Market Response to Inefficient Judiciary

Promoting Rule Compliance and Good Governance Practice

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Aleksandra Gregoric[1], Katarina Zajc[2], Marko Simoneti[3]: MARKET RESPONSE TO INEFFICIENT JUDICIARY: PROMOTING RULE COMPLIANCE AND GOOD GOVERNANCE PRACTICE

Abstract

The paper re-examines the concerns on the rule-based governance in poor institutional environment. By relying on the theories and research vehicles of social psychology, we show that under certain conditions, the 'law on books' may still play role in governing market transactions, even though no formal enforcement applies. We furthermore expose the potential of the Corporate Governance Code as the 'signaling device' and provide arguments as to why this potential may be even stronger in an environment with relatively weak institutions in comparison to the developed market economies.

Introduction

In introducing best governance practice, OECD countries favor an approach to regulation and enforcement that combines relatively high disclosure standards with considerable reliance on voluntary governance mechanisms. The question here is how effective voluntary mechanisms may be in an environment with relatively weak institutions of rule-based governance and weak third party (e.g. market or stakeholder) monitoring capabilities (*Oman and Blume, 2005:3*). This is more so since, in this kind of institutional environment, the effectiveness of the 'law on books' becomes questionable too. Particularly with regard to the emerging markets (e.g. transition countries) it has been often claimed that without efficient institutions (e.g. judiciary) improving, for example, company law makes no sense and contributes nothing to the investor protection (*Pistor et*

al., 2000; Dyck, 2001; Berglöf and Claessens, 2004). The enforcement of rules provides the rationale for the legal rules to exist in the first place. Consequently, the recommendation is to rely on other, alternative sources to legal governance, such as private ordering or private enforcement of the law, together with more visible role of self-regulatory agencies.[4] It is the aim of our paper to re-examine the concerns regarding the limited legal obedience[5] and the limited role of the voluntary rules. By relying on the theories and research vehicles of the social psychology and social norms, we argue that 'law on books' can still play a role in governing market transactions, even though no formal enforcement applies. We furthermore expose the potential of the Corporate Governance Code (CG Code) as the 'device' for signaling firms' commitment to the adoption of best practice and provide arguments as to why this potential may be, under certain conditions, even stronger and more beneficial in poor institutional environment.

As shown by *Bohnet et al. (2000:3*) in fact, if the actors know that the legal system is inefficient, i.e. that contracts are rarely enforced, they will be extremely cautious. Thus, the absence of enforceability and other forms of guarantees generates demand for gathering information about the other party's characteristics or reputation (*Wintrobe, 1995 in Bohnet et al., 2000:5*).[6,7] In the same line, *Gilson and Krakmaan (1984)* propose firm reputation and related signals of corporate character (e.g. financial intermediaries' ratings, experts' verification of product quality, etc.) as the alternative mechanisms that help investors economize on the transaction costs when the markets or other institutions are not fully efficient. Several other studies show that investors, employees, customers and other firm constituencies make their choices by evaluating firm trustworthiness,

which is primarily determined by firm reputation. Consequently, the desire to protect their reputation can inhibit the firms from engaging in activities that the investors and other stakeholders deem unacceptable (*Fombrun and Shanley, 1990:233*). Non-obeying or violating investor legal rights could be one of these activities. If upholding a social norm, such as obeying the law (*Cooter, 1998*) influences the investor perception of a firm's character (reputation), some of the firms will be motivated to obey rules, even without formal sanctions. [8] In fact, people (entities) seldom obey the law because they fear the (formal) punishment, but rather because they believe it is '*proper to do so' (Tyler, 1990)*. Thus, the society will penalize legal disobedience if '*there is a general norm in favor of obeying the law'*.[9] To put it differently, in order for the reputation mechanism to matter in enforcing the law, investors have to attribute the non-obedience of the legal rules to the defecting firm rather than to environmental inefficiencies (e.g. lack of confidence in the courts) and act accordingly.

