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Bakalářská práce

2012 **Kateřina Vrátníková**

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Neglected corporate governance and its consequences: The case of Sazka, a.s.

Bakalářská práce

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Abstrakt

Význam corporate governance, jakožto nastavení vztahů mezi managementem a akcionáři společnosti, v posledních letech neustále roste. Správně nastavené mechanismy corporate governance jsou pro společnost velice důležité, protože zvyšují celkovou důvěru v ní vloženou a také důvěru v rámci společnosti, zejména pak mezi managementem a akcionáři. Tyto mechanismy rovněž mají za úkol pomáhat akcionářům monitorovat činnost managementu. Důležité ale také je, aby si vlastníci korporace uvědomili, že vlastnictví majetkového podílu ve společnosti je rovněž spojeno s určitými akcionářskými právy, která je třeba vykonávat, pokud akcionáři požadují příslušné finanční výsledky.

Tato práce popisuje možné důsledky špatného nastavení mechanismů corporate governance a rezignace na vykonávání vlastnických práv na příkladu české loterní společnosti SAZKA, a.s., která se dostala do bankrotu v květnu 2011 a jejímiž akcionáři byly zastřešující sportovní organizace. Studie demonstruje, že pád společnosti byl způsoben zejména špatným systémem správy a řízení společnosti a ne pouze investicí do stavby multifunkční arény v Praze, která byla spíše důsledkem špatného corporate governance. Tato práce také tvrdí, že chování akcionářů, kteří, spíše než aby kontrolovali management, byli managementem ovládáni, zhoršovalo situaci společnosti rovněž během probíhajícího insolventního řízení se společností. Studie dochází k závěru, že přímé vlastnictví loterijní společnosti sportovními svazy rozhodně není nejefektivnějším systémem jak z pohledu corporate governance, tak následně z pohledu financování sportu.

Abstract

Importance of corporate governance as a setting of relations between management and shareholders of a corporation has been widely acknowledged in the past years. Mechanisms of corporate governance are very important in order to increase overall trust in the company and among the individual part of a corporation, especially between managers and investors. At the same time, these mechanisms should serve to shareholders to monitor better activity of management. However, shareholders must understand that an ownership stake obliges them to execute their shareholders rights and to be involved in the life of company, if they require adequate financial results.

This paper describes possible negative consequences of a bad setting of corporate governance mechanisms and of resignation on execution shareholders rights using an example of a leading Czech lottery company SAZKA, a.s which went bankrupt in May 2011 and whose shareholders were Czech umbrella sports associations. It aims to show that it was the wrong practice of corporate governance which caused the failure of this company and not only the investment into a construction of a multifunctional arena in Prague which was rather a consequence, or a product of the neglected corporate governance. Also this study shows, that behaviour of shareholders who seemed to be controlled by the management (as opposed to a nature control of management by shareholders) was steadily worsening the situation of the company even when the insolvency proceeding was in progress. This paper concludes that ownership of a major lottery company by sports associations is not the most efficient system from both point of view of corporate governance and subsequently sport financing.

Klíčová slova

Správa a řízení společnosti, corporate governance, akcionáři, korporace, sportovní organizace, SAZKA, aktivní akcionáři, problem principal-agent, akcionářská práva

Keywords

Corporate governance, corporation, shareholders, sports associations, SAZKA, shareholder activism, principal-agent problem, shareholders rights

Rozsah práce: 152 tisíc znaků

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V Praze dne 16. května 2012 Kateřina Vrátníková

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Na tomto místě bych ráda poděkovala vedoucímu práce Ing. Zdeňku Hrubému, CSc., svému otci za cenné rady a inspirující diskuze na téma práce a Pavlu Novotnému za ochotu a připravenost vždy pomoci.

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Výroční zprávy společnosti Sazka, a.s.

Stanovy společnosti Sazka, a.s.

Předběžná náplň práce

Corporate governance, tedy soubor politik, norem a pravidel ovlivňující řízení a správu firmy, určuje vztahy mezi jednotlivými akcionáři, investory, managementem a dalšími aktéry spojenými s fungováním společnosti. Jedním z hlavních cílů správného nastavení institucí je vyrovnat se s problémy vznikající oddělením vlastnictví a řízení. Přestože se jednotlivé modely řízení a správy firmy liší, existují společné prvky, které pomáhají společnosti nejen dosáhnout její strategické cíle, ale také uspokojit zájmy všech aktérů – akcionářů, investorů, atd. Nedodržení těchto pravidel může mít pro firmu závažné důsledky.
Tato práce se zabývá strukturou a modelem corporate governance české loterní společnosti Sazka, a.s., která zbankrotovala v květnu 2011. Práce popisuje společnost, její vazby a vztahy v rámci skupiny, investory a akcionáři. Tato struktura měla za následek narušení klasické funkční rovnováhy mezi managementem a akcionáři – management v případě Sazky dosáhl faktické kontroly nad akcionáři, zároveň ale stále vykonává svoji běžnou řídící činnost. Práce dále popisuje způsob financování hlavního investičního projektu společnosti – multifunkční arény v Praze – který opět vyplývá ze struktury Sazky.
Hlavním cílem této práce je ukázat škodlivé následky nedbalé správy společnosti a špatného

nastavení pravidel na její činnost a výsledky na základě příkladu Sazky – situace ve firmě je srovnávána s teoretickými modely. Zároveň je aplikována teorie her na rozhodovací procesy. V závěru pak práce diskutuje, co by se v případě Sazky dalo udělat v minulosti lépe podle teoretických modelů a příkladů dobré praxe.

Předběžná náplň práce v anglickém jazyce

Corporate governance as a set of policies, laws and institutions inside the company among others determines the relationships between various stakeholders related to the organization. One of its major objectives is to deal with the principal-agent problem. Although the models of corporate governance vary, there are some common patterns that help to achieve strategic aims of the company and satisfy all the stakeholders as well as legal norms. Violation of these characteristics could have pernicious consequences for the company.
This thesis deals with the structure and the corporate governance of the Czech lottery company Sazka, a.s. which went bankrupt in May 2011. It describes the company, its constitution and relationships inside the group as well as with the stakeholders that in the end lead to a disturbance of classical role of management and shareholders – management factually controls the shareholders and at the same time keeps its normal operative role. It also portrays principles of financing of the main Sazka´s investment – the multifunctional arena in Prague; principles that result from the structure of the company.
The goal of this thesis is to show the harmful consequences of the bad corporate governance to company's performance. For this purpose I use the example of Sazka by comparing the actual situation in the company with the theoretical models and also by employing the game theory for the decision and policy making. The conclusion discusses what could have been done better in the case of Sazka according to theoretical models and examples of good practice.

Contents

Introduction

It is possible to define corporate governance using various conceptions. Nevertheless, behind every academic or business definition of corporate governance, being a mechanism of setting rules between a corporation and various parties, above all management and owners, there is a crucial asset necessary for a proper functioning of a market economy, the trust.

In the past thirty years the issue of corporate governance has been widely discussed not only in academic circles, but also in business spheres. These debates intensify every time there is a problem caused by neglected corporate governance, such as corporate failures at the beginning of 2000s, or collapses of financial institutions during the financial meltdown in 2008. Every such failure provokes a loss of trust and it is necessary to improve the corporate governance framework in order to restore this necessary trust. Some cases, such as transformation process in the Czech Republic in the 1990s, require an establishment of the whole corporate governance framework in order to introduce this oil for the market economy.

A goal of this study is to demonstrate negative consequences of neglected corporate governance which may lead to a worsening of performance of a corporation, loss of value of shareholders, and even to the failure of a company. Recent economic history offers a lot of examples. This study will work with an example of Czech lottery company SAZKA, a.s. which went bankrupt in May 2011. The paper argues that this failure was primarily caused by a wrong setting of corporate governance, CEO who abused his vast power and controlled the owners; shareholders who did not execute their rights, relied on promises made by management and let themselves be controlled rather than control the management's activity.

The following study is divided into two big parts. The first part focuses on the theory of corporate governance necessary to explain what went wrong in the case of SAZKA, a.s. The first chapter deals with the origins of problems between the management and shareholders. The second chapter describes corporate governance, its functions and mechanisms. Further, two traditional models of corporate governance are introduced in the second chapter, as well as the system of corporate governance in the Czech Republic with its institutional and historical background.

The case study contained in the second part firstly presents in the third chapter lottery company SAZKA, a.s. and its history. The fourth chapter examines in detail its system of corporate governance and identifies its flaws as well as problems in the execution of shareholders rights by the owners of the company. These problems are further described in the fourth chapter which offers an overview of the solutions proposed to the shareholders of the company after falling into deep problems (insolvency claims, insolvency declaration, etc.). In

the fifth chapter, the study also provides a simple analysis of the influence of consequences of neglected corporate governance on company's revenues from its main numeral lottery Sportka and of the development of people's trust in the company.

Part one: Theory of corporate governance

1. Introduction to corporate governance

1.1 A corporation and its basic characteristics

Monks and Minow (2004) refer to the corporation as being "a mechanism established to allow different parties to contribute capital, expertise, and labor, for the maximum benefit of all of them. The investor gets the chance to participate in the profits of the enterprise without taking responsibility for the operations. The management gets the chance to run the company without taking the responsibility of personally providing the funds. In order to make both of these possible, the shareholders have limited liability and limited involvement in the company's affairs"(Monks and Minow, 2004; p. 9).

It is the concept of limited liability of the owners which represents the crucial distinction from other forms and systems of companies and also the crucial attractiveness. The corporate form evolved from specific needs that the previous forms of enterprises could not fulfil. Although the history of the corporation as a bundle of joint capital begins at the turn of the 16th and 17th century (Růčková et al., 2008) with the need of commercial companies to be able to trade with newly established colonies, the corporate form of business enterprises saw its main development with the rapid growth and progress of the industrial revolution. As the companies grew larger with economies of scale resulting from the technological progress and their demands for investment in the fixed capital and new technologies increased, they needed to find new sources of external financing because neither the original owners nor the banks were able to raise enough funds. Therefore the role of corporation as an organization able to create large amounts of capital sprung up (investors exchanged capital funding for a part of ownership of the company and thus for a right to receive a respective part of future profits).

Rapid evolution of corporate form of business and introduction of limited liability resulted in problems with governance of the companies. Since there were a large number of owners of the company's share capital, it was no longer possible for them to rule the company by consensus or majority vote (as it is possible in partnerships). In order to make the company

work as efficiently as possible it was necessary for the owners of the capital to give up the right to make ordinary day-to-day decisions and entrust it to the hands of hired professional managers (Monks and Minow, 2004). Shareholders however kept an authority to approve the most important decisions that the company was facing. The form of a corporation therefore results in the "divorce of control from ownership".

Robert Clark summarises the four most important characteristics of a modern corporation as follows:

1. Limited liability for investors
2. Free transferability of investor interests
3. Legal personality (entity-attributable powers, life span, and purpose)
4. Centralized management

Source: Monks and Minow, 2004

1.2 Agency problem (Principal-agent problem)

1.2.1 Definition

A separation of ownership and control has brought a so called agency problem[1]. Ross (1973) offers the following concept of this issue: "an agency relationship has arisen between two (or more) parties when one, designated as the agent, acts for, on behalf of, or as representative for the other, designated the principal, in a particular domain of decision problems." Jensen and Meckling (1976) add that if we consider both, the principal and the agent, to be utility maximizers, their best interests will hardly be in concurrence and we have a "good reason to believe that the agent will not always act in the best interests of the principal" (Jensen and Meckling, 1976). In order to achieve a higher convergence of their interests, the principal needs either to motivate the agent to follow principal's wishes or to expend significant monitoring costs.

The agency problem covers essentially all contractual arrangements (Ross, 1973) thus can be employed for various relationships (even for partnerships or cooperatives) and we can easily say that from the point of view of a company, the agency problem is present at every level of the organization (Jensen and Meckling, 1976). Nevertheless, we have become used to apply and understand the principal-agent problem in particular for the relationship between the owners of a corporation (shareholders) and managers; one of the reasons may be that this relationship can be the most easily analyzed since it is normally well specified by a set of explicit contractual arrangements (Jensen and Meckling, 1976).

[1] Or a principal-agent problem

1.2.2 Information asymmetry

The most important characteristic of the principal-agent problem is an information asymmetry and asymmetrical access to information. We can further recognise several types of the information asymmetry. The first one is a problem of an adverse selection. Manager (agent) has at his disposal ex-ante information that is not known to the owner (principal) – for instance when an owner wants to hire a manager, information about the manager's real abilities is known only to the manager. Or in the case of selling shares to a new potential investor (thus a new shareholder, principal), it is again only the manager who knows the company's potential productivity (Fidrmuc and Fidrmuc, 2007). The second one is a moral hazard which arises usually ex-post, once the transaction or contract between the principal and the agent has been made – for example managers take excessive risks and hide them from the owners.

It is then difficult for the principal to identify the real reason behind a poor performance of the company – whether it is an inherently low corporate productivity, incompetent managers, bad managerial decisions or pure bad luck (Fidrmuc and Fidrmuc, 2007). Asymmetrical access to information arises from the fact that managers are involved in the day-to-day operations of the firm and thus are better and directly informed about its real performance while principals have to rely on intermediated information.

1.2.3 Agency problem and corporate governance

Oliver Williamson developed a simple diagram of contractual relationships (Mlčoch, 2005). In this simple scheme he uses two variables: specificity of assets (taking value either zero for non-specific assets or superior to zero for specific assets) and safeguards (again taking the value of either zero – the owner of the capital cannot consider his investment to be protected – or superior to zero – investment is to a certain extent safeguarded).

If we follow this simple scheme, the relationship between shareholders and a firm is placed in the B node where the assets provided by investors are specific (specificity of assets is superior to zero because there are specific transaction costs linked to the investment resulting from the information asymmetry) and with low protection and guarantees of the contractual relationship (safeguards are equal to zero since the contracts between shareholders and a company does not undergo a periodic renewal and in the case of bankruptcy of the company shareholders are the last whose claims are satisfied). For that reason owners of capital require a risk premium (or in other words a penalty) as a compensation for the risk of expropriation (Mlčoch, 2005).

A solution offered to this problem is to introduce appropriate systems of protection which the shareholders would perceive as a guarantee and protection of their investment, especially against expropriation and bad management (Mlčoch, 2005).

Requirements of the owners of capital include among others efficiently working bodies of a corporation (board of directors and in some systems supervisory board) which are elected by the capital owners themselves (their voting power reflect the share they possess). These bodies are also required to have a power and authority to change the agents[2] if the company is run unsatisfactorily and to verify and authorise key decisions. For all these reasons they need to have access to all the correct information about the corporate performance and obtain these data on a timely basis (Mlčoch, 2005).

Introduction of all required mechanisms functioning without any frictions would create a perfect structure of control, guarantees and protection for the shareholders and imply a shift from the B node to the node C where the safeguards are superior to zero (Mlčoch, 2005). However, the transaction costs of introduction of such a perfect contract (expressed especially by the costs of acquisition of perfect information, costs of monitoring etc.) would be too high as we still assume a real world which is characterized by imperfect information, agency conflicts, market imperfections (John and Senbet, 1998) and above all by non-zero transaction costs. In the real life of imperfect contracts a system of governance of a company can only converge to the ideal state of affairs. In order to converge as close as possible, we need an adequate system of corporate governance to be established and enforced especially for situations not specified in the initial contract (Hart, 1995). A system of corporate governance should address both an adverse selection and a moral hazard problem (Tirole, 2001). The convergence should be secured by articles of association and other internal rules of game, audit committees and obligation to have the annual results checked by an external audit, public agencies and institutions monitoring and controlling the quality of corporate governance in the companies (Mlčoch, 2005).

A corporate governance issue is present when two conditions are met – there is an agency problem and transaction costs are so high that it is not possible to deal with this problem through a contract (Hart, 1995).

[2] Using the terminology of agency theory

2. Corporate governance

2.1 Definition

Corporate governance when considered as a means of how the corporation is governed has been in fact practised since the corporate form started to exist. But, the theoretical debates about the corporate governance have been quite recent and they have accompanied the growing interest in serious managerial thinking and theory. The name "corporate governance" itself was rarely used until the 1980s (Tricker, 2009).

Currently, the topic of corporate governance belongs to one of the most discussed in the modern economics. Moreover frequency of these debates increases every time there appears a large corporate failure or scandal, such as the accounting scandal following the bankruptcy of an American energy, commodities and services company Enron and its auditors Arthur Andersen in the beginning of 2000s. Recently, the debates have restarted after collapses of some financial institutions during the financial meltdown of 2008.

Definitions of corporate governance differ within the academic, legislative and business literature and among the authors. The Committee on the Financial Aspects of Corporate Governance, lead by sir Adrian Cadbury, defines in its report corporate governance as "the system by which companies are directed and controlled" (Cadbury et al., 1992). A similar definition is offered by the OECD Principles of Corporate Governance – "Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance is designed" (OECD, 2004). Czech representative of Institutional economics Lubomír Mlčoch defines corporate governance as a science of "structures of proprietary controlling" (Mlčoch, 1997).

In recent years it has been widely accepted that the corporate governance should not be simply an issue of the relationship between shareholders and management (OECD, 2004) but also between various stakeholders[3] involved in the life of a company. For instance systems of corporate governance should deal with the interactions between controlling shareholders and minority shareholders (e.g. protection of the rights of minority shareholders), employees and the firm, customers and the firm, creditors and the company, government and the company etc. An important relationship which is very often omitted is the

[3] Stakeholders are those people who have a certain stake in the company, e.g. suppliers, customers and clients, creditors, etc.

liaison between the firm and the entire community stemming mainly from the externalities created by the company (e.g. impact on the employment in a particular region, consequences of the company's activity for the environment, etc.).

Nevertheless, since the relationship between shareholders and the company is distinct from the others; Oliver Williamson argues that it is because shareholders invest financial resources with a risk of their loss whereas other suppliers cooperating with the company can keep their means of production even in the case of failure or bankruptcy (Růčková et al., 2008) and creditors usually require guarantees for their loans. Also, this relationship is based on property rights. For all these reasons the rapport between the owners and management of a company rests the central element of the corporate governance and for that reason; we will deal mainly with this relationship throughout the study.

2.2 Why do we need corporate governance?

We have already described the link between the principal-agent problem and need for corporate governance framework. Studies analyzing empirically a relationship between efficiency of an employed system of corporate governance and performance of the company are not very numerous. However, these studies in general approve the importance of good corporate governance for a company performance and activity.

The European Commission found in its 2010 Green Paper on corporate governance in financial institutions that a lack of appropriate shareholder interest in holding management accountable may have facilitated excessive risk taking (EC, 2011).

The Organisation for Economic Co-operation and Development argues in its 2004 Principles of Corporate Governance that an effective corporate governance system helps to provide a certain degree of confidence necessary for the market economy to function properly (OECD, 2004). However, it is not sufficient to have these systems present but they must be credible and enforced if they are part of the legislature (or the companies should be motivated to comply with non-binding codes of corporate governance prepared by an authority through well functioning capital markets).

Quality of corporate governance in particular firms or countries have become an important element for investment decisions and its importance is continually rising (OECD, 2004). Weak corporate governance can increase costs of raising external capital and deforms investment decisions, so that they do not necessarily maximize value for shareholders (John and Senbet, 1998). Also, the nature of the corporate governance is being monitored by the credit rating agencies who take this parameter into account when evaluating companies. At

the same time there is a number of corporate governance rankings created by various institutions.

2.3 System of corporate governance

We have already seen a definition of corporate governance and the logic behind the system of corporate governance. Now let us turn to the mechanisms of corporate governance themselves. We will first consider the corporate governance and its mechanisms in general; distinct models of corporate governance will be discussed later in this section.

2.3.1 Ownership of a corporation

In the case of a corporation ownership means a possession of a part of the shares of the company. This possession enables an owner to receive a part of annual profit (if this is paid and not reinvested) and in a way obliges him to take care of his property by participating in the governance of the company.

Shares in the companies are owned either by individual investors or, very often, by institutional investors (such as pension funds, mutual funds, insurance companies, or banks). The actual proprietary relation may be at last quite complicated because institutional investors represent the interests of their members and thus act in fiduciary capacity (i.e. it is the institutional investor, operating wealth of others, who in reality executes the shareholders rights, not the owner of the capital). These institutions have to employ a system of corporate governance themselves.

Ownership patterns form a significant characteristic of a system of corporate governance because they characterize voting powers and capabilities of the shareholders and may suggest how the shareholders rights will be executed.

2.3.1.1 Shareholder activism

It must be emphasized, that an ownership does not mean only rights but also some duties. Execution of the property rights in this case means to control the management, challenge it and – in case of need – change it, also to examine carefully decisions for which the company needs shareholders approval in order to decide in the best interest of the owners and of the company. This is particularly important for institutional investors who gather wealth of thousands small individual investors looking for maximization of return. For that reason, OECD suggests that institutional investors should publicly disclose their corporate governance and voting policies and decisions (OECD, 2004).

Their activity thus consists in monitoring of the companies and investing in the best performing ones. Therefore from their nature, they could be perfect active shareholders.

However, traditionally, institutional investors were passive and practised more a "voting by their legs" (if they were not satisfied with the company's performance, they simply sold their shares which have caused changes in prices that gave a sign to other shareholders and also to managers) instead of real voting on the annual general meetings of shareholders.

A large problem of shareholder activism and responsible execution of property rights is the free-rider problem. Monitoring of management activity and any effort for change requires large transaction costs which grow with an increasing number of shareholders (because costs of negotiation on forming a coalition in order to have enough votes increase). It may not be in the best interest of a shareholder to start any activity against the incumbent management or even to join another shareholder in the dissident activity because the costs of this "revolt" might be much higher than the expected benefits.

Some of the institutional investors have started a campaign for a larger involvement of shareholders in the governance of corporations[4] and some of them have become drivers of good corporate governance (Tricker, 2009). In the United Kingdom the Institutional Shareholders Committee was created from an initiative of some of the institutional investors (the association has been renamed to Institutional Investor Committee in May 2011).

2.3.1.2 Mechanisms of controls

Hart (1995) states four mechanisms for controlling management which should try to fight with the risk of moral hazard:

- **The board of directors** – a body of a corporation with a very important role but still not a perfect mechanism (more on the board of directors later)
- **Proxy fights** – a proxy fight is a situation when "a dissident shareholder puts up a slate of candidates to stand against management's slate, and tries to persuade other shareholders to vote for his (or her) candidates (Hart, 1995); however this mechanism is not very efficient in a situation of dispersed ownership (due to a significant free-rider problem resulting from high transaction costs of any effort for a change)
- **Large shareholder** – it is in the best interest of a large shareholder with a decisive share in the company to monitor the activity of management thoroughly (as he gains the largest part of distributed profit); nevertheless, this effort will decrease proportionally to the decrease in share, moreover there is a risk that the large shareholder abuses his position on the expense of smaller shareholders

[4] The primal initiative came especially from the pension funds – see for example California Public Employees' Retirement System (CalPERS) or ERISA.

- **Hostile takeover** – hostile takeover is an efficient external controlling mechanism (though maybe its beneficial is not that quite obvious at the first moment); a potential bid of a raider gives a sign to the shareholders that the company may be undervalued and that there may be something wrong with the way the management runs the company; corporate raiders can be perceived as a special case of institutional investors and they can exert considerable governance power (Tricker, 2009); some of the authors praise hostile takeovers as an effective way to discipline managers (Schneper and Guillén, 2004)
- **Financial structure** – the choice of debt a company takes may engage the management to behave more responsibly so that the debt can be repaid (there is a threat of insolvency and bankruptcy)

Source: Hart (1995)

Another mechanism of control over the management which is very often used is a system of managerial incentives, i.e. bonuses paid to managers according to the firm's performance. Very often, managers get stock options so that it would be also in their best interests to increase the market value of the company. But a problem of this incentive is excessive risk-taking since the managers focus mainly on short-term gain. For that reason, managers very often receive these stock options after some time when it is shown that their management of the company has been efficient.

There are other mechanisms of internal control which deal above all with the relationship between various bodies of a corporation. These mechanisms include special rules, set either by a law or by a code of conduct which the corporations join on a voluntary basis. Usually, special laws on corporate governance apply to listed companies only. However, it may be also in the best regard of non-listed corporations to join such a code because a well established system of corporate governance increases trust in a company and can be one of the factors which makes the interest of potential investors in the company grow. The more attractive the company is on the market of investors, the higher its market value is[5].

