

**A CASE FOR STATUTORY CODIFICATION OF DIRECTORS' DUTIES IN
ENHANCING GOOD CORPORATE GOVERNANCE IN KENYA: A CASE STUDY OF
NATIONAL BANK OF KENYA**

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DECLARATION

I **Kinyua Mercy Gathoni** do solemnly declare that, save for information sources of which have been duly acknowledged, this research study is my original work and has not been submitted for a degree in any other university or any other award.

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

Signature.....

Date.....

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DEDICATION

To The Almighty God, my dearest dad and loving mum

A BIG THANK YOU!

ACKNOWLEDGEMENT

I am forever grateful to my Father-amhumbled by your favour, graceand love and thus far you have brought me, you are *Ebenezer*.

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God bless each and every one of you.

ABBREVIATIONS AND ACRONYMS

AfriCOG: Africa Centre for Open Governance

APRM: African Peer Review Mechanism

CACG: Commonwealth Association for Corporate Governance

CCG: Centre for Corporate Governance

CBK: Central Bank of Kenya

CMA: Capital Markets Authority

ICPAK: Institute of Certified Public Accountants Kenya

IOD: Institute of Directors

KNAC: Kenya National Assurance Company

KNTC: Kenya National Trading Corporation

NBK: National Bank of Kenya

NEPAD: New Partnership for Africa's Development

NGOs: Non-Governmental Organizations

NHC: National Housing Corporation

NHIF: National Health Insurance Fund

NSSF: National Social Security Fund

OECD: Organization for Economic Co-operation Development

PSCGT: Private Sector Corporate Governance Trust

SA: South Africa

SOCs: State Owned Corporations

UK: United Kingdom

LIST OF STATUTES AND SUBSIDIARY LEGISLATION

KENYA

Banking Act Cap 488, Laws of Kenya.

Capital Markets Act Cap 485A, Laws of Kenya.

Companies Act Cap 486, Laws of Kenya.

Companies Bill, 2014.

Competition Act No. 12 of 2010, Laws of Kenya.

Consumer Protection Act No. 46 of 2012, Laws of Kenya.

Employment Act, 2007, Laws of Kenya.

Environmental Management and Co-ordination Act No. 8 of 1999, Laws of Kenya.

Retirement Benefits Act No. 3 of 1997

State Corporations Act Cap 446, Laws of Kenya.

The Constitution of Kenya, 2010.

Central Bank of Kenya Guidelines for Directors of Banks in Kenya, 1996.

Central Bank of Kenya Prudential Guidelines, 2013.

Guidelines on Corporate Governance Practice by Public Listed Companies in Kenya, 2002.

SOUTH AFRICA

Companies Act No. 71 of 2008.

UNITED KINGDOM

Companies Act, 2006.

UNITED STATES OF AMERICA

Sarbanes-Oxley Act of 2002.

LIST OF CASES

1. *Affordable Homes Africa Ltd v Henderson & 2 others* [2004] 2 KLR 473.
2. *Dadani v Manji & 3 others* [2004] 1 KLR 95.
3. *Dovey v Covey* [1901] AC 477 at 488.
4. *Deposit Protection Fund Board as Liquidator of Trust Bank Ltd (in Liquidation) v Vajay Shah & another* [2013] eKLR.
5. *East African Safari Air Limited v Anthony AmbakaKegode & Another* [2006] eKLR.
6. *Foster Bryant Surveying v Bryant* [2007] 2 BCLC 239.
7. *Foss v Harbottle* [1843] 2 Hare 461.
8. *J.S.K (Cargo) Ltd v Kenya Airways Ltd* [2008] eKLR.
9. *James Orina & another v Kenya Tea Development Agency & another* Civil Application No. NAI 22 of 2004 in Nairobi (unreported).
10. *Kamau & others v Maina & others* [2008] 1 EA 151.
11. *J Wambugu & 8 Others V Kenya Railways Corporation* [2005] eKLR
12. *Mitchell & Hobbs (UK) Ltd v Mill* [1966] 2 BCLC 102.
13. *Nairobi Law Monthly Ltd v KENGEN & Edward Njoroge* [2013] eKLR.
14. *Ogada v Owanga & Another* [2004] eKLR.
15. *Otieno v Ougo & another* [1986-1989] EA 468.
16. *R v Ivan Arthur Camps* [1962] EA 403.
17. *Re City Equitable Fire Insurance Company* [1925] Ch 407.
18. *Re Forest of Dean Coal Mining Co. Ltd* [1978] 10 Ch. D 450.
19. *Salomon vs Salomon & Co. Ltd* [1897] AC 22.
20. *Selangor United Rubber Estates v Craddock* [1968] 1 WLR 1555

21. *Shuttleworth v Cox Brothers & Co.*, [1927] 2 KB 9.

22. *Smith v Anderson* [1880] 15 Ch. D. 247.

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ABSTRACT

Directors are employed to manage the assets of the corporation on behalf of the shareholders who own it. However, more often, directors fail to discharge their duties with diligence and due care leading to mismanagement and collapse of many private and public companies. In Kenya, the major reason is the weak corporate governance regulatory framework and legal enforcement mechanism that fails to prescribe the precise duties of directors, to whom they are owed and major consequences for breach. Thus, companies in Kenya are unlikely to see the light of day in good governance unless the current laws are reviewed to reflect changing economic trends and to take into account the evolving duties of directors to company stakeholders.

Accordingly, this research study delves into the corporate governance fragility that characterized National Bank of Kenya (NBK) leading to its near-collapse in the 1980s and 1990s and recommends review of the Companies Act to incorporate a statutory statement on directors' duties for purposes of reducing corporate scandals and litigation and thus promoting good corporate governance practice in Kenya. The study explores a comparative analysis of the corporate law in United Kingdom and South Africa and accordingly makes recommendations on review of the Kenya's Companies Act.

CHAPTER ONE

INTRODUCTION

1.0 Introduction

The objective of this research study is to assess the extent to which the Kenya Companies Act¹ impedes good corporate governance practice in Kenya. Specifically, the study illustrates how performance of company directors in Kenya is undermined by a regulatory framework that fails to define directors' duties with specificity and clarity leading to corporate collapses and failures. The study accordingly argues a case for reform of the corporate governance regulatory framework to codify directors' duties in statute for purposes of enhancing good corporate governance.

The collapse of major companies around the world over has attracted global interest and led to debates on corporate governance. Several of these collapses are largely attributable to directors' irresponsibility, malfeasance and negligence. For instance, the bankruptcy of WorldCom was caused by fraud perpetrated by the management of the telecommunications firm in which the board of directors did not intervene.² The collapse of Enron was blamed on its rogue directors who engaged in dishonest activities of manipulating the company's earnings and concealment of material financial information.³ The directors of Maxwell Company in the United Kingdom were involved in fraudulent financial dealings leading to the loss of funds and collapse of the company.⁴ These corporate failures led to legal reforms to safeguard investor interests. For

¹ Cap 486 Laws of Kenya.

