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Corresponding author:

predrag.dedeic@yahoo.com

## CO-PROTECTION OF MINORITY SHAREHOLDERS: CHALLENGES OF NATIONAL REGULATION AND PRACTICE

**Predrag Dedeić**

Faculty of Business Studies and Law,

„Union – Nikola Tesla“ University, Belgrade, Republic of Serbia

e-mail: predrag.dedeic@yahoo.com

**Abstract:** *The goal of this paper is to point out the legal and economic importance of the protection of small shareholders. That protection is one of the basic pillars of good corporate governance. Without effective protection of those whose votes cannot significantly influence decision-making in a joint-stock company, because it is governed by the majority technique, there is no basic prerequisite for the dispersion of share ownership, the development of corporate culture, shareholding and the capital market. The paper includes the definition of minority shareholders, the categorization of their rights and basic protection measures that represent good practice contained in both the national and European (EU) legal framework, as well as in the “soft law” principles of reference international entities (IOSCO, ESMA, G20, OECD). Although our legislation with its solutions follows the regulatory trend of the most developed market economies, practice shows that the system does not work well, neither internally (within the company), nor externally (in proceedings before administrative and judicial bodies). Protection is weak and the capital market is narrow and shallow. This discrepancy between regulation and practice is the result of numerous factors. The basic one is that the existing regulations are advanced, as a result of the process of harmonizing our legal system with EU law, and the presence of entities on the capital market is the result of the administrative process of privatization, not market trends. In addition, the market environment is characterized by the absence of corporate culture and awareness of the importance of protecting minority shareholders for public joint-stock companies and the entire financial market. Such a situation gives rise to the need to review the existing legal and institutional solutions, as well as to review the capacity of state institutions and market entities (including those with public law powers such as auditors) to ensure respect for the principle of equality of shareholders, ensure the information of small shareholders and protect*

*their economic, governance, control and other rights and provide effective administrative and judicial protection. The protection of minority shareholders is analyzed in the paper on several levels. It was observed in the light of the legal rules concerning the shareholders' assembly (convening, agenda, decision-making, protection from shareholders with significant and controlling participation, etc.). The other side of the coin - the potential for abuse of shareholder rights by the minority - has not been left out either. The focus is further based on the characteristics of the mechanism for selecting members of the management and protection against conflicts of interest and abuses by persons who manage and represent the company. Also, the specificity of protection in complex takeover procedures of joint-stock companies, status changes, situations regarding related parties and group companies was considered. The role of the Securities Commission, in terms of competence and capacity to provide adequate protection, was also critically viewed. The role of judicial authorities was also analyzed, as were the legal means available to dissenting shareholders (individual and derivative actions, etc.). There is also a review of the importance of independence and professionalism of the media in reporting to the public and building responsibility and corporate culture.*

**Keywords:** *minority shareholders, dissenting shareholders, joint-stock companies*

## INTRODUCTION

The protection of small shareholders is materially and procedurally complex and it is certainly an important topic. The appropriate scope of this paper necessitated the selection and processing of some of the representative issues of that protection. Numerous papers of the doctrine testify to its importance, just like the research of international reference organizations and experts, which resulted in codes and recommendations (soft law) of good corporate governance practice that includes the protection of small shareholders (IOSCO, ESMA, G20, OECD). All that had a positive impact on company law solutions around the world, including our country.

The decision-making of the shareholders takes place using the majority technique (instead of unanimity), so by the nature of things, it focuses on the protection of the minority from the majority. That majority by capital, or formed on the basis of a formal or informal agreement, can use (abuse) its decision-making power, to the detriment of the company and small shareholders. The result of such behavior is the lack of confidence of the investment public, reluctance to invest and poor dispersion of ownership. The capital market does not develop in such conditions, and companies cannot attract long-term, cheap and clean capital, so growth, research and other activities, in an effort to improve competitiveness, are financed from bank loans.

