

**CORRUPTION IN STATE CORPORATIONS IN KENYA: COMPLIANCE
WITH CORPORATE GOVERNANCE STANDARDS AS A MEASURE TO
COMBAT CORRUPTION.**

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DECLARATION

I **JOSEPHINE OBANDA MAKOKHA**, hereby declare that this thesis is my original work and that it has not been submitted for examination for the award of a degree at any other University.

DATED at **NAIROBI** this _____ day of _____ 2014

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This thesis has been submitted for examination with my approval as the University Supervisor.

DATED at **NAIROBI** this _____ day of _____ 2014

PROFESSOR ARTHUR A. ESHIWANI

DEDICATION

To my babies: Trevor and Kimberly.

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ABBREVIATIONS

ACECA	Anti-Corruption and Economic Crimes Act
AG	Attorney General
Art.	Article
BoDs	Board of Directors
CEO	Chief Executive Officer
CLARION	Center for Law and Research International
CMA	Capital Markets Act
CSRC	China Securities Regulations Commission
CoK	Constitution of Kenya
EACA	Ethics and Ant-Corruption Act
EACC	Ethics and Ant-Corruption Commission
FRC	Financial Reporting Council
KACA	Kenya Anti-Corruption Authority
KACC	Kenya Anti-Corruption Commission
KTB	Kenya Tourism Board
LIA	Leadership and Integrity Act
NHIF	National Health Insurance Fund
NSSF	National Social Security Fund
OECD	Organization for Economic Co-Operation and Development
POCAMLA	Proceeds of Crime and Anti-Money Laundering Act
POEA	Public Officer Ethics Act
PPP	Public Private Partnership
PS	Permanent Secretary
S	Section
SCA	State Corporations Act
SCAC	State Corporation Advisory Committee
SCs	State Corporations
SOEs	State Owned Enterprises
TI	Transparency International
UK	United Kingdom

UNCAC United Nations Convention Against Corruption
WB World Bank

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The Constitution of Kenya 2010

Anti-Corruption and Economic Crimes Act (2003)

Proceeds of Crime and Anti-Money Laundering Act (2009)

Public Officer Ethics Act (2003)

Public Procurement and Disposal Act (2005)

Ethics and Anti-Corruption Act (2011)

Ethics and Anti-Corruption Commission Act

United Nations Convention against Corruption (UNCAC)

State Corporations Act Cap 446

The Companies Act Cap 486

Leadership and Integrity Act no. 19 of 2012

OECD Guidelines (2004)

OECD- Anti-Bribery Act (2002)

Sarbanes Oxley Act (2002)

UK code of Corporate Governance (2010)

Code of Corporate Governance of China

Penal Code (Cap 75)

Capital Markets Act Cap 485 (A)

The Capital Markets (Securities) (Public Offers, Listing and Disclosures)
Regulations, (2002)

ABSTRACT

This study examines the relationship between the compliance with corporate governance and the level of corruption in state corporations in Kenya. Corruption has manifested itself both as legal and ethical challenge in the governance of state corporations (SCs) with its effects being felt not only in the state corporations concerned but also in all aspects of the national economy. The study is divided into five chapters comprising the proposal as the introduction. Chapter two focuses on the factors that breed and perpetrate corruption and the obtaining anti-corruption regulatory framework, its adequacy and challenges. Chapter three discusses how compliance with corporate governance standards can be used to combat corruption in SCs. Chapter four analyses some of the best corporate governance practices that can be adopted to strengthen the anti-corruption enforcement framework, hence reduce levels of corruption. Chapter five comprises the findings, conclusion and recommendations. Arguably, the theme that runs throughout the research is that, corruption a is a socio-economic challenge to the performance of state corporations and consequently, numerous laws¹ have been enacted to prevent, combat and mitigate its effects, however, the enforcement of these laws has not been effective hence the need to complement the regulatory framework with corporate governance standards.

¹ Examples include the Anti-Corruption and Economics Crimes Act No. 3 of 2003, Ethics and Anti-Corruption Act 11 of 2012, Leadership and Integrity Act (no. 19 of 2012) the Penal Code Cap 65, and the Public Officers Ethics Act No. 3 of 2005.

CHAPTER 1

RESEARCH PROPOSAL: CORRUPTION IN STATE CORPORATIONS IN KENYA: COMPLIANCE WITH CORPORATE GOVERNANCE STANDARDS AS A MEASURE TO COMBAT CORRUPTION

1.0 INTRODUCTION

“Corruption is an insidious plague that has a wide range of corrosive effects on societies. It undermines democracy and the rule of law, leads to violations of human rights, distorts markets, erodes the quality of life and allows organized crime, terrorism and other threats to human security to flourish”²

Corruption has been a major impediment to the prosperity and general performance of state corporations in Kenya and as a result public funds have been lost at the expense of the tax payers’ general benefit. It has been cited as one of the causes of numerous corporate failures nationally and even on international level. Over the years, corruption has become a reality of monumental proportions in Kenya³, it has in fact grown bigger in terms of participating personalities and the amount of money involved for instance the Goldenberg⁴ and the Anglo leasing scandals⁵ whose effects are still being felt to date led to a loss of colossal amount of public funds. Recently, there have been cases of corruption reported by the media and some have been heard before different Parliamentary Committees touching on the governance of state corporations.⁶

² Koffi A. Annan in his speech as the Secretary General of the United Nations; United Nations Convention Against Corruption (New York, 2004)

³ Centre for Law and Research International (CLARION), *The Anatomy of Corruption in Kenya; Legal, Political and Socio-economic Perspectives* edited by Kivutha Kibwana, Smokin Wanjala and Okech-Owiti (Claripress) (2006) p.1

⁴ The Government of Kenya lost Kshs. 27 billion. See Report of the Judicial Commission of Inquiry into the Goldenberg Affair. The Report is also available at <http://www.tkenya.org/documents/Goldenberg> accessed on 18th July 2013

⁵ The government committed to pay 56 billion to Anglo-leasing type of contracts to non-existing companies and in some instances for services that were not offered or whose prices were overstated<archive.transparency.org/publications/newsletter/2006/april_2006/in_the_news/ango_leasing>Accessed on 4th March 2013.

⁶ Top ten most corrupt state firms in Kenya include, National Social Security Fund, National Hospital Insurance Fund, Kenya Revenue Authority, Kenya Airports Authority, Kenya Ports Authority, Kenya Railway Corporation, Kenya Power and Lighting Company, Kenya National Highway Authority, Kenya Seed Company, National Cereals and Produce Board.

Despite anti-corruption legislative enactments by Parliament both general and specific, and despite the elaborate legal and institutional framework to fight corruption, corruption still persists in SCs. In fact, in some cases the perpetrators of corruption have been identified by the authorities however, no action has been taken against them. In other cases, prosecutions have been instituted against certain individuals only to be dismissed or withdrawn. The courts have also been lethargic in completing the cases and have entertained numerous applications seeking judicial review and Constitutional orders stopping the anti-corruption agencies from investigating and prosecuting them for instance in Christopher Ndarathi Murungaru vs KACC.⁷ Concededly, there are weaknesses in the anti-corruption enforcement mechanisms hence this thesis examines how compliance with the corporate governance standards can be used to complement the legislative framework as an enforcement strategy for strengthening the enforcement mechanisms to prevent and combat corruption in state corporations.

1.1 BACKGROUND TO THE PROBLEM

In Kenya corruption can be traceable to colonial era in the late 19th Century which era was characterized by capitalist production in need of cheap raw materials, labour and markets for its products. Capitalism saw the need to acquire, monopolize and protect specific territories which could answer to these needs.⁸ Upon independence, some of the colonial tendencies were extended as the political organization was characterized with a highly centralized power with an all powerful executive with state power revolving virtually centrifugally around the presidency. The executive power of the state resided in the president and could be exercised by him or through subordinate officers who included civil servants and those appointed to head public enterprises.⁹ Corruption could not be openly discussed prior to 1995 and any attempts to do so were meted with victimization and punitive measures. Though widely known as endemic and rising at a rate that threatened the socio-economic well being of the nation, it was not openly debatable particularly in official circles.¹⁰ It was until the Center for Law and Research

⁷ [2006] eKLR HC Misc Civ Appeal No.54.

⁸ CLARION., *The Anatomy of Corruption in Kenya: Legal, Political and Socio-Economic Perspectives*. Edited by Kivutha Kibwana, Smokin Wanjala and Okech-Owiti (Claripress (1996) second reprint 2006) p. 13.

⁹ Ibid.

¹⁰ Jeremy Pope, *Confronting Corruption: The Elements of National Integrity system* (Transparency International (2000) p.12.

International (CLARION) a Non-Governmental Organization (NGO) carried out a study and disseminated its report entitled *The Anatomy of Corruption: legal, Political and Socio-Economic Perspectives* that the debate on the phenomenon was opened up.¹¹ The study revealed an alarming prevalence of corruption in government and private sector notwithstanding existing official anti-corruption measures. This research was the first systematic presentation of the phenomenon of corruption and as a result, it stimulated open intensive public debate and dialogue on the subject of corruption.¹²

By 1997, the government was experiencing increased public debate and pressure coupled with concerns from international community especially Breton Woods institutions to come up with legislative and policy framework to address corruption. This saw the government undertaking legal and policy initiatives to address the phenomena by establishing Anti-corruption squad and Kenya Anti-Corruption Authority (KACA) as well as publication of a number of proposals on corruption.¹³ This gave Kenyans hope that at last corruption would be dealt with more decisively. However, the apparent nobility of these initiatives and the optimism they generated was short lived, as the political environment remained paradoxical, ambiguous and indifferent casting doubt on Government sincerity in its commitment to fight corruption.¹⁴ For instance, the disbandment of Kenya Anti-Corruption Authority¹⁵ was seen as purely politically instigated rather than on strict judicial considerations.¹⁶ Since 1963, the Prevention of Corruption Act had been the main statute dealing with corruption until the Anti-Corruption and Economic Crimes Act (ACECA) establishing the Kenya Anti- Corruption Commission (KACC) was enacted in 2003.

In the year 2002, the third President of the republic of Kenya Mwai Kibaki was overwhelmingly elected on the basis of his promise of zero tolerance to corruption. He committed himself to fight corruption when he stated thus;

¹¹Jeremy Pope (n 10).

¹²Tranparency International (n 5).

¹³Ibid.

¹⁴ibid (n 5p3).

¹⁵A body established under Anti- Corruption Police Unit Act to fight corruption.

¹⁶Barrack Muluka, 'Questions abound as KACA fails to take place, *Sunday Standard*, (Nairobi) 18 March 2001, p7 in Kivutha Kibwana and others (ibid n 3 p.3).

‘Corruption will now cease to be a way of life and I call upon all those members of my government and public officers accustomed to corrupt practice to know and clearly understand that there will be no sacred cows under my government’

Implementation of this promise saw the enactment of anti-corruption legislations to strengthen the fight against corruption.¹⁷ However, these initiatives were soon faced by a draw-back when the Anglo-Leasing scandal was revealed in 2004. The Anglo-Leasing scandal destroyed any anti-corruption credentials that President Kibaki ever possessed as the government committed to pay 56 billion to non-existent companies or companies that overpriced the services they purportedly delivered to the government.¹⁸

State corporations are a creation of the State Corporations Act,¹⁹ (‘the Act’). The corporations are managed through the Board of Directors (BoDs) whose membership and appointment is provided for under the Act.²⁰ The history of state-owned corporations in Kenya too, can be traced from the colonial rule when the colonial Government established corporations mainly in transport, communication and agriculture to facilitate the exploitation in the colonized territory. This concept was embraced by the Government through the state corporations and by Sessional Paper number ten;²¹ however, emphasis was laid on the role of both the private and public sectors. The number of state corporation escalated albeit without proper planning and with great measure of ‘political governance’ rather than professional governance.²²

The establishment of state corporations became important after the government’s realization that there were some functions which needed concentration of resources, further, the government needed to participate in order to discourage monopoly in essential services to the public.²³ The government ownership was important to achieve economies of scale by ensuring that rather than

¹⁷ Anti-Corruption and Economic Crimes Act (2003) and the Public Officer Ethics Act (2003).

¹⁸ See <www.marsgroupkenya.org/pages/stories/Anglo-leasing> accessed on 18th September 2013

¹⁹ Cap 446 laws of Kenya. (Section 3 establishes the state corporations as a corporate body with a legal personality with perpetual succession, capacity to sue and be sued in its corporate name, and capable of holding and alienating movable and immovable property)

²⁰ Section 6 of the State Corporation Act Cap 446, Laws of Kenya.

²¹ Sessional paper No. 10 of 1965 *on African Socialism and its Application to Planning in Kenya*.

²² Paul Musili Wambua, “Corporate Governance and Corruption in Kenya’s Public sector” in Kivuva Joshua and Odhiambo Morris (eds); *Integrity in Kenya’s Public Service; Illustrations from Goldenberg and Anglo-Leasing Scandals*. (CLARION 2010)

²³ This included healthcare services, energy, telecommunications, and petroleum among others.

regulate the private monopolies, the greater public would be served through a dispersed structure of ownership. State corporations control key sectors of the economy and due to their centrality a lot of public funds are allocated to them, it is important therefore, that the funds should be managed accurately and transparently in order to benefit the greater public population. The decisions of the board should therefore be independent and based on public interest, fair, transparent and within the rule of law.

However, the societal expectation of accountability on the part of the trustee of the public funds (corporate directors) has not been fulfilled as corruption has infiltrated the decision making process of the boards of the state corporations due to political influence and competing interests. Incidentally, this results in poor governance and consequently public funds are lost, further, it results in poor performance of the corporations and sometimes to their total collapse and ineffective service delivery to the public. Corruption in the SCs boards has manifested itself through abuse of office, political patronage, fraud, looting, nepotism and favoritism in licensing, among others. The mode of appointment of the directors who are responsible for overseeing the governance of the corporation is paternalistic in nature which concededly influences their independence due to patron-clientele relationship that is created between the appointing authority and the individual directors hence the obligation to please the patron at the expense of public interest.²⁴

The legislature has enacted various laws to prevent and combat corruption generally, state corporations included, despite these laws, corruption still continues to be witnessed in state corporations to date.²⁵ Good examples are the numerous cases against directors that have been litigated and reported in the recent past which include; the Kenya Tourism Board (KTB), National Social Security fund (NSSF) and the National Health Insurance Fund (NHIF)

²⁴ Wamalwa W. N., 'Causes and consequences of Ethical crisis in Africa's Public Services', in Rasheed, Sadig and dele olowu (eds) (1993 (41-48) in Kibwana *et al* (note 7).

²⁵ Peter leftie and Julius Sigei, Radical Plans to Reform Parastatals *Daily Nation* (Nairobi) 4th October 2013. (The restructuring will oversee dozens of state corporations scrapped or merged and if the Government adopts the radical proposals drafted by the Task force to streamline their operations. The restructuring is aimed at stemming corruption, wastage of public funds and overlapping duties among state corporations).

1.2 STATEMENT OF THE PROBLEM

Despite the fact that Kenya has had a fairly good legal and institutional framework to fight corruption, the corruption index is still on the higher side.²⁶ Though the laws and regulations have had some limitations such as overlaps and ambiguity and impressiveness, their implementation and enforcement has been the greatest impediment to the fight against corruption in state corporations. Despite the anti-corruption initiatives that have been put in place through legislative, policy and institutional framework in the state corporations, corruption still finds its way in the management of these institutions, and hence negatively affects the general performance of SCs. The world over recognizes the contributions of the corporations to the national economic growth thus corruption left unchecked does not only affect economic development of the corporation concerned but also the national socio-economic stability of the whole Country. It has at times led to the collapse of some SCs leaving the public to suffer greatly.

Kenya has good anti-corruption laws, however the literature reviewed indicate that the enforcement of these laws is the major impediment to their efficiency and ineffectiveness, hence the inability to prevent and combat corruption in the public sector generally and state corporations specifically. In SCs the anti-corruption enforcement mechanisms have underperformed due to numerous corporate governance challenges which include: political interference and lack of separation of control and ownership; lack of autonomy, multi-agency problem and lack of clear organizational objectives.

The people of Kenya tired of this dilemma and through the referendum in August 2010 passed the Constitution which made provision with regard to appointment, personal integrity, competence, fairness, responsibility and accountability in public bodies under which the state corporations fall. These provisions are all geared towards instilling and incorporating good Governance in SCs. Study shows that good corporate governance, increases transparency and accountability, it reduces costs of doing business, boosts investor confidence and increases

²⁶ East Africa Corruption Index places Kenya at 4th position with Rwanda being the least corrupt. TI and World Bank joint corruption index places Kenya at Number 139 out of world wide. See the TI TRAC Report obtained from <gateway.transparency.org/tools/detail/310 TI TRAC report> accessed on 14.05.2013.

shareholder's profit.²⁷ Admittedly, anti-corruption strategy requires a multi-pronged approach and not just the implementation of the constitution and the enacted legislations. This study therefore seeks to examine how aligning corporate governance with anti-corruption strategy will impact on the level of corruption in SCs and propose best practices to adopt in order to strengthen corporate governance and subsequently reduce corruption through aligning corporate governance of the corporations with the anti-corruption strategy.

1.3 SIGNIFICANCE OF THE STUDY

A good legislative framework can only be effective if it is capable of enforcement, impliedly, that is when its effectiveness can be measured. Enforcement in the context of this research refers to putting into effect the anti-corruption laws and therefore it concerns the mechanisms and systems to ensure and enhance compliance with the laws. The war on corruption can only be won where the enforcement mechanisms are strong and effective enough to ensure mandatory compliance. However, in Kenya generally and in state corporations specifically, corruption continues to rare its tentacles despite having a good number of legislative enactments on corruption. The problem therefore lies not in the laws *per se* but also in enforcement. As earlier stated, anti-corruption strategy requires a multi-pronged approach, it is imperative therefore to consider other mechanisms such as compliance with the standards of good corporate governance which are premised on values of transparency, accountability, fairness and rule of law to ensure compliance with the enacted laws. It is therefore imperative to understand the relationship between compliance by corporations with good corporate governance standards and how it influences the level of corruption in state corporations. The research therefore seeks to espouse this relationship and make suggestions to strengthen and align corporate governance to anti-corruption strategy in state corporations. In recent years, there has been increasing interest in how corporations are governed hence there is a lot of literature on corporate governance. Corruption being a worldwide phenomenon has also attracted discussion in various dimensions. However, not so much literature has been written on how the two can be aligned to prevent and combat corruption. This research seeks to fill this gap and add value to the existing literature and hopefully, the findings of the research will be used by students in their various curriculums for

²⁷ Stijn Claessens 'Corporate Governance and development' pp 99-109 <<http://wbro.oxfordjournal.org>> accessed on 20. 8. 2013.

research and knowledge purposes. The strategies to be proposed can be applied by policy makers of the state corporations in the governance and offer checks and balances to seal the loopholes that breed and perpetrate corruption in the state owned corporations.

1.4 RESEARCH METHODOLOGY

The research involved evaluation of the existing literature on the identified research topic through desk top analysis of secondary materials including but not limited to books, journal articles, and electronic materials such as e-books and reports. Basically, no empirical data was collected. This was due to the difficulty with which carrying out a quantitative research would have been done bearing in mind that corruption is a sensitive and more shunned off topic by not only public officers but more specifically, the state corporation boards would not have been willing to implicate themselves. That being the case, the responses would not have been responsive enough to generate enough data for analysis against which the hypothesis would be gauged. Lastly, the prospective respondents would have been mostly, directors, CEOs and managers who would have not opened up to discuss corruption in SOEs as each would be driven by the need to preserve their jobs and no one would want to be seen to admit corruption in their boards. It could also be difficult to get the respondents to get time to fill in the questionnaires.

The existing relevant literature on the problem was critically analysed, issues identified and possible solutions offered. The objective of the above was to identify the factors that have contributed to a weak anti-corruption enforcement framework in state corporations, the role of good corporate governance, and the need to align corporate governance with anti-corruption strategies. Global best corporate governance practices were examined and linked to combating corruption in Kenya through anti-corruption legislation. Lastly, the study suggests what needs to be done to align and strengthen corporate governance in SCs to assure compliance with the law with a view to preventing and combating corruption.

1.5 HYPOTHESIS

This research study was based on the assumption that; compliance with corporate governance standards would significantly reduce the level of corruption in state corporations. The assumption was premised on the ground that when corporations practice the core values of

corporate governance which include; fairness, transparency, responsibility and accountability in the management of the corporations, corporations will be managed ethically and will shun away from unethical business practices. Additionally, corruption can easily be detected, prevented and/or the culprits prosecuted in accordance with the law, hence significantly reducing the levels of corruption in the SCs. I will recall this hypothesis and make a conclusion in the final chapter.

1.6 SCOPE OF STUDY

The researcher acknowledges that the topic of corruption is very wide and can be studied in different concepts and has consequently narrowed the scope to discuss corruption in relation to governance of state corporations and the attaining legal enforcement framework. This research is basically targeting corruption in state corporations as a sector and why the legal framework has not been successful to stem it out, the factors contributing to weak and ineffective enforcement framework shall be studied. The research therefore examines how strengthening and aligning good corporate governance practices with anti-corruption strategy impacts on the level of corruption in the SCs. The research findings will be discussed in the last chapter and through bench marking, the research hopes to suggest best corporate governance practices that can be adopted to strengthen the anti-corruption legal enforcement mechanisms through compliance with good corporate governance standards so as to assure compliance with the law and consequently reduce corruption in state corporations.

1.7 RESEARCH OBJECTIVES:

The objectives of this research are divided into two comprising the main objective and specific objectives. The main objective of this research study is to assess the impact of compliance with good corporate governance standards on the level of corruption in state corporations in Kenya. However, the specific objectives include:

- To Examine the Anti- Corruption legal and institutional framework pertaining in state corporations in Kenya.
- To identify the factors responsible for the weak enforcement framework of anti-corruptions laws in state corporations.

- To examine the role played by good corporate governance and the need to align it with anti-corruption strategies in preventing and combating corruption in state corporations.
- To suggest appropriate strategies to align corporate governance with anti-corruption strategy to prevent and combat corruption in state corporations.

1.8 RESEARCH QUESTIONS

- How effective is the anti-corruption legislative and enforcement framework in state corporations in Kenya.
- What factors contribute to a weak and ineffective enforcement framework of anti-corruption laws in state corporations?
- How does compliance with corporate standards impact on the levels of corruption in state corporations in Kenya?
- What strategies can be adopted to align corporate governance with anti-corruption to prevent and combat corruption in state corporations?

1.9 THEORETICAL FRAMEWORK

1.9.1 Utilitarian Theory

All state corporation irrespective of whether they have been created under the State Corporations Act or under specific Act of Parliament must perform and be perceived to safeguard public interest. Walter Lippman defines public interest as “what men would choose if they saw clearly, thought rationally, acted disinterestedly and benevolently”²⁸ The philosophical foundation of public interest is espoused by the theory of utilitarianism. Corruption in state corporation is manifested in decision making where conflict of interests leads to the directors and management taking decisions that sometimes are not in the best interest of the public but to the satisfaction of their individual or group interests.

Utilitarian theory as postulated by philosophers such as Jeremy Bentham and John Stuart Mill (1806-1873) is a form of teleology whose central value is human happiness, understood in terms

²⁸Lippman W.; *The Public Philosophy*, (New Jersey: Transaction Publishers) (1995: 2003 reprint) p. 42.

of satisfaction of the various desires that we each have as human beings.²⁹ According to them, an action is judged right or wrong depending on its consequences and hence the end of an action justifies the means taken to reach to those ends. The most famous formulation by utilitarians is that an action is right if that action produces the greatest amount of happiness for the greatest number of persons. In the context of this research, the greatest happiness to greatest number of persons refers to the efficient and effective service delivery to the public on whose behalf the state corporations are established to provide essential goods and services. However, corruption erodes the public interest objective as public funds are diverted and converted to private use at the expense of the general public thus defeating the objective.

