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The law affecting corporate governance in Kenya: a need for review

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***I.C.C.L.R. 213 Introduction**

There is increasing evidence that a country's legal system plays a significant role in determining the success of its corporate governance system. Research has shown that good corporate governance is more likely to be associated with countries with a strong legal system.¹ However, in the recent move towards the privatisation of corporations, Kenya, like other developing countries, has adopted a corporate governance code that is drafted from a combination of codes from developed countries with little thought being given to the underlying conditions of the market in which this code is to be enforced. A significant amount of training of company directors on the importance of good corporate governance is underway.²

While Kenya's effort in training company directors is commendable, it remains questionable whether Kenya can achieve good corporate governance with the current state of its law and a code that is designed without sufficient consideration of its market conditions. Recent financial scandals have shown that Kenya is unable to cope with the self-regulation of its corporations through corporate governance codes. Companies have often been used as instruments of fraud, bringing the Kenyan economy to its knees. An example is the Goldenberg scandal which cost Kenya approximately \$4 billion, roughly 10 per cent of its gross domestic product (GDP).³ These large-scale scandals are not a new phenomenon in Kenya. The 1980s were marked by the collapse of more than 33 banks.⁴ Many companies and parastatals such as Kenya Corporative Creameries (KCC), National Housing Corp and the Kenya National Assurance Co among others have followed suit in the last decade.⁵ Owing to the inefficiency of the legal system, among other factors such as corruption and political interference, investigations into the insolvency of these companies have not borne much fruit. While the perpetrators of the fraud continue to enjoy the benefits of committing fraud at the expense of the majority of the Kenyan population, Kenya continues to base its corporate governance training on codes drafted for markets with different corporate cultures and strong legal systems which are better able to handle corporate fraud.

It is within this context that the effectiveness of corporate governance in public listed companies in Kenya will be considered. This will be done by reviewing the law affecting corporate governance in Kenya. Legislation in English statutes is relied upon in reviewing the law affecting corporate governance as the English statutes and common law doctrines in force in England on August 12, 1897 are of general application in Kenya.⁶ Therefore English statutes and common law after 1897 are not binding but they are entitled to the highest respect, as persuasive authority, if they have not been subsequently amended.⁷ This will be followed by an examination of the effect of current law on the implementation of good corporate governance in Kenya. This article argues that the relationship between law and corporate ***I.C.C.L.R. 214** governance needs to be appreciated, and Kenya's law and corporate governance code reviewed accordingly, if Kenya's quest for good corporate governance is to be realised.

Corporate governance in Kenya

Kenya forms a good case study for discussing the relationship between law and corporate governance, as on the face of it Kenya appears to have all the elements that are necessary to achieve good corporate governance. Kenya's market regulation matches that in developed countries

as it has legislation that governs the market, a regulatory agency in the form of the Capital Market Authority which oversees the stock exchange and, like most developing countries, it has adopted a corporate governance code in the form of the Sample Code of Best Practice of Corporate Governance in Kenya 2002, which was developed by the Centre for Corporate Governance,⁸ an affiliate of the Commonwealth Association for Corporate Governance (CACG). Kenya's corporate governance code is enforced by the Capital Markets Authority through the CMA Guidelines, which are the result of a combination of ideas from corporate governance codes from different jurisdictions. This is particularly evident in s.1.3 of the CMA Guidelines which states that:

"These guidelines have been developed taking into account the work which has been undertaken extensively by several jurisdictions through many task forces and committees *including but not limited* to the United Kingdom, Malaysia, South Africa, Organization for Economic Cooperation and Development⁹ and the Commonwealth Association for Corporate Governance" [emphasis added].

A deeper examination, however, reveals a country which is struggling in its efforts to adopt good corporate governance owing to the absence of a strong legal system.

A review of the law affecting corporate governance in Kenya

The statutory law governing corporate governance in public listed companies in Kenya is embodied in the Companies Act 1962 c.486 (the Companies Act). Kenya, a former British colony, adopted the Companies Act almost in entirety from England's Companies Act 1948 upon attainment of independence in 1963. The Companies Act deals with directors' duties and shareholder protection among other matters pertaining to corporate governance in Kenya. Other regulations that govern Kenya's corporate governance are the Capital Markets Authority Act 2002, the Nairobi Stock Exchange (NSE) Regulations and the Penal Code c.63.

Directors' duties in Kenya are governed by Kenya's common law of companies. Traditionally, directors' duties in common law are divided into the duty of care and skill and the duty of loyalty. The duty of care and skill represents the courts' attempt to regulate the entrepreneurial side of directors' activities. The duty of loyalty, on the other hand, mainly encompasses the duty of good faith, the no conflicts rule and the rule against managerial opportunism. The duty of good faith requires that directors exercise their powers in the best interests of the company.¹⁰ This means that in carrying out the business of the company, which involves dealing with the assets of the company, directors have a duty to preserve these assets. Therefore all decisions taken on behalf of the company must be taken solely for the benefit of the company and not with a view to seeking a collateral advantage for directors.¹¹ The "no conflicts rule" requires directors not to put themselves in a position where their duties and interest conflict, for instance turning down the business offer of a third party with the intention of secretly taking up the same offer themselves and benefiting in a private capacity.¹² The rule against managerial opportunism requires directors to see business opportunities coming to the company as the property of the company and requires them to be treated as such. For instance, the taking of business contracts in the director's name instead of the company's name thereby creates an opportunity for self-interested behaviour.¹³ The directors' duty of loyalty has to be well protected by robust laws, if the directors' duty of care and skill that facilitates entrepreneurship is to be effective and in turn if good corporate governance is to be possible. This is because whether a director performs his duty with the required care and skill to a great extent depends on where the director's loyalty lies. The disloyalty of directors often manifests itself in managerial misbehaviour which takes the form of misappropriation of company assets. Misappropriation of assets by company directors is dealt with both directly through ***I.C.C.L.R. 215** company law such as the legislation on director liability and criminal law such as the law of theft, and indirectly through securities legislation which uses disclosure as a regulatory mechanism to prevent managerial opportunistic behaviour such as insider dealing. Standards of directors' behaviour are enforced through both criminal and civil sanctions as charges against a director who misappropriates property can be brought under both civil and criminal law. To enforce a director's duty of loyalty and therefore secure their duty of care and skill, criminal sanctions are the key to providing the necessary standard of deterrence under which directors can be expected to refrain from misappropriation of company assets. However, an examination of Kenya's companies legislation reveals a comprehensive legal framework that is difficult to enforce owing to underlying weaknesses in the drafting of legislation governing director liability. Director liability is dealt with under s.45 of the Companies Act.