² Theodore F Di Stefano, 'WorldCom's Failure: Why Did it Happen?' *E-Commerce Times* (USA, 19 August 2005) <<http://www.ecommercetimes.com/story/45542.html>> accessed 13 November 2013.

³ William W Bratton, 'Enron and Dark Side of Shareholder Value' (2002) 76 *Tulane Law Review* 1275.

⁴ Erik Ipsen, 'How to Account for Maxwell Scandal' *New York Times* (USA, 10 December 1991) <http://www.nytimes.com/1991/12/10/business/worldbusiness/10iht-max_2.html> accessed 8 February 2014.

instance, the collapse of Enron and WorldCom in the USA led to the introduction of the Sarbanes-Oxley Act of 2002.⁵ In the United Kingdom, the Cadbury committee was formed to look into the financial reporting structures of companies with an aim of improving corporate governance after the collapse of Polly Peck and Maxwell.⁶

Corporate governance issues have often resulted from principal-agent problems where directors as agents of shareholders pursue individual as opposed to corporate interests. Corporate governance mechanisms have therefore been developed to align directors' interests to those of the corporation and protect shareholder's interests.⁷ The board of directors is appointed by shareholders to monitor the management and account to the owners of the company and it acts as an interface between the organization and the external environment.⁸ As such, the board is central to the governance of every corporation and an important participant in the corporate governance environment. Consequently, many jurisdictions recognize that a corporation should be headed by an effective board responsible for governance of the company and aimed at promoting

⁵ The Act mainly provided for audit of financial statements and disclosure requirements. Other commonwealth jurisdictions like Australia, South Africa and Nigeria have also reviewed the legal framework regulating the incorporation, registration, management and governance of companies.

⁶ This was the Committee on the Financial Aspects of Corporate Governance which was chaired by Sir Adrian Cadbury in 1992 and it produced a report famously referred to as the Cadbury Report. The report made several recommendations amongst them the separation of the role of chairman and chief executive officer of an organization, the selection process of directors and composition of the board, transparency in the financial reporting mechanisms and need for good internal control systems.

⁷ There are internal and external corporate governance mechanisms. External measures include market for corporate control and share price, takeovers, institutional shareholder activism and empowerment. Internal mechanisms include board of directors, removal of directors and management, remuneration incentives, audit systems and shareholder litigation. See Stephen G Marks, 'The Separation of Ownership and Control' in Boudewijn Bouckaert and Gerrit De Geest (eds), *Encyclopedia of Law and Economics* (Edward Elgar Publishing 1999) 692 <<http://www.encyclo.findlaw.com/5630book.pdf>> accessed 13 July 2013.

⁸ Humphry Hung, 'Rethinking Agency Theory as a Leading Framework for the Study of Board Performance' (July 1998) 3 (2) AAM Journal 1, 4 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1113121&download=yes> accessed 11 December 2013.

accountability, efficiency, integrity, responsibility and transparency which are the core pillars of corporate governance.⁹

In recognition of the importance of the board of directors in governance of corporations, continents and regions have established legal mechanisms and institutional structures to ensure good corporate governance by strengthening the board of directors. Overtime, global reforms aimed at conforming corporate law with changing international trends have been undertaken to encourage investment in the regional blocks and the world generally. For instance, in Kenya, the collapse of several major companies and industries in the 1980s and 1990s led to legal and institutional reforms which have, over the years, been embarked on through both government and private sector initiatives with an aim of improving corporate governance in corporations.¹⁰ However, despite these reforms, the discussion on corporate failures is far from over and the board of directors has largely been blamed for these failures.

In the past year alone, Kenya has experienced corporate scandals in private and public companies as well as state corporations and the governance challenges that have been cited are directors' conflicts of interest, lack of honesty in management, corruption, lack of independence and abuse of power leading to corporations being run in the directors' interests as opposed to

⁹ See Organisation for Economic Co-operation and Development, *OECD Principles of Corporate Governance* (OECD France 2004) 11; Committee on the Financial Aspects of Corporate Governance, *Report of the Committee on the Financial Aspects of Corporate Governance* (London: Gee & Co 1992) <<http://www.ecgi.org/codes/documents/cadbury.pdf>> accessed 1 July 2013; Private Sector Initiative for Corporate Governance, *Principles for Corporate Governance in Kenya and a Sample Code of Best Practices for Corporate Governance* (Centre for Corporate Governance Kenya, 1999) 4.

¹⁰ Government initiatives include amendments to the law to provide for privatization of public corporations and the establishment of monitoring and oversight authorities such as the Capital Markets Authority and the Insurance Regulatory Authority. Private sector initiatives include establishment of the Institute of Directors (IoD) Kenya and the Private Sector Corporate Governance Trust which later renamed to the Centre for Corporate Governance.

corporate interest.¹¹ A question that remains unanswered is why governance issues prompted by directors' disregard of their corporate duties are still being witnessed in large numbers despite the supervisory and oversight structures that have been put in place to ensure good governance of corporations in Kenya?

The Companies Act provides that the business of the company shall be managed by the directors.¹² Hence, the board of directors holds a core position in every corporation as it is charged with the responsibility of management and governance of the organization. It is therefore imperative that the legal and regulatory framework should clarify the board's duties and obligations in the governance of corporations with certainty and precision. Accordingly, this research study inquires into the sufficiency of the regulatory framework governing directors in Kenya and proposes amendments to the Companies Act to enhance good corporate governance in Kenya.

Noteworthy, in Kenya, directors' duties of care, skill and diligence and fiduciary duties are governed by common law as pronounced in the 1925 decision in *Re City Equitable Fire Insurance Company Ltd*.¹³ This position has not changed since then despite the inherent problems of common law and the evident changes resulting from globalization and international economic trends such as the rise corporate governance. Thus, this research study asserts that legal reform is long overdue and it is necessary to codify duties of directors in statute to ensure a competitive business environment and conform to changing business trends in corporate governance. The

¹¹ The state corporations that have been discussion of poor corporate governance include the National Health Insurance Fund (NHIF), National Housing Corporation (NHC) and Kenya Meat Commission (KMC). Public listed companies have not been left out and they include East Africa Portland Cement Company Ltd (EAPCC) and Cooper Motors Corporation (CMC). Tuskys Supermarket which is a private company is reported to be experiencing corporate governance issues.

¹² Article 80 of Table A.

¹³ *Re City Equitable Fire Insurance Company Ltd* [1925] Ch 407.

case of National Bank of Kenya which is a company incorporated under the Companies Act will be explored and a comparative analysis with best practice in other jurisdictions, to wit South Africa and United Kingdom will also be considered in an attempt to argue for reform of the current law to codify directors' duties in statute.

