancell. Following the terms of the BOT contract, the two firms had exclusive rights to finance, design, build, operate and maintain the mobile telecommunications facilities. The basic rationale behind such a contract was twofold: 1) to introduce the Lebanese consumers to the mobile telecommunication services and 2) to improve efficiency, productivity and development of such services. However, contrary to basic economic principles and to the experience of the majority of other countries, the 1994-privatization of the mobile telecommunications sector in Lebanon led to the adoption of advanced technologies but eradicated competition thereby promoting duopolistic behavior

and price hikes. In the absence of real governmental controls, the LibanCell-Cellis duopoly allowed the two mobile firms to reap phenomenal profits.

The number of mobile phone subscribers between 1994 and 2002 increased by 540% (from around 125,000 to 800,000). As a percentage of total population, the number of people with cellular phones represent a little over 22% (compared to 2.14% in Egypt, and 5.52% in Saudi Arabia). Despite this impressive growth in demand, LibanCell and Cellis seem to charge the same rate per minute and have approximately equal market share: 48% for the former (385,000 lines) and 52% for the latter (415,000 lines). The two companies have virtually offered the same products to their customers. Over the eight-year period of operation, Cellis and LibanCell imposed prices that were among the highest in other Arab countries and in the rest of the world. While mobile telephone calls cost around 3 to 8 cents per minute in other Arab countries like Saudi Arabia, U.A.E, Morocco, Egypt and Turkey, in Lebanon, and according to the Telecommunications Ministry, mobile calls cost 13 cents per minute for dedicated lines and 35 cents per minute for pre-paid phone cards, half of which goes to the government. Not only that but while in the rest of the world, companies gave away free cell phones to attract customers, in Lebanon, customers were forced to pay \$500 deposit. This is at a time when cell phones rates declined by more than 50% worldwide. To have a better idea of how the absence of real governmental controls on prices eliminated effective competition, we report the annual percentage change in the direct cost per minute charged by Cellis and LibanCell. Between 1995 and 2000, the direct cost per minute rises at 5% per year (table 1); specifically, it rose from 5 cents in 1995 to 6.38 cents in 2000). It clear that the two companies have little or no incentive to engage in price wars in an attempt to gain market share or even to attempt to decrease costs by using resources more efficiently as they are able to mask their higher costs with higher prices.

Table 1. Percentage Change in Cellular Rate Prices

Cellis & LibanCell Rates (1995 - 2000)						
	1995	1996	1997	1998	1999	2000
Rate per minute	\$0.05	\$0.0525	\$0.0551	\$0.0579	\$0.0608	\$0.0638
Percentage increase from previous year	-	5.0%	5.0%	5.1%	5.0%	4.9%
Government taxes per minute	\$0	\$0	\$0	\$0.02	\$0.06	\$0.06
Total cost per minute	\$0.05	\$0.053	\$0.055	\$0.079	\$0.121	\$0.124

The absence of competition and effective market discipline in the mobile telecommunication industry made it difficult to attract minority shareholders. This has presented further challenges

to the Lebanese economy with regards to developing the securities and capital markets. The lack of transparency and accountability was further promoted by the preferential treatment the two

mobile firms enjoyed in the bank credit market. With ensured and easy profits, the two firms were able to secure preferred access to bank credit thereby eliminating the need for the securities markets where external financiers often demand transparency and enforce accountability. Lack of corporate disclosure made the task of independently monitoring the two mobile firms' performance very difficult. This problem was deepened by the pervasiveness of corruption and political interference in the legal system. Based on a report prepared by the United States Economic Intelligence Unit and published in the WSJ's 2003 Index of Economic Freedom, the Lebanese government significantly influences the judiciary. This conclusion was supported by a survey, conducted by the U.S. Department of State, which revealed that foreign investors consider contract enforcement and the unpredictable judiciary system as the most important risk factors in Lebanon. According to another survey conducted by the U.S. Department of State, "transparency in Lebanon has never been strong. The government does not always establish clear rules of the game and often there is political interference in contract awards". Based also on the 2001 survey conducted by the United Nations Economic and Social Council for West Asia, "Lebanese investors say that bureaucratic and administrative red tape, lack of transparency, and corruption are among the main obstacles to investment".