The UK Corporate Governance Code (FRC, 2010) emphasizes the importance of a dialogue between shareholders and management (and the board of directors) in order to increase mutual understanding of objectives. Also the companies should disclose information

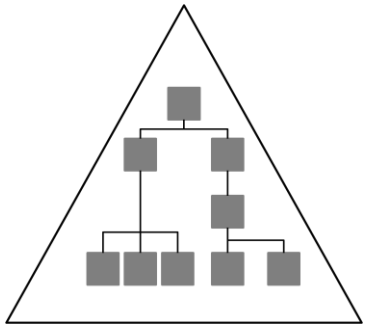
[5] Of course, there are much more factors that influence the performance of the company, its attractiveness for investors and its market value and we do not want to say that the corporate governance is the only thing that matters; on the other hand we have recently seen failures of companies which were considered to have sound financial basis and to be indestructible but which had problems with corporate governance which finally – through a set of bad managerial decisions – destroyed them – see for example the case of Enron.

about their corporate governance (but broader than only a little section within the annual report giving names and functions of the people in management and board of directors).

2.3.1.3 Governance vs. management

While studying corporate governance it is very important to distinguish between "governance" and "management". Management can be in fact described as a hierarchy (Tricker, 2009). On the top there is a chief executive officer who is coordinating ordinary activities executed by lower levels of the management and executive staff. The authority and responsibility is delegated downwards (Tricker, 2009) while the reporting comes the opposite way (from the bottom to top). Graphically, the management would be depicted as a triangle.

Figure 2.1: Management



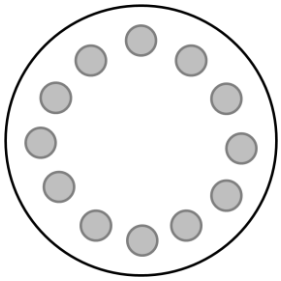
Source: Tricker (2009)

Management is responsible for running day-to-day activities of a company and making operational decisions, following the overall and long-term strategy set by the board of directors and handling the entrusted property. Management is accountable to the board of directors and to the shareholders as a whole.

The most important person for the management is its head, Chief Executive Officer (CEO) whose position may be very strong. A company needs a sufficiently strong and capable CEO; on the other hand it must keep it accountable and guarded all the time (more on this later).

On the other hand a board of directors, representing the "governance", would be graphically depicted rather as a circle; the board is kind of a roundtable where, theoretically, every director has more or less similar responsibilities and powers. Board is not part of the management structure and almost never appears on the organizational charts (Tricker, 2009).

Figure 2.2: Board of directors



Source: Tricker (2009)

In any case, the roles and responsibilities between governance and management need to be clearly divided (FRC, 2010)

2.4 Bodies of a corporation

2.4.1 General meeting of shareholders

General meeting takes place regularly once a year. On this annual meeting, shareholders are informed about the company's situation, annual report and financial statements are presented to the shareholders who then approve them (these documents must be sent to stockholders in advance), shareholders choose whether a dividend will be paid or the profit will be reinvested, approve or reject extraordinary transactions or investments and, if need be, elect members of corporate bodies. Agenda of the general meeting is usually set by the board of directors (above all by its chairman).

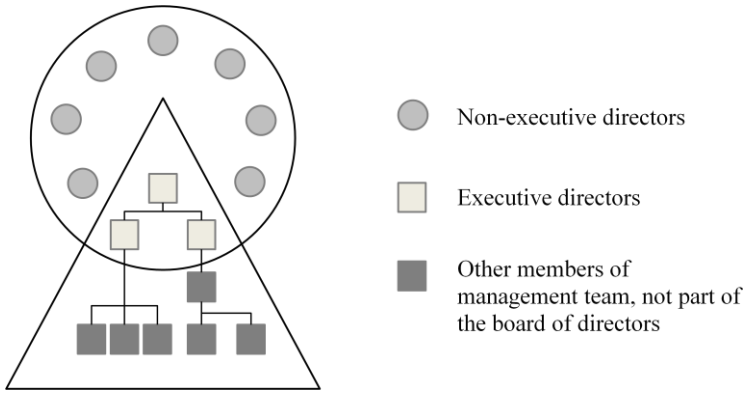
2.4.2 Board of Directors

"The board acts as a fulcrum between the owners and controllers of a corporation" (Monks and Minow, 2004) where controllers are managers. "Directors are representatives of owners (or, in closely held companies, the owners themselves), whose purpose under law is to safeguard the assets of the corporation" (Monks and Minow, 2004; p. 196).

Board of directors is formed from two types of directors. Directors who are at the same time managers of the company are called executive or inside directors (they are employees of the company and thus covered by employment law), the rest of the board is composed from directors who are not part of the management team, these are entitled non-executive, or outside directors. Executive directors in the board have to become aware of the fact that their role within the management – operational role, day-to-day concerns of the life of company – is absolutely different from its role in the board of directors – formulation of strategy and direction for the company, broader look at the company (KCP, 2004).

The board of the directors and management therefore looks as follows:

Figure 2.3: Board of directors and management



Source: Tricker (2009)

We can further distinguish two "types" of outside directors – non-executive directors completely independent of the company and non-executive directors who still have some link with the company (the link can be a close family tie to the chairman of the board, being a representative of a dominant shareholder, or a retired CEO, serving previously as an auditor or consultant to the company, etc.; i.e. any link which could provoke questions about the independence of the judgements of these directors.

We can call these two classes of directors: independent non-executive directors (INEDs) and connected non-executive directors (CNEDs) or alternatively affiliated non-executive directors (Tricker, 2009).

The Cadbury Report (Cadbury et al., 1992)[6], a UK highly respected report on corporate governance, recommends a broader use of independent non-executive directors, its continuation UK Corporate Governance Code talks of at least half of the board to be INEDs.

Composition of the board of directors, its independence and size are the determining factors of board effectiveness. An ideal proportion of executive to non-executive directors has been discussed; nevertheless no solution has been achieved.

At the same time the directors have to be professionally capable to execute their functions, the board should be composed in such way that it ensures its professional diversity (professional backgrounds of individual directors should include various fields) and overall understanding of complexity of the situation in which a company might find itself (EC, 2011). According to the UK Corporate Governance Code (FRC, 2010) boards and their committees should seek to find "a human capital" with an appropriate balance of skills, experience and knowledge.

[6] This report, despite being written twenty years ago, is still taken as a foundation stone of modern conception of corporate governance and its ideas are still widely used.

2.4.2.1 Roles of the board of directors

The board of directors represents interests of shareholders (and in some jurisdictions also of other stakeholders, such as employees) and they should monitor the management whether it is acting with respect to utility maximization of shareholders. Monks and Minow point out that "the board exists to keep management accountable for the vast discretionary power it wields" (Monks and Minow, 2001; p. 208) At the same time, in accomplishing their mission the directors have to take into account the company's current position on the market and its recent results, as well as estimates of the future development (Tricker, 2009).

The monitoring roles of the board include selection, evaluation and, if necessary, change of the chief executive officer (CEO) of the company and determination of the management compensation. Also the board selects and recommends appropriate future members of the board to the shareholders. Moreover it reviews the compliance of the systems with all applicable laws and regulations (Monks and Minow, 2004).

Other role of the board of DIRECTORS is to give the company a DIRECTION, in other words to formulate a strategy which the company should respect and seek to fulfil. Also the board of directors has to oversee compliance with this strategy and, if need be, adapt the strategy to unexpected conditions, push the management to do more to be in conformity with the given policy or change the management.

A board of directors collaborates on the preparation and formulation of a strategy with the top management of the corporation (and especially with its CEO) because management possesses more information than the outsiders in the board. For that reason at least one of the top managers, usually CEO, is normally a member of the board of directors. Notwithstanding, his presence in the board must not hide the fact that the board of directors should protect interests of shareholders (Mlčoch, 2005). The level of cooperation or of delegation of the strategy formulation from the board to the management varies from company to company and depends on the internal rules.

While formulating a strategy the directors need to see the company and its situation from a broader perspective – to consider the company from an inward point of view as well as its position on the market, external competitive environment and market context, political, social (Tricker, 2009) and macroeconomic circumstances etc. In order to take up such a wide view, it is necessary to have also "outsiders" among the people who formulates strategy, hence non-executive directors.

The setting of the roles is therefore quite simple – "management runs the business; the board ensures that it is being well run and in the right direction" (Tricker, 2009; p. 36).

Tricker (2009) summarizes the roles of the board of directors (including the cooperation with the CEO) in the following simplifying scheme:

Figure 2.4: Roles of a board of directors

Source: Tricker (2009)

For all these activities, the board needs to have access to right and complete information on time. It is also very important that the board of directors meets regularly and sufficiently often (KCP, 2004).

As it has been already suggested, board of directors is not the only one and certainly not the best monitoring mechanism. John and Senbet (1998) contest the efficiency of the board of directors when they say that very often shareholders choose non-executive members of the board from a slate approved by the top management. Thus their independence is questionable.

In order to make the activity of corporate directors more professional, a number of institutions were introduced, such as the "Institute of Directors" in the United Kingdom.

2.4.2.2 Board committees

Recent rapid development of interest in corporate governance has also seen a wider introduction and formalization of board committees whose responsibility is to oversee a particular part of the corporate activity and their main goal is to ensure professionalism of the complex activity of the board of directors.

The three main and most widely used committees are:

- **Audit committee** – serves as a point of contact between the board of directors and external auditor and usually it is suggested that it should be composed mainly from independent non-executives directors (auditors usually need very specific and concrete information and for that reason they are mainly in contact with the CEO and CFO; the audit committee should therefore monitor the activity of auditor and top management

and make them and their cooperation more accountable); its importance has been emphasized in particular after the failure of Enron

- **Remuneration committee** – proposes and oversees remuneration schemes for members of the board of directors (particularly for the executive directors) and sometimes also for the senior management, for that reason, its members should be rather outside independent directors
- **Nominating committee** – the main purpose of this committee is to monitor the "market with directors" and choose the right and suitable persons for the board of directors (or also top management)

Certainly, this is not an exhaustive list, there can be also other committees (such as risk management committee, finance committee etc.). A board of directors of a company can naturally create its own special board committee if it feels its need and importance.

2.4.3 CEO vs. chairman of the board of directors

A subject to many discussions concerning corporate governance is whether the role of CEO and chairman of the board of directors should or should not be separated. Proponents of both opinion branches agree that the choice of a leader of the board of directors is crucial for maintenance of accountability of the management (Rechner and Dalton, 1991). Monks and Minow (2004) found out that only quite a small fraction of publicly quoted companies from the Corporate Library (27 %; 519 out of 1,900) had separate functions of CEO and chairman of the board. However, most of these chairmen were CNEDs and therefore their independence was still questionable.

A study by McKinsey (Coombes and Wong, 2004), a consultancy, asserts that nearly 80 % of companies which are part of the American S & P 500 index combined the two roles in one person (and that this proportion had not changed much in previous 15 years). Nonetheless, McKinsey reckons that US companies have increasingly opted for separation of the roles (Felton and Wong, 2004). Conversely, in the United Kingdom around 95 % of companies included in FTSE 350 followed the principle of separation and the role of CEO and chairman of the board was in this overwhelming majority executed by different persons (Coombes and Wong, 2004).[7]

It is not easy to answer a question whether these roles – CEO and chairman of the board of directors – should be executed by two different persons or by the same person. This

[7] This distinction also points out to the large differences between the systems that are considered to be in the same group of corporate governance models.

problem denotes the dilemma between providing the management (and above all the CEO) of a company with sufficient power and authority to do the work properly and at the same time maintaining adequate accountability towards shareholders (Monks and Minow, 2004).

It is also argued that a CEO who remains too long in his office (more than 15 years) may reduce corporate performance (John and Senbet, 1998).

2.4.3.1 Arguments for separation of the roles

If these roles are executed by the same person, it represents a significant conflict of interests.

One of the reasons of existence of the board of directors is maintenance of accountability of the corporate management. If the chairman of the board is also a CEO, the management is accountable to a body lead by management. A separation of the roles might thus create an environment of a bigger mutual trust.

A chairman of the board of directors chooses a composition of the board, draws up an agenda of the board, sets its priorities and procedures and controls compensation of the members of the board. If a chairman wants a strong, independent and effective board, he can have it. Conversely, if he wants a passive, uninvolved board which will blindly approve all his decisions and which will have difficulties to speak out against management, he can have it as well (Monks and Minow, 2004).

The biggest problem which arises when the two roles are combined is that when a CEO is also a chairman he can more efficiently control the quality, quantity and timing of information provided to the directors and all the activity of the board of directors. For that reason, the members of the board can never be sure that the obtained information is sufficient and correct (Monks and Minow, 2004).

However, as Monks and Minow point out, "combining the two positions does not mean that a CEO who is also a chairman will inevitably manipulate his board, but it does give him the opportunity" (Monks and Minow, 2009). In this case it is thus necessary to employ additional measures to ensure that the CEO; and chairman of the board of directors in one person will not abuse his powers and authority, such as strong and independent vice-chairman who will make sure that the information provided is correct and objective, more INEDs in the board etc.

2.4.3.2 Arguments against separation of the roles

The CEO and chairman need to be closely involved in the business (Monks and Minow, 2004) and they should know the characteristics of the enterprise closely. Thus it is

convenient that these functions be executed by the same person in order to ensure a professional insight and complexity of information on both sides. Moreover, if these roles are separated between two different persons, opinion conflicts about the direction which the firm should follow might occur. Similar disputes may weaken the company's performance and at the end of the day harm the interests of shareholders.

Some of the authors assert that a chairman of the board of directors is simply a person who chairs the meetings and thus it is not that important who effectuate the roles as it is still more a problem of the titles (Monks and Minow, 2004).

2.4.3.3 Evaluation of efficiency of both systems

It is very difficult to say which system is better and more efficient. Despite the complexity of this problem, there are a few empirical studies examining efficiency of both systems. An empirical study run by Rechner and Dalton (1991) suggested that firms with different persons on the post of CEO and chairman of the board of directors slightly outperform those in which these positions are occupied by the same person. But since there are more factors influencing a corporate performance and it is difficult to separate the effect of CEO duality on the performance we cannot say firmly that it is more efficient to separate the roles of CEO and chairman.

Even if there were more proofs that separation of the roles of the CEO and chairman between two different persons is more efficient, it would be quite difficult to change the beaten track. First of all, as we have mentioned in the USA the proportion of companies where the CEO and chairman is the same person is very large and it can be considered as a part of traditional establishment and business habits. It is quite easy to change the legislature but it is not that simple to change people's habits and informal institutions of the given country. However, a gradual change may be possible though it will take lot of time to implement it.

British codes on corporate governance recommend separation of the roles of CEO and chairman of the board of directors. However, they acknowledge that for some companies it may be better that the roles are executed by the same person. For this reason, British codes promote a "comply or explain principle". A company should either comply with a code or it has to explain in a logic and persuasive way why it does not employ a particular part of it. Another common feature of all UK corporate governance codes and reports is a preference of independent non-executive directors.

Past development has show even a separation of the functions and board of directors composed predominantly from outside directors cannot ensure a perfect model of corporate

governance. American company Enron, which filed for bankruptcy in the end of 2001, had a board of directors where primarily outside directors were sitting. Also, the CEO and chairman of the board were two different persons. Nevertheless, the corporate scandal that arose after the fall of the company concerned also neglected corporate governance and abuse of power by the management.

2.5.1 Two traditional models of corporate governance

It is not possible to describe a single model of good corporate governance. The individual models of corporate governance in the particular countries reflect cultural and informal habitual patterns of the given society. It should be acknowledged that there are some common elements that underlie good corporate governance (OECD, 2004) and which national codes should adopt, however if these codes do not keep the traditions and cultural habits (in general informal rules or institutions) of the society in question they cannot be properly enforced and respected.

However we can distinguish two general types of corporate governance as they have evolved from different historical and cultural traditions and circumstances: Anglo-Saxon (Anglo-American or also outsider) system and German (Continental-European or also insider) system. Nonetheless, the described models are only theoretical models and in practice, they are normally used with several modification and thus in every country the real model of corporate governance is different.

2.5.1 Anglo-Saxon (Anglo-American) system

The long-term capital is usually obtained through financial markets; banks provide to companies rather short-term loans. An important role in the financing and also in the influencing of the corporate operations is played by institutional investors – pension funds, mutual funds, insurance companies etc. (Mlčoch, 2005).

The Anglo-Saxon system of corporate governance is sometimes also called the "outsider" system which in fact means the "shareholders" system since the countries employing this system usually favour interests of the shareholders and the corporate governance system does not take much into account interests of other stakeholders (such as employees, suppliers etc.).

2.5.1.1 Board of directors in the Anglo-Saxon system

The Anglo-Saxon system of corporate governance employs a one-tier structure and its corporate bodies are board of directors and an annual meeting of shareholders.

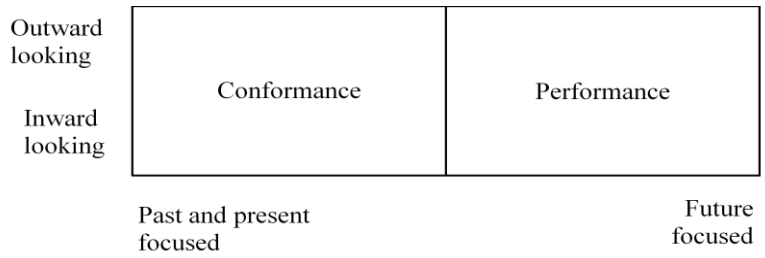
The board of directors is composed from executive and non-executive directors and is responsible for overseeing the management of the company and at the same time accountable to the shareholders. The ideal proportion of executive to non-executive directors is still a subject to discussions.

The board of directors has its chairman who typically presides the meetings of the board and calls it together. In average a board of directors has 12 to 20 members, according to the size of the company; it is assumed that the maximum number of members for an effectively functioning board is 15 directors in total (Růčková et al., 2008).

Taking the roles of the board of directors in a one-tier structure of corporate governance, we can see a possible problem which stands in front of such a board. The board of directors should represent interests of shareholders and make the management accountable. On the other hand, a certain part of the board is formed by the people who work in the company and in fact are accountable to themselves (Tricker, 2009). It would hardly be rational to expect that the executive directors will evaluate their own activities objectively; on the other hand non-executive directors may feel obliged to managers who proposed them for their functions, also it is very likely that they would like to be re-elected (Hart, 1995).

The right hand-side in the diagram on Figure 2.4 depicts performance roles of the board – strategy formulation and policy making – which come from the fact that the board is responsible for setting a direction in which the company should move. On the contrary, the left side displays activities linked to the conformance (Tricker, 2009). We can simplify and summarize the diagram as follows:

Figure 2.5: The dilemma of a board of directors



Source: Tricker (2009)

The Anglo-Saxon model is sometimes called "exit" system. Investors usually hold a stock portfolio[8] and if they are not satisfied with the performance of the company and/or its management they simply "vote by their legs" and exit the company. The corporate governance is executed more by the markets themselves (Mlčoch, 2005) as the managers are

[8] And primarily institutional investors whose main goal and purpose is to maximize the gain for their members.

under permanent pressure of the development of stock prices and also under the permanent threat of being a goal of a hostile takeover (if the company or a decisive share is bought by a raider, the incumbent management is very likely to be changed). Hostile takeovers do provide another monitoring mechanism of the management.

2.5.2 German (Continental-European) system

German model of corporate governance prevails in the countries with civil law tradition. Financial system is dominated by a few universal banks (engaging in commercial as well as investment activities); these banks have very close ties to industrial corporations to which they provide long-term loans (Mlčoch, 2005).

A typical feature of ownership and governance of corporations is the cross ownership (business relations between the companies are reinforced by the mutual ownership of stocks and thus possibility of influencing the governance of other company). Institutional investors (such as investment or pension funds) play very marginal role (Mlčoch, 2005).

2.5.2.1 Board of directors in the German system

Boards of directors in the German system of corporate governance follow the two-tier system which means that the major governing bodies are board of directors[9] and a supervisory board (also, as in the previous case there is the annual general meeting of shareholders which decides important issues).

The board of directors is composed entirely from the chosen top managers of the companies (in fact corresponds to the executive directors from the Anglo-Saxon board of directors) and the supervisory board is formed exclusively from outside directors. A person can be part of only one board[10]. The board of directors is normally the main representative of the company, it sets its strategy and prepares information for the evaluation done by supervisory board to which it is accountable.

The supervisory board monitors activities of the management and board of directors, approving strategies and policies and represents interests of stakeholders who elected it. Supervisory board is accountable to these stakeholders directly.

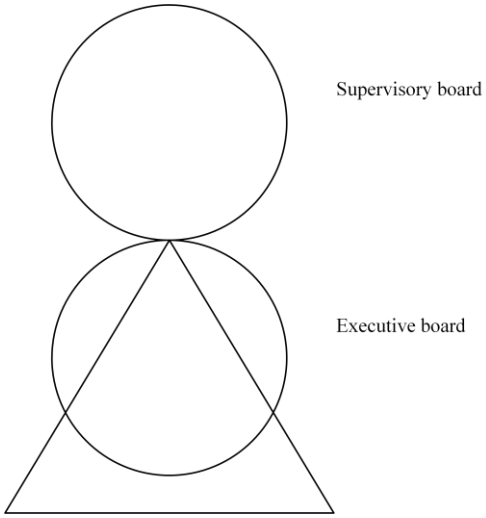
Because companies are viewed as "informal partnerships between labour and capital" (Tricker, 2009) in the German system, employees of the corporations are invited to participate in the governance of their enterprises. For this reason, part of the supervisory board is

[9] Board of directors in the German system is sometimes also called "executive board" or "management board". For the purpose of this study we will keep the name "board of directors" for this particular body.
[10] In practice, the members of the board of directors participate in the meetings of supervisory board but they do not have a right to vote and they are not the persons of primary concern (Tricker, 2009).

appointed by the workers in order to represent their interests. For this reason, the German system is sometimes also called "insider" system, where the word insider stands for the meaning of stakeholder.

The German model of two-tier corporate governance is summarized in the following picture.

Figure 2.6: Two-tier system of corporate governance



Source: Tricker (2009)

Since the corporate governance is executed rather directly, i.e. by active participation of the owners in the governance and direction of the company, this system is also sometimes called "voting" (as opposed to "exit" which applied for the Anglo-Saxon system).

There is a difference in the debates about separation of the roles of CEO and chairman of the board of directors. The German-system's two-tier structure implies that the chairman of the supervisory board must be an outside director (or non-executive) and moreover that it cannot be the same person as the chairman of the board of directors. Thus we have an independent person to which the chairman of the board of directors (and very naturally the CEO at the same time since the board of directors is usually formed by the top management) is accountable. This should limit some of the problems resulting from the simultaneous execution of the two functions (however we will see that even this system is not the ideal one and not completely without flaws)

2.6 Corporate governance in the Czech Republic

Lubomír Mlčoch claims very aptly that the Czech system of corporate governance is a hybrid of the two systems mentioned previously, Anglo-Saxon and German. Let us examine why.

2.6.1 Czech privatisation process

Debates about corporate governance in the Czech Republic stemmed with the process of transformation from centrally planned economy to market economy and in particular with a start of a process of privatization of state-owned enterprises in the beginning of 1990s and transfer of property rights.

The change in ownership of the companies was achieved in several phases and by various methods – direct sale, transformation of a company to a joint-stock company and subsequent sale of the stocks, emission of employee stocks, transformation of cooperatives (in particular agricultural), restitutions or they were simply left under the state-control, (Růčková et al., 2008). However the biggest part of the state-owned property was transformed to joint-stock companies and sold by a so-called voucher privatization[11] which also changed the patterns of ownership in the most important way because the newly emergent share capital of the companies was practically distributed among the people. A concern which arose from this redistribution was that the final ownership would be so diffused that the control over the enterprises would in fact be transferred from the hands of shareholders to the hands of managers[12].

In order to cope with these concerns, investment privatisation funds (IP funds) were established. These funds administered wealth of Czech citizens by portfolio diversification and execution of shareholders rights (above all monitoring role). Therefore, the ownership of companies came in the end to the hands of these several institutional investors[13]. From the point of view of ownership patterns we would say that the situation in the Czech Republic resembled rather the Anglo-Saxon model than the German one to which the country would belong historically.

However, if we take a closer look at the organizational structure and ownership of IP funds, we can see that many of them were directly or indirectly established by banks and therefore the ownership pattern starts to resemble the German model of corporate governance (where banks enter long-term investment with corporations and only a little number of firms is publicly quoted on the stock exchanges).

[11] People could buy (inexpensively) a "book" with thousand vouchers which were then exchanged shares in companies.
[12] The theory supporting these concerns was revived in 1932 with an empirically proved claim of Adolf Berle and Gardiner Means that there is a positive relationship between the concentration of ownership and corporate performance. Dispersed and diluted ownership shifts strong controlling power to the hands of managers.
[13] A big problem of the IP funds and the privatization as a whole was the fact that the rules (laws and other legislative documents) were created during the process and rather ex-post then ex-ante. Approach to the IP funds was at the beginning very liberal and the Government allowed practically anybody to establish an IP fund (Kouba, Vychodil, Roberts, 2005). Later we have seen problems with "tunnelling" of those funds but this is not within the scope of this study.

