

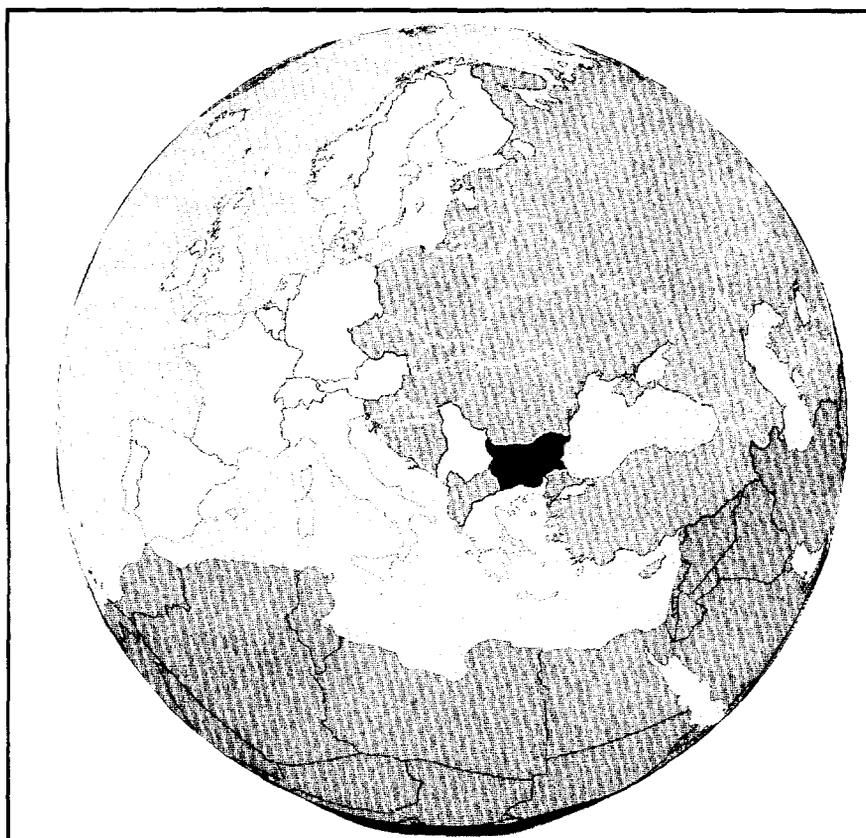


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# The Current Regulatory Framework Governing Business in Bulgaria



*Thomas O'Brien*  
*Christian Filipov*

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# The Current Regulatory Framework Governing Business in Bulgaria

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*Thomas O'Brien  
Christian Filipov*

*The World Bank  
Washington, D.C.*

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**Table of Contents**

V	FORWARD
VI	ACKNOWLEDGMENTS
VII	ABBREVIATIONS AND ACRONYMS
IX	EXECUTIVE SUMMARY
<b>1</b>	<b>INTRODUCTION</b>
1	OVERVIEW
1	PURPOSE
2	APPROACH
2	STRUCTURE
<b>3</b>	<b>THE BACKGROUND AND CONTEXT OF BUSINESS REGULATION</b>
3	BACKGROUND AND TRENDS
4	INSTRUMENTS
5	IMPLEMENTATION
5	Legislative Developments
5	The Court Structure
7	Enforcement Issues
8	BUSINESS REPRESENTATION
<b>9</b>	<b>BUSINESS CREATION</b>
9	CORPORATE FORMS
10	Unlimited Liability Forms
10	Limited Liability Forms
11	PROCESS OF INCORPORATION
13	PRIVATIZATION
14	CONCESSIONS
14	Concessions granted by the state
15	Concessions granted by municipalities
15	Concessions in place
16	LICENSING
<b>18</b>	<b>REGULATING CORPORATE OPERATIONS</b>
18	MANAGEMENT AND REPRESENTATION
19	TRANSACTIONS AND CONTRACTS
20	COMPETITION LAW
22	Prohibited Agreements, Decisions and Consorted Practices
22	Monopolistic and Dominant Positions
22	Governmental Subsidies and Price Setting
23	Unfair Competition
23	COPYRIGHT AND PROTECTION OF INTELLECTUAL PROPERTY
24	LABOR LEGISLATION
28	COLLATERAL
<b>31</b>	<b>ACCOUNTING AND INVESTMENT</b>
31	ACCOUNTING AND AUDITING
34	INVESTMENT MARKETS IN PUBLIC COMPANIES
34	Public Companies and Securities Transactions
35	Public Companies
35	Public Offering of Securities

CAPITAL MARKET INSTITUTIONS .....	36
Securities Trading.....	36
Stock Exchanges .....	36
Investment Intermediaries.....	36
Investment Companies and Portfolio Management Companies .....	37
Central Depository .....	37
THE ROLE OF FOREIGN INVESTMENT .....	37
<i>Foreign Commercial Ventures</i> .....	38
<b>TAXATION REGIME</b> .....	<b>41</b>
OVERVIEW .....	41
CORPORATE INCOME .....	41
THIN CAPITALIZATION RULES .....	43
VALUE ADDED TAX (VAT).....	43
PERSONAL INCOME.....	44
<b>COMPANY TRANSFORMATION</b> .....	<b>46</b>
MERGERS AND CONSOLIDATIONS.....	46
BANKRUPTCY .....	47
<b>CONCLUSION</b> .....	<b>49</b>
BIBLIOGRAPHY.....	51

**TABLES**

Table 1: Number of VAT Registered Entities	46
Table 2: Ratio of Minimum Wage to Average Cross Wage	47
Table 3: Non Wage Components of Labor Costs in Selected Countries	47
Table 4: VAT Registration Thresholds	47

## Foreword

Across the world, increasing attention is being paid to the investment climate as an important determinate of private sector growth. There is a wide acceptance that a business-friendly environment is a key ingredient in helping economies expand, which itself is crucial in the drive to improve living standards and fight poverty.

In the transition countries, many of which are now advanced in their move from planned to market economies, progress has been made in recent years in initially establishing and then improving the investment climate. An important part of the investment climate is the regulatory framework governing business i.e. the collection of important rules, standards, processes, and institutions which define the marketplace within which businesses operate.

This technical paper describes the main features of Bulgaria's regulatory environment for business as it stood in the second half of 2000. The research is launched to promote dissemination of analytical work, and generate further discussion of the issue. As is usual, the findings and interpretations are those of the authors and should not be attributed to the World Bank. Much of the material may well be of interest to a wide audience, including business people. Whilst every effort has been made to ensure the accuracy of the text, the document is not an investment guide and should not be relied upon for any business or commercial purposes.

In Bulgaria, there have been very positive economic developments in recent years. By describing and enhancing the understanding of the regulatory framework, including some of its strengths and weaknesses, this paper may help policy-makers and practitioners alike in their efforts to work together for further improvements in the years ahead.



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## Abbreviations And Acronyms

<b>AD</b>	Joint – Stock Company	<b>LFI</b>	Law on Foreign Investment
<b>AG</b>	Aktiengesellschaften	<b>LFRB</b>	Law on Foreigners in Republic Bulgaria
<b>AGB</b>	Aktiengesetzbuch	<b>LID</b>	Law on Industrial Design
<b>BAS</b>	Bulgarian Accounting Standards	<b>LMGD</b>	Law on Marks and Geographic Designation
<b>BCCI</b>	Bulgarian Chamber of Commerce and Industry	<b>LOA</b>	Law on Accounting
<b>BGB</b>	Buegerlichesgesetzbuch	<b>LOC</b>	Law on Cooperatives
<b>BIA</b>	Bulgarian Industrial Association	<b>LOJ</b>	Law on the Judiciary
<b>BIBA</b>	Bulgarian International Business Association	<b>LP/LoP</b>	Law on Patents
<b>BSE</b>	Bulgarian Stock Exchange	<b>LPC</b>	Law on the Protection of Competition
<b>CBA</b>	Currency Board Agreement	<b>LPH</b>	Law on Public Health
<b>CC</b>	Commercial Code	<b>LPOS</b>	Law on the Public Offering of Securities
<b>CEEC</b>	Central and Eastern European Countries	<b>LTCI</b>	Law on the Taxation of Corporate Income
<b>CMP</b>	Center for Mass Privatization	<b>LTIC</b>	Law on Topology of Integrated Circuits
<b>Constituti on RB</b>	Constitution of Republic Bulgaria	<b>LTPI</b>	Law on the Taxation of Personal Income
<b>CPA</b>	Certified Public Account	<b>LUSEI</b>	Law on Unemployment Security and Employment Incentives
<b>CPC</b>	Commission on the Protection of Competition	<b>LVAT</b>	Law on Value Added Tax
<b>EABG</b>	Employers Association of Bulgaria	<b>MLSP</b>	Ministry of Labor and Social Policy
<b>EAD</b>	Single – owned joint-stock company	<b>MPs</b>	Members of Parliament
<b>EOOD</b>	Single – owned limited liability company	<b>NA</b>	National Assembly
<b>ET</b>	Sole Proprietor	<b>NSI</b>	National Statistical Institute
<b>EU</b>	European Union	<b>OOD</b>	Limited Liability Company
<b>FESAL</b>	Finance and Enterprise Sector Adjustment Loan	<b>OTC</b>	Over – the – Counter
<b>FIAS</b>	Foreign Investment Advisory Service	<b>PA</b>	Privatization Agency
<b>FTOs</b>	Foreign Trade Organizations	<b>PM</b>	Prime Minister
<b>HGB</b>	Handelsgesetzbuch	<b>RWCs</b>	Regional Water Companies
<b>IAS</b>	International Accounting Standards	<b>SAC</b>	Supreme Administrative Court
<b>ICCA</b>	Institute of Certified Chartered Accountants	<b>SCC</b>	Supreme Court of Causation
<b>ILO</b>	International Labor Organization	<b>SD</b>	General Partnership
<b>IPO</b>	Initial Public Offering	<b>SG</b>	State Gazette
<b>KD</b>	Limited Partnership	<b>SJC</b>	Supreme Judicial Council
<b>KDA</b>	Partnership Limited by Shares	<b>SOEs</b>	State – Owned Enterprises
<b>LAP</b>	Law on Administrative Procedure	<b>SPAL</b>	Social Protection Adjustment Loan
<b>LAVP</b>	Law on Administrative Violations and Penalties	<b>SSC</b>	Social Security Code
<b>LBSS</b>	Law on the Budget of Social Security	<b>SSEC</b>	State Securities and Exchange Commission
<b>LC</b>	Law on Concessions	<b>TCM</b>	Training Center for Magistrates
<b>LC</b>	Labor Code	<b>TRIPR</b>	Trade Related Aspects of Intellectual Property Rights
<b>LCRR</b>	Law on Copyright and Related Rights	<b>VAT</b>	Value Added Tax
<b>LCT</b>	Law on Corporate Taxation	<b>WIPO</b>	World Intellectual Property Organization
<b>LDAFRB</b>	Law on the Defense and the Armed Forces of RB	<b>WTO</b>	World Trade Organization



## Executive Summary

**IN INTRODUCTION**, this paper elucidates in one place the key elements of the regulatory environment for business in Bulgaria and so guides researchers and others looking for such an overview. Its eight chapters are based primarily on a review of Bulgarian legislation and regulations, in effect in the second half of 2000.

**AS CONTEXT**, in Chapter 2 the report recognizes the significant progress made in recent years. It points out the rapid development of new legislation and regulatory procedures, largely to adopt the *acquis* - that body of law and regulation defining accepted standards amongst the EU member states. Such rapid legislative development has placed great pressure on those drafting such laws. Sometimes much-needed secondary legislation has been delayed well beyond the adoption of the primary act. Since January 2000 the Government has put in place a streamlined approach to better coordinate the preparation of new legislation, and achieving success here is indeed a priority. The implementation of laws is effected by a three-tier judicial system, in line with continental European models (in fact the three-instance review process is recognized best practice). As to the quality of judgment, several analyses have revealed gaps in skills and training for judiciary and court officials covering the rapidly evolving commercial practice field.

Much of the regulatory environment relies on public administration and judicial officials for its implementation. Reform efforts are underway to enhance the quality of their operations, which is an important task since there are weaknesses in slow and uneven administrative regulation. Whilst it remains difficult to make a firm assessment of the pace, reliability and effectiveness of enforcement procedures in Bulgaria (detailed, up-to-date statistics not being readily available) two issues are worth mentioning. One is the process of appeal in the court system, which is regarded by many as too slow. A second point is that the resources for enforcement are also perceived to be modest. This can often lead to practical, yet important difficulties on the ground, such as a bailiff's inability to track down a defendant's secured assets for lack of accurate records on the same. It is important to turn-around this situation, and improve businesses confidence in the enforcement capacity of the regulatory system.

**BUSINESS CREATION**, described in Chapter 3, can occur through several channels, with the Commercial Code (CC) providing much of the central, comprehensive regulation. Many corporate forms are permitted, in line with European practice. The company registration process is straightforward but some businesses have reported some frustration with the time the process can take, related to the constrained capacity of the courts. The typical cost of registering a company is about BGN35 (US\$17), which seems appropriate for the country and cheap by comparison with international norms. The BULSTAT Registry is easily accessible and can be viewed by an interested party via the Internet. It could be improved further by including access to balance sheet information, which is currently not easily obtainable from a single source.

Another route for business creation in the private sector in recent years has been offered through the privatization process. As of late 2000, some 85 percent of state-owned assets originally slated for privatization had been transferred to the private sector. The use of concessions can also be viewed as another route to the creation of private business in the Bulgarian context. Whilst concession legislation sets an overall framework of reasonable adequacy, reports from practitioners in the

marketplace reveal that much remains to be done to forward this agenda. Success stories can be found, for example, in the exploitation of certain natural resources, but progress has been slower in the energy sector, water and transport. The licensing regime also comes into play in relation to broad based considerations for business start-ups, where one hears the complaint that licenses are frequently over-burdensome in their design, slow or capricious to obtain, and the source of malpractice in their issuance. The Government has accepted much of this criticism and launched a process to eliminate or streamline licensing requirements. This is a welcome change and attention must continue to be focused on this exercise.

**IN REGULATING CORPORATE OPERATIONS**, as set out in detail in Chapter 4, broadly the stake held by a shareholder in the formation of corporate policy – and oversight of management – reflects the shared participation in the corporate capital base (as is common practice). Current legislation places certain restrictions and responsibilities on management actions, to prevent the worst possibilities of malpractice. The existing rules in this respect are consistent with EU Directives. However neither the CC nor securities law require the disclosure of biographical or other material information on directors, and the securities regulations need to impose clearer disclosure requirements on the shareholdings of board members to increase accountability and restrict insider trading. Compared against corporate governance standards as set out by the OECD, the Bulgarian legislation meets many items of recommended practice, but certain aspects could benefit from improvement - for example clear criteria for distinguishing outsider from insider non-executive board members, as well as guidelines to balance board composition between the two. To protect minority shareholders' interests the law contains some provisions, which accord with international norms, but there are reports that the practical effect is less positive. To engender confidence in corporate management standards, and underpin the broadening of share ownership across the community, this is an area for priority action.

The Commercial Code regulates transactions and contracts with similar provisions to most civil law jurisdictions. Aligned with international best practice are the general provisions governing: (i) concluding of commercial transactions, including due care and force majeure provisions; (ii) leasing, commission, and freight contracts. There are more detailed provisions governing insurance and banking transactions; corporate debentures and their maturity. The enforcement of contracts is implemented via the courts. Here business representatives do report weaknesses and more remains to be done to improve implementation.

Bulgarian competition law – an important building block of well functioning markets and proper corporate governance - follows EU doctrine, which penalizes companies for discriminatory behavior aimed at promoting their dominant position within the market. Market behavior is monitored by the Commission on the Protection of Competition (CPC), which has closely defined discretionary powers and is authorized to intervene in market regulation where legally merited. For protection of copyright, the Law on Copyright and Related Rights (LCRR), substantially updated in April 2000, attempts to conform more fully to EU standards in items such as protection of software, artistic copyright, publishing and broadcasting. In addition Bulgaria is a member of the World Intellectual Property Organization (WIPO) and a signatory to a host of international agreements in this area, such as the Universal Copyright Convention.

The core legislation covering labor issues from a corporate perspective is the Labor Code (LC), updated in early 2001. Many of the features of the legislation are in line with international practice, and the new package as a whole appears consistent with many European models. Note however the

social security contributions levied on the employer are burdensome – typically a total of 34.3 percent of salary in various contributions. The Government's recent reduction of contribution rates by 3 percentage points for employers from January 1, 2001 is a welcome first step.

**ACCOUNTING STANDARDS**, highlighted in Chapter 5, are set out in the Law on Accounting, with some enterprises e.g. banks, subject to sector-specific requirements. A statutory audit obligation, to Bulgarian Accounting Standards (BAS), is imposed on most companies, very much in line with EU practice on joint stock and limited liability companies. As for BAS, which are approved by the Government, practitioners report that they are based squarely upon IAS, with some abbreviation and modest modifications. Overall the legal framework for auditing and accounting is significantly harmonized with EC and IAS directives and standards. Key challenges are to be focused on (i) examining opportunities for better implementation and use of audit standards and reports, (ii) solidifying the annual process for updating standards and regulations; (iii) widening the circle of practitioners certified to IAS standards; and (iv) closing remaining regulatory gaps between BAS and IAS.

**INVESTMENT CHANNELS**, also outlined in Chapter 5, for the corporate sector are developing. Public trading of securities is relatively new in Bulgaria, and the core instrument in a fairly complex regulatory framework is the Law on Public Offering of Securities. The governing mechanism corresponds to international and European Union standards in the area of capital markets. The trading of securities is mandated within the regulated securities markets (currently the Bulgaria Stock Exchange, a relatively small market) subject to the supervision of the State Securities Commission. To encourage foreign direct investment in general, the Government works to establish and maintain a foreign-investor friendly regulatory environment which treats foreign investors alike to domestic entities. The current framework contains no restrictions as to equity investments of foreign companies and provides guarantees protecting foreign investment from the adverse effect of subsequently enacted legislation. The repatriation of profit and capital allows the unrestricted acquisition and transfer of funds abroad upon the verification of paid taxes due on income generated in the country. There is, however, a constitutional provision preventing foreign persons and corporate entities from directly owning land in Bulgaria, which may need to change over time to be compliant with EU standards, but which can often be circumvented since it does not apply to local entities with foreign participation, regardless of the percentage of the foreign shareholding.

**THE TAX REGIME**, for which some salient features are set out in Chapter 6, has been overhauled in recent years and its main features are now aligned with the prevailing practice in most EU member states. There is a two-tier corporate income tax: a municipal tax (local level) of 10 percent, and after this deduction a profit tax (at state level) of 20 percent (15 percent for those with annual profits below BGN 50,000). Together therefore the combination of profit and municipal corporate tax yields an overall tax rate in most cases of 28 percent. This is in line with the EU average rate, but somewhat below that observed in some competitor economies such as Poland and Hungary. Apart from minor exemptions, all commercial transactions in Bulgaria involving the transfer of title on goods and delivery of services are charged with VAT at an uniform 20 percent rate. VAT is the single largest source of general government tax revenue, contributing about 36 percent of all revenue from taxation. A graduated tax is levied on the personal income of residents, non-residents, and their income derived from commercial activities as sole proprietors. A middle income employee would pay around 16 percent of taxable earnings in income tax, with the highest marginal rate set at 38 percent. Bulgaria has also concluded double-tax treaties with a wide range of other countries including most EU member states.