In short, Lebanon privatization of the mobile telecommunication technology saw a complete disregard to the concept of effective competition. This in turn made it clear that the Lebanese government did not have any intention of endorsing effective governance standards; rather, the decision to privatize was motivated by some hidden political agenda.

It is not all bad news. Lebanese businesses seem to be cognizant of the urgent need to adopt competitive business attitudes and stronger standards of accountability and corporate governance. On September 11, 2003 Lebanon's local business leaders joined eight other countries' business leaders in the Middle East and North Africa (MENA) in discussing corporate governance trends in the MENA region and the effectiveness of corporate governance reform efforts. The meeting shed light on the "role and responsibilities of corporate directors, the need for greater professionalism among corporate directors, the role of banks as the primary capital provider in the region, and the need to develop sound regional standards of best practice"²⁵. The commitment to reform can be best demonstrated by the words of Taher Helmy, the Chairman of the Egyptian Center for Economic Studies: "The International community needs to hear the Arab

voice in the drive to harmonize corporate governance standards. We need to make sure that our business culture is not shut out of the debate. This isn't about riding a wave of globalization; it is about our own national development". The summit agreed to convene again in the near future to raise further awareness on the need for better corporate governance practices and economic reform. Third, Lebanon is under considerable threat of local business breakdown once the government signs the Euro-Mediterranean and WTO agreements. The Lebanese government recently expressed its ambition to have a modern WTO compatible telecom law in the short period. It is expected that the government will take the initiative to institute the proper legal infrastructure that stimulates effective competition and that creates incentives for local businesses to seek out operational efficiency. By securing competition, more firms will rely on effective governance practices, rather than on political favors, to effectively compete against global businesses in attracting sources of capital, especially minority shareholders.

Where does Lebanon Stand?

In order to evaluate the potential success of the government's planned privatization program, we summarize the determinants of successful privatization efforts based on a number of research findings and apply these factors to Lebanon.

Boubakri, Cosset, and Guedhami (2001) analyze a sample of 201 firms from 32 developing countries over the period 1980 to 1997 in an attempt to assess the determinants of performance changes of newly-privatized firms in developing countries. They argue that post-privatization performance vary with the extent of economic liberalization and corporate governance mechanisms. Specifically, they report that privatization yields better results when trade and stock market liberalizations precede it. Based on the report prepared by the United States Economic Intelligence Unit, Lebanon's trade policy suffers from a very high level of protectionism. The U.S. State Department reports that "non-tariff barriers include 30 types of import control, administered within Lebanon by various ministries, which may issue and administer a range of prohibitions, restrictions, licenses and certificates". However, it is safe to say that given the government's pledge during the Paris II conference to further liberalize the trade policy, Lebanon's trade policy is set to become more liberal. In early 2002, Lebanon entered into an Association Agreement with the EU. Given the difficult fiscal situation at that time, the EU granted Lebanon a 5-year grace period on the dismantling of Lebanese tariffs. In addition, Lebanon is currently advancing towards membership in the World Trade Organization (WTO) that is expected to be in the near future. As such, the government is planning for further import liberalization including liberalization

²⁵ See World Bank (press release, 2003). "Regional Business Leaders Endorse Corporate Governance Reforms".

of pharmaceutical imports, and more legislation including a modern competition law, a law on licensing procedures to streamline trade licensing and abolish ad-hoc administrative requirements, a consumer protection law, and more WTO-related legislation.

Besides economic liberalization, the authors argue that legal protection, i.e. laws protecting shareholder rights with efficient enforcement is positively related to post-privatization performance improvement. According to the United States Economic Intelligence Report, Lebanon does not have strong property rights; the judiciary system and contract enforcement are unpredictable. The problem of judiciary independence and political influence has long been a characteristic of the Lebanese economy. Perhaps the best example of such an influence is the failure of the judiciary system to take actions against a number of politicians and political affiliates in its 1998 anti-corruption campaign. We believe that such a political influence is likely to continue as there has not yet been a political will and consensus among the different political forces in Lebanon that would support establishing an independent and reliable judiciary system. Based on the experiences of African countries, Lebanon's weak legal protection can be expected to cause modest post-privatization gains.

