

## Article: Supervisory Board in LLP: problems of corporate governance in Kazakhstan

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### **Supervisory Board in LLP: problems of corporate governance in Kazakhstan**

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Can the supervisory board perform the functions of the board of directors as, for example, in joint-stock companies? Is the supervisory board one of the management bodies in the LLP? We will try to understand these issues.

#### **Functions of the Supervisory Board in LLP**

Article 57.1 the Law of the Republic of Kazakhstan on LLP provides the possibility for establishing a supervisory board in a Limited Liability Partnership company in order to monitor the activities of the executive body. Further, the law does not specify how this control takes place. The difficulty lies in the fact that the Civil Code of the RK requires to interpret everything literally. With literal interpretation, it turns out that the supervisory board of the LLP has only one function - to control. The supervisory board has all the functions of the audit commission in the LLP. That is, the supervisory board gets all the powers of the audit commission in its absence, if one relies on Article 57.2 of the Law on LLP. The supervisory board is put on the last place in comparison with the audit commission.

The audit commission has the following powers: (1) to carry out at all times inspections of the financial and economic activities of the executive body, (2) mandatory review of the annual financial statements of the LLP before approval by the general meeting of participants, and the general meeting of participants is not entitled to approve the annual financial Reporting without the conclusion from the audit commission or the audit report. Supervisory board also has all of these functions. If so, it becomes obvious that the supervisory board is only needed to recheck the financial results of the LLP activity.

Over the past 10 years we have conducted legal due diligence for more than 20 different Kazakhstani companies and did not meet the circumstances that the audit commissions or the supervisory board would approve the annual reports of the LLP, as most often such annual reports were prepared by audit firms. If this is so, then the audit commission or the supervisory board is in fact not needed in the activity of the LLP.

Despite the fact that the supervisory board of LLP is not a management body and is not an executive body under Article 41.1 of the Law of the

Republic of Kazakhstan on LLP, the supervisory board has a decision-making mechanism within the scope of Article 57.5 of the Law on LLP. However, contrary to the requirements of the legislation, many LLPs have supervisory boards and empower them with management functions, similar to the board of directors in JSCs. It is enough to look at the statutes of such companies as «Baiken-U» LLP, «Eastcomtrans» LLP, «Samruk-Kazyna Contract» LLP, «Kazakhstan Project Preparation Fund» LLP and many other enterprises. These facts may lead to the idea that the LLP legislation does not meet public economic and organizational expectations and requirements. To confirm this hypothesis, we will try to make a superficial overview of corporate law in Germany and the United States.

## **Two models of corporate governance in Kazakhstan**

With the attainment of independence, Kazakhstan opened its doors to own corporate world. By coincidence of different circumstances, Kazakhstani civilians accidentally integrated two models of corporate governance into Kazakh legislation. One model was introduced to develop the stock market through joint-stock companies, and the second model was, in all probability, borrowed from Russians and Germans in the form of legislation on societies with limited and additional responsibilities.

### **Anglo-Saxon model of corporate governance**

The Anglo-Saxon model of corporate governance was implemented in Kazakhstan through a joint stock company. In such a model of corporate governance, the shareholders of the company are, as a rule, its passengers, if to express themselves figuratively, and the function of the bus driver is performed by the board of directors. That is, the entire board of directors takes the whole important role of corporate governance. Therefore, the composition of the board of directors should be formed from very experienced managers and experts. The executive body in the form of the General Director or the Management Board in the JSC executes decisions of the Board of Directors, is engaged in operating activities, and sometimes takes independent decisions on transactions up to certain limits.

For proper motivation, the members of the management board were offered options for shares of this joint-stock company, so the management tried to propose changes and transactions that would increase the company's value. The Board of Directors must make qualitative decisions on the proposed changes and transactions in order to increase the company's value. The value of the company's shares on the stock exchange depended on the publication of financial statements, on the publication of the adopted resolution of the board of directors, as a rule, for major transactions. To solve this problem, leading companies focused on forming a strong board of directors focused on innovation, changes and increasing the efficiency and competitiveness of the company. Head hunters appeared to find and hire experienced professionals for the board of directors.