Section 45(1)(a) of the Companies Act provides that directors are personally liable for misstatements in company prospecti but avails directors with an array of defences in s.45(2). Section 45(2) provides

that where a prospectus has been issued without his consent, where he withdrew his consent or relied on a public official document, a director is exempted from liability for misstatements in the company prospectus. Section 45 of the Companies Act consequently gives company directors no incentive to ensure that they exercise due diligence in the performance of their duties. Shareholders are left vulnerable and unprotected by this provision, in that where a shareholder has relied on incorrect information in the company's prospectus, they can only be compensated if it can be shown that the director was aware of the misstatements in the prospectus or that the director consented to the issuing of the prospectus. The burden of proof here rests with the shareholder, who usually has access to little or no information on the activities of the company. Section 46(1) of the Companies Act goes further in sealing the shareholder's fate by providing that directors will be liable for two years' imprisonment or a fine of KES 10,000 (US \$133) for misstatements in prospecti where they are unable to demonstrate that all they did was to consent to the issuing of a prospectus and therefore not be liable for its contents. This subjective standard of liability is further evident in s.318 of the Companies Act which further exonerates directors by providing that directors can be exempted from liability for offences that are discovered during liquidation if they had no intention to defraud the company, or to conceal the company's state of affairs. In sections of the Act dealing with the appointment of directors, the same trend is evident. Section 188 of the Companies Act provides that:

"... [I]f a person who has been declared bankrupt ... acts as a director of a company *without leave of court*, he shall be liable to imprisonment for a term not exceeding two years or a fine not exceeding Ksh. 10,000 (\$ 133) or both" [emphasis added].

Section 188 of the Companies Act therefore implies that an undischarged bankrupt can act as a company director with leave of the court. Section 188(2) of the Companies Act confirms this by stating that for leave to be granted the bankrupt individual must show that he may safely be involved in the management of companies. It is important to review this section to prohibit undischarged bankrupts from acting as directors of companies. This would prevent bankrupt individuals from starting a business and raising credit using a limited liability company.¹⁴ The exploitation of the limited liability doctrine was a key feature of the Goldenberg scandal and the Anglo-leasing scandal where companies were used as instruments of fraud to raise credit and transfer misappropriated funds for political purposes.¹⁵

Section 189 of the Companies Act empowers the court to make an order restraining the appointment of a person for a period not exceeding five years if the person has been convicted of any offence in connection with the company or if it appears that in the course of winding-up, the person has been guilty of fraudulent trading. Section 189 of the Companies Act therefore implies that persons guilty of past frauds can act as company directors as long as the court allows them to do so and that a person cannot be barred from acting as a director of a company in Kenya on the grounds of fraud for more than five years. Section 189 of the Companies Act suffers from the same limitations as s.188 of the Companies Act as it does not prohibit management who commit fraud from acting as directors of public listed companies. Despite the public outcry and prosecution of individuals who contributed to the insolvency of companies in Kenya such as the Kenya National Assurance Corp and Kenya Posts and Telecommunications Corp, these individuals were subsequently appointed to other directorships.¹⁶

The potential presence of fraudulent management on company boards raises serious questions as to whether good corporate governance is an **"I.C.C.L.R. 216** achievable goal in Kenya, insofar as there is nothing to deter management from acting against the interests of the company. The weakness of Kenya's laws is also reflected in s.402(1) of the Companies Act which states that:

"... [I]f in any proceeding for negligence, default, breach of duty or breach of trust against an officer of a company ... it appears to the court hearing the case that that officer ... is or may be liable ... *but that he has acted honestly and reasonably ... he ought fairly to be excused ...*" [emphasis added].

This suggests that it is possible for directors to go unpunished as a result of negligence arising from their ignorance or inexperience. The court's ruling in *Flagship Carriers Ltd v Imperial Bank*¹⁷ confirms this. The Court held that directors are only required to exhibit a degree of skill and care that may reasonably be expected from a person of their knowledge or experience, but they are not liable for errors of business judgment.¹⁸

The Penal Code c.63 s.329 provides a penalty of imprisonment for seven years for directors who knowingly give false statements with the intention to deceive or defraud the corporation. However, prosecutions at the behest of shareholders, particularly minority shareholders, are difficult to bring

since the legal rights of the company belong to the company and not its members and for that reason only the company may institute proceedings for redress.¹⁹ An exception to this ruling is allowed where a majority of shares are controlled by those against whom relief is sought in particular where they have acted fraudulently or ultra vires in excess of their powers. On the contrary, it appears that suits can only be brought on behalf of minority shareholders where a wrong is done to an individual; in all other cases, only the company can sue the delinquent director.²⁰ This is illustrated in Sir Udo Udoma C.J.'s ruling in *Musa Musango v Eria Musigire* where he states that in finding that the plaintiff was properly before the court:

"He has what is commonly called a right of action, and these decisions which say that, where a wrong is done to the company by the exclusion of a director from the board meetings, the company may sue, and must sue for that wrong, do not apply to the case of a wrong done simply to an individual ... therefore I conclude that I am satisfied that this suit is maintainable in law by the plaintiff in his own right, and that this court has jurisdiction to entertain it as the action is brought for injury done to the plaintiff personally by his co-directors and other members of the company."²¹

Since wrongs are hardly done to a sole individual in a company, the decision to sue rests with the board of directors as it is only the board that can bring proceedings in the company's name.²² Unlike in countries like the United States where an attorney can bring proceedings on behalf of minority shareholders without the consent of the directors of the company,²³ an advocate in Kenya cannot bring proceedings against a company on behalf of the shareholder without the authority of the board.²⁴