1.1 Background to the problem

There have been global attempts to reform corporate law due to the numerous corporate scandals that have been experienced globally and corporate governance has been widely flaunted as a cure to these corporate failures. In corporate governance, company directors are key participants and directors' duties are generally seen as an important corporate governance mechanism.¹⁴

The Cadbury Report defines Corporate Governance as the system by which companies are directed and controlled.¹⁵ The report further acknowledges that the boards of directors are responsible for the governance of their companies.¹⁶ According to Jayashree, corporate governance is concerned with establishing a system whereby directors are entrusted with responsibilities and duties in relation to the direction of a company's affairs.¹⁷

Kenya has in the past witnessed numerous collapses of banks, insurance companies, state corporations and stockbrokers and those companies that have not gone under have been put

¹⁴ Chief Justice David Malcolm, 'Corporate Governance and the Duties of Company Directors' in Ian Ramsay (ed), *Corporate Governance and Duties of Company Directors* (Centre for Corporate Law and Securities Regulation, The University of Melbourne, Melbourne Law School 1997) 60 <http://papers.ssrn.com/sol3/papers.cfm?ab12stract_id=924312> accessed 17 July 2013. Many corporation scandals like Enron (2001), Worldcom (2001), Polly Peck (1990) Barrings Bank (1995), New York Stock Exchange led to the rise of corporate governance due to the far reaching effects on the national and global economy.

¹⁵ Committee on the Financial Aspects of Corporate Governance, *Report of the Committee on the Financial Aspects of Corporate Governance* (London: Gee & Co 1992) <<http://www.ecgi.org/codes/documents/cadbury.pdf>> accessed 1 July 2013.

¹⁶ *Ibid.*

¹⁷ Sadri Jayashree, 'Some Views on Corporate Governance' (Indira Management Review 2006) <http://www.indianmba.com/Faculty_Column/FC282/fc282.html> accessed 15 September 2013.

under statutory management due to mismanagement and poor corporate governance.¹⁸ Several authors have cited non-facilitative, non-prescriptive and weak governance laws as the reason behind these corporate failures.¹⁹ The researcher concurs with these authors and further faults the poor enforcement mechanism occasioned by the underlying weak legal and regulatory framework governing the conduct of directors as the cause of corporate failures in Kenya.

Generally, the legal framework regulating corporate governance and directors' duties in Kenya is the Constitution of Kenya,²⁰ Companies Act,²¹ State Corporations Act,²² Capital Markets Act,²³ common law,²⁴ and Corporate Governance Codes. Other Acts of Parliament and subsidiary legislation have also been instrumental in reining in directors for instance the Banking Act,²⁵ the

¹⁸ Examples include Kenya National Insurance Company, Kenya Creameries Commission (KCC), Uchumi supermarket, Invesco Insurance Company, Blueshield Insurance, United Insurance Company, Discount Securities Limited, NgenyeKariuki Stockbrokers.

¹⁹KiarieMwaura, 'Company Directors' Duty of Skill And Care: A Need For Reform' (2003) 24 (9) Company Lawyer 283; Lois M Musikali, 'The Law Affecting Corporate Governance in Kenya: A Need for Review' (2008) 19 (7) International Company and Commercial Law Review 213; Jacob K Gakeri, 'Enhancing Securities Markets in Sub-Saharan Africa: An Overview of the Legal and Institutional Arrangements in Kenya' (2011) 1 (9) International Journal of Humanities and Social Science 134 <<http://ir.library.strathmore.edu/fileDownloadForInstitutionalItem.action?itemId=373&itemFileId=327>> accessed 1 September 2013; KuriaNjiru, 'Investor Protection and the Capital Markets (Corporate Governance) (Market Intermediaries) Regulations 2011: A Critique' (LL.M Thesis, University of Nairobi, November 2012) <http://erepository.uonbi.ac.ke/bitstream/handle/123456789/9393/Kuria%20Njiru%20-%20Investor%20protection%20%26%20the%20capital%20markets_LLM%20Thesis.pdf?sequence=1> accessed 31 August 2013.

²⁰ The Constitution of Kenya 2010 was promulgated on 28August 2010 and it repealed the 1963 Constitution.

²¹*Supran* 1. The Companies Act is the main Act that governs the incorporation, regulation and winding up of private and public companies and other associations in Kenya.

²² Cap 446 Laws of Kenya. The State Corporations Act is the main Act that establishes and regulates parastatals in Kenya.

²³Cap 485A Laws of Kenya. The Act establishes the Capital Markets Authority which is the regulatory body for Capital Markets in Kenya.

²⁴ Common law is recognized as a source of law in Kenya under S 3 (1) c of the Judicature Act Cap 8 Laws of Kenya.

²⁵ Cap 488 Laws of Kenya. S 9A provides that an elected or appointed director or senior manager of an institution cannot act such unless he has been certified by the Central Bank as a fit and proper person to manage or control the institution.

Central Bank of Kenya Prudential Guidelines 2013,²⁶ and the Retirement Benefits Act,²⁷ to name but a few.

The State Corporations Act was enacted in 1986 to streamline state corporations and provide for their establishment, control and regulation.²⁸ The State Corporations Act does not state the duties of the board of directors but subjects them to the directives and circulars issued by the President, Minister, Principal Secretary and Treasury.²⁹ Most state corporations however, have individual statutes regulating the management and conduct of the affairs of the corporation and the provisions of these individual statutes take precedence over the State Corporations Act.³⁰ Some state corporations have also been exempted from the operation of the State Corporations Act.³¹

The Capital Markets Act, on the other hand, mainly regulates public listed companies and was enacted and revised in 2002 to primarily establish the Capital Markets Authority (CMA) which is the oversight authority for securities in Kenya. The CMA has developed corporate governance guidelines for listed companies in Kenya for purposes of promoting investor confidence in Kenya.³² All public listed companies must comply with these guidelines as a pre-requisite to trading in the Nairobi Stock Exchange.

²⁶ The guidelines have provisions for corporate governance to be adhered to by institutions licenced under the Banking Act.

²⁷ Act No. 3 of 1997. S 4 of the Schedule to the Act requires all board members to disclose any direct or indirect interest they may have in a contract.

²⁸ *Supra* n 23.

²⁹ See S 5, 6 and 7 of the State Corporations Act. Under S 7 of the State Corporations Act, the President has power to issue directions to the Board which must be effected by the Board.

³⁰ *J Wambugu & 8 Others v Kenya Railways Corporation* [2005] eKLR.

³¹ Such corporations include the Kenya Commercial Bank, National Bank of Kenya and Kenya Re-Insurance Corporation which were exempted from the operations of the State Corporations Act vide Legal Notice No 59 of 25 February 1987. S 2 of the State Corporations Act also excludes local authorities, co-operative societies, building societies, the Central Bank of Kenya, banks and financial institutions registered under the respective Acts, companies registered under the Companies Act and subsidiaries of state corporations.

³² The Capital Markets Authority Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya were issued vide Gazette Notice No 3362 and were developed by the Capital Markets Authority primarily for public listed companies in Kenya <<https://www.nse.co.ke/regulatory-framework/category/27-capital-markets-authority-cma.html?download=475%3Acorporate-governance-guidelines-2002>> accessed 20 July 2013.