### **The German model of corporate governance**

The Kazakhstan legislation on economic partnerships reminds, to our subjective view, if not a terrible, then very bad copy of the German legislation on private companies. The Kazakhstan limited liability partnership (LLP) resembles a German private limited company (GmbH). That is, LLP in Kazakhstan is a private limited company with a closed type. The closed nature of the LLP implies that the LLP does not report on its corporate events anywhere, and the participants (partners) directly participate in the management of the LLP and are entitled to resolve any issues related to the activities of the LLP.

As a rule, this model of corporate governance is typical for the European family business. For example, if a participant is a member of a family,

leaves the business, then the existing participants have the right to redeem his share on the pre-emptive right, so as not to let a new participant into their family business in the LLP. The company is closed to outsiders. In addition, there can be at the same time two first leaders in the private limited company, who can act independently from each other without powers of attorney. For example, a son and a father can be such independent directors. When the father is on a ship in a distant voyage and cannot conduct business of the company remotely, but can conclude deals in the ports during the voyage, then his son acts on land, pays checks and avalizes promissory notes issued by the father. In practice, in Kazakhstan, the functions of double directorship, unfortunately, cannot be realized in the egov.kz system, but can be done through the JSC "Uniform Securities Registrar".

In Germany in the XIX century, perhaps family-owned private companies already understood that they needed quality and well-developed corporate solutions. To do this, they needed a corporate governance body that would be the first to take key corporate decisions before they were voiced by the owners of the company. Historically, in Germany in the XIX century was introduced a system of two-level management - dual board. The private company's management body was the supervisory board. The second council or the second governing body is the management board. The difference was that in Germany the board is mainly engaged in operational activities and constantly reports to the supervisory board or the general meeting of participants, and the supervisory board is engaged in long-term plans and key issues, forms the board of a private company, supervises, advises and approves the board's decisions. Both organs are completely separated from each other both by functions and by the composition of their members. If compare with the Anglo-Saxon model, then in the German model decisions are taken twice - the supervisory board first decides, and then this decision is approved by the general meeting of participants.

The presence of a supervisory board is not necessary for German private companies. If there is a supervisory board in the company, then most of the members of the supervisory board are appointed by the shareholders of the company. Interestingly, in Germany, legislation (Mitbestimmungsgesetz, 1976) requires that the supervisory board consist of half of company employees if there are more than 2,000 workers in such a company. This, most likely, was caused by the desire of the German authorities in the 19th century to avoid protest moods, strikes, workers' riots and trade unions, so that workers' representatives could influence the activities of the board. The concept was further extended at the operational level thanks to the Industrial Relations Act (Betriebsverfassungsgesetz).

### **Supervisory board as a management body**

In Kazakhstan, much attention is paid to the legislation on joint-stock companies (JSCs). For example, such respected organizations as the World Bank, IFC, the Association of Financiers of Kazakhstan constantly propose changes to the legislation on joint-stock companies, although in practice most legal entities are limited liability partnerships. LLPs are probably about 95% of all types of legal entities. The reason is probably the following. The minimum authorized capital of the LLP is 500 US dollars, although we knowingly avoid discussion of the authorized capital of LLP from 0 tenge. For comparison, the minimum JSC authorized capital is about 200 thousand US dollars. Most likely, not every novice entrepreneur can absorb this amount. But like any entrepreneur will sooner or later need to give some of the control and management functions to the directors over the "managers" so that the company can become more stable and take cautious collective decisions.

For the reasons described above, we believe that it is necessary to amend the legislation so that the supervisory board has the status of a management body in the LLP by analogy with the board of directors in the JSC and does not duplicate the work of the audit committee.

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