There is a need to revise the law regarding derivative actions to provide shareholders, particularly minority shareholders, with an efficient dispute resolution mechanism which will encourage them to seek legal redress when directors breach their duties.²⁵ At present, minority shareholders cannot sue for wrongs done to the company.²⁶ In addition minority shareholders cannot sue the directors of the company in the company's name where a breach of directors' duties is ratifiable.²⁷ Although this rule limits the rights of minority shareholders, it prevents wasteful litigation in the form of multiple actions by minority shareholders and protects the company from being held hostage by disgruntled minority shareholders where they do not agree with the decision of the company. In addition, it facilitates business and preserves the separate legal personality of the company. In spite of the advantages that follow from restricting suits by minority shareholders where acts are ratifiable, this rule exposes minority shareholders to exploitation by the majority particularly in companies where the ownership structure is concentrated.²⁸ Even in cases where prosecutions ***I.C.C.L.R. 217** are brought on behalf of shareholders, they are rarely successful as courts are reluctant to interfere in the internal management of companies.²⁹ Consequently although the Penal Code gives a penalty of imprisonment for seven years for directors who knowingly give false statements with the intention to deceive or defraud the corporation, suits are only likely to be successful where they are brought by the board. It is true to say that such a case is highly unlikely as it is inconceivable that directors will sue themselves.

The penalties within the Penal Code like those in the Companies Act effectively exonerate directors from liability by requiring shareholders to prove the director's dishonest intention. These penalties do not provide the deterrent effect that is necessary to ensure that directors exercise their duty of loyalty by acting in the best interests of the company. This is further compounded by the fact that action on corporate fraud cases in Kenya is highly selective and only seems to take place in high-profile cases where there is political interest, such as the Goldenberg case and the Anglo-leasing scandal. In both of these cases there was public outcry over the misuse of public funds through the formation of fictitious corporations. In the Goldenberg case for instance, a company was formed for the purpose of exporting gold, an almost non-existent mineral in Kenya.³⁰ Although these cases have been investigated no one has been held liable for these scandals, despite the identity of the perpetrators being clear. In other cases where corporations collapsed as a result of mismanagement, the investigations have borne no results. Examples of these include KCC, Kenya Bus Services and Kenya National Assurance, which were mainly state corporations. The recent move towards privatisation appears to have improved the rates of investigation and prosecution of those who mismanage companies. This is particularly evident following the recent collapse of Francis Thuo and Partners and Nyaga Stock Brokers where the public has demanded accountability following massive losses resulting from the collapse of these stock-broking firms.³¹

There is a need to review Kenya's law on director liability to reflect a dual standard of liability with both objective and subjective elements of liability. The present subjective standard of director liability in Kenya is based on the 1925 decision of Romer J. in *City Equitable Fire Insurance Co, Re*,³² where it

was held that:

“... [A] director need not exhibit in the performance of his duties a greater degree and skill than may reasonably be expected from a person of his knowledge and experience.”

The courts were influenced by a model of corporate decision-making which gave the shareholders effective control over their choice of directors. If they chose incompetent directors, that was their fault and the remedy lay in their hands. This is not an accurate picture of the degree of control exercised by shareholders over boards of most public listed companies,³³ and particularly in developing countries such as Kenya, where corporate boards are dominated by block-holders and even in companies with significant individual ownership, shareholders are not that sophisticated in terms of appreciating the need to attend annual general meetings and exercising their rights as shareholders of the company.

By adopting a dual standard of liability for company directors, Kenya would greatly improve its competitiveness as an objective standard would be incorporated into the law and therefore provide an atmosphere in which good corporate governance can thrive. The objective standard of liability originates from the English decision of Foster J. in *Dorchester Finance Co v Stebbing*,³⁴ where it was held that a subjective standard only applied to the exercise by a director of his skill. Foster J. made a distinction between the director's duty of skill and the director's duty of diligence. The director's duty of diligence is an objective duty that requires that directors take “such care as an ordinary man might be expected to take on his own behalf”.³⁵ Fred Ochieng J.'s ruling in the recent case of *NSSF v Ali Khan Holding Ltd*³⁶ supports this proposition. It was held that the traditional subjective standard of director liability, based on 19th-century British common law, is inapplicable and singularly inappropriate to conditions prevailing in modern Kenya. Incorporating an objective standard into the law affecting director liability would give directors an incentive to take more responsibility for their duties as well as act in the shareholder's interests.

The dual test for director liability under the duty of care and skill has recently been adopted in England. Section 174(2) of the United Kingdom's Companies Act 2006 provides that a director:

“... must display the care, skill and diligence that would be exercised by a reasonably diligent person with both the general knowledge, skill and ***I.C.C.L.R. 218** experience that may reasonably be expected of a person carrying out the same functions as the director in relation to that company and the general knowledge and skill that the director actually has.”

The dual test leaves no room for a defence based on ignorance particularly as s.174 of the UK Companies Act 2006 requires directors to act with reasonable care, skill and diligence.³⁷ Adopting a dual standard of care and skill in Kenya will encourage entrepreneurship while not leaving room for negligence resulting from ignorance or inexperience in the running of Kenya's public listed companies.

Kenya ought to restrict foreign influences upon its legal system to those rules of corporate governance which have proved successful in other jurisdictions with similar market conditions and to be flexible enough to dismantle those legal traditions based on inappropriate market models. Adopting foreign corporate governance practice should be done with caution even in cases where market conditions are similar because not only are the policies in these countries likely to differ from those in Kenya but the size and nature of the business transacted in these countries and the people that company law is seeking to protect may have different standards of sophistication and education.³⁸ In general, the law must by definition keep pace with the needs and demands of a developing society. This need to ensure that the law keeps up with the needs of society was recognised in *Nyali Ltd v A.G. of Kenya*,³⁹ where Lord Denning M.R. (as he then was) with reference to common law stated that one can take an oak tree from English soil and plant it on Kenyan soil, but one cannot guarantee that it will do equally well:

“This wise provision should, I think, be liberally construed. It is a recognition that the common law cannot be applied in a foreign land without considerable qualification... It has many principles of manifest justice and good sense which can be applied with advantages to people of every race and colour all the world over. But it also has many refinements, subtleties and technicalities which are not suited to other folk. These offshoots must be cut away. In these far off lands the people must have a law which they understand and which they will respect. The common law cannot fulfil this role except with considerable qualifications. The task of making these qualifications is entrusted to the judges of these lands. It is a great task. I trust that they will not fail therein.”