**FOR COMPANY TRANSFORMATION**, covered in Chapter 7, the Commercial Code (CC) treats mergers and consolidations in a very similar fashion. It mandates the publicizing of mergers and consolidations, and prevents business amalgamations which are structured primarily as a measure to put third parties at a disadvantage. In disputable cases there is a provision that the merger or consolidation needs to be approved by the authorities prior to the registration of the transformed entity (as governed by the Law for the Protection of Competition). The CC also regulates the process of corporate closure, facilitating two main channels: liquidation (Chapter 17) and bankruptcy (Part 4). Recent amendments to legislation have sought to streamline the process and enhance the role of trustees in the process. It is also clear that further work is needed on the institutions which put the regulations into effect. Bankruptcy and liquidation provides a classic case in which the most significant weaknesses are not in the law but rather in the way it is implemented. Priority action should include: (i) better training for selected judges specializing in this field; (ii) enhanced court administration, most notably in file-keeping; (iii) establishing centers of expertise, including in the Sofia District Court, and so rationalize the case load.

**IN CONCLUSION**, Bulgaria started the transition with a weak and underdeveloped regulatory framework for governing business. Over the last nine years significant efforts have been made to the effect of producing a legal framework for business which by and large includes the key ingredients of best international practice and covers the elements needed for sustained private sector development. There has been substantial approximation to EU standards, and whilst Bulgaria's system in some respects still lies behind that of EU member states, it is well-advanced by transition economy standards. None of this leaves rooms for relaxation. Competitive pressures on Bulgaria's corporate sector can only increase in the future, making it all the more important that regulatory structures and instruments support and sustain entrepreneurial spirit.

There are items in the regulatory framework which deserve continued attention. One is to ensure that the quality of drafting of primary legislation remains accurate even in the face of increasing demands on the limited staff available. A second, equally important task is to improve the quality of secondary legislation (regulations and other statutory instruments) which are so crucial in giving effect to main laws. Yet the greatest challenge ahead is not so much in the design of the regulatory framework, but rather in the quality and timeliness of its implementation. Focusing renewed attention and well-targeted resources on the institutional underpinning of the business environment is a priority. This includes: a more effective judicial system for corporate affairs; enhanced and quicker enforcement of court judgements; and streamlined, transparent services (such as licensing and tax procedures) delivered by the public administration to businesses.

## Introduction

### Overview

A dynamic private sector is the key to securing the robust growth so sought after by the transition economies. In Bulgaria, as in many other economies in the region, the Government has set its store by encouraging a vibrant commercial life.<sup>1</sup> In the same vein, the aim of accession to the European Union (EU) also requires a “fully functioning market economy”.<sup>2</sup> So there is a clear cohesion between these two objectives.

Since the transition process commenced in the early 1990s, there has been a growing recognition of the importance of the institutional and regulatory environment to shape and encourage business success.<sup>3</sup> In short, a sound macroeconomic framework, and a transfer of state-owned assets to private hands, are necessary but not sufficient conditions for an economy such as Bulgaria to produce sustainable growth.

The World Bank has worked with the Government and other partners on this topic in recent years. A Private Sector Assessment (1996) outlined the state of business development at that time, and gave pointers for future policy. A series of policy-based lending, including the Finance and Enterprise Sector Adjustment Loan I (FESAL) and FESAL II loans in 1997 and 1999 respectively, has supported reforms to encourage private sector development.<sup>4</sup> More recently analytical work has focused on “second generation” reforms, such as those associated with corporate governance and reducing barriers to investment.<sup>5</sup>

### Purpose

The purpose of this paper is to elucidate, in one place, the key elements of the regulatory environment for business in Bulgaria. In so doing, we hope that this review will serve as guide to researchers and others – in the public and private sectors – looking for an overview of Bulgaria’s business environment. The paper does not set out to evaluate or rigorously analyze the precise strengths and weaknesses of each component of the business regime. The size and complexity of such a task merits much further work.<sup>6</sup> To prompt debate, however, we have highlighted, in selected areas, directions in which policy analysis (and indeed policy measures) could be further developed.

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<sup>1</sup> See *Updated Government Program Bulgaria 2001* issued by the Government of Bulgaria, March 2000.

<sup>2</sup> As per the Copenhagen Criteria, set out in the Regular Report of the European Commission on the Progress towards Accession. EC (1999)

<sup>3</sup> See for example EBRD Transition Reports (2000); Collier et al. (2000).

<sup>4</sup> Identified as a priority in the Country Assistance Strategy, The World Bank, April 1998.

<sup>5</sup> Bates et al (2000); FIAS (2000).

<sup>6</sup> Indeed the Bank has commissioned several analytical studies to gather further information on topics including, Overview of Licensing and Regulatory Regime; Assessment of Accounting Standards; Privatization.

## **Approach**

Our approach is based primarily on our review of Bulgarian legislation and regulations, in effect as of August 2000. We have relied also on published official reports, and drawn upon sector specific research from many sources. Pulling these strands together helps fulfill the primary purpose of this paper as a descriptive review. Input from discussions with senior representatives of Bulgaria's business community adds to our own analytical assessments and provides the prompt for developing thinking on selected policy issues.

## **Structure**

First, in chapter 2, we describe the background and context of the developing regulatory framework in Bulgaria. In the following chapter 3, we address legislation which governs the start-up of a new company or business activity. In chapter 4 we review a range of instruments which govern the operations of a corporate entity. This discussion is extended in chapter 5 to focus on finance and investment. A brief description of taxation issues is included as chapter 6. The review is completed with an assessment of corporate re-organization, including bankruptcy, in chapter 7. The report closes with concluding comments in chapter 8.

## The Background And Context Of Business Regulation

### Background and Trends

Bulgaria has a long historical tradition as a commercial nation open to trade and private entrepreneurship. During the five centuries of Ottoman Rule,<sup>7</sup> the country's economic activity was organized along the empire's commerce routes and had followed the trade customs of Central to the Eastern Mediterranean. The inherited semi-feudal economic model was largely retained after regaining independence in 1878, with the small and medium scale manufacturing and partial industrialization growing in the decades until 1944, when the country was effectively absorbed within the Soviet Block. Following the communist doctrine, Bulgaria's rapid post-war industrialization, as well as the associated rise of commerce and trade, was dominated by the all-encompassing central plan and state ownership of all property and enterprises.

During this period there was little in the way of sound market-based mechanisms for any business activity. Immediately after the fall of the Berlin Wall, the new government proceeded to dismantle the centrally planned model, which effectively faced Bulgaria with the gargantuan task of overhauling and rebuilding both legislation and institutions for interaction with the business sector. A similar task was also faced by the other Central and Eastern European (CEE) countries; certainly for Bulgaria the legal foundation and market-based experience gained prior to socialism was a relatively weak base on which to start the overall reform process.

Over the last ten years, the expressed intention of the prevailing post-communist governments has been to create a business-friendly, market focused regulatory regime. In this context, the efforts have focused on the reinstatement of the continental (civil) law and the further development of the European-modeled legislative framework begun after gaining independence from the Ottomans.<sup>8</sup> Bulgaria's laws follow closely the Roman civil legal tradition,<sup>9</sup> and therefore the Napoleonic legal approach underpins business legislation as it does other forms of legislation in Bulgaria. This focus on Europe foreshadowed a more recent, yet perhaps even more important driving force, namely that of European Union (EU) accession. This overarching political objective has enhanced the requirement to bring corporate regulation – both the legal framework and its implementation – in line with EU requirements (as encapsulated in the *acquis communautaire*).

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<sup>7</sup> 1396 -1878

<sup>8</sup> Prior to falling under Ottoman Rule, Bulgaria was religiously and culturally linked to the Western parts of Europe (Mediterranean Basin). With the adoption of Christianity in the late 9<sup>th</sup> century, social and political relations of medieval Bulgaria were heavily influenced by the Byzantine empire, and later also by the Latin empire (The Crusaders). These have firmly modeled Bulgarian customs and laws after the Roman legal tradition, at parts preserved by the Christian religion. After receiving legal training in Western Europe (1878-1888) -- primarily Germany, France, Italy, Belgium -- Bulgarian legal scholars, began the reception of modern, market-based continental European laws upon the remnants of Roman legal customs and proceeded to remove all influences of Islamic *Sharifian* law from business life.

<sup>9</sup> That is why, in reviewing Bulgarian law, readers might see the regulations of commercial relations and business ventures familiar to the German Handelsgesetzbuch (HGB) and Aktiengesetzbuch (AGB), contract law following the Roman legal tradition established in the French Code Civil (Code Napoleon), the Italian Codice Civile and texts from the German Buegerlichesgesetzbuch (BGB). On the other hand, apart from minor influences in the criminal law, the regulation of securities and capital markets, Bulgarian law has very little influence from the Anglo-American, common law tradition.

## Instruments

The bedrock instrument is the Constitution, as adopted in 1991,<sup>10</sup> which contains explicit provisions committing Bulgaria to a market-based democracy.<sup>11</sup> The lion's share of sovereign authority is vested in the legislative branch,<sup>12</sup> which by majority vote appoints the government<sup>13</sup> and half of the members of the governing body of the judiciary.<sup>14</sup> The President, who holds an elective office, is entrusted with all functions inherent to the head of state, as well as representative functions and fairly limited authority in the legislative process.<sup>15</sup>

In the regulation of business behavior the Constitutional provisions<sup>16</sup> guarantee:

- Equality in the treatment of all private persons and corporate entities, as well as equality in legal governance of all entrepreneurial activities;
- Legal safeguards upholding consumer protection, as well as preventing abuse from monopolies and unfair competition;
- Protection of business activity and investments of Bulgarian and foreign citizen and corporate entities;
- Freedom of cooperation and consolidation of private persons and corporations aimed at economic and social advancement.

Following the Constitution, businesses are governed by layers of authority, proceeding with the following order:

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<sup>10</sup> Constitution of the Republic of Bulgaria (Constitution RB); promulgated SG 56/13.07.1991. Constitutional amendments may be proposed by either the President or 1/4 of the Members of Parliament (MPs) -- 240 MPs in the regular, National Assembly (Art. 62 ff.) -- whereas, amendment require a 3/4 majority vote of the MPs (Art. 153 ff.). The Great National Assembly has 400 MPs. Constitutional changes are within the authority of the Great National Assembly (Art. 157) which is conveyed for significant constitutional changes (Art.158) upon initiative of the President or half of the MPs. The Constitution has not been amended nor changed since its inception. There has not been a significant debate about changes, which could adversely affect the business community. Currently there are discussions concerning constitutional amendments related to Bulgaria's EU accession -- in particular removing the restriction of foreign ownership of land (Art. 22).

<sup>11</sup> Art. 19 (1) Constitution RB.

<sup>12</sup> The National Assembly (NA) Art. 62 ff. Constitution RB.

<sup>13</sup> The Prime Minister (PM) who selects the members of the Council of Ministers (the government) which are subsequently approved by the NA. (Art. 84 (6) Constitution RB). 1/5 of the MPs may call for a non-confidence vote, by which the NA can effectively dispose of the PM by simple majority.

<sup>14</sup> The Supreme Judicial Council (SJC), who has a broad supervisory authority over the judicial branch (Art. 117 ff. Constitution RB). The SJC has 25 members, 11 appointed by the NA, 11 by the judiciary (under the provisions of Art. 16 ff. Law on the Judiciary (LOJ)); and three members by default -- the Presidents of the Supreme Court of Cassation (SCC); the Supreme Administrative Court (SAC) and the Prosecutor General. The sessions of the SJC are presided by the Minister of Justice, who does not vote.

<sup>15</sup> Art. 92 ff. Constitution RB.

<sup>16</sup> Art. 19 (2-4) Constitution RB.

- Primary Legislation: Laws and Codes passed by the National Assembly<sup>17</sup> and Presidential Edicts.<sup>18</sup>
- Secondary Legislation: all regulatory instruments of secondary legislation adopted by the Council of Ministers or the respective line ministers.<sup>19</sup>

In fact since 1991, at least 50 new laws have been adopted for business regulation, and countless more lower-level instruments have come into being. As in any jurisdiction, the effect of these statutes on business depends heavily on their implementation by the judiciary and the public administration.

## Implementation

### *Legislative Developments*

A prerequisite to smooth implementation of laws is clarity of the original instrument and a consistency and completeness between inter-related laws. The rapid development of new legislation and regulatory procedures, to adopt the *acquis* (that body of law and regulation defining accepted standards amongst the EU member states), has placed great pressure on those drafting such laws. On occasion this has arguably led to deficiencies: for example the Privatization Law has undergone 25 amendments since its first adoption in 1992; the Commercial Code<sup>20</sup> has been amended 23 times in the last six years. There have also been occasions in which much-needed secondary legislation has been delayed well beyond the adoption of the primary act.<sup>21</sup> Since January 2000 the Government has put in place a streamlined approach to better coordinate the preparation of new legislation,<sup>22</sup> and achieving success here is indeed a priority.

### *The Court Structure*

Judicial implementation of laws is effected by a three-tier system. There are 116 Regional Courts - Courts of first instance - established in communities with more than 10,000 inhabitants and dealing with the general caseload. District Courts, established in each of Bulgaria's 28 administrative regional centers, are the second instance courts for the appeal of decisions of the

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<sup>17</sup> In English translations occasionally referred to as "Acts". The normative acts adopted by the National Assembly become law with publication in the State Gazette and are subject to judicial review only by the Constitutional Court. Some of the current confusion in the hierarchy of laws is related to the still valid but outdated Law on Normative Acts of 1973. A new Law on Normative Acts is being currently drafted, and its adoption is expected soon.

<sup>18</sup> Presidential edicts not related to the functions of the head of state are co-signed by the Prime Minister (Art. 102).

<sup>19</sup> Adopted pursuant to more detailed implementation of primary legislation as provided for in such primary acts. These are the rules and regulations issued by the executive branch, such as governmental and ministerial decrees, decisions, instructions, orders and the like. Clear standards in the translation of the dichotomy of secondary legislation are still to come. The more frequently used terms are: Regulations (*Postanovlenie*); Implementation Guidelines (*Pravilnik za prilagane*); Ordinance (*Naredba*); Instruction (*Instruktzia*); Order (*Zapoved*).

<sup>20</sup> In particular Part IV on Insolvency.

<sup>21</sup> The Energy and Energy Efficiency Act, for example, was adopted in July 1999, after several years gestation. More than a year later, however, secondary legislation essential to the regime for independent power production remained incomplete.

<sup>22</sup> Regulation No. 3 of the Council of Ministers on the Coordination of the Measures for the Preparation of Republic of Bulgaria for Accession to the European Union and the Conduct of the Accession Negotiations, dated January 20, 2000, promulgated SG 7, 1/2000.

Regional Courts.<sup>23</sup> The District Courts also have original jurisdiction in some larger cases and include a specialized commercial department in every district.<sup>24</sup> Finally come the Courts of Appeal, in which there is a specialized Commercial Court of Appeal. The highest instance in Bulgaria's general court system is the Supreme Court of Cassation, while the Supreme Administrative Court serves as the highest instance for the appeal of decisions of the lower courts on cases disputing the legality of administrative regulations and actions. The Supreme Administrative Court has original and exclusive jurisdiction over challenges concerning the legality of actions of governmental agencies, including those of the Council of Ministers and the individual line Ministries.<sup>25</sup>

This structure is in line with continental European models, and the three-instance review process is recognized best practice. In total there are about 1,600 judges<sup>26</sup> in Bulgaria, 40 percent of which work on commercial cases, covering an enterprise sector of close to a half a million registered companies. This compares, for example, to close to 5,000 judges in Austria, a country similar in size of population. This gives an indication that in comparative terms the Bulgarian court system is severely under-resourced for business needs.<sup>27</sup> In terms of timeliness, one information source indicates that the typical medium sized commercial cases entering the first level court takes from filing to a court decision about 3-4 years (involving domestic counterparts.)<sup>28</sup>

As to the quality of judgment, several analyses have revealed gaps in skills and training for judiciary and court officials covering the rapidly evolving commercial practice field.<sup>29</sup> Heavy caseloads, poor operating facilities and weak organization do not make the situation any easier. Finally whilst much of the judiciary is respected for its integrity and independence, many

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<sup>23</sup> The Sofia City Court also functions as a District Court.

<sup>24</sup> The presidents of the Regional and District Courts are appointed by the Supreme Judicial Council, which also assigns judges to the specialized departments of the District Courts.

<sup>25</sup> The legality of administrative actions and normative acts (Regulations, Ordinances, Orders etc.) of the Council of Ministers, the Prime Minister and the line ministers may be directly challenged in front of the Supreme Administrative Court (Art. 125 Constitution RB).

<sup>26</sup> As of 1999 the number of judges in Bulgaria is 1588: (i) Regional Court judges: 649; (ii) District Court judges: 443; (iii) Appellate Court judges: 77; (iv) junior grade judges: 80; and (v) execution judges: 319; Source: Ministry of Justice.

<sup>27</sup> It has been indicated, that about 60 percent of the commercial caseload involves company registration matters, which is deemed by many commentators, including the World Bank (Judicial Assessment 1999) as an inappropriate waste of the currently limited judicial resources.

<sup>28</sup> As indicated by BCCI members. Out of an annual average of about 200 commercial disputes resolved through *arbitration* with the BCCI, cases take in average 9 months for disputes involving domestic parties, and little over a year in average when involving foreign parties.

<sup>29</sup> Iorio et al (1998); CSD (1999).

citizens and corporates perceive that corrupt or improper practices can also impede the delivery of justice.<sup>30</sup> Efforts are continuing within the Ministry of Justice and other agencies to tackle this range of problems.<sup>31</sup>

### *Enforcement Issues*

Much of the regulatory environment relies on public administration officials for its implementation. Reform efforts are underway to enhance the quality of their operations, including intensive training and a new comprehensive Code of Ethics for civil servants.<sup>32</sup> This is an important task since there are weaknesses in slow and uneven administrative regulation.<sup>33</sup> In fact about three-quarters of a sample of business representatives report that a weak and unresponsive administration is a significant obstacle to their business in Bulgaria.

