The Political Economy of Governance in the Euro-Mediterranean Partnership

Deliverable No. 14
Working Package 11
Name of Working Package: Domestic Institutions

Domestic Institutions for the Enforcement of Contracts: The Case of Lebanon

Working Paper Number 0803

Author: Makram Malaeb
Contributor: Jad Chaaban

Date: December 2008

The Sixth Framework Programme
Contract No. 028386

SIXTH FRAMEWORK PROGRAMME

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1. Introduction

This paper has three primary objectives: to illustrate the importance of legal bottle necks as institutional impediments to economic development in Lebanon, taking the case of contract enforcement and corporate governance as illustrative examples; to review the EU procedures and programme formulation and see if they would be currently adequate to treat this problem, or indeed, any other generic problem in Lebanon, and finally, to produce recommendations that apply to improving the conditions nationally and improving the effectiveness of EU implemented programmes in the country.

The study aims to illustrate that the Barcelona process has helped, but in an insufficient matter, ameliorate the situation for companies within the MEDA region though efforts aimed at improving the legal infrastructure in the region. The paper argues that current project formulation is done in such a way that it doesn't answer to the core demands. The paper looks at contract enforcement and investment promotion as potential areas of intervention and undertakes a brief review of EU regional effort in legal reform. These two areas of legal enquiry are essential ingredients for the normal operation of the private sector in any given economy and the existing set up in Lebanon forces the companies to assume higher risks and loss and forces investors to withdraw from in-company investment, promulgating the segregation of the economy into more and more small scale enterprises. As a result, more work needs to be done to support private sector institutions in order to lower the cost of doing business and enhance economic activity in general. Unfortunately, the current system of EU project formulation, and the current plans for further EU legal intervention in the country seem to indicate that these important topics will be left unattended.

The mechanism of the formulation of national projects by the EC delegations will be examined and recommendations made in order to enhance the relevance, effectiveness and national ownership of the projects.

2. Why are contract enforcement and investment promotion mechanisms important?

It is now becoming more and more recognized that the success of an economy in general is functions of many inter related factors. These factors have been termed “good governance” “investment” or many other names by numerous economists. One the of the most important theories of development postulate that the physical growth of investment account, or explains, only a fraction of growth registered in western economies, and that the residual of the equation actually explains the real reason behind growth. This is the dilemma presented by Solow in the 1950s and 60s. The importance of this model is that it indicated the non linear fashion of development and the importance of the agency in the process and also, of having a multitude of factors that are difficult to measure in terms of economic efficiency.

Specifically, issues such as contract enforcement and the attractiveness of investment are inter-related. Usually, laws that do not sufficiently protect contracts, are the same laws that hinder investment. A case in point is the issue with minority rights. Weak minority right provision makes contract enforcement difficult (in terms of the firm living up to the expectations of the minority shareholder) and also makes investment unattractive. People will be reluctant to take a minority share in a company if their rights are not adequately protected.

More than just the legal matter, the issue of contract enforcement transcends the boundaries of corporate structures to the procedural and daily aspect of a business’s life. Small contracts, based on selling of products and services to another company or individual are perhaps more important than contracts between businesses or between businesses and large scale purchasers.

The two topics being dealt with are of extreme importance. Cost of regulation, or bad regulation, directly and indirectly impact the success of the businesses in a country. Countries with malfunctioning market economies tend to benefit from increased, more transparent regulations, while countries with liberal and well functioning market economies tend to benefit from lower

regulations. However, this rule is not set in stone as some regulations are universally recognized as essential for the well being of investment and of trust among the business community. Without this trust, the whole system of transactions is in doubt.

Trust is the glue that allows for a smooth functioning of a market system. This trust is not a product of social behaviour or values, rather, it is a function of well developed and established responsive institutions that offer the possibility to deal with transactional problems, and redress them in a generally accepted fair and transparent fashion.

In this paper the issues being dealt with are investment protection, viewed more globally as corporate governance issues and the problem of non-payment, which in turn are a reflection of lost trust in the system and an exaggeration of the free-rider problem in it.

The ranking displayed in the Figure 1 shows that Lebanon is not in an enviable position within the region and especially compared to selected advanced countries that have relevant shared experience (Israel is in the region and Ireland has a multi religious community with high debt/GDP ratio in the 1980s and small population). Lebanon's ranking in protecting investors is 83, while its enforcing contracts ranking is 121. These figures do reflect the extent of the problem in these two topics. Without amendments to the legal code, and without the creation of effective institutions that reduces the cost and the risk of doing business, the above ranking might only improve slightly, and far worse, the situation on the ground for enterprises will improve little.

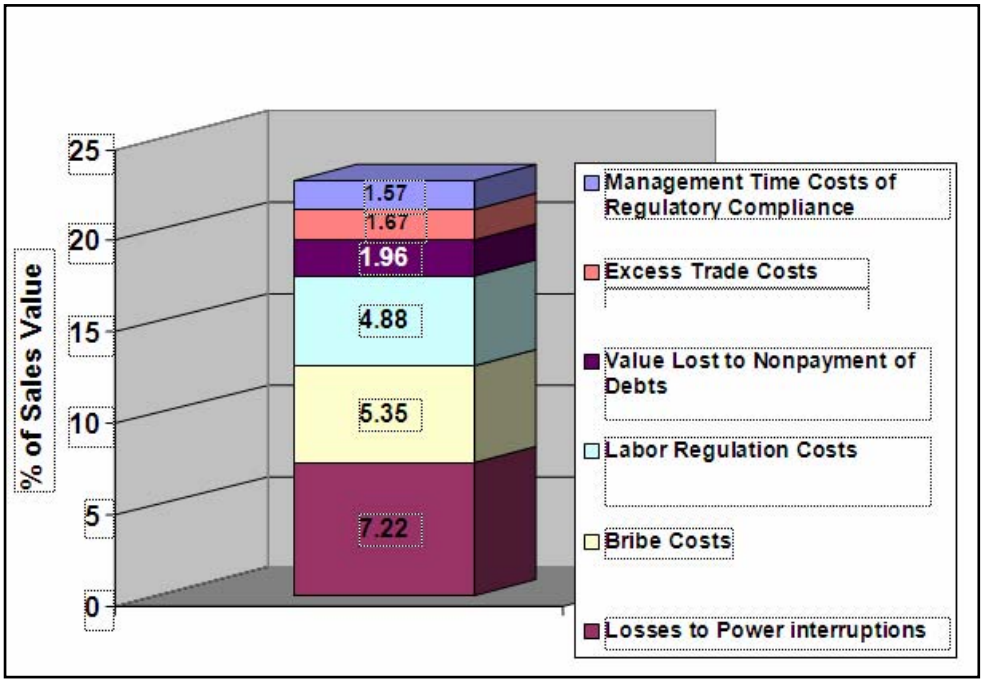
Figure 1: Ranking of selected economies according to the 2008 Doing Business report