The Kenya Companies Act was adopted in 1963 with little amendments to date and Kenya has been in the process of reforming the Act, which is based on England's Companies Act of 1948.³³ The United Kingdom reformed its 1948 Companies Act in 2006 having amended the 1948 Act in 1967, 1980, 1981, 1983 and 1985.³⁴ The Companies Act contains several statutory duties owed by directors and they include duty to keep proper books of accounts,³⁵ duty to register charges created by the company with the registrar,³⁶ duty to disclosure directors' shareholding, salaries and loans³⁷ and duty to disclose any interest in contracts.³⁸ However, enforcement of these duties is weak due to limited capacity in the Office of the Registrar of Companies, limitations in the provisions of the Act and general legal principles that impede responsible behavior of directors.

Another major lacuna in the Companies Act which is the thrust of this research is that the Act does not codify the directors' duties of care, skill and diligence and fiduciary duties and the same is regulated by common law as stated in the English landmark case of *Re City Equitable Fire Insurance Company*.³⁹ Accordingly, these common law duties are uncodified and generally inaccessible to an ordinary company director and thus inadequate to regulate directors' behavior not to mention the inherent problems presented by common law.

³³The Companies Bill which is dated 21st March 2014 was introduced in Parliament by the Honourable Attorney General <<http://kenyalaw.org/kl/fileadmin/pdfdownloads/bills/CompaniesBill2014.pdf>> accessed 1 October 2014.

³⁴RtHon Lady Justice Arden, 'Companies Act 2006 (UK): A New Approach To Directors' Duties' (2007) 81 ALJ 162 <<http://www.hrlrc.org.au/files/lawrep-081-alj-jl-0162.pdf>> accessed 1 August 2013.

³⁵S 147.

³⁶S 97.

³⁷S 196-198.

³⁸S 200.

³⁹Common law duties of directors are the duty of care, skill and diligence and fiduciary duties. The standard of care and skill was laid down by Romer J in the landmark case of *Re City Equitable Fire Insurance Company* [1925] Ch 407, where three principles were formulated. Firstly, a director need not exhibit in performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. Secondly, a director is not bound to give continuous attention to the affairs of the company and thirdly, in respect of all duties that may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly. Rix L.J in *Foster Bryant Surveying v Bryant* [2007] 2 BCLC 239 held that a director, while acting as such, has a fiduciary relationship with his company. That is he has an obligation to deal towards it with loyalty, good faith and avoidance of the conflict of duty and self-interest.

It is in light of the foregoing statutory lacuna, that the Companies Bill was introduced in an effort to resolve these inherent gaps and develop a modern Companies law that supports a competitive economy, while taking into account the current globalization trends and regional integration. The Companies Bill proposes codification of the common law duties of directors with an expectation of raising standards in the governance of both public and private companies. The duties proposed include the duty to act within powers, duty to promote the success of the company, duty to exercise independent judgment, duty to exercise reasonable care, skill and diligence, duty to avoid conflicts of interest, duty not to accept benefits from third parties and duty to declare interest in existing transaction or arrangement. These proposals are perceived as answers to the governance challenges aforementioned of directors' conflicts of interest, lack of honesty in management, corruption, lack of independence and abuse of power. The UK Companies Act, 2006 also has a statutory statement on the duties of directors, previously founded on common law.⁴⁰

Several corporate governance codes have also been developed in various jurisdictions with an aim of improving standards in performance and management of public and private companies. Regional blocks have also come together to raise corporate governance standards among their members.⁴¹ Atieno observes that the numerous corporate scandals led to the development of guiding corporate governance principles in countries and supranational organizations such as the

⁴⁰Part 10.

⁴¹ For instance, the Global Corporate Governance Forum was established by the World Bank Group in conjunction with the Organization for Economic Co-operation and Development (OECD). Others include the Commonwealth Association for Corporate Governance (CACG) and the Regional Centre of Excellence in Corporate Governance which is a liaison of the East African countries.

Organization for Economic Co-operation and Development (OECD).⁴² Such forums have been instrumental in assisting countries develop their own codes of good corporate governance. For instance, the CMA guidelines were largely influenced by several committees, taskforces and jurisdictions such as United Kingdom, Malaysia, South Africa, OECD and the Commonwealth Association for Corporate Governance (CACG).⁴³

The Private Sector Corporate Governance Trust (PSCGT) developed Principles for Corporate Governance in Kenya and a sample code of best practice whose principles are aimed primarily at the board of directors of a corporation.⁴⁴ The code provides that the board shall exercise all the powers of the company subject to the limitations contained in the law and the memorandum and articles of association. The code further outlines responsibilities of the company board and provides that every corporation should be headed by an effective board, acting in the best interest of the enterprise in a manner based on transparency, accountability and responsibility.⁴⁵ In addition, it recognizes that the functions of the board are to exercise leadership, integrity and sound judgment in directing the corporation, determining the company's purpose, values and strategy, implement policies and sound internal control systems, risk management, ensure corporate compliance and effective communication with stakeholders.

⁴² Yvonne AwourAtieno, 'Corporate Governance Problems Facing Kenyan Parastatals: A Case Study of the Sugar Industry'(MLB Thesis, Bucerius/WHU July 2009) <<http://www.gbv.de/dms/buls/631006060.pdf>> accessed 1 August 2013.

⁴³*Supra* n 33.

⁴⁴Private Sector Initiative for Corporate Governance, *Principles for Corporate Governance in Kenya and a Sample Code of Best Practices for Corporate Governance* (Centre for Corporate Governance Kenya, 1999).

⁴⁵*Ibid.*

In 2002, the PSGCT also developed Guidelines for Good Corporate Governance in State Owned Corporations (SOCs) ⁴⁶ in recognition of the role of state corporations in national development and sustainable development. The Guidelines define SOC as those corporate bodies in which the Government of Kenya holds more than fifty percent (50%) share capital or which are controlled by and report to the state. The Guidelines recognize that good corporate governance practice is based upon the principles of accountability, efficiency, effectiveness, integrity, responsibility, transparency and inclusiveness of all stakeholders. They acknowledge that the board is responsible for good governance of the corporation and that the board of directors should promote the foregoing principles for efficiency and productivity.

The Guidelines provide that the role of the board is to ensure that the corporation is governed and managed in accordance to the mandate granted to it by the shareholders and the society. Further, that every corporation should be headed by an effective board exercising leadership, integrity and independent judgment while acting in the best interest of the corporation in a transparent, accountable and responsible manner. The board is also tasked with the responsibility of determining, approving and reviewing the corporation's strategy, purpose and values, appoint senior management and provide oversight and guidance to them, ensure effective control systems, ensure effective communication with stakeholders and to ensure statutory and legal compliance.