Utilitarians acknowledge that there is a controversial view held by egoist that all persons seek their own happiness and tend to define happiness as that state of life in which our most important desires are satisfied, they are quick to observe however that right conduct cannot be what makes one or several of us happy, but that, the right act must make everyone happy. But since this is difficult in any real social situations, where objectives often conflict, utilitarians conclude that the right act is one that makes many people as happy as possible.³⁰ The second tenet of utilitarianism state that an action is morally right if the net benefits over costs are greatest for all affected as compared to the net benefits of all other possible choices considered.³¹ The third tenet is that an action is morally right if its immediate and future direct and indirect benefits are greatest for each individual and if these benefits outweigh the costs of those considered for other alternatives.³²

Utilitarians believe that we can eliminate from deontological lists any rules whose consequences are bad by merely asking which cause of action is likely to have the most beneficial consequences to human beings. They further believe that their method gives reason a place in recurrent task of weighing and balancing conflicting moral rules. Corruption is a result of conflicting moral rules of whether to act in a way to benefit the individual such a directors or the

²⁹ Ronald M. Green; *The Ethical Management: A new Method of Business Ethics*, (New York: Macmillan College Publishing Company) (1994) p. 73

³⁰ Ibid note 16.

³¹ Joseph W. Weiss; *Business Ethics: A Managerial stakeholder Approach* (Belmont CA; Wadworth Rabsilva) (1994) p. 66

³² Ibid.

general public.³³ Unlike the deontologists who base their theory on plurality of basic rules, utilitarianism contains but a high order rule that decides all choices. Hence when any two specific moral rules conflict, for instance in the decision making process of state corporation boards, utilitarians propose that we must not fixate on the rule but ask which course of action is likely to produce the most happiness for the most persons.

Utilitarians admit that reasoning about matters like this will often be difficult as frequently, we cannot identify all the consequences of our actions and it is also very hard to assess how much good and evil we inflict on different people. That notwithstanding, the effects or consequences of corruption are widespread as they affect not only the well-being of the SCs but the welfare of the economy and the society as a whole. Importantly, utilitarian concepts are widely practiced by the Government policy makers, economists and business professionals, the principles are useful in conducting stakeholder analysis since it forces decisions makers to; consider collective as well as particular interests; formulate different alternatives based on the greatest good for all parties involved in a decision and lastly; estimate the costs and benefits of alternatives for different groups affected (DeLong 1981).³⁴

Despite critics of this theory for instance on the basis that, there is no agreement as to the good to be maximized and that the theory does not judge the rightness or wrongness of the action and in themselves, but rather in their consequences, the principles of utilitarianism is still valuable in circumstances when resources are lacking or scarce, when priorities are in conflict, when there is no clear choice of fulfilling everyone's needs and goals and when large or diverse collectives and groups are involved in zero sum decisions that is, when there are a fixed and limited number of resources to be distributed (DeLong: Velasquez 1988, 116).³⁵

1.9.2 What Drives Corruption in Corporations?

Conversely, it is imperative to understand the philosophical foundations upon which the corrupt public officers base their decisions and actions. The rationale behind corruption lies in the consequential theory of ethical egoism which holds the view that an act is right when it best

³³Joseph W. Weiss (n 31) p. 74

³⁴ Ibid note 19

³⁵ ibid

promotes the individual long-term self interest. Its proponents such as Emmanuel Kant argue that, when trying to decide whether a course of conduct is right or wrong, each of us must look only to our own long-run advancing and if an action promotes our long-run well being then it is the morally right thing to do and if not then it is morally wrong.³⁶

However, this theory is open to very strong objections and today, very few philosophers would advocate for it either as a personal or organizational morality.³⁷ It perpetrates not only illegal but also morally unsound decisions and it is on this background that the need to have a strong and effective anti-corruption enforcement framework is needed to protect the public interest as beneficiaries of the activities of state corporations. La Porta, Silanes, Shleifer, and Vishny (1998) in "*Agency Problems and Dividend Policies Around the World*," suggest that shareholder protection and minority shareholders rights (the public) are not considered when there is less or no transparency and that the issue becomes the 'agency problem' between corporate insiders (Manager and directors) and beneficiaries

In *The Wealth of Nations*, Adam Smith wrote:

“The directors of (joint-stock) companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own”.³⁸

The interests of those who control the firm can differ from the interests of those who supply the firm with external finances. This problem is the principal agent problem that derives from the separation of ownership and control and from corporate outsiders and insiders.³⁹ Agency theory is a managerial approach where one individual-the agent act on behalf of another-the principal and is supposed to advance the interests of the principal. A state corporation has multiple agents,

³⁶ Joseph W. Weiss (n 31) p.61.

³⁷William H. Shaw and Vincent Bunny; *Moral Issues in Business*, 6th ed. Belmont CA Wadsworth Publishing Company Inc (1995) p.57.

³⁸ David Vogel. ‘The Corporation as Government: Challenges & Dilemmas’. *Polity*, Vol. 8, No. 1 (Autumn, 1975), pp. 5-37, (Palgrave Macmillan Journals), < <http://www.jstor.org/stable/3234345>> accessed 7th July 2013.

³⁹ Michelle I. Caron, Aysun Fici’ci’ and Christopher L. Ritcher. ‘The Influence of Corruption on Corporate Governance standards; Shared Characteristics of Rapidly Developing Economies’, *Emerging Markets Journal* Vol. 2 (2012) ISSN 2158-8708 obtained from <http://emaj.pitt.edu> accessed on 11th October 2013.

including the directors, government, president and other public officials. In this context, the electorate is considered the principal, as they elect public officials serving in the Government, who in turn appoint the board of directors. It follows therefore that the agents are the public officers serving in the government as well as the boards of directors.⁴⁰ The agent therefore advances both the principal's and his own interest. In state corporations, the agency relationship exists between the government which is the trustee of public interest and the directors. A balance of these interests should be merged in order to arrive at the corporative objectives.⁴¹ This theory holds that there should be proper synergy between the management and the stakeholders, in the case of SCs, the actions of BoDs and management should be in the interests of the tax payers.

In order to mitigate the agency problem and foster a convergence of the agent-principal objectives, the principal can limit divergence through establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit aberrant activities of the agent.⁴² The firm performance would also be enhanced if the agent that is the directors would expend some resources as bonding costs to guarantee that they will not take certain actions that would harm the principal being the Government or ensure that the principal is compensated if the agent takes such actions.⁴³

It is important to note that in most agency relationships, the principal and the agent will incur positive monitoring and bonding costs which may include pecuniary as well as non-pecuniary, and in addition, there will be some divergence between the agent's decision and those decisions that would maximize the welfare of the principal. Jensen and Meckling thus define agency costs as the sum of: the monitoring expenditure by the principal; the bonding expenditure by the agent and the residual loss. It is therefore generally argued that the issue of separation of ownership and control in the modern diffuse ownership corporation are intimately associated with the general problem of agency.⁴⁴

⁴⁰ Kiarie Mwaura, 'Constitutional Restructuring of corporate Governance in State Owned Enterprises: Dynamism or Distractions?' Mount Kenya University Law Journal 2012 at p3.

⁴¹ Albert Omari Otungu, Justus Wesonga Nyongesa, Eliud Otieno ochieng and Simeon Kaburu , 'International Journal of Business and Science' Vol. 2 No. 23 (Special issue-December 2011) p. 234.

⁴² Ibid note 16.

⁴³ Ibid.

⁴⁴ Albert Omari Otungu et al (n 41) p.7.

1.10 CONCEPTUAL FRAMEWORK

1.10.1 Corruption Defined

There is no universal definition of corruption. This can be attributable to the different ways and forms in which it manifests itself. Accordingly, the definition of corruption is influenced by the background opinion and experiences of the individual examining the phenomena.⁴⁵ Corruption in its simplest term has been defined as the abuse of power most often for personal gain or for the benefit of a group to which one owes allegiance.⁴⁶ The World Bank (WB) concisely defined corruption as, the abuse of public office for private gain⁴⁷ though corruption is often associated with the exchange of favours for bribe, the definition offered by WB includes non-monetary transactions such as nepotism, influence peddling, forgery and outright embezzlement.⁴⁸ United Nations Development Program (UNDP) on the other hand provides a more comprehensive definition of corruption to mean ‘the misuse of power, office or authority for private benefit through bribery, extortion, influence peddling, nepotism, fraud, speed money or embezzlement’.⁴⁹ That notwithstanding, the two definitions can be criticized as they limit corruption to the public sphere whereas the supply side of corruption is the private sector. Transparency International on the other hand opens up the definition to include private sector corruption by defining it to mean ‘the misuse of entrusted power for private gain.’⁵⁰ Systemic corruption indicates that resources for public purposes are no longer managed effectively and are appropriated for private gain and therefore there has been remarkable consensus that there is need for good governance.⁵¹

Corruption in its simplest terms refers to the abuse of power most often for personal gain or benefit of a group to which, one owes allegiance. It can be motivated by greed, desire to retain, increase one’s power or perversely enough, by in a supposed greater good. While the term

⁴⁵ Public Service Integrity Programme; A Source book for Corruption Prevention in the Public Service (2000) p.3.

⁴⁶ Rick Stapenhurst and Sedigh Sharzad, ‘An Overview of the cost of corruption and strategies to deal with it’ in Rick Stapenhurst and Sahr j. Kpundeh, *Curbing corruption Toward a Model for Building National Integrity* (The World Bank, Washington D. C 1999) p. 1

⁴⁷ World Bank (2006).

⁴⁸ Anti-Corruption Approach Literature Review p. 40 available at <<http://www.sida.se/contentassets/3f5c8afd51a6414d9f6c8f8425fb935b/anti-corruption-approaches-a-literature-review_3153.pdf > accessed on 10th October 2013. at p. 40.

⁴⁹ UNDP (2004) www.undp.org accessed on 20th October 2013.

⁵⁰ TI (2007).

⁵¹ Kivutha Kibwana, S Kichamu Akivaga, Lawrence M Mute. and Morris Odhiambo, *Initiatives against Corruption in Kenya; legal and Policy Framework 1995-2001* (Claripress Ltd. 2001) p 1

‘corruption’ is frequently applied to abuse of public power by politicians or civil servants, it describes a pattern of behavior that can be found in virtually every sphere of life.⁵²

Various writers have attempted the definition of corruption for instance; Stanislaw Andreski argues that the word corruption ‘designates the practice of using the power of the office for making private gain in breach of laws and regulations normally in force.’ M. Macmillan on the other hand though not attempting a comprehensive or legally precise definition states that, ‘a public official is corrupt if he accepts money or money’s worth for doing something that he is under obligation not to do or exercise a legitimate discretion for improper reasons’.⁵³

In attempting to come up with a working definition of ‘corruption’ Syed Hussein Alatas identified various characteristics which a corrupt act contains which include; a betrayal of trust; deception of public body, private institution or society at large; deliberate subordination of common interests to specific interests; secrecy of execution except in situations which allow powerful individuals or those under their protection to dispense with it; involvement of more than one person or party; the presence of mutual obligations and benefits, in pecuniary or other forms; the focusing of action on those who want definite decisions and those who can influence them; the attempt to camouflage the corrupt act by some form of lawful justification and; the expression of a contradictory dual function by those doing the act.⁵⁴

Kivutha Kibwana *et al* have attempted a definition of corruption in the Kenyan context to be an all pervasive syndrome that resembles one or all the forms as discussed by Syed Hussein Alatas. According to them, ‘corruption is an act or omission perpetrated by an individual or group of individuals which goes against the legitimate expectations and hence the interest of the society.’

The Ethics and Anti- Corruption Act 2003 (ACECA)⁵⁵ defines corruption to mean among others bribery, fraud, bribing agent, bid rigging, abuse of office, embezzlement or misappropriation of

⁵²See note 5.

⁵³ Kivutha Kibwana, smoking Wanjala and Okech Owiti; *An Anatomy of corruption in Kenya; Legal, Political and Socio-economic Perspectives* (Centre for Law and Research International) p.28.

⁵⁴ Syed Hussein Alatas; *Corruption: Its Nature, Causes and Functions*. Aldershot, avebury, 1990:1-2 in Kivutha Kibwana *et al* p.33.

⁵⁵ Cap 65 Laws of Kenya.

public funds, breach of trust and offence involving dishonesty, however, this definition is not adequate as it only state the forms of corruption but does not exactly state the components or elements of corruption. Corruption in SCs is closely linked to poor corporate governance which is precipitated by agency conflict, lack of separation of power and a mismatch between the ostensible objectives and operational regulations under which SCs operate.⁵⁶ Corruption is not only a disease but a symptom of poor corporate governance systems in an organization, it is against this backdrop that compliance with the standards of corporate governance should be enhanced as a complement to the existing regulatory framework

1.10.2 The Governance Structure in State Corporations

The state corporations (SCs) are established under the State Corporations Act⁵⁷ (SCA) herein referred to as ‘the Act’. They are managed through the Board of Directors (BoD) whose composition is outlined in section 6 of the Act. The chairman to the board is appointed by the President and the other members include the Permanent Secretary of the Parent Ministry, the Permanent Secretary Treasury, seven other members appointed by the Cabinet Secretaries who are not employees of the SC. The Chief Executive is appointed by the board, this board composition concededly exhibits the fact that, the executive has a significant influence on its composition, this can be attributed to the ownership structure of SCs as the Government has the largest stake. Apart from the Permanent Secretaries who serve as permanent members to the boards, the Act does not provide for any criteria of appointment of the other members and hence the corporate governance principle that directors should have necessary skill and experience to carry out their duties is negated. This in turn creates a fertile ground to nurture corruption due to the patron-clientele relationship as the system consists of factions each under a leader who dishes out favours such as appointments and promotions to individuals in return for support.⁵⁸

The appointments are therefore on political considerations to reward cronies or individuals who are thought to have supported the political agenda of the leaders. Although the BoD has private

⁵⁶ Austin O. A. Ouko, ‘Corporate Governance of Parastatals: A Critique in the Context of the new constitution’ (LLM thesis, University of Nairobi 2010). P. 4.

⁵⁷ Section 3 of Cap 446 Laws of Kenya and their powers are generally provided for under Section 5 of the Act.

⁵⁸ W. N Wamalwa in an eloquent statement in his article ‘Causes and Consequences of Ethical crisis in Africa’s Public Services’ in Rasheed, Sadig and Dele Olowu (eds) 1993 (41-48) in CLARION, The Anatomy of Corruption in Kenya; Legal, Political and Socio-Economic Perspectives edited by Kivutha Kibwana, smoking Wanjala and Okech Owiti (1st published 1996, 2nd Reprint 2006) p.82.

sector representatives, the management role of the private representatives is undermined by the heavy government presence, consequently, the boards lack independence and autonomy in their decision making.⁵⁹ Unlike the private companies where shareholders exercise their voting rights as oversight to the conduct by directors and managers, the ultimate internal control of SCs lies in the government which performs the role of the general meeting by appointing directors and issuing directives.⁶⁰ The SCA does not impose any limit on the ability of the Cabinet Secretaries to direct the board hence the BoD cannot question or review undesirable directions. Further, the Cabinet Secretaries who are accountable for the SCs are not under any obligation to adopt sound corporate governance practices consequently creating loopholes which breed corruption as the aspect of accountability as envisaged under the SCA is frustrated.⁶¹

Ideally, the governance structure of SCs posits a situation whereby compliance with globally accepted corporate governance standards is difficult to enforce. This encourages corruption, fraud and misuse of public resources. It is imperative therefore to align the practice of corporate governance in SCs in order to seal the loopholes that breed corruption and contribute in the anti-corruption enforcement mechanisms through practices such as corporate disclosures, transparency, accountability and the rule of law. Yvonne Awuor in her thesis⁶² has acknowledged that Parastatals in Kenya are confronted with numerous governance issues of which fraudulent transactions and opaque board nominations process plague SCs the most. They also face the difficulty to ensure that a corporation has a qualified board; excessive ministerial control which continue to impede the ability of state owned corporations to make sound decisions; lastly, the requirements for approval to be fulfilled by Parastatals inherently slows down decision making process for instance, it is the Cabinet Secretary to approve the budget and remuneration systems.

The Constitution of Kenya in effort to realize public reforms through good governance has provided for national values and principles of governance in Article 10, leadership and integrity

⁵⁹ Kiarie Mwaura., 'The failure of Corporate Governance in State Owned Enterprises and the Need for Restructured Governance in fully and Partially Privatized Enterprises: The Case of Kenya'. Fordham International Law Journal Vo. 31, issue 1 Article 1 (2007). P. 34-75.

⁶⁰ Ibid p. 54.

⁶¹ See Section 15 of the State Corporations Act.

⁶² Yvonne Awuor Atieno; Corporate Governance Problems Facing Kenyan Parastatals; A Case Study of the Sugar Industry, Bucerius/WHU MLB Thesis, July, 17, 2009

in Article 73 and Article 232 on values and principles of public service. Article 73 prescribes the responsibilities of leadership and asserts that the authority assigned to a state officer is a public trust to be exercised in a manner that is consistent with the objects of the constitution and demonstrates respect for the people. A public officer is enjoined by this Article to conduct the affairs of his office in a way that promotes public confidence in the integrity of the office. Further, the Article sets out the guiding principle of leadership and integrity to include selection on the basis of personal integrity, competence and suitability, however, the implementation of this article is yet to be fully achieved as direct appointment of SC board members through gazette notices continue as the *modus operandi*.

Despite the fact that Article 152 of the constitution grants the President the power to nominate and with the approval of the National assembly, appoint the Cabinet Secretaries who in turn appoints the members of the board, the constitutional thresholds as envisaged under Articles 10, 73 and 232 are yet to be seen with regard to these appointments. The fact that the Cabinet secretaries are appointed through this process does not guarantee independence on the part of the board of directors. This owes to the fact that the principal (Government) who comprise of politicians who have control over state resources may spend it in return for staying in power hence corruption and power to allocate economic rents to supporters becomes a helpful instruments for buying political survival⁶³.

1.10.3 Corporate Governance in State Corporations

In his 1793 treatise, Stewart Kyde has defined a corporation as ‘....a collection of many individuals united into one body....’⁶⁴ The Companies Act⁶⁵ in Kenya on the hand defines a company to mean a company formed and registered under the Act or an existing company. This definition is imprecise and does not bring out the relationship that exists between the corporations as a separate entity from its owners. The import of section 2 of the SCA is that a

⁶³ Moses Muse Sichei, ‘Causes and Remedies of Corruption: An Economic Perspective’ in Kivuva Joshua and Odhiambo Morris; *Integrity in Kenya’s Public Service; Illustrations from Goldenberg and Anglo-Leasing Scandals*. (CLARION 2010) p 95

⁶⁴ Paddy Ireland, Ian Grigg-Spall and Dave Kelly, ‘The Conceptual foundations of the Modern Company Law’, *Journal of Law and Society*, Vol. 14, No. 1, Critical legal studies (Spring, 1987) pp. 149- 165 published by Blackwell Publishing . <http://www.jstor.org/stable/140303> accessed on 15th august 2013.

⁶⁵ Cap 486 Laws of Kenya.

state corporation is a body corporate which may be established by the president or by statute which body has perpetual succession, is capable of suing and being sued in its corporate name and lastly, it is capable of holding and alienating movable and immovable property.

Corporate governance has been defined as the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation such as the board, manager, shareholders and other stakeholders and spells out the rules and procedures for making decision in corporate affairs (OECD: 199, 2004).⁶⁶ The whole purpose for corporate governance is to ensure accountability and transparency in the management of corporate affairs. Corporate Governance is designed to put in place checks and balances in the exercise of corporate power and to ensure that the same is not misused for personal gain of any shareholder or directors.⁶⁷

There are four basic tenets of corporate governance that have been derived from its definition and these include: separation of roles and power between the main players which include the government, the directors and management; A system of accountability and reporting structures; A system of transparency and disclosure; ethical conduct supported by reward and deterrence systems. While there could be many causes of corruption, weak corporate governance structures have been identified as one of the causes. For instance, there is little disclosure of information and some directors have been known to conceal information from the oversight authority who is the auditor general while others have fraudulently run down the corporations. There has been too much discretion with little accountability which has resulted in massive fraud and corruption.⁶⁸ Poor corporate governance in state corporations has resulted in increase in corporate failures, fraudulent and corrupt behavior, powerful and dominant boards of directors that manipulate

⁶⁶ Organization for Economic Co-Operation and Development available at [www.oecd.org/corporate/corporateaffairs/corporate governance of state-owned enterprises](http://www.oecd.org/corporate/corporateaffairs/corporate%20governance%20of%20state-owned%20enterprises) > Accessed on 11.12.2012.

⁶⁷ Paul M. Wambua, 'Corporate Governance and Corruption in Kenya's Public Sector' in Kivuva Joshua and Odhiambo Morris; *Integrity in Kenya's Public Service; Illustrations from Goldenberg and Anglo-Leasing Scandals*. (CLARION 2010).

⁶⁸ Job Kihumba, 'Role of Shareholders and other stakeholders in corporate Governance' in Corporate Governance Workshop and Seminar Report, Vol 2, Private Sector Corporate Governance Trust, Nairobi, November 1999 at pp 19-31.

shareholders and other stakeholders.⁶⁹ Consequently this has led to devastating effects on the whole economy.

Corporate governance is directly related to the topic of combating corruption. However, in many societies, this is not an easy topic to deal with due to the political sensitivities as well as legal inconsistencies involved. That notwithstanding, and in order to secure position in the global economy and to secure benefits of economic growth, this correlation has to be discussed. There are corporate governance efforts that have been made to combat corruption such as the signing of the OECD Anti-bribery Convention which is the beginning and not the end of a concerted global anti-corruption campaign.⁷⁰ Other efforts to improve corporate governance have been in the provision of transparency in corporate transactions, in accounting and auditing procedures. Sound corporate governance mechanisms therefore target supply side of corruption-the private sector; it also creates a system where the whole process of providing corrupt payments or gifts is quickly exposed through whistle blowing and therefore becomes unsuitable.⁷¹ Corporate governance also sets up mechanisms which not only combat corruption on a legal basis but also in terms of business ethics. In the process of creating sound systems of corporate culture, corruption is bound to become an unacceptable business behavior.

1.10.4 Demand and Supply Dimensions of Corruption in State Corporations

Before corporate governance can be suggested as a mechanism to reduce corruption in state corporations it is imperative to understand the nature of the problem and the parties involved. Corruption has two sides to it; the demand side and the supply side. The supply-side involves those parties that provide money payments, gifts or any other forms of expressing gratitude, though corruption may also involve withholding services.⁷² On the other hand, the demand side involves those who are accepting different forms of payments and consequently providing some form of service or a favour in return, the directors, managers and the chairman of the SCs boards fall under this category. The demand side is usually characterized by environments where

⁶⁹ Kibwana et al (n 3) 4 p 69.

⁷⁰ Alexander Ikonnikov (ed) 'Corporate Governance: An Antidote to Corruption' The Centre for International Private Enterprise <www.afic.am/CG/CG-Antidote-pdf> Accessed on 28th August 2013.

⁷¹ Ibid.

⁷² Alexander Ikonnikov (ed).