Our capital market is specific and significantly different from the market of developed EU countries. First of all, it is a very young market, reestablished after several decades of non-existence in the socialist economy. At the same time, the public joint-stock companies that are on it were created in the process of privatization (employees and former employees became small shareholders through the free distribution of shares) and were

then forcibly included in the organized market. For many of them it brought and brings only an additional cost, and the only reason they are still in the market, is that they do not have the means to comply with the legal obligation to buy back shares from dissenting shareholders. Developed without proper strategy<sup>1</sup> our capital market is narrow, shallow and shareholder protection is weak, as well as relevant institutions.

The economic ratio of the protection of minority shareholders is confirmed by empirical research. They show that companies that respect the interests of small shareholders are more resistant to external risks and are more profitable.<sup>2</sup>

The application of good corporate governance standards helps to minimize the existing principal-agent problems that arise between large and small shareholders, as well as small shareholders and members of the board of directors, especially executives. Also, the study at the EU level<sup>3</sup> shows that adequate protection of small shareholders has a positive effect on the development and attractiveness of the national capital market and the attraction of investments. Especially important are the rules, the application of which leads to a reduction in the risk of expropriation of the rights of minority shareholders, by large ones, in situations of conflict of interest, related persons and the affairs of controlling shareholders with the company in which they have that status (self-dealing)<sup>4</sup>.

The condition for each shareholder to effectively use his rights is to know their scope and content<sup>5</sup>, to be informed in detail about all issues that are important for the business fate of the company, and to have effective administrative and judicial protection. The basic way to get full information is an active approach and presence at the shareholders' meeting, the possibility of effective access to the company's acts and documents, including financial and business reports, etc.

## 1. SHAREHOLDER PRINCIPLES AND EQUAL RIGHTS OF SHAREHOLDERS

A joint stock company is a legal subject created by registration in the public company register. It is responsible for its obligations with its entire property. Shareholders are natural and legal persons who are investors in the company and acquire shares on that

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1 For ideas about proper strategy see: Dedeić P. (2017), Securities Commission in the absence of capital market development strategy. Work in the scientific monograph "*Structural reforms and the role of regulatory bodies in Serbia*". The Scientific Society of Economists of Serbia with the Academy of Economic Sciences and the Faculty of Economics in Belgrade

2 IOSCO Protection of Minority Shareholders in Listed Issuers 2009. <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD295.pdf> (downloaded on August 1, 2022)

3 Study on Minority Shareholders Protection Final report EU Commission <https://op.europa.eu/en/publication-detail/-/publication/1893f7b8-93a4-11e8-8bc1-01aa75ed71a1/language-en> (downloaded on August 1, 2022)

4 IOSCO Protection of Minority Shareholders in Listed Issuers 2009. <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD295.pdf> (downloaded on August 1, 2022)

5 Žerajić B. *Small shareholders* <https://www.otvorenavratapravosudja.rs teme/privredno-pravo/mali-akcionari> (downloaded on August 1, 2022)

basis.<sup>6</sup> They are not responsible for the obligations of the joint-stock company in which they have shares (they are only obliged to pay, within the prescribed period, or to make a contribution as consideration for the subscribed shares). Exceptionally, their responsibility could extend to personal property in the case of application of the legal institute piercing the corporate veil.

The mutual relations of shareholders are regulated in accordance with the principle of equality (within the class to which they belong). Their investment motive may be different (governance, dividend, capital gain), but it is not important for their relationship, only the number and class of shares they own, as well as the possible existence of a joint action agreement, are important.

A joint stock company has a share capital divided into shares. In other words, that capital is the sum of the value of all issued shares. It not possible for invested capital to be paid back to shareholders.<sup>7</sup> Its corporate power depends on the part that belongs to an individual shareholder based on the contributions he has paid (monetary contribution) or entered (non-monetary contribution). The type and extent of his rights depends on the type and number of those shares that are in his name and represent an electronic record in the account maintained by the Central Registry, securities depository and clearinghouse (dematerialization of shares).