All in all, banks who were direct or indirect owners of the shares in the companies were lending to those companies and thus were shareholders and creditors at once. This supported the existence of so called "soft budget constraint" for companies (banks did not want to lose their ownership, on that account they lent the corporations even though they knew the borrowers would not very likely be able to honour the debt because the banks knew that the state – owner of the major banks – would pay for it at last) which the corporations had already well known from the planned economy. An inevitable end to this system of so called "banking socialism" was a profound banking crisis and takeover of the bad loans by the state at the end of 1990s.

2.6.2 Problems of Czech transformation process affecting corporate governance

A large problem of Czech transformation was a reluctance of the state to ensure a quality institutional framework for trading with property rights (Růčková et al., 2008). Also appropriate laws, rules of conduct and codes of best practice were missing and it would not have been efficient to simply adopt rules from abroad (since every country has its own informal institutions needed for a proper enforcement of written legal rules). We can say that in the first five years after the voucher privatization the institutional environment of the Czech economy was very weak. One of the proofs of institutional weaknesses was the fact that a Czech form of Securities and Exchange Commission (which would increase enforcement of rules on the capital market) was created only in 1998, five years after the formation of the Czech capital market (Kouba, Vychodil, Roberts, 2005).

This whole evolution promoted a development of a non-transparent cross-ownership structure.

The state still (through its influence in banks, better to say in IP funds) had an impact on the corporate activities and more importantly financed the companies. The non-transparent cross ownership and mixed proprietary structures provided a large space for moral hazard and information asymmetry. It kept an information monopoly on the side of enterprises and thus reminded little bit the system of planned economy with fuzzy (i.e. unclear) definition of property rights.

From the point of view of corporate governance, we can see IP funds who owned in their portfolios stocks in hundreds of enterprises and thus were not able to execute their shareholders rights properly, on the other hand there were individual participants in IP funds helpless from the point of view of their control over the funds (Růčková et al., 2008). IP funds

were kind of joint accounts of their shareholders and these shares were not associated with voting rights, i.e. individual investors behind an IP fund could not decide how this fund would vote during a general meeting of shareholders (Kouba, Vychodil, Roberts, 2005).

This relative weakness of the shareholders resulted in a strong influence of managers on the execution of property rights without effective institutional control of their responsibility. The position of the managers at the end of 1990s was very strong, sometimes considered to be even stronger than in the previous establishment (Mlčoch, 2005).

Nor was the monitoring of corporate governance by market forces possible since the capital market has not been very active nor liquid, mergers and acquisitions were not very frequent.

2.6.3 System of corporate governance in the Czech Republic

Historically, Czech lands have been connected with the German way of thinking and therefore it seems logical that also the style of control and governance of corporations corresponds more to the German model of corporate governance.

There is no legally bounding law on corporate governance in the Czech Republic, nevertheless there are several laws influencing this area – first of all Commercial Code (Act n°513/1991 of Collect.), then Act on business activity on the capital market (concerning the publicly listed companies), Act on criminal liability of legal persons, Act on auditors and Act on banks.

There is also a non-binding document, Code on Corporate Governance based on the OECD Principles of Corporate Governance and adapted to the Czech system and conditions. However, this document issued in 2004 would need a major revision due to changing legislature and overall business environment in the Czech Republic. This Code is primarily destined to the quoted companies but the authors believe in its usefulness also for non-listed companies.

The Code emphasizes an importance of independent directors in the board of directors and supervisory board, reiterates significance of broader conception of stakeholders and corporate governance (also, the corporate governance framework should be complemented by an efficient insolvency framework and efficient rules for creditors rights enforcement) and need for quality and timely information. According to the Code boards of directors and supervisory boards should have access to services of the lawyer of the corporation and also corporations should establish a role of company secretary who would be responsible for administration processes and preparation of meetings of individual corporate bodies. Overall,

the Czech Code identified itself with the "comply or explain principle" and call for its wider implementation into Czech practice.

Commercial Code establishes two-tier system for governance of corporations. There are three main bodies governing the corporation (and also codified by the Commercial Code): general annual meeting of shareholders, board of directors and supervisory board.

2.6.3.1 General annual meeting of shareholders

The highest body of a corporation is the general meeting of shareholders which takes place regularly once a year and it is assembled by the board of directors. Nevertheless, under certain condition an exceptional general meeting of shareholders can be assembled. Shareholders can participate personally or in proxy.

General meeting can adopt decisions under the condition that attending shareholders possess shares that in total represent 30 % of share capital (if articles of association do not determine it differently). General meeting adopts the most important decisions concerning the life of the company.

Members of the board of directors and supervisory board do participate in the general meeting and they present results of their work.

2.6.3.2 Board of directors

Board of directors is the main governing body of a company and it represents the company externally. It has an important decision power on every important corporate activity. Board of directors secures proper business governance and financial management, including proper conduct of bookkeeping, and prepares financial statements for an approval by the general meeting. Board of directors has at least three members. A study conducted by KPMG Czech Republic, a consultancy, in 2005 shows that 48 % of the examined companies have a board of directors with 4 to 6 members, in 46 % of cases there were between 1 and three members in the board.

In fact, the board of directors of a corporation is fully responsible for the corporate operations as well as long for the long-term strategy and goals (Růčková et al., 2008).

2.6.3.3 Supervisory board

Supervisory board oversees activity of the board of directors and fulfilling of business strategy of the corporation. In order to be able to execute their duties, members of supervisory board have access to all documents, accounts and records concerning operations of the corporation and they supervise bookkeeping. Financial statements are first revised by the

supervisory board which makes its comments and then passes the statements to general meeting of shareholders.

A supervisory board is formed from at least three members (if there are more members, their number has to be divisible by three), if the company has more than 50 employees, (at least) one third of supervisory board must be chosen by employees and the rest is elected by the general meeting of shareholders. Commonly, it is recommended that one fourth of members of supervisory board be completely independent of the company (in our terminology used previously it means that 25 % of supervisory board should be formed by INEDs).

Members of board of directors as well as of the supervisory board are personally responsible for the damage which results from negligence or breaking of their legal duties (this principle of guilt applies also to other persons with a significant influence on the operations of the corporation, such as majority shareholder or the CEO even if they do not form part of the board of directors or supervisory board).

2.6.4 Two models of internal control in the Czech Republic

Fidrmuc and Fidrmuc (2007) define two main prevalent subtypes of corporate governance in the Czech Republic – internal-control structure with strong management and internal-control structure with week management.

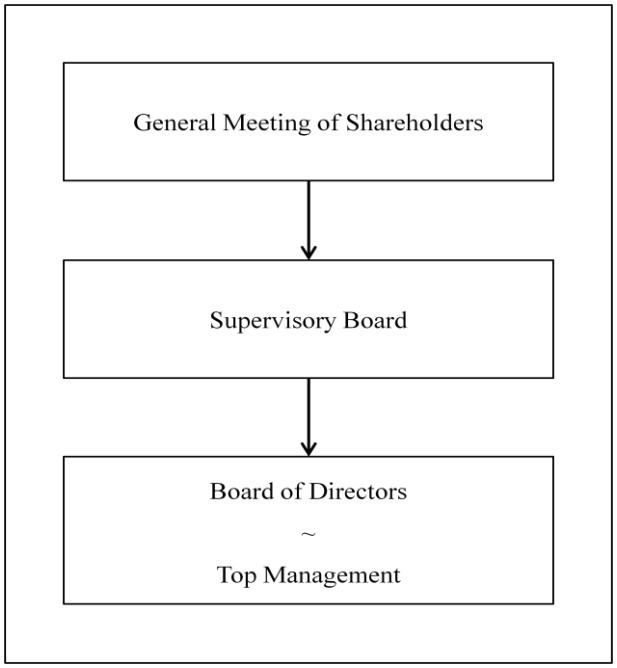
2.6.4.1 Internal-control structure with strong management

The first type is characterized by relatively strong management whose members sit in the board of directors which is an executive body of the company. Nonetheless, the position of the CEO and chairman of the board of directors are not necessarily represented by the same person. General meeting of shareholders elects supervisory board which appoints members of the board of directors and which also oversees the board of directors.

Supervisory board is composed entirely of outside, non-executive directors who are representatives of shareholders; board of directors coincides with the management team.

This model is implemented in majority of Czech firms (Fidrmuc and Fidrmuc, 2007). The first type of internal-control structure is summarized in the following picture.

Figure 2.7: Internal control structure with strong management



Source: Fidrmuc and Fidrmuc, 2007

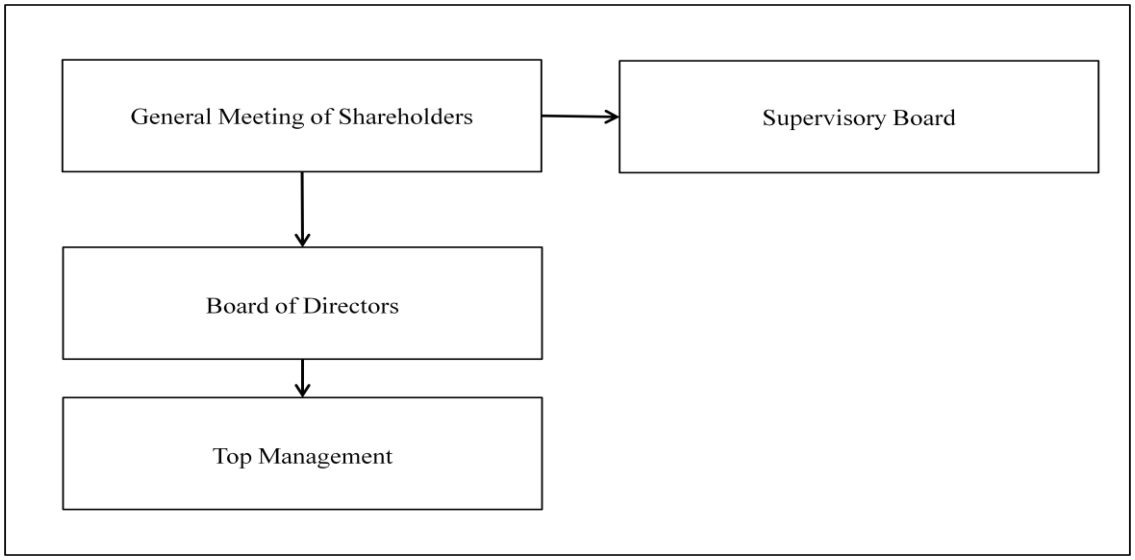
2.6.4.2 Internal-control structure with week management

An important characteristic of the second type are relatively strong shareholders who have tight control over the corporation. Both corporate bodies – board of directors as well as supervisory board are appointed by the general meeting.

Role of the supervisory board is to monitor activities of the board of directors and of the management. Managers are not part of the board of directors and their responsibilities are relatively limited. The board of directors consist of non-executive directors appointed by the shareholders themselves.

This second model was usually applied in corporations where the shareholders were several IP funds (Fidrmuc and Fidrmuc, 2007). The following diagram summarizes the second type of internal-control structure.

Figure 2.8: Internal control structure with weak management

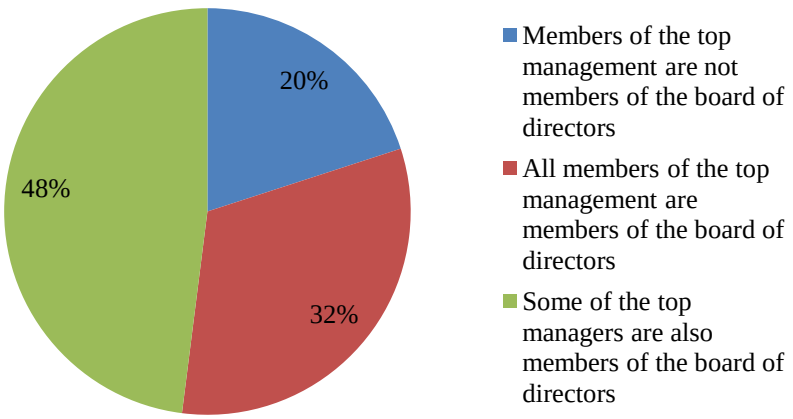


Source: Fidrmuc and Fidrmuc, 2007

The Commercial code of the Czech Republic does not specify the role of management in a corporation; it describes directly only roles and responsibilities of the general meeting, board of directors and supervisory board. Czech corporate jurisdiction gives more power and authority to the hands of the board of directors rather than to the CEO. However, the CEO is very often a member of the board of directors or even its chairman and thus has still relatively lot of power (Fidrmuc and Fidrmuc, 2007).

A study run by KPMG Czech Republic (2005) showed that only in 20 % of examined companies none of the member of the top management was at the same time member of the board of directors. In the remaining cases at least some of the top managers were at the same time members of the board of directors as it is depicted on the following chart:

Figure 2.9: Board of directors vs. management in the Czech Republic



Source: KPMG (2005)

2.6.3 Which model is the best for the Czech environment

As it has been suggested, Czech business environment is very specific since it comes from quite unique circumstances. Therefore the system of corporate governance has to reflect these specificities as well as some point of best practice.

Czech stock market has been traditionally dominated by institutional investors and by banks. Given the power which the institutional investors may possess, they should be also strong players in corporate governance. Moreover, in the centrally planned economy people, and above all managers became used to having information advantage and operated with large moral hazard. Since it is difficult to change people's behaviour from one day to another (in general informal institutions cannot be changed rapidly), the very likely detrimental behaviour should be prevented by a tight control over the managers by shareholders. Thus the shareholders should have their representatives in the board of directors who would be controlling management and at the same time accountable to independent directors sitting in a supervisory board. Role of independent directors is crucial for improving and increasing accountability of Czech non-transparent and still developing system.

In the language of Fidrmuc and Fidrmuc (2007), the best system for the Czech business environment would be an internal-control structure with week management where representatives of shareholders would be present in the board of directors and independent directors in the supervisory board.

Part two: Case study - SAZKA, a.s.[14]

3. Introduction to situation of SAZKA, a.s.

3.1 Company's profile

SAZKA, a.s. as a joint-stock company was established in February 1993. Since then the company has been a non-listed, public limited company; shareholders were and could be only sport civic associations. The main body representing the firm externally was its board of directors according to the articles of association[15].

In the period between 15 February 1993 and 1 November 2011 (thus in the period which is the most central for the scope of this study), the company's business object was an "operation of sports betting games and odds betting, number lotteries and instant lotteries in accordance with Act N° 202/1990 of Collect." SAZKA was the biggest operator of numerical and instant[16] lotteries. Total market share of the company was approximately 7 % in the last years.

Moreover, during these years the company also operated in non-lottery activities such as recharging of mobile SIM cards (since 2002), sale of tickets for events in the SAZKA Arena, the then O_2 Arena (since 2004), sales of tickets for sport events since 2004), servicing of postal orders, invoices and insurance (since 2006), electronic payments (since 2008)[17].

Importance of the lottery activities on the total revenues of the company is depicted in the following chart which displays total revenues of the company and volume of stakes put in all games provided by SAZKA, a.s.:

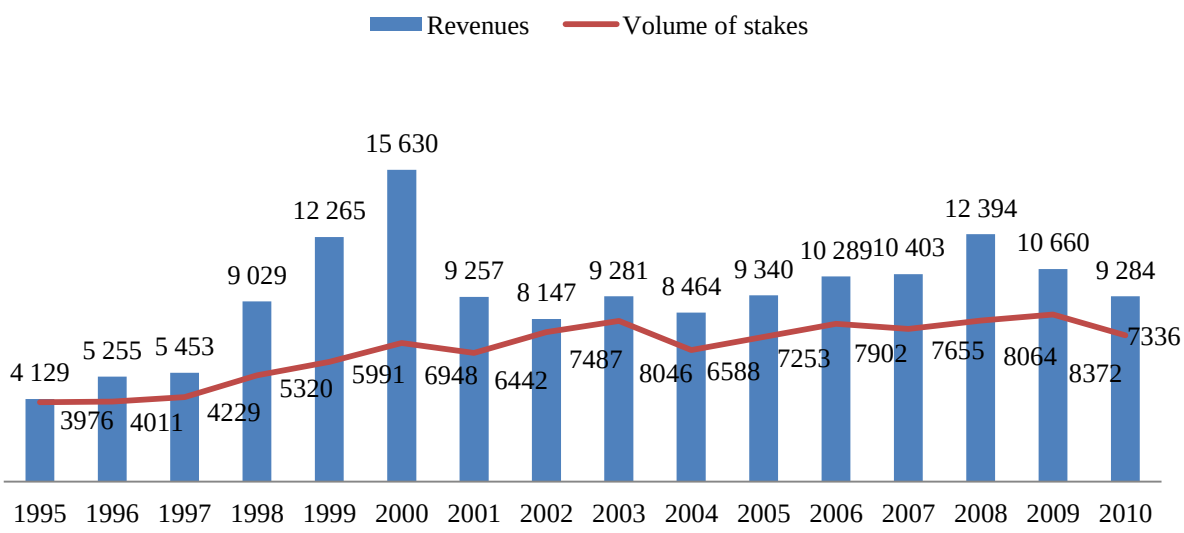
[14] When referring to SAZKA or SAZKA, a.s., we mean the lottery company until 30 October 2011. On 1 November the company started to provide its lottery activities officially under new owners and name SAZKA sázková kancelář, a.s.

[15] Also the company could be represented by an procurator, if the board of directors authorized a person, normally the CEO.

[16] Instant lotteries are those games whose prize is paid immediately by the salesperson after the win is known, e.g. scratch cards, etc.

[17] ČSTV, 2011a; Annual reports of SAZKA, a.s.

Figure 3.1: Total revenues and volumes of stakes (in millions CZK)



Note: Until 2005 the company kept its books according to national standards, then according to the IFRS.

Source: Annual reports of SAZKA, a.s., compiled by the author

SAZKA considered its primary mission to be a financial support of publicly beneficial activities, above all in the field of sport. Shareholders of SAZKA, a.s. were sport associations – Czech Sport Association (ČSTV), Czech Sokol Organization (ČOS), Czech Association Sport for All (ČASPV), Autoklub of the Czech Republic (AČR), Association of Sport Unions of the Czech Republic (SSS ČR)[18], Association of Sport Unions and Clubs (ATJSK), Orel (Christian sporting association), Czech Shooting Federation (ČSS) and Czech Olympic Committee (ČOV).

Revenue from the dividends of SAZKA represented a significant part of revenues of majority of these organizations. Therefore in respect to the broad community, SAZKA created an important positive externality – supported a sporting activity in the Czech Republic via the umbrella sport organizations (shareholders of the company) whose total membership base is estimated to comprise 2.5 million people[19].

Activity of SAZKA, a.s. has been regulated not only by the Commercial Code but also by the Act n°202/1990 of Collect. (including its further changes and amendments), On lotteries and other similar games. This Act opened lottery market to private providers (they must obtain a licence granted by the Ministry of Finance) and it defines the tax regime under which lottery companies operate. Until the change in legislature in 1998, a compulsory part of

[18] Originally Association of Technical Sports and Activities of the Czech Republic renamed during 2003.
[19] The exact number is however not known as there might be duplicities (one person can be member of more clubs and thus more sport associations).

proceeds was destined to the budget of Ministry of Education, Youth and Sports which then transferred this money to sport and other publicly beneficial purposes. In the period between 1999 and 2011, income from lotteries and gambling games was not taxed by corporate tax but this activity was subject to a levy applied on the net proceeds from gambling activities (the net proceeds was defined as the difference between the sum of put money and sum of paid wins, administrative costs and costs of state supervision during the game), the rate of levy varied between 6 to 20 % according to the level of net proceeds – SAZKA's rate was 20 % in the years prior to its fall (see following table):

Table 3.1: Rate of levy for lottery companies

Net proceeds (millions CZK)	< 50	50 - 100	100 - 500	500 - 1 000	> 1 000
Rate of levy	6%	8%	10%	15%	20%

Source: Act n°202/1990 of Collect. On lotteries and other similar games

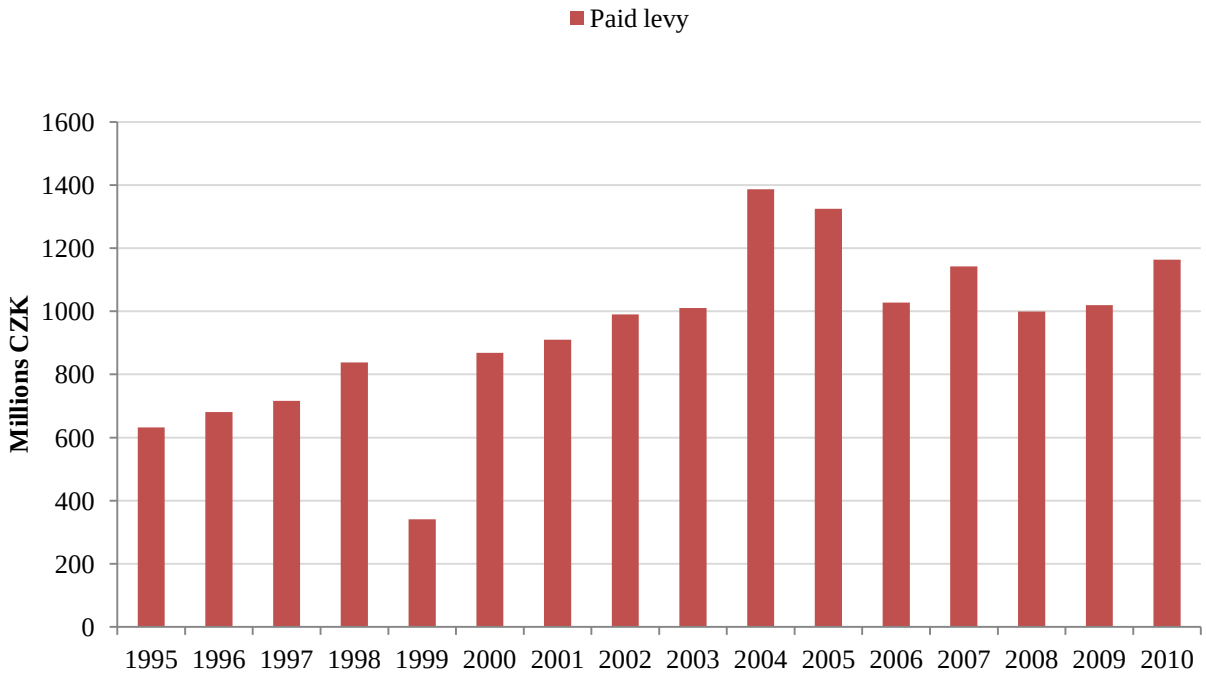
The resulting part of proceeds had to be paid to publicly beneficial purposes, better to say to a non-governmental organization active in some of the publicly beneficial areas (e.g. sports, social activities, health care, etc.). The particular purpose was determined in the granted licence (in the case of numeral lotteries and odds betting, the main part was destined to support of sport).

The latest change of the Lottery Act has fundamentally changed this system (which was sometimes opaque and the money sometimes did not come to its planned purpose.). Since 1 January 2012 the proceeds from lotteries and other similar games are taxed in a special regime and these taxes are paid to the state budget and municipal budgets. Nonetheless, this period is already out of scope of this study and we are not going to describe it in further details.

The articles of association of SAZKA stipulated that "only civic associations[20] operating in the field of sport" can be shareholders of the company. New coming shareholders could be only umbrella sport associations and shares could "be transferred only to existing shareholders of the company (or alternatively on their legal successors) and only with an explicit consent of the general meeting of shareholders" (SAZKA, 2010). Shareholders were entitled to receive the levy from net proceeds (usually they obtained even more). This money had to be used for publicly beneficial purposes (for which the association was established).

[20] Non-governmental organizations

Figure 3.2: Obligatory levy paid by SAZKA, a.s. (in millions CZK)



Source: ČSTV, compiled by the author

Ownership of the leading lottery company by sport associations is quite unique among the states of the European Union. It is quite normal that yields generated from lotteries and other similar games are used to support development of sporting activity, what differs is the way the money is distributed (e.g. via the state budget and responsible Ministry, via an umbrella sport association, via a special fund gathering all financial resources for sport, etc.). However, the main lottery companies are usually state-owned (and other – often smaller – companies in private ownership operate on the market) and their activity as well as duty to support sport is regulated by law. The direct ownership of a lottery company by sport association represents a good and efficient way of securing financial resources for sport (SAZKA in its best years distributed around 1 billion CZK for the purposes of sport); nevertheless it may pose big problems from the point of view of corporate governance as we shall see later.