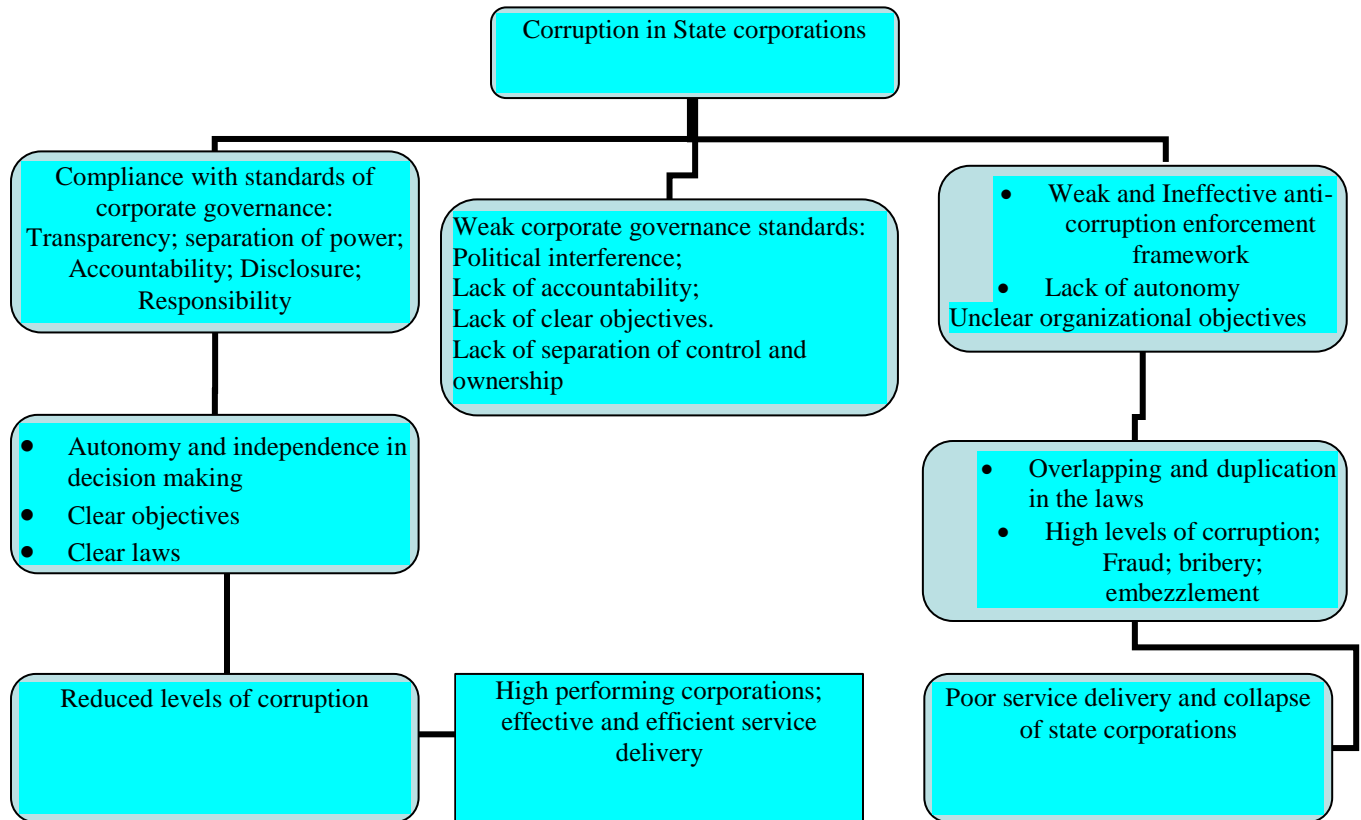
government officials have a lot of discretionary powers and the system of checks and balances is weak or non-existent. The supply side on the other hand is characterized by the private sector which is willing and sometimes forced to provide monetary and other forms of payment to the government officials for services provided or denied.⁷³ The upshot of this division of the participants is that, corruption does not only involve public bodies but private firms too. Compliance with corporate governance standards therefore need to be enhanced both in private firms and public corporations so as to cut the corruption link, and consequently have responsible and accountable firms who shall not thrive on unethical and uncompetitive practices. Consequently there is need to invoke private public participation in order to build effective anti-corruption strategies.⁷⁴

This research study is premised on two variables; with the independent variable being compliance with good corporate governance standards as against the level of corruption in state corporations. This has been necessitated by the fact that though there are numerous anti-corruption legislations, they are not without limitations in terms of adequacy and their enforcement. It is therefore imperative to consider other complementary enforcement mechanisms such as compliance with good corporate standards as an anti-corruption enforcement mechanism as it ensures compliance with the law and inculcates business ethics in the governance of corporations.

⁷³ See note 70.

⁷⁴ *ibid*

Organizational Chart Showing the Correlation between Corruption and Corporate Governance:



1.11 LITERATURE REVIEW

Corruption has established itself as a problem of a main concern throughout the world community.⁷⁵ Its negative effects on countries’ economic performance both in private and public sectors have been discussed. Today corruption continues to undermine good governance and to distort public policy. It contributes to slow economic growth and discourages genuine investors.⁷⁶ Corruption increases the poverty level of a country as found out by Transparency International. The World Bank President- James Wolfensohn while acknowledging the need to have proper and well governed corporations stated that “The governance of the corporation is now as important in the world economy as the governance of countries”. Morris Odhiambo in

⁷⁵See (n 60).

⁷⁶See (n 32).

his contribution to the book *Integrity in Kenya's Public Service; Illustrations from Goldenberg and Anglo-Leasing Scandals*⁷⁷ observes that most studies on the subject of corruption depart from the position that corruption is a vice that stands in the way of democracy, social and economic development. Hence left unchecked, it has devastating and far reaching consequences to the socio-economic well-being of a country. Different authors and commentators have attempted different definitions of what corruption is, for instance Ludeki Chweya (2005:3) defines corruption as;

“dishonest and irregular transaction of official business for direct or indirect or direct personal gain as is perpetrated by individuals in formal positions of authority-either in the public or private sphere-acting either independently or in connivance with clients among ordinary citizens”⁷⁸

Odhiambo attributes corruption to regime consolidation in which case, there is continuum between a state of un-consolidated regimes and consolidated regimes with a midway transition status and according to Pershing while citing Schmitter and O'Donnell, the transition is over when ‘abnormality’ is no longer the feature of political life.⁷⁹ He observes that regime consolidation is achieved through both legitimate and illegitimate means depending on the political context and in Kenya, it takes place within a neo-patrimonial system.⁸⁰ A political leader in a patrimonial system exercises wide discretion in decision making and applies illegitimate means for quicker and higher benefit. The formal institutions of the state are not usually respected, for personal whims of the individual leader and the priority of maintaining political power takes precedent. Neo-patrimonial system is also characterized by a ruler who dominates state apparatus and stands above its laws, illicit rents, prebends and petty corruption are prevalent.⁸¹

In a neo-patrimonial state, the subordination of otherwise independent institutions of government such as the judiciary erodes systems of checks and balances and use of power. Subordination especially of the watchdog agencies leads to abuse of power and is responsible for

⁷⁷Morris Odhiambo, ‘Corruption and Regime Consolidation in a Neo-Patrimonial State System’ in *Integrity in Kenya's Public Service; Illustrations from Goldenberg and Anglo-Leasing Scandals*. Edited by Joshua Kivuva and Morris Odhiambo (CLARION 2010) p 95

⁷⁸ Ibid.

⁷⁹ Ibid at p.5.

⁸⁰ Which is characterized by centralization of state power, the exercise of patron-client politics, and personalized rule among others.

⁸¹ Ibid (n 66 p) 7.

ineffectiveness of anti-corruption initiatives.⁸² Odhiambo further argues that corruption is a feature of the neo-patrimonial system and provides an avenue for consideration of political power so far as it avails the largesse necessary for maintenance of patronage relationships.⁸³ The system of checks and balances against abuse of authority are undermined, the rule of law⁸⁴ is weakened and the fight against corruption rendered an exercise in futility and anti-corruption behavior is considered an aberration.⁸⁵

J.J Senturia has defined corruption as the misuse of entrusted power for private benefit.⁸⁶ For purposes of this study, corruption involves behavior on the part of public officers in state corporations including board of directors, the chairman and the management. This ideally brings out the agency problem that has bedeviled most state corporations in Kenya which creates avenues for corrupt conduct. There is a tendency in the BoDs to exercise discretionary power and improperly and unlawfully enrich themselves or those close to them by misuse of the power entrusted on them by the public-tax payers. Corporate Governance is a critical focal point in creating safeguards against corruption and mismanagement, while promoting fundamental values of a market economy in a democratic society. These values include accountability, transparency, the rule of law, fairness, responsibility and ownership rights.⁸⁷ Consequently, the concept of corporate governance has attracted a great deal of interest due to its economic health of corporations and the welfare of Society in general.⁸⁸

⁸² See (n 66)p. 8

⁸³ See (n 66) p. 9.

⁸⁴ A. V. Dicey attributes to the rule of law is to the effect that, no man can be made to suffer in body or goods except for a distinct breach of law established in the ordinary legal manner before the ordinary courts of the land. Secondly every man, whatever is his/her rank or condition, is subject to the ordinary law and amenable to the jurisdiction of ordinary tribunals. This principle emphasizes legislated rules and formal procedures as the basis for compliance. If applied to corporate governance, this principle would compel the reduction of corporate governance principles into law so that they can be obeyed. (See also Osogo A, 'Rule of Law: A Restatement in Judiciary Watch Report: Readings on the Rule of Law in Africa' (ICJ Kenya Nairobi 2008) 2.

⁸⁵ Oxford Advanced Learner's Dictionary defines aberration as a deviation from what is accepted as normal or right.

⁸⁶ J J Senturia, Encyclopedia of Social Sciences, Vol. VI (1993) in Jeremy Pope (n 4).

⁸⁷ Center For International Private Enterprise, 'Corporate Governance: An Antidote to Corruption' www.afic.am/CG/CG-Antidote.pdf accessed on 10.12.2012.

⁸⁸ Private Sector Corporate Governance Trust; *Principles for Corporate Governance in Kenya and a Sample Code of Best Practices for Corporate Governance*, ISBN 9966-9969-0-12 (Nairobi 1999) www.ecgi.org/codes/documents/principles_2.pdf accessed on 2nd January 2013.

Corruption in the SCs boards has manifested itself through abuse of office, political patronage, nepotism, favoritism in licensing, among others. Systemic corruption indicates that resources for public purposes are no longer managed effectively and are appropriated for private gain and therefore there has been remarkable consensus that there is need for good governance.⁸⁹

1.11.1 Causes and Effects of Corruption in State Corporations

Some of the causes of corruption in state corporations include; political patronage, influence and favoritism:- This is often manifested through appointments to public offices made on political consideration rather than merit, tribalism and nepotism and political interference with the management of public services and institutions and allocation of resources.⁹⁰ The second cause of corruption is lack of professional integrity which is manifested through failure by the directors and managers to adhere to professional and ethical standards. Thirdly, there is lack of transparency and accountability in public investment decisions, public procurement and disposal of public property, personnel management and financial management systems and reporting. Consequently all these factors result into monopoly of decision making.⁹¹ Inefficient public sector which is characterized by outdated technology and lack of codes of conduct for the public service also creates loopholes for corruption. Corruption is also caused by failure to fully implement proposals and recommendations of watchdog institutions such as the Controller and Auditor-General, and the Ethics and Anti-Corruption Commission.⁹²

The chairman of the institute of Certified Public Secretaries while writing about the role of shareholder and stakeholder in corporate governance observed that; ‘while there could be many causes of poor corporate performance, keen observation points a finger at weak corporate governance structures as one of the main causes’.⁹³ Kenya’s corporate sector has experienced scandals that have led to the questions about the BoDs’ integrity and its legal and ethical standing and whom they serve.

⁸⁹ Michael Johnstone and Allan Doig, Different Views on Good Governance and Sustainable Anti-Corruption. Strategies (The World Bank, Washington D.C) at pg 19.

⁹⁰ See note 39 p. 5.

⁹¹ See note 39 p. 6.

⁹² Ibid p. 7.

⁹³ Kibwana et al Ibid note 4 p 69.

Moses Muse Sichei in his article *'Impact of Corruption on National economy'* observes that despite the fact that the cost of corruption can be felt at individual, political, national and international levels, its actual quantification on economy is a complicated task. This is because corruption occurs within economic institutions which are already experiencing other inadequacies and shortcomings hence making it difficult to apportion blame and ascertaining the contribution of corruption.⁹⁴

Wamalwa W. N. in his article *'Causes and Consequences of Ethical Crisis in Africa's Public Services'* argues that, the African political systems have created the conditions which have provided a fertile ground and nurtured corruption in a variety of ways⁹⁵. For instance, the nomination to the boards of directors is based on patron client relationships and not merit based. On the other hand Kibwana *et al* while carrying out their field work study on causes of corruption found out that out of 598 respondents interviewed, 42.1% which is 576 respondents attributed corruption to ineffective laws and 25.6% attributed it to the political leaders, hence ineffective laws and political leaders' interference accounted for a total sum of 67.7%⁹⁶.

Corruption has been one of the reasons why SCs have experienced poor economic performance; it leads to decisions of BoDs being determined by ulterior motives with no regard to public interest. Dieter Frisch, a former Director-General of Development at European Commission observed that; corruption raises the cost of goods and services and hence the debt of the country.⁹⁷ It slows down the growth of the economy, leading to unemployment and an increase in poverty. It is manifested through unplanned, misdirected expenditure on projects resulting to huge losses. It is also manifested in currency fluctuation and increased inflation and interest rates, increased taxation burdens to Kenyans and increase in the prices of goods and services.⁹⁸

Another effect of corruption is the disregard for standards and the pillars of integrity which in turn leads to disregard of the rule of law and sub-standard work, services and products. It also

⁹⁴ See note 56 p. 131.

⁹⁵ See note 52.

⁹⁶ See note 4 p. 83.

⁹⁷ Dieter Frisch, 'Effects of corruption on development' in Jeremy Pope *ibid* note 6 p 3.

⁹⁸ *Ibid* note 39 p. 8.

leads to looting of public resources which in turn leads to losses through fraud, theft and embezzlement.

Professor Kiarie Mwaura in his article *'The failure of Corporate Governance in State Owned Enterprises and the Need for Restructured Governance in fully and Partially Privatized Enterprises: The Case of Kenya'*⁹⁹ observes that political influence and lack of autonomy of the boards has in turn led to dismal performance of some corporations and total collapse of others. Despite the Constitution seeking to streamline corporate governance through provisions on competence, personal integrity and upholding of national values in the public service, we have continued to witness direct political appointments through gazette notice which continue to weaken the independence of state corporations. This study has identified the problems in the state corporations that breed corruption to be; agency problems due to lack of clear identifiable owners or principals which has in turn led to competing interests and sometimes conflicting ones which hinders these corporations from efficiency in delivery of goods and services. Lack of autonomy of the state corporations' boards hinders their independence in policy and decision making and overlapping regulations which bring about confusion in terms of the boards not knowing which regulations to be followed to achieve the organizational objectives.

Michele I. Caron *et al* in their article *'The Influence of Corporate Governance standards: Shared Characteristics of Rapidly Growing Economies'*¹⁰⁰ sees corporate governance as an anti-thesis to corruption and that deficiency of corporate governance practices and low levels of compliance to these standards by firms breed corruption leading to a plethora of transparency dilemmas. According to them, corruption in state corporations is multi-faceted as the participants include; the trustor, the fiduciary and the corrupter. They argue that there are two types of corruption in SCs; bureaucratic corruption which involves officials taking bribes and the second type is grand corruption where Ministers and top officials misuse public power for private or pecuniary profit.

⁹⁹ See note 53.

¹⁰⁰ Michelle I. Canon, Aysun Fici'ci' and Christopher L. Richter; 'The Influence of Corporate Governance standards: Shared Characteristics of Rapidly Growing Economies'. *Emerging Markets Journal* Vol. 2 (2012) ISSN 2158-8708 <<http://emaj.pitt.edu>> at p. 22 accessed on 20th August 2013.

They further observe that corruption is more prominent in countries where anti-corruption laws are weak.¹⁰¹

Though Kaufmann and Jim Wei (2000) suggest that corruption may improve efficiency, especially in developing countries such as Kenya, since it is related to bribery and gradually leading to “lower effective red-tape,” other scholars argue that corruption comes with a variety of consequences such as negative economic growth, additionally, it leads to exploitation of a country’s regulatory significance¹⁰².

Cochran and Wartwick describe corporate governance as an “umbrella term that includes specific issues arising from interactions among senior management, shareholder, board of directors and other shareholders”¹⁰³ On the other hand Fernando A. C. argues in his article ‘*Corporate Governance: An Overview of Corporate Governance Principles, Policies and Practices*’ that corporate governance ensures transparency, full disclosure and accountability of companies to all its stakeholders.¹⁰⁴ Michelle *et al* emphasized the importance of evaluating corruption which becomes patent when performance and service delivery becomes questionable. This occurs when a corporation’s operations have to be disrupted by incurring additional costs due to corruption. Accordingly, corporate governance is typically perceived as dealing with ‘problems of separation of ownership and control’.¹⁰⁵ Consequently, the agency problem arises where managers have incentives to pursue their own interests at the expense of the public.¹⁰⁶

As a result of the financial crises which negatively impacted on countries with varying degrees in the 1990s and the 2000s, more countries are now paying more attention to corporate governance policies as they realized that failure to implement efficient corporate governance can decrease

¹⁰¹ Michelle I. Canon *et al*.

¹⁰² Kaufman Daniel and Wei Shang Jin ‘Does ‘grease’ money speed up the wheels of commerce’ World bank Working Paper no. 2254 (1999), Harvard University 1-19.

¹⁰³ Ibid.

¹⁰⁴ Fernando A. C. argues in his article ‘Corporate Governance: An Overview of Corporate Governance Principles, Policies and Practices’ (Upper Saddle River: Pearson Prentice Hall, 2009). 3-32 in Michelle I. *et al*.

¹⁰⁵ Ibid note 93 p. 23.

¹⁰⁶ Ibid p. 24.

efficiency of operations, increase the cost of the company's funds and open doors for more corruption.¹⁰⁷

In crafting or proposing the efforts to combat corruption, it is important to understand the nature of the problem and the parties involved. Corruption has the supply and the demand sides. Supply-side involves those parties that are providing money payments, gifts or any other forms of expressing gratitude for services. Demand-side represents the recipients of the payments and consequently providing some services or favour in return.¹⁰⁸ The demand side is characterized by government officials who have a lot of discretionary powers and operate in environment where the system of checks and balances is weak or non-existent. The supply side is usually represented by the private sector which is willing and sometimes forced to provide monetary and other forms of payment to government officials for the services provided or denied.¹⁰⁹

Klapper and Love¹¹⁰ in their study found a positive correlation between corporate governance structures and a country's level of measures of investor protection. Additionally, they suggested that it is crucial for firms located in countries with weak legal systems to adopt improved corporate governance practices. However, corporate governance should not be used to replace the legal system but as a complement.¹¹¹ In support, Wu observes that corporate governance is among the important factors determining the level of corruption hence corporate governance standards have profound impacts on the effectiveness of the global anti-corruption campaign.¹¹²

State Corporations control key sectors of the economy and therefore given their centrality to the economy, a lot of public funds are allocated to them, it is important that the directors in making decisions on how and on what to apply these funds should do so accurately, responsibly and transparently and without any external influences. However, this has not been the case due to the

¹⁰⁷ See Fernando A. C. p. 25.

¹⁰⁸ Ibid note 17.

¹⁰⁹ Ibid note 72.

¹¹⁰ Klapper Leora and Love Inessa,. Corporate Governance: Investor Protection and Performance in emerging Markets' *Journal of Finance* 10.5 (2003): 703-28 in Michelle *et al.*

¹¹¹ This is because the corporate governance is premised on principle based rules and guidelines whole enforcement is not mandatory hence some level of voluntariness and change of attitude is required.

¹¹² Wu Xun. 'Corporate Governance and Corruption: A Cross country Analysis' *Governance; An International Journal of Policy Administration and Institutions*. 18 (2) 2005. 151-170 in Michel I. *et al.*

statutory power given to the President and the Cabinet secretaries to appoint directors of the corporations, these appointments are made albeit no statutory requirement of the directors to have expertise and experience in management of SCs.

The literature reviewed shows that there is no much study carried out on direct link of corporate governance to anti-corruption strategies in state corporations hence necessitating the current research study. This research is aimed to fill this academic gap and propose best corporate governance practices that can be adopted by policy makers and strategy formulators to prevent and combat corruption in state corporations, while boosting their service delivery to the tax payers.

1.12 CHAPTER BREAKDOWN

Chapter One: Introduction and Setting out the Agenda of the Study

This chapter introduces the agenda of the study setting out the introduction and background of the study, with a brief statement of the problem, a justification as to the significance of the study and the academic contribution to be achieved. The chapter states the hypothesis against which the conclusion will be drawn; the research objectives and questions are set out as guide maps throughout the research. The methodology to be used is also set out together with the conceptual framework which determines the scope of the study. The theoretical framework discusses the philosophical background upon which the research is founded. Finally, the Chapter sets out an overview of what the body of the research project comprises through the chapter breakdown.

Chapter Two: Corruption in State Corporations; what Ails the Legislative Framework?

This chapter begins with a brief introduction, followed by an analysis of corporate governance challenges that breed corruption in state corporations and the issues to be discussed include; the mode of appointment of the board of directors and how it affects transparency, accountability and independence in the management and control of SCs. The chapter will also analyze the legislative framework in place that is used to fight corruption including the Anti-Corruption and Economic Crimes Act (ACECA), Ethics and Anti-Corruption Act (EACA), Leadership and Integrity Act (LIA), the Penal Code, and the International Instruments in the fight against

corruption such as the United Nations Convention Against Corruption (UNCAC) in line with Article 2 of the Constitution. The Chapter examines the effectiveness of these pieces of legislation as tools to combat corruption in state corporations. The factors responsible for weak enforcement of the anti-corruption laws will be discussed in the context of SCs. The role of the Courts and EACC as enforcement agencies, their achievements and limitations will be discussed and possible solutions suggested.

Chapter Three: Corporate Governance: A Mechanism to Combat Corruption in State Corporations?

An introduction to this chapter will be offered, followed by a discussion emphasizing the relevance of good corporate governance in SCs as a mitigating factor in the fight against corruption. The issues to be discussed include; The principle of separation of control and ownership; the duties and responsibilities of directors; accountability and transparency; the role of the gate keepers; disclosure philosophy; internal control measures necessary to detect and prevent corruption; the role of human resource in corporate governance; and the impact of the constitution 2010 on corporate governance of SCs and by extension on the level of corruption.

Chapter Four: Best Practices in Corporate Governance and their Application in the Fight against Corruption

This chapter will begin with an introduction. Thereafter, global best practices on corporate governance of state owned enterprises will be discussed and benchmarked with Kenya' sample code of best practices hence come up with best practices to suit the local environment upon benchmarking with other jurisdictions as to how they have strengthened the independence and effectiveness, transparency, integrity and responsibility of their boards and how this has been used to mitigate the effects of corruption in state owned enterprises.

Chapter Five: Findings, Conclusion and Recommendations

At the end of the study, a summary of the key issues identified in the research will be discussed and recommendations suggested to align corporate governance with anti-corruption strategy in order to enhance the anti-corruption enforcement framework so as to increase transparency, responsibility, openness and fairness and adherence to the rule of law. Incidentally this will aim

to reduce corruption in SCs. A conclusion will also be made either approving or rejecting the hypothesis of the study as formulated.

CHAPTER 2

CORRUPTION IN STATE CORPORATIONS: WHAT AILS THE LEGISLATIVE FRAMEWORK?

2.0 INTRODUCTION

Having made an introduction to the issues for discussion in this research study, the stage has been set to discuss the legal challenges that encounter the anti-corruption legislative framework in the governance of state corporations. The review of literature above reveals that though the laws in themselves are not without limitations, the weakness in the enforcement framework is the major issue. Corruption thrives in institutions that lack proper corporate governance as the core values and standards of corporate governance are compromised. This chapter discusses the corporate governance challenges that breed and perpetrate corruption in state corporations, the current legislative framework to prevent and combat corruption and the effectiveness of the enforcement framework.