Other factors promoting post-privatization performance include: government intervention in the economy, and foreign ownership. Research results indicate that the extent of government intervention in the economy is negatively related to performance improvement. The U.S. Economic Intelligence Report states that Lebanon has a moderate level of government intervention. This is supported by the World Bank statistics that report government consumption as a percentage of GDP of 13.6% in 2002 and total government current revenues of 18.3% in 2001. Financial experts expect government intervention to remain stable as it is evident in the government's declaration during the Paris II meeting to focus its future efforts toward increasing public savings through more taxes and fees while protecting expenditures for basic social services.

With regards to foreign ownership, the study finds evidence of a positive association between foreign ownership and post-privatization profitability. The U.S. Economic Intelligence Report affirms that there is no discrimination against foreign investment and that there are moderate barriers to foreign ownership. The April 2001 amendment to the 1969 law removed legal distinctions between Arab and other foreign investment and made other changes facilitating foreign investment. The government has pledged to make further incentives with regard to foreign investment and ownership. Besides selective tax incentives, the government in 2001 adopted an investment promotion law that focused on reducing bureaucratic obstacles to foreign investment and entrepreneurial activity; "the

government also increased loan limits "kafalat" guarantee scheme and introduced interest rate subsidies for small and medium-size enterprises. In 2002, the government adopted a strict new law for fighting money laundering. To further promote foreign investment, the government is preparing for the settlement of violations of public coastal properties. It is clear that the government is trying to build an adequate legal framework to create incentives for foreign investors to participate in local business enterprises; however, the government should also focus on promoting political and economic stability that are considered fundamental for attracting foreign investments.

In addition to the above-mentioned factors, perhaps the most important factors influencing post-privatization improvement is transparency and accountability. Unfortunately, transparency has always been a problem in Lebanon. It is quite difficult for any investor to access information. Lack of transparency, in turn, resulted in a weak system of accountability. The best example of the absence of accountability in Lebanon is the presence of a developed black market with very high level of activity. Even though black market activity involves illegal trade, no one has the power to control such activity. According to the U.S. State Department, Lebanon's black market includes extensive trade in pirated material including books, videotapes, cassettes, computer software, pharmaceuticals, illicit drugs, and cigarettes. Notwithstanding the effects of transparency on accountability, Lebanon's weak system of accountability seems to be supported by clear absence of political consensus among the country's political forces. The effects of political consensus are clear in the powers decreed to the Secretariat of the Higher Council for Privatization. Contrary to other privatization agencies, and as a result of a genuine political interference by the Parliament, the Council's powers have been weakened by "making it nontransparent and micromanaged by the political authorities, who neither have the capability to do it nor the right interests"²⁶.

Approaches to Instituting Effective Corporate Governance

The absence of transparency and accountability in Lebanon presents significant challenges to the Lebanese government, especially in its attempt to attract external financing for its planned privatization program. The government's privatization plan thus far has focused on instituting the proper regulatory framework to promote effective competition with the belief that competition would eventually promote corporate governance mechanisms and hence external capital. However, market competition alone

²⁶ See The Daily Star, August 30, 2003, "Securitization no good without sell-offs, reform" by Tarek El-Zein.

does not provide a guarantee that competitive returns will not be expropriated after the capital is sunk. Therefore, external financiers need some kind of an assurance that they will get back the return on their capital. Such assurance goes beyond effective competition; it requires adopting good corporate governance mechanisms.

As evidenced by the experiences of countries around the world, there are two commonly used approaches to corporate governance. Unlike other methods to attract capital (reputation-building, excessive investor optimism), the two approaches of corporate governance attract capital while giving investors power. This power can be enforced either by legal protection (legal protection of minority rights, legal prohibitions against managerial self-dealing) or by concentrated ownership (ownership by large investors).

Shleifer and Vishny (1997) argue that the principal reason that investors provide external financing to firms is that they receive control rights in exchange. Such rights need to be enforced by law so that investors' interests would be protected in case of any managerial wrongdoing.

Our discussion of control rights will focus on those of external equity financiers because the Lebanese privatization plan considers equity capital as the main source of external financing.