More generally, it remains difficult to make a firm assessment of the pace, reliability and effectiveness of enforcement procedures in Bulgaria. Detailed, up-to-date statistics are not readily available, this being in part due to the relative lack of sophistication in court records and case-load documentation. That said, many observers and commentators in the market place express the view that enforcement is typically weak: an acerbic assessment from a businessman was that “the real problems with the courts start when you actually get your judgement.”<sup>34</sup>

There are at least two issues worth mentioning. One is the process of appeal in the court system. On the one hand the well-established appeal system can be regarded as a safeguard for all parties – plaintiffs and defendants alike. On the other, the slowness of court procedures can frequently frustrate the business imperatives of an injured party. Some estimates suggest that an execution in a straightforward case can typically take six months, when there is no appeal. With appeals, however, cases can easily take one or more years, by which time the remedy may be too late for the plaintiff. For example Ministry of Justice figures for 1997 suggest that of 531,000 cases in the business domain before the courts in that year, about 17 percent of them were closed during that period (by value of claims lodged, about 20 percent of cases closed). So the majority of cases appear to take in excess of 12 months for resolution.

A second point is that the resources for enforcement are also perceived to be modest. Bailiffs (“execution judges”) are part of the trained judiciary. In common with their courtroom colleagues, they have received relatively little training in recent years regarding best-practice

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<sup>30</sup> From a pool of 1114 people surveyed (April 2000) to determine the most corrupt Bulgarians: 56 percent place judges in this category; 54.4 percent place prosecutors in this category; 45.2 percent place non-judicial supporting staff in this category; 48 percent place criminal investigators in this category; and 51.9 percent place lawyers in the category of the most corrupt. Source: Coalition 2000 (2000).

<sup>31</sup> Recent actions include the Judicial Development Project (implemented by East West Management Institute and financed by USAID), which would create eight fully computerized and (with the introduction of court administrators), administratively overhauled pilot courts by the end of 2002. This is in addition to the ongoing support for the Magistrate’s Training Center (financed by USAID), where all sitting judges and judicial appointees receive specialized education and training. The EU PHARE program will extend the services of the TCM to prosecutors and criminal investigators as of 2001.

<sup>32</sup> Open to public online discussion and comments at the web site of the Bulgarian Government: [www.government.bg](http://www.government.bg).

<sup>33</sup> Problems with regulatory application have been noted by *inter alia* foreign investors and the European Commission (1998).

<sup>34</sup> Iorio et al. (1998).

techniques in the new market environment. Their own practical means of supporting their work – such as transportation, computer equipment, protection when needed – are often thin on the ground. The European Commission, for one, has recently drawn attention to inadequate funding of the judicial system as an important issue. Also systems of court related records, and access thereto, are underdeveloped (computerization has hardly commenced). This can often lead to practical, yet important difficulties on the ground, such as a bailiffs inability to tack down a defendants secured assets for lack of accurate records on the same.

It is important to turn-around this situation, since if businesses do not have confidence in the enforcement capacity of the regulatory system, this will unduly constrain risk-taking the commercial exploitation of new market opportunities. Clearly it will take time – and resources – to make a substantial improvement. One suggestion worthy of further consideration is to introduce a greater element of private participation in enforcement – such as in straightforward, non-contested cases, private notaries doing some of the work currently reserved for public officials.

### **Business Representation**

There is no shortage of associations to represent common business interests, and to engage in dialogue with Government and other partners. Notable bodies include:

- The Bulgarian Chamber of Commerce and Industry (BCCI), with close to 38,000<sup>35</sup> members representing a wide-ranging constituency;<sup>36</sup>
- The Bulgarian Industrial Association (BIA), with more than 14,000 members representing this sector;<sup>37</sup>
- The Bulgarian International Business Association (BIBA), with 130 members representing largely foreign-owned or connected companies;<sup>38</sup>
- The Employers Association of Bulgaria (EABG), with about 60 members recently established to represent large companies.<sup>39</sup>

Many of these bodies are in consultation with Government on issues of interest to their members, including in the setting of the National Tripartite Council,<sup>40</sup> which meets bi-annually to secure the views of employers and trade unions alongside Government. The Foreign Investment Advisory Council also meets twice per year with the Prime Minister and the Council of Ministers to discuss business policy questions.

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<sup>35</sup> The figure includes BCCI associated members.

<sup>36</sup> The BCCI has voluntary membership, which grew exponentially in the last ten year. Prior to the transition period, BCCI membership was restricted to foreign trade organizations (FTOs) and joint ventures with foreign participation. The conditions for open BCCI membership were created after the passing of the infamous Edict 56, allowing a mixed breed central plan-market business activities in Bulgaria. In this relation the membership base grew to about 1000 members in 1990. Web site: [www.bcci.bg](http://www.bcci.bg).

<sup>37</sup> Founded in 1980 with 400 founding members. Web site: [www.bia-bg.com](http://www.bia-bg.com).

<sup>38</sup> BIBA web site: [www.biba.mobikom.com](http://www.biba.mobikom.com).

<sup>39</sup> EABG members have an average of 500 employees. Web site: [www.eabg.org](http://www.eabg.org).

<sup>40</sup> The scope of activities and authority of the Tripartite Council is governed by the provisions of the Labor Code. For details see Chapter Labor Issues.

## Business Creation

The Commercial Code (CC)<sup>41</sup> provides the central, comprehensive regulation of: (i) the types of commercial companies and incorporation; (ii) commercial transactions and specific provision for commercial contacts; and (iii) bankruptcy proceedings and reorganization. It is item (i) upon which this chapter focuses.

### Corporate Forms

Traditionally, Bulgarian law regulating these matters follows a continental European (significantly French and German) doctrine. Following this legal tradition the types of corporate forms are determined not so much by the mechanism for raising of corporate capital,<sup>42</sup> but rather by the extent of financial liability of the entity's shareholders in commercial transactions. This key distinction in corporate structure is summarized below:

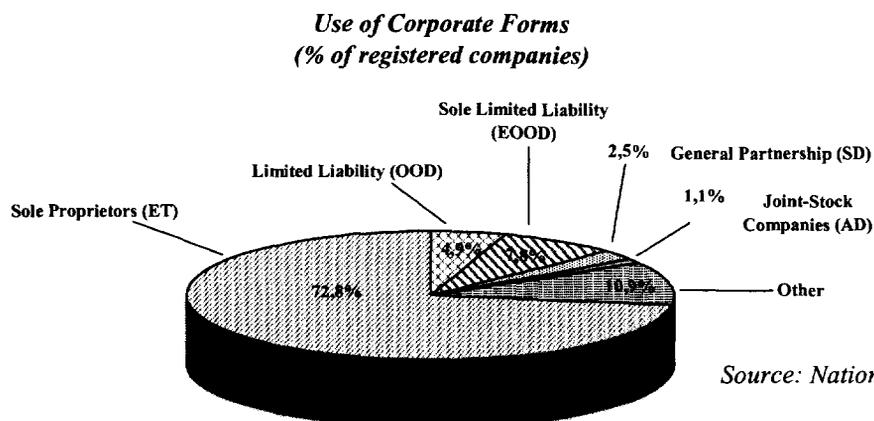
#### Unlimited liability forms:

- (i) Sole proprietor "ednolitchen targovetz" (ET);
- (ii) General partnership "sabitatelno druzestvo" (SD);
- (iii) Limited partnership "komanditno druzestvo" (KD).

#### Limited liability forms:

- (i) Limited liability company "druzestvo s ogranichena otgovornost" (OOD);
- (ii) Single-owned limited liability company "ednolichno druzestvo s ogranichena otgovornost" (EOOD);
- (iii) Joint-stock company "actionerno druzestvo" (AD);
- (iv) Single-owned joint-stock company "ednolichno actionerno druzestvo" (EAD);
- (v) Partnership limited by shares "komanditno druzestvo s actii" (KDA).

The corporate forms provided within the scope of the CC, follow international practice and allow businesses to select which corporate form is most appropriate and fitting to their commercial goals and business dynamics. The statistics of the current usage of corporate forms are included below.



<sup>41</sup> Promulgated SG, 48, 6/1991, last ammend. SG 114, 12/1999.

<sup>42</sup> Such as the differentiation of public and owner managed companies in the common law jurisdictions.

### *Unlimited Liability Forms*

General and limited partnerships are appropriate vehicles for smaller scale commercial ventures since they allow the securitization of commercial risk with the personal assets of the investors. Not requiring any minimum capital, the general partnership<sup>43</sup> can be founded by more than two persons<sup>44</sup> intending to engage in commercial activities under a joint business name. The investors in the venture are also its business proprietors and in this context there is no need for sophisticated schemes of management and representation. The partners have full discretion over the decision-making process and carry the burden of unlimited liability for actions of the company. The legally prescribed joint and several liability of the partners, whilst laying upon them as individuals greater effective risk, provides some increased safeguard for the interests of business counterparts. The corporate form is particularly convenient for entrepreneurs with limited resources.

Unlimited liability is secured on (or in effect equal to) the personal assets of the general partners, which are often insufficient to carry the liability burden for larger transactions. To achieve higher flexibility, the CC permits a corporate formation allowing limited shareholdings in commercial ventures while preserving the unlimited liability of the principal partners.<sup>45</sup> Such a partnership, the KD,<sup>46</sup> modeled after the German Komanditgesellschaft, allows for arrangements between the partners to furnish the business venture with combined general and limited liability. As the general partners bear the risk of unlimited liability, they are also responsible for management of the company, while the partners whose liability is limited to the extent of their agreed capital contribution are entitled only to an appropriate share of the profits.

### *Limited Liability Forms*

The most frequently used corporate forms are limited liability companies (OOD)<sup>47</sup> and the joint stock companies (AD),<sup>48</sup> along with their solely-owned variations.<sup>49</sup> An additional opportunity to allocate commercial risk among the partners of a commercial venture is provided under the mechanism of the limited partnership divided by shares (KDA).<sup>50</sup> For these types of corporations, the liability of the partners is limited to the amount of their agreed contribution. In this context, the limited liability forms allow investors the ability to balance commercial risk through share participation. As with the OOD and the AD, the KDA has been devised by the Bulgarian legislator after the respective Civil Law investment vehicles and is intended for medium and large scale commercial ventures. Although the CC follows the corporate forms

<sup>43</sup> Art. 76 ff. CC Sabiratelno Druzhestvo (SD) not to be confused with cooperatives. Cooperatives are regulated by a separate law and must have at least seven members, and management and supervisory boards.

<sup>44</sup> Foreigners must be legal residents in Bulgaria in order to participate in a general partnership.

<sup>45</sup> The general partnership limited by shares, following the concept of the German Komanditgesellschaft.

<sup>46</sup> Art. 99 ff. CC Komanditno Druzhestvo (KD).

<sup>47</sup> Art. 113 ff. CC Druzhestvo s Ogranichena Otvornost (OOD); Equivalent to the German GmbH and the French S.A.

<sup>48</sup> Art. 158 ff. CC Akzionerno Druzhestvo (AD); Equivalent to the German AG and the PLC in the UK.

<sup>49</sup> The solely owned limited liability company: EOOD (Art. 147 CC), follows the German model (Einman-GmbH), as its regulatory mechanism allows limiting the commercial liability for single share ownership. The EOOD is most often embraced by foreign investors (See: 1999 FIAS Report) and is next to the solely owned joint stock company, the EAD, it is the pre-privatization form used for SOEs.

<sup>50</sup> Art. 253 ff. CC Komanditno Druzhestvo s Akzii (KDA): After the German Komanditgesellschaft auf Aktien. Similar to the AD, the KDA can raise capital through public offerings and is subject to the same requirements as the AD.

inherent to continental jurisdictions, with the most recent legislative enactments,<sup>51</sup> the Bulgarian legislator codified public corporations in the context of the Anglo-American legal tradition.

A limited liability company (OOD) may be formed by any number of partners, including with a sole shareholding of capital of the company – single-owned limited liability company (EOOD). The minimum capital required to register an OOD/EOOD is BGN5,000, (approx. US\$2,500) divided into shares with registered value of not less than BGN10. The shares can be freely transferred to other partners and - in case the requirements for admitting a new partner are met - to third parties. Decisions are made by majority vote in the general meeting. One share is equal to one vote unless provided otherwise in the company incorporation agreement. Managers of OODs are appointed by the general meeting of the partners.

By law, joint-stock companies (AD) are formed by no fewer than two shareholders. The State is allowed to be the only founder and shareholder of an AD called a single-owned joint-stock company (EAD). The minimum capital requirements are: (i) BGN50,000 - if an AD is set by private offering of shares; (ii) BGN100,000 – if it is set up via public offer. Higher capital requirements apply also for ADs engaged in the provision of financial services.<sup>52</sup>

**Table 1. Number of VAT Registered Entities**

<b>Corporate Forms</b>	<b>State</b>	<b>Municipal</b>	<b>Private</b>	<b>Total</b>
Sole proprietors (ET)	0	0	446,255	446,255
General partnerships (SD)	0	0	15,072	15,072
Limited Partnerships (KD-KDA)	1	0	101	102
Limited Liability (OOD)	168	37	47,32	48,037
Sole Limited Liability (EOOD)	2,142	842	27,16	30,000
Joint-Stock Companies (AD)	323	16	5,608	5,947
Sole Joint-Stock Companies (EAD)	613	111	10	734
<b>Corporate Forms</b>	<b>State</b>	<b>Municipal</b>	<b>Private</b>	<b>Total</b>
Holdings and Consortia	11	1	202	214
Public Enterprises (SOEs)	144	184	0	328
Cooperatives	0	0	6,581	6,581
Civic Business Associations	0	0	5,425	5,425
All registered commercial entities	10,231	10,921	591,728	612,880

Note: As of May 1999 only 58,197 commercial entities are VAT registered

Source: 1999 BULSTAT Registrations, NSI

The corporate oversight of ADs in Bulgaria can be structured in a one- or two-tier system.<sup>53</sup> In the one-tier system, the general meeting of the shareholders is entrusted to vote on all matters of significant importance, with a Board of Directors responsible for the daily operations. In the two-tier management system, the role of the general meeting of the shareholders is the same, however the management of the company has two levels: supervisory board and a managing board. In both systems by law, the general meeting should be held once annually. Board members are appointed by the general meeting for a term not longer than five years, whereas, the

<sup>51</sup> The Law on Public Offering of Securities, promulgated SG 111, 11/1999.

<sup>52</sup> Minimum capital: (i) banks: BGN10 million (\$5 million); (ii) insurance companies: BGN2-4 million – depending on insurance activity; (iii) investment companies: BGN500,000. (BGN exchange rate BGN1 = DM1).

<sup>53</sup> Similar to the regulation of Aktiengesellschaften (AG) in under the German Aktiengesetzbuch (AGB).

term of the first board after incorporation, cannot be extended longer than three years. The CC does not prescribe any nationality or citizenship requirements for the members of managing bodies. Further there is no business activity for which a particular management form is mandated.

### **Process of Incorporation**

Under Bulgarian law, the incorporation of commercial entities becomes effective upon registration at the District Court's Commercial Register. This registration process is straightforward and in line with international best practices, involving as it does the submission of duly completed forms furnished with evidentiary documentation.<sup>54</sup> However businesses have reported some frustration with the time the process can take, related to the constrained capacity of the courts of registration to handle a rapidly growing number of applications.<sup>55</sup>

The CC prescribes the conditions which need to be met prior to the registration of a commercial entity, the most significant of which are the minimum capital requirements. For example, the founding partners of a limited liability company must contribute at least 70 percent of the company's capital prior to registration.<sup>56</sup> With respect to joint stock companies, at least 25 percent of the subscribed shares<sup>57</sup> must be paid prior to incorporation. The shareholders may pay for the subscribed shares in cash, or meet capital obligations in-kind<sup>58</sup> by contributing: (i) imported machines, (ii) technological equipment or installations; (iii) including vessels, aircraft, railway, and motor vehicles. As the in kind contributions are actually made upon the monetary value of the contribution to the company's capital, the CC prescribes a special regime governing order for performance, appraisal<sup>59</sup> and registration of these contributions with the commercial registry of the court.

Intending to make certain corporate information publicly available, all details concerning the: (i) official business name and registered office; (ii) management bodies; (iii) partners with limited or unlimited liability; and (iv) facts related to incorporation and transformation are recorded in the commercial register of the Court and respectively promulgated. The typical cost of registering a company is about BGN35 (US\$17), which seems appropriate for the country and cheap by comparison with international norms.

The incorporated entity is subject to registration with the tax authorities, the National Statistics Institute and the Social Security Service. With the new Law on Statistics these requirements are

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<sup>54</sup> Such as proof of residence.

<sup>55</sup> Unofficial estimates indicate that about 50 percent of the commercial caseloads of the courts is related to company registration. Some commentators, argue that keeping the company register within the courts is a waste of judicial capacity; for detailed discussion see: "Bulgaria: Judicial Assessment", The World Bank, 1999; Program of the Judicial Reform Initiative, JRI/CSD, 1999, Assessment Report of Bulgaria's Judiciary, SIGMA, 2000.

<sup>56</sup> Art. 117 CC: The minimum capital requirement for the registration of an OOD is BGN 5,000.

<sup>57</sup> Art. 161(2) CC: The minimum capital requirements for the registration of an AD is BGN 50,000, respectively BGN 100,000 if the capital is raised via public offering. For the establishment of banks, insurance companies and investment companies the capital requirements are significantly higher: BGN 10,000,000 for banks, BGN 2,000,000 for insurance companies, etc.

<sup>58</sup> Art. 72-73 CC.

<sup>59</sup> Art. 72(2) CC: The evaluation must be performed by three independent appraisers.

included in the mandatory statistical registration (BULSTAT)<sup>60</sup> process, which is fairly straightforward and takes about one week.<sup>61</sup>

This BULSTAT Registry is accessible and can be viewed by an interested party via the Internet. It also enables checks to be run on corporate applicants, for example on whether or not proposed company directors are fit and proper persons. It could be improved further by including access to balance sheet information, which is currently not easily obtainable.

## Privatization

Another route for business creation in the private sector in recent years has been offered through the privatization process. Since 1993 various techniques have been used, including open and closed tenders, auctions, management-employee buy-outs, negotiations with potential buyers, and Stock Exchange sales. The privatization process<sup>62</sup> is being carried out under three separate, but associated programs: (i) cash privatization of state and municipal property; (ii) voucher privatization; (iii) restitution of land, forests and urban property. Within the decentralized privatization model, the Privatization Agency (PA) operates as the main privatization authority, while the (i) small scale privatization of state-owned enterprises (SOE) is managed by the respective line ministries; (ii) the privatization of municipal property is under the authority of the respective municipalities; (iii) the voucher privatization scheme is executed by the Center for Mass Privatization (CMP).

As of late 2000, some 85 percent of state-owned assets originally slated for privatization had been transferred to the private sector. It is not our objective here to provide much further review – a detailed discussion can be found in relevant publications.<sup>63</sup> Specific points of interest include:

- A prevalent use of MEBOs, which were offered attractive participation terms (now curtailed since early 2000);
- A modest voucher scheme (accounting for about 10 percent of total assets sold), now in its second and last stage;
- A tie-in with state debt instruments (Zunk bonds) which can be used as a payment method to buy privatized assets;<sup>64</sup>
- Very little use of the stock exchange, which remains relatively small and underdeveloped.