We study the case of Slovenia, an advanced transition country that is however characterized by high inefficiencies in the legal enforcement and institutions' functioning. The results of our experiment and option survey, specifically focusing on the legislation in the area of company and commercial law, show that in Slovenia non-compliance with the legal rules is perceived as something negative, shameful and potentially harmful for firm reputation. Notwithstanding the lacunas in the institutional enforcement, the general mistrust in the judiciary and the small size of the economy, where personal relations may have more importance in governing market transactions then the rules, legal obedience is embedded in the social norms. This ensures the

necessary condition for the social sanctions to apply. We show that these sanctions realize (also) through the loss of firm reputation and trustworthiness in the eyes of the business community and firm investors (the market).[10] On the other hand, respecting recommendations of best practice (CG Code) is not yet considered 'a norm'. Firm managers do not (yet) perceive that the market pressure for the adoption of these recommendations is relevant. This is to a certain extent also reflected in the analysis of the declarations of the compliance with the CG Code. However, the low consensus[11] in relation to the introduction and obedience of the Code makes it more likely that the market will attribute the behavior of the firms to the intrinsic motivation and characteristics of the firms, namely their voluntary commitment to improve the way they are governed. This should consequently increase the payoffs in the form of reputation improvements from introducing best practice. Although this remains an open question for our future research, we provide examples of Slovenian firms that have been widely disclosing corporate matters, even beyond the recommendations of the CG Code. The adoption of best governance practice follows the expected payoff from signalling; the level of voluntary disclosure partly reflects the characteristics of the firm ownership structure, market efficiency and the identity of the main investors. We consequently expect the Code to play a stronger role in the future, in line with the changes in their ownership structure, the withdrawal of the State and the internationalization of firm activities and financing.

The article is structured as follows. After the introduction, the second part briefly describes the judiciary system and the dynamics in the introduction of best practice in

Slovenia. The third part overviews the theory on reputation and internalization of law. Perceptions and opinions on the role of rules and recommendations are evaluated in the fourth part. Conclusion and discussion follow.

Judiciary in Slovenia

Despite the quality of the law on books in Slovenia *(see EBRD, 2006),* the functioning of the courts and the enforcement procedure is close to catastrophe *(Heritage Foundation Index, 2005)*. According to the *World Bank (2006)*, it takes more than two years to recover debt. For instance, it takes approximately the same time to enforce a contract in Colombia, Mozambique and Lebanon.[12,13,14] Due to the lengthy trials, Slovenia had to pay, up until July of 2006, approximately EURO 500.000,00 in damages to Slovenian entities. There are approximately 100 cases against Slovenia still pending at European Court for Human Rights at Strasbourg (*Finance, 2006, p.12*) and the number keeps on increasing. For instance, it takes on average one year to be entered in the Slovenian land register as an owner of a real estate and at least 60 days to start a limited liability company.[15,16] Also, in 2004, commercial courts, (excluding bankruptcy cases and compulsory settlement cases), solved only 51 % of the cases filed in a certain year.[17] In a period between one to three years, they solved 28.4% of the cases, and the rest of the cases had to wait (or are still waiting) more than three years to be solved.[18] The worst situation is at the enforcement courts, since cases at the enforcement courts represent 59 % of all the cases that are treated as backlogged cases.[19,20] The backlogs are so high that it would take only the enforcement court up to three years to clear them, if they work at the same speed as now and they would not get any new cases, to solve all cases. *Zajc and Trampuz (2005)*, by stating very conservative assumptions, evaluated social costs of

backlogs in the enforcement courts (which represent a small percentage of all courts in Slovenia) at almost 0.28% of the Slovenian GDP.

Even though the judicial system hasn't been functioning for the last 11 years, there seems to be no political will to improve it. On the other hand, significant improvements have been made in the promotion of good business practice. In order to define in more detail the governance and management principles of the public joint-stock companies, to contribute to transparent and intelligible governance system and to promote the confidence of domestic and foreign investors (*Slovenian Corporate Governance Code, p.2*), the Ljubljana Stock Exchange, the Association of Supervisory Board Members and the Managers' Association adopted the Slovenian Corporate Governance Code (CG Code) in March 2004. Apart from the provisions of the relevant legislation with direct bearing on the corporate governance system (expressed by means of an appropriate form of *'must'*), the CG Code introduces voluntary practice through: i) the provision containing the word '*should*', which have the nature of recommendations and are not legally binding but need to be complied with or explained; ii) optional provisions, which are expressed with the words '*it is recommended that/it can be done*'.