The corporate power of shareholders is a variable category and is correlated with the increase of share capital. That indicates the importance of the right of pre-emption of newly issued shares (of the same class) and one of the rights belonging to every shareholder. Each increase in the basic capital through a new issue of shares allows him to use the right of pre-emption (in proportion to the value of the entire paid-up shares) and preserve the percentage with which he participates in it, and thus the degree of governance influence. A shareholder has no obligation to buy newly issued shares, but has the right to dispose of those he owns (in a public joint-stock company, this right cannot be limited by the right of pre-emption of other shareholders), thereby ending his status as a shareholder. A shareholder with a share of more than 25% can significantly influence the joint-stock company (a shareholder with a significant share in the share capital), and a shareholder who owns more than 50% has a majority share and belongs to the category of controlling shareholder. However, it is not all about the percentage of participation in the basic capital, there is also something in the mutual agreements of the shareholders.

Dividend is the most common investment motive and it is the shareholder's right to participate in the profit. A shareholder has the right to a dividend according to the number of shares. However, the decision on the payment of dividends is made by the assembly of the joint stock company, which consists of all shareholders (shares with voting rights), and therefore whether a decision on the payment of dividends will be made or not depends

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6 The legal position of shareholders is regulated by the Companies Act, and shares are traded on an organized market regulated by the Law on Capital Market, Law on Takeovers and other regulations.

7 Stefanović, Z. (2021). *Commentary on the Companies Act*. p.135. Official Gazette. Belgrade

on the will of the majority of shareholders. The one who did not vote in favor remained both in the minority and without a dividend.

Every shareholder has the right to timely, complete, true and relevant information and access to company documents. Also the right to participate in the work of the assembly (in person or by proxy) and to vote if there are regular shares (one share one vote).

A joint-stock company is a complex organization in which and on which subjects of heterogeneous interests act. As a result, there are three agency problems. The first concerns the relationship between shareholders and management, the second concerns the majority and minority shareholders, and the third concerns the company and the social community. Solving every agency problem requires transparency and good financial and business reporting, as well as quality internal and external auditing. This is especially important in the more complex relationships we have with related parties, group companies, status changes, takeover procedures, existence of management and control contracts, etc.

The separation of the function of ownership and the function of management gives rise to the first agency problem. The answer is not easy to the question of how the shareholders should direct the activities of the management in the interest of the company. If they do not do that, they are exposed to the risk that the directors will pursue their own interests at the expense of the company and shareholders. Theory and practice deal with that set of rules, which are based on the material incentive of the director, adequate supervision and a system of punishment<sup>8</sup>. Protection measures include the impact on the composition of the board of directors, especially the status of non-executive and independent, clearly defined rights, obligations and responsibilities<sup>9</sup>, the issue of reporting and transparency of decisions, etc. It is important to achieve a balance of power between shareholders and directors (enterprise and operability must not be hindered for the sake of ultimate legal certainty).<sup>10</sup>

All shareholders are interested in a system where CEOs are loyal to the company. The dynamics of the relationship sometimes lead to the management acquiring a majority package of shares (management buyouts - MBO), which puts the other shareholders in a minority position. The situation in a joint-stock company is further complicated by the fact that shareholders are not a homogeneous category and may have completely conflicting interests.<sup>11</sup>

When it comes to the relationship between majority and minority shareholders, the second mentioned level of the agency problem arises.

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8 Kim A, K Nofsinger RJ (2007). *Corporate Governance* . p. 11-21. Pearson Education Ltd., London.

9 Special rules on directors' liability for damages in the case of related parties (they are generally protected by business judgment rules).

10 Practice shows that the influence of management on shareholders is strong, almost decisive. Kim A, K Nofsinger RJ (2007). *Corporate Governance*, p. 4-5. Pearson Education Ltd., London.

11 An example can serve as a situation, which is very common in our country, where company employees who are also shareholders see their interest in the highest possible salaries, and care less about the dividend. On the other hand, shareholders who are not employees of the company are only interested in dividends, and see the salaries of employees as an expense.

## 2. PRINCIPLE OF THE MAJORITY AND PROTECTION OF THE MINORITY

The rights of minority shareholders derive from the law, the bylaw of the company, as well as the agreement between the shareholders. They can be classified into several categories: economic, control, access to information, the right to administrative and judicial protection and the right to equal treatment.