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<sup>60</sup> Art. 35(3) Law on Statistics promulgated SG 69, 6/1999

<sup>61</sup> FIAS (1999)

<sup>62</sup> By Fall 2000, about 1,600 privatization transactions had been concluded, with about 2/3 of those completed in the most recent three years.

<sup>63</sup> Privatization in Bulgaria, Stoyanova et al., OECD conference paper, 1998.

<sup>64</sup> Up to 50 percent of the negotiated price of SOEs can be offset against external (Brady bonds) or internal (ZUNK bonds) state debt instruments. As of 1999, in the same manner may be utilized compensatory notes. The notes are issued to indemnify former owners of nationalized properties not subject to restitution. By law these can be used in all privatization transactions, as well as for payment in the acquisition of selected government securities. Depending on the activity and area of investment, the provided up-front discount through the use of state debt instruments can be also combined with future benefits encompassed within the tax incentive regime.

- Numerous updates of legislation governing privatization, with the most recent changes (Fall 2000) seeking to enhance transparency and involve Parliament (in sectors of strategic importance).

## Concessions

The use of concessions can also be viewed as another route to the creation of private business in the Bulgarian context. In the past, large spheres of economic activity, particularly in public utilities and infrastructure, were regulated and supplied by the public sector. But with deteriorating facilities and falling standards of service, the Government and its agencies are looking to encourage private participation in these sectors. As experience in many OECD and emerging market economies has shown, this is an important mechanism to attract much-needed investment and modernization in key sectors.

The Constitution regulates that actions in particular areas, and ventures utilizing certain properties<sup>65</sup> are within the sovereign exclusivity of state. As of June 2000, the principal governing legislation is the Law on Concessions.<sup>66</sup> This allows private companies, including foreign individuals and entities, to engage in commercial activities in these areas of sovereign exclusivity,<sup>67</sup> as well as in areas where the constitution grants monopolistic status to the state.<sup>68</sup> This is motivated by the concept of increased fiduciary care<sup>69</sup> in areas of pronounced public interest, which by law supersedes the otherwise protected freedom of private entrepreneurship.

In this respect, the Constitution allows the authorities, vested with the powers to safeguard the public interest, to prescribe market behavior in areas where private commercial dealings raise implications and obligations of public concern. Based upon this constitutional principle, and by extension the principle of local self government, the privilege to engage in commercial activities<sup>70</sup> may be granted for activities utilizing: (i) public state property and public municipal property, including when the object of the concession will be constructed by the concessionaire, and: (ii) for activities constitutionally defined as state monopoly.<sup>71</sup>

### *Concessions granted by the state*

Under the Law on Concessions, such privileges are granted by the Council of Ministers with respect to: (i) the development and exploitation of underground mineral resources; (ii) beaches; (iii) activities concerning the development and exploitation of the biological, mineral and energy

<sup>65</sup> This concept comes in continuation of the established legal tradition in Bulgaria to vest authority to dispose and utilize property within the public domain in the sovereign powers. Prior to 1944, concessions were granted exclusively by the Parliament.

<sup>66</sup> Law on Concessions (LC) promulgated SG 93/10/1995 last ammend. SG 12/2/2000.

<sup>67</sup> Art. 4 LC.

<sup>68</sup> Art. 5 LC.

<sup>69</sup> Art. 18 (6) Constitution RB.

<sup>70</sup> Concessions are granted only with respect to commercial activities. Commercial companies with state and municipal participation are also subject to the general concession regime. Companies excluded from the concession requirement are those with 100 percent state participation: § 3 Final Provisions to the LC.

<sup>71</sup> Art. 18 Constitution RB. Art. 18(3) includes the activities in the area of telecommunication which allows an exclusive monopoly of the state, however these are not subject to the concession regime established under the LC but are subjected to licensing under the new Law on Telecommunications promulgated SG 93/1998 last amend. SG 10, 2/2000.

resources of the continental shelf and exclusive economic zone; (iv) the republican road network; (v) ports and airports for public transportation, including their separate structures; (vi) water resources and mineral waters; (vii) irrigation and water supply structures and systems; (viii) forests and national parks; (ix) utilization of nuclear facilities and the use of nuclear energy; (x) natural and archeological reservations; (xi) the railroad transportation of passengers and cargoes; (xii) the manufacturing of radioactive products, weapons, explosives and biological substances of formidable effect.

#### *Concessions granted by municipalities*

Under the Law on Municipal Property, the municipalities are authorized to grant concessions with respect to activities utilizing public municipal property and activities which fall within the competence of the municipality to serve the public.<sup>72</sup> These are serving public needs to: (i) water resources and mineral waters used exclusively for municipal needs; (ii) municipal water basins and their beaches; (iii) mineral resources extracted for the needs of local populations and not exceeding 10,000 cubic meters annually; (iv) local roads and parking facilities; (v) municipal forests; (vi) municipal water supply and sewerage; (vii) passenger transportation and activities involving its infrastructure; (viii) commercial activities utilizing public municipal property. In order to create uniformity of the regulatory framework, the recent amendments to the law synchronize the term of concession agreements granted by the municipalities with these granted by the central government.<sup>73</sup>

#### *Concessions in place*

Whilst this legislation sets an overall framework of reasonable adequacy, reports from practitioners in the marketplace reveal that much remains to be done to forward this agenda. Success stories can be found, for example, in the exploitation of certain natural resources. Upwards of 15 concessions, for terms ranging between 10 and 30 years, have been granted for usage of ores, limestone and other minerals. Foreign-owned companies are amongst the concessionaires. In the energy sector, including oil and gas, whilst some exploration rights have been awarded, full exploitation has not ensued. The new (1999) Law for Underground Exploration and Exploitation provides a clearer framework for such concessions, for which there could be considerable potential in the mining sector. Again, however, to date no such concessions have been awarded, perhaps reflecting the fact that the involvement of several ministries and agencies in the process makes for bureaucratic hindrances.

In the water sector, by contrast, no concessions are yet operating. In Sofia, a deal has been concluded, and it is hoped that private sector managed services will be started by 2001. Much groundwork has been done in other cities including Varna and Shumen. Key points in the legal framework, however, remain to be clarified. In certain cases the assets under question – for example the pipe network for water – are not considered as public (and so suitable for concession) since they are registered with the regional water companies (RWCs) which are private limited companies. To resolve this, an amendment to the Water Act<sup>74</sup> is required to clarify public ownership status.

<sup>72</sup> Art. 67(1) Law on Municipal Property, promulgated SG 44, 5/1996, last amend. SG 96, 11/1999

<sup>73</sup> Concession agreements have an initial term not longer than 35 years, with a limit of 50 years total term of the concession agreement after respective extension: Art. 3 LC, and Art. 67 ff. Law on Municipal Property.

<sup>74</sup> Specifically to Article 96 of the Water Act.

Similarly, progress has also been very limited in the transport sector. Whilst it is reported that there are no legal obstacles for a toll road or toll bridge to be built and operated with private participation, this has not yet occurred (although a scheme for a major toll-highway was explored as far back as 1993). Low traffic volumes and limited capacity to pay may be the main constraining factors.

## Licensing

Broad based considerations for business start-ups also come into play in relation to the licensing regime. As in most countries, both central and local government agencies are given certain legal powers to regulate business, for a variety of purposes typically related to protection of public interest. Much of the licensing authority for local Government emerges from the Law on Local Self-Governance and Local Administration (1991). Typical examples include planning and building licenses, and permits for the sale of certain products such as alcohol and tobacco. The authority for central Government or national agency licensing emerges from sector-specific legislation applying country-wide standards. Examples include licensing for transport operations,<sup>75</sup> health and safety,<sup>76</sup> and environmental controls.<sup>77</sup>

Given the wide-ranging nature of licensing, it is not the subject of review in this paper.<sup>78</sup> It is worth reporting, however, a common theme emerging from business representatives and others. The complaint is that these types of licenses are frequently over-burdensome in their design, slow or capricious to obtain, and the source of malpractice in their issuance. One survey<sup>79</sup> found that a new company could quite easily require 10 or more licenses or other permits, and that this could take 7.5 weeks of input (with 14 calls on the public institutions involved) before completion. The average cost to the business was put at BGN176 (about US\$100). Whilst these figures are not out of line with experience in some other countries, they also indicate that there is room for improvement in this interface between the public sector and businesses. Reviews have focused on items such as improving the clarity of documentation; streamlining submission requirements (notably by sharing information better between public agencies); and curtailing unnecessary licensing.

The Government has accepted much of this criticism and launched a process to eliminate or streamline licensing requirements.<sup>80</sup> In January 2000 it announced that some 44 licenses would be eliminated and 104 would be simplified, and that the review process would continue with further changes anticipated throughout 2000. This is a welcome change and attention must continue to be focused on this exercise. It remains a challenge not least because of indications that in recent years license requirements have been growing sharply.<sup>81</sup> At the same time the

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<sup>75</sup> Governed by the Law on Road Freight Transportation (SG 92, 17 September 1999).

<sup>76</sup> Regulated by the Hygiene-Epidemiological Institute.

<sup>77</sup> Set out in the Law on Environment and Water Protection.

<sup>78</sup> Further reviews of the licensing and regulatory regime can be found in Turkewitz, Joel 2000: "Assessment of the Bulgarian Regulatory System", Draft Paper, and Yonkova et al. 2000 "Legal and Regulatory Reform: Impacts on Private Sector Growth", Institute for Market Economics. Sofia, Bulgaria.

<sup>79</sup> A survey of business experience of licensing in retail and wholesale trade, and commercial transport.

<sup>80</sup> The Program for the Optimization of Licensing, Permit, Registration & Coordination Regimes.

<sup>81</sup> The IME study reports that there are now 106 licensing requirements, up from below 10 at the beginning of the 1990s.

number of companies has risen rapidly, increasing the administration and monitoring task. A more robust and embedded approach is needed which seeks to enforce (self) discipline on the public sector in its regulatory role. Although some EU states may themselves have considerable licensing regimes, Bulgaria must choose one which suits its needs, balancing business needs whilst at the same time respecting the EU's core standards.

## Regulating Corporate Operations

### Management and Representation

As is common to the European corporate structures on which Bulgaria's regulations are modeled, broadly the stake held by a shareholder in the formation of corporate policy – and oversight of management – reflects the shared participation in the corporate capital base.<sup>82</sup> In practice for corporations based upon shared capital there are many variant schemes of management and representation. The partners in a limited liability company form corporate policy jointly<sup>83</sup> as they decide upon: (i) changes and amendment of the articles of association; (ii) admittance of new partners and the exclusion of existing ones; (iii) acceptance of the annual balance and division of profits; (iv) increases and decreases of the company's capital; (v) appointments of the director; (vi) openings of company branches and participation in other companies; (vii) acquisitions and sales of real property; (viii) additional contributions; and (ix) claims against directors.

For the shareholders of joint stock companies, the share in the company's capital determines the participation and voting power in the devising of corporate policy and appointment of management and supervisory bodies. All shareholders in the company convene at least once annually for the general meeting of shareholders.<sup>84</sup> The general meeting is vested with the powers to determine corporate policy as it decides upon: (i) changes and amendments of the articles of association; (ii) increases and decreases of the capital; (iii) transformations and liquidations, including the engagement of liquidators in cases different than bankruptcy; (iv) elections and dismissals of directors in a one-tier management structure<sup>85</sup> or the members of the board of directors and a supervisory board in a two-tier management structure,<sup>86</sup> (v) engagements and dismissals of certified accountants; (vi) approvals of the annual balance; (vii) issuances of bonds.

Current legislation places certain restrictions and responsibilities on management actions, to prevent the worst possibilities of malpractice. The existing rules in this respect are consistent with EU Directives.<sup>87</sup> However neither the CC nor securities law require<sup>88</sup> the disclosure of biographical or other material information on directors,<sup>89</sup> such as long-term relations between board members, suppliers or major shareholders. Additionally, the securities regulations need to impose clearer disclosure requirements on the shareholdings of board members to increase

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<sup>82</sup> A similar philosophy applies in respect of financial issues, see chapter 5.

<sup>83</sup> Art. 136(1) CC.

<sup>84</sup> Art. 219 ff. CC.

<sup>85</sup> Art. 233 ff. CC.

<sup>86</sup> Art. 241 ff. CC.

<sup>87</sup> Directors are required to maintain a deposit at the company of no less than three months' salary. They are jointly and severally liable for damage arising from their breach of duty and there appears to be no provision by which the shareholders can indemnify them other than absolute proof of no fault. (Art. 240 CC). For detailed discussion see: Bates, J, et al: (2000) :72.

<sup>88</sup> LPOS.

<sup>89</sup> Currently, only in the banking sector there is a register of disqualified directors. For all other corporate entities, prospective directors must present only a court record listing pending and closed cases against them. The court record certificate is standard for all inhabitants, obtainable from any regional court office.

accountability and restrict insider trading. The requirements for disclosure of board decisions and activities is also very limited. The stock exchange (BSE) has the power to require disclosures of this kind, however, no such disclosure has yet been required.<sup>90</sup>

Compared against the relevant provisions of corporate governance standards as set out by the OECD,<sup>91</sup> the Bulgarian legislation meets many items of recommended practice, but certain aspects could benefit from improvement. It is necessary to introduce clear criteria for distinguishing outsider from insider non-executive board members, as well as guidelines as to how board composition can be balanced between the two.<sup>92</sup> It would be beneficial to introduce remuneration practice guidelines linking top managerial pay to company performance, as well as an obligation to align the shareholding incentives of board members with those of shareholders.

Another topic of interest is the protection of minority shareholders' interests, which has been viewed as a problem in many transition economies.<sup>93</sup> The protection mechanism<sup>94</sup> for small individual investors and respectively minority shareholders is relatively limited. Whilst the law contains some provisions which accord with international norms, there are reports<sup>95</sup> that the practical effect is less positive. In addition, the majority of individual shareholders in Bulgaria are citizens who became shareholders via privatization and voucher schemes. In general, they have no experience as owners and lack the shareholder activism to make sure that their shares grow in value.<sup>96</sup> To engender confidence in corporate management standards, and underpin the broadening of share ownership across the community, this is an area for priority action.<sup>97</sup>

## Transactions and Contracts

The regulatory mechanism provided under the Commercial Code does not deviate substantially from similar provisions in most civil law jurisdictions. Aligned with international best practice are the general provisions governing: (i) concluding of commercial transactions,<sup>98</sup> including due

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<sup>90</sup> Bates, J., et al. 2000.

<sup>91</sup> OECD Principles of Corporate Governance, OECD, 1999.

<sup>92</sup> Executive remuneration is currently very low by Western standards and it is almost understood that this must be supplemented with commissions earned from various activities associated with managerial and board positions. See: Bates, J., et al (2000).

<sup>93</sup> See: Transition report, EBRD, 2000; *The Economist*, July 2000.

<sup>94</sup> As established under the provisions of the Commercial Code (CC) and Law on the Public Offering of Securities (LPOS).

<sup>95</sup> Many reports set examples of breach of minority shareholder interests. For detailed discussion see: Transition Report, EBRD, 2000; and Bates, J., et al (2000).

<sup>96</sup> Employee-shareholders' main concern is to keep their jobs. It was argued that, no matter how good the law, small/individual investors are unlikely to take advantage of the authority that the law gives to minority shareholders. Bates, J., et al (2000).

<sup>97</sup> Aside from the gaps in the formal regime, and indications of practices which have been discriminatory, implementation in policy has perhaps been a systemic governance problem. For detailed recommendations see: pp. 74., Bates, J., et al. (2000) : 53

<sup>98</sup> Art. 286 ff. CC.

care<sup>99</sup> and force majeure<sup>100</sup> provisions; (ii) leasing,<sup>101</sup> commission,<sup>102</sup> and freight contracts.<sup>103</sup> Slightly more detailed are the provision governing insurance<sup>104</sup> and banking transactions,<sup>105</sup> corporate debentures<sup>106</sup> and their maturity.<sup>107</sup>

The enforcement of contracts is implemented via the courts. Here business representatives report weaknesses, in that with about two in every five judging that poor enforcement of laws is a significant obstacle in doing business (though not as serious an issue as some other problems). The perspective seems to be that whilst contract agreements are typically well regulated in principle, much remains to be done to put this into more robust effect. A "Court of Arbitration" has been established for nearly fifty years at the Bulgarian Chamber of Commerce and Industry (BCCI). Also much more recently an NGO called Partners Bulgaria has conducted training programs for mediators and assisted in several mediations of commercial disputes between private parties.

Provisions also exist for arbitration and appeals on contracts to be conducted outside the mainstream Bulgarian courts.<sup>108</sup> With the exception of private arbitration (whose use is limited), the system does not provide meaningful alternatives to a full (and lengthy) trial, nor does it feature "small claim" courts (known for their simplified procedures and limited appellate rights). Without the pressure of imminent judgement, the parties' incentives to mediate their disputes (or use the conciliation alternative) remain weak. The unavailability of law-based alternatives to trial denies businesses alternative avenues through which to pursue their disputes. Given the institutional weakness of the court system and its lack of appeal to the business community, dispute settlement options such as mediation and conciliation would afford litigants a viable option to a full trial.

On large-scale commercial transactions, Bulgarian legislation also permits, where both parties consent, for appeals or arbitration to be conducted by international agents outwith the country boundaries. Some commentators have argued that the legislative framework lacks clarity in permitting such arrangements when a foreign-registered company is involved.

## Competition Law

Bulgarian competition law – an important building block of well functioning markets and proper corporate governance - follows EU doctrine, which penalizes companies for discriminatory behavior aimed at promoting their dominant position within the market. Within the scope of the law are all entities which directly or silently prevent, restrict or violate competition, or are in the

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<sup>99</sup> Art. 302 CC.

<sup>100</sup> Art. 306 CC.

<sup>101</sup> Art. 342 ff. CC.

<sup>102</sup> Art. 348 ff. CC.

<sup>103</sup> Art. 361 ff. CC.

<sup>104</sup> Art. 380 ff. CC.

<sup>105</sup> Art. 420 ff. CC.

<sup>106</sup> Art. 455 ff. CC.

<sup>107</sup> Art. 486 ff. CC.

<sup>108</sup> For detailed discussion see: Iorio, A., Mikhlin, G. 1999 "Bulgaria: Judicial Assessment", The World Bank Washington, DC.

position to do so. This broadly encompasses: (i) all domestic or international entities; (ii) executive bodies and local self-governments; (iii) private entities which were granted privileges by the state to provide services in the public interest; (iv) individuals which assist the creation of monopoly position and unfair competition practices.

At the same time, the legal provisions are not applicable to: (i) relationships covered within the scope of the legislation for the protection of industrial property, copyright, and associated rights; (ii) actions resulting in the restriction and violation of competition in other countries, unless explicitly prohibited by international treaties. The competition regime provides opportunities for recourse against the anti-competitive actions of market participants aimed at the prevention, limitation or violation of competition. The protective mechanism of the law is triggered upon the presumption that the defined prohibited actions may lead to distortion of the competition in the relevant market.

