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# USAID-TIJARA PROVINCIAL ECONOMIC GROWTH PROGRAM

## IMPROVING INVESTOR PROTECTION IN IRAQI JOINT STOCK COMPANIES



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## IMPROVING INVESTOR PROTECTION IN IRAQI JOINT STOCK COMPANIES

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# ACRONYMS

ISX	Iraq Stock Exchange
OECD	Organization for Economic Cooperation and Development
USAID	United States Agency for International Development

# 1. Introduction

A legal and institutional framework for protecting investors from management and majority-owner predation will encourage investment in the Iraqi private sector. Without a regulatory structure for corporate governance that requires boards of directors to represent the best interests of all shareholders, the confidence to invest in Iraqi joint stock companies will not reach its full potential. When a country's legal system protects investors, the perception alone can have positive effects on investment.

One important publication shaping perceptions is the annual *Doing Business* report of the World Bank. The *Doing Business* index provides guidelines for the legal enforcement of sound corporate governance and addresses a variety of regulatory issues. The report ranked Iraq 166 out of 183 countries in the overall "ease of doing business," measuring procedures such as starting a business, transactions in real property, permits for construction, import and export licensing, and the subject of this paper: the protection of investors with less than a majority share in a company. Within the *Doing Business* investor protection standards alone, Iraq's ranking for 2011 was 120 out of 183 countries, based on the World Bank's analysis of Iraq's law. These rankings shape the perceptions of foreign investors.

Regulation protects investors when it promotes corporate transparency and shields the equity of minority shareholders from self-dealing and asset looting by majority shareholders and the board of directors. The *Doing Business* index for investor protection is based upon a methodology developed by the economists Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer.<sup>1</sup> The methodology posits a hypothetical transaction between two corporations with the same majority shareholder and measures: (1) the power of the directors with majority interests in both corporations (the "related parties") to deal with each other to their own benefit and the detriment of the company as a whole, (2) the extent of the required disclosure of this transaction, (3) any requirement of disinterested party approval of the transaction, (4) the potential civil and criminal liability of the self-interested directors, and (5) the ability of shareholders to litigate in behalf of their interests before and after the transaction. More transparency and limits on the ability of interested directors to deal with related parties which prevent the looting of the company's assets results in a higher *Doing Business* grade. The high grade means legal safeguards against the selfish dealing of majority shareholders protect the integrity of the company and preserve its legal personality for the benefit of all shareholders. These grades, and the investor protection rules they represent, bring confidence which contributes to the growth of capital markets and the economy as a whole.

We believe that some additions to the Iraqi Stock Exchange (ISX) listing rules and the Iraq Securities Commission regulations would provide the easiest and quickest means of improving Iraq's ranking for investor protection. Other changes to company law, the penal code and civil procedure law would also improve the protection of minority shareholders. Our recommendations are listed below in a parallel format with the three grading categories of the *Doing Business* investor protection report: (1) the required extent of disclosure and disinterested review and approval of related-party transactions, (2) potential director liability

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<sup>1</sup> S. Djankov et al. *The law and economics of self-dealing*, Journal of Financial Economics 88 (2008), p. 430.

or deals with related parties which plunder the company, and (3) access to a fair court process for shareholders seeking rescission or damages for wrongful related-party deals.<sup>2</sup>