Eurobrand, European institute for brand research, declared SAZKA, a.s. to be the most valuable brand of the Czech Republic in 2010, however the company did not succeed to be ranked among the 50 most valuable European brands (in 2010 the brand was valued at 413 million EUR, more than 10 billion CZK; nonetheless this meant a decrease by 7 percent in comparison with 2009).

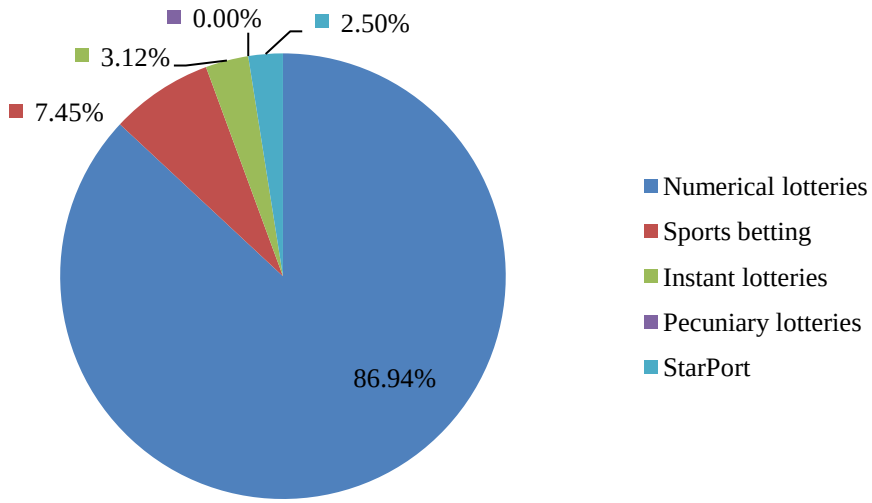
3.1.1 Game portfolio

The main activity of the company lied in lotteries and other similar games. While in 1994 SAZKA, a.s. operated only 7 games and lotteries, by 2010 the number of provided games rose to almost sixty. SAZKA operated five types of lotteries and other similar games:

- Numerical lotteries
- Sports betting
- Instant lotteries
- Video-lottery terminals (then StarPort project)
- Pecuniary lotteries (only very short period of time)

The largest share of the total revenue was generated by numerical lotteries as it is depicted in the following scheme (the scheme describes situation in 2010, however it more or less copies the situation in an average year):

Figure 3.3: Share of lotteries types on total revenue (2010)



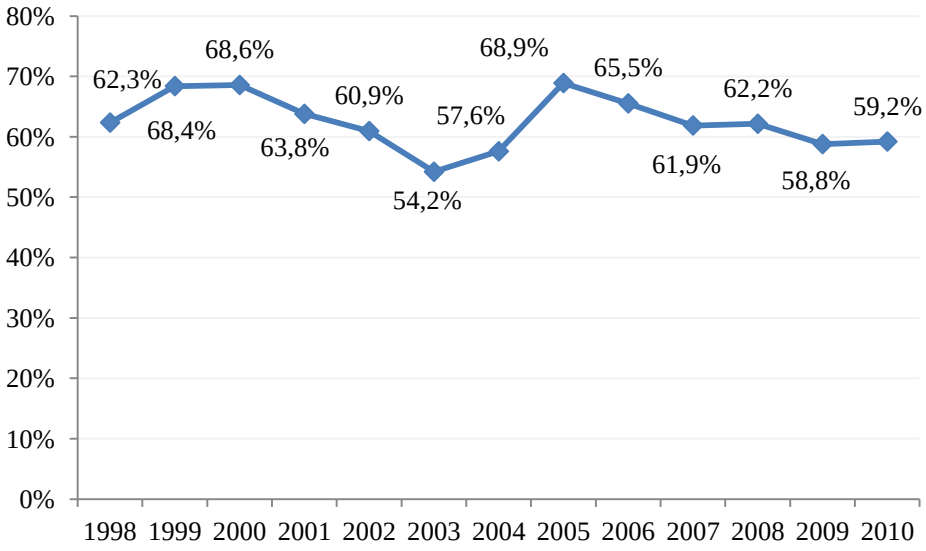
Source: Annual report of SAZKA, a.s., 2010

In 2010 the company operated in total 8 numerical lotteries which more than 6.5 billion CZK volume of stakes. Among the numerical games an absolute leader has always been Sportka, a game which was launched in 1957 and in which it is necessary to guess correctly 6 drawn numbers out of 49 possible. The volume of stakes in this game represented in average around 62 % of the total money put in lotteries (over 1998 to 2010). In some years Sportka itself even generated larger profit than all the lotteries and other games together[21]. In

[21] It means that some of the games generated loss which was in general overall result compensated by the profit of Sportka.

average the volume of stakes in Sportka was almost 4.5 billion CZK every year. Following chart describes money put in Sportka as a share of total volume of stakes.

Figure 3.4: Volume of stakes in Sportka as share of total volume of stakes (% of total)



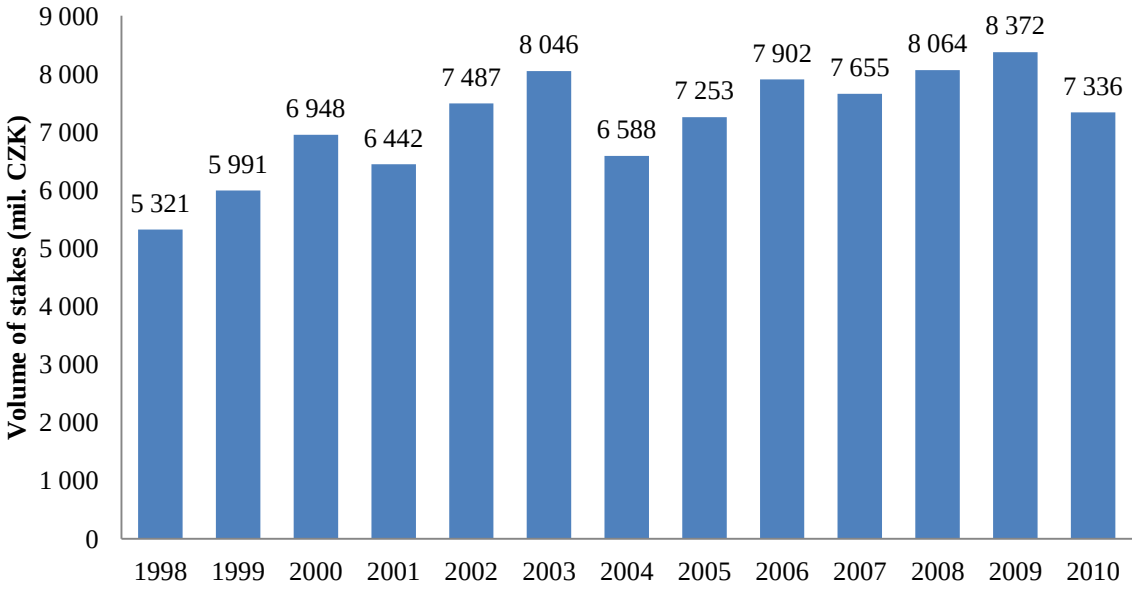
Source: Annual reports of SAZKA, a.s., compiled by the author

We can see that the share was quite stable over time. Sportka remained a very popular game even during the financial problems of the company (despite a temporal decline; see further in this study).

Second most popular game in SAZKA's portfolio was numerical lottery Šťastných 10 with a year sum of put money regularly over 1 billion CZK and in average 18 % share total volume of stakes. We can conclude that these two numerical lotteries, Sportka and Šťastných 10, which represented in average 60 % of total received money, drove the lottery activity of the company. Given that the total number of provided games rose to almost sixty by 2010, this may raise questions about profitability and subsequent desirability of keeping some of the other games (or entire projects) in company's portfolio.

The last chart in this part shows yearly volumes of stakes in lotteries and other similar games.

Figure 3.5: Volume of stakes – lotteries and other similar games (in millions CZK)



Source: Annual reports of SAZKA, a.s. (1998 – 2010)

3.1.2 Companies with ownership interest of SAZKA, a.s.

Company	Ownership interest of SAZKA, a.s.	Purpose of business
Agro Tera, a.s.	100 %	Real estate company owning estates around Prague
Arkadia, a.s.	100 %	Real estate company owning estates around Trutnov
Business Centre Services, a.s.	100 %	Provision of various services in the field of facility management for the needs of the group and operates the headquarters building
Bestsport, a.s.	0.07 %	Owner and operator of the Arena
GTECH CR LLC.	63 %	Provides technical support, especially with operation of the on-line terminals
KPS MEDIA, a.s.	100 %	Ensures creation of TV programmes and operates video technologies in the Arena
KOLBY, a.s.	99.99 %	Produces and sells wine (mainly for the purposes of the Arena)
SAZKA International	100 %	A Russian subsidiary operating lotteries and other games on on-line terminals, as well as non-lottery activities (recharge of SIM cards, etc.)
SPORTEASE, a.s.	100 %	Ensures provision of leasing
SAZKA Foundation	-	Supports youth and education in the Czech Republic by providing scholarships to young and talented people and grants for projects in the field of science, technology, culture, etc.

Source: Annual reports of SAZKA, a.s. with help of iDNES.cz

Definitely the most important company with ownership interest of SAZKA, a.s. (though very little one) for the purpose of this study is Bestsport, a.s. which owns and

operates the O_2 Arena (formerly SAZKA Arena, see later). Resting share in Bestsport (99.93 %) was owned by a civic association "Zelený ostrov" (OSZO) formed by the shareholders (sport associations) of SAZKA.

3.2 History of SAZKA, a.s.

3.2.1 Foundation

In August 1956 State Committee for physical education and sport of Czechoslovak Republic decided to found a lottery company which would serve as a provider of sport betting. This company started its business activity in mid-September 1956 under the name SAZKA[22].

The first betting game called Sazka (a column with 13 sport matches in various discipline) was launched in October 1956. Due to its large popularity right from its inception – until the end of the year almost CZK 65 million were spent in the betting game – (Šimek, 2011) a new numerical lottery called Sportka[23] started in March 1957. This game has gained a large popularity among Czech people and has remained sought after until these days.

SAZKA was established as a state-owned company, net proceeds from the gambling activities were destined for the support of physical education and sport to which they were taken through the state budget. In 1957, Czechoslovakia sports association was founded and SAZKA was placed under its responsibility (but still the proceeds were destined to the state budget). However, SAZKA was not the only lottery company even until the year 1989, there were other games such as Czechoslovakia state lottery or numerical lottery Mates under the responsibility of the Ministry of Culture.

3.2.2 Velvet revolution and period of transformation

An important turning point in the life of the company was the transformation to market economy in the 1990s. Czechoslovakia sports association ceased to exist in 1990 and three successor associations were created – Czech Sport Association (ČSTV), Czech and Slovak Confederation of Sporting Associations and Slovak Sport Association – and SAZKA was placed under their subordination; also the plan was to change SAZKA in joint-stock company.

Another important change came with the process of division of Czechoslovakia. The company in its modern corporate form was founded by ČSTV and Czechoslovak Sokol Organization (ČOS) on 27 November 1992. Finally and officially, lottery company SAZKA

[22] The name SAZKA is an acronym for betting company; in Czech "SÁZková KAncelář = SAZKA"
[23] The aim of this game has been to guess 6 drawn numbers out of total 49, each number represented a particular sport (Šimek, 2011).

started its activity as a joint-stock (limited) company on 15 February 1993. Originally, share capital registered in the Company register of the Czech Republic was set at 300 million CZK so that ČSTV controlled 75 % of shares and ČOS 25 %. During the first months of the "modern" SAZKA agreements were made on gratuitous transfer of shares to other sport association. In mid-March 1993, the shareholders of SAZKA, a.s.[24] were following sport associations:

- Czech Sport Association (ČSTV)
- Czech Sokol Organization (ČOS)
- Czech Association Sport for All (ČASPV)
- Autoklub of the Czech Republic (AČR)
- Association of Technical Sports and Activities of the Czech Republic (STSČ ČR)[25]
- Association of Sport Unions and Clubs (ATJSK)
- Orel (Christian sporting association)
- Czech Shooting Federation (ČSS).

Shares held by the particular sports association were changing during the following years as it was being decided to gradually increase share capital (this was done by forfeiting of dividend and using them to pay the share capital and also by a loan through bills of exchange).

Also, during 1997 ČSTV and ČOS agreed to transfer parts of their shares in favour of Czech Olympic Committee (ČOV) which therefore became the ninth shareholder of the company. Moreover, the annual general meeting in 1998 decided to increase the share capital to 1,399.6 million CZK and to repay it by the beginning of February 2000. This last increase in share capital established final shareholder structure of the company as it is described in the following table and chart.

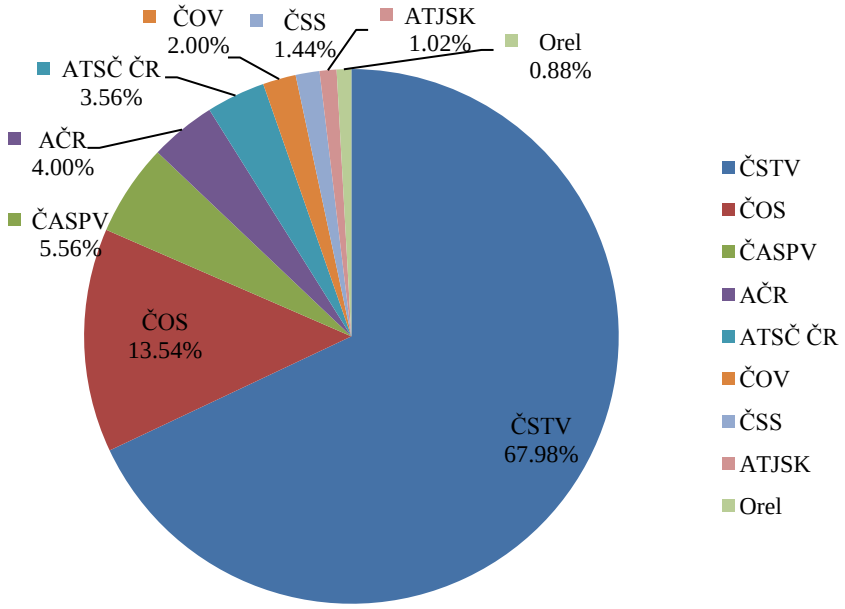
Table 3.1: Shareholders of SAZKA, a.s.

Sport association	**Czech Acronym**	**Share**
Czech Sport Association	*ČSTV*	67.983%
Czech Sokol Community	*ČOS*	13.542%
Czech Association Sport for All	*ČASPV*	5.563%
Autoklub of the Czech Republic	*AČR*	4.000%
Association of Technical Sports and Activities of the Czech Republic	*ATSČ ČR*	3.563%
Czech Olympic Committee	*ČOV*	2.000%

[24] For further purposes of this study by "SAZKA" we mean "SAZKA, a.s."
[25] Renamed in 2003 to Association of Sport Unions of the Czech Republic (SSS ČR)

Czech Shooting Federation	*ČSS*	1.445%
Association of Sport Unions and Clubs	*ATJSK*	1.022%
Orel	*Orel*	0.882%

Figure 3.6: Shareholders of SAZKA, a.s.



Source: Annual reports of SAZKA, a.s., compiled by the author

3.2.3 Period of financial consolidation

In 1995 new leadership, i.e. new people to management and boards of the company were appointed, and the chairman of the board of directors and a months later also CEO became Aleš Hušák who was the main and also the most controversial person of the company in the next years until its fall in 2011.

Until the change in the Lottery Act in 1998, the company was under control of the Ministry of Education, Youth and Sports which distributed proceeds generated by the company and whose representatives were sitting in the board of directors and supervisory board.

Due to changes in the Lottery Act a more favourable concept of variable levy (for the company) paid to publicly beneficial purposes was introduced and helped to improve the situation of the company's cash flow. We have already mentioned that in the period after 1998, the share capital was finally stabilized as well as the number of shareholders. Increase in the capital stock partially helped to finance a costly investment in building of new company headquarters which started at the end of 1980s (for which the company did not have enough

resources and had to take out a bank loan). The debts were partially refinanced ex-post (under the new management) by a bond emission.

During these years, the profit was steadily increasing. Also the net proceeds from lottery activity and thus levy to shareholders were rising. SAZKA was regularly at the front positions of surveys on 100 most successful firms in the Czech Republic. Until 2002 the main activity of the company lied in the lotteries and other similar games (income from non-lottery activities was generated mainly by secure operations on financial markets). Since 2002 SAZKA started to use its net of on-line terminals for other services – first recharging of credit SIM cards of mobile operators, then sale of tickets to events organized in the SAZKA arena (the ten O2 Arena, see further) and payments of postal orders and other payments, etc.

This calm period of financial consolidation from 1995 to 2001 which coincided with an arrival of the new management suited shareholders whose main concern was how much they get for their sport associations; as long as they received enough, they were satisfied. This may very likely be the crucial period for the future because it built in them an almost boundless trust in the CEO and chairman of the board of directors Aleš Hušák.

3.2.4 Decision to build an Arena

The Czech Republic hosted the Ice Hockey World Championship in 2004 and did not have a proper major stadium for this event. Responsibility for building such an arena was transferred from one body to another. In mid-July 2001, SAZKA suggested that it could build the stadium if the shareholders agreed with it. Executive committee of ČSTV approved the investment under certain conditions[26] on 1 August 2001. The following, representatives of all shareholders approved the investment under two conditions:

- Investment will not have any negative impact on the amount received by the shareholders (the levy will be rising at least in concordance with inflation and will remain around 1 billion)
- Construction will be finished on time so that the World Championship will take place in the Arena (ČSTV, 2011a).

Fulfilment of these conditions was promised to the shareholders who did not require any guarantees and settled for the public proclamations of the CEO Hušák (who promised a new video-lottery terminals project able to pay for a part of debts) and they took them for granted. However, the conditions of unchanged payments to shareholders could have been

[26] The conditions were: clarification of property rights of estates under the planned arena, a formal support by the city of Prague, a new game will be introduced and SAZKA will obtain licence for it, the State will provide an exceptional contribution of 1 billion and the present principle of levy to shareholders will be kept.

fulfilled only if the original estimates of the price of the Arena had held and/or the new game had been profitable enough. But expertise studies proving reliability and likelihood that the promises can be fulfilled were not prepared.

The company and its shareholders also relied on promises made by the Government and Parliament of the Czech Republic which reputedly said the construction of the Arena was a public interest and state administration will help SAZKA with paying the debt through special incentives (State had already helped prior to SAZKA's decision when it financed the cleaning of the estates). The aid should have been in a form of exclusive licence for video-lottery terminals, and constancy of the legislative environment. These promises, which were made orally, were however not fulfilled as we will see later.

The first estimates talked about costs of construction inferior to 3 billion CZK. Due to increasing demands for higher capacity, above-standard equipment and in particular non-existing limits for the investment, the investment plan which the board of directors discussed and then unanimously approved spoke about costs higher than 7 billion. The final price for the building climbed up to more than 9 billion.

Figure 3.7: The Arena

The O2 Arena (former SAZKA Arena, we are referring to it as "the Arena")

The Arena, whose construction started in September 2002 and was finished in March 2004, is a multifunctional stadium located in Prague. Trigger for the construction was a need to have an adequate stadium for the upcoming Ice Hockey World Championship in 2004. But the Arena can be used for a wide range of sporting events, it has 26 alternative spatial, operational and technical solutions (the Arena is a home stadium of an ice hockey club, it has hosted concerts of popular music, tennis matches, motorbike shows, etc.). Its capacity varies according to the event, maximum is 18.000 visitors.

In March 2008, SAZKA sold the name of the Arena to Telefónica-O2 (however, the lottery company did not gain as much as it had hoped from this transaction).

The Arena is a member of a prestigious European Arenas Association and in 2005 was announced to be the fifth best operated arena in Europe.

The Arena generated profit which covered its operational costs and expenditures; however it was not able to gain enough money to help with repayment of the bonds issued to finance its construction.

Owner of the Arena was a daughter company of SAZKA, Bestsport, a.s. (which was declared insolvent and a reorganization was allowed).

In the beginning the construction of the Arena was financed from company's own sources and short-term loans provided by banks. Parallelly with the construction, possibilities

for long-term financing were being negotiated. Since banks were not willing to provide a long-term credit on the investment (not even in a form of club financing, banks did not have enough trust in a project of such a large scale), SAZKA started to negotiate a bond emission. It was evident that the emission would have to be denominated in euro and subscribed on a foreign capital market since it would not have been possible to sell this kind of emission on a small and not-that-liquid Czech market. In the beginning of November 2003 the general meeting of shareholders of SAZKA approved an emission of ten-year bonds in the amount around 190 million EUR (approx. 6 billions CZK) intermediated by Nomura International. But this operation failed due to inability of SAZKA to get a rating in the investment band. In May 2004 SAZKA finally subscribed an emission in the volume of 175 million EUR, the bonds were in the category of so called junk bonds.

Nonetheless, this amount resulted from the emission subscribed with arrangement of Penta Investments, a.s. was not sufficient for debt servicing and unchanged payments to shareholders (and its conditions were not ideal either). Final costs of the Arena were higher than predicted and the situation was worsened by the shareholders who insisted on the promised payments even when the company was not in an appropriate financial condition. However, the CEO Hušák tended to claim that SAZKA is financially strong and healthy even when it was obvious that the situation was critical. And the shareholders on the other hand believed without reservations in what the CEO said.

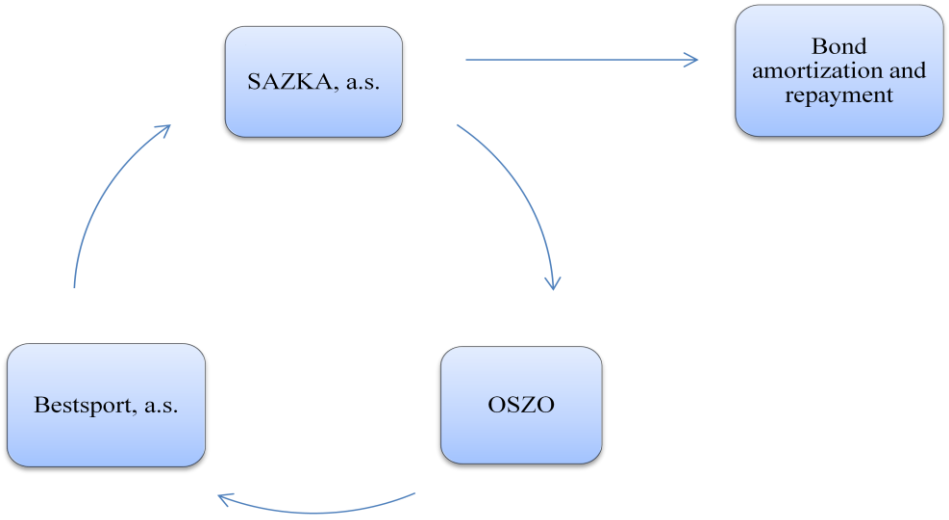
In 2005 conditions in the capital markets became more favourable and therefore SAZKA in cooperation with Penta prepared a second emission for which the company has finally acquired a rating. The second emission was approved (after some delays) by the general meeting in April 2006 and the company then in July 2006 succeeded in subscription of all its 15-years bonds in volume 215 million EUR. Conditions of the emission were in the end less favourable than it had been thought due to delays, change in the overall investors' appetite and worsening of the company's rating.

For debt servicing a special mechanism (so called "circlet of cash flows") was designed. There are three major entities forming this circle: SAZKA, civic association Zelený ostrov (formed by the shareholders of SAZKA, i.e. sport associations) and Bestsport, a.s. whose majority shareholder is civic association Zelený ostrov (OSZO) and the remaining shareholder is SAZKA, a.s.

Bestsport is the owner of the constructed Arena. OSZO was established in order to finance liabilities resulting from construction of the Arena through financial leasing payments; the OSZO should take over the Arena once repaid.