Although Lord Denning's quote refers to common law as opposed to legislation, it encapsulates the difficulties that arise when laws are transplanted from one jurisdiction to another without reviewing them to reflect the economic conditions and political environment of the receiving jurisdiction. Clearly, an effort has not been made to review Kenya's Companies Act so that it fits the needs of Kenya today. This can be attributed to the hefty requirements needed to sustain an effective common law system such as the need for frequent review of the law to reflect the changes in society. This requires effective institutions, human capital and an environment in which the judiciary is independent from political influence. This weakness in adopting forms of regulation but not qualifying them to fit the conditions of the country in which they are to operate requires urgent attention.

A review of the Kenyan Corporate Governance Code

As we have seen above, s.1.3 of the CMA Guidelines validates the proposition that the Kenyan Code is not a "home-grown" solution to Kenya's corporate governance as the CMA Guidelines are based on a significant number of foreign corporate governance codes. The CMA Guidelines will now be examined within the context of how effectively they facilitate the operation of internal control mechanisms in corporate governance in a country with a weak legal system. The effectiveness of each control mechanism will be examined in turn.

Chairman/CEO duality

The board is an important internal control mechanism in corporate governance and the position of the chairman and the CEO are often described in corporate governance theory as a company's board leadership structure. The manner in which directors are to exercise their powers in managing the company is not dealt with by the Companies Act, but by Table A of England's Companies Act 1948. It is worth pointing out that Table A is optional and may not be part of the constitution of the company. The provisions of Table A are therefore discussed with the general assumption that they will be applicable to Kenyan companies.⁴⁰ Article 101 Table A provides that, "the directors may elect a chairman to their meetings and determine the period for which he is to hold office". Section 3.2(iii) of the CMA Guidelines states that chairmanship of a public listed company ***I.C.C.L.R. 219** should be held by an independent and non-executive director. This provision contradicts art.101 Table A which states that directors may choose "one of their number" to act as chairman if the elected chairman is not present within five minutes following appointment to hold a meeting. Under both the law and the CMA Guidelines, the chairman should be elected by the board. Although both the CMA Guidelines and Table A are not mandatory, where a company has adopted Table A into its constitution, as Table A is part of England's Companies Act 1948, from which Kenya's Companies Act 1962 was adopted, it is the mandatory legislation upon which the appointment of chairman is likely to be based. Directors of companies can therefore challenge the recommendations of the CMA Guidelines as they are not mandatory, therefore suppressing Kenya's quest towards adopting good corporate governance. There is a need to review art.101 Table A accordingly to prevent it from suppressing compliance with the requirement that the chairmanship of a public listed company should be held by an independent and non-executive director.

Where Table A does not apply, a public listed company listed on the stock exchange will be expected to comply with the CMA Guidelines on corporate governance. Section 2.2.1 of the CMA Guidelines provides that:

"... [T]here should be a clear separation of the role and responsibilities of the chairman and chief executive ... where such roles are combined a rationale for the same should be disclosed to the shareholders in the annual report of the Company."

Corporate governance codes recommend that the positions of the chief executive officer (CEO) and the chairman of the board (chairman) are separated, because to have one person occupying both the roles of CEO and chairman is to concentrate too much power in one person's hands, therefore making the company vulnerable to abuse. The Centre for Corporate Governance (CCG) states that in some corporations in Kenya "the board tends to go beyond its level of operation and therefore usurp the role of management", and in some cases, "managers have a lot of control at board level overshadowing other directors".⁴¹ This former statement reflects a lack of clarity of the roles of the board and management, while the latter statement depicts a lack of quality in the membership of the board. Personal leadership is a board chairman's most important quality in effectively playing their role,⁴² and as such there is a need to hire directors who have strong leadership skills and a good understanding of the company's business so that they may be confident enough to question, direct

and monitor management. An empirical study on Kenya, however, shows that the majority of directors in Kenya displayed a lack of understanding of their role in the company.⁴³ There is a need for continuous training of management to enable them to keep abreast with modern management techniques. The CCG is currently addressing this need, although for Kenya to achieve an adequate pool of directors, training has to be targeted also at the directors of small and medium-sized enterprises (SMEs). At the moment the training is aimed at directors of public listed companies and state corporations whereas evidence shows that 99 per cent of companies in Kenya are actually SMEs.⁴⁴

To solve the problem of lack of clarity of roles, the CMA Guidelines clearly state the role of the chairman and the role of the CEO. Section 3.1.1 of the CMA Guidelines gives a detailed description of the role of the board of directors as primarily “fostering the long-term business of the corporation”, and among other responsibilities, defining the company's strategy, risk policy plans, overseeing the corporate management, ensuring compliance with applicable laws, ensuring that shareholders are well informed and taking into account stakeholder interests in decision-making.

It is doubtful, however, whether splitting the role of CEO and chairman is likely to solve the corporate governance problem in Kenya. Donaldson and Davies state that reduced agency costs and improved corporate performance would be achieved through the greater independence in decision-making that would be achieved by splitting the role of the CEO and the chairman.⁴⁵ The agency costs described in Donaldson and Davies's study are those that are between management and shareholders. As the agency problem in Kenya occurs between majority and minority shareholders, and management as opposed to shareholders and management, splitting the roles of the CEO and chairman does not target the right agency problem which is to align the interests of majority and minority shareholders and those of management and shareholders generally. Majority shareholders are the controllers of companies in Kenya and therefore the board is likely to act in the majority shareholder's interests as the majority shareholder has, among other powers, the power ***I.C.C.L.R. 220** to hire and fire management which does not act in its interests.⁴⁶ An effective control mechanism in corporate governance in Kenya would be one that targets the independence of the board, not from within itself, but from the external influence of the majority shareholder at the expense of minority shareholders.

The ineffectiveness of the splitting of the roles of CEO and chairman is reinforced by the fact that there is no sanction in the CMA Guidelines for non-compliance with the Guidelines. The CMA Guidelines adopt the “comply or explain” principle, which is based on the assumption that the market will monitor compliance with the code and either penalise non-compliance by lowering share prices or observe that non-compliance is justified in the circumstances of the particular company.⁴⁷ The Nairobi Stock Exchange is at an early stage of development and owing to the small number of companies listed on it and the lack of sanctions in the CMA Guidelines there is no incentive for directors and management to comply with the CMA Guidelines so as to keep the company competitive.⁴⁸ This lack of sanctions within the CMA Guidelines is further exacerbated by the current state of Kenya's companies legislation. Kenya's companies legislation waters down the CMA Guidelines mechanisms by providing a subjective standard of liability for breach of directors' duties which takes away any incentive that directors and management may have to act in the interests of the company.⁴⁹

Shareholder protection

Section 1.1 of the CMA Guidelines states that the CMA Guidelines have been developed as a response to the recognition of the role of good governance in “maximisation of shareholders value as well as protection of investors' rights”. The focus of the Guidelines appears to be on shareholders rather than stakeholder interests. This is confirmed by s.3 of the CMA Guidelines, which provides that:

“... [T]he adoption of international standards in corporate governance best practice is essential for public companies in Kenya in order to maximize shareholders value ...”