## 2. Summary of Recommendations

- 2.1 **Draft and publish new listing rules for the Iraq Stock Exchange which:**
  - 2.1.1 **define material related-party transactions;**
  - 2.1.2 **require the disclosure of material related-party transactions to directors and shareholders;**
  - 2.1.3 **require the approval of directors without interest in the related-party transaction; and**
  - 2.1.4 **require external review of the material related-party transaction.**
- 2.2 **Codify the revised Iraq Stock Exchange listing rules on defining, disclosing and approving material related-party transactions in the regulations of the Iraq Securities Commission.**
- 2.3 **Amend the Company Law No. 21 of 1997 to:**
  - 2.3.1 **further define material related party transactions;**
  - 2.3.2 **clarify the requirements for disclosure of related-party transactions;**
  - 2.3.3 **require external review of material related party transaction in mixed and joint stock companies; and**
  - 2.3.4 **expressly allow for shareholders to sue to enforce company contract rights and for damages for breach of the company contract.**
- 2.4 **Amend the Law of Civil Actions No. 83 of 1969 to:**
  - 2.4.1 **establish a clear procedure for initiating a lawsuit;**
  - 2.4.2 **describe the form of pleadings filed in a lawsuit; and**
  - 2.4.3 **establish a process for shareholder lawsuits on behalf of the company.**
- 2.5 **Amend Article 476 of the Penal Code, Law No. 111 of 1969, to incorporate violations of Article 4(Third) of the Company Law as penal offenses.**

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<sup>2</sup> The World Bank's *Doing Business* report and the individual country report for Iraq for 2011 describing these categories are available at <http://www.doingbusiness.org/> . The Arabic website is <http://arabic.doingbusiness.org/>

## 3. Recommendations

### 3.1 **IMPROVING THE EXTENT OF DISCLOSURE AND REQUIRING THE APPROVAL OF DISINTERESTED PARTIES**

The first ways to protect investors are preventative: to require the disclosure of transactions between parties with related or common ownership or control to shareholders, and to require that the disinterested parties among directors or shareholders approve those transactions.

The Company Law No 21 of 1997 as amended in 2004 (hereinafter the "Company Law") already provides significant protection for minority investors, but greater clarity in the law, and some additional listing rules for the Iraq Stock Exchange, would strengthen the protection of minority investors by more clearly requiring disclosure and the approval of disinterested directors for transactions between related parties.

In Iraq, under Article 119 (First) of the Company Law, not only is immediate and predicate notification of all shareholders of related-party transactions required, but the permission of shareholders is required for *any* related-party transaction. Article 119 of the Company Law also provides for significant controls on related-party transactions:

Article 119: First. It is impermissible for the chairman or a member of the board to have direct or indirect interests in deals that are concluded with the company, except after obtaining the permission of the general assembly with full disclosure of the nature and extent of such interests. The chairman or board member shall be liable to the company for any damage to it arising from violation of this article. Compliance with this Article shall not exclude liability under Article 4, paragraph Third.

Second. It is impermissible for the chairman or a member of the board to vote upon or participate in a matter in which he or she has direct or indirect interests without disclosing the nature and extent thereof to disinterested members and receiving the permission of a majority of them.

The question is whether the approval of a majority of the *disinterested* members of the board is required before the interested chairman or member of the board can vote in general assembly of shareholders and approve a related-party transaction. Does the "majority of them" in paragraph (Second) refer to the preceding "disinterested members" or to the board as a whole? If only "disinterested members" can vote on the board, the director who had a conflict of interest in a transaction would not be given "permission" to vote in the General Assembly of shareholders on that transaction. Article 119 could, and should, be interpreted to mean that only the disinterested members of the board vote on the related-party transaction *before* any interested board member is allowed to vote or "participate" in the decision of the General Assembly with the disinterested board members' permission. Otherwise, a chairman or member of the board representing majority shareholders could easily approve the transactions they were interested in by voting in the General Assembly.

Article 119 is not as clear as it could be, because of the order of the paragraphs. Does paragraph (Second) control paragraph (First), or does the first paragraph control related-

party transactions on its own? We recommend that the order of the paragraphs be reversed, and that the current paragraph (Second) be amended to read (suggested amendments in italics):

It is impermissible for the chairman or a member of the board to vote upon or participate in a matter in which he or she has direct or indirect interests *at a board or general assembly meeting* without disclosing the nature and extent thereof to disinterested members and receiving the permission of a majority of them *to vote or otherwise participate*.