Economy	Ease of Doing Business Rank	Starting a Business	Dealing with Licenses	Employing Workers	Registering Property	Getting Credit	Protecting Investors	Paying Taxes	Trading Across Borders	Enforcing Contracts	Closing a Business
Ireland	8	5	20	37	79	7	5	6	20	39	6
Israel	29	17	109	87	152	7	5	69	8	102	40
Turkey	57	43	128	136	31	68	64	54	56	34	112
Jordan	80	133	71	45	109	84	107	19	59	128	87
Lebanon	85	132	113	53	92	48	83	33	83	121	117
Tunisia	88	68	96	113	66	97	147	148	28	80	30
West Bank and Gaza	117	166	132	103	118	68	33	22	77	125	178
Egypt	126	55	163	108	101	115	83	150	26	145	125
Morocco	129	51	88	165	102	135	158	132	67	114	60
Syria	137	169	86	126	89	158	107	98	127	171	77
Iraq	141	164	104	60	40	135	107	37	175	150	178

Given this, data from the Investment Climate Assessment (ICA) implemented by the World Bank in 2005-2006 in Lebanon, shows even more startling facts about the business climate in the country. The ICA surveyed almost 500 major companies in Lebanon, asking specific questions about business operations and the impact of the legal environment on companies working in the country. Figure 1 below shows the combined impact of factors related to the investment climate on the losses of firms (in percentage of sales). Several of the leading investment climate costs in Lebanon can sum to nearly 23% of the sales value of a firm.

Losses due to power interruptions come first, accounting for nearly 7% of the sales value of firms; losses from the cost of bribery amount to almost 5%; losses due to labour regulations also amount for almost 5%; while non-repayment of debt, losses due to costly trade facilitation, and losses due to regulatory compliance time all sum for nearly 5% of sales value.

Figure 2: Losses due to investment climate, by main factors



Source: The World Bank, ICA 2006.

The table below illustrates the changes that occurred in Lebanon's ranking over the past two years and reflects the general lack of progress made and the possibility of affecting more lasting and meaningful change if the proper framework and actions are developed and utilized.

Figure 3: Changes in Lebanon's ranking from 2007 to 2008

	2008 rank	2007 rank	Change in rank
Doing Business	**85**	**77**	**-8**
Starting a Business	132	122	-10
Dealing with Licenses	113	106	-7
Employing Workers	53	54	+1
Registering Property	92	93	+1
Getting Credit	48	45	-3
Protecting Investors	83	81	-2
Paying Taxes	33	29	-4
Trading Across Borders	83	83	0
Enforcing Contracts	121	119	-2
Closing a Business	117	112	-5

Source: Doing Business 2007. Rankings have been recalculated to reflect changes to the methodology and the addition of three new countries.

Overall, the country's position deteriorated in 2008 compared to 2007 with the overall score losing 8 points and with contract enforcement and protecting investment both also deteriorating by two points each.

These institutional and legal failures are having an impact on the country's performance. A pilot study conducted by the SME Integrated Support Programme in the ministry of economy and trade in 2007 compared Lebanon to Greece, Jordan and Ireland, with Lebanon coming last in terms of competitiveness.

Figure 4: Lebanon pilot competitiveness index

Competitiveness index for Lebanon	Lebanon	Jordan	Greece	Ireland
Total average pillar 1: Economic Performance	2.71	2.57	2.79	1.93
Total average pillar 2: Government Efficiency	3.23	2.31	3	1.46
Total average pillar 3: Business Efficiency	3.57	2.29	2.29	1.86
Total average pillar 4: Infrastructure	3	2.6	2	1.8
Total Average Ranking	**3.07**	**2.45**	**2.59**	**1.75**

Source: Competitiveness Index Report (SME support programme and CRI, 2007, p 22)

Almost in all aspects, Lebanon's ranking was the worst, including for government efficiency and perhaps surprisingly also for business efficiency, lending credence to the hypothesis that poor government leads to poor business and vice versa.

The specific breakdown of the contract enforcement and investment protection problems will be elaborated in a later section. However, this section was meant to demonstrate why these issues are important and elaborating the current situation in the country regarding the two topics being discussed.

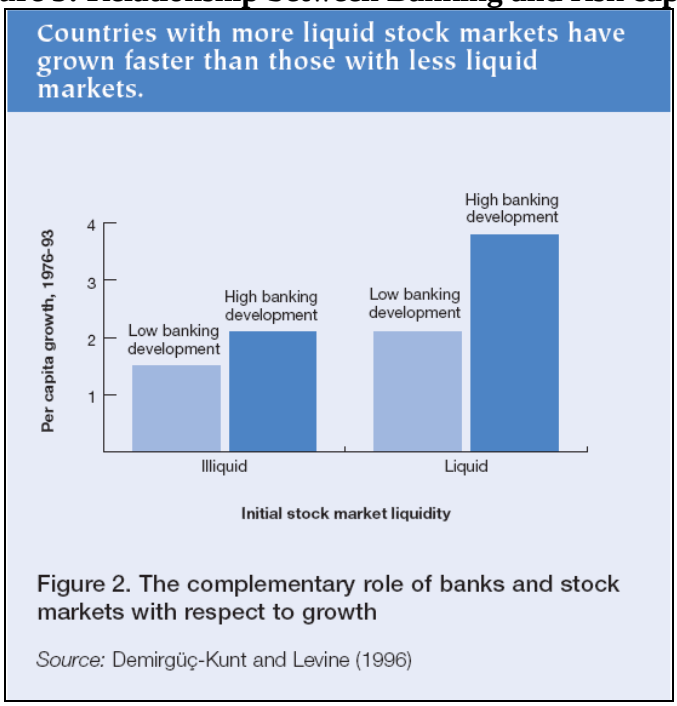
2.1 Understanding investment protection and its importance

Investment protection is the litmus test of cooperate governance. In turn, the concept of corporate governance in general is understood by how a firm chooses to govern itself, vis-à-vis its members, partners, customer, and stakeholders in general. The examples of Enron, Arthur and Anderson are still fresh enough to warrant attention to the type of system wide damage that can result from bad corporate governance issues. A more striking example, but slightly more distant, is the east Asian crisis that perhaps was not triggered or caused by corporate governance and transparency issues, but was nonetheless given stimulus and thrust by the rising concern regarding corporate governance issues.

Internationally, a well functioning financial system presupposes in many instances a well functioning and developed corporate governance system. This is especially true of stock markets and venture capital. However, international experience demonstrates that stock

markets and venture capital grows hand in hand with the banking sector and thus, a system with a well functioning banking system is more likely to have a liquid and well functioning risk capital structure.