2.1 CORPORATE GOVERNANCE ISSUES THAT BREED AND PERPETRATE CORRUPTION IN STATE CORPORATIONS

2.1.0 Mode of Appointment of Directors

State corporations are governed by the Board of Directors (BoDs). The directors are appointed pursuant to the provisions of section 6(1) of the State Corporations Act. The board comprises of the chairman who is appointed by the President, the Chief Executive, the Permanent Secretary of the parent Ministry, the Permanent Secretary of the Treasury and seven members not being employees of the state corporation and out of which not more than three shall be public officers who are appointed by the Minister for the time being responsible for that state corporation. Out of the eleven members, only four are appointed from the private sector.

The fact that all these directors are directly appointed by the President or the Minister without any procedural interviews or selection on some identifiable criteria raises the questions of their competence and independence of judgment. Consequently, most of these appointments are politically instigated or favour relatives, friends and cronies. This mode of appointment breeds corruption as nepotism and rent-seeking is perpetrated which negatively influence independence

of these boards in decision making in the interest of the owners. The doctrine of separation of control and ownership is therefore negated as the executive does not separate its oversight functions from the management of the corporations.

2.1.1 Multiple Agency Problems

The principle of separation of ownership and control ensures that the government owns greater percentage of the corporation in a dispersed ownership structure apparently necessitating the agency relationship. The agency relationship that exists between the board and the corporation involves the shareholder (principal) delegating some decision making authority to the board (agent). In such a relationship, if both parties to the relationship are utility maximisers, there is good reason to believe that the agent will not always act in the best interest of the corporation/principal.¹¹³ To minimize these agency problems and forge a convergence of the directors' objectives and those of the corporation, the corporation must establish appropriate incentives for the agent by incurring monitoring costs designed to limit the aberrant activities of the agent.¹¹⁴

2.1.2 Lack of Autonomy and Independence in Corporate Boards

The OECD guidelines on corporate governance of State-Owned Enterprises 2005 require states to give full operational autonomy to state corporations and that the government should not be involved in the day-to-day management of the SCs but allow them full operational autonomy to achieve their defined objectives. The guidelines also require that the state should let SCs boards to exercise their responsibilities and respect their independence. Although the State Corporations Act (SCA) makes the board responsible for the proper management of the affairs of the SCs,¹¹⁵ it does not give the board the autonomy to set the goals of the Parastatals or appoint CEOs as it tends to put the ultimate control of these corporations in the hands of the Government. For instance, the Act gives the Minister (Cabinet Secretary) unlimited power to direct the board which therefore means that the board is likely to implement decisions which are undesirable and not in the best interest of the general public. This is because the SCA does not require the

¹¹³ Michael C. Jensen and William H. Meckling; *The Theory of the firm; managerial Behavior; agency costs and Ownership structure*. P 6.

¹¹⁴ Ibid.

¹¹⁵ Section 15(1) of the State Corporations Act Cap 446 (1987).

Minister to adopt sound corporate practices nor is the Minister obliged to publish in Parliament Ministerial decisions affecting the SCs so that they can be scrutinized.¹¹⁶

The mode of appointment and the composition of the board of directors also affect the autonomy and independence of the board. The Act permits the President, rather than the board to determine who is nominated to form the composition of the board of directors. Apart from denying the board the opportunity to nominate directors transparently, such Presidential and Ministerial appointments deny the boards the power to discipline non-performing and wayward directors and hence rendering monitoring of performance a difficult task as the allegiance of the political appointees is to the person appointing and not to the corporation and its shareholders.¹¹⁷ The political appointments also brings into the board rooms persons without the right qualifications and experience and who owe their allegiance to the appointing authority hence making it difficult for them to discharge their duty of care, skill and acting in diligence. The political interference in the running of State Corporation therefore provides a fertile ground for transacting fraud and corruption.

2.1.3 Overlapping Regulations

State corporations do not have a centralized system of corporate supervision and as a result, they are supervised by several sectoral Ministries and Government departments which may have different objectives. The ownership organization and holding structure of state corporations in Kenya takes the centralized model which owes its roots to implementation of privatization programmes in the 1990s. In this model the state corporation is put under the responsibility of one Ministry or agency and the rationale for this model is to have a clear line of accountability from the SC to the Government and to enable the government to exert close fiscal supervision and to form a coherent SC policy.¹¹⁸

Whereas the agency relationship in the private companies is clear between the shareholder and the directors, this relationship gets complicated in the state corporations. This owes to the fact that a SC has multiple agents including directors, government, the President and other public

¹¹⁶ See note 15 p. 5.

¹¹⁷ Ibid.

¹¹⁸ Maria Vagliasindi; Governance Arrangements for the State Owned Enterprises; Policy Research Paper 4542, World bank Sustainable Development network March 2008 p. 11.

officials such as the Minister.¹¹⁹ Apart from the SCA, the Parastatals are regulated by the individual Acts creating them as well as the various directives they get from their parent Ministries and the President. This consequently causes confusion in the boards especially where the regulations are conflicting, a good example is the conflicting provisions between the Kenya Communications Act¹²⁰ and the SCA. This confusion results in lack of clear lines of accountability, and the hence director's duty of good faith to the corporation is overshadowed by overriding interests such as pursuit of personal and political interests.¹²¹ Consequently the SCs loose colossal amounts of public funds.

The three corporate governance issues consequently result into and perpetrate policies which lack or have weak policies on accountability, disclosure and transparency. State Corporations are under the direct regulation by Parliament as Parliament scrutinizes them under their establishing legislations. The Government therefore exercises control of the SCs through Ministers, who have powers to give directions of general character to the corporation.¹²² Unlike in the private corporations where the board sets the objectives of the company, the Minister is responsible to identify and set both commercial and non-commercial objectives. The parastatal board is consequently accountable to the Minister who in turn is accountable to Parliament and as such, accountability of the directors is limited to their financial performance. This structure of governance does not provide an environment where the directors are held accountable of their actions as they are more likely to act in the interests of the government.¹²³

Excessive control exerted by political actors, the mode of appointment and the composition of the board as previously discussed results into conflicting and even competing self interests by the directors. The directors therefore find themselves with onerous task to discharge their duties towards the corporation that is the duty to act in good faith, in a transparent manner and in the

¹¹⁹ See note 15 p 3.

¹²⁰ See Section 6(a) and (b) of the Kenya communications Act 1998 which empowers the President to appoint the chairman and the minister to appoint the directors at the same time the Act establishes the CCK with similar mandate.

¹²¹ ISee note 15 p. 5.

¹²² Kiarie Mwaura; *The Failure of Corporate Governance in State Owned Enterprises and the Need for Restructured Governance in Fully and Partially Privatized Enterprises: The Case of Kenya*. Fordham International law Journal. Vol. 31, Issue 1 2007 pp.34-75 at p.56.

¹²³ See Section 19(4) of the State corporations Act.

best interest of the corporation and providing timely and accurate disclosure of information to shareholders. For instance in August 2001, the Parliamentary Public Investment committee revealed how the Board of Directors of National Social Security Fund (NSSF) abdicated their duties when they awarded themselves executive treats consequently subjecting the Parastatals to a loss of three billion Kenyan Shillings between 1996 and 1998.¹²⁴

2.2 CORRUPTION AND ITS EFFECTS ON THE PERFORMANCE OF STATE CORPORATIONS

According to Kibwana *et al*,

‘Corruption takes place in all spheres of human endeavor which include in the government, corporate bodies, and private institutions among others and if it is not checked, it grips the whole society and eats into its very fabric; it becomes a way of life, culture.’¹²⁵

The seismic wave of scandals that rocked the corporate world between year 2001 and 2003¹²⁶ indicate that, no single state or corporation is immune to corruption and consequently to corporate governance failure. Concededly, corporations are crucial to the socio-economic structure of a state, and therefore, failure of corporate governance implicitly injures the socio-economic well being of a nation.¹²⁷

In the Kenyan context, the failure of corporate governance in the state corporations has been cited to have facilitated two mega financial frauds that rocked the nation in the recent past; the Goldenberg¹²⁸ and the Anglo-leasing scandals.¹²⁹ In both cases, the government lost colossal amounts of public funds. Due to the huge amounts that were involved, the scandals have had and continue to have wide and negative implications on the country’s economy.

¹²⁴ See note 45 p. 58.

¹²⁵ Ibid.

¹²⁶ From Enron to WorldCom and Tyco in USA to Parmalat in Europe corporate scandals.

¹²⁷ Ibid note 19 p 180.

¹²⁸ The Government of Kenya lost Kshs. 27 billion. See Report of the Judicial Commission of Inquiry into the Goldenberg Affair. The Report is also available at <http://www.tkenya.org/documents/Goldenberg>

¹²⁹ Over 56 billion Kshs were lost, see Special Audit Report of the Controller and Auditor General on Financing, Procurement.

From the finding of the Bosire Commission¹³⁰, it was apparent that corruption increases the national debt of the country; it weakens the value of the shilling consequently exerting pressure on prices of domestic goods which triggers inflation and increase in poverty levels. It also increases the cost of lending by the private commercial banks. During the lifetime of the Goldenberg scandal, 40% of the national revenue went to service the national debt and little revenue was left for general economic development of the country. With an economically non-performing government, many people lost their employment and the effects of such mass retrenchment have continued to be felt to date. Corruption directs public resources to private interests and therefore puts unanticipated pressure on the fiscal structure hence exposing the government to perennial debt (Prof. Ryan- a witness in the Goldenberg inquiry).

2.3 CURRENT LEGAL FRAMEWORK TO PREVENT AND COMBAT CORRUPTION

There are no specific laws or legislation for state corporations governing the fight against corruption, however, the general Anti-corruption legislations apply even to SCs. Currently there are several anti-corruption laws put in place to prevent and combat corruption which generally apply to all public offices, state corporations included. Chronologically, the key legislative initiatives to combat corruption include the enactment of the: Prevention of Corruption Ordinance (cap 65 of 1956); Formulation of the Anti-Corruption Police Squad by amendment of the Prevention of Corruption Act (1992); further amendment of the Prevention of Corruption Act and formation of the Anti-corruption Authority (KACA) in 1997; Formation of the Anti-Corruption Police Unit (ACPU) in 2001. In the year 2003, the Kibaki government was elected on the promise of zero tolerance to corruption, the aftermath saw the enactment of Anti-Corruption and Economic Crimes Act (ACECA)¹³¹, and the establishment of the Kenya Anti-Corruption Commission in May 2003, the Public Officer Ethics Act (POEA) was also enacted in may 2003; The Public Audit Act, 2003; The Government Financial Management Act, 2004; The Privatization Act, 2005 and the Public Procurement Proposal Act (PPOEA)¹³².

In the year 2010, Kenyans through a referendum voted overwhelmingly for a new Constitution which saw its promulgation in August 2010. This Constitution recognized the need to have

¹³⁰ See note 53.

¹³¹ Act No. 3 of 2003 (Cap 65), Laws of Kenya.

¹³² Act No. 3 of 2005.

institutions governed in a transparent and accountable manner and institutions that adhere to the rule of laws and are responsible for the allocation and use of public resources. In line with this objective, it anchored even more anti-corruption initiatives through Article 79¹³³ this saw the enactment of the Ethics and Anti-Corruption Commission Act,¹³⁴ the leadership and Integrity Act¹³⁵. Other legislative enactments include the Penal Code,¹³⁶ the special magistrates' courts established under the Anti-Corruption and Economic Crimes Act, and the Proceeds of Anti-Money Laundering Act¹³⁷

Kenya was the first Country to sign and ratify the United Nations Convention against Corruption (UNCAC) in 2003. In 2009 Kenya conducted a self-check on the state of anti-corruption laws and policies and came up with a Gap Analysis Report¹³⁸ on the initiatives that are currently being undertaken in the fight against corruption. Before the ratification of UNCAC, Kenya had established her own Anti- Corruption and institutional framework and its main anti-corruption statute was the Anti-Corruption and Economic Crimes Act 2003.

Despite there being an elaborate legal and institutional framework to fight corruption, the vice is still rampant in SCs and it has been behind various scandals and poor performance and sometimes collapse of SCs. Corruption is a crime that is opaque in its nature and its definition under the ACECA does suffice to cure this as it does not clearly state the elements of corruption rather, it gives the different forms in which corruption is manifested hence the ambiguity in interpretation. When the ACECA was enacted and under it established a specialized investigatory agency and special anti-corruption courts, many were hopeful that corruption would be tamed.¹³⁹ However, that did not happen and may not happen soon unless change of tactic is applied. Odhiambo observes that, the persistence of corruption is a consequence of failure to implement existing legislation rather than the absence of effective legislation. However, I beg to differ with him as enforcement of anti-corruption does not only depend on the

¹³³ This Article empowers Parliament to enact legislation to establish an independent ethics and anti-corruption commission with a mandate of ensuring compliance and enforcement of leadership with integrity.

¹³⁴ Act No 18 of 2012.

¹³⁵ Cap 65 A, Laws of Kenya.

¹³⁶ Cap 75 Laws of Kenya.

¹³⁷ Anti-Money Laundering Act, 2009.

¹³⁸ Kenya: UN Convention against Corruption Gap Analysis and Implementation Plan 2009.

¹³⁹ Ibid note 69 p. 10.

legislation but also on the attitude of the people and their willingness to embrace ethical behavior. The existing laws as noted in the earlier literature are also inadequate, sometimes conflicting, overlapping and most often not deterrent enough to ensure compliance.

2.4 EFFECTIVENESS OF THE ANTI-CORRUPTION ENFORCEMENT FRAMEWORK: WHAT ARE THE CHALLENGES?

Despite Kenya having an elaborate framework to prevent and combat corruption, incidents of corruption are still rife in the State Corporations. In the recent past, the country has witnessed board wrangles ending up in court proceedings as was the case of Tana Athi River Development Authority¹⁴⁰, East Africa Portland cement, Kenya Co-operative Creameries, National Housing Corporation,¹⁴¹ and National Social Securities Fund. Another example is the case of the managing director of Kenya Meat Commission who was suspended for misuse of cash in May 2013.¹⁴² In all these cases the common denominator has been corruption either due to, conflict of interests, self dealing abuse of office or fraud.

Though there have been numerous investigations and prosecution of cases of graft involving the directors and senior managers of state corporations, only a few convictions have been obtained. A case in point involved the former managing director of Kenya Tourism Board and former Permanent Secretary in Ministry of Tourism.¹⁴³ The effort of law enforcers to use the rule based approach in dealing with these corporate governance issue by court prosecution and recovery of the looted public funds has not bore much fruit as this socio-economic vice persist. Some of the challenges that have been experienced especially by the Anti-Corruption agency include; Lack of political good will on the part of the state and arms of Government to fight corruption, the Ethics

¹⁴⁰ The people reporter, 'Besieged Tarda Boss Hit by New Corruption Allegations' *The People* (Nairobi, 2nd May 2013) 6. In which case the Tarda managing director was being investigated for abuse of office.

¹⁴¹ Harold Ayodo, 'House of Corruption' *The Standard* (Nairobi, 6th September 2012) 8. In which the audit committee report revealed that graft was deeply rooted in the National Housing Corporation which graft was being perpetrated by the managing director and the senior managers.

¹⁴² Ponciano Odongo 'KMC Boss Suspended in Cash Misuse probe' *Daily Nation* (Nairobi 30th May 2013) 38. This was despite the fact that, this Commission has been faced with a huge debt owing to non-payment of for the meat supplies from the farmers.

¹⁴³ Wahome Thuku, 'Justice Strikes Hard; Reality of Changed Times at Judiciary Felt as Ex- PS and Top State Officials Jailed and Fined Kshs. 21.6 Million over Kshs 9.3 Million KTB Scandal'. *Daily nation* (Nairobi, 11th September 2012) 1. Nabutola and Ex-KTB boss jailed for fraud they were charged with the offence of conspiracy to defraud the Ministry of Tourism of Kshs. 8.4 million. However, the effect of this conviction was short lived as the duo was released upon being granted bail pending appeal.

and Anti-Corruption Commission, the agency charged with the mandate to investigate, and recommend for prosecution and recover proceeds of crime and corruption lacks prosecutorial powers which would significantly increase its effectiveness in enforcement of the anti-corruption laws and regulations. However, these powers would need to be exercised with appropriate safeguards.

The judiciary has presented a significant challenge in the fight against corruption through unwarranted delays, often caused by the defendant's legal teams in cases filed by the anti-corruption agency. The courts have made numerous unfavourable rulings against this agency therefore curtailing its investigation and prosecutorial powers of the agency, for instance in the case of *Stephen Mwai Gachiengo & Another vs. Republic*.¹⁴⁴ Where the applicants had been charged with 9 counts of abuse of office contrary to section 101 (1) of the Penal Code,¹⁴⁵ though the Attorney General (AG) had sanctioned, the prosecution, constitutional issues were raised on whether section 26 of the ACECA was conflicting with the Constitution. The court ruled that by delegating his prosecutorial powers to the Kenya Anti-Corruption Authority (KACA) the Attorney General was being escapist and abdicated the responsibilities bestowed on him by the Constitution and hence the exercise of the prosecutorial power by KACA was unconstitutional.¹⁴⁶

The Courts have also stopped investigations upon defendants making judicial review applications for instance in the Anglo Leasing scandal, in which the court stopped investigations declaring that, to allow such investigations would be a breach of the contracts between the government and the various Anglo Leasing companies, which also had the approval of the Attorney General.¹⁴⁷ Further, the courts have also made controversial rulings that have had the effect of setting back the anti-corruption drive.

¹⁴⁴ (2000) eKLR p.6.

¹⁴⁵ Cap 63, Laws of Kenya.

¹⁴⁶ See note 67.

¹⁴⁷ Africa Centre for Open Governance (Africog): Five Years Later on; How Effective is the KACC in Kenya's Fight against Corruption? A Brief of the Africog Report Reviewing the Effectiveness of the Fight against Corruption, December 2009.

Though Kenya was the first country to ratify the UNCAC, there has been general lack of observance of international conventions¹⁴⁸. Though the office of the Attorney General is responsible for its enforcement, not much achievement can be seen. It has instead been accused of excessive bureaucracy in dealing with criminal and civil cases, additionally, it has been accused of coming up with poorly drafted bills.¹⁴⁹ For instance, critics of the Leadership and Integrity Act have attributed it to poor draftsmanship.

The factors that breed and perpetrate corruption in SCs have always hindered the enforcement of the anti-corruption legislative initiatives. These include too much political interference in the management of the affairs of the boards. The judiciary on the other hand has been plagued by inconsistencies in court decisions as observed above, hence lack of a consistent anti-corruption jurisprudence. Being an arm of the Government, it suffers from external influence of the judicial process which benefits the corrupt litigants and judicial officials.¹⁵⁰ Concededly, there is institutionalized corruption in the Judiciary which erodes the rule of law and in turn makes it difficult to enforce of anti-corruption laws.

Despite these laws, Kenya witnessed the collapse of 33 of its banks in 1985, which has been blamed on poor legal and regulatory environment.¹⁵¹ Lois Musikali in her paper therefore, recommends strengthening of the legal framework. On the other hand Arjoon Surendra points out that many company collapses have occurred despite apparent legal compliance.¹⁵² This means that companies would have complied with legal provisions but still collapse due to lack of integrity and ethics in conduct of business.¹⁵³

¹⁴⁸See The National Anti-Corruption Plan (1st printed in 2006, reprinted in 2008).

¹⁴⁹ Ibid.

¹⁵⁰ Ibid.

¹⁵¹Lois M. Musikali, 'The Law Affecting Corporate Governance in Kenya: a Need for Review'. International and commercial Law Review, ICCR 123
<http://www.academia.edu/1524463/The_law_affecting_corporate_governance_in_Kenya_a_need_for_review>. accessed on 6.8.3013.

¹⁵² Surendra Arjoon; 'Corporate Governance; An Ethical Perspective'
<<https://sta.uwi.edu/conferences/financeconference/Conference%20Papers/Session%205/Corporate%20Governance%20-%20An%20Ethical%20Perspective.pdf>> 14 (accessed on 9.8.2013).

¹⁵³ Collapses due to deterioration of the moral and ethical values.

There is concern about the lack of ethics in the business world, particularly in the financial system, since there are greater incentives for unethical conduct. As a result of many scandals, there has been a renewed interest and focus on legal compliance mechanisms. For example, the Sarbanes-Oxley Act¹⁵⁴ established to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to securities laws and other purposes, contains proposals that increase chief executive officers accountability for financial statements, increases penalty for fraud. Although a necessary component of corporate governance, legal compliance mechanisms have clearly proven to be inadequate; they lack the moral firepower to restore confidence and the ability to rebuild trust in the corporation.

Corporate governance of state corporations is regulated by the Companies Act, listed companies are governed by the Capital Markets Act and the Regulations and the Capital Markets Authority. Current legal framework on securities market in Kenya is traceable to the 1907 when the UK Parliament promulgated an Order in Council, declaring that the sources of law of Kenya would henceforth be the statute of General Application, the common Law as modified by the doctrines of Equity and Judicial Precedent.¹⁵⁵ The Companies Act that is currently in use was as a result of adoption of the United Kingdom Companies Act of 1907 which was adopted in 1922 and remained in force until January 1962 when the Companies Act of 1948 was adopted and has remained the operative statute.¹⁵⁶ Due to its static nature, most of its provisions do not reflect the developments in the law. For instance, Section 188 and 189 of this Act provide a challenge to corporate governance with regard to appointments and disqualifications for directors.¹⁵⁷ In an attempt to amend the law relating to corporations, the companies Bill 2010 has been proposed and it is hoped that it will be a cure to the many shortcomings of the Act.

Conclusion

This chapter has discussed the corporate governance challenges that breed and perpetrate corruption in State corporations. These include: the mode of appointment, which can easily be

¹⁵⁴ (2002)

¹⁵⁵ Section 3 Judicature Act, Cap. 8.

¹⁵⁶ Gakeri J. K. 'Enhancing securities market in Sub-Saharan Africa; An Overview of the Legal and Institutional Arrangements in Kenya. International journal of Humanities and Social Science, Vol 1 No. 9 (Special Issue-July 2011).' P.138.'

¹⁵⁷ These sections provide for undischarged bankrupts acting as directors and power to restraint fraudulent persons from managing companies respectively.

challenged in court as unconstitutional as it negates the Constitutional thresholds of transparency, merit, competency and integrity. The SOEs also suffer from multi agency problems as they receive, regulations, policies, and circulars from different agencies hence they find it difficult to amalgamate the conflicting objectives therefore creating loopholes for corruption and unethical conduct.

Autonomy is also lacking in the governance of SOE as they are either government funded or quasi-autonomous and the government is the majority shareholder. In most cases it is the whims of the government that are adhered to at the expense of nurturing principles of good corporate governance. The SOEs are subjected to numerous legislations and regulations which in most cases are overlapping. The chapter also examined corruption by attempting its definition, effects on performance of SOEs and the current legal framework to prevent and combat corruption. The fight against corruption has now been embedded in the Constitution as the supreme law of Kenya. More anti-corruption legislations have been enacted as a result of this for instance the EACA and the LIA. These efforts have been augmented by the enactment of the Proceed of Crime and Anti-Money Laundering Act. (2009). However, the effect of these new legislation is yet to be fully felt partly because of the challenges discussed.

CHAPTER 3

CORPORATE GOVERNANCE: A MECHANISM TO COMBAT CORRUPTION?