The CMA Guidelines in s.1.2 only require that stakeholder interests be taken into account in realising shareholders' long-term value. Theoretically, these provisions appear to be sound; however, research has shown that a majority of the top 20 companies listed in the Nairobi Stock Exchange including Unilever Tea Kenya, Limuru Tea Co, Kakuzi Ltd, Williamson Tea, Kapchoria Tea, Rea-Vipingo Plantations, Barclays Bank, Standard Chartered, the East African Breweries, Total Kenya Ltd and BAT Kenya Ltd are foreign controlled.⁵⁰ This ownership pattern is further reflected in the NSE where 20 of the 58 companies listed in the NSE as of 1996 were available for foreign investment. In the last decade, the number of companies with foreign investment has increased following the Kenyan

Government's steady relaxation of restrictions on foreign ownership in locally controlled companies from 20 per cent for investors and 2.5 per cent for single holdings to 40 per cent for investors and 5 per cent for single holdings in 1995. Following these amendments, in 2002 the foreign investor regulations were further amended to provide Kenyan citizens with a minimum ownership of 25 per cent while the balance of 75 per cent⁵¹ became a free float for all classes of investors, with no restriction on the amount held by a foreign investor.⁵² It is arguable that the CMA Guidelines, within the context of the regulations governing foreign ownership, were not serving the interests of the Kenyan community who are the stakeholders of the companies listed in the stock exchange. Recently the legal threshold of foreign ownership of a public listed company in Kenya has been reduced from 75 per cent to 60 per cent.⁵³ This reduction has been controversial, with the Government seeing the increase of local ownership to 40 per cent as an incentive to the local investor to participate in the NSE while others see the reduction of the margin of foreign ownership in public listed companies as a disincentive to prospective foreign investors.⁵⁴

Foreign investors are not likely to have an incentive to participate in shareholder activism ***I.C.C.L.R. 221** if the company is not acting in the interests of minority shareholders and stakeholders as "foreign shareholders will not share in externalities such as pollution and unemployment in Kenya".⁵⁵ The CMA Guidelines deal with the extent of foreign ownership in s.3.3(i) by stating that, "a board of a public listed company should ensure equitable terms of shareholders including the minority and foreign shareholders". This provision reiterates the fact that the interests of minority shareholders need to be taken into account. Other provisions in the CMA Guidelines however, contradict this end. Section 3.3(iv) states that, "every shareholder shall have a right to participate and vote at the general shareholders meeting including the election of directors". With foreign ownership in some companies exceeding 40 per cent, with a possibility of 60 per cent ownership, it is doubtful whether minority shareholder votes will have any effect in securing the interests of minority shareholders. Shareholder protection appears to only be possible if minority shareholders vote as a block. Research in developed countries has shown that shareholders as a group have an incentive to monitor the actions of management.⁵⁶ However, recent research on compliance with the "comply or explain" principle in the United Kingdom has shown that market discipline through codes is having little effect on compliance.⁵⁷ The probability of achieving collective action of shareholders and effecting market discipline in a developing country such as Kenya is quite small. The common law of companies appears to provide better protection for shareholders by providing that a shareholder may exercise his own interest as he thinks fit except where he wants to perpetrate a "fraud on the minority"; the vote must be exercised bona fide for the benefit of the company as a whole when a proposed alteration of articles is under consideration.⁵⁸ This implies that a large shareholder may not be able to vote against the interests of minority shareholders. However, demonstrating to the court that the majority shareholder had a fraudulent intention against minority shareholders is too high a threshold for minority shareholders, as the majority shareholder can always argue that they were exercising business judgment and acting in the interests of the company.

Of particular importance for Kenya is the nature of the minority shareholders who are investing in the NSE. It can be argued that a significant number of shareholders in Kenya are under-informed about their rights as shareholders of the company and are not sufficiently educated on corporate governance issues to discover that there is anything to complain about. In cases where shareholders may want to complain, they find it difficult to come up with better suggestions. Some shareholders are indifferent and do not see the company's under-performance as being their problem to complain about, as they see investing in stock as a gamble. A lack of good returns from investment is seen as a "bad investment" in the wrong company as opposed to poor firm performance, the emphasis being on the shareholder not being in luck as opposed to managerial ineffectiveness. When a large number of minority shareholders think in this way, this thinking can have a devastating effect on corporate governance, as shareholder activism will no longer be an effective internal control mechanism. While the effort of the CCG in addressing this issue through the provision of training on corporate governance is good, there is still a long way to go before shareholders in Kenya are educated on their rights, as current training is mainly targeted at company directors and only about 900 persons from 11 countries had been trained by 2005.⁵⁹ However, greater shareholder protection may be achieved through the increased coverage of matters relating to stocks following the recent wave of initial public offerings in the NSE. Shareholders in developed countries such as the United Kingdom get most of their information from business papers and this keeps the companies in check. The recent increase in press freedom in Kenya is likely to play a substantial role in the attainment of good corporate governance as the role of a free and vibrant press is the reason why soft law, such as corporate governance, works so well in the United Kingdom. A free and vibrant press gives corporate governance the back-up it needs by providing a powerful investigative process which exposes dodgy

dealings in companies, therefore keeping potential misuse of company powers in check. On the other hand, an inactive press in the area of corporate governance means that shareholders may not discover a fraud until much later when the damage is already done.