Figure 5: Relationship between Banking and risk capital



Source: Corporate Governance and Development, IFC, 2003, p9.

Thus, countries with low per capita growth have illiquid stock markets and lower developed financial systems and the reverse is true. Thus, there is complimentarily between growth in general and growth of finance and risk capital as well. The later, are instinctively linked to corporate governance in general and to investment protection in particular.

International findings indicate so far that corporate governance, and specifically well developed and protected minority rights and shareholder and creditor's rights are correlated to:

1. Better access to finance: the findings have established a relationship between better creditor and shareholder rights and better access to finance of all kinds in general
2. More developed capital markets: countries with better developed minority and shareholder rights tend to have larger stock markets. In fact, the difference between the lowest performing countries in terms of legal rights and highest performing countries is more than four folds.

3. Lower cost of capital: better corporate governance leads to lower cost of capital, generating enormous general savings and allowing for more economic activities to take place.

The relationships are real and not theoretical. Corporate governance is linked to all of the above, but it is also essential for investment promotion and attraction, whether be it foreign direct investment (FDI) or local cross company investment activities. The impact of investor's protection will be examined in more details in the section relating these issues to the status in Lebanon.

A study done by the international finance journal reaffirms the positive relationship between enhanced investor protection in general and access and cost of finance for emerging markets. The study concludes that "where corporate governance ensures the protection of minority shareholders, external capital will be forthcoming to meet the capital budgeting needs of firms based on profitability of investments. On the other hand, where corporate governance does not provide for the protection of minority shareholders, firms will have to rely on their internal resources."[1]

Economically speaking, the efficient distribution of resources is essential for the development of a country. Domestic and foreign investment is an essential element in the transfer of capital and know how across the globe. The institutional set up and the clarity of laws and procedures, and the practices of companies might be more important in many investment decisions than the types of incentives often offered to attract FDI into the country.

The stability presented in economic and political settings, reflected in the rule of law being applied on the ground, is perhaps the best investment promotion programme a country can have. Lebanon, having many geographical, demographical and economic advantages should be a magnet for regional investment. However, the continuous political problems keep most foreigners away, and more damaging, the non-stability of the institutional set up protecting the rights of investors in the country is refraining internal meaningful investment to take place. This is will be elaborated more in the section analyzing the current situation in Lebanon.

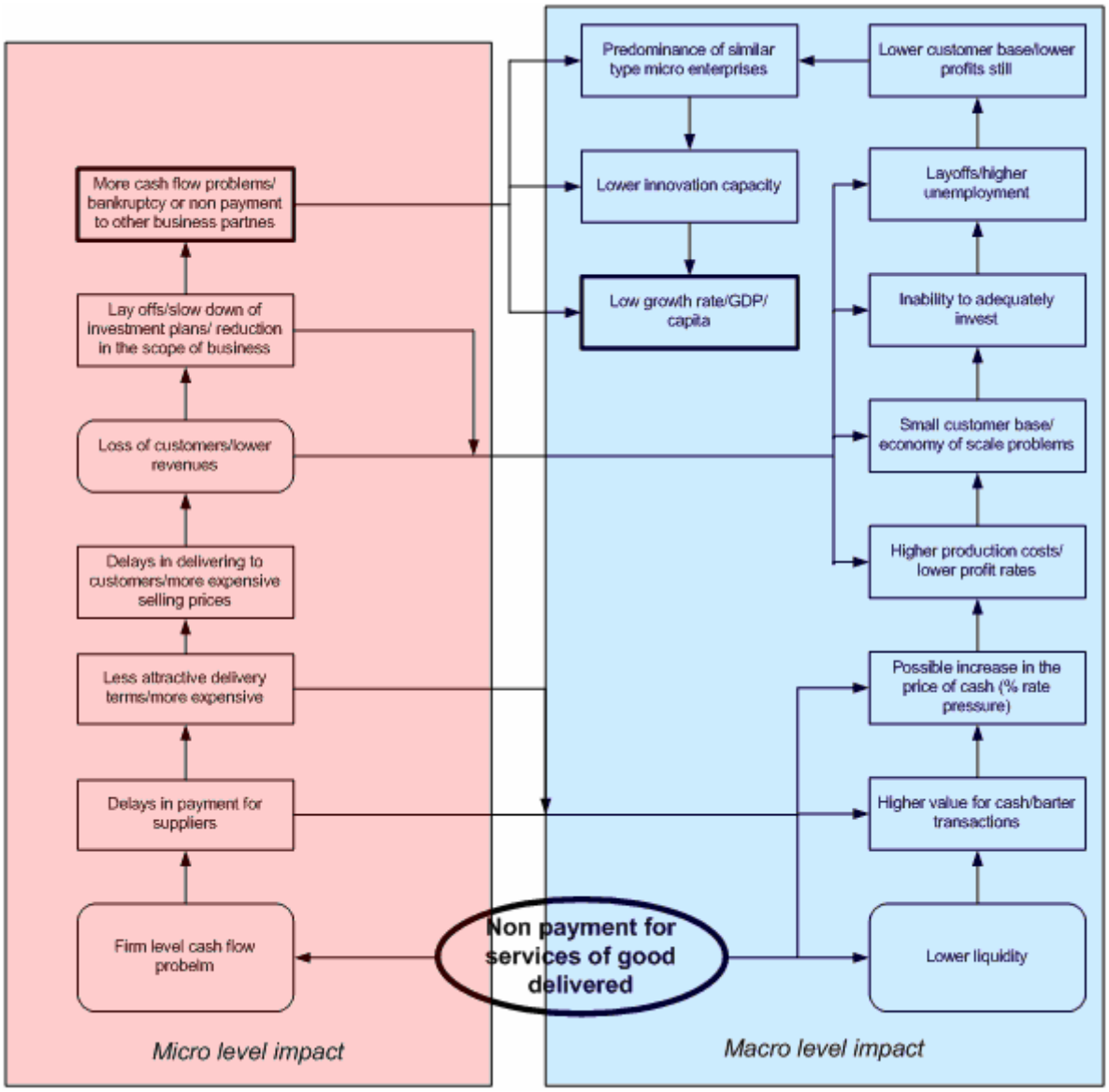
[1] Tanweer Hasan, Palani-Rajan Kadapakkam and P. C. Kumar Firm Investments and Corporate Governance in Asian Emerging Markets *Multinational Finance Journal*, 2008, vol. 12, no. ½, p 41.