3.0 INTRODUCTION

The second chapter of this research paper has analysed some of the corporate governance issues that breed and perpetrate corruption in state corporations which included the mode of appointment and composition of the boards of directors, lack of autonomy and independence of the boards due to political interference, and overlapping regulations. From the issues identified the underlying problem is with regard to governance and integrity of public institutions which include state corporations. The Constitution 2010 in effort to restructure the public sector and instill transparency, accountability and integrity has explicitly provided for national values and principles; principles of leadership and integrity; and values and principles of public service. This chapter therefore analyses how these principles and values should be incorporated in the governance of state corporations with the aim of preventing and combating corruption.

Corporate governance as developed by the association of Common Wealth on Good Governance is defined in broad terms as a system by which a corporation is directed, controlled and held accountable.¹⁵⁸ It therefore deals with a group of people who direct or lead the corporation who are the directors. Directing means leadership while control addresses the management who are directed by the directors but control certain actions. Whether directing or controlling, there is need to account to the shareholder and other stakeholders. Corporate governance also concerns the manner in which the power of the corporation is exercised in the stewardship of its assets or resources in order to add value as well as satisfy the interest of shareholders and other stakeholders.

Good corporate governance requires that the board of directors must offer leadership to the corporation and must not look at the executive officer or the government to give leadership to the corporation. The leadership must be strategic and not non-sensical or political, it must be based on fact and evidence. The leadership must not be spontaneous but should set out policies, principles and practices premised on the corporate objectives. However, in Kenya the directors

¹⁵⁸ Private Sector Corporate Governance Trust; Guidelines for Good Corporate Governance in State Owned Corporations. ISBN 9966-9969, (Private sector corporate governance Trust (2002)) P 1.

are usually faced with the complexity to satisfy a complex and often conflicting range of political, economic and social objectives.

3.1 SEPARATION OF CONTROL AND OWNERSHIP AND THE NEED FOR BALANCE OF POWER

State corporations have been established by the government with financial resources from tax payers. The main shareholders in SCs therefore are members of the public whose taxes have been vested in these corporations.¹⁵⁹

a) Separation of Ownership and Control:

To the extent that the shareholders of a typically publicly held corporation are widely dispersed and no single shareholder owns a significant percentage of the firm's share, it is apparent that they will find it difficult to coordinate their actions so as to monitor management effectively.¹⁶⁰ Michael Jensen and William Meckling analysed the theory of the firm as proceeding from the organizational problem of the modern corporation.¹⁶¹ The problem of separation of ownership and control was identified by Adolph Berle and Gardiner Means when they argued that ownership rights (stocks) are not held by the individuals who manage the corporation.¹⁶² This is the separation of decision making and risk-bearing functions in a corporation which has been described as a nexus of contracts. Jensen and Fama hypothesize that the contract structure in such corporations separate the ratification and monitoring of decisions from initiation and implementation.¹⁶³

This observation led to Berle and Means, argument that management in publicly held corporations had become autonomous,¹⁶⁴ and that it could hire equity as well as factors of production. This hypothesis that separation of ownership and control in the public corporations

¹⁵⁹See note 158.

¹⁶⁰ William A. Clain and John C. Coffee; *Business Organization and finance; Legal and Economic principles*, 9th Edn (Foundation Press, 2004) p.176.

¹⁶¹ Roberta Romano; *Foundations of Corporate Law*, New York, (New York Foundation Press 1993) p1

¹⁶² Gregory Jackson, 'Understanding Corporate Governance in the United States; A historical and Theoretical Reassessment'. *Arbeitspapier 223* (can be accessed on www.boecker.de).

¹⁶³ Eugene F. Fama and Michael C. Jensen, 'Separation of Ownership and Control'; *Journal of Law and Economics*, Vol. XXVI, June 1983.

¹⁶⁴ Adolph Berle and Gardiner Means; 'The Modern Corporation and Private property' (1932) and revised edition (1968).

made management largely autonomous has been the subject of debate and controversy for most commentary about publicly held corporations. The debate has been to the extent that one believes that the management is free from constraints, it is easy to expect that the interests of shareholders will not be well served and to question the legitimacy of the exercise of economic power by management.¹⁶⁵

According to Jensen and Fama, the forces that make separation of decision management, decision control and risk bearing efficient includes; Specific Knowledge and Diffusion of Decision Functions in that specific knowledge relevant to different decisions and which is costly to transfer is diffused among agents at different levels of the organization. The agency problems of diffuse decision management can therefore be reduced by separating the management (initiation and implementation-management) and control (ratification and monitoring-shareholders).¹⁶⁶

Another factor that makes the concept of separation of ownership and control efficient is the diffusion of the residual claim and delegation of decision control. In large public corporations, the residual claims are diffused among many agents, this has advantage because the total risk of net cash flow to be shared is generally large and there are large demands for wealth from residual claimants to bond the payoffs promised to a wide range of agents and to purchase risky assets.¹⁶⁷ In complete separation and specialization of decision control and residual risk bearing, diffuse residual claimants are not qualified for roles in the decision process and thus delegate the decision control right to other agents. When residual claimants have no role in the decision control, it is expected to observe separation of the management and control of important decisions at all levels of the organization.¹⁶⁸

Economists of the neo-classical school of thought argue that managers have a strong incentive to contract with shareholders to reduce their opportunities to depart from the shareholders'

¹⁶⁵ Michael C. Jensen and William H. Meckling; *Theory of the Firm: Managerial Behavior; Agency Costs and Ownership Structure*. Harvard Business School, Journal of financial Economics, October, 1976 Vol. 3 no. 4 PP. 305-360. p. 183.

¹⁶⁶See note 152 p 10.

¹⁶⁷ Ibid p. 11.

¹⁶⁸Ibid.

interests. The board members and the senior managers are therefore required to expend some resources (bonding costs) to guarantee that they would not take certain actions which would harm the principal or ensure that the principal would be compensated if the agents take such actions.¹⁶⁹ Jensen and Meckling thus define agency costs as the sum of: the monitoring expenditure by the principal; the bonding expenditure by the agent and the sum of the residual loss. With regard to agency cost of outside equity where the manager has a percentage in the residual claim (owner-manager), as the fraction of equity falls, his fractional claim on the outcome falls and this would tend to encourage him to appropriate larger amounts of corporate resources in form of perquisites. This makes it desirable for the minority shareholder to expend more resources in monitoring his behavior.

State Corporations can only be efficient and productive if they apply corporate governance practices that are premised on an effective body responsible for governance, which is separate and independent of management. Consequently, this will promote; accountability, efficiency and effectiveness, probity and integrity, responsibility, transparency and open leadership. Additionally, there must be an all-inclusive approach to governance that recognizes and protects the rights of members and stakeholders.¹⁷⁰

b) The Need for Balance of Power in the Boards of Directors

The principles of corporate governance postulate that there should be a balance of power in the composition of the board. There should be a mix of executive and non-executive (independent) directors so as to offer checks and balances to the decisions of the board. Each type of the directors however, plays their own role in supplementing each other's role thus strengthening the board. The advantage of the executive directors is that they are internals and assist the board with information about the corporation, they also play an oversight role over the performance of other employees and the corporation in general.

Conversely, the presence of the independent directors on the board enhances governance through transparency as sound decisions informed by expertise of the independent directors relating to

¹⁶⁹See Michael C. Jensen et al (n 168).

¹⁷⁰ See note 147.

the company and its business is made. The independent directors also use their expertise to the good advantage of the company. Through their oversight role in the audit committee they enhance financial reporting and internal audits through reviews and hence ensure accountability and transparency in the financial disclosures of the corporation hence generally enhancing corporate governance practice. However, for these independent directors to be independent in their judgment, there must be provision for agency costs for their incentives and remuneration. The role of the chairman who should be an independent director and that of the chief executive officer should also be separated to avoid incidents of conflict of interest.

3.2 DUTIES AND RESPONSIBILITIES OF THE BOARD OF DIRECTORS

Corruption often occurs where the directors have derelicted their duties either due to conflict of interest or due to political interference hence the need to uphold fiduciary duties of corporate directors. The corporate governance guidelines require that every State Owned Enterprise (SOE) should be led by an affective board which exercises integrity and judgment in directing the corporation and which acts in the best interest of the corporation in a transparent, accountable and responsible manner. The duties of the directors are therefore broadly categorized as:

a) Duty of loyalty:

The directors of a corporation have a fiduciary duty to deal fairly and in good faith with the corporation. This duty requires that a director puts the interests of the corporation ahead of any personal interest. This duty also requires a director to declare any conflict of interests between his duty as a director and his personal transactions. The directors are also prohibited from making secret profits at the expense of the corporation's objectives. Failure by a director to make complete disclosure of any interest he has in a corporate venture before the corporation renders the transaction voidable.¹⁷¹ Bad faith on the part of the fiduciary that results to a detriment to the corporation is not tolerated by the courts under the corporate standards.¹⁷²

¹⁷¹ Virginia Law Review; *The Fiduciary Duties of loyalties and care Associated with the Directors and Trustees of Charitable Organizations*; Vol. 64 No.3 (April. 1978) PP.449-465 <http://www.jstor.org> accessed on 28th May 2013. p 453.

¹⁷² See p.457

b) Duty of Care:

This duty requires that directors exhibit the diligence and care exercised by ordinary prudent men under similar circumstances in their function of steering the corporation in realizing its objective of profit maximization. However, this imprecise standard gives directors a broad discretion in making business decisions. Liability therefore depends upon finding of at least ordinary negligence.¹⁷³ If the directors are acting in good faith, they are entitled to rely on information and reports of subordinates. While a director must keep abreast to the corporate activities, he never the less may delegate to managers the operations of the business as long as he monitors their actions. No liability arises for simple errors as the director escapes liability under the “business judgment rule” if he acts *intra vires*, in good faith and in furtherance of his fiduciary duty.¹⁷⁴

However, the board can only be effective where there is clarity of objectives. The board should therefore determine the corporation’s objectives, values and the strategy to achieve its purposes and to implement its values. The board should also approve and review overall business strategies, significant policies and the structure of the corporation. The government should therefore minimize its interference in the day to day management of the corporation and allow them full operational autonomy to achieve their defined objectives.¹⁷⁵

3.3 ROLE OF GATE KEEPERS IN FINANCIAL PROBITY OF THE CORPORATION

The term gatekeeper is commonly used to mean reputational intermediaries who provide verification and certification services to investors¹⁷⁶. These services can consist of verifying a company’s financial statements (as the independent auditor does), evaluating the creditworthiness of the company (as the debt rating agency does), assessing the company’s business and financial prospects vis-a-viz its rivals (as the securities analyst does), or appraising the fairness of a specific transaction (as the investment banker does in delivering a fairness

¹⁷³ See (n 171) p.1.

¹⁷⁴ Ibid.

¹⁷⁵ Organisation of Economic Corporation of Development ‘*Guidelines on Corporate Governance of State Owned Enterprises*, ISBN No. 92-64-00942-6, (OECD Publishing, 2005).

<www.oecd.org/corporate/ca/corporategovernanceofstate-ownedenterprises/34803211.pdf> accessed on 30.03.2013.

¹⁷⁶ John C. coffee Jr. ‘Understanding Enron: It’s about the gatekeepers, stupid’, Columbia Law School. The Centre for Law and Economic studies. Working paper No. 207, July, 30 2002. Obtained from

<http://www.columbia.edu/law-economicstudies>.

opinion). Attorneys can also be gatekeepers when they lend their professional reputations to a transaction, however, the attorney serves more as a transaction engineer, rather than the reputational intermediary¹⁷⁷. The market recognizes that the gatekeeper has a lesser incentive to lie than does its client and thus regards the gatekeeper's assurance or evaluation as more credible.

The gatekeeper as watchdog is typically paid by the party that it is to watch, but its relative credibility stems from the fact that it is in effect pledging a reputational capital that it has built up over many years of performing similar services for numerous clients. In theory, such reputational capital would not be sacrificed for a single client and at a modest fee. However, logic and experience can conflict. Despite the clear logic of the gatekeeper rationale, experience over the 1990's suggests that professional gatekeepers do acquiesce in managerial fraud, even though the apparent reputational losses seem to dwarf the gains to be made from the individual client¹⁷⁸.

Gatekeepers have been blamed for recent business failures such as Enron¹⁷⁹. The conventional view is that auditors, lawyers, underwriters, analysts, and others have shirked their responsibilities and permitted illegal conduct. It has been thought that enhancing the responsibilities of gatekeepers, will avoid such debacles in the future¹⁸⁰. This claim traditionally depended on a rational actor model under which a gatekeeper would prevent misconduct by a primary violator because the gatekeeper's expected liability or reputational harm from failing to prevent misconduct exceeded the benefits gained in fees¹⁸¹. Because investors understand a gatekeeper would not act irrationally, his statements are to be believed.¹⁸² One also must ask why gatekeepers have not been more robust monitors. At least part of the answer is that the

¹⁷⁷ See John C. coffee Jr. (n 176).

¹⁷⁸ Ibid p 6.

¹⁷⁹ Ibid p 7.

¹⁸⁰ See, e.g., Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53, 55 (2003) (noting consensus that insufficient deterrence is to blame for corporate scandals); Hillary A. Sale, *Gatekeepers, Disclosure, and Issuer Choice*, 81 WASH. U. L.Q. 403, 407 (2003) (stating that gatekeepers did not do their jobs in companies such as Enron). Compare John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 345–63 (2004) (proposing modified form of strict liability for auditors and proposing gatekeeper responsibilities on attorneys), with Frank Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U. L. REV. 365, 368–74 (2004) (proposing modified strict liability limited by contract).

¹⁸¹ Ibid note 170.

¹⁸² Ibid.

conventional view of the gatekeeper's role is inadequate, focusing on the actions of a single individual, rather than the dynamics of the group. Similarly, until recently Congress, regulators, and courts have relied largely on a command and control philosophy of governance, rather than addressing biases that can cause one small misstep but lead incrementally to large scale disasters.

A simple question arises as to why a gatekeeper would permit the abuse of his services? The question assumes that the gatekeeper consciously acquiesces. That certainly occurs. Where it does, a gatekeeper commits a serious criminal offence. Their motivation is fuelled by greed and a risk benefit analysis (often aided by a lack of legislative and judicial infrastructure to prosecute these cases) from which they conclude that the chances of being caught are slim.¹⁸³

Good Corporate governance stipulates the need to employ independent gatekeepers who will better monitor and report fairly and accurately on the financial position of the corporation. However, in order to perform a more robust role, the terms, duties and liabilities of the gatekeeper should to be clearly and precisely stated in the contract, and in the event of breach the law of strict liability should be invoked. This is because gatekeeper's duties are not only owed to the corporation but also to the tax payers who fund the SCs.

3.4 CONSTITUTIONAL RESTRUCTURING OF CORPORATE GOVERNANCE AND ITS IMPACT ON LEVELS OF CORRUPTION IN STATE CORPORATIONS

3.4.1 The Constitution in Addressing the Corporate Governance Issue Identified in State Corporations: Articles 10 (2c), 73(2) and 232 Considered

The national values and principles under Article 10 of the Constitution generally bind all state organs, state officers, public officers and all other persons whenever they apply the provisions of article 10(1) (a-c). The national values and principles to be applied are enumerated in sub-article 2. This research examines how the principles under article 10(2(c)) of good governance, integrity, transparency and accountability can be incorporated in the governance of state

¹⁸³ John C. coffee Jr. 'Understanding Enron: It's about the gatekeepers, stupid', Columbia Law School. The Centre for Law and Economic studies. Working paper No. 207, July, 30 2002. P 6 Obtained from <<http://www.columbia.edu/law-economicstudies>>. accessed on 5.5.2013.

corporations so as to prevent and combat corruption and hence enhance their general performance.

Article 10 (2c) provides for good governance, integrity and accountability as values and principles of good governance. Good governance has been defined as the efficient and effective management of the resources of the corporation with the objective of increasing the shareholder value while taking into account the interests of stakeholders. One of the reasons identified for state corporations' failure and failure to realize their objectives is poor corporate governance which emanates from inadequate initiatives adopted by the SCs. The ineffectiveness has been directly linked to the mode of appointment of the chief executives and directors of these state owned corporations. There is no transparency or competitiveness in the appointment of directors and the CEO as they are appointed by either the President or the Minister responsible for the time being which consequently compromises the autonomy of the board in decision making. Despite the fact that the Government enters into performance contracts with the board, it limits its discretion in policy and decision making to those that are favourable to either the Government or the political authority appointing the board.

Despite the promulgation of the Constitution (2010) and the requirement under Article 73 (2), direct and politically instigated appointments continue to be witnessed every other day in the Kenya Gazette notices.¹⁸⁴ Under this Article, the guiding principles of leadership and integrity include; 'selection on the basis of personal integrity, competence and suitability or election in free and fair elections'¹⁸⁵. The appointing authority has therefore willfully neglected to adhere to the Constitutional threshold and these appointments could easily be challenged in Constitutional Courts as being unconstitutional. In interpreting this Article, the courts ought to apply the mischief rule¹⁸⁶ in order to determine the mischief that the Constitution intended to cure or the rationale of formulating such a threshold for public and state officers.

One of the principles of good corporate governance requires that for directors to effectively and efficiently perform their duties, they must be equipped with the relevant skill and

¹⁸⁴ See Appendix (copies of recent gazette notices).

¹⁸⁵ Article 73 (2(a)).

¹⁸⁶ J. W. Harris, *Legal Philosophies*, 2nd edition, (Butterworths, London, Edinburgh, Dublin (1997)) p. 158.

competence/knowledge and further that there must be proper ‘fit’ of the skill. The directors therefore need to be subjected to an open and transparent recruitment process so as to obtain a proper mix of skill and competence and expertise for the specific state corporation depending on its sector of operation. Personal integrity is also a value that must be considered in the recruitment process, integrity denotes honesty and transparency in dealing by the directors and managers as agents of the public. This is aimed at preventing and combating corruption through honest, accurate and timely disclosures and accountability by the directors to the public and other stakeholders.

3.4.2 Constitutional Threshold in Board Appointment; The Role of Human Resource in Good Corporate Governance

The poor and ineffective management of SCs can be attributable partly to the appointment criteria, which is based on political influence rather than technical expertise.¹⁸⁷ In many countries however, Kenya included, when board members are being nominated, the skill and ‘fit’ of the candidate are rarely the main considerations, and the board and the chairman are not always involved in the process.¹⁸⁸ Board positions tend to be considered as a reward for a political supporter or current or former company executive and consequently there is no structured nomination process.¹⁸⁹ Therefore, a structured nomination process that includes appraisal of board members can be employed to avoid complex, opaque, multiround negotiations between various parts of the government and allow for greater transparency and merit and playing a larger role in the selection process.¹⁹⁰

The Board composition of State Corporations pursuant to the SCA,¹⁹¹ comprises of state representatives who include; the Cabinet Secretary of the parent Ministry, Cabinet Secretary of treasury, the chief executive, the chairman appointed by the president and seven members appointed by the Cabinet Secretary. However, this model of board composition reflects the tendency to see the board as a kind of ‘parliament’ where a range of groups are represented, rather than a body to direct the company. Consequently, true directorship of the company comes

¹⁸⁷ See note 51 at p. 50.

¹⁸⁸ The World Bank; ‘Corporate Governance; Held By the Visible Hand; The Challenges of SOE Corporate Governance for Emerging Markets’ May 2006. p 26.

¹⁸⁹ Ibid.

¹⁹⁰ Ibid.

¹⁹¹ Section 6 of the State Corporations Act (Cap 446).

from the ownership entity in this case the government or another part of the government.¹⁹² In the past, all Ministers were elected members of Parliament and hence wielded a lot of political influence on the SC boards. The new Constitution has laid down the procedure for nomination of the Cabinet Secretaries by the President which involves approval by the National Assembly and thereafter appointment of Cabinet Secretaries. This has in turn enhanced transparency and meritocracy to some extent; it is also a straightforward way to limit political interference by providing that Cabinet Secretaries shall not be elected members of Parliament.¹⁹³ This is a departure from the 1969 Constitution (Revised edition (1982) 1992)¹⁹⁴ which granted the President power to appoint Cabinet Ministers from among the members of the National Assembly and because the president had the power to direct their removal at any time, they had to pay their allegiance to the President, including their decisions in nomination of the SC directors. The paradigm shift in the appointment of the Cabinet Secretaries gives hope that transparency and accountability as core values of corporate governance can be achieved.

Article 232 provides for values and principles in the public service which apply to all state organs including state corporations in both national and county governments¹⁹⁵. Under Sub-Article (1) (h), the basis of all appointments and promotions in the state corporations should be fair competition and on merit, however, the direct appointments of the directors and the chairman by the Minister and the President through gazette notices goes contrary to the constitutional provisions. Irregular appointment of directors has in the past attracted both local and foreign criticism, for instance, the Parliamentary General Investment Committee in 2000 urged the Attorney General to introduce legislation that would empower Parliament to vet the appointment of parastatal directors.¹⁹⁶

In 2001, the appointment of some three members to the Electricity Regulatory Board was challenged by World Bank (WB) for not meeting the requirements of the Electric Power Supply Act as the WB was concerned with the fact that the government ignored the autonomy of the board and removed one of the directors who had vowed to run the company in accordance with

¹⁹²See note 77.

¹⁹³ Article 152 (2) and (3); Constitution of Kenya 2010.

¹⁹⁴ Article 16 (2), The Constitution of Kenya Revised edition (1982) 1992, (Government Printers, Nairobi).

¹⁹⁵ Article 232 (2)(b).

¹⁹⁶ See note 51 at p. 50.

the Electric Power Act rather than the SCA.¹⁹⁷ Ineffective corporate governance due to lack of requisite managerial skills by the directors has been attributed as one of the reasons for failure to perform by state corporations, therefore, appointment of qualified persons would enhance the performance of the boards by raising the standard of care expected from the directors. Further, periodic appraisals and relevant training for board members should be encouraged; this would ensure competence and independence in judgment rather than too much dependence on the CEO who may act in his self interest or that of influential senior government officials or politicians who are not his immediate bosses.

The other issue that breeds corruption in the boards of state corporations is the low remuneration of the board of directors as they would compromise the interest of the corporation for personal gain and in compensation of the remuneration gap. This also affects the motivation and consequently discourages them from observing strict business ethics.

3.5 THE PLACE OF ETHICS IN CORPORATE GOVERNANCE OF STATE CORPORATIONS

Ethics refer to values and to say that something is valuable is to make judgment or an appraisal. Despite the fact that there are many kinds of value such as economic, artistic, ethical or moral or religious among other, ethical values differ from other values because they refer to human conduct as they are rooted in the freedom to behave in one way or the other.¹⁹⁸ Ethics presents itself as an order of human acts which is based on the concepts of good or evil. Ethics revolve around three elements being: ‘the good, the person (self) and the other (others)’. Business ethics therefore seeks to balance the self interest, other people’s interests and the common good.¹⁹⁹

A question has been raised as to why do we need ethics in business? Different answers have been given to this question as other commentators argue that; because there are people who esteem them-tautological, and others have argued that it is because of common consensus, however this proposition has been criticized as being incomplete as it explains how and not why?. Business ethics is the theoretical inquiry into ethical dimensions of economic behaviour

¹⁹⁷ See note 51 at p. 50.

¹⁹⁸ Christine W. Gichure; in Private Sector Corporate Governance Trust; Corporate Governance Workshop and Seminar report, vol. 2 (Nairobi, November 1999) p.42

¹⁹⁹ Ibid p. 43

and practices.²⁰⁰ There are many conjectures as to why business ethics have become important as they encompass the three concepts which are constantly at play. In that; the self, the other and in between them, the good in such terms as fair and unfair, trust, mistrust, truthful, honesty, dishonesty, accountability and unaccountability among others.²⁰¹

The rise of business ethics has been linked to some alarming cases of insider trading on Wall Street which were noted as a consequence of deterioration of basic value of human relations that is *trust and loyalty*. Ethics underscores a fact that, in the concrete life of companies there can be situations that call for a more ethical consideration.²⁰²

One of the justifications for ethics in business is that, there is generally lack of ethical values in business in most countries which has been traced by forensic studies to various factors among them poor corporate governance. The assumption is that, the weakness of ethical and social values translates into a crisis whose results have been institutionalized corruption and fraud.²⁰³ To corroborate this, study has shown that many companies experience: Manipulated and roasted financial statements to defraud tax revenues; others have almost non-reporting and disclosure mechanisms; haphazard and distorted planning; clumsy or non-existent accounting techniques and; external audit systems that did not guarantee for efficient and effective corporate governance.