Article 119 should also be supplemented with regulations of the Iraq Securities Exchange Commission<sup>3</sup> and new listing rules of the Iraq Stock Exchange<sup>4</sup>. The Securities Commission by law now enforces a requirement of "timely public disclosure of any information that might have a significant effect on the price of its securities to be admitted for trading,"<sup>5</sup> in other words "material information." The Securities Law also requires annual reporting of such transactions. However, this rule is not clear enough, and should be supplemented with rules defining what a "significant effect" is, what "material information" is, and requiring immediate disclosure to shareholders of related-party transactions, along with requiring the approval of such transactions by disinterested directors.

The Company Law, Article 117 (Eighth), also requires that "a record is kept in the course of the year of **all** material related-party transactions, within the meaning of international accounting standards, for discussion with the company's external auditors."

These "related party" transactions are required to be disclosed in the annual accounts sent to the Companies Registrar<sup>6</sup> and required by the Iraq Securities Commission.<sup>7</sup>

The issue is the meaning of "related party transactions within the meaning of international accounting standards," which is perhaps too vague a term for clear legal effect. For example, standards vary among the OECD countries which score best in the World Bank's *Doing Business* index. Standards often include some lower threshold for transactions too small to warrant disclosure and approval.

Since both Articles 117 and 119 require disclosure and reporting of related-party transaction, the term "related party" needs to be further defined in Iraqi law and regulation. "Material transaction" should also be more precisely defined, and should include "related party" transactions within the definition of "material."

There are various definitions for "related party" in national and international listing rules and accounting standards, for example "related party" was defined by the UK Accounting Standards Board as a relationship in which:

- (i) one party has direct or indirect control of the other party; or
- (ii) the parties are subject to common control from the same source; or
- (iii) one party has influence over the financial and

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<sup>3</sup> See <http://www.isc.gov.iq>

<sup>4</sup> See <http://www.isx-iq.net>

<sup>5</sup> Law No. 74 of 2004 and Resolution No. 40 of 2008, at [www.isc.gov.iq](http://www.isc.gov.iq)

<sup>6</sup> Article 139, Company Law

<sup>7</sup> Iraq Securities Commission Instruction No. 14 of 2011 and "Disclosure Requirements", at <http://www.isc.gov.iq>

operating policies of the other party to an extent that that other party might be inhibited from pursuing at all times its own separate interests; or (iv) the parties, in entering a transaction, are subject to influence from the same source to such an extent that one of the parties to the transaction has subordinated its own separate interests.<sup>8</sup>

Since the issue of whether parties are "related" can be very complex, an expanded definition of "related party" could be left to a new listing rule of the ISX, where the issue can be dealt with the length and complexity which it requires and the rule limited to publicly traded joint stock companies.

"Material transaction" also requires definition. "Transaction" generally includes sales of assets, purchases, leases, lending, borrowing, guaranties, service fees and individual salaries. "Materiality" is often measured by the percentage of the company's capital value or annual revenue which is involved in the transaction. Since Article 119 of the Company requires the disclosure and approval of *all* related party transactions by shareholders, an amendment to provide for an exception for transactions valued below a threshold of company assets should be discussed and considered. Many countries have exceptions for minimal transactions, but this might not be appropriate in the Iraqi context.

Rules on measuring the threshold of materiality could be modeled on the Listing Rules of the New Zealand Stock Exchange, which define "related party" with a minimum threshold of ten percent of stock ownership and define "material transaction" with a threshold of ten percent of total company assets involved in the transaction.<sup>9</sup> However, we recommend that this threshold be lowered to five percent of total company assets if a threshold is adopted.

We also recommend that a rule requiring external auditor review prior to board approval of a material related party transaction, with "material" and "related party," as defined by the rules mentioned above, be included in new listing rules of the Iraq Stock Exchange and regulations of the Iraq Securities Commission. Amendment of the Company Law to require external auditor review for material related party transactions in mixed and joint stock companies is also recommended.