2.2 Understanding the non payment issue and its importance

The issue of none payment for services rendered or products sold is common in many countries. The phenomena is indicative of the general economic well being of the sectors in question and is reflective of the overall risk associated with doing business in a particular country. Non payment is not only a legal issue requiring legal actions to take place, but it is also indicative of the general well being of the businesses operating in a particular country. Some non payment issues are caused by malice or criminal intent, many more are caused by cash flow problems and general slow down in economic activity. However, the ease of getting out of the problem, the benefits of non compliance, amplify the problem and cause severe problems overall for the companies in question and for the economy in general. Problems are two sided, micro level and macro level. The figure below illustrates the theoretical flow of problems caused by non payment.

The figure below attempts to illustrate the theoretical consequences of a serious non payment problem and the type of ripple effect it can have. The issues as illustrated above are inter-connected and self reinforcing and by no means exhaust all the possibilities of problems and constraints to be faced through non payment. However, what is needed is an effective enforcement structure that makes collection of money due for services rendered more efficient, fairer, and more worthwhile. What is needed are institutions that are effective, i.e., they are the correct instruments to deal with this problem and also, these institutions need to also deal with the problem in a sufficiently efficient manner to allow for better utilization of these institutions.

Figure 6: Micro and micro impact of non payment problems



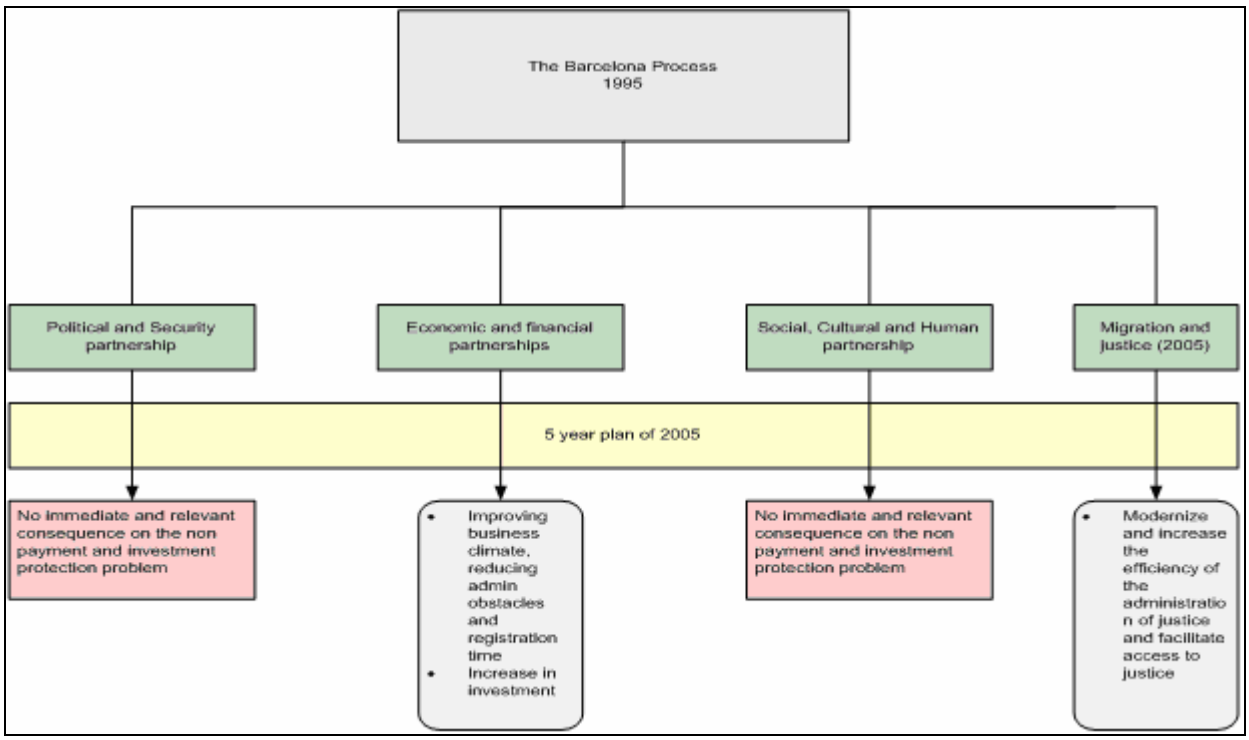
3. The Barcelona process and the efforts done so far by the EU to strengthen the legal framework in the MEDA region

The Barcelona process, started in 1995 aims at establishing a new framework for relations between the MEDA countries where convergence over time allows for a more secure and prosperous area. Initially, the process had three main pillars, security, economic, and social, a fourth one (migration and justice) was added in 2005. These three pillars have an impact on non payment and protecting investors, that is, their proper achievement cannot be done without working on these problems across at least two of the pillars of the Barcelona process.

The type of intervention needed should focus not only on the formal judicial system, but on

clearing mechanisms and on institutional set ups that allows for mediation and non judicial solutions to be found in the first place, and then, providing the proper legislative environment to ensure a proper overarching set up that is conducive for business in the country.

Figure 7: Description of the Barcelona pillars and their immediate relevance to investment protection and non payment problem



The 2005 action plan emphasizes the need to improve business climate and increase investment in addition to modernizing and increasing the efficiency of the justice system. This is indeed encouraging, but legal changes, or even non legal change has not been implemented yet, and most legal programmes still focus on building the capacity of judges, privatization efforts or approximating rules and regulations, ignoring for the large part, non trade related legal economic issues.

Since 2004, the EU has funded at least 17 projects in the MEDA region relating to justice or legal issues. A summary table of these programmes is included below:

Figure 8: List of EU legal projects in MEDA region since 2004

	Subject	country	value	date	Type
1	Technical Assistance for Better Access to Justice	Turkey	1.1	2006	Justice
2	Institutional Strengthening of the Ministry of Justice	Jordan	1	2006	Justice
3	Technical Assistance for the Programme “Empowering the Palestinian Judicial System	Palestine	3.75	2005	Justice
4	EuroMed JUSTICE II	MEDA	5	2007	Justice
5	Marché relatif au Recrutement de l’Unité d’Appui au Projet « Appui à la Réforme du Secteur de la Justice en Algérie »	Algeria	6.2	2006	Justice
6	Promotion of International Commercial Arbitration and other Alternative Dispute Resolution Techniques	MEDA	1.144	2004	Justice
7	Marché relatif au Recrutement de l’Unité d’Appui au Projet « Appui à la Réforme du Secteur de la Justice en Algérie »	Algeria	6.175	2006	Justice
8	Assistance juridique opérationnelle à la privatisation et à l’ouverture du capital des entreprises publiques économiques	Algeria	2.79	2006	Justice
9	Mise à disposition de capacités d’accueil et de moyens pour le déroulement de formations et l’organisation de voyages d’études	Algeria	1	2007	Justice
10	Informatisation des Juridictions par le développement des applications « métier »	Morocco	1.25	2005	Justice
11	Mise en oeuvre des bases de données juridiques et judiciaires	Morocco	0.781	2006	Justice
12	Supervision for the Construction of Courts of Appeal Buildings in Ankara, Erzurum and Diyarbakır	Turkey	1.159	2006	Legal / Construction
13	Technical Assistance for Judicial Modernisation and Penal Reform in	Turkey	0.73	2006	Legal / Institutional