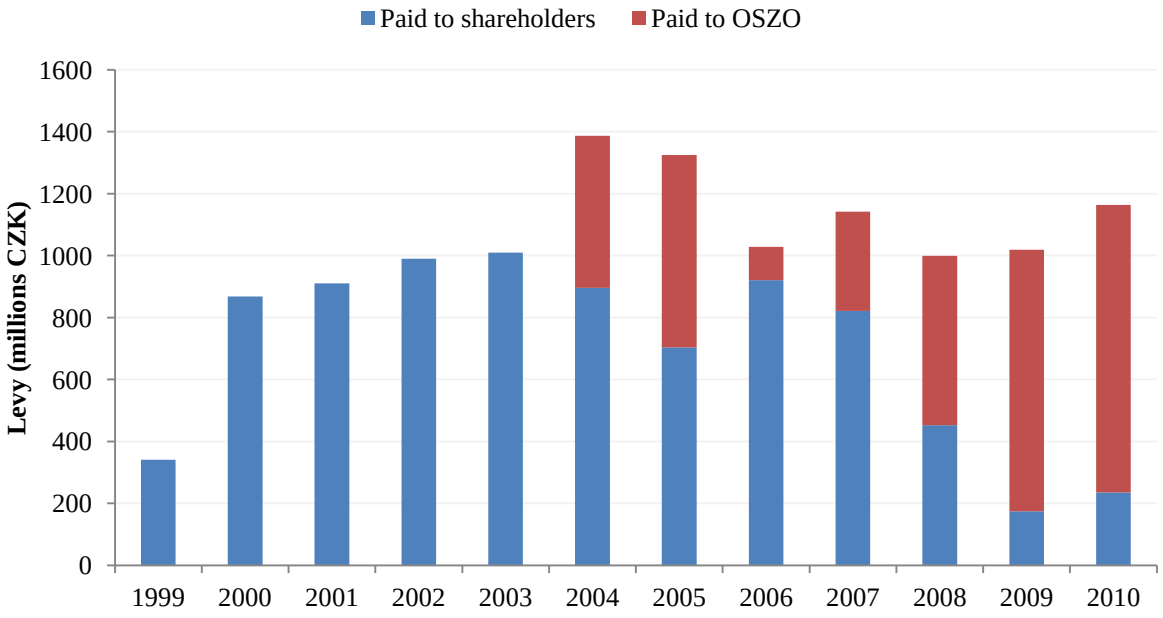
First of all, SAZKA granted a credit to Bestsport, a.s. in the amount of the proceeds from bond emission (from the first one as well as from the second one). For debt redemption, the circlet is then used.

Figure 3.8: Circlet for financing of the Arena



At the annual general meeting of shareholders the sport associations decide to pay the obligatory levy for publicly beneficial purposes to the OSZO. The civic association pays this amount for the rental of the Arena to Bestsport, a.s. which finally takes this money and services the debt to SAZKA, a.s. which uses it for amortisation of issued bonds. In addition to this, SAZKA backed bills of exchange issued by Bestsport, a.s. The whole system is bound by a series of contracts. This circlet therefore smartly uses the duty to pay a levy for the debt servicing. The distribution of the obligatory levy is depicted in the following chart:

Figure 3.9: Destination of paid levy (in millions CZK)



Source: ČSTV (2011), compiled by the author

Moreover, since the bonds were denominated in EUR, SAZKA contracted a currency hedging for which it had to pay as well. Also, an arrangement fee had to be paid to the advisor of the bond emission, Penta Investments, a.s.

3.2.5 Financial problems

In 2005 a change in legislature caused that SAZKA lost a possibility of deduction of VAT from entrance tickets despite promises made by the state administration prior to the construction of the Arena[27]. The company lost approximately between 250 and 300 million a year (ČSTV claims that between 2005-2010 the cumulative loss of cash was more than 1,5 billion CZK) by this change (ČSTV, 2011a). Moreover, licences for pursuit of video terminals were granted to more than forty companies (although the State administration reputedly promised to SAZKA an exclusive licence prior to the construction of the Arena) and thus the profits from SAZKA's system STARPORT were diluted and it even generated a loss over the long period.

Despite a temporal improvement in the company's rating by Standard & Poor's in 2007, warning and announcements of the deteriorating situation in the cash flow of the company were issued by the corresponding departments of the company. In 2008 six members of the board of directors were confirmed in their office for another 5-year term (the seventh member was reappointed already in 2006).

[27] But as it has been already said, these promises were oral and therefore not binding in the real sense.

In order to ensure satisfaction of claims made by shareholders (who required promised payments), SAZKA had to contract other debts with banks, especially between 2006 and 2008 (ČSTV, 2011a). This system shortly afterwards met a reluctance of the banks to provide further loans due to the company's large indebtedness and approaching financial crisis in 2008 due to which some smaller banks left the Czech market and the larger were more cautious and demanding when providing loans.

In July 2009 SAZKA started to negotiate with its two main partner banks (Česká spořitelna, a.s. and Komerční banka, a.s.) conditions of a so called bank syndicate (or club financing); Raiffeisenbank and Fortis Bank were invited soon afterwards. During the negotiations, many types of contracts were presented introducing a range of austerity measures (limits to the level of indebtedness, investment restrictions and restrictions of payments to shareholders, decrease in overhead costs, etc.) in exchange for financial help in refinancing of the short-term liabilities to the banking sector and of Bestsport's bills of exchange. Banks also wanted the shareholders to put their stocks as guarantees. Due to prolonging negotiations and reluctance of shareholders to accept the terms (shareholders were not willing to put their stocks as guarantees and they did not want the payments coming from the company to decrease), Raiffeisenbank lost its patience in the beginning of December 2010 and sold its claims to Siderius Holdings, soon afterwards also Komerční banka sold its claims to Moranda, both buying companies are owned by a businessman Radovan Vítek. This was practically an end to the efforts of establishing a bank syndicate which represented the easiest and the best solution to the situation of SAZKA, a.s. Also, during the end of 2009 and year 2010 the company's credit rating set by Standard & Poor's was deteriorating quite rapidly to reach D (default) in January 2011.

Vítek did not make any secret that he would file an insolvency claim in the beginning January if he has not gotten paid by this time. On 16 December SAZKA conceded that it did not have enough resources to amortize the bonds. Four days later Martin Ulčák is installed as a financial facilitator and new strategy is prepared – a single one account for the company should be created through which all the cash flows would pass, this account would be controlled by the company, creditors and commercial partners. Also a part of this plan should a sale of dispensable property. On 22 December a first offer by Penta investments, a.s. is coming (more on the offers further in the study). Nevertheless, claims of Radovan Vítek were not satisfied and therefore the businessman filed an insolvency claim against SAZKA, a.s. on 17 January 2011 with Prague City Court claiming that the company failed to make a payment of 820 million CZK on time.

KKCG group (owned by Karel Komárek) which bought claims of Fortis bank firstly joined the insolvency claim filed by Vítek and then in the beginning of March filed its own claim against the company. At the same time, Vítek and KKCG were buying bonds issued by SAZKA and gradually became the biggest creditors of the company. To the end of March, Radovan Vítek sold his claims to the PPF group (owned by a Czech billionaire Petr Kellner).

In the end of March firstly via its vice-chairman of the board of directors Roman Ječmínek and then also via its CEO and chairman of the board Aleš Hušák the company file for insolvency itself. Few days after, on 29 March 2011 the court declared the company insolvent.

During the time until the end of May, when the creditors declared SAZKA bankrupt, shareholders received various offers of help from several companies. The first offers were posed by the owners of competition betting companies (which wanted to penetrate also in the market of numerical lotteries and asked for corresponding licences) Penta group (which owns Fortuna and which then cooperated on the offer with E-Invest) and Synot Group. The other offers were made by the creditors – Radovan Vítek, KKCG group and then PPF and KKCG group together.

Board of directors and shareholders (above all the majority shareholder ČSTV) decided for the offer made by Penta and E-Invest which was however put down by the insolvency administrator Josef Cupka.

The most suitable option for the representatives of the company and also for the creditors was a reorganization which would not have decreased the value of the company as much as the bankruptcy did. However, from many reasons (above all inability to find a compromise) on 26 May 2011 the creditors declared SAZKA bankrupt. The bankruptcy administrator than announced an open tender on the business activities of SAZKA, a.s. (the decisive was the highest price offered) which was won by the groups KKCG and PPF on 26 September 2011.

Since the 1 November 2011, company has been operating under the name SAZKA, sázková kancelář, a.s. and restoring its services. The sports associations, former shareholders of SAZKA, a.s., thus lost their ownership and the source of money it produced.

3.3 Could the bankruptcy have been avoided?

Bankruptcy of SAZKA, a.s. could have been avoided if the critical situation of the company was responsibly recognized and treated in time. Shareholders of course could have sold the company in the right time (which was in fact before the first insolvency claim

because afterwards arrangements were risking to be considered as harmful for the interests of shareholders and thus dismissed by the creditors) and maximize their utility by receiving quite large amount of money at once.

Or the failure could have been averted if the shareholders had agreed with banks on the conditions of the club financing. Also the future development could have been changed just before the end of 2010 when the shareholding sports associations were given various offers in order to ward off the first insolvency claim. By all means, the owners would have had to accept an external financial help which would be repaid, but they would still have been the only owners of the company with a possibility to change the management of the company and to become more active shareholders who would be more efficiently involved in leading of the company. In other words, they could have realized that the management is not acting in their best interest and could have changed the corporate governance.

4. System of corporate governance of SAZKA, a.s.

While studying history and story of SAZKA, one cannot help thinking how is it possible that a lottery company which should be from its nature and also was considered to be "a machine for cash" went bankrupt. If we are not satisfied with an explanation that it was either poor management which caused the failure or the corporate raiders who wanted to take over the firm and thus launched an aggressive campaign against the company, we have to ask further.

Is it possible that it was neglected corporate governance, bad practices, and poor corporate governance mechanisms what was behind the failure of SAZKA, a.s.?

Let us first consider the problem of a poor management. As we have argued in the theoretical part, the management team and above all its CEO are accountable to the board of directors (and in the case of two-tier system to the supervisory board as well). If the corporate governance had been properly set (in accordance with any of the codes we have mentioned) and its mechanisms had worked efficiently in SAZKA, then the management and especially the CEO would have been immediately replaced under unsatisfactory news of the company's performance or at least its position would be questioned and contested. Moreover, we have said that hostile takeover bids may serve as a good controlling mechanism of the management – when a bid is made, it might wake up the shareholders to the fact that company is underperforming and that it might be a fault of the management.

As opposed to the views of the best practices, the CEO of SAZKA, Aleš Hušák, was in function from 1995 to 2011 and he was not removed even when the critical situation of the

company was fully revealed. Also, in the case of SAZKA rescue plans offered by other companies (and these may be viewed as hostile takeovers, or friendly takeovers) were not taken as a warning against underperformance, but they were being refused by the shareholders without changes in management and corporate governance of the company.

From these two short examples, we can see that the answer to our question would be rather yes than no. Let us now verify more in details the following hypothesis:

One of the main reasons of the failure of SAZKA, a.s. was neglected and inefficient corporate governance, poor corporate governance mechanisms and bad practices of the execution of corporate governance.

4.1 Bodies of SAZKA, a.s.

Business operations and life of SAZKA were regulated by the Czech Commercial Code – Act n°513/1991 of Collect[28]. The company was therefore using the two-tier system of corporate governance with the board of directors, supervisory board and general meeting of shareholders being the main bodies of the company. Their composition, nomination and election process, responsibilities and main roles are defined in articles of association.

Corporate bodies were in the described form since 1999 when a new legislature came into force. Until the end of 1998 the Ministry of Education, Youth and Sports did have representatives in the board of directors and supervisory board and also proceeds were distributed to sport through the Ministry.

4.1.1 General meeting of shareholders

General meeting of shareholders is the highest authority of the company and takes place at least once a year. General meeting makes the most important decisions, such as: decrease or increase in share capital, bond emission, appointment of members of the board of directors and supervisory board (with exception of those members of the supervisory board appointed by employees), remuneration of members of both boards and approval of contracts of discharge of office, approval of merger or sale of the company, approval of financial statements and above all approval of the amount and way of distribution of the obligatory levy paid to publicly beneficial purposes.

General meeting of shareholders can be called together by the board of directors or, if it is in the best interest of the company, by the supervisory board. Shareholders holding at least 3 % of share capital can ask the board of directors for summoning an exceptional general

[28] Apart from the Act n°202/1990 of Collect. On lotteries and other similar games mentioned previously.

meeting to discuss proposed problems if they are justifiable. General meeting is quorate if present representatives of shareholders possess in total at least 30 % of the share capital. Decisions are adopted normally by majority of attending shareholders if not determined differently. Two-thirds majority of attending shareholders is required for some decisions (change in articles of association, change in share capital, etc.), some others have to be approved by the three-quarters majority of attending shareholders (merger, remuneration of members of the board of directors and supervisory board). Moreover, some of the most important decisions require parallel approval by three-quarters majority of affected shareholders (any change linked to stocks).

4.1.2 Board of directors

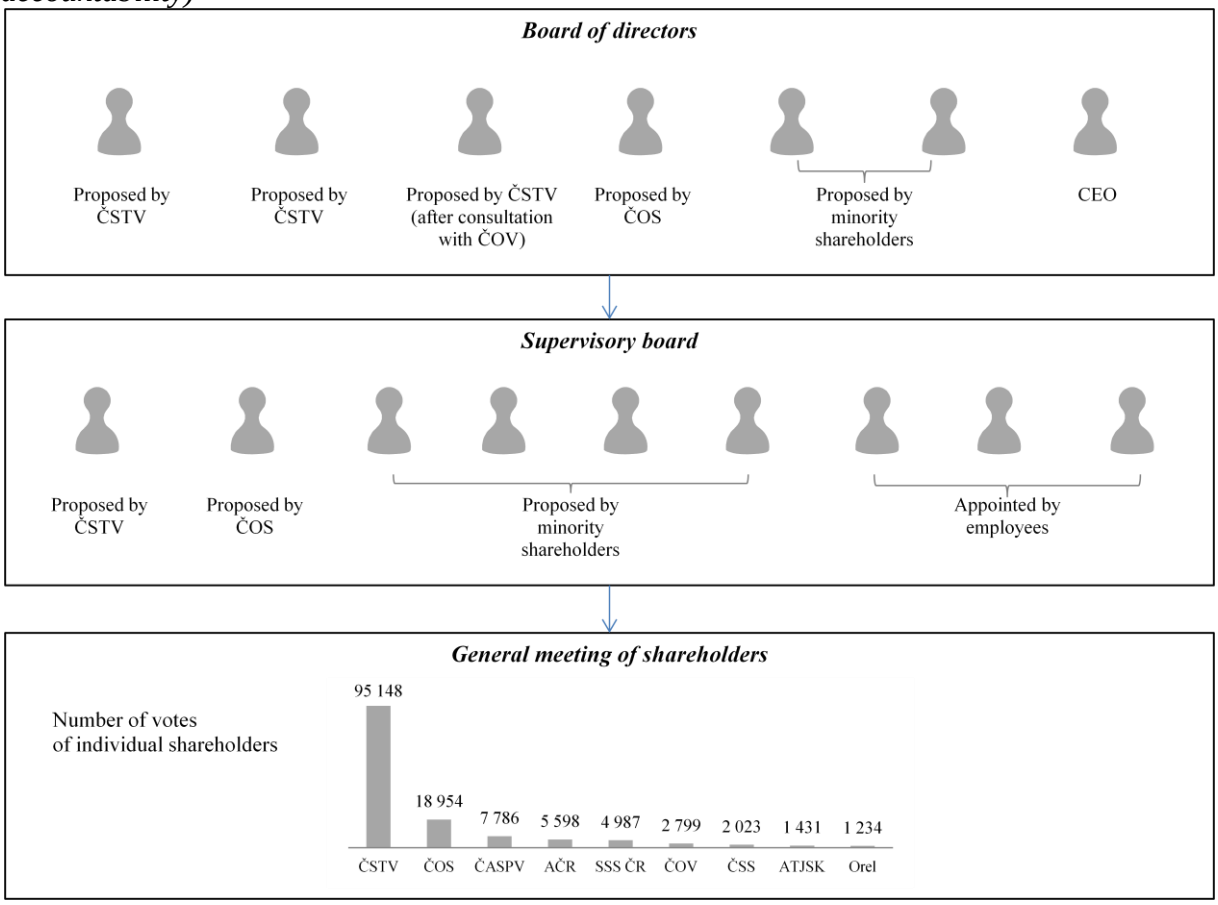
The board of directors runs the company, acts on behalf of the company and represents it externally. Its activity must be in compliance with the directions given by the general meeting of shareholders. Since 1998, the board of directors has seven members, one of them must be the CEO of the company, and the rest is proposed and appointed by the general meeting of shareholders (distribution of nomination rights is depicted in Figure 4.1). Members of the board then choose among them their chairman and vice-chairman. Also the board of directors appoints CEO of the company. Term of office for the members of the board is five years.

The board of directors can adopt a decision if half of the members is attending and it decides by a simple majority of attending members. Majority of all members is needed to appoint a chairman and vice-chairman and also to elect a CEO, three-quarters majority is needed to remove these persons from their posts. This means that 6 votes are needed to remove the CEO from his function. This requirement is very restrictive since in practice the chairman of the board or the CEO (who has to be a member of the board) has to persuade only one more person not to vote for his removal to be secure.

4.1.3 Supervisory board

Supervisory board oversees activity of the board of directors. There are nine members of the supervisory board appointed for 5 years term of office. One third of the members is elected by and represents employees of the company, six members are appointed by the general meeting of shareholders and nominated by the individual shareholders as depicted in Figure 4.1. Members choose their chairman and vice-chairman and also a person representing the company during legal proceedings against a member of the board of directors. Supervisory board adopts decisions on the basis of absolute majority.

Figure 4.1: Corporate bodies of SAZKA, a.s. since 1998 (displayed in succession by accountability)



Source: Articles of association, Annual reports of SAZKA, a.s., compiled by the author

4.1.4 Chief executive officer

The CEO is appointed by the board of directors. His functions are operational such as determination of organizational structure of the company, execution of the instructions given by the board of directors and execution of day-to-day operations of the company. Also, the CEO appoints directors of individual divisions and other employees.

4.1.5 Comparison with two models of corporate governance in the Czech Republic

In the section discussing corporate governance in the Czech Republic, we have presented two sub-types as they are described by Fidrmuc and Fidrmuc (2007) – internal-control structure with strong management and internal-control structure with week management.

According to this sorting, SAZKA would belong to the second type – its board of directors as well as supervisory board were appointed by the general meeting of shareholders. Managers were not part of the board of directors (with exception of the CEO) and the role of

supervisory board was to monitor activities of the board of directors. The authors also point out that this model was usually used in corporations where several IP funds, i.e. institutional investors, were shareholders. In the case of SAZKA sport associations, thus another type of institutional investors, were shareholders.

However, the authors claim that within this model, shareholders are relatively strong and have a tight control over the corporation, and the management is relatively weak. This does not seem to be the case of SAZKA. From an outer perspective, the management may have seemed weak (with an exception of the CEO and chairman of the board Aleš Hušák) but we cannot consider the shareholders in this case to be strong due to the characteristics of these sports associations (legal form, decision-making procedures, etc.) and due to their behaviour – see further. Very often they did not execute their shareholders rights properly, renounced their execution and therefore were rather relatively weak.

4.2 Analysis of the corporate governance practice in SAZKA, a.s.

4.2.1 Articles of association

Some of the main problems of corporate governance practice in SAZKA can be identified directly in the articles of association.

Firstly, let us go back to Figure 4.1 depicting the structure and composition of corporate bodies of the company.

We have asserted in the theoretical part of the study that academic authors as well as various codes on corporate governance (OECD Principles, UK Combined Code, Czech Code on Corporate Governance) emphasize importance of independent non-executive directors in the board of directors (and in the supervisory board in the case of two-tier system), where completely independent are those directors who have no link with the company, i.e. they are not even representatives of the shareholders (Czech Code on Corporate Governance recommends at least ¼ of members of the supervisory board to be independent). We can see that in the case of SAZKA a vast majority of directors was non-executive; on the other hand there was no single completely independent director neither in the board of directors nor in the supervisory board (only, until the end of 1998 the Ministry of Education, Youth and Sports did have representatives in the board of directors and supervisory board. But due to a change in legislature during 1998 this form of state control was abolished). Apart from the CEO and the directors representing employees, all the directors were representatives of the shareholders (appointed by their respective sport associations who could have appointed various professionals in order to represent their interest in the boards as efficiently as

possible; however in practice the directors were top representatives of the sport associations (presidents, vice-presidents, etc.).

Independent directors are very important because they have no links to the company and thus it is easier for them to take a broader and independent external view of the company. For that reason they are essential for assuring objectivity of adopted decisions (e.g. investment decisions, strategic decisions) and prepared policies and strategies.

Secondly, the articles of association promise to the members of the supervisory board a right to have all the corresponding material, technical and personal facilities necessary for the pursuance of their activity in the supervisory board. Extent of these provisions is set by the board of directors. This creates a background for possible pandering to the supervisory board from the side of the board of directors.

The main role of the supervisory board is to control the activity of the board of directors. At the same time, the board of directors sets the magnitude of provisions for the supervisory board. It might thus be very easy for the board of directors to provide the members of the overseeing body with above-standard services (these provisions might have been necessary for the execution of the role of the supervisory board but could have been provided also in a different, standard way) in exchange for their co-operation.

The articles of association attribute the same provisions also to the board of directors and also in this case, the extent is set by the board of directors itself. This represents a conflict of interest since a body is attributing some provisions (though necessary for its operations) to itself and all this happens without a control by any other body.

These two regulations also strengthen the position of the chairman of the board who may have an influence over the other members of the boards through proposing of these provisions which are necessary for activity of the boards and their scale. These necessary provisions may have various forms and they can be more expensive or less costly[29]. Moreover, if the chairman is at the same time the CEO of the company, as he was in the case of SAZKA, a large influence over the boards is concentrated in the hands of this person (naturally, this does not mean that he will abuse it, but the provisions might give him an opportunity).

4.2.2 Corporate bodies in reality

A significant pattern of the boards and especially of the board of directors was a relative invariability - directors stayed in the office for very long time: the chairman and its

[29] For example the company can use less costly cars than Bentleys are.

vice-chairman[30] held their posts for 16 years from 1995 to 2011; majority of the other directors (directing the company until its insolvency) were in office since 1997 or 2003 (see Appendix No.1 and Appendix No.2). Also the minority shareholders were represented by the same sports association in the board of directors during this period. Six members of the board of directors were confirmed in their posts for the next five years by the general meeting of shareholders in 2008 (the seventh member had been reappointed already in 2006) which suggests that the shareholders were satisfied with its work which is not wrong in principle. However, in a situation when the company's financial situation was deteriorating rapidly and the shareholders were aware of it from the internal expertises and notices provided to them (which were however mitigated by the CEO) this decision does not seem correct. Neither the board (especially its chairman Hušák) nor the CEO (again Hušák) were removed when an insolvency was declared over the company.

The Czech Code on Corporate Governance (KCP, 2004) asserts that "the role of institutional investors is crucial and they should be active in requiring resignation of the management and board of directors if their performance is poor" and therefore if the performance of the company is poor. According to the Code institutional investors should be encouraged not to act as passive investors because this may lead to a loss for the final owner (KCP, 2004).

4.2.3 CEO & chairman of the board of directors

In the case of SAZKA, a.s. the roles of CEO and chairman of the board were executed by the same person, Aleš Hušák. Czech Code on Corporate Governance (KCP, 2004) claims that although it is not a duty, it should be considered to be a part of the best practice to separate the execution of the role of CEO and chairman of the board. If these two roles are held by one person, the "comply or explain principle" should be used in order to explicate convincingly why the company decided not to separate execution of these functions.

As we have said in the theoretical part, a combination of these two roles is not an explicit violation of corporate governance principles; but it may pose problems (conflict of interests, information asymmetry, etc.). It is therefore necessary to keep the CEO and chairman in one person "guarded". The best practice usually talks about a senior non-executive director being a vice-chairman who would control activities of the CEO/chairman and mitigate the potential risks. There are also other ways how to neutralize possible negative

[30] Aleš Hušák and Roman Ječmínek.

effects of combination of the two roles as employing more independent non-executive directors etc. (we have discussed these means in the theoretical part).

Lack of independent directors in SAZKA has already been suggested; let us now therefore look at the post of the vice-chairman of the board of directors.

Just as the CEO/chairman, also the vice chairman of the board of directors, Roman Ječmínek, stayed on his post from 1995 to 2011. His position in the company is very interesting from the point of view of corporate governance. Roman Ječmínek is president of the Autoklub of the Czech Republic (4 % share in the company) thus a major representative of one of the shareholders of SAZKA. In addition, he was the vice-chairman of the board of directors and also since 1 January, 1999 statutory deputy chief executive officer.

Thus, the vice-chairman of the board was not an independent director, he was not even a non-executive director and moreover in charge during (almost) the same period as Aleš Hušák. A long term working co-operation and relationship like this raises questions about disproportionate loyalty to the CEO and chairman and the vice-chairman cannot be considered to be an adequate means (according to best practices) to "guard" the chairman of the board of directors who is at the same time a CEO.