Rules, best practice and firm reputation

The higher the informational asymmetry in the markets, the higher the ambiguity of market transactions and the poorer the functioning of the courts and other institutions of legal governance, the more reputation should matter in determining the choices of firm constituencies.[21] Consequently, in a weak institutional environment reputation to significant extent influences firm performance: it increases the potential for profit

margins on firm product and services, it improves firm access to the capital markets, and it attracts investors, employees and customers. In this regard, reputation is a general perception of firm quality, based on different signals such as information about the firm management, financial performance, quality of product and services, long-term investment value, innovativeness, financial soundness, reliability to perform contracts and promises, ability to attract, develop and keep talented people, community and environmental responsibility and the use of corporate assets.[22] Finally however, what matters is the assimilation and verifiability of this information. Human judgment about corporate reputation in fact depends on the individuals' perception of the environment and to its related interpretation of the information of the observed behavior *(Dhir, 2005)*. As suggested by the traditional attribution theory, the society will attribute a particular behavior (e.g. non-compliance with a legal rule) to internal characteristics of the actor (i.e. her character) when her behavior differs from the one observed at or expected as a normal one (*Evans, 2006:7*). [23] With regards to legal enforcement we can thus expect that, if the legal disobedience is perceived as something 'normal', the society will tend to discount its importance by searching for a justification in the factors external to the defecting actor. When this is the case, the firms will know that the society marks the defection as insignificant and consequently have more reasons to disobey since (in their estimation) the defection payoffs will be higher than the reputation losses (*Eberl, 2004:263*). To put it differently, a firm will uphold a social norm when commitment conveys an advantage relative to the original preferences that is, when the net price of upholding the social norm is positive *(Cooter, 1998).*[24] Similar reasoning underlines the compliance with voluntary recommendations (i.e. CG Code).

To sum up, to exert an impact on firm reputation, the market has to perceive the non-compliance with a legal rule or a recommendation as something that is not 'normal' or expected. In fact, the public may pay no attention to a rule/recommendation, when rules/recommendations are not generally complied with in the society (high consensus in non-compliance). This could likely be the case in the countries with poor legal enforcement. The compliance with the rules may also be less important for firm reputation when the public has little trust in the judiciary and the law making institutions (due to corruption) and may consequently perceive the legal rules as the product of the interest group pressure with little benefits for the general public.

Public perception of non-compliance and related social sanctions

We evaluate the public's perception of the firm disobedience of norms and recommendations by performing an experiment involving a group of MBA students at the Faculty of Economics at the University of Ljubljana (Slovenia).[25] The students were identified with numbers, so that their anonymity was fully preserved. As shown in Table 1 below, they have some general knowledge of good governance practice and most of them have at least sometimes invested in shares. Their perception about the legal environment complies with the finding in section II: they generally conceive the rules as poorly enforced.

Table 1: Perception of the legal environment by the participants of the experiment

OPINIONS ABOUT THE LEGAL ENVIRONMENT IN SLOVENIA	MEAN (MEDIAN)
What is your knowledge about Corporate Governance? 1-poor 5-I know the subject well	3(3)
Have you ever invested in firm shares? 1-never 5-very often	2.11(2)
How effective is your national Parliament as a law-making institution? 1-very ineffective 5-very effective	2 (2)
The legal framework in your country for private businesses to settle disputes and challenge the legality of government actions and/or regulations is: 1-inefficient and subject to manipulation; 5-efficient and neutral	2.35(2)
Is the judiciary in your country independent from influences of members of government, citizens or firms?1-no,-heavily influenced; 5- yes, entirely independent	2.47 (3)
Is the judiciary in your country efficient in enforcing law? 1-totally inefficient; 5-very efficient	2.41(2)