The majority has a decisive role in the legal and legitimate governance of the company (the generally accepted principle of the majority). The decision-making right in the hands of the majority shareholder is accompanied by the obligation to make decisions in the interest of the company (fiduciary duty towards the company). Good corporate governance implies the ability to balance the interests of majority and minority shareholders. Practically, this means preventing the abuse of the majority (theory of abuse of majority shareholders), as well as of the minority (theory of abuse of minority shareholders - in the sense of decision-making blockage).<sup>12</sup> Establishing a balance of interests is the solution to another agency problem.

Minority shareholders are not a separate class of shareholders, nor are the shares they own different from those held by major shareholders. Minority status exists and is acquired in relation to specific decisions or legal actions. For example, a shareholder who voted against a decision of the shareholders' assembly, and it is still adopted by the prescribed majority of votes, remains in the minority. Then the question of protecting his interest can be raised.

Also, a certain percentage of share ownership allows minority shareholders to take certain legal actions, such as filing a derivative lawsuit or requesting to convene a regular or extraordinary meeting of the shareholders' assembly. It seems that the status of a minority shareholder is more of a procedural than a material nature, because as a rule it is related to the legal possibility of initiating a procedure demanding the annulment of the assembly's decision, execution of some legal action, compensation for damages, cancellation of a harmful contract, termination of the company, etc.

Small shareholders have a number of shares that, in the majority decision-making system (ranging from a simple majority to a qualified majority), does not give them the possibility of significant or controlling influence on the company's operations and decision-making in the shareholders' assembly. However, it should be understood that decisions are made by voting (one share, one vote), so the composition of the majority of shareholders that made the decision also changes. That is why the transparency of their agreements is important.

The dynamics and complexity of economic life and relations between companies, including status changes, bring numerous challenges and risks for minority shareholders.

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<sup>12</sup> Vasiljević M. (2007), *Corporate Governance-legal aspects*, p. 124. Law Faculty of the University of Belgrade and Proinvest doo, Belgrade. Belgrade.

Transactions with related parties, which can be very risky for them, represent a special challenge for the protection of small shareholders (due to presence of moral hazard and frequent fraud). Therefore, they must be transparent, continuously monitored, approved, and even blocked by persons who have no direct interest in the transaction (including minority shareholders). Information technologies can significantly contribute to better transparency of the entire procedure and the identification of business participants (through the control of social security numbers). Transparency best solves the problem of information asymmetry and is especially important for groups of companies (minority shareholders must be provided with access to information and documents, and the court must also provide effective protection). Disclosure rules are a pillar of corporate governance. The OECD Principles of Corporate Governance point out that good reporting has a positive effect on investor confidence.

A good solution could be to empower the Securities Commission to collect and determine the validity of relevant documents. Also important is the possibility of appointing an independent auditor by the minority shareholders, to confirm the usefulness of the transaction for the company.

The strategy for the protection of minority shareholders implies transparency. The G20/OECD Principles of corporate Governance highlight the need to disclose the capital structure and agreements that show a degree of control that is not proportional to the ownership of shares<sup>13</sup>. Determining who the owners are and what their corporate structures are is not always an easy and simple task.<sup>14</sup> Already when it acquires 5% and more, it is worth monitoring in terms of further acquisition and participation in governance. Information technology and artificial intelligence could be of great help there.

The rights of minority shareholders from influencing management are important. A good example is the use of a cumulative voting system or the existence of a statutory rule that minority shareholders elect a member of the board of directors. It is useful to put the obligation on board to review, and then clarify, the impact of their decision on minority shareholders.<sup>15</sup>

As a measure to attract foreign investors, the possibility of using a foreign language in the work of the shareholders' meeting, the possibility of efficient access by electronic means, the right to participate in the meeting accompanied by an advisor can be provided<sup>16</sup>. Also, it should be borne in mind that foreign shareholders have a higher level

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13 G20/OECD Principles of Corporate Governance The Rights and Equitable Treatment of Shareholders and Key Ownership Functions. II-E.