To sum up, no specific means of a tighter control over Aleš Hušák were employed. It is a question whether the shareholders knew about these mechanisms and their significance. In any case, they did not come to realize their importance We will examine the behavioural patterns of the shareholders further in this section.

4.2.4 Shareholders

Owners (and therefore shareholders) of SAZKA, a.s. were sport associations[31] whose purpose of existence and main focus is to promote sporting activity and ensure its functioning. In the case of SAZKA, these organisations can be viewed as institutional investors who have to employ some kind of system of corporate governance themselves in order to ensure an adequate representation of interests of their members.

The system of governance of these association is however not easy. Sport associations are composed from unions representing interests of particular sports (e.g. football federation, ice-hockey association, etc.) which group individual sport clubs. Moreover, the majority of the umbrella sport associations (shareholders of SAZKA) have also their regional committees which possess a part of decision power. Every sport association has its executive body (in the case of ČSTV it is an executive committee) which runs the association and represents it

[31] We can also call them umbrella organizations.

externally. However (especially in the case of ČSTV), important decisions must be decided by the general meeting of members of the association (i.e. of member sport unions)[32].

The legal form of sport associations (civic associations, i.e. non-governmental not-for-profit organizations) does not give them ideal background to be a perfect and successful business entity. The procedures of decision-making of sport association, i.e. of individual shareholders of SAZKA are very complex and therefore not very efficient (notably when a rapid and brisk decision is needed). This fact is amplified by the complex structure of the associations (as described above).

Another problem of sport associations which may impede them in the proper execution of shareholders rights is a lack of qualified professionals in the areas needed (e.g. insufficiency of financially literate professionals who would be able to oversee activity of an owned company). This problem is even more striking if we consider that direct representatives of the shareholders were sitting in the boards (nomination were acquired rather according to the position in the association's hierarchy than according to professional skills).

Green Paper on Corporate Governance issued by the European Commission emphasized an importance of balanced professional structure of the boards. In the case of SAZKA, the members had various professional backgrounds (e.g. studies of physical education on pedagogical faculty, technical studies, law studies, leadership of sports associations, etc.) but we can say that it was far from optimal for running a lottery company. There is of course always an option to employ external advisors for professional expertises, however the sports association very likely would not be able to pay for these (as they may too costly for them).

4.2.5 Execution of shareholders rights

Execution of shareholders rights remains one of the crucial concerns of the corporate governance and in the case of SAZKA, it is even more important. Normally, if shareholders are not satisfied with the performance of a corporation and its leadership, they have two options how to maximize their utility – they can either start to be active in the corporate governance and change the leadership of the company or they can simply "vote by their legs" and by selling their shares exit the company.

[32] Moreover, again especially in the case of ČSTV, there are also specialised committees (e.g. Legislative committee, Committee for sport financing, etc.) which can give their expertise opinion to a particular problem.

However, for the shareholders of SAZKA, the latter option was not that easily possible in practice. First of all, dividends from SAZKA represented a significant part of their revenues and by leaving the company they would lose this regular source. Moreover, the shares could be transferred only to existing shareholders (with limited sources for payment for the shares) and the transaction had to be approved by the general meeting of shareholders which does not make it quickly viable. For these reasons, the shareholders – in order to maximize their wealth and utility from being owners of the company – should have rather executed properly and carefully their rights and should have been active shareholders. Also, they were representing not only their interests, but above all interests of their members. Nevertheless, we can observe that the shareholders rather renounced execution of their rights (as will be described further).

We have already talked about some of the decisions by the shareholders of SAZKA, a.s. but let us summarize them and see their continuation and consequences.

The period which very likely determined the trust of shareholders in the management, personified in the person of the CEO and chairman of the board of directors Aleš Hušák, was the period of financial consolidation between 1995 and 2001 when revenues and profits rose steadily and sports associations were receiving sufficient sums of money.

4.2.6 Decision to build the Arena and corporate governance

It is commonly accepted that the problems behind the fall of SAZKA, a.s. were caused by the investment in the Arena. This is true; however the truth is not complete since the reason beneath is more complex. A decision is not made alone and thus it is necessary to focus rather on the question how it is possible that such an investment was agreed when the past financial results may have suggested that it would be very difficult to finance it and might be possible only if significant savings on dispensable costs and investments were made (such as sale of dispensable ownerships, such as real estates, and no new large investments, decrease in costs, etc.).

On the example of the decision to build the Arena, we can most easily demonstrate that SAZKA's shareholders renounced execution of their rights.

As said in the part discussing the history of the company, shareholders demanded only two conditions to be fulfilled in order to approve an investment in the construction of the Arena:

- Unchanged level of payments to the shareholders

- The Arena will be finished on time so that the Ice Hockey World Championship in 2004 could take part

Sport associations did not require any profound analyses of the investment or contracted guarantees given by the State administration (unchanged legislature, exclusive licence for video-lottery terminals VLT). Shareholders settled for oral promises made by the State and public proclamations of Aleš Hušák that a new video-lottery terminal will bring enough cash to repay the loans for the Arena and unchanged payments to shareholders. Again, no profound analyses proving reliability and performability of these promises were required.

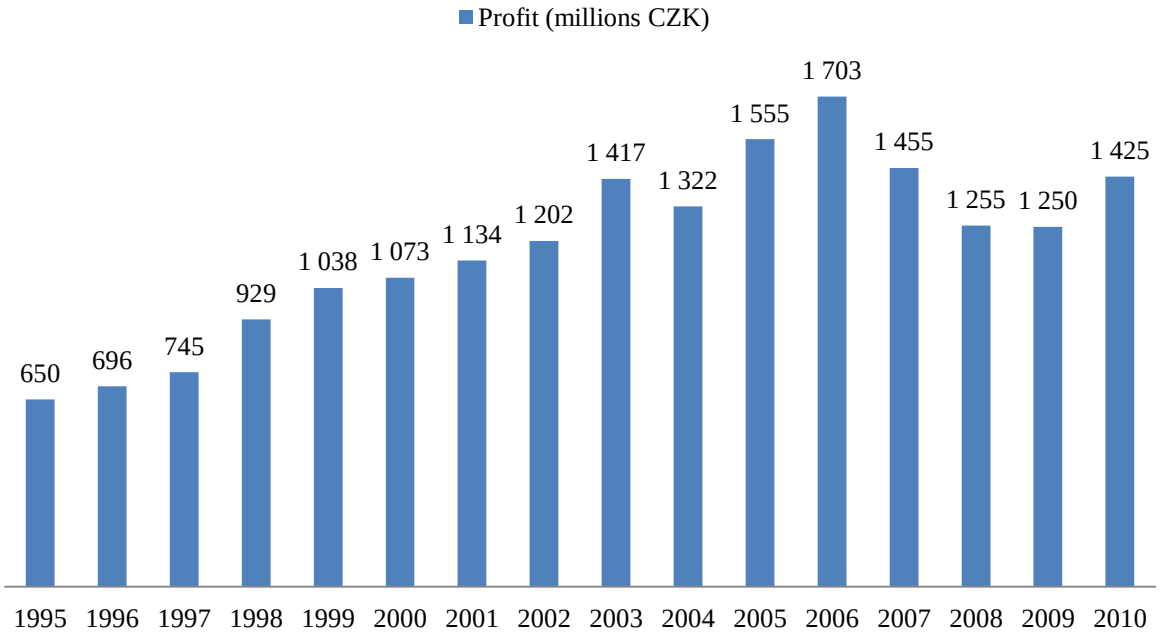
Nevertheless, the biggest mistake which the shareholders made is that they did not set any limits to the construction which enabled an increase the costs of construction of the Arena to more than 9 billion CZK.

It should be primarily a responsibility of the board of directors (where in the case of SAZKA representatives of shareholders were involved) to run further inquiries (KCP, 2004) into the investment plans, interpellate the management, or even ask for external expertises if needed. This responsibility comes from a simple reason. Although the management is obliged to provide proper information on time, it is improbable that the information would be sufficient under any circumstances and for any investment decision (principal-agent problem and problem of asymmetric information). This does not have to be a purpose; we have to realize that the way of thinking of the executive people (management) is and naturally should be different from the way of thinking of non-executives. Therefore also the scope of information needed will be different.

The board should be also responsible for setting a scope of prioritization of investments according to existing opportunities and sources (KCP, 2004). We have seen that a scope and limits of the investment were not set and further inquiries not run nor required. One of the roles of the directors is to protect interests of the shareholders. On the other hand, they should be responsible for a strategy formulation and company's orientation (as we have seen in Figure 2.4). Nevertheless, since the board of directors and supervisory board were comprised almost entirely from direct representatives of the shareholders, both boards were satisfied with a promise that the shareholders will continue to receive 1 billion CZK and they did not care much for the consequences and whether it was really possible.

At the same time, one of the main principles in investment decision making should be conservatism and not over-optimism[33] as in the case of the board of directors and shareholders of SAZKA while deciding on the construction of the Arena. For illustration of the financial situation of SAZKA we provide a following chart.

Figure 4.2: Profits of SAZKA, a.s. (in millions CZK)



Source: Annual reports of SAZKA, a.s., compiled by the author

This irresponsibility in the decision-making seems even more incomprehensible if we consider that SAZKA was not a normal joint-stock company for its owners. Shareholders in this case were not that much concerned with the initial investment which they put in[34] but rather in the future flow of money that the ownership meant. For this reason, they should have looked to future even more carefully and pragmatically and should not have relied only on promises while making important decisions.

It is important to remark that it was naturally an absolutely free decision of the shareholders to build the Arena and they had full right for it. However, they should have prepared for the decision more thoroughly; set limits for the actual construction so that the

[33] As an example of over-optimistic expectations we can mention much higher predicted numbers of rented VIP private rooms on the Arena (so called Sky Boxes) and also much larger expected amount of money raised from a sale of commemorative bricks. In both cases, the real numbers were significantly under these expectations.
[34] With the exception of situations when share capital was increased, the initial shares were mostly granted to sport associations gratuitously.

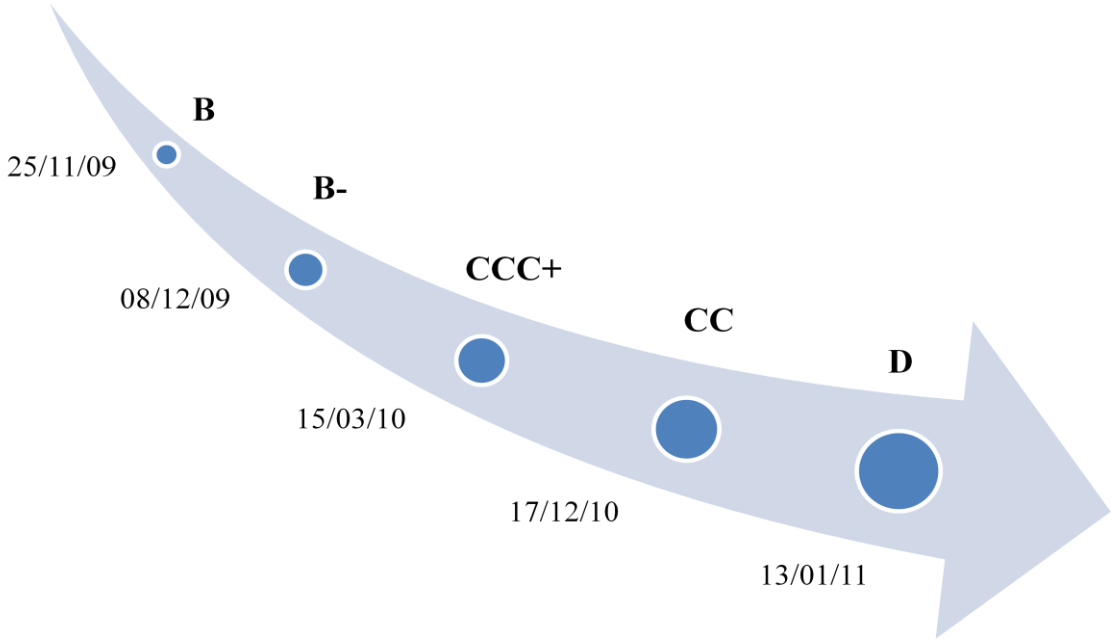
company would be able to pay it, take full responsibility for the decision and in the end confront the arising problems pragmatically[35].

4.2.7 Neglected corporate governance which was worsening the situation

Servicing the debt and satisfying claims of shareholders were rapidly worsening outflow of liquidity from the company in the years following the construction of the Arena (with a slight improvement in 2006 when the second bond emission was subscribed). Although expertises from the corresponding departments of SAZKA were suggesting that the situation might get serious (and since 2007 these departments were issuing also warning notices), Aleš Hušák was trivializing these messages and kept saying that SAZKA was a healthy and financially strong company. Shareholders tended to believe rather in his proclamations than in the expertises.

Deterioration in the economic and financial situation of the company was suggested also by a relatively rapid worsening of credit rating issued by Standard & Poor's as can be seen from the following scheme.

Figure 4.3: Evolution of credit rating of SAZKA, a.s.



Source: iHNed.cz, compiled by the author

Worsening of credit rating which was also increasing the cost of bonds amortization was always accompanied with a justification and recommendations. The rating agency mentioned repeatedly that the problem of SAZKA was a high dependence on the short-term

[35] Let us remind again that the umbrella sport association represent interests of around 2,5 million sportsmen in the Czech Republic and not only their own. Therefore they should have been responsible.

financing provided by banks, aggressive financial policy, slow progress of club financing negotiations, etc. In the report to worsening to level CCC^+ (which means that the company is in bad conditions and might be close to default) S&P recommended to SAZKA to lower overall indebtedness, solve situation with the financing from the part of banks, etc.

In every standard company with conscious shareholders, such news would (strengthened by a warning of SAZKA's auditors that financing of the company is too dependent on short-term credit provided by banks and situation in liquidity is serious and worsening rapidly) provoke calls for removal of the CEO (nevertheless, removal of the CEO and chairman of the board of directors would not have been an easy task as 6 votes (i.e. votes of all members of the board but one) would have been needed) and entire leadership of the company, gathering of the exceptional general meeting of shareholders, preparation of plans with an aim to make the company financially healthier (such as sale of dispensable ownerships and investments), immediate start of negotiations with creditors and banks.

However, in the case of SAZKA, these messages did not change anything. All notices, reports of the boards or financial statements (which also suggested rapidly worsening situation in the company) were approved unanimously by the general meeting and there was even no discussion and further inquiries on these reports. Also the post of the chairman of the board of directors was never questioned until the crisis got really serious (until mid-March, however it was not until the bankruptcy declaration when his post was contested also by ČSTV).

Further, SAZKA invested in a lot of projects which do not have much in common with its primary business objective – such as Agro Tera and Arkadia, real estate companies owning estates near Prague and Trutnov, Kolby, a producer of wine, etc. SAZKA also owned and operated its own fitness centre, nursery school and real estate property dispensable for the corporate operations. Costs were increased also by attempts to acquire foreign lottery company and to expand to foreign markets. Moreover, the company kept operating non-profitable or even loss-making games (such as VLT project StarPort) and had high operational (especially overhead) costs. High costs can be illustrated on the example of financial year 2009 when SAZKA achieved the highest revenues from lottery activity in its history whereas the profit was the lowest since 2002 (and profit from lottery activities the lowest since 2004).

Although some of the projects were making loss even over long period and some of the investments were redundant, they were never seriously questioned by the shareholders and no analyses were made. This may seem odd especially in the case of project StarPort which did not generate promised profits (the project accumulated a net loss around 0,5 billion CZK

over its functioning) which should have contributed significantly to the repayment of the Arena. One of the reasons that this project was not that successful may have been a non-exclusivity of video-lottery terminals for SAZKA (State administration in the end granted around forty licences for VLTs to various operators), but on the other hand given the very low probability that this state of affairs will change, shareholders should have rather focused on the project itself, its future and whether it would not be better to finish it[36].

Profligacy and extravagance of the leadership of SAZKA is very often illustrated on the remuneration and wages for the management team, members of the board of directors and of the supervisory board. Their amounts are depicted in the following table:

Table.4.1: Remuneration of the management, board of directors and supervisory board of SAZKA, a.s.

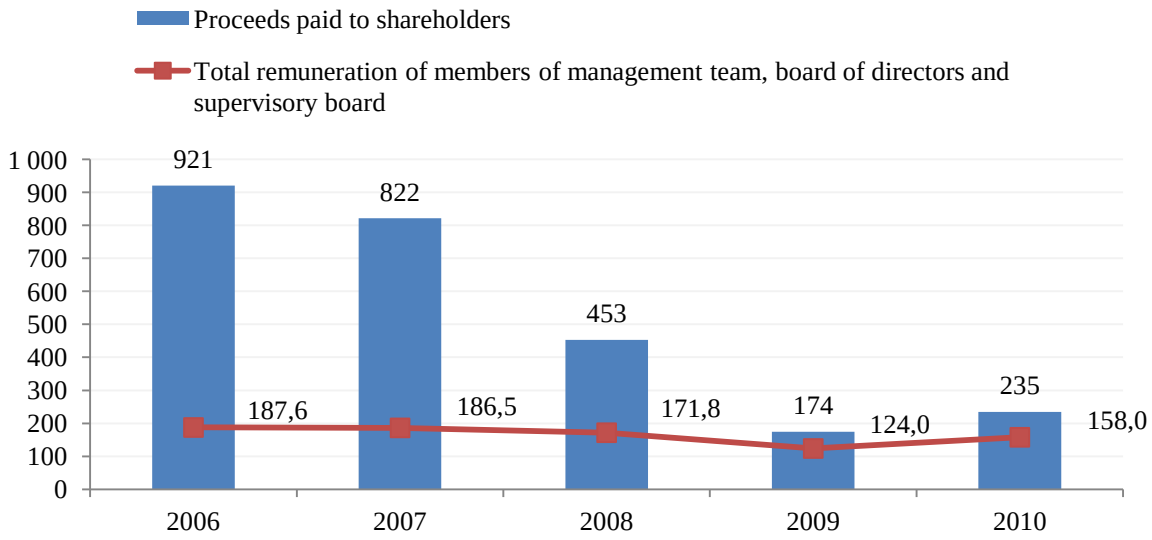
	2006	2007	2008	2009	2010	2011
Remuneration-management	155 522 267	144 528 652	146 518 807	113 124 554	131 535 012	53 165 516
Remuneration-board of directors	25 700 985	33 293 585	18 291 224	6 400 136	16 186 137	3 894 732
Remuneration-supervisory board	6 407 985	8 629 848	6 973 160	4 478 699	10 299 125	1 922 498
Total remuneration of management, board of directors and supervisory board	187 631 237	186 452 085	171 783 191	124 003 389	158 020 274	58 982 746

Source: ČSTV (2012)

The chart below compares total remuneration of management team, members of the board of directors and members of the supervisory board, with respect to the amounts paid directly to shareholders (i.e. without payments to civic association Zelený Ostrov, OSZO):

[36] The end to this project was made by the bankruptcy administrator Josef Cupka in June 2011.

Figure 4.4: Comparison of total remuneration and amounts paid to shareholders (in millions CZK)

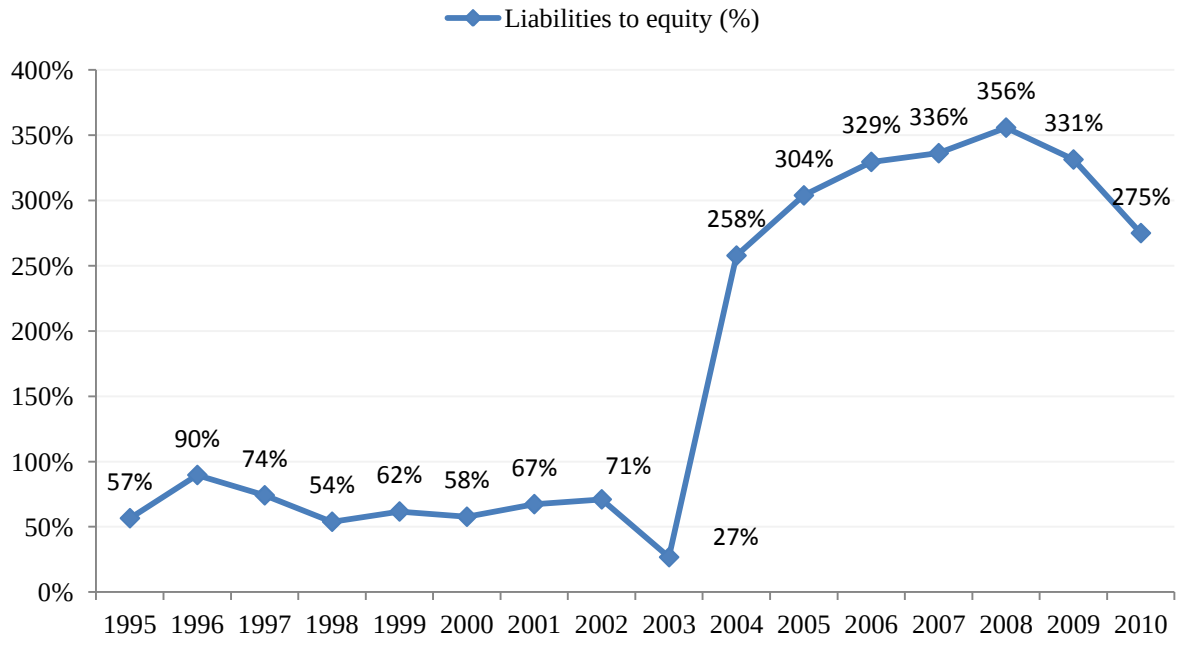


Source: ČSTV (2011a), ČSTV (2012), compiled by the author

Although the amounts paid to management and members of the board may seem very high, especially in comparison with the amounts paid to shareholders, this paper does not treat this issue in detail from following reasons. First of all, in a company as large as SAZKA, and normally also as profitable, high remuneration of the leading people may be seen as a reasonable motivation factor how to keep highly specialised workforce. Further, in the case of SAZKA, the problem was not in the core business of the company but in its high indebtedness which even lower wages and remuneration would not have improved. Last but not least, this topic has been widely discussed in the media and people may feel disgusted by these levels of remunerations, therefore this paper does not want to treat it more. Also from the point of view of corporate governance we have to say that they were approved by shareholders whose right is to pay to the managers and members of the boards as much as they consider reasonable.

There were many recommendations given to SAZKA by various expertises on how to solve its critical situation. Some of them suggested that SAZKA is undercapitalised (which might be also suggested by Figure 4.4 depicting the ratio of liabilities to equity) and thus an increase in share capital could be adequate and helpful (the increase could be done e.g. through an IPO, entry of a new investor, by existing shareholders, which would not have been possible given that the financial sources of sport associations were limited).

Figure 4.4: Liabilities to equity of SAZKA, a.s.



Source: Annual reports of SAZKA, a.s., compiled by the author

As said before the company started to negotiate a club financing in July 2009. Banks required some guarantees and measures in order to approve the financing scheme. The demands comprised limits to the level of indebtedness, limitations of new investment activity (and maybe sale of the dispensable property) and decrease in overhead costs; nevertheless the two measures which involved the most the shareholders were restrictions on the payments to shareholders and requirement on all the shareholding sport associations to put their stocks in the company as guarantees. The exact conditions were evolving over time as the CEO Hušák and representatives of shareholders were renegotiating the terms over and over. Shareholders apparently did not perceive a gravity of the situation and did not want their promised payments to decrease (or even disappear) and not at all put their shares in SAZKA, a.s. as guarantees. After several months of negotiations, the shareholders finally approved the terms but banks started to lose patience and required more guarantees. Finally in the beginning of December 2010, Raiffeisenbank sold its claims to Radovan Vítek which initiated a spiral of an end of SAZKA.

This plan of club financing is usually seen as the last chance to save the company from the worst scenarios (insolvency, bankruptcy) since SAZKA could have acquainted needed money and moreover an austerity plan aimed at helping the company out of critical state would have been applied and enforced. Shareholders however did not understand that acceptance of these terms would save and protect their investment and for a long time they

were not prepared to make sacrifices. It is very likely that the information given to them by the CEO and chairman of the board of directors Hušák did not emphasize adequately how the situation was serious and how the contract on club financing could be beneficial for the company because he was contending until the time when insolvency was declared that SAZKA did not have any financial problems and was healthy and strong.

4.2.8 Summary

We have tried to prove that shareholders rather than relying on expertises and professional analyses believed in promises and declarations of the CEO and chairman of the board of directors Aleš Hušák by whom they stood even when the problems of the company seemed absolutely clear. The majority shareholder, ČSTV, stood by Hušák until the bankruptcy and decided to remove him two months after the company was declared bankrupt. Naturally a question which arises is where the loyalty of the shareholders to Aleš Hušák comes from and how it is possible that in the case of SAZKA management controlled shareholders (and not the other way round as should be a normal state).