	Turkey				strengthening
14	Technical assistance for the Ministry of Agriculture and Rural Affairs for the alignment of organic agriculture legislation to the EU acquis and the development of organic agriculture in Turkey	Turkey	0.909	2006	Legal
15	Technical Assistance to support the legal and institutional alignment of the Fisheries Sector to the EU Acquis	Turkey	2.11	2005	Legal
16	Technical Assistant to Strengthening the Fight against Money Laundering	Turkey	1	2004	Legal
17	Technical assistance for the Ministry of Agriculture and Rural Affairs for the alignment of organic agriculture legislation to the EU acquis and the development of organic agriculture in Turkey Location - Turkey	Turkey	0.909	2006	Legal / agriculture
	Total		**37.007**		

As the table above explains, the EU has funded more than 37 million Euros in justice and legal reforms in the region since 2004 only. If this is an average example of EU funding, then it is possible that the EU has spent at least three times this amount since the start of the Barcelona Process in 1995.

In fact, under the new European Neighbourhood Policy (ENP), justice and Legal issues will receive more attention, and this is indeed reflected in the National Indicative Programme (NIP) for Lebanon covering the period of 2007 – 2013. The NIP has reserved 10 million Euros that will come on line in 2009 in order to facilitate the operation of the justice system in Lebanon and to train judges. This emphasis on training is important, but it is also an action that is quite ordinary in light of the needs identified in his paper so far in terms of Good corporate governance relating in reducing the burden of non payment and increasing the protection of investors, two legal problems with substantial impact on the economic well being of the country.

3.1 Relationship between the EU and Beneficiary state: formulation and implementation of projects

Under the European Neighbourhood Policy, EU interventions in the beneficiary countries are regulated and co-owned in principal through the extensive system of dialogue between the Delegation in the country and the government. Priorities are set together, and an indicative budget and time frame of activities along with provisional time table are set. Following which, the EU commission several field identification missions to study how the programmes can be best structured. These missions provide an elementary description of the programme and the budget, and also include the identification of the local counterpart. The local counterpart is in all cases a government body. Theoretically, the local counterpart provides contribution to the action by making available staff and office space, and sometimes, transportation and stationary for the project. Furthermore, the ownership of the project rests with the contracting authority (the local partner) who may refuse payment to the contractor (usually an EU company) if they find the work to be substandard.

In theory, this arrangement allows for flexibility and ownership and effectiveness in project implementation. However, there still exists a great gulf between what is sometimes needed and what is available. The capacity of many ministries to absorb EU projects is low, and the commitment to the project from the contracting authority varies to a great degree with the variation of personnel. Thus, a change of minister, and or a change of an immediate priority jeopardizes the whole project. Moreover, the beneficiaries are most of the time incapable of dealing with the EU rules and procedures and are ill equipped to learn these complex procedures in the needed time to successfully implement the project. Furthermore, many projects are initially identified without the full knowledge and support of the main contracting authority, and the project might sometimes be viewed as a nuisance.

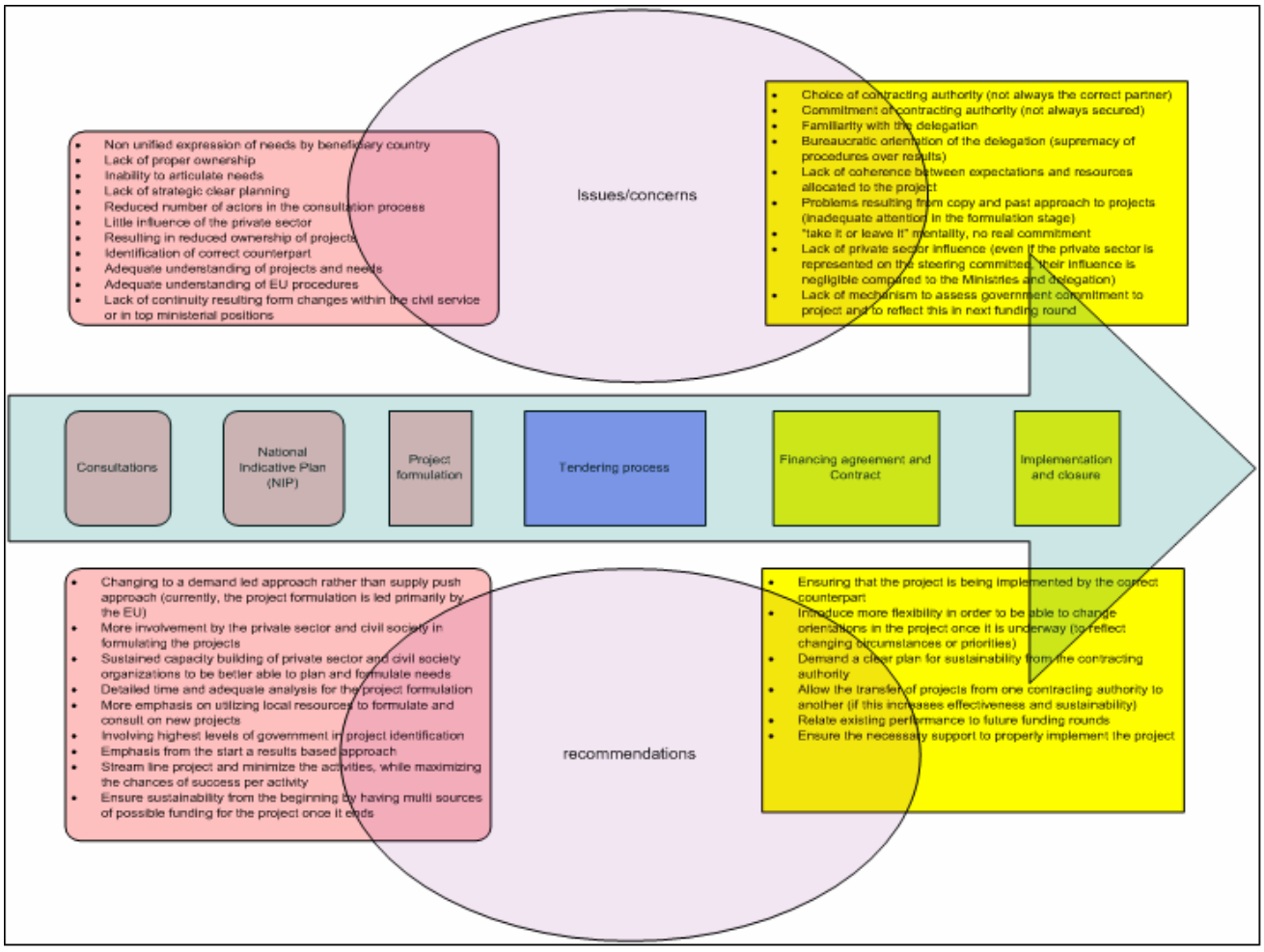
The end result is that many projects are implemented without the needed commitment and end up withering away as soon as the EU funding ends. This is a reflection of a serious problem by the government of the beneficiary country to take control of the project and to properly consider the project as its own.