The students[26] were asked to evaluate the decision to appoint a former CEO (currently in retirement) on the firm's Supervisory Board. Initially ('*control' conditions*), they were provided with a general description of the potential conflicts involved in the nomination of a former CEO on the Supervisory Board. They were told that the nomination of the former CEO on the Supervisory Board was proposed by the current CEO. The latter was actually employed by the former CEO and the two have been working closely since then. After the retirement, the former CEO continued having lunches with the new CEO and the Management Board members. The members of the Management Board justified the nomination of a former CEO by stating that '*his experience in the field will largely contribute to the company's success.'* The description included no reference to any rule or best practice in relation to the appointment of a former CEO on the Supervisory Board. The students had to indicate the agreements (on a scale from 1: '*I definitely don't agree*' to 5: '*I strongly agree*') with the statements capturing the impact of the nomination on the

student's perception of firm's reputation and trustworthiness. The statements and the corresponding results are presented in Table 2 below.

The second round of questions instantly followed the first round. The students were not allowed to discuss among themselves in between the two rounds. In the second round, they were randomly split in two groups (12 persons each). The first version ('recommendation') of the case, which was distributed to a half of the students, included the following statements: 'In proposing the new member of the Supervisory Board, the management has disregarded that he may not be objective in supervising the Management Board since, due to the past collaboration, he and the Management Board are old friends. In fact, the proponents of the good business practice do not recommend appointing an old manager on the Supervisory Board. On the other hand, the new member has a substantial experience in business, which may largely offset the drawbacks associated with eventual conflict of interests or lack of objective supervision'. The second version ('law'), on the other hand, included the following statements: 'By appointing the former board member on Management Board, the firm voluntary violated the article 10 of the Companies Act which explicitly states that: 'The person who has been member of the company's Management Board or member of the management of associated companies within the last three years can not be appointed on the Supervisory Board'. In fact, the legislator doubts about the objectivity of an ex board member to exert supervision over his 'old friends'. However, given the court delays in the country, it would take a shareholder more than 5 years to get a redress for the violation (when finding out that he/she was misled). The managers of the company believe that the

benefits from appointing a former CEO on the Board largely exceed the costs of potential court litigation.'

After reading the second version (either *'law'* of *'recommendation'*) the students were again asked to express their agreement/disagreement with the statements indicated in Table 2. The table also presents the means (medians) and the significance in the difference between the means of the control conditions and each of the two versions respectively. Finally, the students answered some manipulation checks, demographic questions and stated their opinions with reference to the statements presented in Table 1 (see above).

Table 2: Perception of non-compliance of legal rules and recommendations

(5-I strongly agree; 4-I agree; 3-I am uncertain; 2-I don't agree; 1-definitely don't agree)

	control	recommendation	law
	Mean (Median)	Mean (Median)	Mean (Median)
The nomination of a former manager in the Supervisory Board is beneficial to the company.	3(3)	2.66(2.5)	2.62 (3)**
The new member will exert an objective and efficient supervision of the managers.	3(3)	2.92(2)	2.46(2)**
The company's management can be trusted.	3.29 (3)	3.375 (3)	2.4(2)**
The shares of company in question are a good investment.	2.94 (3)	3(3)	2.69(2**)
Following the nomination of a new member, my opinion of the company and its management has deteriorated.	2.88(2)	3 (3)	3.53(4)**
I believe most of the other companies also have former managers on their Supervisory Boards.	3.18(4)	3(2.5)	2.5(2.5)**

**Significant at 5 percent level.

The comparison of the students' perception between the versions '*control*' and '*law*' show that the non-compliance with the legal rule significantly hurts the reputation of the

company and reduces the trustworthiness of the firm management. On average, in the '*law*' version the students tend to agree less with the fact that the nomination is beneficial for the company and with the fact that the new Board member will exert an objective supervision. They trust less in the management of the company and to a lower extent consider the company as a good investment. On the other hand, they mostly expect that the other firms will follow the law; non-compliance is thus not considered something 'normal' in the society. On the other hand, no significant differences in relation to the '*control*' version are observed in the version '*recommendation*'. These results somehow imply that not respecting a recommendation is considered less harmful in the terms of corporate reputation than not-respecting a legal rule. This is so despite the fact that the participants of the experiments were explicitly 'reminded' about the inefficiency of the judiciary in the country and despite the fact that they actually perceive the judiciary as inefficient (see Table 1). In sum, students therefore treat obedience of law as 'normal' or expected, which is less the case in regard to the obedience of recommendations.