Ethics are important in business because of the various competing interests of stakeholders. Balancing these interests demands that parties act responsibly and in a trustworthy manner.²⁰⁴ Simply defined, ethics in corporate governance refer to *the "application of a moral code of conduct to the strategic and operational management of a business."*²⁰⁵ Business ethics refer to a set of moral principles and values that govern the conduct or behavior of the organization with

²⁰⁰ See Christine W. Gichure in (n 198) p. 44.

²⁰¹ The concepts of the self, others and the common good.

²⁰² See note 42 p. 44

²⁰³ Ibid p. 45.

²⁰⁴ Surendra Arjoon, 'Corporate Governance; An Ethical Perspective' <<https://sta.uwi.edu/conferences/financeconference/Conference%20Papers/Session%205/Corporate%20Governance%20-%20An%20Ethical%20Perspective.pdf>> 14 (accessed on 19.04.2013).

²⁰⁵ Applied Corporate Governance Report, accessed at <http://www.applied-corporate-governance.com/define-business-ethics.html> on 5th August 2013.

respect to what is right and what is wrong.²⁰⁶ It covers all aspects of business conduct including that of business organizations and individuals.²⁰⁷

Business ethics have become important because hitherto, many businessmen were only interested in profit making without regard to the harm they would probably cause to people or even to nature.²⁰⁸ Ethics became even more important because companies engaged in practices, though legal were wrong. For example, companies were discovered to have filed misleading accounting statements which were within the law.²⁰⁹ It is important to note that while all parties listed have ethical responsibilities, the Code of Conduct places ultimate responsibility with the boards of companies.²¹⁰

Trevino et al (1999) in their study found that specific characteristics of legal compliance programs matter less than broader perceptions of the program's orientation toward values and ethical aspirations. They found that what helped the most are consistency between policies and actions as well as dimensions of the organization's ethical climate such as ethical leadership, fair treatment of employees, and open discussion of ethics. On the other hand, what hurts the most is an ethical culture that emphasizes self-interest and unquestioning obedience to authority, and the perception that legal compliance programs exist only to protect top management from blame.

Byrne (2002) pointed out that following the abuses of recent times, executives are learning that trust, integrity, and fairness do matter and are crucial to the bottom line. Corporate leaders and entrepreneurs somehow forgot that business is all about values and are now paying the price in a downward market with a loss of investor confidence. Byrne also noted that in the post-Enron, post-bubble world, the realization that many companies played fast and loose with accounting rules and ethical standards and which allowed performance to be disconnected from meaningful corporate values, is leading to a re-evaluation of corporate goals, values and purpose.

²⁰⁶ John Velentzas & Georgia Broni, Ethical Dimensions in the Conduct of Business: Business Ethics, Corporate Social Responsibility and the Law. The "ethics in business" as a sense of Business Ethics, Paper presented at the International Conference on Applied Economics – ICOAE 2010.

²⁰⁷ Ibid.

²⁰⁸ See John Velentzas *et al* (n 206).

²⁰⁹ See note 193.

²¹⁰ Ibid.

What is emerging is a new model of the corporation in which corporate cultures will change in a way that puts greater emphasis on integrity and trust. Such changes would include the diminishing of the single-minded focus on “shareholder value” which measures performance on the sole basis of stock price; the elevation of the interests of employees, customers, and their communities; a reassessment of executive pay to create a sense of fairness; a resetting of expectations so that investors are more realistic about the returns a company can legitimately and consistently achieve in highly competitive markets.

Other advantages of ethics in good corporate governance are that: Ethical business conduct reduces the cost of finance, builds trust and attracts investors, builds trust relationships that exist between the corporation and the owners. Assures risk management of legal suits by persons affected by the activities of the corporation e.g. picketing, environmental pollution and a need to maintain a good relationship with the Government. Corporate Social Responsibility in corporate governance refers to corporate self regulation which emanates from the realization that corporations cannot operate in isolation from the rest of the society. It is argued that in order ensure a corporation’s integration, corporation sustainability and to gain strategic advantage the corporation has to move away from concentrating on profit maximization alone and consider incorporating responsible and ethical business practices and forms.²¹¹

The growth of the concept of corporate social responsibility has been necessitated by factors such as globalization through emergence of global capital markets which recognize the global principle that international competitiveness is enhanced by having business practices that take into account public interest. This concept has also been brought about by governmental and intergovernmental relations through development of declarations, treaties, principles and other bilateral and multilateral instruments that outline social reforms for accepted business conduct. Ethics therefore strengthens relationship and builds trust both within and outside the corporation. Consumer activism has also led to firms shifting their concentration on share value and adopting business practices that demonstrate concern for other stakeholders. Termes (1995) compares ethical compliance mechanisms (virtues) versus legal compliance mechanisms (codes) and

²¹¹ Claessens Stijns, ‘Corporate Governance and Development, Global Corporate Governance Forum (Focus 1) http://www.ifc.org/wps/wcm/connect/7fc17c0048a7e6dda8b7ef6060ad5911/Focus_1_Corp_Governance_and_Development.pdf?MOD=AJPERES accessed on 17.5.2015.

concludes that the ethical functioning of financial institutions cannot be trusted to the imposition of codes of ethical conduct but the only way in which companies can be ethical is for people to be ethical.²¹²

In summary therefore, ethical justification of corporate governance ensures that the corporation carries its activities in a socially responsible manner, it promotes good corporate culture through ethical business practices. Ethics ensures sustainability of corporations through recognition of stakeholder rights, it also encourages co-operation between the company and its stakeholders in creating wealth, jobs and economic stability not only of the company but of the country as a whole. Ethics ensures preservation and enhancement of the shareholders investments as it enables the convergence of agent's objectives with that of the principal and also builds trust in the consumers of the company's products. This in turn lowers the corporation's risks and costs thus preserving the shareholder value.

Ethics also ensure quality standards and responsibility to customers as the company's products are produced with the customer's interest in mind, as more sales by customers purchasing the products means more profits for the shareholders. Ethical conduct fosters integrity relationships as trust is built. Ethics ensures that transparency and accountability as pillars of good corporate governance are fulfilled through accurate and timely reporting and adopting a disclosure philosophy. It attracts investors through investor confidence as it assures them of the kind of corporation they are dealing with and whether they can trust it with their investment.

Ethics can be used as a competitive strategy tool as it creates competitive and efficient companies due to the ethical norms and culture that it inculcates in them. It also promotes efficient and effective use of limited resources especially with regard to executive remuneration which despite the fact that, it should be good enough to attract and retain a good caliber of professionals, it should not be too exorbitant as to be unfair and unethical.

²¹² See Surendra Arjoon at (note 204) p. 16.

3.6 INCORPORATING ETHICAL AND SOCIAL VALUES IN ANTI-CORRUPTION LEGISLATION AND ENFORCEMENT

The Leadership and Integrity Act²¹³ (LIA) herein referred to as ‘the Act’ provides for a General Code of conduct for public entities under which SC’s fall. This Act is established pursuant to Article 80 of the Constitution and in its preamble, it is an Act of Parliament to give effect to, and establish Procedures and Mechanisms for the effective administration of Chapter Six of the Constitution and for connected purpose. This Act applies to both state officers and with modification to public officers as defined in Article 260 of the Constitution. All state officers and public officers are required to respect the values, principles and requirements of the constitution including Articles 10, 73, 75, Article 99 (1) (b) and Article 99 (1) (b) , and Article 193 (1) (b) and Article 232. Section 8 of the Act provides that a state officer holds that office in public trust and shall hold and exercise the authority of that office in the best interest of the people of Kenya. The State Officers shall in the best of their ability carry out duties of the office efficiently and honestly, in a transparent and accountable manner, and keep accurate records and documents relating to the functions of the office, and further, report truthfully on all matters of the organization which they represent.²¹⁴

Section 11(a) of the Act provides for professionalism and requires that state a officer shall carry out duties in a manner that maintains public confidence in the integrity of the office. Most independent directors are usually professionals hence section 11 (e) is applicable to them as they are required to observe and subscribe to the ethical and professional requirements of what their respective professional bodies ascribe to. They are also required to maintain high standards of performance and level of professionalism within the organization.²¹⁵

Section 12 (1) prohibits all state officers from using the public office to unlawfully or wrongfully enrich themselves or any other person. The Act also prescribes the moral and ethical requirements²¹⁶ which include demonstration of honesty in the conduct of public affairs, it prohibits officers from engaging in activities that amount to abuse of office, they are required to accurately and honestly represent information to the public, and avoid wrongful conduct in

²¹³ Act No.19 of 2012.

²¹⁴ *ibid* at Section 10.

²¹⁵ *ibid* at Section 11 (d).

²¹⁶ *ibid* at Section 13 (a-i)

furtherance of personal benefits, not to misuse public resources, not to discriminate against any person and not to falsify records among others.

To curb instances of bribery of public and state officers, section 14 (a) of the Act prohibits receipt and retention of any gifts received state and public officers in an official capacity, and in the event of receipt pursuant to sub-section 2, the officer should declare and surrender the gift to the officers' employer. This is supported by the Constitution.²¹⁷

A state officer is prohibited from use of his office to wrongfully or unlawfully influence the acquisition of property.²¹⁸ Section 16 (1) is in line with the principles of good corporate governance and requires that a state officer shall use best of efforts to avoid being in a situation where personal interests conflict or appear to conflict with the state officer's or public officer's official duties. State officers are prohibited from participation in tenders to public entities where they are serving.²¹⁹ They are also prohibited from misusing information obtained through or in connection with the office which is not in public knowledge. This misuse in the case of directors could be through insider trading or non-disclosure of material facts.²²⁰ They are also required to be politically neutral so that they do not make decisions affecting the organization based on political affiliations.

Part III of the Act provides that for specific Leadership and Integrity Codes, all public entities are required to prescribe a specific Leadership and Integrity Code for the state officers in that public entity which code shall include all requirements in the general Leadership & Integrity Code under part II of the Act. The codes are to be vetted and approved for implementation by the Ethics and Anti-Corruption Commission.

Part IV of the Act provides for enforcement of the Leadership and Integrity code and requires all state officers upon appointment/election to sign and commit to the specific Leadership and Integrity Code as issued by the relevant public entity.²²¹ A breach of the code amounts to misconduct for which the state officer may be subjected to disciplinary action.²²² The Act also

²¹⁷ Article 76 of the Constitution of Kenya.

²¹⁸ Section 15 of the Leadership and Integrity Act.

²¹⁹ Section 17 of the Leadership and Integrity Act

²²⁰ Section 22 of the Leadership and Integrity Act

²²¹ Section 40 of the Leadership and Integrity Act

²²² Section 41 of the Leadership and Integrity Act.

provides for procedure for lodging a complaint against a state officer and the process of carrying out investigations.²²³ Section 43 provides for action to be taken where investigation reveal that an officer ought to be subjected to either civil or criminal proceeding.

It is important to note that though part V of the Act generally provides for offences and penalties, most of those pertinent sections in the general code of conduct and which should be included in the specific Leadership and Integrity codes do not have respective offences hence enforcing them under section 10 of the Act might pose challenges and hence a need to amend the Act to include offences with complimenting sanctions or reference to other anti-corruption legislation such as the Anti-Corruption and Economic Crimes Act and the Penal Code. The general penalty as prescribed under section 47 may not be deterrent or remedial enough bearing in mind the power, portfolio and authority held by directors as state officers and public officers vis a vis the public interest of the tax payers.

3.7 THE ROLE OF THE JUDICIARY IN CORPORATE GOVERNANCE OF SCS AND THE FIGHT AGAINST CORRUPTION

Successful law enforcement requires that the various state bodies are equipped not only with proper mandates on paper, but also with the capacity to fill their mandates in practice. But they must furthermore cooperate smoothly which in turn boils down to rules and practices across institutional boundaries. Properly functioning as a whole, this system is to balance the state organism, deter criminal behavior in general, including corruption, as much as being an apparatus merely for punishing individuals. Rule of Law programmes tend to emphasize judicial institutions, with the terms *judicial reform* and *Rule of Law reform* often used interchangeably (Carothers 2003). Support to the police often comes in separate Security Sector Reform programmes, sometimes with weak links to efforts targeting other elements of the justice system.

It is admitted that a country's legal system plays a significant role in determining the success of its corporate governance system. According to Musikali²²⁴, research has shown that good

²²³ Section 42 of the Leadership and Integrity Act.

²²⁴ Lois Musikali, 'The Law Affecting Corporate Governance in Kenya: a Need for Review'. International and commercial Law Review, ICCR 123 accessed at

corporate governance is more likely to be associated with countries with a strong legal system. A strong legal system in this sense implies a system with clear laws which are capable of enforcement through sanctions that are deterrent enough to ensure compliance. Though Kenya has adopted a corporate governance code in the form of a sample code of best practices, in 2002, which code is enforced by the Capital Markets Authority, deeper examination however reveals a country struggling in its efforts to adopt good corporate governance owing to the absence of a strong legal system.²²⁵

The Chief Justice, Willie Mutunga, when he took over at the helm of the Kenya's judiciary, he acknowledged that the judiciary was plagued with excessive bureaucracy, backlogs of cases, endemic corruption, inefficient and ineffective case management, poor terms of services for judicial and administrative staff and poor infrastructure (Lansner, 2012).²²⁶ This creates a supportive environment for corruption to flourish in state corporations as a corrupt system cannot be trusted to fully deal with cases of corruption impartially and conclusively.

According to Freedom House 2011, courts suffer from understaffing, are underfinanced, and lack the capacity to efficiently prosecute corruption cases. While about half a dozen Ministers have been suspended over corruption allegations, many of them have been reinstated and no Minister of high profile official has been convicted. The judiciary was not guaranteed independence under the "old" constitution, but the new Constitution offers an important step towards constraining executive interference into judicial affairs, even though attempts to interfere with judicial independence remain prevalent (Bertelsmann Foundation, 2012). That notwithstanding, business executives surveyed within the framework of the Global Competitiveness Report 2011-2012 the report revealed low levels of independence of the judiciary, scoring 2.9 on a 1 (heavily influenced) to 7 (entirely independent) scale.²²⁷

http://www.academia.edu/1524463/The_law_affecting_corporate_governance_in_Kenya_a_need_for_rev. (accessed on 9.8.2013).

²²⁵See Musikali (n 224).

²²⁶ Maira Martini; 'Kenya: Overview of Corruption and Anti-corruption (Transparency international), 18th October 2012; 348.

²²⁷ Ibid.

3.7 RULE OF LAW: THE ANTI-CORRUPTION PERSPECTIVE

Since the 1990s, with the emergence of anti-corruption as a field, rule of law is – in addition to the “Good Governance” perspective – also seen as an *anti-corruption* means: clear rules of correct behaviour in conjunction with deterring prospects of disclosure, criminal investigation, prosecution and conviction (enforcement) are held to prevent corrupt behaviour in the public sector.²²⁸ Over the years a generation of new interventions has come in addition to the larger, pre-existing good governance and rule of law efforts, namely the focus on the introduction of more specialized anti-corruption legislation (anti-corruption laws)²²⁹ and institutions (anti-corruption commissions). Some of these initiatives have been based on the need to put in place new and more modern organizations that are capable and have the mandate to address particularly difficult problems, such as economic crimes and corruption – specialized bodies that have become part of the Rule of Law system in many industrialized countries as well. But the rationale for many of these initiatives has also been to bypass existing but often corrupted ordinary police and prosecutorial systems.

This has often led to conflicts over roles and mandates, created the impression that many of the new bodies are in fact donor-supplied and 24 Anti-Corruption Approaches to a large extent beholden to the international community rather than to the local political system, and thus has questionable legitimacy and credibility in the eyes of many local stakeholders. Within a neo-patrimonial context, however, it is not clear what other avenues are open for establishing within-the-state bodies that can begin addressing corruption.

3.8 ACCOUNTABILITY AND TRANSPARENCY

In addition to attracting investment, improving competitiveness, and managing risks, corporate governance is fundamental to changing the relationship between business and state in many emerging markets. By injecting transparency into the equation, corporate governance helps to remove cronyism, corporatism, and favouritism, instead facilitating an open exchange between the private sector and government. Corporate governance helps countries to attract investment, facilitate institutional reform, reduces opportunities for corruption, increases competitiveness,

²²⁸ See Maira Martini (n 226).

²²⁹ See note 1.

and promotes minority shareholders rights protection, corporate governance helps to build a foundation for economic growth.²³⁰ As Gladwell Otieno ably puts it, corruption thrives where systemic and ethical controls are weak. Corporate governance guidelines require that the corporation board should put in place reporting and control mechanisms. The board should establish an audit committee with majority members being non-executive independent directors who should analyze the financial risks and ratify the accuracy of the financial statements accurately and objectively.

Conclusion

Having identified the challenges facing state corporations in terms of governance and challenges with regard to regulatory and enforcement framework of anti-corruption laws, this chapter embarked on examining how good corporate governance can be applied as a mechanism to prevent and combat corruption. This chapter has examined what corporate governance is all about and sought to demystify what governance and good corporate governance relates to. The corporate governance issues discussed include; separation of control and ownership, need for balance of power in boards, need to have clear responsibilities of boards, the role of the gate keepers in financial probity of corporations and the role of auditors both internal and external (independent) was emphasized.

The role of the constitution in restructuring corporate governance in SCs was also examined. In addressing the issues of nominations and appointment, the role of human resources in good corporate governance was discussed. Corporate Governance is anchored on ethical values, hence the place of ethics in the governance of state corporations was discussed. The levels of corruption are reduced when the perpetrators know and understand that they can be detected, investigated, prosecuted and convicted. This therefore calls for strong investigative agencies and the Judiciary, the role of the investigation agencies and the judiciary in corporate governance and the fight against corruption was therefore not left out. This was augmented by the rule of law in the anti-corruption perspective.

²³⁰ Center for International Private Enterprise; 'Corporate Governance: The Intersection of Public and Private Reform' edited by Eric Hontz and Aleksandr Shkonikov.

Good corporate governance requires that a corporation should be managed in an accountable and transparent manner. The management of SCs owes its leadership to the board of directors, it will only be managed as such if it gets it right from the point of appointment of directors to formulation of internal standards including the systems of accounting, auditing, whistle blowing policy, witness protection policy, adherence to statutory provisions and corporate governance standards and accounting standards.

CHAPTER 4

BEST PRACTICES IN PREVENTION AND COMBATING CORRUPTION: THE NEED TO ALIGN CORPORATE GOVERNANCE TO ANTI-CORRUPTION STRATEGY

4.0 THE CODE OF CORPORATE GOVERNANCE FOR LISTED COMPANIES IN CHINA (2002): LESSONS FROM CHINA

The state corporations in Kenya have a lot in common with the public listed companies in China whose significance in this research is that it is an emerging and rapid growing market. Some of the corporate governance challenges²³¹ it faces include: Overwhelming concentration of state ownership. Two-thirds of companies listed in the Shanghai Stock Exchange are state enterprises, a legacy of the state-controlled economy. Consequently issues such as lack of independence of boards of directors and insider trading emerge. It also has the effect of diverting resources away from companies, reducing the liquidity of the capital markets, and discouraging minority investors from engaging in long-term investment. Recent reforms have improved protection of minority shareholders, however it remains difficult for them to disagree with state shareholders.

A direct result of ownership concentration is the lack of independence among boards of directors. Members of both corporate boards of directors and boards of supervisors are typically selected and removed by the dominant owner of the company, which is often the Chinese government. As a result, directors are likely to be impeded in carrying out fiduciary duties, and supervisors are less likely to be able to exert independence from the board of directors and senior managers.

The ownership structure encourages rampant insider trading. This is because many Chinese enterprises are state-owned, with non-tradable shares, more often insiders of these companies have made fortunes on stock offerings. This problem is widespread that one well-known Chinese economist once called the stock markets “a casino without rules”²³² The problem is exacerbated by the absence of a well-defined concept of “fiduciary duty” and by weak enforcement provisions under Chinese law.

²³¹ < http://www.rand.org/pubs/research_briefs/RB9405/index1.html>. (Accessed on 6th July 2013).

²³² Ibid.

The third challenge involves weak mechanisms to control false financial disclosures. Corporate fabrication of financial reports is a serious problem in China. Although steps are being taken to change a business culture that has long tolerated corruption, weaknesses in the accounting profession, the media, and the courts undermine reform. The accounting profession has little independence from management and suffers from a severe shortage of qualified auditors. Although the media has made progress in exposing corporate fraud, journalists are often hired through a process that is influenced by senior corporate officials. Securities litigation did not appear in China until 2001, when the Supreme People's Court of China developed a framework for investors to sue listed companies for losses caused by false financial disclosures. But even today, the process is slow and cumbersome. About 1,000 (One Thousand) suits have been filed against 14 companies, but most remain in legal limbo and none has yet been settled by the court in favor of investors.

Though corporate governance of corporations in china is premised on a two tier board comprising of the supervisor and supervisory board, the same cannot be said of Kenya which adopted the UK model of single tier board, a few lessons can be learnt from china's corporate governance of SOEs. China's Corporate Governance Code has clearly highlighted the duties and responsibilities of the directors whom it states should faithfully, honestly and diligently perform their duties for the best interest of the company and all the shareholders.²³³ The code also advocates for separation of control and ownership and independence in the conduct of the business of the corporation from the controlling shareholder. The board is obliged to abide by relevant laws, regulations, rules and the company's constitutive documents. To ensure independence, china's SOEs have many independent directors on boards with large numbers of government representatives which presents a variety of solutions to corporate oversight.²³⁴

China's revised securities laws have increased the legal responsibilities and rules on integrity obligations of the controlling shareholder or those in actual control; it strengthened investor protection especially for minority investor and established securities investor protection fund.

²³³Chapter 3 part 2 of the Code of Corporate Governance for Listed Companies in China <www.ecgi.org/codes/documents/code_en.pdf> accessed on 12th July 2012.

²³⁴< <http://www.corpgov.deloitte/site/chinaEng/>> accessed on 30th September 2013.

Restructuring and reorganization of the SOEs has attracted a large number of individual and institutional investors. Since its establishment in the 1992, China Securities Regulations Commission (CSRC), more than 300 laws, regulations, rules, standards and guidelines concerning securities law have been stipulated.²³⁵ CSRC has formed the fundamental framework of ‘Company Law’ and ‘Securities Law’. Within this framework, one of the levels that relate to corporate governance are that there is provisional regulations prohibiting securities fraud²³⁶

The Regulations provide that all listed companies must appoint a specialized person responsible for information disclosure to the CSRC, stock exchange, relevant brokers and managing relationships with public media. However, the Board of Directors is ultimately responsible for the information disclosure. A third of the board of directors are independent and shareholder rights have been strengthened and shareholder can now pursue civil litigation for financial fraud this has been provided for under the Corporate Law (1.7.1994) and Securities Law (29.12.98).²³⁷ In January 2002, CSRC and state Economic and Trade Commission issued the Code of Corporate Governance for Listed Companies in china. Some of the pertinent requirements of this code included that; the board should pay special attention to minority shareholder rights; listed companies should promptly disclose its financial information to its shareholder and stakeholders and particularly to its creditors, and lastly, that listed companies should promptly disclose the details of controlling shareholders.²³⁸

4.1 THE UNITED KINGDOM (UK) CODE ON CORPORATE GOVERNANCE

Having been colonized by the British Government, Kenya borrows a lot from the UK in terms of governance and the laws regulating corporations, hence an in-depth discussion of the UK Code. The first United Kingdom (UK) Code on Corporate Governance was produced in 1992 by the Cadbury Committee chaired by Sir Adrian Cadbury which issued a series of recommendations - known as the Cadbury Report. The Cadbury Report addressed issues such as the relationship between the chairman and chief executive, the role of nonexecutive directors and reporting on internal control and on the company’s position. This Code is divided into five sections which

²³⁵ China Securities Regulations Commission, Information Disclosure and Corporate governance in China www.oecd.org/corporate/ca/corporategovernanceprinciples/193/117.pdf p. 9 accessed on 14/7/2014.