### **3.2 IMPOSING DIRECTOR LIABILITY FOR IMPROPER RELATED-PARTY TRANSACTIONS**

Imposing liability on directors for related party transactions which harm the company has a deterrent effect. Few, if any, disputes over related party transactions have been litigated or prosecuted in Iraqi courts, because of the relatively small size and family-based ownership of many Iraqi joint stock companies, and the small share of domestic joint stock companies in the Iraqi economy. As with debtor-creditor issues, disputes are most often resolved informally rather than with recourse to the courts for fraud or collection actions or bankruptcy asset distribution. However, if direct investment and capital markets grow in Iraq, Iraqi joint stock companies will grow and the familial basis of Iraqi companies will diminish relative to the amount of capital. The potential for disputes over related party transactions will rise

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<sup>8</sup> Financial Reporting Standard 8, UK Accounting Standards Board, 1995. This standard has since been amended to encompass a broader definition of financial control, which may or may not be necessary in the Iraqi context.

<sup>9</sup> Rules 9.2, 9.3, NZX Listing Rules, at [http://static.stuff.co.nz/files/NZSX\\_NZDX\\_Listing\\_Rules.pdf](http://static.stuff.co.nz/files/NZSX_NZDX_Listing_Rules.pdf)

concurrently with investor diversity. The legal basis for holding directors liable will need to be clearer.

There are legal means in Iraq by which an investor can hold a director liable for a related-party transaction which damages the company. Article 119 of the Company Law requires disclosure of related party transactions and disinterested board member approval. It also states that "the chairman or board member shall be liable to the company for any damage to it arising from violation of this article." This liability to "the company" is not expressly devolved to the individual shareholder, however. Article 4 of the Company law provides that the "company is a contract binding two or more persons" and that "owners of capital in a company may not exercise their voting or other authority in the company to cause it to do or consent to acts that . . . harm or disadvantage the company to benefit themselves or those associated with them at the expense of other owners of the company." Liability for violation of this article is broader than that provided by Article 119, which states: "Compliance with this Article shall not exclude liability under Article 4, paragraph Third." In other words, even if Article 119 is complied with, if the related party transaction harms the company, the directors may be liable under Article 4.

The Civil Code, Law No. 40 of 1951, governs general contractual and personal obligations, including aspects of company contracts. The Civil Code imposes an obligation of good faith in contractual obligations, in Articles 118, 150 and 233, and specifically provides for avoidance of a transaction for bad faith in Article 118, the award of damages for void contracts in Article 138:

If the contract is voided the parties will be reinstated in the positions which existed prior to the contract; and if such reinstatement is impossible damages equivalent to the loss may be awarded.

Given the provisions in Article 4 prohibiting directors from causing harm to the company for personal benefit, an insider deal causing harm to the interests of the company could be construed as either a breach of contract or tortious bad faith under the Civil Code.

Iraq's law thus provides a legal basis for the liability of interested directors harming a company in a self-interested transaction, but the law could be clearer. We recommend that a clause be added to Article 4 of the Company Law which states that "*an owner of capital of the company who is damaged by another owner who violates this article may claim damages or have the transaction rescinded by a civil action.*"

We also recommend that Article 119 of the Company Law be amended to state that "the chairman or board member shall be liable to the company [**or any shareholder of the company**] for any damage to it arising from violation of this article."

The Company Law also imposes fines and imprisonment upon those who breach duties of disclosure, in Article 218:

Any company official who purposely gives inaccurate statements or information to an official quarter on the company's business, results of operations, financial condition, member shares and quotas, and distribution of dividends shall be subject to punishment of imprisonment for a period of not more than one year, or a fine of not more than 12,000,000 dinars, or both, depending on the severity of the violation.

This should be construed as imposing fines and imprisonment on a wilful failure to disclose related party transactions to the board and shareholders as is required by Article 119, and to report such transactions in annual reports as required by Article 117.

There are also strict liability offences for failing to file annual reports and yearly accounts, in Articles 216 and 217 of the Company Law:

Article 216: Any company that does not prepare the records stipulated under this law shall be subject to a fine of not more than 10,000,000 dinars, depending on the severity of the violation.

Article 217: Any company failing to submit the required statements and information to a competent official quarter at the times fixed under the provisions of this law shall be subject to punishment of a fine of not more than 300,000 dinars for every day of delay, depending on the severity of the violation.