Statutes prohibit (or significantly limit): (i) agreements and decisions aimed at market dominance,<sup>109</sup> and the concerted practices of several companies; (ii) abuses of monopolistic or dominant position in the relevant market; (iii) price-setting and those state aids<sup>110</sup> (direct and indirect forms) which distort competition; (iv) concentrations of market share; and (v) unfair competition practices.<sup>111</sup> In fact the Law on Accounting (Accounting Standard 20) explicitly envisages an obligation on enterprises which receive state aid to have data on the form and type of such assistance as an attachment to their annual accounting reports. The competition regime broadly defines prohibited behavior, whereas the monitoring of market behavior<sup>112</sup> is entrusted to the Commission on the Protection of Competition (CPC), which has closely defined discretionary powers.

The CPC is appointed by the National Assembly and its eleven members can be appointed for up to two consecutive five-year terms. It is vested with the authority to: (i) make determinations on violations and to impose legally defined sanctions; (ii) issue permits; (iii) suggest to bodies of the executive and local governments to appeal regulations in violation of competition. It is authorized to intervene in economic activity by: (i) surveying the positioning of entities in the relevant markets; (ii) influencing executive bodies and institutions and local governments with respect to their decision-making processes; (iii) giving opinions on matters of privatization and transformation of state-owned enterprises.

Some research has indicated that the CPC had a very active case-load in the early to mid-1990s. Many of the cases appeared to be related to contract enforcement issues or property rights. As the CPC has become a more well-established organization (and as market-players have grown in size), efforts are continuing to strengthen its effectiveness and focus more actively and selectively on anti-competitive practices that restrict entry and expansion.

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<sup>109</sup> Art. 9 Law on the Protection of Competition (LPC), promulgated SG 52, 5/1998, last amend. SG 81. 9/1999.

<sup>110</sup> The Government is developing further instruments to clarify and regulate the use of state aids.

<sup>111</sup> Art. 1(2) LPC.

<sup>112</sup> Competition in specific sectors of the economy, including for example telecommunications, provision of voluntary private pensions, are regulated by the respective agencies viz. the State Commission on Telecommunications; the regulator on Private pensions. These sector specific competition regulations are not reviewed in this paper.

### *Prohibited Agreements, Decisions and Consorted Practices*

The competition regime seeks to eliminate corporate deals and practices intended to prevent, limit or violate competition. By statutory definition,<sup>113</sup> null and void are arrangements between associated or consolidated companies aiming at the creation of uniform practices with respect to: (i) pricing; (ii) market or supplier segmentation; (iii) limiting of production output; (iv) limiting of trading areas; (v) agreed control of research and development or investment activities; (vi) selectivity in the contractual conditions for different business counterparts; (vii) conditioning of commercial agreements in a manner different than established trade practices.

In line with the government's efforts to further the reform process and encourage exports, excluded from the prohibitive regime are agreements and consorted practices of enterprises which, in their essence: (i) increase product quality; (ii) result in higher quality service provision; (iii) contribute to technical and economic progress or raise competitiveness of Bulgarian entities on external markets; and (iv) allow for equally distributed economic gains to the general public in the country.<sup>114</sup>

### *Monopolistic and Dominant Positions*

With monopolistic position provided to private counterparts under the concessions regime, Bulgarian law directly endorses monopoly positions and exclusivity on particular economic activities<sup>115</sup> on behalf of the state. To preserve equal opportunity<sup>116</sup> for all market participants not engaged in the public domain, any other form of monopoly is examined to ensure that such a position does not abuse the operation of the market. In terms of dominant position, the regulatory regime imposes a self-notification duty of prohibited activities to the Commission on Protection of Competition. The Commission decides upon the permissibility of these actions in terms of their likelihood to distort the market. The legitimacy of otherwise prohibited actions is measured with respect to their possible effect on competition. By statutory definition, the effect is limited if the combined market share of evaluated market participants is not larger than 5 percent of the relevant market. Competition in the relevant market may be determined as distorted if the dominant position of associated companies involves the control of more than 35 percent market share.

### *Governmental Subsidies and Price Setting*

In cases where entities have established a monopolistic position in violation of the LPC, the Council of Ministers is entitled to set the pricing policy of the violating entity.<sup>117</sup> This regime is different than the fairly limited authority of the Government to subsidize private businesses. State assistance to commercial enterprises which may potentially distort competition is prohibited. Not affected by the prohibition are only: (i) subsidies for social relief provided directly to consumers; (ii) national assistance for damages caused by natural disasters or other emergency situations.

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<sup>113</sup> Art. 9 LPC.

<sup>114</sup> Art. 13(1) LPC.

<sup>115</sup> Art. 18(4) Constitution RB.

<sup>116</sup> This rule is particularly invaluable to small and medium commercial ventures sprouting in a market defined by large enterprise formations inherited from the past and the few cash-rich foreign investors entering the market under privatization schemes.

<sup>117</sup> Art. 19 LPC.

All other subsidies must be reviewed by the Commission on the Protection of Competition. It may allow subsidies which would otherwise be prohibited if these are aimed to: (i) accelerate economic development in areas of high unemployment; (ii) promote commercial activities in weak economic sectors; (iii) support the completion of priority projects; (iv) aid in the preservation of national cultural and historical assets; (v) assist the implementation of recommendations made by external parties monitoring Bulgaria's state subsidy regime.<sup>118</sup>

### *Unfair Competition*

The established regime prohibits unfair competition.<sup>119</sup> This is broadly determined as practices violating good faith and established trade customs, which potentially harm both competitors and consumers on the internal market. By statutory definition<sup>120</sup> unfair competition is: (i) maligning the competitors name or image; (ii) misleading promotional practices; (iii) imitations; (iv) unfair solicitation of clients.<sup>121</sup> The Commission decides if violations of this kind are present and is authorized to impose monetary sanctions.<sup>122</sup> The Commission is further authorized to influence governmental agencies with respect to regulations, ordinances and other administrative rules contradicting the competition regime. In this respect, the Committee may initiate judicial review of the actions of governmental agencies.

### **Copyright and Protection of Intellectual Property**

For some businesses the ability to make, maintain and enforce copyrights and other protective tools for intellectual property are integral to their operation. Since the transition Bulgaria, starting from a low base, has fairly rapidly developed a legal framework for this purpose. The central instrument is the Law on Copyright and Related Rights (LCRR),<sup>123</sup> substantially updated in April 2000 from its original version. This law attempts to now conform more fully to EU standards in items such as protection of software, artistic copyright, publishing and broadcasting. The implementation of copyright protection falls under the umbrella of the Ministry of Culture, with the National Film Center having responsibility for copyright on films and videos. Abuse of copyright, however, is punishable by relatively modest fines.

In addition Bulgaria is a member of the World Intellectual Property Organization (WIPO) and a signatory to a host of international agreements in this area, such as the Universal Copyright Convention. As a member of the World Trade Organization (WTO) it is also committed to implementing the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS). Notwithstanding this framework of protection, some had argued that in practice substantial abuses were occurring. In particular the US authorities placed Bulgaria on the US Trade Representative's Special 301 Priority Watch list in January 1998 amidst complaints of widespread illegal duplication of compact discs. Since then the US administration has recognized significant improvement in implementation and removed Bulgaria from the watch list in April 1999.

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<sup>118</sup> Art. 20(4) LPC.

<sup>119</sup> Art. 30(2) LPC.

<sup>120</sup> Art. 31-35 LPC.

<sup>121</sup> Art. 34 LPC.

<sup>122</sup> Of up to BGN 500,000 for commercial entities and up to BGN 20,000 for individuals engaged in such practices.

<sup>123</sup> LCRR, promulgated SG: 56/26.06.1993; last amend.: SG 28/04.04.2000.

The Law on Patents<sup>124</sup> (LP), together with three new laws brought into force in 1999 – the Law on Industrial Design,<sup>125</sup> the Law on Marks and Geographic Designations<sup>126</sup> (LMGD), and the Law on Topology of Integrated Circuits<sup>127</sup> (LTIC) – provide the framework for protection of industrial property. Patents may be granted on inventions and specific machinery, for periods of between 10 and 20 years, and the approach is similar to that used in common international practice. Trademarks are protected through steps including registration with the Patent and Trademark office. The Bulgarian approach also conforms with international cooperation and best practice in that right of priority to a trademark is established based on the timing of a request made in Bulgaria and/or one of the member countries of the Union for the Protection of Industrial Property. Enforcement of trademark protection is implemented by the Patent Office and breaches can incur substantial fines (over US\$250,000), although as in many countries catching minor offenders such as market traders is not an easy task.

### Labor Legislation

The core legislation covering labor issues from a corporate perspective is the Labor Code (LC).<sup>128</sup> Even though the original provisions of the LC, have been subjected to revisions and amendments on an almost bi-annual basis,<sup>129</sup> many commentators<sup>130</sup> have argued that this law is outdated, reflecting a different socio-economic model than the one now being developed in Bulgaria. In this regard the Government, in consultation with its social partners, has prepared amendments to the LC, which were submitted to Parliament in June of 2000, and adopted in the first part of 2001. Our discussion indicates how provisions are expected to develop, along with the influence of other relevant legislation including the much debated Law on Unemployment Security and Employment Incentives (LUSEI).<sup>131</sup>

In recruiting workers, there are relatively few regulations outside the scope of the LC, and those which do exist conform with established international practice.<sup>132</sup> For the most part, the legislative intent behind the regulatory framework is in conformity with European Union standards. An employer may utilize the services of the National Employment Service to advertise a vacancy, or may use any other recruitment channels of his choosing. There are

<sup>124</sup> LOP, promulgated SG: 27/02.04.1993; last amend.: SG 81/14.09.1999.

<sup>125</sup> LID, promulgated SG 81/14.09.1999.

<sup>126</sup> LMGD, promulgated SG 81/14.09.1999; last amend.: SG 82/17.09.1999.

<sup>127</sup> LTIC, promulgated SG 81/14.09.1999.

<sup>128</sup> Labor Code (LC), promulgated: SG 26/01.04.1986; last amend.: SG 110/17.12.1999.

<sup>129</sup> LC has been revised and amended 32 times since the adoption of its original text in 1986.

<sup>130</sup> For details see: FIAS (1999); IMF (1999)

<sup>131</sup> Law on the Unemployment Security and Employment Incentives (LUSEI), promulgated: SG 120/16.12.1997; last amend.: SG 110/17.12.1999; as well as related Law on Foreigners in Republic Bulgaria (LFRB), promulgated SG 153/23.12.1998; last amend.: SG 70/06.08.1999; and secondary regulations: Implementation Guidelines to LUSEI, adopted with Regulation No.152, SG 81/15.07.1998; and Ordinance on the Order and Conditions for the Issuance of Work Permits to Foreigners in Republic Bulgaria, adopted with Regulation No. 257, published SG 4/15.01.1993, last revision: SG 120/16.12.1997.

<sup>132</sup> Labor relations within the scope of the LC are also governed apart from the LUSEI and its related laws and secondary rules and regulations (Ibid.), also by: (i) Law on Administrative Procedure (LAP), promulgated: SG 90/13.11.1979; last amend.: SG 83/21.09.1999; (ii) Law on Administrative Violations and Penalties (LAVP), promulgated SG 92/28.11.1969; last amend.: SG 114/30.12.1999; (iii) Law on Public Health (LPH) promulgated: SG 88/06.11.1972; last amend.: SG 36/02.05.2000; Law on the Defense and the Armed Forces of Republic Bulgaria (LDAFRB), promulgated: SG 112/27.12.1995; last amend.: SG 64/04.08.2000.

provisions to prevent discrimination<sup>133</sup> according to sex, age, ethnic group, or disability,<sup>134</sup> however, the positive criteria defining those groups are not very straightforward. Special regulations are in place for the hiring of non-nationals,<sup>135</sup> which in our assessment are not more burdensome than common international practice.<sup>136</sup>

Several provisions exist on the modality of employment. In respect of contract forms, current options allow the fixed-term, and open-ended forms.<sup>137</sup> Broadly, open-ended contracts, viewed as permanent, bestow upon the worker a wide range of benefits, including among others, paid annual vacation, leave due to illness of the employee or immediate family, seniority rights and training benefits.<sup>138</sup> At the other end of the spectrum are those workers employed under fixed-term contracts which grant them very little job security. The March 2001 amendments curtail the use of fixed-term contracts, which the Government considers have become too prevalent and in many cases act against legitimate social interests. With the respective amendments, the fixed-term contracts will still be permissible, but up to a maximum of two consecutive fixed-term contracts, after which the employment relation is to be governed by the provisions of the open-ended forms, granting in this manner a more permanent status to employees. The new package as a whole appears consistent with many European models.

In releasing workers, regulations<sup>139</sup> are more detailed. Currently, to effect a redundancy an employer among other things has to:

- Provide a notice of termination based on just cause (with minor exceptions);
- In cases of termination protected categories of employees,<sup>140</sup> consult with the National Employment Service and Trade Unions.

The LC regime governing lawful termination has fostered much debate, quite understandably, particularly in view of the socio-economic impact vested in such regulations. The provisions of the LC in its current version, grants employers with a fairly broad authority to dismiss employees. The most stringent limitation is the requirement to give advance notice of the termination. Closely regulated are the cases where employment contracts may be unilaterally and effectively terminated without such notice.<sup>141</sup> These are, in general, the cases where the actions of the employee justify such drastic measures: the employee (i) is imprisoned to serve a sentence; (ii) has her/his professional qualifications, diplomas, or residency in place of employment revoked by court order; (iii) has her/his membership in professional organizations allowing the practice of the profession cancelled; (iv) employee refuses job placement offer; and (v) immediate termination upon disciplinary measures due to serious misbehavior of the employee at the work place.

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<sup>133</sup> Art. 8 ff. LC.

<sup>134</sup> Art. 319-326 LC.

<sup>135</sup> For detailed discussion see: FIAS (1999:7-26)

<sup>136</sup> Art. 98 ff. LUSEI.

<sup>137</sup> Art. 66-68 LC.

<sup>138</sup> Art. 61 ff. LC.

<sup>139</sup> Art. 328 ff. LC.

<sup>140</sup> Art. 333 LC.

<sup>141</sup> Art. 333 LC.

The circumstances where employees may be terminated with advance notice are also defined, with thirteen just reasons of employee termination.<sup>142</sup> The LC however, requires employers to seek the approval of National Employment Service and trade unions in the termination of certain protected groups of employees.<sup>143</sup> Such provisions, whilst debatable, are similar to those observed elsewhere in transitioning countries seeking EU membership.<sup>144</sup> The recent amendments to the LC seek to make this regime more flexible, notably by including cases defined as economic and financial hardship on the part of the enterprise, and would allow employers to release their workers without advance notice provided they pay each released worker a severance pay equal to four respective monthly salaries. Whilst those proposed provisions are not out-of-line with some continental European practice, they do impose a cost on employers which could impede the developing competitiveness of industry and commerce.

On salaries, the national minimum wage is set with a Regulation of the Council of Ministers in conformity with the Law on the Budget for each year. As of October 2000, it was BGN 79 (about \$38) per month, net of taxes. It will be subject to adjustment in October 2000, following the assessment of projected growth of the average wage in the public sector,<sup>145</sup> to which it is now linked. The minimum wage is a touch below 30 percent of the national average wage, well within the parameters observed internationally.

**Table 2. Ratio of Minimum Wage to Average Gross Wage**

	1990	1991	1992	1993	1994	1995	1996	1997	1998
<b>Bulgaria</b>	43,1	54,2	35,9	38,3	35,7	32,6	29,3	27,1	28
<b>Czech Republic</b>	...	52,4	47,1	37,4	31,6	26,9	27,4	23	...
<b>Slovakia</b>	...	52,4	48,4	40,9	38,9	34	35,9	...	...
<b>Hungary</b>	37,3	37,4	35,9	32,8	31,2	31	32,9	...	...
<b>Poland</b>	21	34	43	41	43	38,6	43,3	...	...

Source: ETF (2000) for Bulgaria and Czech Republic and Vaughan-Whitehead ed., *Paying the price*, ILO, 1998.

<sup>142</sup> LC: for example (i) measures to reduce the staff (reorganization); (ii) or workload of enterprises; (iii) employee lacks of professional qualifications - for different reasons, including due to change of job description; (iv) various reasons of defined objective impossibility to fulfill contract (Art. 328 (1) pts.1-12 LC); as well as (v) terminality of the management when the enterprise concludes new management contract (Art.328 (2) LC).

<sup>143</sup> Art. 333 LC: Employers need the approval of the National Employment Service in cases where they seek the termination of: (i) female employees which are pregnant, have a baby under the age of three; or have a husband drafted in the military; (ii) employees under a job placement program sponsored by the National Employment Service; (iii) employees, which are sick or on vacation leave. The restrictive validity of this provision extends to the employer's authority to terminate the contracts of trade union leaders (Art. 333 (2) LC) during their term in elective office and 6 months afterwards. In these circumstances, such employees can be terminated only with the permission of the trade union.

<sup>144</sup> The regulatory mode of labor relations observed within the provisions of the Bulgarian LC does not deviate substantially from the 1999 Hungarian Labor Code (Act XXII/1992); For details see: Taboks, P., Kiska, G. and Bauer, E. 2000 *Termination of Employment: The Hungarian Labor Court's Pro-Employee Interpretation of the Labor Code's Provisions*; publishing house Budapest, 2000.

<sup>145</sup> Art. 2 Regulation No. 12/ 14.02.2000 on the Setting of the Minimum Wage for 2000.

The LC endorses a social dialogue in the regulation of employment relations.<sup>146</sup> The National Council of Tripartite Cooperation<sup>147</sup> is devised as the avenue for the negotiation of acceptable thresholds in terms of implementation of labor policy, social security and living standards. Such an instrument in essence is close to the Continental European practice in this area. Industry-specific agreements and wages are generally negotiated making use of collective bargaining tools in consultations between trade unions<sup>148</sup> and representative organizations of the employers.<sup>149</sup> With the proposed June 2000 amendment to the LC,<sup>150</sup> improvements are needed towards more de-centralized bargaining at local level to reduce high regional unemployment persistence and differentials.

Other main parts of the benefit package to workers, largely governed by the Social Security Code (SSC),<sup>151</sup> which are funded by the employer include:

- Maternity and childcare leave;
- Education leave;
- Illness related leave.

The duration of the guaranteed maternity leave is set at a total of 135 days, with a mandatory commencement date 45 days prior to childbirth, and paid at a rate equal to 90 percent of the base salary. The benefit amount and the duration of leave are reduced for second and ensuing children. The law also provides for generous child care leave<sup>152</sup>, which arguably places a financial burden on enterprises and may induce employers to engage in discriminatory practices against women of child bearing age.

In addition to the paid vacation leave,<sup>153</sup> which is more or less in line with European practice, the LC allows education leave. At present an employee is entitled to 12 days of paid leave in addition to the vacation, if he/she is applying for university or high school education.<sup>154</sup> Employees who are studying are entitled to 25 days of the educational leave per year.<sup>155</sup> In the recent LC amendments, the duration of educational leave is left unchanged, but the employer has been given a right to determine whether or not education pursued is consistent with the needs of the enterprise, and accordingly whether or not to grant the leave. This change eliminates the distortion whereby employers were forced to incur costs associated with employees taking educational leave, regardless of whether or not it was in their interest.