²³⁶ Ibid p 4.

²³⁷ Xiaozu Wang, State Owned enterprises Reform and Corporate Governance of China <coe21-policy.sfc.keio.ac.jp/ja/eventfile/si-6pdf> accessed on 20.5. 2014.

²³⁸ Ibid p 8.

include: Leadership, Effectiveness, Accountability, Remuneration and Relations with Shareholders respectively. It also comprises two schedules, the first one being on the design of performance-related remuneration for executive directors, and the second one provides for disclosure of corporate governance arrangements.

The UK has developed a market based approach that enables the board to retain flexibility in the way in which it organizes itself and exercises its responsibilities while ensuring that it is properly accountable to its shareholders. The Code is maintained by the Financial Reporting Council (FRC) which is the financial regulatory body. The Code operates on the basis of the principle of ‘Comply or Explain’ and therefore offers flexibility in the way companies are governed in that a corporation can choose to adopt a different approach to their circumstances and where they do so however, they are required to explain the reason to their shareholders who must decide whether they are content with the approach that has been taken.²³⁹

The principle of ‘comply’ or ‘explain’ gives a very wide discretion to the corporations and the boards, and consequently it is capable of abuse due to self interests as most corporations and boards will not comply so long as they have a convincing reason to give to the shareholders. May be this principle can fully be realized in developed world where the shareholders are literate and corporations have many institutional holders unlike in Kenya where most shareholders are either illiterate or semi illiterate and hence do not bother in the governance of the corporation so long as they get some dividends which is decided upon by the board. The corporations in Kenya have to attain the status of having many institutional shareholders, and the impact of shareholder activism has not fully been felt.

There is need therefore to balance flexibility and compliance with the sustainability of the corporation in mind. Concededly, there is need to strengthen internal control measures through mandatory and statutory disclosures such as through annual reports and financial statements, and disclosure of information which is material to enable investors make informed decisions. Therefore, the governance of corporations should not only be guided by the principles of comply

²³⁹ The UK Corporate Governance Code (2010) www.sl.c.o.uk/media/78872/uk-corporate-governance-code-september-2012.pdf accessed on 13th July 2013 p 4.

or explain but also mandatory and statutory provisions. Furthermore, this code is limited to being a guide only. It cannot guarantee effective board behavior because the range of situations in which it is applicable is much too great for it to attempt to mandate specifically than it does. The law in Kenya such as the Companies Act, the CMA regulations, the Penal Code, the Anti-Corruption and Economic Crimes Act, and the Constitution have provided for measures of good governance through responsibility, accountability and integrity on the part of directors who are in charge of overseeing and steering the corporations to attain their objectives .Some of the best corporate governance practices in the UK code are discussed below.

4.2. BOARD & LEADERSHIP

a) Role of The Board:

Every Company should be headed by an effective board which is collectively responsible for the long term success of the company. The board plays a central function in the governance of the SOE. It carries the ultimate responsibility for SOE performance and it has the authority and autonomy to make decisions that determine performance.²⁴⁰ It also acts as the intermediary between the state and the SOE on behalf of the owners. A number of countries have implemented this model to good effect. This principle is in line with the boards fiduciary duty to the company in that, it is required to act in what is considered to be the best interest of the company. In the Kenyan context, the ACECA, the POEA and the LIA have provided for declaration of conflict of interest by an officer and further have prohibited an officer from putting himself in a situation of conflict of interest.²⁴¹ The board should offer entrepreneurial leadership by putting in place framework of prudent and effective controls which enable company risks to be assessed and managed. The board should also set the company's strategic objectives and mobilize necessary resources in order to achieve them and review management performance. The board members should create time to meet sufficiently regularly to discharge the board's duties. The board should advise the company to make provisions for legal actions against them through arranging for appropriate insurance cover.²⁴²

²⁴⁰ Fredrick, W. (2011), "Enhancing the Role of the Board of Directors of State Owned Enterprises," OECD Corporate Governance Working paper No. 2, OECD Publishing <http://dx.doi.org/10-1787/5kg9xf6n4wj-en> accessed on 13th May 2014. P. 12.

²⁴¹ See Sections, 42, 12 and 16 and 17 of the ACECA respectively.

²⁴²Section A. 1of the UK Code (2010).

Despite the fact that courts have been reluctant in their interpretation of what is in the best interest of the corporation, it involves the efforts of the shareholders to exercise their rights to protect and increase their property and its value. The shareholders should also make provision for agency costs which may include incentives for remuneration, bonding costs to ensure that the interests of the directors converge with theirs or that the directors act in their (shareholders) interest.

b) Division of Responsibilities:

Though an empowered and autonomous board is the goal, certain decision making responsibilities are usually retained by the state for instance; deciding on the fundamental outcomes (including aspects of strategy), appointment of board members, appointment of the CEO, succession planning and executive and board members remuneration and incentive schemes among others.²⁴³ The UK Code proposes a clear division of responsibilities between the CEO and the chair of the board, this separation of power ensures that no one individual has unfettered power of decision or discretion²⁴⁴. This practice has been adopted in both unitary and two tier boards, even United States of America which prior to the Enron scandal favoured the managerial board has now adopted board composition that separates the role of the chair and that of the CEO. Kenya has not been left behind as it has adopted a unitary type of board with separate roles for the chair and the CEO.²⁴⁵

There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running the Company's business. This envisages the principle of separation of the role of the chairman of the board from that of the Chief executive. It is one of the checks and balances for conflict of interest and unfettered exercise of powers of decision. The chairman is however responsible for the leadership of the board and to ensure its effectiveness in all aspects such as setting the board agenda, promote a

²⁴³ See note 239.

²⁴⁴ See Section A. 2 UK Code (2010).

²⁴⁵ Private Sector Initiative for Corporate Governance; Principles for Corporate Governance in Kenya and a Sample Code of Best Practice for Corporate Governance. ISBN 9966-9969-0- 12 (Private Sector Corporate Governance Trust, Nairobi, (2002).

culture of openness, fairness, and ensuring that directors receive timely and accurate information.²⁴⁶

The Government should be fully committed to a system of autonomous control by the board. Such a situation is achieved when the state and board have a clear understanding of their roles, in an environment of frequent communication and trust.²⁴⁷

c) Non-executive Directors:

The Non-Executive Directors should constructively challenge and help develop proposals on strategy. They are seen as the watchdogs for the achievement of the company objectives as they monitor and scrutinize the performance of management in meeting the goals and objectives set, they should certify on the financial integrity of the accounts, are also responsible for determining the appropriate levels of remuneration of executive directors. They also have a prime role in appointing, removing directors and their input is also important in formulating the succession plan.

d) The Chairman:

The role of the chairman is to lead the board and ensure effectiveness on all aspects. The role of the chairman must therefore be separated from the role of the chief executive officer. He must set the agenda and ensure adequate time is available for discussion of all agenda items. He must then chair meetings of the board and members, ensuring order, proper conduct of meetings, affording participants reasonable opportunity to speak, ensuring decisions are fairly made, deciding on the technicalities and casting the vote in case of a tie. He must organize and facilitate the balance between internal and external relationships and must also facilitate effective board management. The chairman must therefore have relevant skills and experiences in the business of the corporation, must be firm but impartial, and must also be witty.

The UK code provides that, the board should appoint one of the independent non-executive directors to be senior independent director to provide for a sounding board for the chairman. The

²⁴⁶ Section A. 3 of the UK Code (2010).

²⁴⁷ *ibid.*

sample code in Kenya has provisions similar to those of the UK and emphasizes on clear division of the roles of the CEO and those of the chairman to ensure that a balance of power and authority is maintained and that no individual has unfettered powers of decision.²⁴⁸

4.2.1 BOARD AND EFFECTIVENESS

a) The Composition of the Board:

There should be a balance of executive and non-executive directors including (independent non-executive directors), this ensures independence in decision making as it discourages board captures. Further, the board and its committees should have appropriate balance of skills, experience, independence and knowledge of the company to enable them discharge their duties and responsibilities effectively. The proper mix and balance of skills and experience enriches the board and ensure that there is no undue reliance on particular individuals. The size of the board should be sufficient so as to meet the requirements of the business, it should not be too large and hence costly to the corporation or too small to hamper proper conduct of business.²⁴⁹ The composition of the board and its committees should be capable of being managed without undue disruption. Contrary to the UK guidelines, in Kenya and especially in state owned corporations such as the investor protections board, there are large numbers of board members mostly appointed on political basis, and there are no guidelines to ensure that committee membership is refreshed.

b) Appointment to the Board:²⁵⁰

The ideal way to approach board members nominations is to appoint on merit and retain on performance. However, what stands in the way of this ideal is the penchant for politicization.²⁵¹ There should be a formal, rigorous and transparent procedure for the appointment of a new director to the board. The process of appointment should be publicly transparent, made on objective criteria and on merit. Factors such as age, gender, cultural diversity and regional balance should be considered. The board should put in place plans for orderly succession plan for appointments to the board and management so as to maintain appropriate balance of skill and experience within the company. To ensure effectiveness therefore the board must put in place a

²⁴⁸ See note 214 Section A 4 of the UK Code (2010).

²⁴⁹ Section B. 1 of the UK Code (2010).

²⁵⁰ Section B. 2 of the UK Code (2010).

²⁵¹ Section C1 of the UK Corporate Governance Code (June 2010).

nomination committee to lead the process of board appointments and make recommendations to the board.

Majority of the membership of this committee should be independent non-executive directors, the committee should be chaired by the chairman of the board or an independent director, however, the chairman should not chair when the committee is dealing with the nomination of the successor to the chairmanship. This guidelines can appropriately fit in the private corporations in Kenya, however, for state owned enterprises, it is difficult to implement due to the mode of appointment which is often riddled with direct appointments through gazette notices which lack transparency, and merit.

4.2.2 BOARD AND ACCOUNTABILITY²⁵²

Best practice countries use public transparency as a tool to drive greater SOE performance. Disclosure practices usually emulate those of private sector. Disclosure has focused on financial reporting standards and the verification of financial reports through audit. Increasingly, disclosure covers governance practice and is used as a measure as a method to create checks and balances in particular in the area of nomination.

a) Financial and Business Reporting:

The board should present a balanced and understandable assessment of the company's position and prospects, together with other price sensitive reports, and reports to the regulators as well as information presented by statutory requirements. The directors must cause to be prepared an annual report and state their responsibilities in its preparation and accounts, and the auditors should state such responsibilities. They should also state their vision and their strategy for delivering the company objectives. They should also state either in the annual or half-year report that the business is a going concern with supporting assumptions or qualifications as necessary.²⁵³

²⁵²The UK Corporate Governance Code (June 2010) <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/The-UK-Corporate-Governance-Code.pdf> (accessed on 20.08.2013).

²⁵³ The UK Corporate Governance Code (June 2010) (see note 252).

The Kenyan sample code of best practices while providing for similar guidelines, has grounded its guidelines on disclosure of accounts and audit on statutory provisions²⁵⁴ and emphasizes that the board shall be responsible for ensuring integrity, and adequacy of accounting and financial systems and the need to employ qualified and competent staff to undertake accounting and financial responsibilities. The directors are also responsible in ensuring that the company complies with the accounting standards applicable. Unlike the ‘comply’ or ‘explain’ approach which the UK has adopted, the Kenyan code envisages strict compliance with regard to accounting and financial reporting. Sections 29 of the Leadership and Integrity prohibits state and public officers from knowingly giving false or misleading information to any person. Section 30 on the other hand prohibits falsification of any records or misrepresentation of information to the public.

b) Board and Risk Management and Internal Controls:²⁵⁵

The Board must determine the nature and extent of the significant risk it is willing to take in achieving its strategic objectives. It should therefore maintain sound risk management and internal control systems. This should be done through annual reviews of the company’s management and internal control systems and reporting to shareholders. The review should cover material controls including; financial, operational and compliance controls. However, it is worth to note that the principle of comply or explain could be misused where a board has negligently failed to carry out its responsibilities to detect, prevent or mitigate the risks hence the need to supplement it with statutory sanctions.

c) Audit Committee and Auditors:²⁵⁶

²⁵⁴ Sections 393, 398 and 399 of the Companies Act Cap 486.

²⁵⁵ Section C. 2 of the UK Code.

²⁵⁶ Section C3 of the UK Corporate Governance Code. The FRC Guidance on Audit Committees suggests means of applying this part of the Code. Copies are available at: <http://www.frc.org.uk/corporate/auditcommittees.cfm>.

The board should establish formal and transparent arrangements for financial reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company's auditor. The board should establish an audit committee comprising independent non-executive directors, and should ensure that at least one member has recent and relevant financial experience. The main role and responsibilities of the audit committee should be set out in written terms of reference. The audit committee should monitor and review the effectiveness of the internal audit activities, they should also make arrangements and formulate policies in which staff of the company may in confidence raise concerns about possible improprieties in matters of financial reporting. The audit committee should also be involved and play a primary role in the appointment, reappointment and removal of the external auditor. However, its work is limited to recommending to the board which makes the ultimate decision. Questions have however been raised over the independence of the external auditors especially bearing in mind that they are retained by the corporation and may give fraudulent reports to protect the directors and to maintain the relationship with the company.

The key success factors indicate that the best practice countries are transparent in order to enhance the accountability of both the SOE and accountability of the public administration. Best practice countries do not have SOEs that are accountable solely to themselves or the government.²⁵⁷

4.2.3 SOES EMULATING PRIVATE SECTOR PRACTICE:²⁵⁸

Norway and other Nordic countries have decided that the best way to emulate private sector practice is to make SOEs partly private. Share listing can significantly alter the quality and nature of governance as it forces SOEs to comply with the listing standards, disclosure requirements, securities regulations and governance codes.²⁵⁹ Ad hoc or unconsidered political intervention is thus significantly limited. Above all it provides boards with powers and forces all decision making to actually go through the board. A number of countries including Australia, New Zealand, the Nordic countries and United Kingdom have had considerable success with

²⁵⁷ Transparency International Policy Position Number 03/2009, www.transparecy.org accessed on 27.08.2013. p 4.

²⁵⁸ Ibid.

²⁵⁹ Ibid p. 5.

their models. Under this models, the influence of the government is measured, transparent and bounded by clear procedures. The board has the needed authority and operate autonomously. There is little if any government intervention and very little to distinguish SOEs from private sector.²⁶⁰

4.3 THE OECD GUIDELINES FOR STATE-OWNED ENTERPRISES²⁶¹

The Organisation for Economic Cooperation and Development (OECD) 2005 Guidelines on state owned enterprises sought to address the corporate governance challenges affecting many economies. The guidelines provide an international benchmark to help governments assess and improve the way they exercise the ownership of these enterprises.²⁶² The guidelines propose that in carrying out its ownership responsibilities, the state can benefit from using tools that are applicable to the private sector, including the OECD Principles of Corporate Governance. This is especially true for listed State Owned Enterprises (SOEs). However, SOEs also face some distinct governance challenges among them; SOEs may suffer just as much from undue hands-on and politically motivated ownership interference as from totally passive or distant ownership by the state. There may also be a dilution of accountability. SOEs are often protected from two major threats that are essential for policing management in private sector corporations, *i.e.*, takeover and bankruptcy.²⁶³ More fundamentally, corporate governance difficulties derive from the fact that the accountability for the performance of SOEs involves a complex chain of agents (management, board, ownership entities, ministries, the government), without clearly and easily identifiable, or remote, principals.

To structure this complex web of accountabilities in order to ensure efficient decisions and good corporate governance is a challenge. As the Guidelines are intended to provide general advice that will assist governments in improving the performance of SOEs, the decision to apply the Guidelines to the governance of particular SOEs should be made on a pragmatic basis.²⁶⁴ The Guidelines are primarily oriented to state-owned enterprises using a distinct legal form which is

²⁶⁰ See note 257.

²⁶¹ OECD Guidelines on State Owned Enterprises-ISBN 92-64-00942-6-© (2005) p. 3.

²⁶² Ibid.

²⁶³ Ibid p. 10.

²⁶⁴ See note 261.

separate from the public administration and has a commercial activity with the bulk of their income coming from sales and fees, whether or not they pursue a public policy objective as well. These SOEs may be in competitive or in non-competitive sectors of the economy. When necessary, the Guidelines distinguish between listed and non-listed SOEs, or between wholly owned, majority and minority owned SOEs since the corporate governance issues are somewhat different in each case. The Guidelines can also be applied to the subsidiaries of these SOEs, whether listed or not.²⁶⁵

The OECD Guidelines on Corporate Governance of State-Owned Enterprises suggest a governance structure composed of three distinct layers, each with a distinct role that is; a state ownership function which is responsible for defining the ownership policy and high-level objectives for SOEs ; secondly, a board which is charged by the state with overseeing the development of a strategy to achieve the state's objectives, and monitoring of progress; and lastly, executive management who propose a strategy and who are accountable to the board for implementing the strategic plan.²⁶⁶ Under this ideal structure, the board plays the central function in the governance of the SOE. It carries the ultimate responsibility for SOE performance, and it has the authority and autonomy to make decisions that determine performance. It also acts as the intermediary between the state and the SOE on behalf of the owners. One of the challenges that face state corporations in Kenya is lack of autonomy and independence in decision making process of the board. The proposed structure could be adopted in Kenya to strengthen the board. The guidelines that will strengthen and align corporate governance of SCs with anti corruption strategy are discussed below:

4.3.0 Ensuring an Effective Legal and Regulatory Framework for State Owned Enterprises

In order to avoid market distortions, there is need to put in place an effective legal and regulatory framework for SOEs which should ensure a level playing ground where SOEs and private

²⁶⁵Ibid.

²⁶⁶ Richard Fredrick W., Enhancing the Role of the Board of Directors of State-Owned Enterprises; OECD Corporate governance Working Paper No. 2 available at <www.oecd.org/daf/corporateaffairs/wp> accessed on 11th October 2013.

companies compete. The framework should be fully compatible with the OECD principles of corporate governance.²⁶⁷ The framework should provide for a clear separation between state's ownership function and other state functions that may influence the conditions for SOEs particularly with regard to market regulations.²⁶⁸ The governments should strive to simplify and streamline the operational practices and the legal form under which the SOEs operate. This helps to seal the loopholes created by a complicated legal framework which can be abused by corrupt public officers. SOEs should not be exempt from the application of general laws and regulations as this would perpetrate impunity and erosion of the rule of law in the governance of the SOEs. One of the role of the board is to ensure compliance with all relevant laws hence it is upon the board to ensure that all laws including anti-corruption legislation including the Constitution, ACECA, LIA and POEA are complied to.

4.3.1 The State Acting as an Owner

The OECD guideline connote that, the state should act as an informed and active owner and establish a clear and consistent ownership policy, ensuring that the governance of state-owned enterprises is carried out in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness. This is to be achieved through; development and issuance of an ownership policy that defines the overall objectives of state ownership, the state's role in the corporate governance of SOEs, and how it will implement its ownership policy; secondly, the government should not be involved in the day-to-day management of SOEs but should allow them full operational autonomy to achieve their defined objectives.

The state should let SOE boards exercise their responsibilities and respect their independence. Additionally, the exercise of ownership rights should be clearly identified within the state administration. The guidelines propose facilitation of this role by setting up a coordinating entity or, more appropriately, by the centralization of the ownership function. In Kenya, the task force which was established to look into how to streamline SOEs has proposed the merger of SOEs with related functions and scraping of non-performing ones and the establishment of a single

²⁶⁷ OECD Principles of Corporate Governance (2004).

²⁶⁸ See note 266 at p. 12.

regulatory body to be known as; The Government Investment Company.²⁶⁹ This body will be an integrated regulatory body with the mandate to oversee the management of all the State Owned Enterprises, consequently it is hoped that this integration will deal with some of the corporate governance challenges that face the SCs such as overlapping regulations and unclear objectives.

The coordinating or ownership entity should be held accountable to representative bodies such as the Parliament and have clearly defined relationships with relevant public bodies, including the state supreme audit institutions such as the Auditor General and Controller of Budget. The ownership rights of the state should be exercised according to the legal structure of each company. In order to deal with the corporate governance challenges that are brought up by the opaque manner of nominations and appointments, the state should establish a well structured and transparent board nomination processes in fully or majority owned SOEs, and actively participate in the nomination of all SOEs' boards.²⁷⁰

The state should play an active role in setting up reporting systems allowing regular monitoring and assessment of SOE performance. To strengthen the internal control and risk management measures where permitted by the legal system and the state's level of ownership, the state should maintain continuous dialogue with external auditors and specific state control organs. Lastly, the state should ensure that remuneration schemes for SOE board members foster the long term interest of the company and can attract and motivate qualified professionals.

4.3.2 Transparency and Disclosure

State-owned enterprises should observe high standards of transparency in accordance with the OECD Principles of Corporate Governance. Consequently, the board or ownership entity should develop consistent and aggregate reporting on state-owned enterprises and publish annually an aggregate report on SOEs. The SOE should develop efficient internal audit procedures and establish an internal audit function that is monitored by and reports directly to the board and to the audit committee or the equivalent company organ.

²⁶⁹ Peter Leftie and Julius Sigei, 'Radical Plans to Reform Parastatals' (*Daily Nation* 4th October 2013).

²⁷⁰ See note 266 at p. 13.

SOEs, especially large ones, should be subject to an annual independent external audit based on international standards. The existence of specific state control procedures does not substitute for an independent external audit. To enhance transparency and accountability, the guidelines propose that, SOEs should be subjected to the same high quality accounting and auditing standards as listed companies. Large or listed SOEs should disclose financial and non-financial information according to high quality internationally recognized standards.

Further, SOEs should disclose material information on all matters described in the OECD Principles of Corporate Governance and in addition focus on areas of significant concern for the state as an owner and the general public. In Kenya, disclosure of material information has been provided for under the Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002 formulated pursuant to section 12 of the Capital Markets Act. Examples of such information to be disclosed include: a clear statement to the public of the company objectives and their fulfillment; the ownership and voting structure of the company; any material risk factors and measures taken to manage such risks; any financial assistance, including guarantees, received from the state and commitments made on behalf of the SOE and any material transactions with related entities.²⁷¹

4.3.3 Problems with Current System where Good Corporate Governance & Anti-Corruption Legislation Exist Separately

The current system where corporate governance is not aligned to the anti-corruption legislation possess challenges in terms of enforcement as they exist as though they are dealing with parallel and non-related issues, yet their ultimate objective is the same. The way the corporate governance codes of conduct and ethics are drafted implies that their compliance is not mandatory in nature and their breach therefore does not attract strict legal sanctions hence lack of enforcement. The perpetrators of corruption are likely to rely on the codes of conduct and ethics to evade strict liability for their misdeeds for instance where the principle of ‘comply or explain is applied’. The two codes governing state corporations that is the LIA and the POEA are not

²⁷¹ Third, Fourth and Fifth Schedule.

without limitations for instance LIA does not provide for offences and require amendments, to fill this gap, business ethics under corporate governance should be applied.