In order to 'double - check[27]' the results, we collected the opinions about the role of legal compliance for firm reputation from a sample (32) of successful young executives (of age under 40) of the top Slovenian companies. If the non-compliance with the legal rule is generally attributed to the inefficiencies in the legal environment and the low reliance on the law, the managers will feel little social pressure to comply with the legal rules. First, the managers were asked to express their agreements or disagreements with the statements reflecting the importance of different factors for firm reputation (*1-completely disagree; 3-partly agree; 5-fully agree*). The questionnaires were again anonymous and

the results provide support to the claims stated above. The managers in general fully agree that the reputation is important for corporate performance (M^{28}=4.51, SE^{29}=0.15). Similarly, full agreement is reflected with regard to the compliance with the legal rules (M = 4.27, SE=0.19), respect of contractual obligations (M= 4.53), firm financial performance (M = 4.18, SE=0.17) and listing on the Stock Exchange (M = 4, SE= 0.20). Similar importance as to the legal rules is attributed to the accepted social standards (M=4.14, SE=0.18; t (28) = 0.55, p<0.3). Compliance with the CG Code and other recommendations of business practice is however less important (M = 3.7, SE = 0.19), t (27) = 2.7497, p<0.1, r = 0.46) than the compliance (or non-compliance) with the legal rules themselves.

The superiority of social pressure for legal compliance in relation to recommendations is confirmed also in our analysis of the Declarations of Compliance issued by the Slovenian joint stock companies. For instance, several companies deviate from the Code provisions with a justification that they '*comply with the legislative requirements'*. Some companies rely on this justification quite extensively. In 2006, this validation was most frequently used for the recommendation to determine rules on limitations of trade in company's share in internal bylaws, the use of international accounting standards for non-consolidated accounts, etc. Moreover, the improvements in the number of issued declarations since the first adoption of the CG Code can be attributed to an actual change in the regulation: the amendment of the Ljubljana Stock Exchange Rules in 2005, which now require the issuers of shares traded on the official market to make a public disclosure of the declaration of compliance (*Cankar, 2006*).[30]

The results show that it is not (yet) perceived that the CG Code should be respected. This is probably due to the fact that the CG Code is relatively new (adopted in March 18, 2004) and that it introduces some relatively high requirements that might well characterize corporate practice corporations in the countries with a long tradition in market economy, but which are more difficult to follow in an environment of transition.[31] In any case, in absence of any 'real' social sanction for non-compliance with the recommendations of best practice, the adoption or respect of the CG Code should result from the intrinsic motivation of the firms themselves. Given that the CG Code or better put, respecting CG is not yet a social norm, the effect of such compliance could be stronger than in the developed economies, where the CG Code has been widely followed. In terms of the attribution theory, low consensus behavior (i.e. a behavior that differs from the behavior of the others in the same situation) is more likely to be attributed to the internal characteristics of the actor. Thus, by complying with the best business practice, the firm may signal its 'commitment' to applying the 'above-high' standards of corporate governance. Moreover, the absence of real social pressure to a certain extent ensures the credibility of the signals provided. As shown by *Cowen, Glazer and Zajc (2000)*[32] when firms do not feel threatened to comply, they might reveal about themselves much more and more detailed information or adopt more (or less) credible actions as compared to the situation in which they are bound by stringent rules.