At present not many shareholders are interested in attending shareholder meetings and voting. The CMA Guidelines note this and in s.3.3(ix) provide that, “[a]ll shareholders should be encouraged, to participate in the annual general meetings and to exercise their votes”. However, the foregoing presumption of a general lack of interest from ***I.C.C.L.R. 222** minority shareholders was recently reversed following the collapse of Uchumi, one of Kenya's leading supermarket chains. For the first time, minority shareholders demanded accountability from management on what had led to the collapse. This resulted in government action to resuscitate Uchumi. This achievement in shareholder activism is a milestone in Kenyan corporate governance. Notable victories for shareholder activism following the collapse of Uchumi were that issues often associated with causing free-rider problems were addressed. For instance, Uchumi reimbursed shareholders the cost of turning up to meetings during the investigation following its collapse. This is important for corporate governance, because not only is it not costless for shareholders to attend meetings and exercise their voice, but reimbursing shareholders is arguably beyond compliance with s.2.3(ii) of the CMA Guidelines, which states that “[t]he board should make shareholders' expenses and convenience primary criteria when selecting venue and location of annual general meetings”. Uchumi's reimbursement of shareholders might be seen as compliance with the spirit of corporate governance as opposed to the guidelines of corporate governance. Cost is what often leads to proxy voting, a mechanism through which free-riders and active shareholders who are unable to attend company meetings can have their say through votes cast on their behalf by management. In practice, however, research has shown that proxy voting often reflects the interests of management rather than shareholders. Uchumi's reimbursement of shareholders is however open to interpretation and the reimbursement of shareholder attendance costs may be perceived as a misuse of the company's resources resulting in a reduction of dividends for shareholders.⁶⁰

Institutional investors

It has been argued that the presence of institutional investors may have a positive effect on corporate performance.⁶¹ There are both local and international institutional investors in Kenya. Kenya Airways is an example of a company which has both local and institutional shareholders. Following the privatisation of Kenya Airways in 1995, KLM has been Kenya Airways' main international institutional shareholder, owning 26 per cent of Kenya Airways. The other institutional investors own 14 per cent, local institutional investors own 12 per cent, the Government owns 23 per cent, the Kenyan public owns 22 per cent and employees own 3 per cent.⁶² It is hoped that institutional investors will become more active as they are better informed. Evidence in the United Kingdom suggests that institutions are, behind the scenes, ready to put pressure on directors.⁶³ Institutional investors in Kenya may, however, face some difficulties in being effective control mechanisms in corporate governance. It is arguable that although the potential flight of institutional investors acts as an incentive for the board to behave well, the role of institutions as shareholders does not reconcile with their role as investors. As investors, institutions have the role of seeking maximum return for their investors and therefore need to move around in search of the best opportunities for the best returns. The expectation that institutional investors will hang around the company long enough to act as a control mechanism on the company's management is open to question.

In dealing with institutional investors, s.2.1.3(ii) of the CMA Guidelines requires that a list of 10 major shareholders is given in the annual report of the company. Under s.3.3(x) of the CMA Guidelines institutional investors are particularly encouraged to make direct contact with the company's senior management and board members to discuss performance and corporate governance matters as well as vote during the annual general meetings of the company. The purpose of this provision is to facilitate the role of institutional shareholders as a corporate governance control mechanism in that by directly contacting management, the institutional investors will be performing a monitoring function and management will be aware of their interest in company performance, thereby enhancing good corporate governance practice within the company. Section 3.3(x) of the CMA Guidelines, however, carries the risk of sidelining the interests of minority shareholders. The CMA Guidelines in s.3.3(xiii) deal with this risk by encouraging public listed companies to establish a shareholders' association:

“... to promote dialogue between the Company and the shareholders ... [and] ... play an important role in promoting good corporate governance and actively encourage all shareholders to participate in the annual general meeting of the Company or assign necessary voting proxy.”

***I.C.C.L.R. 223** This provision is not likely to be effective where there is an agency problem between institutional shareholders and minority shareholders, as the institutional shareholders would be promoting their interests by directly contacting management and thus influencing the matters that the shareholders' association chooses to discuss with the board. Minority shareholder interests are further put at risk by providing in s.3.1.2(iii) of the CMA Guidelines that minority shareholder interests should not be allowed to sway the direction of the board. Section 3.1.2(iii) states that:

“The structure of the board ... should also provide a mechanism for representation of the minority shareholders without undermining the collective responsibility of the directors.”

Like stakeholders, the interests of minority shareholders receive little protection in the CMA Guidelines. They are only to be considered, that is to be “thought about”, in decision-making. Demonstrating the consideration of shareholder interests is not required by the CMA Guidelines, with s.3.1.2(iv) only requiring the board to state in its annual report whether “it satisfies the representation of the minority shareholders”. This further highlights the need to protect the rights of minority shareholders in law by reviewing the law affecting derivative actions to provide an efficient dispute resolution mechanism for minority shareholders.

Board structure and executive remuneration

The collapse of Uchumi has been attributed to having a dysfunctional board.⁶⁴ Dysfunctional boards have also been associated with corporate governance failures in well-established corporate governance regimes, such as those present in developed countries like the United States. In the collapse of Enron in the United States, directors failed in monitoring the activities of the management of Enron and its financial affairs, by mainly relying on the explanations of management because they trusted them and did not question the information that was given to them. This may be what happened in Uchumi. Eshiwani characterises typical non-performing boards in Kenya as having directors who are always present at company meetings, as executive remuneration takes the form of an allowance awarded for each meeting attended. Age-wise, the members of the board are typically elderly people and the discussion that takes place for the better part of the meeting has little to do with the objectives of the company. This is in line with Gustavson *et al.*'s finding that some executives perceive taking up a board position as being a form of semi-retirement.⁶⁵

Recent research has shown that the gap between the remuneration of employees and management has continued to grow, with the remuneration of management in top companies being approximately KES 2.5 million (US \$33,400) a month, which is about 400 times higher than the lowest-paid employee.⁶⁶ With this type of board where executive remuneration is not tied to firm performance, it is almost inevitable that there will be misappropriation of company assets and a lack of strategy leading to underperformance of corporations as management will be able to prioritise their remuneration over company performance leading to underperformance and the possible collapse of corporations. The collapse of Uchumi has been attributed to irrational expansion plans by the board coupled with a lack of risk management strategies. It is arguable that if executive remuneration in Kenya was tied to company performance, perhaps the collapse of Uchumi would have been alleviated as management would have had a greater incentive to ensure that their expansion plans were rational and risk management strategies were in place.