Where the anti-corruption legislation is not aligned to corporate governance, corporations may act legally right but ethically wrong hence corporations will lack the aspect of sustainability as the stakeholders, community, environment or the government may not agree with their activities if they do not take into account the interests of all other stakeholders affected by the activities of the corporation. The law therefore protects the rights of the owners and stakeholders. In adherence to the law for instance on issues of accounting and reporting, the objectives of corporate governance such as financial probity and integrity are met. The law also seals loopholes where governance is weak. The law such as the Sarbanes Oxley Act which increased the penalty for fraudulent accounting and reporting by directors are good monitoring and deterrent measures go guard against such like occurrences.

Provisions such as Constitutional threshold for state and public officers should be incorporated in the corporate governance codes so that as state corporations implement the Constitution, the principles of corporate governance are fulfilled. The Companies Act should be applied in line with the codes of corporate governance so as to ensure that the role and functions of the board are anchored in the Act hence mandatory. One of the roles of the board is to ensure that the corporation complies with the relevant laws, regulations, and codes of best business practice.

The anti-corruption legislation exist to enforce the board for instance, directors' liabilities and obligations for example, with regard to criminal and penal law relevant to corporations, fiduciary trust and agency, fraudulent trading with an insolvent companies, personal liability for fraud, secret profits, corruption and bribery.

It is therefore recommended that law and corporate governance should complement each other in that misdemeanor should be dealt with at the corporate governance level, however, where there is persistent negative behavior the law should be invoked.

4.3.4 Strategies for Strengthening Corporate Governance to Combat Corruption

According to the Transparency International Policy Position,²⁷² the process that characterize strong corporate governance systems align in many respects with the key elements for countering bribery, effective risk management, integrity, transparency standards and accountability.²⁷³ The overlap between rights and responsibilities, controls and oversight provide some clear entry points for linking the two complementary agendas and lessening the possibility that corrupt acts will occur. To reinforce and operationalize this alignment, the active engagement of the board is essential. Given its organizational role, the board assumes responsibility over matters related to auditing both external and internal standards, legal compliance systems and ethical policies which can be used to prevent abuses.²⁷⁴

Additionally, increasing a company's commitment to corporate social responsibility and sustainability initiatives as part of overarching efforts to promote company values and ethical standards can build the level of business integrity needed to mitigate corruption risks. Globally, nations have worked together to advance such good practices and policies and to provide an international standard for helping to align corporate governance and anti-corruption. These include the OECD guidelines and the passage of international anti-corruption accords such as the OECD Anti-Bribery Convention and the United Nations Convention against Corruption (UNCAC).²⁷⁵

Recent corporate governance reforms have focused on the sources of system failures and their inability to effectively mitigate the full spectrum of company risks which include: financial, operational and corruption. Companies and governments have increasingly pursued mechanisms to regulate and respond to the breakdowns that can lead to corruption by: strengthening shareholder voting rights; providing clear accounting standards to prevent fraud and making more transparent executive remuneration practices.

²⁷² Transparency International Policy Position Number 03/2009, www.transparency.org accessed on 27.08.2013. p 4.

²⁷³ Ibid.

²⁷⁴ Transparency International Policy Position Number 03/2009, www.transparency.org accessed on 27.08.2013. p 4.

²⁷⁵ The United Nations convention against Corruption (UNCAC) chapter one, two and five, www.undoc.org/pdf/crime/convention_corruption/signing/convention-e.pdf and www.oecd.org/document/21/0,3343,en_2649_34859_2017813_1111,00.html > accessed on 27.08.2013.

4.3.4.1 Voting Rights²⁷⁶

Strengthening shareholder democracy is a trend most evident in Europe which is helping to create an accountability mechanism to combat corrupt practices on the part of the company board. Rather than simply having ‘the right of recommendation’, shareholders vote to approve the board’s performance from the past financial period and appoint its members. Shareholder and stakeholder rights should include holding boards, owners and the senior management accountable for their actions and respecting the rights of owners. The rights of minority should also be safeguarded to ensure their voice. Strengthened rights help to counter the decisions that could provide a veil for boards to hide their corrupt actions or mask abuses.

4.3.4.1 Accounting Fraud²⁷⁷

The sudden collapse of the Italian conglomerate Parmalat (2003) and the US energy firm Enron (2002) are reminders of how manipulation of company’s financial information may be designed to hide losses and bribes, bolster profits, inflate sales or disguise the level of indebtedness.²⁷⁸ Accounting practices can be used to misrepresent a company’s true financial affairs, external assurance processes should therefore be used to independently verify financial and non-financial data. These are now almost universally mandated by law for company financial reporting. For instance in Kenya this has been provided for under sections 147 to 164 of the Companies Act and Regulation 7 of the Capital Markets (Corporate Governance), (Market Intermediaries) (2014), and the Capital Markets (Securities), (Public Offers, Listing & Disclosures) Regulations, 2002.

Consideration should also be given to formalizing stakeholder dialogues as a way of improving stakeholder rights. This measure is particularly essential to provide for management’s accountability on important business decisions which directly impact stakeholders and corruption risks.

²⁷⁶ Transparency International Policy Position Number 03/2009, www.transparecy.org accessed on 27.08.2013. p 6.

²⁷⁷ Ibid at p. 6.

²⁷⁸ Ibid.

4.3.4.2 Executive Remuneration²⁷⁹

According to the TI policy position, it is difficult to determine when executive salaries and severance packages overstep the board's boundaries of trust and cross into the realm of corruption. However, most reformers agree that lack of disclosure on why and how much remuneration company directors are given makes it hard for shareholders to hold boards accountable. In response, countries such as the US and Germany have called for independent company 'remuneration committees' as well as clear criteria for setting salary levels.²⁸⁰ In its advocacy to strengthen the transparency, accountability and integrity of corporate governance, TI proposes that board and senior executive remuneration and benefits packages should be made public, tied to sustainable performance and determined by independent non-executive directors.

TI observes that the global crisis has revealed how excessive risk taking within companies has been fuelled by the lack of transparency, accountability and integrity which allowed abuses and corruption to go unchecked. In many instances, corporate governance fell short in responding to these problems as a result of not having fully aligned their corporate governance systems with the anti-corruption mechanisms.²⁸¹ In striving to achieve risk management therefore, corporate governance must equally and accurately assess corruption hazards if the framework is to work. Companies need to do much more to support good corporate governance and its role in contributing to the fight against corruption. To promote the change, TI advocates for action to strengthen the transparency, accountability and integrity in corporate governance through;

4.3.4.3 Transparency²⁸²

Board and senior executive remuneration and benefit packages should be made public, tied to sustainable performance and determined by independent non-executive directors. Companies should report on corporate governance structures and anti-corruption system. While many

²⁷⁹ Transparency International Policy Position Number 03/2009, www.transparency.org accessed on 27.08.2013, p 7.

²⁸⁰ The German government created a commission to prepare a national corporate governance code. A final version was approved in February 2002 with revisions in June 2007. www.corporate-governance-code.de/index-e.html. accessed on 28.08.2013.

²⁸¹ Ibid note 255.

²⁸² Ibid at p 6.

companies dedicate a section in their annual report to describe their corporate governance system, this should be complemented by information on what a business is doing to combat corruption, this can also be included in the corporate citizenship of sustainability reports of the company.

4.3.4.4 Accountability²⁸³

External assurance processes should be used to independently verify financial and non-financial data. These are now almost universally mandated by law for company financial reporting. Assurance should also be considered in areas such as employment, environment and integrity standards, including anti-bribery programmes. Shareholder and stakeholder rights should include holding boards, owners and senior management accountable for their actions and respecting of the rights of the owners. The minority rights of shareholders must also be safeguarded to ensure their voice. Strengthened rights help to counter decisions that could provide a veil for boards to hide their corrupt acts or mask abuses. TI further proposes that considerations should be given to formalizing stakeholder dialogue as a way of improving stakeholder rights. This measure is particularly essential to provide for management's accountability on important business decisions which directly impact stakeholders and corruption risks.

4.3.4.5 Integrity²⁸⁴

Integrity implies the company doing the right thing at all the time, hence corporate governance standards should be applied across all units of a company and in all countries it operates. These standards, rules and ethical principles should not be limited to the parent company. Poor practices should not be allowed to be passed off to operating units or exported to other countries. Equally companies should be committed to improving corporate governance standards in entities where they have influence.

Specific board responsibilities should be designated to oversee corporate governance as well as ethical integrity issues. Functions for policy formulation and oversight in the areas of corporate governance and company ethics should be clearly assigned to certain board member(s) and

²⁸³ Transparency International Policy Position Number 03/2009, www.transparency.org accessed on 27.08.2013. p 7.

²⁸⁴ Ibid at p 7.

committee(s). TI strongly supports the creation of the Audit and remuneration committees. Companies should also formulate whistle blower protection policy which ensures that employees alerting the management of abuses should be protected from victimization and retaliation. In supporting these components of good corporate governance, companies will be able to establish some of the mechanisms needed to mitigate corruption risks and demonstrate their zero tolerance for abuses.

4.4 SAMPLE CODE OF BEST PRACTICES IN CORPORATE GOVERNANCE

The Kenyan Sample Code of best practices has defined governance to concern processes, systems, practices and procedures – the formal and informal rules that govern institutions, the manner in which these rules and regulations are applied and followed, the relationships that these rules and regulations determine or create, and the nature of those relationships. Governance addresses the leadership role in the institutional framework. Corporate Governance, therefore, refers to the manner in which the power of a corporation is exercised in the stewardship of the corporation's total portfolio of assets and resources with the objective of maintaining and increasing shareholder value and satisfaction of other stakeholders in the context of its corporate mission. It is concerned with creating a balance between economic and social goals and between individual and communal goals while encouraging efficient use of resources, accountability in the use of power and stewardship and as far as possible to align the interests of individuals, corporations and society.

4.5 GUIDELINES FOR GOOD CORPORATE GOVERNANCE IN STATE-OWNED CORPORATIONS; THE KENYAN PERSPECTIVE²⁸⁵

These guidelines define what is corporate governance and expounds on its contribution to sustainable development, further, underlying assumptions and pillars of good corporate governance are discussed, and it also provides justification and purpose for the guidelines. Some of the guidelines that are directly relevant to this research are with regard to appointment of directors and board composition, mix of skill and competences, remuneration, disclosure of

²⁸⁵ Private sector Corporate Governance Trust, 2002 (See note 245).

interests by directors, independence of the board of directors, establishment of the board committees, and accountability of the board and liabilities of the directors.

With regard to appointment of directors, the guidelines provide that the procedures followed by the boards and the State Corporation Advisory Board should ensure that only the best qualified persons who can add value to the SC are appointed as directors. The BoD should set up an independent remuneration committee to determine, in consultation with the State Corporation Advisory Committee (SCAC), equitable and attractive remuneration packages for directors as well as management for ratification by the Government as shareholder.²⁸⁶ To enhance transparency and accountability, disclosure of interests by directors should be on a continuous basis and all directors should in good faith, disclose to the board and SCAC for recording any business or other interest that is likely to create potential conflict of interest.²⁸⁷

Independence of the board of directors should be achieved through the appointment procedure which ensures that directors disclose actual or perceived conflicts of interest so that the state corporation board can function independently, objectively and only in the interest of the corporation. However, to assure convergence of interests of the principal and agents, the state should provide for agency costs and to some extent bonding costs.²⁸⁸ The board should also establish a process of identifying, analyzing and managing risks.²⁸⁹

Due to the fact that the SCs are not exempted from the general laws of the country, and further, due to the fact that the directors are bestowed with duties and obligations, the directors of the SOE must exercise the highest degree of care and diligence in the discharge of their duties and should be held jointly and severally liable for acts and omissions.²⁹⁰

Corporate governance promotes fair, efficient and transparent administration of corporations to meet well-defined objectives. It promotes systems and structures of operating and controlling corporations with a view to achieving long-term strategic goals that satisfy the owners, suppliers,

²⁸⁶See note 245 at p 17.

²⁸⁷Ibid.

²⁸⁸Jensen and Meckling ibid note 16.

²⁸⁹Ibid at p. 20.

²⁹⁰See note 288 at p 19

customers and financiers while complying with legal and regulatory requirements and meeting environmental and society needs; Further, it promotes efficient process of value-creating and value-adding. Good corporate governance achieves this by ensuring that: The corporate Board has set strategic objectives and plans and put in place proper management structures to achieve those objectives and plans; the structures put in place function to maintain corporate integrity, reputation and responsibility towards all stakeholders.

Corporate governance also ensures that the board acts as a catalyst, initiating, influencing, evaluating and monitoring strategic decisions and actions of management and holds management accountable. It further ensures that the board is not a mere formality which takes a back seat, leaving management to make all strategic decisions. It also ensures that, the board has established and put in place mechanisms to ensure that the corporation operates within the objects established by shareholders and the mandate given to it by society. It ensures that the board utilizes the resources entrusted to it efficiently and effectively in pursuit of the stated mandate, and meets the legitimate expectations of its various stakeholders. Additionally, corporate governance ensures that, there are established mechanisms, processes and systems to constantly ensure that governance practices are effective and appropriate; there is transparency and accountability to the various stakeholders; the corporation complies with legal and regulatory requirements; there is disclosure of all pertinent information to stakeholders; there is effective monitoring and management of risk, innovation and change; the corporation remains relevant, legitimate and competitive; and the corporation is viable, solvent and sustainable.²⁹¹

Simply put, corporate governance refers to the establishment of an appropriate legal, economic and institutional environment that allows companies to thrive as institutions for advancing long-term shareholder value and maximum human-centred development while remaining conscious of their other responsibilities to stakeholders, the environment and the society in general.

These principles and guidelines are based on the fact that Corporate Governance of SCs is a major challenge in many economies, yet there is no international benchmark to help governments to assess and improve the exercise of ownership of these enterprises. To this end the Organization

²⁹¹ Private sector Corporate Governance Trust, 2002 (See note 245). At p 11-12

for Economic Co-operation has formulated guidelines to be adopted and applied by member Countries and Kenya is included. The guidelines set out the specific role of the boards, the need for separation of power, effective legal and regulatory framework, transparency and disclosure among others.

Conclusion

This chapter has examined the best corporate governance practices that can be learnt and adopted in Kenya to enhance good corporate governance in state corporations. The research considered the Code of Corporate Governance for Listed Companies in China (2002), the United Kingdom (UK) code of good corporate governance, the OECD Principles for Corporate Governance, the OECD guidelines for State corporations, and the Kenya sample code for Corporate Governance. The research linked good corporate governance practices such as transparency, integrity, accountability and responsibility to the anti-corruption legislation and the strategy to prevent and combat corruption in state corporations. Indeed the research found out that there is a correlation between good corporate governance and the level of corruption in state corporations. Corporate governance promotes fair, efficient and transparent administration of corporations to meet well-defined objectives. The strategies for aligning corporate governance to anti- corruption legislation were identified as

CHAPTER 5

FINDINGS, CONCLUSION AND RECOMMENDATIONS

5.0 FINDINGS AND CONCLUSIONS

This paper has given an account of and the reasons of widespread corruption in the public sector and specifically in the state corporations; the effects of corruption on the performance of the SCs and the corporate governance issues in the SCs that breed and perpetrate corruption were also discussed. Corporate governance challenges that affect state corporations were found to be the major causes of corruption in SCs. These included political interference by the government in the decision making process of the board hence lack of autonomy; secondly, the mode of appointment to the board and to the position of the chief executive are not transparent and merit-based as political patronage is often at play hence perpetrating rent seeking and patron-clientele relationship.

The governance structure of the SCs which has multiple agents was found to be a challenge because it creates multiple objectives which are sometimes conflicting and confusing to the boards. This in turn presents loopholes for corruption to flourish. The other challenge is the agency problem that arises from separation of control and ownership creates a divergence of interests between the residual owners (principal) and the implementers of decisions (the agents). Where these interests are not converged through provision of agency and bonding costs, public resources are converted to private property through fraud, looting and outright embezzlement.

Lack of autonomy in the decision making by the corporation board is a great challenge to the proper governance of the SCs as most decisions have to be approved by the Cabinet Secretary (CS), hence the board lacks independence. Due to the fact that, there is no mandatory provision committing the CS to comply with corporate governance standards, the CS may make decisions that do not benefit the corporation but which decision the board has no power to review. The research found out that, there was too much political interference in the management of the SC's affairs which affects accountability as the whims of the appointing authority are satisfied at the expense of public interest.

The legal framework governing the State Corporations and anti-corruption are not without limitations thus providing a fertile ground for corruption. For instance, the mode of appointment does not ensure transparency as there is no public participation to vet the suitability of the nominees to hold public office as trustees to the tax payers. The appointment is often direct appointments through gazette notices. There are no appointment criteria to ensure that the board is enriched with diversity and right skills to manage the public funds in the interest of the public. To ensure an effective board, the state corporations need to have a structured board nomination process.²⁹² Some of the anti-corruption laws are ambiguous and lack clarity; some are overlapping in turn confusing the public and enforcers. The corrupt public officers therefore capitalize on these loopholes to defraud and misuse public resources for private gain. Enforcement of the anti-corruption laws has been largely ineffective as the perpetrators thrive on the cost benefit analysis, they argue that the benefit of corruption is more than the cost of being caught and convicted. The enforcement agencies such as EACC have not been strengthened enough to prevent and combat corruption as the contentious issue has been whether to grant the agency prosecutorial powers to prosecute the cases investigated by this agency. The courts on the other hand have been found to be lethargic in adjudicating corruption matters, as they have entertained numerous applications stopping investigations in corruption cases, their judgments and rulings have been worrisome. The cases also take too long to complete as the courts entertain postponements at the behest of defendants thus denying justice to the victims. The penalties for corrupt conduct are not deterrent enough to discourage the participants and generally, there is lack of political will to support the enforcement agencies to tackle corruption.

The research found out that, generally, compliance with globally practiced corporate governance standards was lower in state corporations as compared to private sector. As noted above, accountability and transparency are not above board. Additionally, the risk management and internal control measures are not adequately provided for as the state corporations have not fully embraced technology especially in accounting and reporting. The whistle blowing policy is lacking in some corporations and where there is one, the procedure and protocol is not clear. The

²⁹² David Robinett; *The Challenges of SOE, Corporate governance for Emerging Markets* (World bank Corporate Governance Department) <<http://rru.worldbank.org/documents/other/corpgov.SOE.pdf>> accessed on 24th June 2013.

whistle blower mechanisms are not adequate hence discourages the-would-be whistle blowers who shy away for fear of victimization.

The study found out that there is a correlation between compliance with corporate governance standards and the level of corruption in state owned enterprises. This is because corporate governance reduces corruption in two broad perspective that is: corporate governance will ensure compliance with the law for instance, compliance with the provisions of the Constitution, the Companies Act with regard to financial accounting and reporting, audit, and transparency in disclosure and corporate governance reporting; compliance with the Capital Markets Act and Regulations with regard to disclosure on material information ensures compliance with the law, hence corporate governance complements the law. Compliance with corporate governance also ensures that there is balance of power in board with diversity and proper mix of skills and expertise. The presence of independent non-executive members on the board assures independence of judgment and provides checks and balances, however, this is only realized where the government refrains from interfering in the day-to-day management of the corporation. The principles or standards of good corporate governance are usually enforced through codes of ethics and conduct. Compliance with these standards inculcates ethical conduct and behavior in the business, both in the private and public sector hence the links between the supply side of corruption through bribery and the demand side (recipient- corrupt public officials) are cut short.

Good corporate governance contributes to combating corruption, which remains one of the greater threats to development around the world. Good corporate governance makes bribes harder to give and harder to conceal. Compliance with corporate governance standards also contributes to the broader climate of transparency and fairness dealings. The core values of corporate governance and the core principles of democracy that have been widely quoted are; fairness, transparency, responsibility and accountability. Some of the advantages for compliance with the standards of corporate governance are that: corporate governance brings stability to markets and strengthens institutions through sealing the loopholes that breed and perpetrate corruption hence ensuring that resources are applied to the right, properly planned for and profitable projects. Corporate governance also improves risk mitigation as internal controls

mechanisms are put in place to detect and prevent corruption. Further it ensures that costs are set aside to mitigate the risk.

Corporate governance weakens corruption as it removes the incentives and seals the gaps that breed and perpetrate corruption both from the public and private perspective. Generally, corporate governance promotes reform of state-owned enterprises. Lastly, it builds transparent relationships between business and the state.

5.1 Recommendations

To effectively realize the impact of compliance with corporate governance to the levels of corruption, the genesis of governance of state corporations should begin on the right note. The appointments to the board should comply with the constitutional provisions especially articles 10, 73 and 232. The mode of appointment should be transparent and merit based. The composition of the board should ensure a balance of power between executive and non-executive independent directors who should form the majority in the audit committee. The composition should also ensure proper mix of skill and expertise. The appointments to the governing body of a parastatal organization should be made by the relevant Minister on the advice of the parastatal oversight body. This process should ensure that appointments are based on merit, as a result of free and open competition.

Having appointed the board to oversee the activities of the corporation, the government should not be involved in the day-to-day management of the state corporations but rather give credence to the agency relationship created. To reduce levels of corruption, there is need for board to steer the corporation with clear objectives in such a way to ensure convergence of the interests of the principal and the agent. The government should also provide for agency costs which include proper remuneration to the board and executive officer in order attract and retain a good caliber of directors, however, the executive remuneration should not be a burden to the corporation. The board appointing authority should also have the board members and the management to commit bonding costs to ensure that they act in the interest of the corporation and in the event of breach, the corporation is compensated by the party in breach.

The corporations should enhance internal risk control measures through establishment of an effective whistle blowing mechanisms and embrace technological development to enhance detection and prevention of financial fraud and embezzlement, through reporting and proper, timely and accurate accounting. All state corporations should adopt the whistle blower policy which should be well structured to encourage reporting and whistle blower protection. The duties and responsibilities of the directors should be clearly specified and aligned to the corporate objectives so that the directors do not expropriate public funds bestowed upon them by the tax payers.

To cure the problem of overlap in the laws, there is need to have a single regulator as an umbrella body governing all state owned corporations as recently recommended by a task force which was mandated to look into measures to streamline SOEs. All state owned enterprises will be answerable to this body which is proposed to be Government Investment Company. This is intended to deal with the multi-agency problem too, consequently sealing the loopholes of SCs opting to use the legal framework that is deemed weakest in enforcing anti-corruption laws.

To strengthen the anti-corruption enforcement mechanisms, there is need to strengthen and even grant more powers to the enforcement agencies such as the EACC and the Judiciary. Though a highly contested issue, there is need to reconsider giving the EACC prosecutorial power as having investigated the cases, the Commission and its staff has a better understanding of the cases hence in a better position to articulate them before a court of law, perhaps lack of these powers could be behind the low levels of convictions. This can be a good basis for further research. The Judiciary should establish a consistent jurisprudence in anti-corruption laws so as to deter corrupt officers from capitalizing on the inconsistency in the jurisprudence.

Reporting on compliance with corporate governance standards has been made mandatory by the OECD guidelines and should be fully embraced by the SCs as it enhances proper accounting and reporting, timely and accurate disclosure. It is hoped that where policy makers of public bodies and state corporations will adopt some if not all of these recommendations by aligning their organizational strategies with standards of good corporate governance and anti-corruption laws,

corruption will be significantly reduced and the country will not only witness high performing SOEs but also the its socio-economic growth in leaps and bounds.

APPENDIX: GAZETTE NOTICES

Gazette notice Number 5614 of 15th August 2014

Gazette notice Number 5615 of 15th August 2014

Gazette notice Number 4607 of 11th July 2014

Gazette notice Number 3224 of 16th May 2014

Gazette notice Number 4475 of 4th July 2014

Gazette notice Number 11571 of 16th August 2013

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