What is needed is true ownership at the highest level, and also, an expansion of the scheme horizontally so as to include different governmental and non governmental players. The EU also need to rethink its policy of not contracting directly with the private sector organizations,

although it does contract directly with NGOs and other civil society organizations.

The figure below better illustrates in general how EU programmes are formulated in Lebanon, what are the issues involved, and how to ameliorate the situation. The figure is illustrative only and reflects experience with the EU in Lebanon only, so it is not necessarily valid everywhere else.

Figure 9: An illustration of EU project formulation process as it applies to Lebanon



The above figure illustrates that the way EU projects are currently formulated in Lebanon would be insufficient to deal with these two problems. According to the national Indicative programme for 2007-2010, the 10 million Euros allocated for judicial reform will target the "efficiency and independence" of the judiciary. However, changing the laws and regulations are not integrated in this. This task is generally given to the Ministry of economy and trade, who in this country has very little ability to change the law as it relates to the commerce code. Thus, the plans for Lebanon do not address these two important problems while improving the independence of the judiciary, important as it is, is essentially a political aim, that depends for its "true" implementation on the political landscape of the country, and not, the success of failure of an EU project. However, small changes, that can have an impact on the lives of ordinary businesses, and that can be supported and backed by the private sector organizations, are left unattended in favour of large scale, politically motivated, EU designed and centred approach.

4. Describing the current legal and institutional set up dealing with contract enforcement and protecting investors

Non payment is a serious problem in Lebanon. Whereas in some countries, alarm bells are sounded because non payment accounts for around 1% of turnover for SMEs (which is the average European rate for SMEs in 2008), the figure for Lebanon is more than 6 times higher than the European average.

In 2007, average non payment for SMEs in Lebanon according to the SME programme at the Ministry of Economy and Trade was 6.4% and 49% of all their sales was in delayed payment, aggravating the cash flow and competitiveness position for these enterprises. These non payment issues are resolved mostly outside of the courts as is illustrated below.

Figure 10: Conflict resolution mechanism

Personal communication	69.00%
Courts	31.00%
Other	0.00%
Total	**100.00%**

Source: SME survey 2006

This indicated a lack of effectiveness of the courts system, which is collaborated by the Doing

Business Report findings regarding the length of the proceedings and the amount of money spent on the proceedings.

The issue of contract enforcement, with non payment being the main indicator, is also captured in the Doing Business report. In that report, Lebanon ranks in category 121 as mentioned earlier, having dropped two places from 2007. The table below further elaborates the problem as captured in the doing business report.

Figure 11: Breakdown of the non payment problem

Indicator	Lebanon	Region	OECD
Procedures (number)	37	43.5	31.3
Duration (days)	721	699.0	443.3
Cost (% of claim)	30.8	24.0	17.7

Source: Doing Business report 2008

It takes roughly two years in Lebanon to enforce a contract through courts with a cost equalling approximately 31% of the amount disputed. Thus, the system as a whole is non conducive to solving the non payment problem. Faster outlets are needed in order to make the situation more favourable. The introduction of clearing mechanisms through factoring and invoice selling could go along way in helping alleviate the impact of non payment problems. The creation of a dedicated guarantee system will also reduce the risk on the facilitating institutions and allow for the creation of an effective clearing system. With a deposit to GDP ration in excess of 180%, the financial sector is looking for ways to further expand productive low risk lending, and discounting invoices might be an adequate vehicle to find outlets for otherwise dormant costly deposits.

In addition, the creation of small claim courts, and the widening sphere of arbitration should also assist in lowering the risk for the non payment issues. However new facilities, and new training to the judges and to the assistants and court clerks is needed to make a functional small claim court system.

As for protecting investors, the Doing Business Report also indicated Lebanon's problematic position in this field. As reminder Lebanon's rank in 2008 is 83, but this is only for legal

aspect of the protecting investors problematic, and does not include the wider concept of creating an investment friendly institutional structure.

Figure 12: Protecting investors' breakdown

Indicator	Lebanon	Region	OECD
Disclosure Index	9	5.8	6.4
Director Liability Index	1	4.7	5.1
Shareholder Suits Index	5	3.6	6.5
Investor Protection Index	5.0	4.7	6.0

Source: Doing Business report 2008

Overall, the country is doing better than the region but less so than the OECD (the higher the number, the better the grade). However, and as has been mentioned before, protecting investors is also related to the internal corporate governance laws and practices that are common among companies and shares.

A recent study done by the SME programme at the ministry of economy and trade identified the major shortcoming of the SAL form (the major share holding company form in the country). The main results are outlined in the figure below.

From the list in the figure below, the three most important obstacles are the double voting rights, the nationality requirement and the shareholding requirement for directors. The first concept is perhaps unique now days to Lebanon, and it stipulates that share holders who have held the shares for two years can have double the votes in relation to the shares held. This strange concept initially intended to encourage and protect founders of enterprises is engrained in the commerce code and is a major obvious obstacle for any investor.

Venture firms in Lebanon and individual investors are resorting to a practice of writing an agreement in front of a solicitor that this double voting rule will not apply and will not be used. Thus, investors are thus protected. However, this is merely a gentlemen's agreement since the law takes precedence over an agreement and if the double voting right is used, then the agreement will be able to override this right. Moreover, this right is passed on to future generations in form of inheritance right, and cannot be revoked, so the owner of shares cannot

revoke his or her right to double voting. This arrangement makes it difficult for investors and especially those intending to buy a small share, to enter into partnership with existing companies. Thus, what is witnessed is a prolific tendency to create new companies, rather than invest or purchase existing ones, leading to increasing fragmentation of capital and lowering of the scale of production and thus, increasing costs and lowering overall competitiveness.

Figure 13: Shortcomings of the SAL Company form in Lebanon for promoting investments

- Double voting Barrier The law should allow the Articles of Association (AoA) to waive this possibility. In our opinion, the double voting issue must be entirely abolished because it can discourage an investor from acquiring a stake in a company where other shareholders who have less shares than him can dilute his investment.