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<sup>146</sup> Art. 3 ff. LC.

<sup>147</sup> Two members from each: (i) the government, (ii) employer organizations; and (iii) trade unions; proposed Art. 3a, June 2000 amendment to LC.

<sup>148</sup> Recognized within the scope of the LC as national level collective bargaining organizations if these have more than 50,000 members with national and regional bodies from more than half of the economic sectors; Art. 3 (3) LC.

<sup>149</sup> Recognized within the scope of the LC if these have more than 500 members with regional representative bodies; Art 3 (4) LC.

<sup>150</sup> Proposed Art. 3 (a) - 3 (f); June 2000 amendments to the LC.

<sup>151</sup> Promulgated: SG 110/17.12.1999; last amend. SG 64/04/08.2000.

<sup>152</sup> Paid the statutory minimum wage for the period of up to two years (up to three years if twins, or a third child).

One of the parents is paid the statutory minimum wage for the period of up to two years, expandable to three years for twins, or third child; (Art. 164-165 LC).

<sup>153</sup> In the amendments to the LC, 2001, now set as a minimum of 20 days.

<sup>154</sup> Art. 169 LC.

<sup>155</sup> Art. 170 ff. LC.

The Social Security Code instigated changes to the LC regime governing paid illness related leave.<sup>156</sup> In the Bulgarian case, contrary to established international practice, the bulk of the cost of sickness benefit is still borne by the state. Both employers and employees bear little financial responsibility.<sup>157</sup> Amendments are being considered which envision to share in the costs associated with illness related leave among both employers and employees and thus making it possible to reduce payroll contribution rate.

In addition, and perhaps most burdensome of all, are the range of social security and other contributions levied on the employer.<sup>158</sup> With voluntary pension and health insurance schemes, unemployment fund and various social security contributions, employers pay a total 34.3 percent of salary.<sup>159</sup>

**Table 3. Non Wage Components of Labor Costs in Selected Countries<sup>1/</sup>**

	Social security contributions			Health care contributions			Contributions to unemployment fund			Total
	Employer's	Employee's	Total	Employer's	Employee's	Total	Employer's	Employee's	Total	
Bulgaria	0.26	0.07	<b>0.33</b>	0.05	0.01	<b>0.06</b>	0.03	0.01	<b>0.04</b>	<b>0.43</b>
Slovak Republic	0.22	0.06	<b>0.28</b>	0.10	0.04	<b>0.14</b>	0.03	0.01	<b>0.04</b>	<b>0.45</b>
Czech Republic	0.20	0.07	<b>0.26</b>	0.09	0.05	<b>0.14</b>	0.03	0.00	<b>0.04</b>	<b>0.43</b>
Hungary	0.22	0.05	<b>0.27</b>	0.11	0.03	<b>0.14</b>	0.00	0.00	<b>0.00</b>	<b>0.41</b>
Poland	0.10	0.10	<b>0.20</b>	0.07	0.09	<b>0.16</b>	0.04	0.00	<b>0.04</b>	<b>0.39</b>
Slovenia	0.09	0.16	<b>0.24</b>	0.06	0.06	<b>0.13</b>	0.00	0.01	<b>0.01</b>	<b>0.38</b>
European Union	..	..	<b>0.24</b>	..	..	..	..	..	<b>0.13</b>	<b>0.37</b>

<sup>1/</sup>Contributions are based on the gross salary received by the worker.

.. – not available

Source: International Monetary Fund, Country Reports (various issues).

Such a rate is far higher than that observed in the European Union and indeed is at the top end of the range even for other Central and Eastern European economies. It remains a priority to bring down this instrument of taxation without jeopardizing the funding of much-needed social security. The Government's recent announcement that it intends to reduce contribution rates by 3 percentage points for employers from January 1, 2001 is a welcome first step.

## Collateral

In developed economies, the ability of commercial parties to use collateral as security against credit is a major tool in financing new economic activity. There is increasing attention being given to the legal and administrative framework for pledges and collateral in transition economies. In Bulgaria, as in many other CEE countries, the framework governing the use of collateral is still fairly new. In that regard whilst there are examples of successful use of pledges, the market is still one which can be strengthened further and expanded in the coming years.

<sup>156</sup> Art 162 ff. LC.

<sup>157</sup> For scope of mandatory health insurance coverage see: Art 45 ff. Law on Health Insurance (LHA); promulgated SG 70/19.06.1998 last amend.: SG 64/04.08.2000.

<sup>158</sup> According to Article 20(1) of the June 2000 amendments to the LC, *security income* which serves as the basis to calculate social security contributions (i.e. "levyable income") should not exceed ten times the minimum wage. Linking security income with the minimum wage creates a perverse incentive to increase the minimum wage in order to boost social security revenues. Needless to say that an increase in the minimum wage can adversely affect employment.

<sup>159</sup> 25.6 percent for pension contributions; 0.7 percent for work related accident and illness; 4.8 percent for health insurance and maternity contributions; and 3.2 percent for unemployment fund.

Several legal instruments impinge on collateral use. Perhaps the clearest is the Law on Registered Pledges (LRP), adopted in late 1996 and amended slightly in 1997 and 1999. This defines the rights and obligations of pledgor and pledgees against moveable property<sup>160</sup>. Moveable property is defined to include:

- Accounts receivable;
- shares;
- machines, equipment, materials and inventory;
- commercial enterprises (as going concerns); and
- future property (such as crops).

Pledges entered into between two parties (and to be covered under the provisions of the law) are entered into a Central Pledge Registry (CPR). The CPR resides in the Ministry of Justice, is located in Sofia, and administered by a Director appointed by the Minister of Justice<sup>161</sup>. Through the support of USAID, the registry has now been computerized to a web-based application which maintains a database of information about registered transactions and allows inquiries and legal analysis based on this data. The Registry is open to the public and users pay a modest fee (currently about US\$20 to register a pledge).

Foreclosure on pledges is also regulated by the LRP<sup>162</sup> which broadly allows the pledgee to take possession of collateral under appropriately defined circumstances (debtor default). In principle, and it seems in practice, certainly creditors do find it easier to recover assets which have been pledged in this framework, than is the case when they stand in line for recovery of claims in standard court procedures. That being said, difficulties are reported to emerge quite frequently not least in the fact that typically the pledgor retains physical possession of the collateralized asset (e.g. inventory), and can frustrate recovery by the creditor. In those cases another legal instrument comes into play, namely the Civil Procedure Code (1952, amended 44 times through March, 2001), under which Article 414 describes the pledgee recourse to an executive judge (bailiff) for the recovery of claims. Entering into this arena a participant can be faced with the type of difficulties already described in section 2.3.3 above.

Considerable discussion has also taken place amongst policymakers and commentators about the approach of commercial banks to collateral. In short, it appears that banks – certainly compared to those in more developed economies – are very cautious in their lending and insist of high levels of secure collateral (often with a value of 150 percent of the loan in question). The are various reasons for this. Some are associated with generally conservative practices in a banking system which was in crisis conditions in late 1996 and early 1997. Others are connected with collateral recovery difficulties in the event of a need for a bank to foreclose. And it is argued by some that there is an actual or perceived interaction between banking regulations and the penal code which place great pressure on loan officers to request very substantial collateral – and so be sure that it is “adequate collateral” and protects against potential charges of improper lending.

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<sup>160</sup> Articles 8-11. Real Estate is not covered under this instrument, and considerable work is required to develop a more coherent and effective Real Estate Registration System as the bedrock for more effective use of this asset as collateral. The Bank is in discussion with the authorities to provide support in this area.

<sup>161</sup> Articles 22-25

<sup>162</sup> articles 32-43

This is still an area under research, to develop recommendations which will improve the situation.

Finally a short reference is warranted to the new Mortgage Bonds Law adopted in late 2000. In brief, this is an innovative step in developing a new tool on the capital markets. A commercial bank can now issue mortgage bonds backed by mortgage loans (typically pledged against domestic real estate) of the issuing bank. As this instrument has yet to be tested, but it appears one likely to grow in use as Bulgaria's real estate and credit markets expand in the future.

## Accounting And Investment

### Accounting and Auditing

All commercial entities are subject to accounting and financial standards, as set out in the Law on Accounting (LOA),<sup>163</sup> with some enterprises e.g. banks, subject to sector-specific requirements. Bulgarian enterprises have a well-established tradition of bookkeeping through the socialist period, but this was significantly different from the approach adopted in market economies. Over the last few years a period of adjustment has been taking place to improve not only the formal accounting standards, but also the breadth and depth of their use.

The LOA places an obligation to maintain accounting records, with guidance on items ranging from accounting principles to the nature of reports. For companies below a certain size<sup>164</sup> (no registered capital or less than 10 employees and annual turnover below BGN75,000), however, the LOA does not require double-entry bookkeeping and indeed there are no real enforcement mechanisms - so for these entities one might view the regulations as an official exhortation to good practice.<sup>165</sup> As of last year's data about 75 percent of the commercial entities registered in Bulgaria fall into this category.

A statutory audit obligation<sup>166</sup> is imposed on:

- all companies with capital divided into shares;
- all companies incorporated with a contract, where shares are issued for the contributions to the capital of the unlimited liable partners;
- all banks, insurance companies and financial institutions;
- all other companies, for which at least two of the following criteria are met:
  - total assets for prior year greater than or equal to BGN 300,000
  - net amount of trade and financial income for prior year greater than or equal to BGN 600,000
  - average number of employees for prior year – 30 people
- all cooperative partnerships with flexible amount of capital and flexible number of partners, incorporated for the purpose of trade activity through mutual support.<sup>167</sup>

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<sup>163</sup> LOA, promulgated SG 4/15.01.1991; last amend. SG 1/04.01.2000.

<sup>164</sup> Art. 2 (2) LOA.

<sup>165</sup> This is not unusual, as it is common international practice that firms with what is considered "insignificant annual turnover" for the respective jurisdiction are not subjected to comply the rigidity of the national accounting standards. In the various jurisdictions where such practice can be observed -- UK, USA and some EU member states -- it is widely accepted that rigid enforcement of accounting standards for businesses falling below a certain financial threshold would be economically unsound. Similar reasoning in defining businesses of "insignificant value" is applied in the Bulgarian case: (i) by utilizing the VAT registration threshold (BGN75,000) with 58,198 entities registered under the VAT regime (Source: NSI 1999); or (ii) the lack of registered capital: the unlimited liability corporate forms of sole the proprietor (ET) and general partnership (SD) -- similar to owner managed corporations in the UK -- which are closely monitored under the personal income tax schemes -- about 75 percent of registered entities.

<sup>166</sup> Art. 52 (1) LOA.

<sup>167</sup> Art. 62; Law on Cooperatives (LOC); promulgated SG 113/28.12.1999.

The financial statements of budget companies do not fall under the above criteria and are certified by the Public Auditing Institution.

This obligation is very much in line with EU practice on joint stock and limited liability companies. The turnover criteria are also used by most EU member states, and the table below<sup>168</sup> shows some comparisons between Bulgaria's floor turnover and that used elsewhere.

**Table 4. VAT Registration Thresholds**

	Total assets for previous year higher than (USD)	Turnover for previous year higher than (USD)	Annual number of employees higher than
Bulgaria <sup>a/</sup>	150 000	300 000	30
Czech Republic <sup>b/</sup>	500 000	1 000 000	20
Poland <sup>c/</sup>	1 000 000	3 000 000	50
Slovak Republic <sup>d/</sup>	500 000	1 000 000	20

Source: PriceWaterhouseCoopers, Bulgaria

Notes:

- <sup>a/</sup> Bulgaria: (i) net assets value higher than BGN 300,000; (ii) turnover higher than BGN 600,000; Art. 52 (1) LOA
- <sup>b/</sup> Czech Republic: (i) net assets value higher than CZK 20 million; (ii) turnover higher than CZK40 million; Art. 20 (2) Accounting Act and Art. 39 (1) Commercial Code.
- <sup>c/</sup> Poland: (i) net assets value higher than EURO 1 million; (ii) turnover higher than EURO 3 million; Art. 64 Accounting Act.
- <sup>d/</sup> Slovak Republic: (i) net assets value higher than SK 20 million; (ii) turnover higher than SK40 million; Art. 20 (2) Accounting Act 563/1991 para.20.

The statutory audit to Bulgarian Accounting Standards (BAS) must be completed annually<sup>169</sup> and be performed by a Bulgarian Certified Public Accountant (CPA), member of the Bulgarian Institute of Certified Chartered Accountants (ICCA) or by a "specialized auditing company". Again this is a similar requirement as practiced in EU member states, although we note that Bulgarian practice allows certified accountants to audit companies in which they are creditors or hold shares,<sup>170</sup> a practice which is not allowed in established international practice.<sup>171</sup> Currently there are 460 individual members of the ICCA, and another 6 CPAs who are not members of the ICCA.<sup>172</sup> Amongst the 105 specialized audit and accounting practices in Bulgaria, there are only 6 firms who offer audits according to International Accounting Standards (IAS).

Following international practice in this area, the access to financial statements and the auditor's report is available to the public, as corporations with audited financial statements are obliged<sup>173</sup>

<sup>168</sup> Data collected with the kind assistance of PriceWaterhouseCoopers, Bulgaria.

<sup>169</sup> The audit year corresponds to the calendar/ financial year.

<sup>170</sup> Art. 54 (5) LOA.

<sup>171</sup> Internationally recognized due to possible conflict of interest as the "Independence Rules", e.g. auditors must be independent of financial interest in performing professional services.

<sup>172</sup> These are mostly the practices performing audits according to IAS, which are not mandated by the ICCA.

<sup>173</sup> In cases of non-compliance with the publication requirement the violating entity may be fined BGN 3,000-BGN 6,000 and in case of repeated violation BGN 6,000-12,000 (Art. 56 (3) LOA).

to publish their accounts in a daily newspaper or specialized economic or financial magazine.<sup>174</sup> Apart from the voluntary disclosure of their financial information on the web-site of the Bulgarian Chamber of Commerce and Industry (BCCI), there is no centralized place nor specific institution in Bulgaria where the broader public can view the financial statements and audits. The public companies reporting to the State Securities and Exchange Commission (SSEC) follow international practice of presentation of annual statements in full to the SSEC, and also present interim financial statements on a bi-annual basis.

As for BAS, which are approved by the Government, practitioners report that they are based squarely upon IAS, with some abbreviation and modest modifications. The format of accounts is largely similar to IAS. The Government reports that they meet the fourth, seventh and eighth directive of the EC, and that they undergo a process of annual review to harmonize areas which remain different from EC and/or IAS directives. As a practical matter, a full set of IAS has been translated into the Bulgarian language, and published in 1999 with the recognition of its issuing body, the International Accounting Standards Committee.

A recent review<sup>175</sup> has indicated 13 substantial differences between BAS provisions and those found in international practice. Amongst these is the fact that bad and doubtful debt provisions are computed on mathematical rules without judgement to the extent of recoverability of receivables.<sup>176</sup> In the sometimes volatile commercial environment during transition, this is a treatment which could cause difficulties: a revision to the BAS deserves careful consideration.<sup>177</sup> BAS accounts may also be inadequately stating the value of some fixed assets, since these are almost always depreciated on the (more favorable) tax-allowable rates, rather than that indicated by useful economic life.

It is difficult to assess properly the level of compliance with proper accounting standards. As a guide, amongst the top 50<sup>178</sup> Bulgarian registered companies, a little more than half actually produce accounts audited to IAS (as well as BAS). Foreign companies (investors) also typically are audited to IAS standards. And in the banking sector, as required by legislation, all banks are producing IAS accounts, written BAS standards, which by and large are on par with best international practice. The BCCI reports that most of the enterprises liable for audit do meet BAS requirements on time.

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<sup>174</sup> This requirement is slightly modified for banks, subsidiaries of foreign financial institutions and insurance companies, which must publish their financial statements in the *State Gazette* by May 31<sup>st</sup> of the year following the reporting one. Art. 43 (2) LOA.

<sup>175</sup> PriceWaterhouseCoopers (2000)

<sup>176</sup> BAS 3, compared to IAS: There is no specific IAS guiding the provisioning for bad and doubtful debts as to formulate rules according to which it should be performed. For this purpose the generally accepted accounting practices and principles are applied on the basis of judgmental assessment of the recoverability of the assets.

<sup>177</sup> "Standards explicitly state that the provisioning for bad and doubtful debts is not ruled under IAS 37 – Provisions, Contingent Liabilities and Contingent Assets. (IAS 37, Scope, para. 7). This Standard defines provisions as liabilities of uncertain timing or amount. In some countries the term 'provision' is also used in the context of items such as depreciation, impairment of assets and doubtful debts: these are adjustments to the carrying amounts of assets and are not addressed in this Standard," PriceWaterhouseCoopers (2000)

<sup>178</sup> By turnover in the preceding year ending December 1998.

By law, submissions are performed to the BCCI and to the National Statistical Institute (NSI).<sup>179</sup> These institutions are separate and completely independent from one another. The financial statements are presented to the tax authorities as well, as accompanying the tax return.<sup>180</sup>

Some commentators<sup>181</sup> argue, however, that in practice there are significant examples where local accounts are driven largely for tax-compliance or tax reporting requirements, which limits their usefulness for other users – especially shareholders, investors, banks and other financiers. It is also reported that over recent months some 30 companies have de-listed from the Stock Exchange to reduce their reporting and disclosure obligations, which were felt to outweigh any benefit from this source of access to share capital.

Overall the legal framework for auditing and accounting is significantly harmonized with EC and IAS directives and standards. Key challenges are to be focused on:

- examining opportunities for better implementation and use of audit standards and reports, particularly by more careful delineation of uses for tax purposes and those for other/standard business objectives;
- solidifying the annual process for updating standards and regulations, with involvement and oversight from established practitioners;
- widening the circle of practitioners certified to IAS standards;
- closing remaining regulatory gaps between BAS and IAS.

### **Investment Markets in Public Companies**

Bulgarian companies have the traditional sources of finance, including bank lending, retained earnings, private subscription and trade finance. Of particular interest as a longer-term development is the potential for larger firms to access capital on the security market, most notably in shares and bonds. It is this topic which we describe in more detail below.

#### *Public Companies and Securities Transactions*

The public trading of securities is a relatively new phenomena in Bulgaria, and the country's legislature has borrowed heavily from the Anglo-American securities framework. The core instrument in a fairly complex regulatory framework is the Law on Public Offering of Securities (LPOS).<sup>182</sup> The governing mechanism established with the enactment of this law corresponds to international and European Union standards in the area of capital markets as well as the offering and trading of securities.<sup>183</sup> The law regulates: (i) public offering of securities; (ii) securities trading; (iii) regulated and open trade securities markets; (iv) central depository (v) investment intermediaries; (vi) investment companies; and (vii) state control of the securities regime. In

<sup>179</sup> To the BCCI, of the year following the reporting one and to the NSI by March 31, and to the BCCI by June 30 the year following the reporting one or up to June 15, the year following the reporting one in case of consolidation. Art. 40 (5) LOA.