We have claimed that the governance of the sport associations and lack of qualified personal were one of the reasons. Ignorance of professional expertises and rather leaning on the promises and public proclamations were other problems behind which a personal charm and ability of Aleš Hušák to rule people may stand.

In any case, wrong corporate governance setting and practice and behaviour of the shareholders since the negotiations on club financing failed were prolonging a way to plausible solution. This prolongation was also steadily decreasing the value of the company because it was decreasing the revenues from (and thus value of) its core business, lottery activities (see chapter 5) and damaging the brand.

A question which emanates is whether the faulty practice of corporate governance was caused by wrong corporate governance setting, mechanisms and whole system, or whether it was rather a fault of people executing it. The answer is quite complex.

On the one hand, the system had serious flaws – we have said that there were no independent directors in the boards of the company, and that sports associations are not the best business entities. On the other hand, these non-ideal institutions for business life could have appointed professionals in the boards either from their internal sources or in a form of external advisors.

Guilt for the wrong corporate governance is therefore on both sides, but slightly larger guilt may be assigned to the human factor – the effect of controversial or directly bad parts of

the corporate governance model was reiterated by irresponsible people in the boards of SAZKA, who were not acting in the best interest of the shareholding sports associations behind them.

4.3 Possible solutions to the situation of SAZKA, a.s.

Questions which must necessarily arise are: What could have been done to save the company for its shareholders, what were the possibilities and options of solution, how did the shareholders handled them and what could have been done to prevent bankruptcy which was not the best solution for either party?

The most valuable assets of SAZKA were its net of on line terminals and above all the traditional brand and brand of its games, especially traditional game Sportka. We have already said that Eurobrand (European institute for brand research) repeatedly announced SAZKA to be the most valuable Czech brand and in 2010 estimated its value to be 413 million EUR (more than 10 billion CZK). However, prolonged negotiations and long-term uncertainty about the future of the company decreased its value and temporally hurt popularity of its games (see later in the next section). Finally, in the autumn 2011, the business core of SAZKA (thus the most valuable what the company had) was sold to groups PPF and KKCG for 3.81 billion CZK.

SAZKA and especially its shareholders received a number of proposals, offers and recommendations aiming primarily at guiding the company out of problems. These varied in extent of help and conditions under which it will be provided. We will discuss some of these offers and how they were evolving in time according to the development of outer circumstances. From the point of view of corporate governance, the most important two criteria for evaluation of offers will be:

- Is the offer conditioned by a change in the leadership of the company, especially by a remove of the CEO and chairman of the board Aleš Hušák?
- How would the ownership structure change? What (if any) would be the pecuniary benefits, both present and future, for the current shareholders (i.e. sports associations)?

Normally, once a legitimate insolvency claim is filed, the last step – if it is not prevented – is a bankruptcy. When the company is declared bankrupt, its assets are sold and from the proceeds first the creditors' claims and then those of shareholders (if there is something left) are satisfied. In the case of SAZKA, which was extensively indebted[37], the shareholders could have supposed that if the whole process was to finish with a bankruptcy,

[37] For illustration, see Figure 4.4

all the money from the sale of the assets would be used for satisfaction of creditors' claims and the shareholders would gain nothing. We have already mentioned that more than an investment, SAZKA represented a regular inflow of money for its shareholders. In the event of bankruptcy they would (and they in the end did) lose this source. For that reason, they should have tried to prevent the bankruptcy as much as possible once the company was in an insolvency proceeding.

In the following pages, we will distinguish three periods of time:

1. Period until the first insolvency claim on 17 January 2011(more or less since the beginning of the negotiations on club financing in July 2009)
2. Period between the first insolvency claim and insolvency declaration on 29 March 2011
3. Period between the insolvency declaration and bankruptcy declaration on 26 May 2011

4.3.1 The first period

(Until 17 January 2011 when the first insolvency claim was filed by Radovan Vítek)

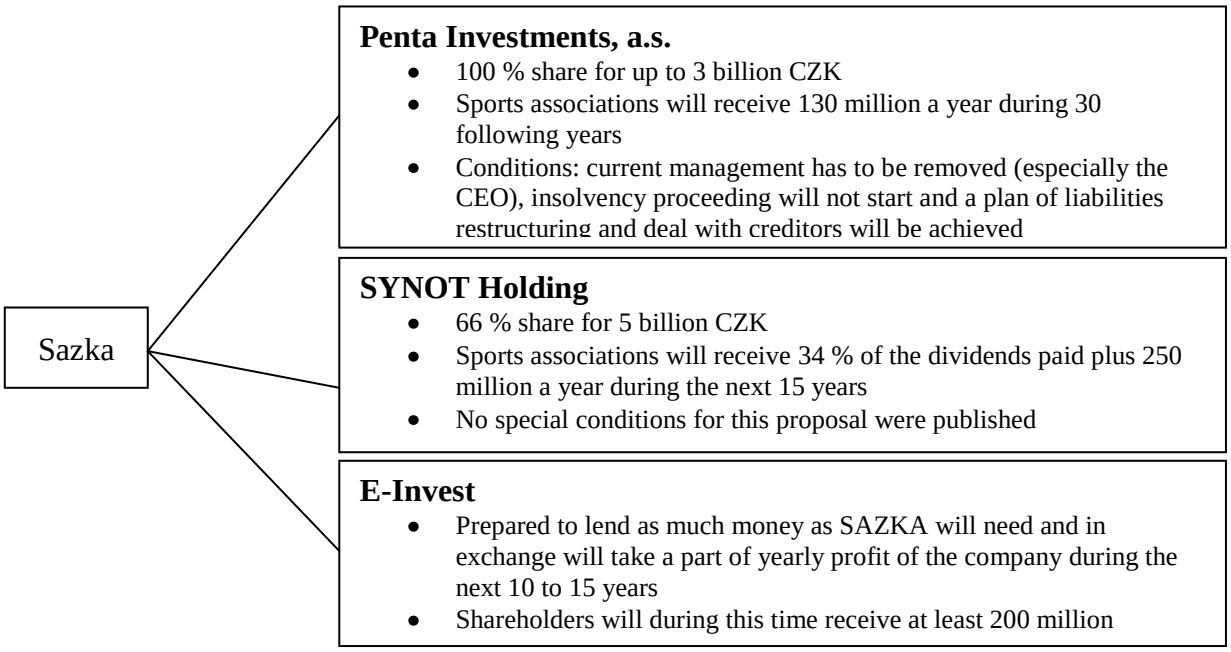
The first part of this period consists of negotiations on banking club financing and on restructuring of the debt held by banks. We have already spoken about these negotiations which finally failed after more than 1.5 year due to inability to achieve a plausible compromise when Raiffeisenbank sold its claim to Radovan Vítek in the beginning of December 2010. This action delimits beginning of second part of this period. Vítek then in mid-December bought also claims of Komerční banka, became the largest creditor and made clear that he wanted to pay for his claims. If the debts were not honoured by the beginning of January 2011, he would file an insolvency claim against the company.

This whole period is also characterized by a rapid deterioration of the credit rating of SAZKA provided by Standard & Poor's (we have seen it before[38]), by a change of president of ČSTV (April 2010) and also by first serious disagreements over SAZKA in this majority shareholding sports association. In addition, long-term chief financial officer left the company due to long-term disagreements with the CEO over company's financial policy in October

[38] The credit rating was firstly decreased to B from B+ on November 25th 2010 and through other deteriorations finally it fell to D on 1 January 2011.

2010. On 16 DEcember 2010 SAZKA admitted that it does not have enough resources to pay for bonds amortization.

Consequently, first offers appeared around Christmas. They are summarised in the following diagram:



Meanwhile, Radovan Vítek himself prepared a restructuring plan though he asserted that he only wanted his claims to be paid and not to run the company.

Among these three offers, the one made by SYNOT probably seems to be the best one. However, knowing that SYNOT operates a rival sports betting company and wanted to start its own lottery game, the offer may seem as a good way of how to get rid of the competition. The same applies (however maybe not that explicitly due to complexity of its portfolio of services) to Penta which owns a betting agency Fortuna which also wanted to penetrate the market of numerical lotteries.

The executive committee of the majority shareholder ČSTV decided that the association does not want to lose SAZKA and therefore would refuse any offers involving an entry of an investor (and subsequent change in ownership pattern which would reduce existing shares of the sports associations). For that reason ČSTV continued to run negotiations with E-Invest. (Nevertheless smaller shareholders lead by the Czech Sokol Organization

wanted to enable an entry of an external investor and to change the articles of association correspondingly, but these shareholders could not outvote ČSTV.)

4.3.2 The second period

(Between the first insolvency claim and insolvency declaration)

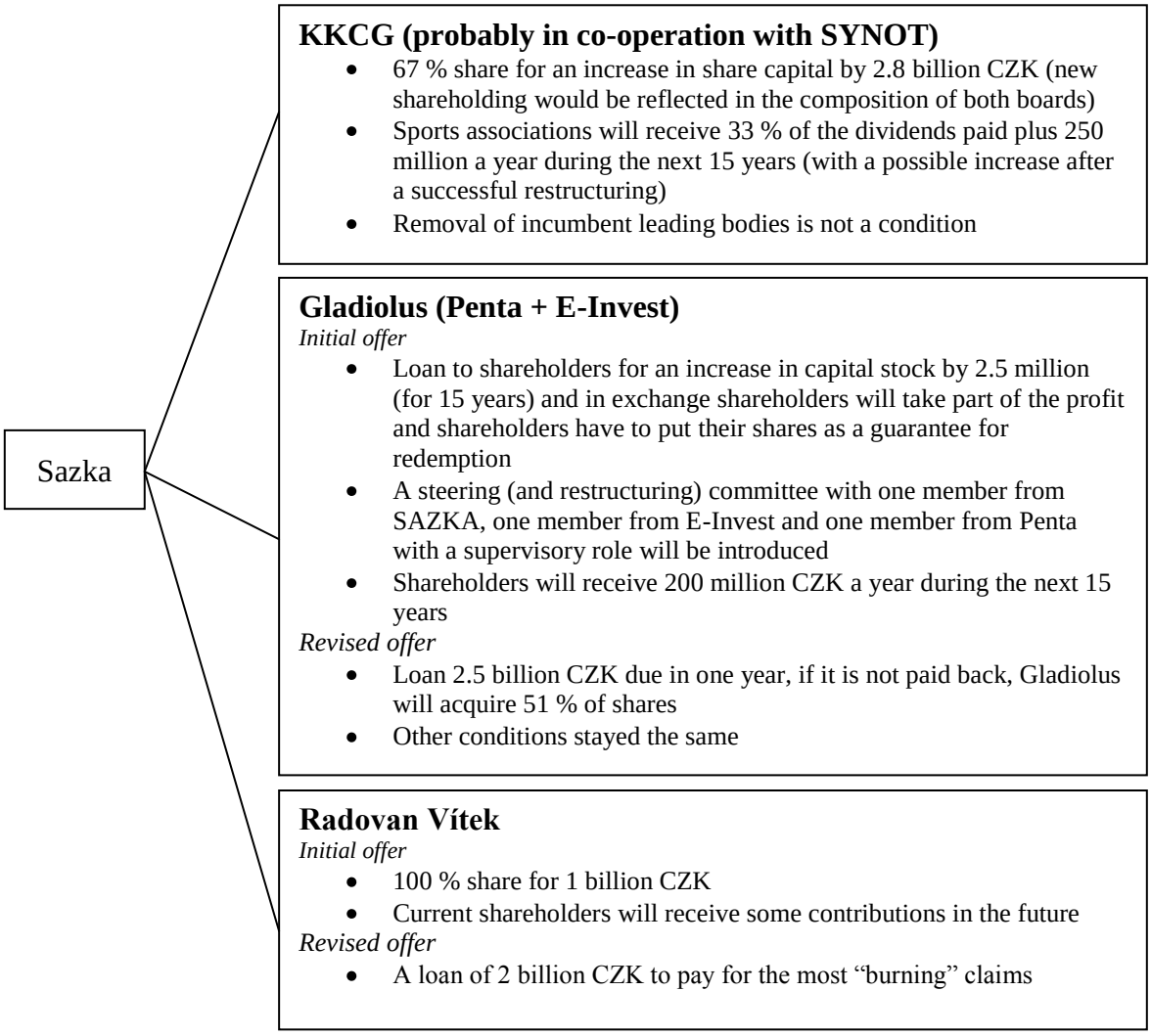
Radovan Vítek started to buy corporate bonds of SAZKA and achieved a blocking minority. The company asked bondholders for a moratorium which was rejected. This period is characterized by an effort of smaller shareholders for larger involvement in the decision-making process (in fact only the board of directors and majority shareholder ČSTV decided on the future of the company) and ČOS removed its representatives from both boards because they had not represented the interests of their association in the bodies of SAZKA.. Minority shareholders agreed that the situation needed an entry of a strategic investor and they also required an equal decision right as the ČSTV. ČSTV on the other hand published conditions of a tender for a strategic partner which included exclusion of those parties who were running insolvency proceedings against SAZKA (which excluded offers made by KKCG and Radovan Vítek).

During the second period KKCG group[39] entered the "contest" first with an offer of strategic partnership, then as one of the biggest creditors and soon afterwards filed its own insolvency claim. Just before the end of this period (by 21 March, 2011) also PPF group[40] came on scene by taking over claims owned by Radovan Vítek.

A preliminary insolvency administrator was installed in SAZKA on 21 February 2011 and after the board of directors had signed two contracts with Penta and E-Invest, the management of SAZKA was prevented from treating the property and all transactions above 500 thousand CZK had to be approved by the administrator. The vice-chairman of the board of directors filed for insolvency on behalf of the company on 21 March after SAZKA admitted that it did not have enough cash to pay prizes and asked for a temporal suspension of lottery activities. Finally on 22 March the board of directors concluded that the company was insolvent and authorized its chairman Aleš Hušák to file for insolvency on behalf of the company (either by joining the claim made by Roman Ječmínek or by filing his own claim) which he did so on 25 March. This period ends by SAZKA declared insolvent on 29 March.

A summary of the offers in the second period is provided in the following scheme:

[39] Owned by Karel Komárek
[40] Owned by Petr Kellner



The board of directors approved a contract with Gladiolus in the beginning of March; this transaction was however rejected by the insolvency administrator. Conditions of this second offer were in compliance with requirements given by ČSTV (no change in the ownership pattern), however they were quite severe. If SAZKA was not able to repay the debt in one year, Gladiolus would become a 51-percent-shareholder of the company (which would not satisfy conditions given by ČSTV). Given the financial results of the company, a repayment of the debt in one year would not be very probable and thus the change in ownership pattern (i.e. increase in share capital in exchange for part of shares) would only be postponed. Nevertheless, minority shareholders preferred the offer given by KKCG which pragmatically seems better. We have said that the main problem of the company lied in its corporate governance and in the shareholder’s resignation on execution of their rights. It is very likely that KKCG, who would have majority share in the company, would also participate actively in its governance and would appoint its own directors. This could be

beneficial to shareholders who would still possess a share in the company which would be very likely governed in a better way and thus a part of profit resulting from their share would mean a significant portion of money. Moreover they would receive promised 250 million CZK a year. This offer could thus solve the problem with governance of the company and especially of the lack of professionals among the shareholding sports associations.

4.3.3 The third period

(Between the insolvency declaration and bankruptcy declaration)

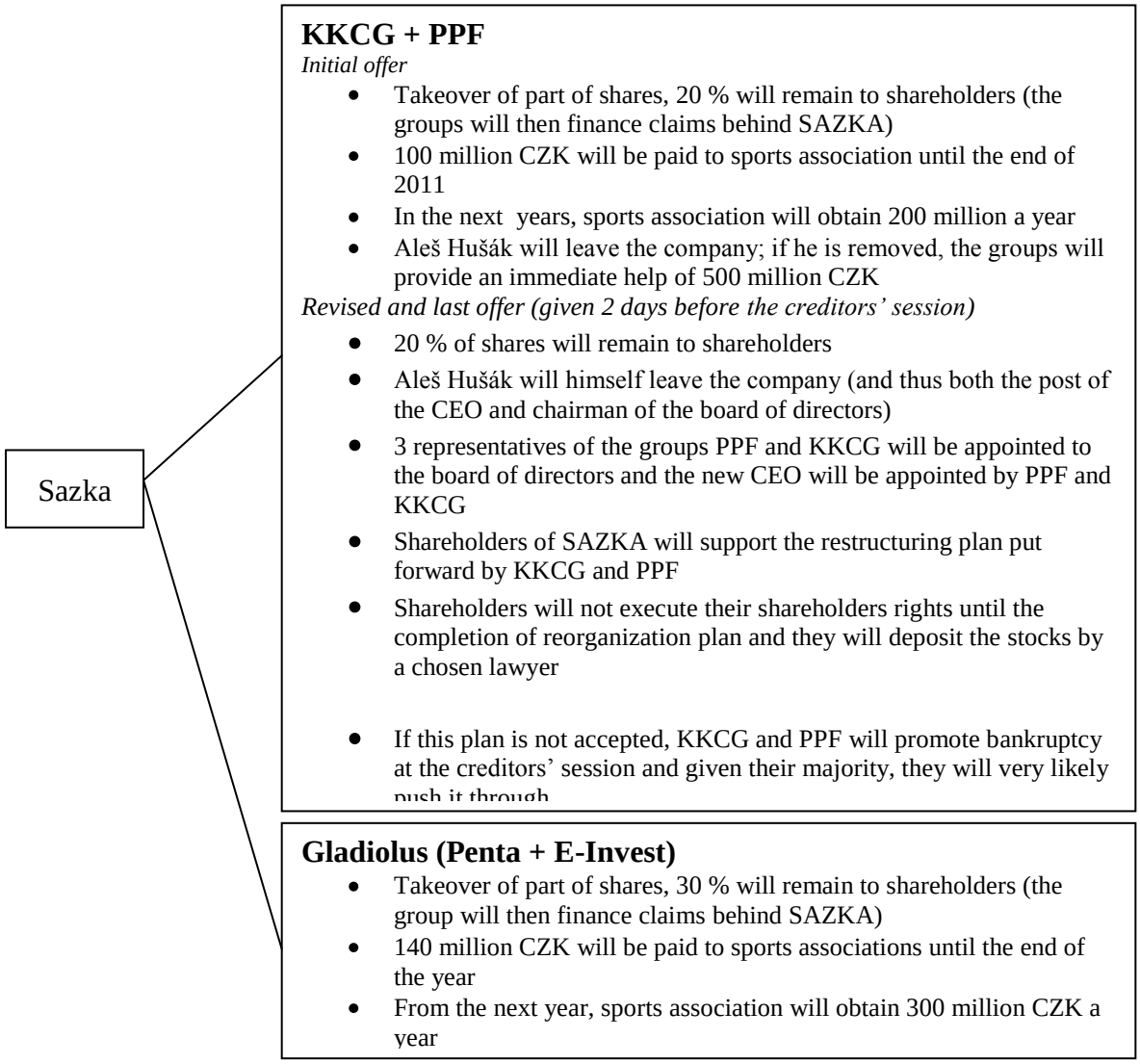
The most significant characteristic of this period is a fight for the biggest registered claim in order to have the largest word in the subsequent creditor committee. Civic association Zelený ostrov (OSZO) tried to file a claim for the proceeds that SAZKA should pay to it until 2021 (more than 8 billion CZK) so that the association (represented by the shareholders of SAZKA) would have a large voting power in the committee. This claim was then annulled by the new leadership of OSZO.

During the third period, voices calling for removal of Aleš Hušák were growing stronger not only from the minority shareholders but also from a part of the members of ČSTV. However his position in the company remained untouched. On the contrary, Roman Ječmínek (who stood for a long time by Aleš Hušák but then in the beginning of March 2011 when he first informed the insolvency administrator about the prepared contract with Gladiolus and then filed for insolvency on behalf of SAZKA) was removed first from the post of statutory deputy chief executive officer and then also from the post of vice-chairman of the board of directors.

Also in this period SAZKA had to cope with an imminent threat of licence revoking from the Ministry of Finance.

Just before the session of the creditors which was held on 26 May, Aleš Hušák announced that SAZKA was about to cease its activity, it did not have cash for paying prizes and employees were being dismissed. At the same time, he asked for a termination of the lottery licence (without informing the shareholders). This action shows his independency on the managerial post and the fact that it was rather the CEO who controlled shareholders than the other way round (which should be a normal practice).

The most crucial question for the creditors' session was whether reorganization would be approved or whether bankruptcy would be declared. During the third period, shareholders received following offers which could have avoided bankruptcy which cannot be considered a good solution for either of the parties:



Due to conditions of the bond emission, the bondholders started to require an immediate redemption of the bonds on 18 April because SAZKA was not able to amortize them on time. They therefore claimed 5 billion CZK. This was unfavourable news for Gladiolus who would have to, in the case of accord with shareholders of SAZKA, pay more than presumed 2 billion CZK to keep the company operating. On the other hand, KKCG and PPF owned large part of the bonds and thus in reality the company would have to pay only to the remaining bondholders if it was acquired by PPF and KKCG.

ČSTV did not approve the revised offer by KKCG and PPF though some of its members were calling for it. Another important failure in the execution of shareholders rights was performed by the president of ČSTV Pavel Kořan who at this critical period for the future of ownership of SAZKA was abroad on holiday and was not solving the situation. Since no

agreement was achieved, SAZKA was declared bankrupt on the creditors' session on 26 May and the shareholders practically lost the company and the source of money it produced.

After the bankruptcy declaration, individual members of the board of directors started to step down and the board was unable to remove Aleš Hušák from his posts (CEO and chairman of the board of directors) since according to the articles of association, votes of six members out of total 7 directors would be needed for such an action. On 7 June 2011 Hušák was however removed from the post of the Chief Executive Officer by the bankruptcy administrator. Two days afterwards, Aleš Hušák filed an appeal against the bankruptcy declaration.

In mid-July ČSTV, up-to-that time a sports association the most devoted to Aleš Hušák, decided to remove him from his posts in the company on the general meeting of shareholders. But the former CEO said he was not able to come to the Czech Republic from abroad due to problems with passport. After coming back, on 19 July, he performed another turning and without knowledge of shareholders annulled the appeal against bankruptcy which let almost free course for sale of business activities of SAZKA. This event together with a request for stoppage of SAZKA's licence for lottery activities only proved a small accountability and large independence of Aleš Hušák in his functions because the shareholders did not know about what he was doing (and both of these actions were essential for the life of the company). The CEO thus rather than being controlled did control the shareholders.

Aleš Hušák finally stepped down from the post of the chairman of the board of directors in the end of August 2011 and the general meeting of shareholders subsequently removed him from the function on the firm. This action thus terminated 16 years of Aleš Hušák in SAZKA, a.s.

4.3.4 Summary

To sum up, shareholders had two options what they could do:

- Sell the company as fast as possible (before it lost value due to long negotiations and disputes) with the highest gain possible

- Realize that the system of governance of the company was not optimal and change it – change the incumbent management and composition of the boards, improve the setting

of corporate governance and become active shareholders (thus not passive as they had been)

- However, there is a problem with this second option. The company was largely indebted and the shareholders did not have enough resources to keep the company solvent. Therefore, this second choice in its "pure" form could have been applied only under the condition that the club financing (by banks) would have been achieved.
- In any event, if they decided for this second option, a crisis plan would have to be prepared with a set of austerity measures, sale of redundant property, complete reorganization of the firm and elimination of superfluous costs etc.

In the second phase, when it was evident that the company was not able to pay for its debts and at the same time the shareholders (sport associations) could not help the company financially, there were again two types of solutions:

- Sell the company so that the net present value from the sale would be as high as possible
  - We have seen that shareholders were given various offers which comprised a regular inflow of a certain amount of money even if the company was sold entirely (e.g. the very first proposal given by Penta Investments, a.s.)
- Sell a share in the company so that the incumbent shareholders would still form a part of the owners of the company (i.e. sports associations would obtain in the future a certain promised amount plus possibly a part of interest), moreover they would still have a right to participate in the governance of the company but they would share this right and it can be assumed that all in all, it would be executed more professionally and more efficiently.