14 ESMA Report on shareholder identification and communication. p. 11-13 [https://www.esma.europa.eu/sites/default/files/library/esma31-54-435\\_report\\_on\\_shareholder\\_identification\\_and\\_communication.pdf](https://www.esma.europa.eu/sites/default/files/library/esma31-54-435_report_on_shareholder_identification_and_communication.pdf) (downloaded on 1.08.2022)

15 Study on Minority Shareholders Protection Final report EU Commission <https://op.europa.eu/en/publication-detail/-/publication/1893f7b8-93a4-11e8-8bc1-01aa75ed71a1/language-en> (downloaded on 1.08.2022).

16 Study on Minority Shareholders Protection Final report EU Commission <https://op.europa.eu/en/publication-detail/-/publication/1893f7b8-93a4-11e8-8bc1-01aa75ed71a1/language-en> (downloaded on 1.08.2022).

of protection than domestic ones, thanks to the possibility of using means of protection provided by international bilateral and multilateral agreements.<sup>17</sup>

The comprehensive protection of minority shareholders provided for in company law is achieved in practice by the active role of the local competent commercial courts. They must provide effective protection within a reasonable time. Resolving disputes before alternative forums (arbitration and mediation) represents a significant and untapped potential.

Numerous legal actions are available to minority shareholders. One of the most important rights is the possibility to sue for damages from the majority shareholders (controlling and with significant participation) due to the violation of special duties towards the company.<sup>18</sup> For that lawsuit, a mandatory census is provided (shareholder with shares representing 5% of the company's basic capital).

Decisions of the shareholders' assembly can be challenged with a lawsuit, they can ask for access to documentation when it is denied, and in certain cases (a shareholder with 5%) can sue for the annulment of a legal transaction or legal action, that is, the disposal of high-value assets.

When relations between shareholders are very disturbed, the only solution can be dissolution, so that shareholders who own shares whose value is 20% (and more) of the share capital are authorized to sue the company for mandatory dissolution.

Determining a violation of rights is often a very professional job, so good comparative law practice shows the benefit of the right of minority shareholders to hire an expert to determine the existence of a violation.

The Securities Commission also has the authority to conduct court proceedings for the protection of the rights of minority shareholders, but this potential is unused. The reason for this is the negligence of the state to materially strengthen this key institution of the capital market and the continuous outflow of professional personnel. Also, administrative courts should be more active and professional in reviewing the decisions of the Securities Commission.

The media in Serbia have a serious problem regarding independence and expertise when it comes to the topics of share ownership. In addition to the need for sensationalism, they are often also an instrument in the hands of individual interests. The influence of interest groups through the media can represent the manipulation of public opinion and an attempt to put organizational pressure on the work of state authorities.<sup>19</sup>

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17 Tasić M. Minority shareholders : general defining questions-concepts and mechanisms of legal protection. (file:///C:/Users/win10/Downloads/Istosic,+Minority+shareholders+General+issues+on+the+definition+of+the+concept+and+mechanisms+of+legal+protection%20(4).pdf( downloaded on August 1, 2022).

18 violations of the rules on approving jobs in which there is a personal interest, violations of the duty to avoid conflicts of interest, violations of the duty to keep business secrets and violations of the rules on the prohibition of competition

19 One of the classic examples is the reporting on the case of " Energoprojekt" takeover in 2017.



### 3. RIGHTS OF DISSENTING SHAREHOLDERS

The Institute of dissenting shareholders has been present in our legal system since 2004 (Companies Act). This is the right of minority shareholders, which is activated after the adoption of corporately significant decisions.

Decisions of the shareholders' assembly are made by the majority, but this does not mean the arbitrariness of the majority. The main limitation to the abuse of the majority is the obligation to act in the interest of the company. If they violate that rule, minority shareholders have the right to protect both their interest and the interest of the company (derivative lawsuit). But even with certain legal and legitimate decisions, a shareholder who believes that they are not in accordance with his interest, has the right to leave the company, assuming that he meets the conditions for the status of dissenting shareholder. The status of dissenting shareholder is acquired by the shareholder who has voted against (or abstained from voting) of a specific decision of the assembly. This does not apply to all parliamentary decisions, but only to corporately significant decisions that are provided for by law (*clausus numerus*).