Ogola states that under the current legislation in Kenya, “for technical reasons” directors are not regarded as employees of the company.⁶⁷ However, s.5(c) of the Income Tax Act c.470 classifies earnings from directorships as employment income. Article 76 Table A, on the other hand, states that the remuneration of directors shall from time to time be determined by the company in the general meeting while Kenya's common law of companies provides that a provision in the articles authorising the payment of directors does not give the right to be paid any specific amount.⁶⁸ The law regarding executive remuneration in public listed companies needs to be revised so that the various sources of law are consistent with each other.

Research shows that potential candidates for board positions in Kenya are unwilling to take up positions on company boards⁶⁹ in lieu of the financial security that can be derived from any other job that they may be holding. Section 3.1.4 of the CMA Guidelines provides that ***I.C.C.L.R. 224** executive remuneration is to be determined by a remuneration committee appointed by the board and:

“... consisting mainly of independent and non-executive directors (NEDs) to recommend to the board the remuneration of the executive directors and the structure of their compensation package.”

Section 3.1.4 of the CMA Guidelines appears to strengthen the monitoring function of NEDs and independent directors as an internal control mechanism in corporate governance by allocating them the role of recommending executive remuneration. The CMA Guidelines, however, need to be revised in order to give non-executive directors more independence in the performance of their duties. Section 3.1.4(ii) gives executive directors the power of determining the remuneration of their monitors, therefore providing for a situation where non-executives may be wary of being too critical of the decisions of the board in case this lowers their remuneration. Section 3.1.4(iii) of the CMA Guidelines states:

“The remuneration of the executive director should include an element that is linked to corporate performance including a share option scheme so as to ensure the maximization of the shareholders' value.”

This is a move in the right direction.

Research has shown that the sensitivity of pay to performance in the United States has increased over time owing to executive ownership of stock as well as share options and that stock options are the fastest growing component of executive remuneration in the United States.⁷⁰ This suggests that paying executives in Kenya in the form of share and stock options is likely to improve the general performance of the company, in that executives will be motivated to improve the performance of the company, resulting in an increase in their own pay. Section 196(1) of the Companies Act provides that every company should keep a register showing the number of shares which are held by a director in the company's registered office and it shall be open to inspection by any member of the company 14 days before the date of the annual general meeting and three days after the annual general meeting. Section 3.1.4(iv) of the CMA Guidelines provides for further access to information on ownership by directors by providing that the consolidated total remuneration of the directors should be disclosed to the shareholders in the annual report specifying the total remuneration for executive directors and the total fees for non-executive and independent directors. The company's annual report can be accessed by any shareholder at any time of the year. This is contrary to the trend in developed countries where there is a demand for greater transparency and detailed disclosure of the components of remuneration packages.⁷¹ The rationale behind having a consolidated form of disclosure of directors' remuneration may be because it is easier to understand for the shareholders, who may generally not be familiar with finance terminology such as share options or stock options. Although evidence suggests that the level of executive remuneration in top companies is high, there is limited empirical information on the level of remuneration of company executives of most companies in Kenya. Information in literature on the form that executive remuneration takes is also limited, with both Eshiwani and Gustavson *et al.* noting that payment in the form of allowances per meeting attended are common.⁷² The Kenyan public so far have not shown an interest in the level of executive remuneration. This is partly a consequence of the low level of awareness in Kenya on corporate governance issues.

Section 2.1.4 of the CMA Guidelines deals with board balance by requiring that the board should be composed of at least one-third of independent and non-executive directors of diverse skills or expertise in order to ensure that no individual or small group of individuals can dominate the board's decision-making processes. The role of a non-executive director in the CMA Guidelines is defined by what they should not do, as opposed to what they should do. Section 2.1.4.2 of the CMA Guidelines provides that an NED is “a director who is not involved in the administrative or managerial operations of the Company”. Other than s.2.1.4.2 of the CMA Guidelines, the role of non-executives is to sit in committees within the board, such as the remuneration committee, the audit committee and the nomination committee. The CMA Guidelines should be reviewed to reflect the monitoring function of NEDs to facilitate their effectiveness as monitors, rather than passive members of the board by clearly defining their role as monitors. The diversity of the board mentioned in s.2.1.4 of the CMA Guidelines is a matter of interest for Kenya's corporate governance. Eshiwani points out that a typical dysfunctional board will denote a lack of corporate culture and ***I.C.C.L.R. 225** given its broad regional composition, a lack of national values such as hard work and integrity in the doing of business.⁷³ This may be due to the lack of a labour market for directors.

The CMA Guidelines s.3.1.3 recommends that the board should have a nomination committee whose role is to appoint members of the board. Gustavson *et al.* note that one of the problems that nomination committees face is the lack of diversity in the pool of potential directors.⁷⁴ There are few candidates who can meet the requirements of s.3.1.3(ii) of the CMA Guidelines which provides that the nomination committee should only consider “persons of calibre, credibility and who have the necessary skills and expertise in exercising independent judgement”. This often means that there is

no competition within the labour market for directors and therefore directors do not have the incentive to perform well in order to keep their job in the company. The term “calibre” is often interpreted as meaning persons of high social standing, with research showing that appointment to boards in Africa are often political⁷⁵ and based on “know who” rather than “know how”. Section 3.1.3(vi) of the CMA Guidelines requires that:

“... [N]ewly appointed directors should be provided with necessary orientation in the area of the company's business in order to enhance their effectiveness in the board.”

This provision is likely to go a long way in addressing the weaknesses revealed by Mwaura's study, which showed that most directors in Kenya were not aware of their duties.⁷⁶ As far as skills and expertise go, Gustavson *et al.* note that qualified candidates are not always willing to take up positions on the board owing to, among other reasons, the lack of a remuneration package that provides an incentive for them to take time off their current jobs.⁷⁷ Section 3.1.3(viii) of the CMA Guidelines provides that in appointing members of the board, the nomination committee should ensure that:

“The process of the appointment of directors should be sensitive to gender representation, national outlook and should not be perceived to represent single or narrow community interest.”

This reflects a need for more female representation on Kenyan boards, as the majority of board members are male. There is also a need for age-balance within the board, as this brings with it different views and skills that can contribute to the company's success.