- Lebanese nationality requirements for the Board of Directors: The law should bring down the Lebanese members of the Board of Directors, which should now constitute the majority of the Board of Directors, to one third of the Board's members - except when the company is exploiting a public service;

- Directors who are non-shareholders: Under the Lebanese Commerce Code (LCC) the director has to be a shareholder and own a minimum number of shares of guarantee. Sometimes specialized and qualified persons cannot be members of the Board of Directors because they have no such shares.

- Requirement to be a shareholder in order to hold an office at the Board: The law should accept the principle of directors who are not shareholders provided they do not constitute more than one third of the Board of Directors.

- Proxy voting barrier at the General Assembly level: The law should accept the principle that non-shareholders can represent shareholders during shareholders General Assemblies.

- Voting on transactions: At present the LCC does not state strict transparency rules as this lack of transparency discourages the investors.

- Cumulative position for the Chairman and the General Manager: The law should allow to split the two positions as companies have now many Assistant-General Managers appointed with their Chairman.

- Additional Auditor: The additional Auditor is proving to be a hassle for most companies, so this is why it will be appropriate not to waive it as a requirement but rather to make it compulsory for companies with a capital of LBP/1/ billion or above.

- Consolidation of Balance Sheets: At this stage, the law does not allow a consolidation of balance sheets even if the /51/% Generally Accepted Accounting Principles requirement is met.

- Rights of shareholders (minority and majority): The law should be updated in order to allow recognizing the minority protocols and shareholders agreements.

- Non-judiciary excision of a shareholder: Corporate excision of a shareholder is not possible under the LCC. Shareholders who suffer from the abuses of another shareholder usually tend to incorporate a separate company; this indirect excision leads to competition lawsuits. Repeated court ratified abuses should lead to the possibility of a corporate excision.

- Limits of quorum and majority: At present the LCC states for rules of quorum and majority to be not less than a certain "minimum" of a percentage; and so companies are increasing these sometimes to the maximum extent. These rules become cumbersome as far as the minority is concerned.

The other two clauses that cause immediate concern are the nationality requirement, the current law imposes that the majority for the board of directors be Lebanese, this discourages foreign companies from establishing offices in Lebanon and does not give the country any protection since the majority of the board does not constitute the majority of shares, thus, the system is archaic and provides no national protection to the economy and reduces the incentives for investment.

The third immediately troublesome concept in the table above is the need to have the directors be shareholders. This reduces good corporate governance and does not allow for professional management of the companies, or rather, reduces the possibility of optimal management. Instead of being “one of the boys” the director, or directors, need to be operationally independent and at the same time answerable to the board.

The remainder of the list is troublesome as well, but if an urgency list is to be drawn up, then those three blocks should be removed or changed first. Currently, none of the EU projects in the area in terms of justice address changes to the laws, and the programmes for private sector support, such as the SME programme in Lebanon, that were tasked with changing the laws, failed to do so, because changing the laws and promoting for this change should not be a side product of an existing programme, rather, it should be an essential element in the makeup of legally oriented private sector programme.

5. Weaknesses of institutions for enforcing contracts in Lebanon

The poor functioning of the Lebanese judiciary system is a strong impediment to the

development of the private sector in Lebanon. Enforcement of all contracts, debts and collateral is costly and takes such a long time that investors and entrepreneurs have lost confidence in the capacity of the judicial system to resolve their disputes and facilitate the development of smooth business relationships.

According to a recent World Bank study[2], the ineffectiveness of enforcement mechanisms in Lebanon is rooted in all aspects of the judiciary system: selection and career of judges, organization of the ministry of justice, organization of the courts, lack of updating of existing business laws, non-compliance and misusing of procedural laws. The quality of judgments can be considered satisfactory for disputes involving the most basic types of agreements, but it becomes very quickly unsatisfactory for agreements involving more sophisticated or more recent business practices (license agreements of intellectual property rights, call option, put option, assets securitization, etc.).

It has thus become easy for bad faith debtors or failing contractual parties to take advantage of legal loopholes and lengthy proceedings. The longer the case, the less possible it becomes to enforce successfully a final decision against a failing party as it will either have become truly insolvent or will have taken advantage of the delays to fraudulently organize its insolvency. Some legal provisions deal explicitly with such risk, but in practice their enforcement often adds to the delays. Finally, debtors always have an incentive to delay a case as damages awarded by courts rarely cover the full extent losses suffered as a direct result of lengthy proceedings. As a direct consequence, private parties in Lebanon tend to develop their businesses based on family and other personal relationships rather than on business commitments in order to avoid any risk of dispute. Alternatively, companies and lawyers increasingly rely on informal negotiation, arbitration or choose foreign laws and courts whenever possible.

The World Bank's legal assessment identifies several flaws in the system for resolving legal disputes. These flaws echo findings in several other studies and expert opinions in Lebanon.
First, the Lebanese court system lacks courts in charge of small claims (i.e. to resolve small-value cases, typically with a ceiling between US$ 1,000 and US$ 3,000). In many countries, small claim courts resolve such cases with restricted appeal possibilities and with exclusive competence over such matters as landlord/tenant disputes, relieving pressure on the regular

[2] The World Bank (2007), *Selected Judicial, Legal and Regulatory Issues in Lebanon*, unpublished manuscript.

courts by substantially reducing their caseload. In Lebanon, the only accommodation for small value cases is a system that reduces the number of judges from three to one in Courts of First Instance for cases involving a value less than a hundred million Lebanese pounds (approximately US$ 65,000). Nonetheless, a substantial share of the backlog in the court system today is due to small-value cases and, in particular, landlord-tenant disputes.

Second, the Lebanese judicial system organizes courts in "chambers", with commercial chambers being in charge of commercial matters. Commercial chambers could offer a basis for the specialization of judges in commercial matters provided judges are assigned to them on a long-term basis. However, the steady increase in the number of judges in the Lebanese judiciary has resulted in more rotations and less time spent in each chamber by judges. As a consequence, many observers noted that judges assigned to commercial chambers do not stay long enough to develop their knowledge and skills in business matters.

Third, the allocation of judges (and number of chambers) is often not based on caseloads and actual needs of courts. The mapping of the court system in Lebanon dates back to before the civil war. In many respect it has become irrelevant as a result of new demographics.
Last but not least, all court documents are paper-based, with no computerization. Judgments are prepared longhand. Given the lack of technology available in the courts, transcripts do not necessarily reflect a verbatim account of court proceedings. Statements made by the parties are restated by the judge in classical Arabic and then handwritten by the court recorder. This process requires the judge to constantly stop proceedings, and risks a change or an omission in the restatement by the judge. Court clerks register cases, set dates for hearings, record court proceedings, and ensure court procedures are followed. There is no public judicial database of court decisions available to judges and almost no computerization of case management.