These offenses only hold the company liable, not individuals, but directors who caused the company to be liable under these provisions would presumably be personally liable for a breach of duty under Article 4 of the Company Law if the failure to disclose was an attempt to hide a wrongful related party transaction.

In addition, the Iraq Penal Code, Law No. 111 of 1969 (as amended)<sup>10</sup>, contains several provisions which could impose criminal liability, fines and imprisonment upon a director for a related party transaction which was grossly negligent, fraudulent or a breach of corporate fiduciary duties. Among the provisions in the Penal Code which could result in the imposition of fines and/or imprisonment for breach of a director's duty to disclose interest or improper transactions are:

Paragraph 476: Without prejudice to any greater penalty prescribed by law, any person who violates another's right of corporate ownership which is protected by law or by international agreement to which Iraq is a party is punishable by a fine. Any goods arising from the violation of such right will be ordered to be confiscated.

Paragraph 476 could be construed to protect minority shareholders' "right of corporate ownership" and incorporates by implication Article 4 of the Company Law:

Owners of capital in a company may not exercise their voting or other authority in the company to cause it to do or consent to acts that:  
. . . harm or disadvantage the company to benefit themselves or those associated with them at the expense of other owners of the company;

A violation of Article 4 of the Company Law is a violation of a "another's right of corporate ownership which is protected by law" and could be considered punishable under Paragraph 476.

However, Paragraph 476 should be clarified to make this connection explicit and outlaw related-party or other transactions by directors or officers which knowingly cause harm to the company with the intent to benefit themselves. As violation of this article only carries the penalty of a fine, the option of a penalty of imprisonment should be added.

Another provision in the Penal Code which potentially protects investors is Paragraph 456, Deception. It prohibits the transfer of moveable property by deceptive means:

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<sup>10</sup> English translation at <http://www.ictj.org/static/MENA/Iraq/iraq.penalcode.1969.eng.pdf>

(1) Any person who obtains or transfers for himself or another ownership of any moveable property that is in the possession of another in any of the following circumstances is punishable by detention in any of the following circumstances:

- a. If the offence is committed by deception.
- b. If the offence is committed by assuming a false name or identity or by misrepresenting a particular fact, thereby deceiving the victim or compelling him to surrender such ownership.

In addition, Paragraphs 466 and 467 prohibit fraudulent transactions where there is concealment of the qualities of the goods transacted, and Paragraphs 468 - 475 impose director liability, fines and imprisonment for fraudulent or grossly negligent bankruptcy and concealment of transactions and assets. These laws provide means to prosecute fraudulent or predatory insider transactions.

### **3.3 IMPROVING THE EASE OF SHAREHOLDER LAWSUITS**

The core of efforts to improve the ability of shareholders to recoup damages and protect themselves from predatory behavior by directors and majority owners in civil court actions is again the Company Law, specifically Articles 4 and 119. Article 4 states:

Owners of capital in a company may not exercise their voting or other authority in the company to cause it to do or consent to acts that:  
... harm or disadvantage the company to benefit themselves or those associated with them at the expense of other owners of the company;

As was stated above, what is missing in the Company Law is an explicit statement that violation of Article 4 is a cause for legal action and that shareholders may sue directors and majority shareholders for damages to the company.

Article 119 also states that "the chairman or board member shall be liable to the company for any damage to it" [arising from the failure to disclose and seek approval for a related-party transaction].

Articles 4 and 119 appear to create a cause of action for a company harmed by improper related-party transactions which harm the company by creating liability, but the right of a shareholder or group of shareholders to sue for their derivative rights on behalf of the company is at least unclear in Iraqi law. This right should be made explicit and subject to prudential controls such as requirements to submit the lawsuit to the court for a preliminary ruling on whether a *prima facie* case exists.

The ability to discover evidence of the improper transaction is aided by Article 140 of the Company Law, through which shareholders owning 10% of shares can request that an inspector appointed by the Companies Registrar investigate a transaction. The Companies Registrar must disclose the inspector's report to the shareholders requesting the investigation<sup>11</sup> and, if "questionable" transactions are revealed, to "responsible authorities."<sup>12</sup> The terms "questionable" and "responsible authorities" need to be clarified to provide clear responsibilities and lines of action and authority.