The examination of the effectiveness of the law that governs companies as well as Kenya's corporate governance, demonstrates that Kenya lacks a corporate culture. This lack of corporate culture can be attributed to the lack of national values. It has been argued that Kenyans identify more with their tribes than they identify themselves with being Kenyans.⁷⁸ For corporate governance, this implies that having a board that represents a tribal bias will lead to the interests of a particular community overriding the interests of the shareholders. The role of social norms in African corporate governance is an issue of importance that is seldom discussed in public and less so in academic debate. Gustavson *et al.* discuss this issue within the context of the appropriateness of the Anglo-American corporate governance system for the Kenyan market.⁷⁹ Requirements by international financial institutions, such as the International Monetary Fund and the World Bank, that developing countries implement structural adjustment programmes as a condition for awarding loans to developing countries, have meant that developing countries like Kenya find themselves having to adopt a corporate governance system that is akin to the Anglo-American system of corporate governance. Kenya should adopt a model that takes into account its cultural context and represents the interests of stakeholders such as the community, through employee representation on the board. Most countries with weak legal systems, such as Italy, tend to adopt the German model of corporate governance, as it ensures more accountability as the employees of the company are represented on the board. The German model is often associated with the long-term success of the company which should be the goal of both local and foreign investors.⁸⁰

The CMA Guidelines give enormous flexibility when it comes to dealing with the conflict of interests of directors in the performance of their duties. Several sections of the Guidelines once again contradict themselves. Section 2.1.4.1 of the CMA Guidelines contains the criteria of determining the independence of directors. ***I.C.C.L.R. 226** Section 2.1.4.1(i) provides that for a director to be independent, they must not have been employed by the company as an executive within the last five years. Section 2.1.4.1(ii) then goes on to say that a director will be considered to be independent if the director:

“... has not had any business relationship with the Company (other than service as a director) for which the Company has been required to make disclosure.”

Section 2.1.4.1 of the CMA Guidelines contradicts itself in that it implies that a former director can be considered an independent director as long as the board discloses this. This provision gives room for weak leadership on the board where management may seek to usurp the authority of directors. A former director acting as an independent director on the board is not likely to criticise the decisions of the current directors owing to the fact that doing so may reveal the shortcomings in the board at the time the individual in question was director. This reflects a similarity in weakness between the CMA Guidelines and the provisions on director liability in the Companies Act 1962.

This article has so far attributed the collapse of Uchumi to a dysfunctional board and lack of strategic

management; however, the collapse of Uchumi can be attributed partly to the failure of external control mechanisms. External control mechanisms in corporate governance such as takeovers are seen as the weapon of last resort for companies whose assets are not being utilised properly. Through the takeover mechanism, shareholders can replace poor management of corporations with good management, and thereby in this respect provide an atmosphere for economic development. This is demonstrated in Franks and Mayer's study which examined hostile takeovers in the United Kingdom and found that they are followed by high board turnovers and significant restructuring of the companies involved.⁸¹ However, many markets in developing countries do not have an active market for corporate control. They are likely to be imperfect markets that suffer from information deficits and therefore, corporate governance control mechanisms such as takeovers are not effective. The market as a mechanism for corporate control is not currently in use in Kenya, although its use is permitted under the Capital Markets (Take-overs and Mergers) Regulations 2002.⁸² Relying on markets to provide solutions to corporate governance issues in Kenya is likely to be an exercise in futility.

Conclusion

This article has argued that Kenya's weak legal system is likely to affect the country's quest for good corporate governance. Although shareholder activism led to the resuscitation of Uchumi, the law in place played little or no role in this. The Government's resuscitation of Uchumi is better explained as being political. The collapse of Uchumi, which is a leading local supermarket, was obvious to the ordinary Kenyan citizen, and Kenyans, not just the shareholders of Uchumi, demanded an explanation from the state as to what had led to the collapse. It was in the Government's interest to restore investor confidence in the market and therefore the Government resuscitated Uchumi. This is in line with research which shows that when stock markets fail, it is the obligation of governments to facilitate their resuscitation.⁸³

Following the adoption of the Companies Act 1962 to date, Kenya has witnessed the collapse of many of its corporations. Poor corporate governance led to the collapse of 33 banks in Kenya in 1985⁸⁴ and continues to be the cause of the collapse of many corporations to date. Companies in Kenya perform poorly not only because of the nature of the laws in place but also because of the political and regulatory environment in the country. Although it is possible to argue that enforcing the law that is currently in place would improve corporate governance to an extent and that reviewing the current law without improving the environment in which it operates is likely to have a limited impact on corporate governance, implementing effective laws is a fundamental requirement for establishing a successful corporate governance system. A review of the current system of companies legislation to reflect the market conditions in Kenya today is way overdue. The current standard of director liability needs to be revised to a dual standard of liability. Adopting a dual standard of liability such as that of the United Kingdom would encourage entrepreneurship while facilitating accountability. For the dual standard of liability to be effective in achieving good corporate governance, it is necessary to increase the criminal sanctions within the Companies Act and the Penal Code to a level that reflects the business world today. Directors who are not willing to act in the best interests of the company are not going to be deterred by a sanction of imprisonment between two and seven years or a civil sanction of US **I.C.C.L.R. 227* \$133 coupled with a high burden of proof for the prosecutor. The sanctions governing director liability need to be revised to reflect the benefits that are likely to be derived from engaging in financial crime.

The need to attract foreign investment appears to be the primary reason for adopting a corporate governance code that is based on the corporate governance codes of a number of developed nations. The result of this type of drafting has been that Kenya has a corporate governance system which does not adequately serve the interests of the Kenyan economy, particularly those of the community as stakeholders and local investors as minority shareholders in Kenyan companies. There is a need to review the CMA Guidelines in the light of these findings.

For development to be possible, corporate governance codes and companies legislation have to complement each other, in terms of the objective that is to be achieved. Section 1.4 of the CMA Guidelines states that the Guidelines are meant to "promote the standards of self-regulation so as to bring the level of governance in line with international trends". For self-regulation of markets to be possible, the underlying regulatory system has to be strong. A free and vibrant press also needs to be in place to back up corporate governance efforts by keeping companies in check. Effective self-regulation of the financial market through the CMA Guidelines cannot exist in a vacuum. It has to be built on a strong foundation, therefore necessitating the need for a review of the Companies Act 1962.

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I.C.C.L.R. 2008, 19(7), 213-227

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