5. Evolution of customers' trust in SAZKA, a.s.

We have already suggested in the theoretical part that modern conception of the corporate governance (and especially on the European continent) takes into account not only relationship between the owners and managers (though this one is the most important) but also between the company and various other stakeholders among which we can also count customers or clients of the company. Customers pay for products or services and they expect the company to give them the best reasonable price and then to render them the services. Just

as in the case of shareholders and managers, a crucial component of the relationship of a customer towards a company is trust – if a client does not believe that the firm will be able to provide contracted (or already paid) products or services, he will not enter into this relationship (and very likely he will go to the competition able to satisfy his needs in a more persuasive way). In order to secure a loyalty of customers a company has to develop a certain framework for its relations with clients. To be concrete – in the case of SAZKA[41] the company had to keep people betting – offer them high prizes and persuade them that it will be able to pay them their potential wins (prizes) so that they do not stop betting.

In the following pages, we would like to illustrate how the volumes of stakes were falling with releases of disturbing news, such as inability to repay a win for two months or insolvency claim filed by the vice-chairman of the board of directors Roman Ječmínek, which were consequences of neglected corporate governance, as a relationship between the shareholders and management, and thus how the revenues from lottery activities of SAZKA were affected by its neglected corporate governance (therefore its external relations with customers).

We will principally use data for the company's most popular game, numerical lottery Sportka. Sportka was launched in 1957 and since that has been the most successful game of the company. We have seen that the money put in this game represent a large part of total volume of stakes. Also, in some years this game itself generated larger profit than the whole set of lottery activities together, therefore Sportka is very important for the company. Moreover, since the game has been on the market for 55 years, it is commonly very well known that this game is operated by SAZKA, a.s.[42] and thus its financial results can best reflect a trust in the company.

5.1 Sportka

Sportka is a numerical game launched in 1957; lottery drawing takes place regularly twice a week on Wednesday and Sunday (each session – i.e. on Wednesday and on Sunday – consists of two draws)[43]. Two sets of six numbers (out of 49) are drawn in each of these sessions. The objective is to guess as many numbers which will be drawn in the same set as possible. There is a complementary game called "Šance" in which 6 single-digit numbers are drawn.

[41] Which its former CEO Aleš Hušák sometimes liked to call a factory for hope (or rather dreams).
[42] This cannot be said that firmly about some other games, such as Euromilióny or Keno, which some people may not link to SAZKA instinctively such as in the case of Sportka.
[43] There might be also some exceptional draws on special occasions, such as Friday 13th (considered to be an unlucky day), special anniversary of the game, etc.

The prize depends on how many numbers a player bet on correctly. Prizes are paid from an amount (called winning principal sum) which represents half of the total volume of stakes put in Sportka. This sum is divided into two equal parts (for the first draw and for the second draw). Each of them is then divided to five winning quotas (in accordance with the number of correctly guessed numbers) and quota for Bonus. Quotas which are not distributed are transferred to the first quota for the next draw session. Jackpot is then a sum of expected value of the first quota and not-distributed part of the first quota from precedent draw day[44]. There are two Jackpots in each session distinct from each other (one for the first draw, second for the second draw). Jackpot can be won if a player chooses correctly all the 6 numbers which will be drawn in the same draw (i.e. in the first or in the second draw of a chosen day).

Non-distributed amount of money for Bonus is added to the quota for Bonus in the next draw. In 2010 a concept of so called Superjackpot was introduced. Superjackpot is a sum of current level of Bonus (including non-distributed past quotas) and the higher from two current Jackpots. Superjackpot can be won if and only if the following conditions are fulfilled. A player:

- Chooses the six drawn numbers from either of draws[45]
- Guesses correctly the last number drawn in Šance game
- All the ten bets on lottery ticket are filled

Bets are made via on line terminals located in a net of tobacco shops, newsagent's and posts where also current level of Superjackpot is displayed (rarely also Jackpots for the draws). The draw is broadcasted by the Czech Television and drawn numbers then published by Czech News Agency and on the websites of the company.

5.2 Factors influencing volume of stakes

The primary and most important factor influencing the willingness of people to bet is the amount of money they can win. In the case of Sportka, people know in advance the value of expected Superjackpot. People's willingness to take part in lottery games increases with the previewed jackpot (therefore we can expect a positive correlation among them).

This information is not the only important factor in the decision making process. People also consider their current economic situation and compare it with the prospect of a win. We can take development of average wages, development of consumer prices (inflation) and overall level of unemployment as variables describing immediate economic environment

[44] This amount can be discretionally and occasionally increased by the CEO by a certain part of non-distributed prizes; these can be for example Spring Premiums, Summer Premiums, etc.
[45] Taken part on the particular day

of the people. A generally prevalent view is that in the time of economic crisis (higher unemployment, low economic growth, low wages, etc.) people are willing to bet more because they think that they have already nothing to lose and they can only gain. However, it can also be said that if there is a crisis, people try to save money and avoid superfluous spending, such as spending on betting. Very likely, both factors will be playing role and it will only depend on which of them will prevail.

We have already seen that in the case of SAZKA revenues from lottery activity were the highest in 2009 which is the year when the Czech economy was in recession (the overall revenues from both lottery and non-lottery activities fell significantly from 2008 when they were the highest since 2000). We might say that the crisis did not have a significant negative impact on the company from the point of view of revenues from lottery activity; nevertheless it is not possible to state it firmly without a further detailed analysis.

However, these factors may be considered to be significant in longer term than the examined period will be. During the year (and also almost two years) which was the analysed period, no significant change in these variables came (such a change could be a fall of a larger Czech employer, banking crisis, etc.). Therefore we does not have to consider them in our analysis, which examines development of volume of stakes by sessions (and thus by half-weeks approximately).

What might be an influencing factor (also connected with the previous one) is the minimal amount that has to be staked – if this was too high, it might discourage people from betting. In the case of Sportka, this amount is 16 CZK, which is not a significant amount of money and therefore we will not count with this factor[46].

All these factors may have seemed to be quite obvious factors in decision making whether to bet or not. However, there is another, not that evident determinant connected to trust. If a person does not believe that the company will be able to pay him his potential prize, not even a very high Jackpot will persuade him to bet. People usually form their opinion about a company and therefore a trust in it according to the news served to them by media. Such news can be an announcement that SAZKA has not paid a prize won more than 2 months ago[47], declaration of SAZKA itself that it does not have enough cash to pay for the prizes, insolvency claim by its own vice-chairman of the board of directors, insolvency and bankruptcy declaration.

[46] For comparison – the minimal stake in Euromiliony (other numerical game provided by SAZKA) is 30 CZK, minimal stake in Šťastných 10 a Královská hra is 10 CZK.

[47] SAZKA is obliged to pay the prizes in a scheduled time; in this case the won amount of more than 100 million CZK should have been paid in 60 days.

5.3 Analysis of Data

The most crucial data necessary for this analysis, volume of stakes in individual lotteries for every week, is publicly accessible on the webpage of SAZKA. The winning lists provide data about staked amount of Sportka, Šance, Euromiliony and Sazka.

Šance is connected to Sportka (it is also on the same lottery ticket). Volumes put in Šance increase significantly if the Superjackpot is high because as we have seen recently, one of the conditions of winning the Superjackpot is to guess correctly the last number of Šance.

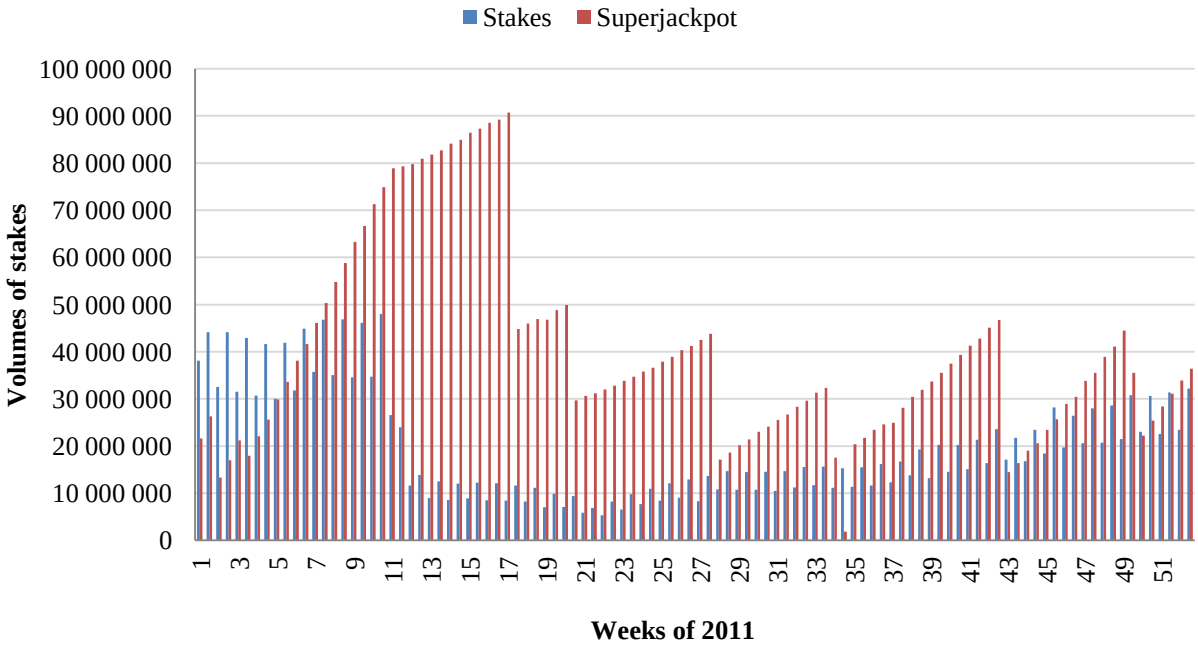
Popularity of Sazka varies with attractiveness of the matches listed on the lottery ticket which is very difficult to describe. In any case, Sazka does not form a large part of the revenues from lottery activity.

Staked money in Euromiliony fell significantly during the critical period (since the mid-March 2011) and has not been restored completely even until the 16th week of 2012 (by this time, Sportka has already achieved its past results).

From the reasons stated above, we will focus rather on the results of Sportka. In general, we can say that in the large majority of cases, more money is put in the Sunday draws than in the Wednesday ones. Also, during "normal times" the stakes usually increase in an important way with increasing levels of Jackpots and Superjackpot.

The following graph offers a comparison of stakes put in Sportka (blue colour) and the corresponding level of Superjackpot (red colour) during 2011:

Figure 5.1: Stakes in Sportka vs. size of Superjackpot in 2011



Source: www.sazka.cz; compiled by the author

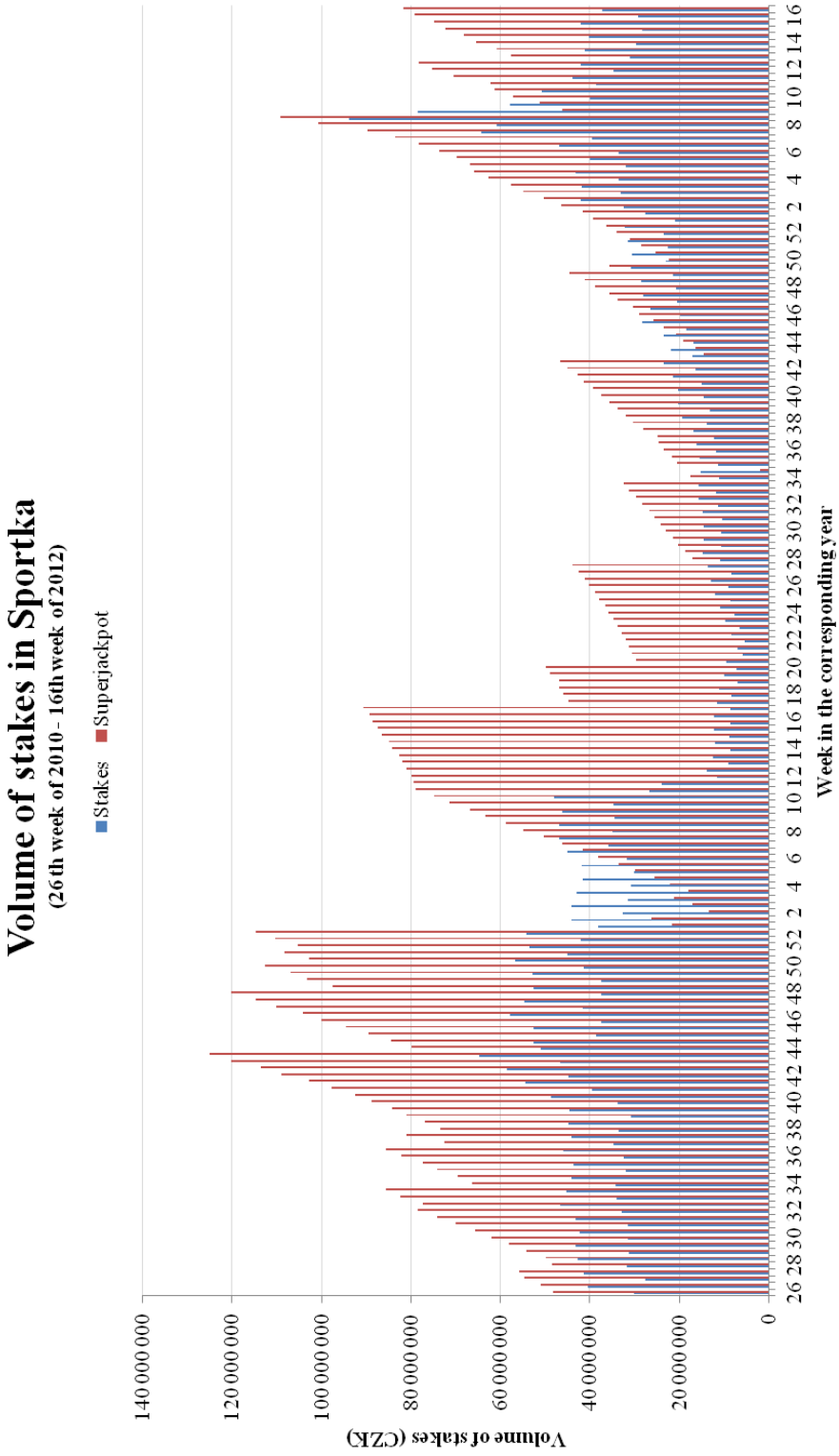
We can see that the largest immediate fall in the staked money came in the 12th betting week of year 2011 (21 March to 27 March) despite growing Superjackpot. During this time, SAZKA was heading to being declared insolvent. By 15 March, the company announced that it was not able to repay the prizes (after speculations in media that it had not repaid a prize in a legally determined period) and Ministry of Finance of the Czech Republic started to examine the situation thoroughly. At the same time, SAZKA asked for a temporal suspension of the lottery activity. On 21 March, the vice-chairman of the board of directors, Roman Ječmínek filed his own insolvency claim against SAZKA on behalf of the company[48] (people might have thought that even one of the most influential persons in the company does not believe in it) and finally the second insolvency claim on behalf of the company was filed by the CEO and chairman of the board Aleš Hušák on 25 March. Four days later, SAZKA was declared insolvent (people may have been unsure of what that meant and whether the company would continue its operations).

The biggest drop in volumes of stakes came in the 22nd week which corresponds to the period around bankruptcy declaration (end of May 2011) when it may have seemed unclear what will happen with the company and its business. The chart above shows how these events and their subsequent publicizing influenced negatively the willingness of people to bet, i.e. the volume of stakes.

All these news were amplified by the fact that the CEO and chairman of the board had been persuading the society that SAZKA does not have any problem and all the assertions made by others are just part of a campaign against the company; when suddenly SAZKA admitted it was not able to pay the prizes and asked for temporal discontinuation of its lottery activities. Moreover, media were filled with the news about disputes within the company and within its shareholders (thus in a way about problems with corporate governance) which does not add any calm in the trust of people in the company.

For a further comparison, the next chart extends the previous one and describes the stakes in Sportka since the 26th week of 2010 (half of the year) to 16th week of 2012 (almost end of April) relative to the corresponding levels of Superjackpot.

[48] According to the articles of association he was entitled to do such an action.



Source: www.sazka.cz, compiled by the author

Again, we can see a significant drop in volume of stakes in the 12th week of 2011 (and then in the 22nd week) which we have explained above. However, this chart gives us further possibilities for an analysis. If we compare situation around 12th to 18th week and compare it with a similar level of Superjackpot in different periods of time (e.g. around 40th week of 2010, or 45th week of 2010) we can see that the staked volumes were much higher in 2010 than in 2011, thus very likely the people's willingness to bet was influenced by something more than only level of Superjackpot in 2011. Very likely this factor was represented by the situation in which the company found itself and notices about it.

An interesting period of time are the weeks at the turn of 2010 and 2011 when stakes exceeded the level of Superjackpot (and therefore also the level of both Jackpots). Nevertheless, during these weeks media were informing about Radovan Vítek's threats that he would file an insolvency claim in January (which he did on 17 January, 2011). if the claims he owned were not repaid. Also, rescue plans were the company started to being prepared. On the other hand it might not be that surprising given that Aleš Hušák was mitigating and trivializing the critical situation of the company in media (and in front of shareholders) and the betters might have believed him. The drop in the bets did not come around the time when the first or second insolvency claim were filed (the first one was filed by Radovan Vítek, the second one by KKCG group) but it came with news about vice-chairman of the board of directors Roman Ječmínek filing an insolvency claim, about the unpaid prize, and about the announcement of the company that it was not able to pay the prizes.

5.4 Summary

All in all, we can see that people reacted to the news about development of situation in SAZKA, a.s. which were more or less consequences of the neglected corporate governance as we have talked about it in the previous chapters of the study. Also, it is visible that prolonging uncertainty about the future of the company pushed revenues from the main numeral lottery Sportka (and also of other games) to low numbers. The revenues were restored once the company was safely in new hands and achieved its previous results completely in the beginning and spring of 2012.

On the other hand, the two depicted graphs have shown that people were willing to put still significant amounts of money in the games operated by SAZKA, a.s. (in our case in the game Sportka, but evolution of revenues from other games was more or less the same) even when the company was in deep problems which were discussed publicly in media and when it was heading to the bankruptcy. Revenues from lottery activities did not evaporate completely

even after the bankruptcy declaration and entry of competition on the market of numeral lotteries. This fact shows that the main problem of the company was not on the revenue side and that the core business of the company did not have major problems. This fact was also proved by relatively large interest of various companies in taking over the company. The real problem lied in the financing of the construction of the Arena, and better to say in the decision which stood behind it allowed by the neglected corporate governance.

Conclusion

The goal of this study was to point out that the corporate governance matters and that neglected corporate governance can lead even to a failure of the company. For this purpose a case of a Czech lottery company SAZKA, a.s. was used. SAZKA used an internal-control mechanism where the board of directors is composed from representatives of shareholders. However, contrary to the recommendations of this paper, it lacked independent directors in its bodies and the shareholders were not strong as it would be implied by this model.

As opposed to a popular view, the Arena (currently O_2 Arena, former SAZKA Arena) was not the only reason why the company went bankrupt, nor was it the most important. Decision to build the Arena was rather a consequence of the main cause of SAZKA's problems – neglected corporate governance and resignation on execution of shareholders rights from the part of the owners, i.e. sports associations. Also some other issues often bandied around in the media (high remuneration of management, board of directors and supervisory board, personal provisions for the CEO Aleš Hušák, etc.) have to be viewed as a failure of the system of corporate governance since they highlight a resignation on responsible execution of property rights. This paper also argued that the non-ideal practice of corporate governance was rather a fault of both the wrong setting and maybe little bit more of the filling of the positions which reiterated problems of the system.

From the point of view of sports financing, the system where sports associations own directly a leading lottery company seems reasonable because sports associations obtain regularly a quite certain amount of money which usually represents a significant part of their revenues.

On the other hand, this type of ownership of a large lottery company may represent a threat from the point of view of corporate governance. There are two main reasons for this conclusion. First of all, it may be reasonable to suppose that normally sports associations are directed by people who are more sportsmen than managers of portfolio (as in a institutional investor, such as investment fund), or people who would be active representatives of shareholders. Lacking the adequate human capital, they are not able to control adequately professional managers; this problem is even more visible when they are represented directly in the corporate bodies of the company (board of directors, supervisory board) as they were in the case of SAZKA, a.s. This concern was also proved by many situations in the business life of SAZKA, a.s. when the shareholders did not know exactly what the CEO and chairman of the board of directors Aleš Hušák was about to do on behalf of the company.

Secondly, a structure of these sports associations is usually very complex since they are composed from individual federations representing a particular sport and there are various bodies that play a decision-making role. This difficulty does not enable them to make swift and adequate decisions (since it might be often difficult to achieve a plausible compromise).

These two characteristics of sports associations were some of the reasons leading to resignation on execution of shareholders rights, relying on promises made by the management and believing almost boundlessly to the CEO (we should not forget also a power of personality of the CEO Aleš Hušák and his influence on people around him).

As this study has shown, if shareholders rights are not executed efficiently and properly, management possesses an uncontrollable power and eventually the value of an investment decreases for shareholders as they are controlled by the management. Sports associations did not seem to be able to become active shareholders and thus the ownership of a lottery company by them is in the end not an efficient system from either of the points of view because wrong corporate governance decreases value for shareholders and thus possibilities of financing of sport from the revenues of lottery activities. To make it more efficient, it would be advisable either to start to behave as responsible active institutional investors when there was still time for it or – because the first solution was due to reasons stated above highly improbable even when it was possible – to let an external investor who would be an active shareholder enter the company with as large financial benefit for shareholders as possible. The company would very likely be directed more efficiently and sports associations would still obtain a part of profit of the company.

The fact that problems of SAZKA, a.s. were caused by neglected corporate governance which permitted an investment in the Arena without proper guarantees and measures and high indebtedness of the company was also proved by still quite high revenues from Sportka (and other games) even in the most critical times which the company went through (naturally, the revenues shrank but did not disappear completely.

All in all, theory of corporate governance may seem as a piece of theory which is quite natural and obvious. But the most important about corporate governance is how the theory is implemented into practice, how it is applied and which of the principles are respected. This is also the most difficult because it requires a certain degree of knowledge and consciousness. Theory in practice will never be perfect because where a human factor plays role, the result can never be completely perfect. Nevertheless, more and more advisory firms and institutions provide information, codes, best practices and even courses on corporate governance in order to improve a practice of corporate governance and make it as efficient as possible.

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List of appendixes

Appendixes

Appendix No. 1: Board of directors of SAZKA, a.s. in time – 1998[49] – beginning of 2011

- Chairman of the board:
  - Aleš Hušák (1995-2011; member of the board since 1994)
- Vice-chairman of the board:
  - Roman Ječmínek – AČR (1995-2011; member of the board since 1993)
- Members of the board:
  - Petr Bulín – ČOS (1998-2003)
  - Jaroslav Bernard – ČOS (2003-2011)
  - Milan Jirásek – ČOV (1997-2011)
  - Rudolf Šimek – ČASPV (1995-2003)
  - Jiří Laurenc – ČASPV (2003-2011)
  - Karel Malý – ČSTV (1997-2011)
  - František Chvalovský – ČSTV (1997-2001)
  - Vladimír Srb – ČSTV (2001-2010)
  - Tomáš Král – ČSTV (2010-2011)

[49] The structure of the board as depicted in Figure 4.1 stabilized in 1998; for that reason, we choose this year as a starting point.

Appendix No.2: Supervisory board of SAZKA, a.s. in time – 1998 – beginning of 2011

- *Members appointed by shareholders*
  - Jan Obst – ČSTV (1998-2008)
  - Pavel Kořan – ČSTV (member and chairman 2008-2011)

  - Ivan Kolejka – ČOS (1998-1999)
  - Jaroslav Bernard – ČOS (1999-2003)
  - Jiří Krátký – ČOS (2003-2008)
  - Jan Ulrych – ČOS (vice-chairman 2009-2011, member since 2008)

  - Hynek Kohl – STSČ[50] (vice-chairman 2002-2003, member 1997-2003)
  - Václav Kobes – SSS ČR[51] (2003-2011)

  - Jaroslav Korčák – ATSJK (1997-2001)
  - Jaroslav Němec – ATSJK (2001-2011)

  - Jaroslav Pekař – ČSS (chairman 1995-2008, member until 2009)
  - Petr Baroch – ČSS (2009-2011)

  - Ladislav Šustr – Orel (vice-chairman 1998-2002 and 2003-2009, member 1997-2009)
  - Ladislav Kotík – Orel (2009-2011)

  - Josef Dobeš – Ministry of Education, Youth and Sports[52] (until 1998)

- *Members appointed by employees*
  - Jan Kašpárek – Monitoring Help Desk (1999-2011)
  - Karel Wencl (until 1999)
  - Jan Prádler – CFO (1997-2010)
  - Ilona Kubecová – legal department (1997-2001, 2010-2011)
  - Karel Rozhoň – department of claims collecting (1997-2011)

[50] The then SSS ČR
[51] Former STSČ
[52] Representatives of the Ministry were members of the boards until 1998 due to valid legislature.