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<sup>11</sup> Article 142, Company Law

<sup>12</sup> Article 145, Company Law

Other measures to broaden the access to documents and scope of discovery by plaintiffs in a civil case would require amendments to the Law of Civil Actions No. 83 of 1969 and Law of Evidence No. 107 of 1979.

Amending the Law of Civil Actions to establish clearer and better procedures for the form and filing of civil actions and procedures for multiple plaintiffs and defendants would also facilitate shareholder litigation. The Law of Civil Actions does not specify the form of a civil complaint or how a civil action is commenced. In many locations, civil actions are commenced by submitting a sworn statement to a police officer by dictation. The police officer is then empowered to investigate it at his leisure (presumably to determine if there is criminal fault) and refer it to an investigative judge at his discretion. There is a Commercial Court in Baghdad which will accept complaints at its clerk's office, but so far this court is reportedly reserved for disputes involving foreign contractors.

The Law of Evidence in Articles 53 - 58 allows a party to a civil case to ask the court to order the production of documents relevant to the subject matter of the litigation. Article 53 provides for discovery of documents in civil actions:

First: The Court by itself or upon a demand of one of the parties of a suit may order the other party to produce a book or instrument which exists in his possession or under his disposal which relates to the subject of the suit whenever it is necessary to ensure a good decision thereof.

Second: In the demand it must be shown:

- A. Description of the book or instrument kept;
- B. Contents of the book or instrument in as much detail as possible;
- C. The facts expected to be proved;
- D. The proofs and circumstances that support the possession or control of the book or instrument by the opposing party.

Third: The Court must reject the demand if it does not fulfill the conditions required by this Article.

Articles 54-58 go on to provide further legal guidance for the resolution of disputes over the existence of documents demanded for production to Court. These articles provide a means by which shareholder litigants could demand the accounting books, directors' memoranda and correspondence and other documents bearing on a case of directors' breach of duty. These articles could be broadened to provide for the production of categories of documents relevant to litigation, but already provide a basis for shareholders seeking to discover documents related to director liability.

As with many aspects of complex commercial law being introduced to Iraq's jurisprudence, it is unlikely that Iraqi courts will be familiar with shareholder lawsuits. Family trading groups, company management and majority shareholders have been closely correlated in the relatively small sector of Iraqi joint stock companies to date. These close relationships and informal resolution of disputes have preempted litigation, but as Iraqi joint stock companies grow, and the minority, foreign, and non-family-related shareholder proportion of ownership grows with the companies, issues of self-dealing by boards of directors and majority shareholders may prompt lawsuits. The establishment of a Commercial Court in Baghdad attuned to complex commercial disputes could provide a basis for the adjudication of minority investors' rights in this context if its jurisdiction were expanded, but actual litigation may take years to develop, depending on the pace and nature of investment. Of course, protections for investors would encourage the growing and diverse investment which would create a healthy market - which will have its occasional problems addressed in the courts. In that sense, lawsuits would be the inevitable result of a large and diverse investor base and the rules protecting them.

## 4. Conclusion

85 companies are listed now on the Iraq Stock Exchange, and their total capital is less than \$4 billion.<sup>13</sup> For a country of Iraq's size, resources and economic potential, this is a small fraction of what the market could be. For example, Australia, with similar natural resources and a population of almost 10 million less than Iraq, has a stock market capitalized at more than a trillion dollars. If Iraq frees businesses to raise capital and protects investors, there could be huge growth in the market and the economy at large. The investor protection provisions in Iraqi law are seldom if ever exercised now, but the existence of those protections and the additional protections recommended in this paper can help create the growth and investor diversity which will lead to the real need for protection. In this way, the reality of strong investor protection shapes the perception of safety in Iraq's markets, which in turn will create the real need to protect investors in a large and diverse capital market.

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<sup>13</sup> Iraq Stock Exchange at <http://www.isx-iq.net/>