However, it is imperative to note that the provisions of the Corporate Governance Code and the Guidelines for SOC are neither mandatory nor binding upon corporations but only enabling. Accordingly, this study proposes amendments to the existing corporate governance regulatory

⁴⁶ Private Sector Corporate Governance Trust, *Guidelines for Good Corporate Governance in State Owned Corporations* (Oakland Media Services Ltd 2002) 1.

framework to incorporate provisions of the codes in mandatory terms in order to facilitate good performance and accountability of company directors in the discharge of their duties. In so doing, this research study employs the National Bank of Kenya (NBK) as the case study to demonstrate that poor corporate governance practice can be remedied by reviewing the law regulating the conduct of company directors in Kenya.⁴⁷

The Government of Kenya established commercial banks after independence because of the perception that the existing foreign owned banks were failing to serve credit needs of African businesses.⁴⁸ Consequently, NBK was established in 1968 with the main objective of facilitating the financing of African businesses and the transfer of productive assets to Africa.⁴⁹ NBK has been in existence since then but it began experiencing liquidity problems in the 1980s and 1990s. This was mainly due to mismanagement and government interference in the governance of the bank.

For instance, the bank lent heavily to the public sector and politically connected borrowers whose loan repayment record was poor, with adverse consequences for its profitability and the quality of its asset portfolio.⁵⁰ The directors also gave loans to politicians without satisfying themselves of their creditworthiness and more often the loans were left unpaid forcing the bank to write them off.⁵¹ The government would also guarantee loans to parastatals and these loans went unpaid too. As at 1998 the bank had accumulated losses of Kshs. 26billion and was facing

⁴⁷ The National Bank of Kenya is incorporated under the Companies Act Cap 486 Laws of Kenya and it is a major player in Kenya's banking industry.

⁴⁸ Martin Brownbridge and Charles Harvey, *Banking in Africa: The Impact of Financial Sector Reform Since Independence* (Africa World Press 1998) 84.

⁴⁹ *Ibid.*

⁵⁰ *Ibid.*

⁵¹ *Ibid.*

ruin.⁵² As a result, NBK was nearing closure until the National Social Security Fund (NSSF) and the Kenyan government who were the biggest shareholders in the Bank injected billions into the bank to raise it.⁵³

It is probable that the NBK board (and many other boards) is not purely to blame considering the mode of appointment of the board members and the numerous overlapping regulations that leave directors confused as to what their duties are, the purpose of their duties and to whom they are owed.⁵⁴ In addition, many company boards have consisted mainly of family members, associates, social club members and political allies and little or no regard is given to their qualifications and competencies.⁵⁵ The lack of clear, concise and accessible guidelines on their duties as company directors does not salvage the situation either.

It is against this backdrop that this thesis advances a case for codification of directors' duties in the Companies Act to facilitate clarity, accessibility and certainty with commensurate penalties for breach as the solution for promoting good corporate governance practice in Kenya.

1.2 Statement of the Problem

Currently, directors' duties in Kenya are based on English common law as pronounced in the 1925 decision of *Re City Equitable Fire Insurance Co Ltd*.⁵⁶ Common law is generally uncodified and largely inaccessible and directors in Kenya have to search through a web of case law to understand their duties of care, skill and diligence and fiduciary duties. Further, the

⁵² See James Mbugua, 'Kenya: Marambii's Last Stand-Avoid Spin and Say It Like It Is' *The Star* (Nairobi, 22 June 2013).

⁵³ See BD Reporter, 'National Bank Unveils First Rights Issue Plan' *Business Daily* (Nairobi, 13 May 2013)

⁵⁴ Government interference in the management of NBK is widely cited as one of the major reasons for its financial problems. For instance, under S 7 of the State Corporations Act, the President has power to issue directions to the Board which must be effected by the Board.

⁵⁵ Mwaura Kimani, 'Most Family Firms Ignore Corporate Governance-And It Matters' *Business Daily* (Nairobi, 20 March 2006).

⁵⁶ *Supra* n 14.

limitations of common law cannot be overlooked. Common law is inherently subjective as it is influenced by an adversarial system, judges' attitudes, beliefs, biases, backgrounds and circumstances of each case.⁵⁷ Common law is also persuasive rather than mandatory and largely inflexible due to the staredecisis principle and therefore undesirable in regulating directors' conduct in these present times and this may in effect compromise good corporate governance in Kenya.

Since 1925 when the law on directors' duties of care, skill and diligence and fiduciary duties was stated, a lot has significantly changed. Globalization and international competition has seen an influx in the number of local and transnational corporations. Expectations have also shifted from the original pro-shareholder to pro-stakeholder.⁵⁸ Nevertheless, the law in Kenya has remained unchanged and unwavering and therein lies the problem that is the reason for the continued corporate failures.

In a move to correct this deficiency, the Private Sector Corporate Governance Trust (PSCGT) in Kenya introduced self-regulatory codes of conduct to regulate company directors and promote good corporate governance practice in Kenyan companies. The Principles of Corporate Governance in Kenya as well as the Guidelines for Good Corporate Governance in State Owned Corporations prescribe duties of the board of directors and enumerate various principles which

⁵⁷ See generally Edward Levi, 'The Judicial Drama' in MDA Freeman, *Lloyd's Introduction to Jurisprudence* (7thedn, London: Sweet & Maxwell Ltd 2001) 980.

⁵⁸ See generally Paddy Ireland, 'Company Law and the Myth of Shareholder Ownership' (January 1999) 62 *The Modern Law Review* 32, 56. Ireland states that at present our company law lacks the conceptual tools to reflect our new perception of the [public] company as no longer a shareholders' collective, but an enterprise in which the interests of many stakeholders have to be balanced; See also Paddy Ireland, 'Corporate Governance, Stakeholding, and the Company: Towards a Less Degenerate Capitalism' (September 1999) 23 (3) *Journal of Law and Society* 287. Ireland posits that changes in business culture and company law could and should be made to ensure that in their decision making and policy formulation companies take into account interests of not only shareholders but also other stakeholders.

the board should focus on in discharge of their duties.⁵⁹ However, these codes of conduct are only prescriptive and non-mandatory and regrettably their provisions have not been recognized under any statute and specifically the Companies Act which regulates the management and governance of public and private companies in Kenya.

Consequently, the implementation of directors' duties remains idealistic and illusionary thus compromising accountability to shareholders and other stakeholders. Indeed, the absence of codified statutory duties of care and skill and fiduciary duties connotes that there are no commensurate penalties for breach prescribed in statute and this evidently prompts malfeasance by company directors. More so, the penalties prescribed under the Companies Act for directors' breach of duty are very low. For example, the Act provides that a director who fails to disclose any interests he has in contracts made with the company shall be liable to a fine not exceeding Kenya Shillings Two Thousand.⁶⁰ This low penalty is clearly not deterrent for rogue directors as it does not take into account the benefit derived by the concerned director from such a contract.