<sup>180</sup> By March 31, the year following the reporting one (Art. 51 (2) Law on the Taxation of Corporate Income (LTCI). If failed to do so, the corporations are fined BGN1,000 and in case of repeated violation BGN1,500 (Art. 65 LTCI).

<sup>181</sup> See: PriceWaterhouseCoopers (2000).

<sup>182</sup> Law on the Public Offering of Securities (LPOS), promulgated SG 114 12/1999.

<sup>183</sup> IMF Report on the Observance of Standards and Codes.

the legal context securities are shares, bonds and corporate debentures, including the rights offered to the own shareholders employees.

### *Public Companies*

Enterprises which have issued shares under the conditions of an initial public offering (IPO), have issues traded at the Bulgarian Stock Exchange,<sup>184</sup> or over-the-counter (OTC) markets, are subject to the reporting requirements of public companies.<sup>185</sup> These entities report to the State Securities and Exchange Commission (SSEC) on: (i) planned uses of the capital raised through initial and subsequent public offerings; (ii) general information and prospects of the company in the current fiscal year; (iii) the rights granted by the subscribed shares. Public companies are restricted from using the general provisions for the raising of capital<sup>186</sup> provided under the Commercial Code.<sup>187</sup> The statutory criteria for the de-registration of public companies, and respectively a prohibition for the public trading of their corporate securities is if: (i) the number of shareholders falls below 50; (ii) the corporate capital falls below BGN 200,000; (iii) the entity has offered shares in a public tender or; (iv) the company is subject to liquidation or bankruptcy proceedings.

### *Public Offering of Securities*

By statute, a public offering is defined as the process of raising corporate capital through the offering of securities: (i) to more than 50 persons or any number of offerees utilizing public means of communication; and (ii) when the offering is made by persons different than investment brokers or persons holding title on the securities.<sup>188</sup> This must not be confused with situations where securities are offered in liquidation or bankruptcy proceedings and when corporations offer securities to less than 300 of their own shareholders and employees under preferential schemes.

The issuer of the securities, or the investment intermediary underwriting on the issuer's behalf, must prepare a prospectus providing sufficient information on the issuer to allow investors to determine the financial condition of the issuer and the expected benefits related to the offered securities issue.<sup>189</sup> Subject to mandatory reporting in the prospectus is information related to: (i) the issuer; (ii) description of the issuer's commercial activities, including the annual balance sheets for the last three years; (iii) current issue and income and paid dividends on previous issues. The initial public offering is valid only after respective approval of the prospectus by the Commission. Similar to the US model, in cases where the investor discovers that information

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<sup>184</sup> Bulgarian Stock Exchange - Sofia, Ltd.

<sup>185</sup> Art. 110 LPOS.

<sup>186</sup> Under the CC, all major (and vital) corporate decisions -- by law within the authority of the General Assembly of the company shareholders (Art. 221 CC) -- are passed with a 2/3 majority of the voting stock. The CC prescribes the same qualified majority of the voting stock to close the company down (Art. 153 CC); or raise the company capital (Art 192, 195 CC). Art. 113 LPOS allows for a better protection of minority shareholder rights as major corporate decisions are passed with a 3/4 majority of the stock if at least 3/4 of the voting stock of the company is represented at the meeting; Art. 114 (2) LPOS.

<sup>187</sup> Art. 113 ff. LPOS.

<sup>188</sup> Art. 4 LPOS.

<sup>189</sup> Art. 81 LPOS.

contained in the prospectus is incomplete or false, the investor may request the Commission to declare the transaction null and void, unless the investor himself was acting in bad faith.<sup>190</sup>

## Capital Market Institutions

### *Securities Trading*

Following international practice in this area, the trading of securities in Bulgaria is mandated within the regulated securities markets<sup>191</sup> subject to the supervision of the SSEC. Trading is differentiated from their initial offering of corporate shares by investment intermediaries and underwriters, and the initial offering of shares in investment companies.<sup>192</sup> The LPOS broadly incorporates in the definition of trading, any secondary transaction made after the initial public offering of the securities.<sup>193</sup>

### *Stock Exchanges*

Shares are traded on the Bulgarian Stock Exchange (BSE), which has been operational since October 1997 following the effective merger of two competing exchanges in Sofia. Both the constitution and mode of operation of the BSE is governed essentially by the LPOS. This framework gives detailed regulations which are largely in line with international norms. To protect investors and support the development of the marketplace, the SSEC supervises the BSE and related institutions. The SSEC itself constitutes six members, appointed by the Council of Ministers, on five-year term.<sup>194</sup> Notwithstanding this reasonable regulatory framework, the BSE remains small. About 25 companies are currently listed on the official market (about a further 640 companies are on the free market), with a total market capitalization of around \$125m, and only 2 of these are in first tier (segment "A") of active trading. Expansion of the market probably requires a process of further corporate and investor education; the emergence of larger successful companies in the economy; and the demonstration of the independence and effectiveness of the still-fledgling SSEC, rather than major changes to the legal framework.

### *Investment Intermediaries*

The Bulgarian law allows all banks to act as investment intermediaries as authorized by the Law on Banks.<sup>195</sup> All other entities are defined as investment intermediaries if they are: (i) dealers acting on their own behalf or on the behalf of clients in the acquisition or trading of securities; (ii) underwriters; (iii) individual security portfolio managers and brokerages and; (iv) individuals that hold securities in depository institutions on behalf of their clients. In consideration of portfolio management activities, investment intermediaries are not allowed to manage the portfolios of mutual and pension funds.

Foreign entities acting as investment intermediaries in Bulgaria are licensed by the Commission which, also exercises supervisory functions on the former's worldwide activities.<sup>196</sup> Investment

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<sup>190</sup> Art. 78(4) LPOS.

<sup>191</sup> Art. 7 LPOS.

<sup>192</sup> Art. 5 LPOS.

<sup>193</sup> Art. 6 LPOS.

<sup>194</sup> The first Chairman was appointed in 1996.

<sup>195</sup> Art. 11 ff. Law on Banks (LB), promulgated SG 52, 7/1997, last amend. SG 114, 12/1999.

<sup>196</sup> Art. 55(5) LPOS.

intermediaries are further authorized to engage in: (i) investment consultations; (ii) market and stock acquisition analysis; (iii) preparation of prospect for the public offering of securities; (iv) representation as proxies of their clients, and (v) the facilitation of loans for the acquisition of securities (*limited marginal trading*).

### *Investment Companies and Portfolio Management Companies*

The provisions governing investment companies are similar to the regime established for investment intermediaries.<sup>197</sup> However, investment companies are incorporated under the general provisions of the Commercial Code as either open<sup>198</sup> or closed<sup>199</sup> types, and their capital must be equal to the net value of its assets. The minimum capital requirement is BGN 500,000. All the book-entry shares managed by the investment companies are subject to mandatory registration with the central depository. In addition, all of the liquid assets and other securities of the company are held in a specially designated depository bank. This depository bank must: (i) guarantee the issue, sale and buy-back of the shares of the investment company and; (ii) guarantee all payments in transaction made by the company.

The investment companies are subject to mandatory reporting to the Commission with respect to their: (i) capital; (ii) contracts with portfolio management companies and depository banks and; (iii) names and information of the individuals who own more than 10 percent of the shares.

Apart from managing the portfolios of qualified institutional investors, portfolio management companies are restricted from engaging in any other activities. These companies are subject to the same reporting requirements to the Commission as investment companies.<sup>200</sup>

### *Central Depository*

Under the regime the issuing and trading with book-entry<sup>201</sup> securities is subject to mandatory registration with the central depository.<sup>202</sup> The depository does not generate profits, nor does it distribute dividends. The members of the central depository are: (i) banks; (ii) investment intermediaries; (iii) portfolio managing companies; (iv) stock exchanges and open trade security markets; and (v) foreign depository and clearing institutions.<sup>203</sup> The majority of the capital of the central depository is owned by public institutions.<sup>204</sup>

## **The Role of Foreign Investment**

From a public policy perspective, the Bulgarian Government (in a way similar to many others elsewhere) has sought to encourage business development by establishing a foreign-investor

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<sup>197</sup> Art. 164 ff. LPOS.

<sup>198</sup> Art. 192 ff. LPOS.

<sup>199</sup> Art. 198 ff. LPOS.

<sup>200</sup> Art. 202 ff. LPOS.

<sup>201</sup> Art. 2(1) LPOS.

<sup>202</sup> Art. 127 LPOS.

<sup>203</sup> Art. 131 LPOS.

<sup>204</sup> At least 3/4 of the capital of the central depository is owned by the Ministry of Finance, the Bulgarian National Bank, commercial banks, and investment intermediaries. Excluding a minimum required shareholding of 34 percent of the Ministry of Finance and a unrestricted share for the Bulgarian National Bank, all other shareholders are limited to a maximum of 5 percent of the shares.

friendly regulatory environment. At its core are provisions to ensure that foreign investors are treated alike to domestic entities, with the benefit of receiving certain preferences in limited circumstances. Equality of treatment is recorded in constitutional provisions<sup>205</sup> which also grant priority of duly ratified international treaties over domestic legislation.<sup>206</sup> In this respect, it is constitutionally warranted that discriminatory practices towards foreign investors are inadmissible, which in turn allows for judiciary review of potentially discriminatory legislation<sup>207</sup>. Furthermore, the constitutional priority of international over domestic law transplants the international protective rules for investment activity in a valid and binding manner. This affords foreign investors in Bulgaria with the opportunity to take advantage of the beneficial regime established under existing international treaties<sup>208</sup> in cases where domestic legislation prescribes less favorable conditions for their activities.

The principal instrument for providing foreign investor preferences is the Law on Foreign Investment (LFI).<sup>209</sup> Excluding some minor registration requirements,<sup>210</sup> the incorporation of commercial ventures by foreigners occurs under the general rules for local entities encompassed within the scope of the Commercial Code (see above). The current framework contains no restrictions as to equity investments of foreign nationals or corporations in Bulgarian entities, nor any limitations concerning their relative share of ownership in a company.<sup>211</sup> It further provides guarantees protecting foreign investment from the adverse effect of subsequently enacted legislation.<sup>212</sup> The statutory guarantee is supplemented by legal safeguards limiting the circumstances under which expropriations of foreign owned property may occur by the mandating of the investor's consent to the expropriation and offered compensation.<sup>213</sup> In this way it fully meets EU requirements and indeed is more liberal than that found in some other emerging economies.<sup>214</sup>

The LFI utilizes the broadest possible qualification of foreign investor. For corporation these need to be only legal persons and partnerships not registered in Bulgaria, while encompassing all foreign natural persons. Bulgarian nationals residing abroad are afforded the option to invoke the provisions of the Law on Foreign Investment (LFI).<sup>215</sup>

### *Foreign Commercial Ventures*

Local commercial ventures of foreign persons are not subject to any special registration requirements, other than the national tax, social security and statistics reporting requirements

<sup>205</sup> Art. 19(2) Constitution RB.

<sup>206</sup> Art. 5(4) Constitution RB; and Art. 2 LFI.

<sup>207</sup> Discriminatory legislation is subject to review by the Constitutional Court; Art. 149(1) pt. 4 Constitution RB.

<sup>208</sup> Art. 3(1) LFI affording beneficial treatment to foreign investors under the international and bilateral treaties, such as treaties for the avoidance of double taxation and the protection of investments.

<sup>209</sup> Law on Foreign Investment (LFI), promulgated SG 97, 10/1997 last amendment. SG 110, 12/1999.

<sup>210</sup> Foreign investors are subjected to a special permit regime for commercial activities the areas of (i) banking and finance; (ii) insurance activities and participation in insurance companies; (iii) manufacturing and trading of weapons, explosives and military equipment; (iv) securities transactions: issuing, underwriting and trading of securities; (v) ownership of buildings and limited property rights in border areas.

<sup>211</sup> Art. 8(2) LFI.

<sup>212</sup> Art. 4 LFI.

<sup>213</sup> Art. 26 LFI.

<sup>214</sup> For details see: U.S. Department of State (2000).

<sup>215</sup> Art. 5 LFI.

applicable to all local entities.<sup>216</sup> In fact, business opinion<sup>217</sup> confirms that these are not onerous provisions.<sup>218</sup> Furthermore, apart from a differential treatment of Bulgarian and foreign entities engaged in the public offering of securities,<sup>219</sup> foreigners enjoy equal treatment under Bulgarian law with respect to the ownership or trading of equity securities, corporate debt securities and government debt instruments.

The current regime concerning the repatriation of profit and capital allows the unrestricted acquisition and transfer of funds abroad upon the verification of paid taxes due on income generated in the country. This legal provision is applicable to all income generated in Bulgaria through: (i) investment; (ii) indemnification proceeds from property expropriation; (iii) proceeds from the sale or liquidation of investments; (iv) proceeds from the enforcement of judgements; as well as the remuneration of foreign individuals residing legally in Bulgaria, or from membership in cooperatives and limited partnerships. This unfettered regime for the transfer of funds fully meets the standards of the EU and indeed is more flexible than in several other transition economies.<sup>220</sup> Combined with the fact that the lev is fixed against the Euro under the country's currency board arrangement (CBA), it provides corporate entities operating in Bulgaria and other jurisdictions with a stable and frictionless regime.

In terms of the existing prohibitions,<sup>221</sup> there is a constitutional provision<sup>222</sup> preventing persons and foreign corporate entities from directly owning land in Bulgaria. This is not consistent with the obligations made on EU member states, although currently land ownership restriction is to be found in several other of the candidate countries including Poland<sup>223</sup> and Hungary.<sup>224</sup> In time Bulgaria would have to change to meet EU requirements. At present there is the onset of a debate concerning amending the constitution to meet the requirements of European accession and respectively EU membership. It has been argued that given imperfections in the functioning of the land market at present, and the stage Bulgaria is at in its economic development cycle, the opening of the land market could raise prices, especially for agricultural land, with possible adverse social consequences. So one view expressed in Bulgaria is that it would be prudent to wait a few years more before removing this barrier. Such a stance may also be justified given that for practical purposes the prohibition does not typically cause a headache: it can be easily circumvented since it does not apply to local entities with foreign participation, regardless of the percentage of the foreign shareholding. Foreign persons also enjoy equal treatment with respect to the acquisition of buildings, structures and limited ownership rights, such as the "right to use"

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<sup>216</sup> Statistics reporting and BULSTAT registration Law on Statistics SG 57, 6/1999. There is a mandatory registration of representative offices of foreign entities with the Bulgarian Chamber of Commerce and Industry, Art. 6(1) LFI, however these representative offices have no legal personality and may not engage in direct commercial activities in Bulgaria; Art 6(2) LFI.

<sup>217</sup> Business Survey: The Legal and Regulatory Environment for Business in Bulgaria, The World Bank Sofia Office, August 2000.

<sup>218</sup> U.S. Department of State (1999)

<sup>219</sup> Art. 141 ff. Law on the Public Offering of Securities SG 114, 12/1999.

<sup>220</sup> Confirmed by responses from businesses; Business Survey, The World Bank, August, 2000.

<sup>221</sup> Art. 29 Law on Property, promulgated SG 92, 11/1951 last amend. SG 90 10/1996 ; Art. 23(2) LFI.

<sup>222</sup> Art. 22 (1) Constitution RB.

<sup>223</sup> Foreigners may own up to 0.4 hectares real property in urban areas or 1.0 hectares arable land.

<sup>224</sup> Foreigners are not restricted to own real property but may not acquire arable land.

and “right to develop” land or buildings on terms similar to these of a leasehold limited in time.<sup>225</sup>

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<sup>225</sup> The “right to use” is non-transferable and does not entitle to property development. The “right to develop” land is transferable, as well as the title to the buildings constructed on the property.

## Taxation Regime

### Overview

Bulgaria's tax regime has been overhauled in recent years and its main features are now aligned with the prevailing practice in most EU member states. Some of its broad provisions in respect of the business environment are noted below, but this description is by no means exhaustive, leaving aside as it does detailed provisions of the tax code. Whilst we do not perform a detailed quantitative comparison against other states, a broad assessment would indicate that whilst Bulgaria could benefit from further tax reductions, its current rates are typically consistent with those found in the EU.

### Corporate Income

The taxation of corporate income is based upon two-tier tax system, a profit tax (at state level), in conjunction with an accompanying municipal tax (local level). The general rate is 20 percent of declared profits in the preceding tax year.<sup>226</sup> For those entities with annual profits less than BGN 50,000,<sup>227</sup> the tax rate is 15 percent. However, this provision is not applicable to entities engaged in financial activities which are always taxed at the higher 20 percent rate. It is worth noting that these two categories of taxable rates are distinct from each other, and an entity falls in either one or the other, and pays the prevailing tax rate on all its profit. This creates the situation that a company declaring a profit of a little over the threshold – say BGN 50,100 – faces an incredibly high effective marginal tax on its profits above the threshold. Such an anomaly is in contrast to the model used in the UK, for example, where allowances are made to smooth marginal tax rates between bands.

In parallel with the profit tax, the income of commercial ventures is levied with 10 percent municipal tax.<sup>228</sup> Under the current taxation mechanism, the amount of the levied municipal tax is deductible from the taxable earnings for profit tax purposes. Together therefore the combination of profit and municipal corporate tax yields an overall tax rate in most cases of 28 percent. This is in line with the EU average rate, but somewhat below that observed in some competitor economies such as Poland and Hungary. It is also worth noting that in Bulgaria (as indeed in other jurisdictions), corporate face a range of other obligations, not least high social security contributions on employees around 37.5 percent of salary, which add to the overall burden.

Corporate tax obligations apply to all companies and partnership forms registered in Bulgaria and/or receiving income from a Bulgarian source.<sup>229</sup> This includes: (i) local corporations, as well as individuals engaged in commercial activity (local entities not engaged in commercial activities are not subject to profit tax even when generating revenue); (ii) budgeted organizations engaged in commercial activities; (iii) partnerships; (iv) foreign entities engaged in commercial

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<sup>226</sup> In Bulgaria the tax year and the calendar year coincide.

<sup>227</sup> Equal to DM 50,000 or little below \$25,000 at the current exchange rate.

<sup>228</sup> Art. 45 Law on Corporate Taxation (LCT), promulgated SG 115, 12/1997, last amend. SG 111, 12/1999.

<sup>229</sup> Art. 5-8 LCT.

activities.<sup>230</sup> The model of Unitarian tax base, defined for personal income is also applied for corporations. In this context, subject to corporate tax is the worldwide income of corporate entities registered in Bulgaria. The deviations from the personal income tax regime concerning the Bulgarian sources of income are quite minor and include among others, the profits and other income derived from: (i) capital gains; (ii) retail and export of merchandise; (iii) dividends and liquidation proceeds; (iv) interest and royalties; (v) all income of branches of foreign entities.