Dissenting shareholders are thus enabled, under the prescribed conditions, to exercise the right to exit the company<sup>20</sup>, with fair compensation for the value of the shares.

Corporately significant decisions are of such legal effect that they significantly affect the company's assets, its financial position or the rights of shareholders. This category consists of decisions on changing the company's statutes, on approving the acquisition or disposal of assets of high value, on decisions reducing or changing the rights of shareholders, on changing the status of the company, on changing its legal form or changing the duration of the company, delisting, as well as other legal grounds by statute<sup>21</sup>. The significance of those decisions and their indirect or direct impact on certain shareholders required that their rights in those cases be protected by law. A shareholder who voted against its adoption (or abstained from voting for a decision that he considers harmful to the company or against his interests) belongs to the category of "dissenting shareholder" and can use certain legal means to protect his interest. First of all, he can demand that the company buy back his shares. The question of price is determined by law.<sup>22</sup>

This principle of share repurchase and the same criterion for determining the value of shares is also applied in situations where forced repurchase of shares is allowed. That is, when there is a right of small shareholders, to ask from the majority shareholder, to repurchase their shares. We are talking about such an ownership relationship in which

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20 Radović V. (2017). Conditions for exercising the rights of dissenting shareholders. *Law and Economy* 4-6. p. 50.

21 Radović V. (2017). Conditions for exercising the rights of dissenting shareholders. *Law and Economy* 4-6. p. 59

22 The lack of our law regarding price determination, see Vasiljević M. (2016) "Economy and the regime of some rights of minority shareholders - unity of interests or unity of opposites", p. 16. in Vuk Radović (ed.) *Harmonization of business law of Serbia with the law of the European Union*. Faculty of Law, University of Belgrade.

the majority shareholder (controlling) owns 90% of the shares, that is, 90% of the votes of all shareholders. Compulsory redemption does not occur automatically, but at the proposal of the majority shareholder, and the realization of the right to sell is initiated by the minority shareholder.

The decision on the payment of the price (according to the principle for dissenting shareholders) is made by the shareholders' meeting. After that, two situations can arise for the minority shareholder. One is that the controlling shareholder does not pay the value of the shares in accordance with the decision of the shareholders' meeting. A minority shareholder has the right to sue. The second is that he was paid a certain amount of money, but he believes that the price of the share was not established in accordance with the law or was not determined in the correct way (abuses in the assessment of value), so that the disagreeing shareholder can sue the court for payment of the price difference.

### CONCLUSION

The protection of minority shareholders is of great legal and economic importance. It is part of corporate governance and provides legal certainty to investors, and it provides companies with the ability to attract long-term, cheap and clean capital. It is also a condition for the development of the national financial market.

The underdevelopment of our capital market is the result of numerous factors. That market was formed administratively through the process of privatization of social enterprises and developed spontaneously without a development strategy. The logical consequence is that it is also shallow and narrow, with a weak protection system. At the same time, due to the process of harmonization with EU law, the legal solutions are advanced, but in practice for a large number of companies they cause only additional costs and the inability to withdraw from it. They are not able to pay dissenting shareholders, which is what the law obliges them to do, in the public joint-stock company becomes closed joint-stock company.

The ability of small shareholders to exercise their rights depends to a large extent on knowledge of the regulations that protect them, access to information, the efficiency of the judicial and administrative protection system, and the economic strength to bear the associated costs (e.g. in the case of a derivative lawsuit where the costs may fall on the shareholders). Professional investors are in a better position in this regard.

The state would have to strengthen the material and personnel capacities of the Securities Commission, so that it could be more involved in protecting the rights of small shareholders. In the present position it is not realistic to expect a significant shift in that kind of protection. The right strategy would include education and awareness development about the importance of protecting small shareholders and its impact on the company and the market.

The role of the media can be very significant in building a corporate culture, promoting share ownership and financial markets as generators of real sector development. This

requires a higher level of independence and expertise from the media, as a condition for successfully opposing the pressures of interest groups.

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