Holderness and Sheehan (1988) argue that the most important legal right external equity financiers demand is the right to vote on important corporate matters, such as mergers and liquidations, as well as in elections of board of directors. However, research suggests that voting rights alone are not effective in protecting the rights of shareholders, especially minority shareholders. For example, in many countries where shareholders had to show up at the shareholding meeting to vote, small investors often did not exercise their voting rights. In Russia, managers sometimes had threatened employee shareholders with layoffs unless the employees voted with management. In addition, evidence showed that even in the case of the board, which itself, was elected by shareholders, directors did not always stand for shareholders' interests. Available evidence from different developed countries with varying forms of board structure shows that boards dominated by outside directors, as in the U.S., boards dominated by inside directors, as in Japan, and two-tier boards, as in Germany, were often quite passive except in cases of true performance disasters. Given the ineffectiveness of voting rights in protecting shareholders' interests, many countries have supplemented shareholders' voting rights by an affirmative duty of loyalty of managers to shareholders: managers have a legal duty to act in shareholders' interest. Such legal protection is supposed to induce financiers, especially small investors, to invest their capital. The legal perspective of the concept of loyalty encompasses several elements including legal restrictions on

managerial self-dealing such as outright theft, excessive compensation, and additional equity securities to management and its relatives; legal restrictions on managers constraining their actions, for example demanding the board's approval before major decisions, or giving shareholders appraisal remedies to stop asset sales at low prices; legal restrictions specifying that minority shareholders be treated as well as insiders. Despite the concept of duty of loyalty, research shows that courts enforce such restrictions with varying degrees. For example, in the U.S. the legal system would surely interfere in cases of theft and asset diversion but less likely to interfere in cases of excessive pay or to even second-guess managers' business decisions. Nevertheless, shareholders in the U.S. have the right to sue the corporation if they believe that managers have violated the duty of loyalty.

In short, the varying effectiveness of legal protections across countries makes it evident that legal protection alone is not enough to ensure that investors get their money back. Therefore, in an attempt to secure more protection, investors tend to concentrate their control rights either by increasing ownership or by engaging in hostile takeovers.

Increasing ownership is the most direct way to protect shareholders' interests. With large/substantial minority ownership stakes, shareholders would have incentives to collect information, monitor management, and use their concerted voting rights to put enough pressure on management to have their interests respected. The practice of heavily concentrated shareholding and controlling ownership as a protection mechanism seems to be the norm around the world, except in the U.S. and U.K. where there are legal restrictions on high ownership (Shleifer & Vishny, 1997). For example, in Germany, large shareholders are usually associated with high turnover of directors (Franks & Mayer, 1990). In Japan, firms with large shareholders are more likely to replace managers in response to poor performance than firms without concentrated ownership (Kaplan & Minton, 1994). In the U.S., research shows that large shareholders increase the likelihood of takeovers (Denis & Serano, 1996), and in case of failed takeovers, management turnover is higher in poorly performing firms with large shareholders. Of course the disciplining power of large shareholders largely depends on the degree of legal protection of their votes. In the case of majority ownership, minimal legal protection is required as votes are mainly determined by the majority shareholder's preferences. However, in the case of large minority shareholders, sophisticated legal systems are needed to prevent management's interference in alliances among large minority shareholders and hence to protect large shareholders' rights.

Notwithstanding the effectiveness of large shareholders in securing their return on capital, some legal protection is required to protect the interests of minority shareholders. After all, large investors

would use their control rights to maximize their welfare either by expropriation or by redistribution of wealth from other stakeholders, including minority shareholders. Such a situation would have a significant effect on reducing the incentives of small investors to participate in external financing. Such a situation is exemplified in many countries of Continental Europe including Italy, Germany, and France. The lack of minority investor rights in these countries has had two major consequences: first, it has discouraged minority investors to participate in financing, and second, it has limited the growth of the countries' public equity markets.

Besides increasing ownership, investors can utilize hostile takeovers to secure their capital. Such a mechanism is particularly important in countries where there are legal restrictions on majority shareholding. The rationale behind takeovers is simple: to replace or at least control management, an investor needs to make an attractive bid to the dispersed shareholders of the target firm. The effectiveness of takeovers in protecting external investors' capital has been thoroughly documented. Research shows that takeover targets are usually poorly performing firms and that managers of such firms are often removed following a successful takeover (Palepu, 1986; Morck, Shleifer & Vishny, 1990). However, research also shows that such control mechanisms are sufficiently expensive and that only major performance failures are likely to be addressed.