Further, the Companies Act does not impose minimum qualifications for the holder of the office of a director. It also provides that the acts of a director or manager shall be valid notwithstanding any defect that may afterwards be discovered in his qualification.⁶¹ This means that quacks can be actively involved in management and decision making of a corporation and still be protected by the law.

⁵⁹ These principles of good corporate governance are transparency, accountability, integrity, responsibility, efficiency and effectiveness.

⁶⁰*Supra* n 39.

⁶¹S 181.

Also, the most fundamental concept of company law is the corporate personality principle which was first enunciated in the case of *Salomon v Salomon & Co Ltd*.⁶² This corporate personality principle absolves directors from personal liability for torts or breach of contract. Whereas the principle is here to stay as it has brought business advantages that could not have been achieved in its absence, directors have hid behind the corporate veil to mismanage company assets. The courts have introduced the concept of lifting the veil of incorporation but the circumstances under which the same is applied are sometimes unclear and the absence of precise statutory rules does not help the situation. Further, in the case of fraud, the standard of proof is very high as fraud must be proved beyond reasonable doubt thus making it even harder to hold the culprit liable at law.⁶³ There is therefore an urgent need to reform the law to provide for circumstances where a company director can be held personally liable for breach of duty. This can definitely be achieved through statutory codification of directors' duties as well as prescribing hefty and deterrent sanctions.

In addition, where powers are vested in the board of directors, the courts have held that shareholders cannot interfere with directors' management of company affairs unless they are acting contrary to the provisions of the Companies Act or the company's articles of association.⁶⁴ Moreover, directors' duties are owed to the company and in case of any breach, the proper plaintiff is the company and not even a shareholder can bring an action against miscreant director

⁶²*Salomon v Salomon & Co Ltd* [1897] AC 22. Interpreting the Companies Act of 1862, the House of Lords stated that the company had been properly formed and as such should be treated as a completely separate entity from the owner. Lord MacNaughten argued that 'the company is at law a different person altogether from the subscribers to the memorandum and it has rights and duties in law'.

⁶³ See Kiarie Mwaura, 'Internalization of Costs to Corporate Groups: Part-Whole Relationships, Human Rights Norms and the Futility of the Corporate Veil' (2012) 11 *Journal of International Business and Law* 16 <<https://litigation-essentials.lexisnexis.com/webcd/app?action=DocumentDisplay&crawlid=1&doctype=cite&docid=11+J.+Int'l+Bus.+%26+L.+85&srctype=smi&srcid=3B15&key=28ae638bc2e10420e92147eb6f835dae>> accessed 1 July 2013. See also LCB Gower, *Principles of Modern Company Law* (5th edn, London: Sweet & Maxwell 1992).

⁶⁴*East African Safari Air Limited v Anthony AmbakaKegode & Another* [2006] eKLR.

except in some circumstances.⁶⁵ Even so, the relief sought should be for the benefit of the company and this discourages individual shareholders from instituting legal proceedings as the relief granted will be for the benefit of the company which includes such miscreant directors.⁶⁶

This is the deficiency in the law that this research study anticipates to have cured by proposing statutory codification of directors' duties to facilitate clarity, consistency, certainty and enforcement of the same thus restoring sobriety in the governance of corporations in Kenya. The case study of this research is National Bank of Kenya (NBK) where mismanagement and political interference resulting from lack of clear statutory guidelines on responsibilities of directors to the company led to the near closure of the bank, thus demonstrating an urgent need for codification of their duties in statute to avert future corporate failures.

Other spilling effects of corporate scandals include loss of public confidence in the management of companies, loss of investor confidence, poor corporate image as well as loss of taxpayers' money.⁶⁷ Codification of directors' duties in statute is therefore expected to impact positively on governance of companies in Kenya as this research will demonstrate, thus promoting investor confidence, global competitiveness and competency in management of public and private companies.

⁶⁵*Foss v Harbottle* [1843] 2 Hare 461. The Kenyan Courts have upheld this position in the case of *Affordable Homes Africa Ltd v Henderson & 2 others* [2004] 2 KLR 473.

⁶⁶*Dadani v Manji & 3 others* [2004] 1 KLR 95.

⁶⁷ These effects are demonstrated in recent cases such as CMC where the CMA as the regulatory and supervisory authority had to step in and suspend the trading of CMC shares in the stock exchange in order to conduct investigations relating to alleged fraud and improper procurement procedures by the company directors. See BD Reporter 'Bill Lay Exits CMC as Warring Owners Call for Ceasefire' *Business Daily* (Nairobi, 7 February 2013) 3. In public corporations such as Kenya Meat Commission (KMC), the government has been forced over the years to use taxpayers' money to revitalize the parastatal. See article by Mathias Ringa 'Kenya Meat Commission in Crisis over Sh300m Debt' *Daily Nation* (Kenya, 19 September 2013). Also, misappropriation of funds by directors of the National Social Security Fund (NSSF) has been the subject of discussion in many forums recently. See article by Thomas Kariuki 'Court Summons Former NSSF Boss in Sh1.6bn Fraud Case' *Daily Nation* (Kenya, 12 September 2013).

1.3 Justification of the study

Currently, directors' duties in Kenya are based on common law, meaning that they have been developed by English common law which is a synthesis of general judicial principles. Common law in Kenya is recognized as a source of law under the Judicature Act⁶⁸ and Kenya being a former British protectorate is to apply common law and the doctrines of equity applicable in England as at 12th August 1897.

However, common law is complementary to the written law and it is to be applied to fill up what is not provided for in the written laws in conformity with the aims of the Constitution. Further, common law is applicable in Kenya in certain circumstances only and Courts should exercise jurisdiction in the order set out in Section 3(1) of the Judicature Act which ranks statute law higher than common law.⁶⁹ This evidences that statutory provisions take precedence over common law provisions and therefore codified directors' duties will no longer be persuasive but mandatory obligations.

In addition, the common law directors' duties of care, skill and diligence and fiduciary duties are capped in wide discretionary terms which implies that directors may not know what is expected of them since their duties are not concise, certain and codified in statute. This is because case law, being a product of various judicial interpretations, is susceptible to different analysis and inconsistencies depending on the circumstances of each case and thus prone to confuse directors who are meant to be guided by it. Codifying directors' duties in statute would therefore ensure directors' duties are certain, accessible and clear thus promoting the performance of directors in discharging their functions.

⁶⁸ Cap 8 Laws of Kenya.

⁶⁹*Ibid.* Proviso to S 3 (1) states that common law shall apply so far as the circumstances of Kenya and its inhabitants permit and subject to such qualifications as those circumstances may render necessary. This position was also emphasized by the Court in the famous S M Otieno case-*Otieno v Ougo & another* [1986-1989] EALR 469, 475.