Few Slovenian firms in fact already follow the example of the Western corporations and implement high standards in their operations and governance. We try to analyze the

factors underlying the adoption of best practice by extending the *Berglof and Pajuste (2005)* study on the disclosure practices. Our study involves a sample of 72 Slovenian public companies at the end of 2005. While the disclosure lags behind in a large part of the firms, we find that few firms (6) publish a separate Corporate Governance section on the web page, 17 firms had bylaws available on-line, while 33% of firms provided some kind of information on the ownership structure (although not yet recommended by the Code at the time of our analysis). The results of our empirical analysis imply that the level of disclosure follows[33] the potential pay-offs from transparency. The latter are (in our view) determined also by the investors' capacity and motivation to understand and 'use' the information provided by the firms. Transparency is higher in larger firms ($b = 0.30$, $p<0.5$); in firms with a higher number of small shareholders ($b = 0.43$, $p<0.1$); in the firms with the shares listed on more efficient, official market, which ensures a better incorporation of the information in the firm value ($b = 0.75$, $p<0.1$) and; in the firms with a larger share of financial investors, which probably value firm transparency more highly ($b=0.011$, $p<0.1$).[34] This is somehow in line with the conclusions of other studies, which predict the compliance with the Code to increase with the growing influence of institutional shareholders and their willingness to invest on a global scale, with a country's integration in the world trading system and with its progress in the economic liberalization and integration (Cankar et al., 2007; Aguilera and Cuervo-Cazurra, 2004).

One caveat however applies. In arguing about the role of the CG Code as a 'signal of commitment' to good practice, we implicitly assumed that the public (investors) agrees with the recommendations of the CG Code. Only if this is the case, the adoption of CG

recommendations will be actually perceived as a positive signal. In ensuring the latter, the Ljubljana Stock Exchange has been following three main policies. Firstly, Slovenian CG Code arises as a product of the general business practice, as a compromise between the external recommendations (OECD Principles) and the requirements of the firm managers and their supervisors. With the aim to reach a general consensus, the Ljubljana Stock Exchange has decided to invite two additional partners to draft the CG Code: the Managers' Association (representing the CEOs) and the Association of the Supervisory Board Members (representing the supervisors). The three 'underwriters' of the CG Code have fully committed to the promotion of the CG Code among its members. Secondly, the underwriters continuously evaluate the appropriateness of the provisions for the average firm in the economy and adjust them accordingly.[35] Thirdly, it is important that the general acceptance of the Code is explicit: with this aim, the authors of the Code invited several institutions to express their support to the Code. In 2006, the Slovenian Institute of Auditors, the Stock Exchange Members' Association, the Slovenian Employers' Association, the All-Slovenian Association of Small Shareholders, and the Chamber of Commerce and Industry of Slovenia have signed the statements of accession to the CG Code and thus committed to strive to implement and promote the Code in their respective areas of businesses. The implementation of the CG Code has also won the support of the Bank of Slovenia, while no such support was unfortunately (yet) expressed by the main shareholders of Slovenian firms: the State-controlled Funds and the Association of the Investment Funds' Management Companies.

Discussion and conclusions

Our analysis, relying on the theory of social norms, indicates that improving law on books and/or recommendations might still have a role, even in the deficient institutional environment such as Slovenia. This finding to certain extend contradicts some of the existing claims in literature, which condition the functioning of the legal rules to their enforcement in the legal practice.

Indeed, as argued by *Sunstein* (1996:909), people feel shame when they violate social norms. This may be the case also in the absence of any formal mechanism that would sanction the violation of norms in the society. Thus, if the society internalizes a legal rule or if obeying the law is perceived as a social norm, the society might sanction any non-compliance, when (if) observed. One of the mechanisms, through which social sanctions work, is through the loss of firm reputation and trustworthiness. By relying on experiments and option survey as a research vehicle, we show that the above-mentioned social sanctions apply even in an environment with inefficient judiciary, where the incorporation of the legal rules and their respect and obedience in social norms may be limited. Notwithstanding the fact that the social pressures to obey law on books can to a certain extent substitute the formal institutions, strong effort should still be directed towards improving the functioning of the courts and the judiciary. There is in fact an extensive range of empirical research confirming the role of institutions in promoting economic growth and ensuring the success in transition.[36]

It is moreover not our intention to generalize the results to all the countries with poor judiciary and to the implementation of the 'law on books' in general. We believe that, in

order for the (social) norms to have a role, some other conditions need to be satisfied: the society must reach a certain level of economic development, openness, culture and morality. Most importantly, it needs to share some legal knowledge, information dissemination about the 'rule of law' and the 'verifiability' of the compliance in practice. In this regard, the Slovenian CG Code plays an important role. By summarizing the main legal requirements (propositions with *must*) it certainly increases the public (investors) awareness of its rights and raises the 'anchor' of the public judgments in relation to the firms and their behavior. Also, by its recommendations, it increases the public's awareness of certain standards, which are desired in the business community and lays the grounds for internalization of such rules.