Based on the above analysis, it is clear that a good corporate governance system needs to include both, legal protection of investors (especially minority shareholders) and some form of concentrated ownership. Either approach alone would not be adequate to induce external financiers to invest. For example, in the U.S. (Shleifer & Vishny, 1997) argue that both small and large shareholders are protected through an extensive system of rules that protects minority rights, allow for easy transfer of shares, keeps elections of directors relatively uninhibited by managers, and gives shareholders extensive powers to sue directors for violations of fiduciary duty.

What can Lebanon do to attract external financing and fulfill the promises of its planned privatization program?

Almost thirteen years after the end of the civil war, Lebanon finds itself facing a major challenge. The country's high fiscal deficit, driven mainly by high levels of interest payments on outstanding public debt, is paralyzing the government's ability to stimulate the stagnating economy. The fiscal deficit is becoming more of a crisis especially with the drying up of corporate investments and the inability of domestic financial savings to further provide the necessary fiscal financing. Today, the Lebanese government is in dire need to external financing to

put the country on the road to recovery. Attracting capital would not be an easy task for the Lebanese government especially with the country's well-publicized weaknesses in promoting effective competition and corporate governance mechanisms.

The evaluation of the Lebanese corporate governance system focuses on the applicability of the five basic principles of corporate governance as laid out in the World Bank's main document entitled, "Corporate Governance: A Framework for Implementation". Based on the World Bank study, there are five basic principles of corporate governance:

- ❖ Protection of shareholder rights
- ❖ Equitable treatment of shareholders
- ❖ Protection of stakeholder rights
- ❖ Timely and accurate disclosure and transparency
- ❖ Diligent exercise of the board of directors' responsibilities

In Lebanon, the law does not provide adequate protection of shareholders' rights. A company is not legally obligated to share in company profits with shareholders or to provide shareholders with complete disclosure of company information. The law only obligates firms to disclose corporate charters along with information related to equity holders, their aggregate holdings, and shareholder meetings to the Commercial Register. Firms are also required by law to disclose budget-related information to the Ministry of Finance. However, it is not easy to access such information: first, the law does not obligate governmental agencies to disclose company information to anyone; and second, the process of searching for needed company information is time consuming as it involves going through piles of related paper documents. Notwithstanding the limited disclosure requirement, the legal system grants shareholders the right to influence firms through shareholder meetings and votes. The law grants shareholders the right to elect a board of directors, whose job is to monitor management and make sure that shareholder interests are being served. The law holds the board accountable for its actions to shareholders.

Despite the limited empirical evidence of the role of the board of directors in Lebanon, we attempt to shed light on how the legal system secures the oversight function of directors. The law does not set legal specification with regard to the structure of the board nor does it obligate the board to have independence from management. It is clear that the law has not yet fully developed the concept of separation of ownership from control. After all, an elected board member may be appointed a member in the firm's management! Furthermore, the law does not force the board to treat all shareholders fairly and give them access to information, nor to guide corporate strategy, manage the firms' executive functions (such as compensation, business plans, and executive employment), and implement systems to

comply with applicable laws (Iskander & Chamliou, 2000).

Despite the limited empirical evidence, we posit that the oversight function of corporate boards has not yet been utilized in Lebanon. As such, we do not expect Lebanese companies to emphasize the role of informed and independent directors who are able to pass independent and objective judgments on corporate activities.

As to the protection of minority shareholders and the concept of equitable treatment, the legal system does not seem to differentiate between foreign, local, majority and minority shareholders; however, the law fails to provide adequate protection for minority shareholders against abusive self-dealing and insider trading. As such, there are no legal restrictions specifying that minority shareholders be treated as well as other stakeholders nor there are controls on managerial actions. Nevertheless, the law grants shareholders the right to sue a company if there is evidence of illegal behavior such as theft and asset diversion. Such suits are directed to and handled by the Commercial Court. Even though the Commercial Court seems to be a good control mechanism, we question its effectiveness given the limited disclosure of material information.

With regard to timely and accurate disclosure and transparency, the legal system in Lebanon does not seem to support full disclosure of all matters material to company performance as indicated in our previous discussion of shareholder rights. Lack of transparency has clearly paralyzed the monitoring function of the markets as well as the shareholders' ability to effectively exercise their voting rights. Shareholders in Lebanon seem to have no interest or desire to interfere in business; all they ask for is to participate in the profits. Still the law tries to protect accuracy of information disclosed, particularly, those related to the budget, as it requires every firm to have its own independent auditor in addition to the auditor assigned by the state. Nevertheless, based on our own observations, full information disclosure needs quite some time to advance in Lebanon as the prevalence of family-owned businesses in the local environment has created a strong anti-disclosure corporate culture and protocol.