Various allowances and/or deductible expenses are provided to offset against taxable income. The general rule is that such allowances are deductible from gross profit before arriving at taxable profit (taxable base). The total amount of reductions cannot exceed the taxable amount<sup>231</sup> in any given tax period. Corporations can carry forward losses over the following five years, whereas the statutory carry-over period for banks and financial institutions is ten years.<sup>232</sup> The loss carry-over vehicle can be used with regard to the advance tax payments. In terms of restrictions, loss carry-back, as well carry-forward after liquidation and bankruptcy is not permitted. Further, the transfer of tax credit is allowed only if there is a 50 percent change in the ownership structure of the beneficiary corporation effected by merger or consolidation with other enterprises.

Recently legal amendments have been made to effect tax incentives for commercial activity in target areas. Entities investing in regions with unemployment rates exceeding 150 percent of the national average rate enjoy preferential taxation status.<sup>233</sup> Furthermore, companies employing disabled persons are entitled to utilize the full amount of their taxable obligations for measures promoting rehabilitation and social integration of the disabled.<sup>234</sup> Tax allowances are granted to businesses for the purpose of redirecting portions of the taxable income<sup>235</sup> to pension and health insurance funds, establishments for higher education and health care institutions associated with the area of their commercial activities.

Foreign entities which wish to repatriate profits must note that their income from a Bulgarian source is typically subject to a 15 percent withholding tax. Subject to this regime are: (i) dividends and liquidation proceeds; (ii) interest, including such under finance lease agreements; (iii) royalties; (iv) technical services remuneration; (v) rents; (vi) payments under operating leasing, franchising and factoring agreements; (vii) capital gains arising from sale of immovable

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<sup>230</sup> Representative offices are not deemed commercial entities in the context of the law. As they fall within the scope of the Law on Foreign Investment they are restricted from engaging in commercial activities and are not subject to taxation.

<sup>231</sup> Art. 24(2) LCT.

<sup>232</sup> Art. 38 ff. LCT: Entities may carry forward losses over the following 5 years. The losses from foreign sources, are subject to the same regime, however the entity may carry-forward losses only with respect to taxable income of the same source. Banks may carry forward losses over the following 10 years. Loss carry-back, as well carry forward after liquidation and bankruptcy is not permitted. The loss carry-over vehicle can be used with regard to the advance tax payments as well as on an annual basis.

<sup>233</sup> Art. 60 LCT: The deduction is equal to 10 percent the amount of the company's founding capital, or respective capital increases used to acquire long-term assets and modernization. The list of high unemployment is attached to the LCT and updated annually.

<sup>234</sup> Art. 59 LCT: Full tax allowance is granted if the number of employees with disabilities exceeds 50 percent of the employed personnel, or respectively if 30 percent of the employed personnel are with visual disabilities (blind). A proportioned tax allowance is also granted to any company employing disabled personnel.

<sup>235</sup> Art. 61 LCT: 80 percent tax allowance.

property, stakes in the limited liability companies' capital, securities, and financial assets. There is, however, a wide range (43 or so) of bilateral treaties, which Bulgaria has concluded for the avoidance of double taxation.

### Thin Capitalization Rules

In some situations the utilization of debt financing instruments, in particular when corporations borrow from their shareholders<sup>236</sup> to cover incurred operational losses or to retire existing debts, can allow the concealed distribution of the corporate profits to the lenders. To guard against this, recent amendments limit the deductibility of expenditures incurred through the utilization of debt financing instruments. Thin capitalization resultant from excessive borrowing is treated unfavorably as the interest deductions exceeding the equity of the corporation are not allowed and interest payments and loan repayments are taxed corporate income. The amended thin capitalization rules:<sup>237</sup> (i) define restricted interest expenditures; (ii) limit their tax deductibility; and (iii) prescribe a mechanism for the deductibility of restricted interest from the taxable income in the following year.

As companies are evaluated upon their individual computable profits and losses, the current regime provides relatively little guidance concerning the taxation of corporate groups. Expenditures incurred in transaction between affiliates are penalized with the exception of the transfer pricing and related persons rules established under bilateral treaties for the avoidance of double taxation.

### Value Added Tax (VAT)

Apart from minor exemptions, all commercial transactions in Bulgaria involving the transfer of title on goods and delivery of services are charged with VAT. The tax base is generated upon all prices invoiced to customers, which blends manufacturing costs with other taxes, fees, excise duties, subsidies and related financing charges, interest and penalties, expenditures for packaging, shipping and handling and the like. VAT is levied at a uniform 20 percent rate,<sup>238</sup> and is the single largest source of general government tax revenue, contributing about 36 percent of all revenue from taxation.<sup>239</sup>

The VAT levy has significant influence on commercial conduct. Entities engaged in commercial transactions with a taxable turnover exceeding BGN75,000<sup>240</sup> over the last 12 consecutive months or entities whose export turnover for 12 consecutive months exceeds BGN50,000 are subject to VAT registration. Similar to the general taxation regime, group and divisional registration is not permissible. Registration is subject to monthly review, and deregistration is mandatory if the criteria is not met in an 18 consecutive month period following registration. Voluntary registration is afforded when the taxable turnover is below the mandatory BGN

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<sup>236</sup> Provided under Articles 134 and 190 CC.

<sup>237</sup> Art. 26 LCT.

<sup>238</sup> Art. 53 Law on Value Added Tax (LVAT), promulgated SG 153, 12/1998 last ammend. SG 111, 12/1999.

<sup>239</sup> If social insurance contributions are defined as part of total tax revenue then this reduces the VAT share to 25 percent of the total.

<sup>240</sup> Which has established itself as the *de facto* financial threshold in defining the significance of commercial ventures. For details see chapter on Accounting and Audit Standards.

75,000 but the applying entity is engaged in non-exempt export transactions accumulating a turnover above BGN 50,000. VAT treats foreign companies the same as the local ones, however if these do not have a registered local entity in Bulgaria,<sup>241</sup> they are allowed to register for VAT purposes through a special authorized representative.

With recent amendments the scope of registration was expanded to include entities registered in Bulgaria with contributed capital higher than the equivalent of USD 1 million in local currency. This investor-oriented type of VAT registration is not subjected to annual renewal. It is maintained for 3 years, and respectively subject to mandatory deregistration if the entity has not been able to meet the general registration criteria in this period. Under a similar mechanism, companies not meeting the criteria are afforded registration for one year if their short-term assets value exceed BGN 150,000 throughout the past year.

There is only a very modest range of goods and services which are VAT exempt<sup>242</sup> – and by and large coverage is comprehensive (Bulgaria does not have the significant exemptions or lower rate of VAT for food, books and publications, domestic energy supplies etc that may be found in some EU member states. Consistent with EU guidelines, following the place of performance rule,<sup>243</sup> services and goods provided outside of the legally defined territory of the country are VAT exempt. This includes transactions in warehouses subjected to the authority of the customs directorate, and certain exports.<sup>244</sup>

### Personal Income

Under Bulgarian law, a graduated tax is levied on the personal income of residents,<sup>245</sup> non-residents, and their income derived from commercial activities as sole proprietors.<sup>246</sup> After its recent alignment with international practice<sup>247</sup> in this area, Bulgaria has sought to close loopholes which had earlier allowed tax avoidance. The recent shift to follow the Unitarian income model allows the taxation of the worldwide earnings of residents,<sup>248</sup> and for non-residents<sup>249</sup> the taxation of all income of derived from sources in the country.

The income tax burden on employees is reduced by about 2 percentage points from the beginning of 2001. For a worker in the middle-income bracket, the marginal rate of income tax

<sup>241</sup> Representative offices, branches, shops, construction sites, quarries, etc.

<sup>242</sup> For example exempt from VAT is the provision of good and services related to: (i) transfer of ownership and limited property rights on land; (ii) lease of buildings for housing; (iii) financial and insurance services; (iv) social and health services; (v) educational services and services provided by cultural establishments; (vi) services of lawyers and notaries; (vii) transfer of entire enterprise in cases of nationalization or privatization; (viii) auctioning of confiscated goods; (ix) non-compensated use of municipal and state property; (x) pledges, financial guarantees and mortgages; (xi) charitable donations; (xii) good and services provided by cooperatives to their members; (xiii) gambling.

<sup>243</sup> Art. 21 ff. LVAT.

<sup>244</sup> Art. 36-52 LVAT: Exempt export transactions.

<sup>245</sup> Art. 6 LTPI, Exempted from taxation is only the remuneration of diplomatic mission's personnel: Art. 12(1) LTPI.

<sup>246</sup> Sole proprietors are levied taxes according to the Law on Corporate Tax by transforming the financial result of their activities with the payments and deductions specified in Article 23 of the LCT (Art. 21 of the LTPI).

<sup>247</sup> Law on the Taxation of Personal Income (LTPI), SG 118, 12/1997 last amend. SG 111, 12/1999.

<sup>248</sup> Art. 8(1) LTPI.

<sup>249</sup> Art. 8(3) LTPI.

is 26 percent (and the worker on average salary would pay about 16 percent of taxable earnings in income tax). The highest marginal rate of income tax is set at 38 percent. These figures are not out-of-line with experience in several EU states, although it should be noted that once one includes other payments for social security, income tax and other costs (by employers and employees) the combined tax burden on labor in Bulgaria remains fairly high.

As might be expected there are a range of provisions relating to non-residents and others with overseas earnings. The legal definitions are broadened to qualify as residents all Bulgarians and foreigners who spend in the country more than 183 days during each 365 day period. A non-resident for taxation purposes is any person obtaining income from Bulgaria who fails this qualifying condition. Additionally, Bulgaria has concluded double-tax treaties with a wide range of other countries including most EU member states.

## Company Transformation

### Mergers and Consolidations

The Commercial Code (CC) treats mergers and consolidations in a very similar fashion. The differentiation between the two lies in the mechanism used for combining two existing companies into one. In short, in the process of consolidation one of enterprises ceases to exist after being taken over by the other, and the remaining legal entity after the change is that of the bidding company. In the case of a merger, both enterprises are transformed into grander one. Liabilities are duly transferred in this process. As the transfer of liabilities in the cases of consolidation is very straightforward, the governing regime for this type of company transformation is also less narrow.<sup>250</sup>

The CC mandates the publicizing of mergers and consolidations. By statutory provision, the creditors of a business which is to disappear as a result of consolidation are granted a six month period to file their claims with the transformed entity.<sup>251</sup> Following international practice in this area, the CC places the decision for a merger or consolidation of the enterprise within the discretion of the shareholders.<sup>252</sup>

In terms of restrictions, the Bulgarian law prevents business amalgamations which are structured primarily as a measure the put third parties at a disadvantage, and in this respect the merger or consolidation needs to be approved by the authorities prior to the registration of the transformed entity.<sup>253</sup> Such approval is subject to review of the effect of the business amalgamation in terms of impact on the market and the possibilities for exercise of undue influence over competitors due to concentration of the business activity. In this regard the Law on Competition comes into play. The law defines as concentration: (i) the merger of two or more independent companies; (ii) persons controlling one or more enterprises that attain control over other enterprises through the acquisition of the latter's securities, assets, or contracts; (iii) the creation of a joint venture which behaves like an independent agent in the market.<sup>254</sup>

Generally excluded from this provision are: (i) banks, non-banking financial institutions and insurance companies, which purchase and hold securities for investment purposes or resale for no longer than one year and do not exercise their voting rights in a manner that influences corporate policy; (ii) trustees in liquidation or bankruptcy proceedings; and (iii) financial holding companies with the sole purpose of maintaining the value of the capital of an enterprise.

Transactions leading to prohibited concentrations are defined by law<sup>255</sup> when: (i) the combined turnover of the evaluated companies exceeds BGN 15 billion for the year prior to the transaction; and (ii) the involved companies gain control of more than 20 percent of the relevant market

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<sup>250</sup> Art. 261 CC.

<sup>251</sup> Art. 263 (1) CC.

<sup>252</sup> Art 262 (1) CC; The decision to transform is passed with a 2/3 majority of the voting stock. Under Art. 264 CC., the issue of transformation may not be put to vote within the first two years after incorporation.

<sup>253</sup> Art. 262 a CC.

<sup>254</sup> Art. 21-22 LPC.

<sup>255</sup> Art. 24(1) LPC.

share. In exceptional cases, the concentration may be approved if the transaction will also result in positive developments which outweigh the negative impact of the increase in dominant position. Upon request of the involved companies, the Commission decides within one month of the application whether the concentration is admissible.<sup>256</sup>

## Bankruptcy

A well-functioning market economy must facilitate the orderly and timely exit of non-performing companies. This is an integral part of the mechanisms for ensuring that capital and other inputs are continuously available to flow to opportunities of greatest return. Certainly the need for orderly corporate exits is particularly pressing in transition economies such as Bulgaria. The pattern of distribution of assets, including the pervasive role of Government-directed state owned enterprises, emerging from the old system often does not reflect the priorities of the marketplace. Allowing market mechanisms to work is a key to re-patterning the economy over time. And yet in Bulgaria to date we have seen about 17,000 business closures, a modest 2.5 percent of the corporate sector.

The Commercial Code<sup>257</sup> regulates the process of corporate closure. The relevant provisions have been largely modeled on corresponding German statutes. Two main channels are facilitated: liquidation (regulated by Chapter 17) and bankruptcy (regulated by Part 4). Liquidation is primarily designed to cover those circumstances in which the continued activity of the enterprise is undesirable from a business perspective. It is essentially a procedure with minimal judicial involvement, where the Court's role is to register the claim for liquidation and then review the creditor's proposed liquidator (trustee) and confirm his appointment.<sup>258</sup> Thereupon the liquidators act to define, trace and recover assets for settlement amongst interested parties, after which the Court is requested to close liquidation proceedings on deletion of the company from the Commercial register.

In contrast bankruptcy revolves around court proceedings in four key stages. The bankruptcy filing – by a creditor or the debtor – commences the process, upon which the Court ascertains the entity's insolvency, institutes bankruptcy proceedings and appoints an approved Trustee to represent the creditors. The key issues in developing this part of the framework is in strengthening the role and responsibility of the trustees. In the second stage the company continues to operate under the supervision of the trustee. Creditors then submit claims, in the third stage, which the Trustee seeks to meet through several potential means. If creditors can be satisfied (including through the possibility of a reorganization which may see the firm continue in operation) then the bankruptcy proceedings are terminated. Otherwise, stage four is reached in which the court declares the entity bankrupt, all operations are ceased and conversion of assets is conducted by the trustee for distribution to claimants according to established priority.

Whilst this model conforms to elements of EU practice, it has significant weaknesses both in design and implementation. Recognizing this, the Government proposed substantial amendments to the Commercial Code, which were submitted to Parliament in February 1999 and

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<sup>256</sup> Art. 25 FF LPC.

<sup>257</sup> Sections [4] and [17].

<sup>258</sup> Art. 70(3) CC.

were finally adopted in October 2000. Their purpose is to speed up and clarify the process, including through: (i) shortening of the claim filing period (to 30 days); (ii) incorporating claims arising after the opening of the bankruptcy procedures under the reorganization plan. The amendments seek to make the financial analysis of the debtor's condition optional. Perhaps the most important amendment is to devise bankruptcy as a comprehensive method for the resolution of claims, moving away from the current state, where the ruling of the court is simply a determination which can be further disputed. Under the proposed format, bankruptcy court rulings correspond with the *res judicata* effect and are final decision ending the dispute.

The amendments are also designed to re-balance the role of judges and court-appointed trustees in the process. By perfecting the role of trustees, increasing their discretionary powers and enhancing the rules for their supervision, the larger part of the burden in bankruptcy proceedings is shifted from the judge to the trustee. Regulations will be established to ensure greater independence of the trustee, whilst at the same time imposing proper disclosure requirements on Trustees. Courts will also take a fuller view on the circumstances of removing trustees for just cause – essentially only in cases where his actions jeopardize the interests of creditors as a whole, rather than the interests of a single creditor.<sup>259</sup> New compensation arrangements are also envisaged to allow payments to Trustees based on work undertaken as the process unfolds, and based on a “success fee” (related to assets recovered) upon completion of the bankruptcy.

These changes may improve the situation, although a judgement of the impact of this new legal framework must await the way its provisions are implemented. In any case, it is clear that further work is needed on the institutions which put the regulations into effect. Bankruptcy and liquidation provide a classic case in which the most significant weaknesses are not in the law but rather in the way it is implemented. Priority action must be focused on: (i) better training for selected judges specializing in this field; (ii) enhanced court administration, most notably in file-keeping; (iii) establishing centers of expertise, including in the Sofia District Court, and correspondingly rationalizing the case load.

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<sup>259</sup> For example Article 657(1) pt. 4 CC of the current law provides that 2/3 of the creditors may remove the trustee at any time.

## Conclusion

Bulgaria started the transition with a weak and underdeveloped regulatory framework for governing business. Over the last nine years significant efforts have been made to redress that situation. Most particularly, Parliament has adopted numerous new laws to establish a sounder base for commercial activity. If anything the pace of change and improvement in the business environment has picked up over the last year or so, in response to the European Union's decision to invite Bulgaria to commence formal accession negotiations. The desire to harmonize the domestic position with the *acquis communautaire* will provide a useful driving force and guide for further changes in the years ahead.

The effect of the steps in recent years has been to produce a legal framework for business which by and large includes the key ingredients of best international practice and covers the elements needed for sustained private sector development. There has been substantial approximation to EU standards, and whilst Bulgaria's system in some respects still lies behind that of EU member states, it is well-advanced by transition economy standards. Items such as the new Law on Offering of Public Securities (1999), which regulates securities markets, and the updated Law on the Protection of Competition (1998), provide examples of legislation which adopts the very best of international and EU practice. Other areas will need further development, such as improvements in the bankruptcy framework and in accounting legislation, and plans are in hand for this process.

None of this leaves rooms for relaxation. Competitive pressures on Bulgaria's corporate sector can only increase in the future, making it all the more important that regulatory structures and instruments support and sustain entrepreneurial spirit. Even whilst harmonizing with EU norms, the authorities have to strike the right balance between a "light touch", which liberates free enterprise, and robust regulation which provides proper safeguards for legitimate businesses, investors and consumers.

There are items in the regulatory framework which deserve continued attention. One will be to ensure that the quality of drafting of primary legislation remains accurate even in the face of increasing demands on the limited staff available. A second, equally important task is to improve the quality of secondary legislation (regulations and other statutory instruments) which are so crucial in giving effect to main laws. Yet the greatest challenge ahead is not so much in the design of the regulatory framework, but rather in the quality and timeliness of its implementation. Focusing renewed attention, and well-targeted resources, on the institutional underpinning of the business environment is a priority. This includes: a more effective judicial system for corporate affairs; enhanced and quicker enforcement of court judgements; and streamlined, transparent services (such as licensing and tax procedures) delivered by the public administration to businesses. And this last challenge provides opportunities for further research and international collaboration to help Bulgaria not just to design but to operate a high quality regulatory environment.



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