Given all the above inefficiencies, it is to be noted that the Lebanese judiciary is still recovering under reforms that have improved salaries and meritocratic recruitment. The number of judges, 450 in 2005, is constantly increasing but remains short of the 550 positions called for in the relevant legislative decree of 1983. The rapid recruitment of judges has contributed to excessive rotation of judges. Challenges remain in finding high quality candidates. The selection of judges for higher positions remains subject to political influence and confessional distribution that reduce the impact of meritocratic recruiting.

Yet the main impediment for contract enforcement remains the cost of judicial proceedings. Entrepreneurs have to pay court costs, which are prohibitively expensive for civil cases in Lebanon, as well as stamp duties on each original of their contracts to ensure that it will be enforceable before courts. Stamp duties are calculated as a percentage of the contractual value. They have to be paid for each original of a contract and they are due within five days after the signing of the agreement. If not paid, there is an additional penalty that amounts to ten times the value of the initial stamp duties. These fees act as a strong deterrent to concluding formal legal transactions in Lebanon, and many Lebanese companies choose to conclude their international transactions abroad, selecting another nation's laws as the applicable law.

There are also severe weaknesses in the arbitration procedure in the country. Commercial arbitration in Lebanon can be used in three settings: the Lebanese Center for Arbitration, ad hoc arbitration, and the International Chamber of Commerce in Paris. The Lebanese Center for Arbitration, established in 1995, has developed a good reputation for resolving disputes. Lebanese law gives the Center the right to hear arbitration cases. Law No. 440 of 2002 also permits the state or any public body to submit to arbitration, both locally and internationally. Where contracts do not have arbitration clauses, the Center can help parties reach informal agreements through arbitration. The parties may request one arbitrator or a three-judge panel. Arbitrators include former judges, law professors and lawyers, the latter of whom should have at least twenty years of experience in legal practice.

Nonetheless, the process has two weaknesses. This first is the need for an execution order ("exequatur") from the Court of First Instance to enforce arbitration awards. Under applicable law, the president of Court of First Instance grants exequatur orders. The judge should review the award only to verify compliance with the rights of defense and the "public order", but not on the merits. In practice, losing parties often contest arbitration awards on these grounds, hence appeals are subject to a case-by-case interpretation. Hence arbitral awards become subject to the same execution delays and costs as those of decisions by judicial courts.

A second issue is the cost of arbitration. Although the Center for Arbitration works well, costs are high and arbitration awards do not determine which party should bear the attorney's fees. The need for an exequatur order by ordinary courts adds to the fees and lessens the incentive to use arbitration, as parties have to pay an additional 0.3% on the claimed amount as stamp

duties and 1.25% as court costs. No procedure is in place to reduce the cost of small-value arbitration.

The mediation procedure also suffers from many shortcomings. The Ministry of Justice has proposed in the past that small claims be resolved through mediation as a tool to relieve case backlog. The proposal, which has not been implemented, has broad support, particularly for landlord/tenant disputes and small community disputes. The proposal also contained a provision for mandatory mediation prior to trial, which has been rejected.

The Bar Association has also considered a mediation scheme for the informal resolution of civil and commercial disputes. However, there is a need to promulgate rules for mediation and to build up a cadre of lawyers with mediation skills. A training program should be organized by the Bar on Commercial Law to prepare lawyers to offer mediation services. However, the Bar may have to overcome some internal opposition to the scheme because of concerns that it will have a negative impact on the overall amount of work available to lawyers.

6. Some recommendations for reform

Several reform initiatives can be efficiently enacted, within the support of the EU Neighbourhood Policy, to help establish better contract enforcement institutions, both in the formal judicial system and the mediation sector. Some of the recommendations, raised by local and international experts, include the following:

6.1 For the judicial system

- Amend the commerce code to adjust for investment law shortcomings
- Amend bankruptcy law so as to make it a non criminal activity
- Allow companies to right off taxes if they buy money losing companies
- Encourage the establishment of factoring organizations and transaction guarantee bodies
- Create courts or chambers in charge of small claims (i.e. US$ 2,000), with restricted possibilities of appeal (i.e. appeal not available for cases under US$ 1,000) and exclusive competence over specific matters such as landlord/tenant disputes.

- Review the allocation of judges and the number of commercial chambers through a revision of the law on judicial organization and implement case management by computerization of the courts.
- Identify laws responsible for a substantial percentage of litigation and clarify their drafting in order to facilitate consistent interpretation by judges.
- Establish a specific court organization to deal with this type of existing case backlog, i.e. setting up small claim courts and allowing some judges to specialize.
- Avoid abuse of hearings by (i) requiring judges to apply strictly time-limits rules set in the Code of Civil Procedure (ii) allowing parties to sue the state whenever judges render a decision out of a reasonable time frame without any serious justification (iii) modifying the Code of Civil Procedure to eliminate or reduce greatly the need of court hearings to exchange briefs.
- Modify court costs and stamp duties into flat fees or determine at least a reasonable cap.
- Review the Code of Civil Procedure to simplify the exequatur procedure and narrow the definition of violation of "public order" to prevent use of such violation as a delaying tactic or as an indirect means of re-opening the merits of an arbitral award.
- Set up a simplified arbitral procedure with shorter deadlines in order to expand the availability of arbitration for small local commercial disputes.
- Improve interaction between the private sector, law schools, the Bar and the Institute of Judicial Formation.
- Improve the quality of the continuing education program of judges provided by the Institute of Judicial Studies.

6.2 For mediation and arbitration

- Increase the teaching of mediation for commercial disputes in law schools.
- Promulgation by the Bar of mediation rules and setting up of a training program for lawyers.
- Examine the feasibility and impact of creating compulsory or specific procedures for mediation before trial for certain commercial matters.

6.3 For the European Union

- Changing to a demand led approach rather than supply push approach (currently, the project formulation is led primarily by the EU).
- More involvement by the private sector and civil society in formulating the projects
- Sustained capacity building of private sector and civil society organizations to be better able to plan and formulate needs.
- Detailed time and adequate analysis for the project formulation.
- More emphasis on utilizing local resources to formulate and consult on new projects.
- Involving highest levels of government in project identification.
- Emphasis from the start a results based approach.
- Stream line project and minimize the activities, while maximizing the chances of success per activity.
- Ensure sustainability from the beginning by having multi sources of possible funding for the project once it ends.
- Minimize “cut and paste” project formulation, and focus on the specifics of the countries and issues.
- Ensuring that the project is being implemented by the correct counterpart.
- Introduce more flexibility in order to be able to change orientations in the project once it is underway (to reflect changing circumstances or priorities).
- Demand a clear plan for sustainability from the contracting authority.
- Allow the transfer of projects from one contracting authority to another (if this increases effectiveness and sustainability).
- Relate existing performance to future funding rounds.
- Ensure the necessary support to properly implement the project.