Courts also generally have a hands-off and lax approach when adjudicating on company law matters that relate to the internal management of the company and they are always reluctant to interfere with the internal management of companies. For instance, the Court of Appeal at Nairobi in the case of *James Orina & another v Kenya Tea Development Agency & another*,⁷⁰ held that “courts are ill equipped to manage the affairs of companies especially where the dispute involves internal management and operations of a company which is administrative in nature”. Chief Justice David Malcolm,⁷¹ also notes that courts, in interpretation of duties owed by directors, are reluctant to interfere with internal management of the company and even so, they will take into account ‘commercial reality principle’ in so far as it reflects the reasonable participant’s expectations. It is therefore imperative that this research study argues a case for statutory codification of directors’ fiduciary duties as well as duties of skill to facilitate adjudication of company matters by courts especially in cases of breach of directors’ duties.

Additionally, as countries and economies of the world become more integrated and inter-dependent due to globalization and competition, high standards of conducting business are increasingly demanding responsibility from company directors.⁷² Society is more presently concerned with the governance of corporations than before and has also increased its expectations of directors and this is demonstrated by the recent legislation that has been enacted in Kenya, and more so the new Constitution, labour laws and environmental laws. Companies provide essential services to the society, pay taxes to government, provide employment to locals and partner with communities in development projects. This interdependence between the

⁷⁰*James Orina & another v Kenya Tea Development Agency & another* Civil Appeal Civil Application No NAI 222 of 2004 (Nairobi) (unreported).

⁷¹*Supra* n 15.

⁷² See Mwaura n 20.

society and businesses demands that companies be accountable to society as their activities impact on the society and environment generally.⁷³

Further, while directors initially owed a fiduciary duty or one of care to the company itself only, the situation has now changed and directors can be held liable for losses occasioned to third parties. For instance, the Environmental Management and Co-ordination Act (EMCA)⁷⁴ requires companies to conduct continuous environmental assessment impacts of the corporation's industrial actions and educate the public on the same in line with the constitutional right to information, inclusiveness and public participation. Also, the Constitution of Kenya, 2010 provides that the Bill of Rights applies to all and binds all State organs and all persons.⁷⁵ The Constitution further interprets a "person" to include 'a company, association or other body of persons whether incorporated or unincorporated'.⁷⁶ Lady Justice Arden posits that the company is an ingenious institution for the creation of wealth, but views on how wealth should be created has changed over time since its inception.⁷⁷ In view of these developments, codification of directors' duties is likely to impact on the quality of corporate decisions by directors with over-spilling benefits to the rest of society.

Furthermore, developed and developing countries and organizations such as the Organization for Economic Co-operation and Development (OECD)⁷⁸ and the New Partnership for Africa's

⁷³ See generally LisioloLishenga and AcquillyneMbaka, 'The Link Between Compliance with Corporate Governance Disclosure Code, and Firm Performance for Kenyan Firms' (*University of Nairobi*, 2012) 3 <<http://erepository.uonbi.ac.ke/bitstream/handle/123456789/10160/aibuma%202012-submission%20216.pdf?sequence=1>> accessed 1September 2014.

⁷⁴Environmental Management and Co-ordination Act No. 8 of 1999 Laws of Kenya, S 58 and 59.

⁷⁵Article 20 (1).

⁷⁶Article 260.

⁷⁷*Supra* n 35.

⁷⁸The OECD developed non-binding principles of corporate governance for member countries which focus mainly on publicly-traded companies. However privately held companies and state enterprises are encouraged to adopt the principles so-far-as they are applicable. See Organisation for Economic Co-operation and Development, *OECD Principles of Corporate Governance* (OECD France 2004) 11 <www.oecd.org> accessed 1 August 2013.

Development (NEPAD)⁷⁹ are increasingly becoming more concerned with the level of competence of directors. Private sector organizations in several countries have also established the Institute of Directors (IOD) to promote good corporate governance.⁸⁰ The Institute of Directors Kenya for instance, provides continuous training to actual and potential directors with an aim of raising the level of knowledge and skills for directors and inculcating the highest level of ethics.⁸¹

The duties of directors have also evolved from the traditional common law duties to corporate responsibility to stakeholders.⁸² The corporate social responsibility (CSR) debate has been raging on for years with critics claiming that CSR conflicts with the organizational goal of maximizing shareholders' wealth.⁸³ Shareholders have a legitimate expectation of returns in terms of profits and dividends but on the other hand, stakeholders' interests cannot be ignored in the modern business world. Companies are now expected to have regard to other stakeholders' interests in the conduct of their businesses and they are required under local and international legal instruments to have concern for the environment,⁸⁴ human rights,⁸⁵ responsible advertising and marketing,⁸⁶ fair trade practices⁸⁷ and fair employment policies.⁸⁸ It is therefore important to

⁷⁹ NEPAD is an African initiative to promote Africa's development and regional integration to address challenges facing the continent. A key focus of NEPAD is economic and corporate governance which is implemented through the African Peer Review Mechanism (APRM). The APRM, in which Kenya is a participating country, promotes and enforces high standards of governance by ensuring that the policies and practices of participating countries conform to agreed values such as corporate governance. See <www.nepad.org> accessed 1 August 2013.

⁸⁰ The Institute of Directors exists in several countries such as South Africa (IoDSA), United Kingdom, New Zealand, Australia (AICD) and Singapore.

⁸¹ See <<http://iodkenya.co.ke/training.php>> accessed 19 July 2013.

⁸² For instance, NEMA requires companies to conduct environmental assessment impacts. Financial institutions have also resorted to environmental protection to attract international funding, See MuthokiMumo, 'Banks Won't Fund Projects Harmful to Environment' *Sunday Nation* (Kenya, 15 September 2013).

⁸³ Anant K Sundaram& and Andrew C Inkpen, 'The Corporate Objective Revisited' (2004) 15 (3) *Organization Science* 350.

⁸⁴ *Supra* n 75.

⁸⁵ Universal Declaration of Human Rights 1948.

⁸⁶ Consumer Protection Act No 46 of 2012 Laws of Kenya.

⁸⁷ Competition Act No 12 of 2010 Laws of Kenya.

⁸⁸ Employment Act 2007 Laws of Kenya.

codify directors' duties so as to guide directors clearly and precisely in decision making to ensure a balance and avoid conflicts in shareholders and stakeholders interests.

The UK Steering Committee for Review of the Companies Act⁸⁹ in its report observed that a codified statement of duties would generally enable defects in the present law to be corrected in important areas where it no longer corresponds to accepted norms of modern business practice. Consequently, reform of the Companies Act would therefore be used as a mechanism to address the aforesaid inadequacies and loopholes present in the corporate governance regulatory framework including deficiencies relating to the standard of duty and care expected of directors when assessing directors' liability for negligence.⁹⁰

It is in light of the foregoing that this research study argues a case for codification of directors' duties in statute with commensurate penalties for breach as this is expected to promote good corporate governance practices in Kenya and responsible actions by directors leading to fewer incidences of corporate failures and litigation.

1.4 Objectives of the study

The objectives of this study are:

1. To assess whether Kenya's corporate governance regulatory framework hinders good performance of directors in the management of companies in Kenya.