Perhaps the most challenging principle of corporate governance is the one related to enforcement of contracts and the effective redress for violations of stakeholders' rights. Again, since the government's financing plan focuses on external equity capital, our analysis will be limited to those mechanisms that are in place to enforce shareholders' rights and address any potential violation of those rights. The system of accountability in Lebanon suffers from a clear evidence of limited enforcement capabilities. The political interference in the Lebanese legal institutions has caused legal regulations to seem vague and ill-defined. The government's recent

experience with privatizing the mobile telecommunications industry and its inability to control the active black market activities stand as a proof of the prevalence of political interference and contractual and legal uncertainties. Notwithstanding Lebanon's deficient legal system, which makes it almost impossible to attract both domestic and foreign investors, we attempt to self-assess the effectiveness of share ownership and hostile takeovers as substitute mechanisms to securing control rights of financiers and hence attracting their capital.

Given the limited empirical evidence regarding the practice of majority/minority ownership, we can't accurately evaluate the effectiveness of share ownership in Lebanon. Still, we can draw a couple of conclusions based on our own observations. First, the law does not seem to restrict majority/substantial minority stakes; for example, prior to government's control of LibanCell and Cellis, 86% of the former was owned by Ali and Nizar Dalloul while 30% of the latter was owned by Najib, Taha and Azmi Miqati²⁷. Notwithstanding the potential of majority ownership in securing external financing, we posit that such a mechanism is far from effective especially in the absence of adequate legal protection of minority shareholders.

The Lebanese market for corporate control is still undeveloped. The limited information on the profitability of corporations, illiquidity of the local capital market aggravated by the government's planned monetary restraint, and the prevalence of political authorities in the business environment among others, make it very difficult for takeovers to both discipline poorly performing companies and to provide a reliable and efficient exit mechanism to investors.

Given the difficulties of establishing an effective corporate control market in Lebanon, we try to assess the effectiveness of the local competitive environment in disciplining performance and securing investors' rights.

Lebanon does not have an effective competition policy as evidenced by the country's recent experience with the privatization of the mobile telecommunication industry. Failure to institute the proper regulatory framework supporting effective competition promoted duopolistic behavior and resulted in serious costs to the society at large. We do hope that the government's initiative to policy reforms, particularly with regards to competition, as laid out in the Paris II conference, would be serious enough so that past mistakes could be avoided. In the absence of empirical evidence to the contrary, we remain skeptical of the ability of the reformed competition policy in promoting an effective market-disciplining mechanism that could alone solve Lebanon's problems of corporate governance.

²⁷ Gambill, G. "Lebanon's Cell Phone Scandals".

Concluding Remarks

Lebanon's recent experience with privatization, specifically with the mobile telecommunications industry, has raised doubts as to the government's intention behind privatization and in its ability to achieve its widely publicized goal of economic reform: improving productivity and development of state-owned sectors, increasing national and foreign investments, creating new job opportunities, and providing better and cheaper services to local consumers of all classes. Instead of providing social and economic efficiency, the government's privatization of mobile telecommunications simply substituted a public sector monopoly by a private duopoly. The resulting duopoly was promoted primarily by the government's failure to establish a favorable regulatory atmosphere inducing competition between the companies fueled by a clear disregard of corporate governance principles of full disclosure, accountability and respect and protection of the rights of the investor and the society at large. Today, Lebanon is facing another challenge with its privatization of a number of state-owned enterprises. However, the conditions are now different. The success of such a wide privatization program would have substantial consequences on the country's ability to recover from its overwhelming fiscal and economic crisis. Notwithstanding the country's critical state, it does not look like privatization is likely to happen soon. The political forces in Lebanon seem to freeze privatization efforts as there has not yet been a political consensus supporting the details of the privatization program. As always, it seems that the particularly delicate and sectarian nature of Lebanon is breaking in. Nevertheless, we do hope that when such support prevails, the government would have learned from its past privatization experience and be more appreciative of the role that corporate governance and effective competition can play in the success or failure of its privatization program.

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