Although it is not (yet) perceived as a social norm, we expect that the reliance on the CG Code will increase in the future, in line with the changes in the ownership structure of Slovenian firms, withdrawal of the State funds from the economy, further integration of financial markets and consequently, stronger presence of educated investors, which will appreciate firm commitment to best practice highly. In the long run, its role may upgrade from a 'commitment' device to a generally accepted norm: in line with the advancements of transition and the development of a well-educated shareholder base, the compliance with the Code may not be an exception but will become 'a rule'.

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[4] For an excellent overview, see *Berglöf and Claessens (2004).*

[5] In this regard, we focus on the company law. Two reasons apply. One being that our research is mainly in the corporate governance field and therefore we dispose with knowledge and empirical evidence, and second reason being that we believe that company law is very similar across countries and therefore it is very unlikely that it is captured by special interest groups. However, we do believe that certain segments of company law are indeed influenced by special interest groups.

[6] We believe that the arguments made by Bohnet et al. (2000) in relation to contractual obligations can be extended to the compliance with the legal rules in general. Even though respecting contracts and obeying rules overlap to a certain extent, they are not the same. We could say that by obeying rules, firms signal their credibility and trustworthiness in general. By respecting contracts they might only focus on the other

contracting party, even though there is some spill over effect, probably because this kind of signal is cheaper.

[7] As claimed by Cooter (1998:598):'Good character increases person's value in cooperative activities.'

[8] *Cooter (1998:588*) similarly argues that upholding a social norm can bring benefits, such as deterring future injuries, undermining a competitor or most importantly, enhancing reputation, of course at a certain cost.

[9] See also Sunstein (1996).

[10] This assumption is a logical extension of the theoretical claims made by *Cooter (1998*), supra, footnote 7 and 8.

[11] This is, the fact that most of the other actors (firms) do not act in the same way in the same situation *(Kelley, 1967 in Friedman et al., 2007).*

[12] http://www.doingbusiness.org/ExploreTopics/EnforcingContracts/Details.aspx?economyid=169.

[13] As far as rule of law is concerned, Slovenia ranks quite high. Among the countries in transition, only Poland and Hungary ranked higher, and Estonia had the same ratings. In the area of legal efficiency, Slovenia lags behind Bulgaria, the Czech Republic, Estonia, Macedonia, Hungary, Romania and Poland. Uzbekistan, Poland and Estonia are more efficient in rights protection than Slovenia. According to the shareholders rights index, Slovenia is among the very last of the countries in transition whereas according to the creditors and lenders rights index it was rated quite high.

[14] There are 2448 cases at Slovenian courts that are older than 10 years; two of them date back to 1974.

[15] Some of the courts are quicker at entering the data, some are slower. The most critical situation is in the capital city of Ljubljana and in Maribor, the second largest city in Slovenia.

[16] For example, it takes only 5 days to start a business in USA, 29 days in Austria, 38 days in Hungary and 40 days in Czech Republic.
(http://www.doingbusiness.org/ExploreTopics/StartingBusiness/Details.aspx?economyid=197)

[17] The latest figure is for the year 2004.

[18] The duration of the cases is presented for the courts of first instance. The duration is prolonged if we include Appellate Courts and Supreme Court.

[19] Once the courts decide that a certain right or payment belongs to a certain party and if the other party does not want to perform his/her obligation, the party to which the right or payment belongs can file a motion at the enforcement court to enforce the judgment.

[20] Backlogged cases are defined by Judicial Order, Official Gazette of the Republic of Slovenia, No.*17/1995* and further changes and amendments.

[21]*Bohnet et al.* (2000) show that, due to the cautious behavior of the agents, the 'good' and trustworthy counterparts will get more contracts and be more successful than others: thus, it pays to be good. This will be more so the worse is the enforcement of the legal environment since with medium enforcement the expected payoff of entering a contract is higher than the payoff of abstaining even if you know that the contract will be breached. Similarly, counterparty's honesty is irrelevant with high levels of enforcement since all contracts will be enforced (*Bohnet et al.,* 2000:4).

[22] These are the factors included in the Fortune reputation ranking. See *http://www.prfirms.org/resources/research/harris/page4.asp*

[23] According to attribution theory *(Keley, 1967)* the consensus information or namely, the degrees to which other actors perform the same behavior with the same object determine the formation of attributions. If a violation of a rule is attributed to the company or its management (internal attribution), the punishment (i.e. loss in reputation) will be stronger than when a violation is attributed to the factors outside the firms' control.

[24] The net price refers to the price the actors pay for upholding the norm minus the advantage she gains by upholding the norm.

[25] As shown in Table 1, the participants in the experiment dispose with some financial knowledge; they are moreover free of any 'mental' burdens related to the pre-transition period. Thus, we believe this group of students approximates well the group of future Slovenian managers, financial analysts and investors, which will likely co-determine the reputation of Slovenian firms in the future.

[26] Many thanks to Vlado Miheljak from the Faculty of Social Sciences in Ljubljana and to Mateja Drnovsek from the Faculty of Economics in Ljubljana for their comments and suggestions in regard to our experiment. The mistakes are our own responsibility.

[27] One could argue that the experiment should involve 'effective' representatives of the business society, not MBA students. However, this is a general practice in the experimental studies.

[28] M stands for the Mean.

[29] SE stands for the Standard Error of the Mean.

[30] In 2004, only 14 out of 24 firms quoted on the official market of the Ljubljana Stock Exchange actually issued a 'declaration of compliance'; the number of issued declaration increased to 29 (out of 30) in 2005, while in 2006 all of the companies with share traded on the Ljubljana Stock Exchange issued a Declaration of Compliance (*Cankar, 2006*).

[31] With regard to firms' compliance with the Code recommendations, Cankar et al. (2007) observe a tendency towards a 'pooling equilibrium'; on the whole, companies tend to adopt strikingly similar strategies in the terms of deviation from the Code and type of explanations of the deviations. There are lots of identical declarations and copy pasting. However, the authors observe an increase in the quality of declarations over time with the companies listed on the highest market segment (the prime market). These companies stand out in the terms of disclosure and signalling of best practice in general.

[32] In a theoretical model concerning the central bank operations, the authors show that discretion, which motivates the agents to reveal their type (i.e. by complying with a general rule), can sometimes increase the credibility of the agent beyond what a regime of rules can. They show that it is often difficult to discover information about market players, when most of their behavior is constrained by the rules.

[33]In evaluating the level of disclosure, we rely on the web disclosure index constructed by *Berglöf and Pajuste (2005*): we assign 0 points to the index if the company does not have a web site; 0.5 if the web is only in local language, 1 if the web site is also in English. The firm is assigned 0 points if the latest annual report is not available on line and 0.5 if it is available in local language and 1 point if it is available also in English. If a firm publishes a specific CG section on the web site, we assign 1 point and 0 otherwise. Points are correspondingly assigned for the availability of the names of the key managers, board members, ownership structure and company bylaws (7 points in total).

[34] We also control for the level of ownership concentration, leverage and firm financial performance. The impact of these variables turned out negative but not significant.

[35] For instance, two years ago a group of experts examined the Code for the first time. The proposed changes, to name only the few most important ones, included a more precise definition of the firm goal (since not properly defined in the Slovenian Company Law), a better disclosure of the conflict of interest and of the independence of the Management and Supervisory Board members, also with reference to the Co-Determination as the specific of the Slovenian corporate governance. All the changes were well received and were incorporated in the disclosure documents by most of the companies.

[36] As Cooter (1998, p.595) stated: 'In reality, a combination of expression and coercion accounts for the effectiveness of many laws'. See also McMillan and Woodruff, 1999.