⁸⁹UK Department of Trade and Industry, *Company Law Review* (White Paper, March 2005) <<http://www.berr.gov.uk/files/file13958.pdf>> accessed 20 July 2013. One main recommendation of the UK Steering Committee was to improve corporate governance in a number of ways but principally by the codification of directors' duties.

⁹⁰*Supra* n 40. The test used is a subjective one as enumerated in the *Re City Equitable Fire Insurance Company*. This subjective approach has been thought to be too law and authors such as Mwaura have advocated for adoption of both a subjective and objective test. See KiarieMwaura, 'Company Directors' Duty of Skill And Care: A Need For Reform' (2003) 24 (9) *Company Lawyer* 283. Legal reform can therefore be used to correct this defect while taking into account the current business environment.

2. To assess how codification of directors' duties will be effective in enhancing good corporate governance practice in Kenya.
3. To evaluate the directors' duties to be introduced in the Companies Act to promote the performance of company directors in Kenya.
4. To interrogate the comparative lessons that Kenya can draw from the United Kingdom and South Africa.
5. To propose changes to the Companies Act to codify directors' duties and thus enhance good corporate governance practice in Kenya.

1.5 Research questions

The research questions are:

1. Does the current corporate governance regulatory framework regulating the conduct of company directors in Kenya inhibit good corporate governance practice in Kenya?
2. What is the importance of statutory codification of directors' duties in enhancing good corporate governance practice in Kenya?
3. To what extent will codification of directors' duties enhance good corporate governance practice in Kenya?
4. To what extent can Kenya draw comparative parallels from best practice in United Kingdom and South Africa?
5. What changes can be proposed to the Companies Act with regard to codification of directors' duties in order to enhance good corporate governance practice in Kenya?

1.6 Research Hypothesis

This research study will be premised on the following hypothesis:

1. The current corporate governance regulatory framework inhibits good performance of company directors in Kenya and thus good corporate governance practice.
2. It is important to codify directors' duties in statute to enhance good corporate governance practice in Kenya.
3. A statutory statement of directors' duties will promote the performance of company directors in Kenya and thus enhance good corporate governance practice in Kenya.
4. Kenya can draw incomparable lessons from best practice in United Kingdom and South Africa.

1.7 Theoretical Framework

Several theories underlie this research and the major theories to be discussed are the agency theory, law and economics theory and the stakeholder theory.

The agency theory was formulated by Berle and Means⁹¹ in 1932 and advanced by Jensen and Meckling⁹² in 1976. The latter define an agency relationship as a contract under which one or more persons engages another to perform some service on their behalf.⁹³ The proponents of this agency theory assert that the need for good corporate governance systems in corporations arises from the separation of ownership and control, where due to dispersed ownership and for

⁹¹ Adolf A Berle and Gardiner C Means, *The Modern Corporation and Private Property* (New York: Macmillan 1932).

⁹² Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 (4) *Journal of Financial Economics* 305. Jensen and Meckling understood the firm as a legal fiction which serves as a nexus of contracts for a set of contracting relationships among individuals.

⁹³ *Ibid.*

convenience purposes such as lack of expertise, differences in interests, goals and capabilities of individuals, the owners of corporations hire managers to run the corporation on their behalf.⁹⁴

Often, these managers to whom the corporation assets are entrusted are not the owners and it is expected that they will not run the company with the same zeal as they should. They may be tempted to engage in unfair self-dealing activities which in the long-run hurt the performance and viability of the company and therefore there exists a necessity to align their interests to those of shareholders. The shareholders accordingly consent to monitoring costs to limit the divergence of interest and they appoint directors as an internal mechanism to monitor managers' actions.⁹⁵ This forms the basis of corporate governance and the fiduciary duties of directors are also perceived as a form of an agency contract where shareholders are principals and directors are the agents.⁹⁶

The role of corporate law in this regard is to establish rights and duties among the various participants in corporate governance.⁹⁷ This study consequently aims at articulating the duties of directors vis-à-vis the rights of shareholders and other stakeholders thereby minimizing divergence in the agents' interests and corporate interests. The research further advocates for reform in legislation to codify these directors' duties in statute in order to promote certainty, clarity and accessibility and thus enhance good corporate governance in the country.

⁹⁴ See generally, Dr Catherine L Kutcha-Helbling and Dr John D Sullivan, 'Instituting Corporate Governance in Developing, Emerging, and Transitional Economies' in John D Sullivan et al (eds), *In Search of Good Directors: A Guide to Building Corporate Governance in the 21st Century* (The Centre for International Private Enterprise, Washington DC, 3rd Ed, 2003) 9
<http://hawkama.net/files/toolkit/content/corporategovernancebasics/In_Search_of_Good_Directors_CG_in_the_21st_Century_English.pdf#page=349> accessed 28 August 2013.

⁹⁵ *Supra* n 8.

⁹⁶ *Supra* n 95.

⁹⁷ Frank H Easterbrook and Daniel R Fischel, 'The Corporate Contract' (1989) 89 *Columbia Law Review* 1416, 1428.

Closely linked to the agency theory is the law and economics theory which influences approaches to antitrust law, tort law and commercial law. The proponents of the law and economics school are Guido Calabresi and A. Douglas Melamed,⁹⁸ Ronald Coase,⁹⁹ Richard A. Posner¹⁰⁰ and Easterbrook and Fischel¹⁰¹ who propounded the nexus of contracts theory.

The law and economic scholars propound that corporations and firms are not fictitious creatures of state law but rather they are complex sets of implicit and explicit contracts and corporate law is only an enabling framework for the various participants in that contract.¹⁰² Various contracts exist between the corporation and its shareholders, directors, managers, employees, suppliers, financiers, government, society and customers. All these participants are stakeholders and have an interest in how the corporation is governed. A stakeholder is defined as any group or individual who can affect or is affected by the achievement of the organization's objective.¹⁰³

The economic theory views individuals as rational maximizers of their own interests. Various participants have varied interests and the contract defines each participant's rights, duties, benefits and obligations. Directors are therefore required to balance the various interests while acting in the best interest of the company without unnecessarily compromising shareholders'

⁹⁸ They articulated the concept of 'entitlements' which are protected by property, liability and inalienability rules. See George C Christie and Patrick H Martin, *Jurisprudence Text and Readings on the Philosophy of Law* (2nded, West Publishing Co 1995) 1150.

⁹⁹ Ronald Coase propounded the transaction or social costs theory of the firm in his seminal published in 1937 *The Nature of the Firm*. His article established a framework for analyzing the assignment of property and liability in economic terms.

¹⁰⁰ Judge Richard A Posner was of the view that economic analysis is a valuable tool for understanding, interpreting and creating law. According to him, law seeks to maximize the economic well-being of citizens. See Brian Bix, *Jurisprudence: Theory and Context* (Carolina Academic Press Durham 1999) 189.

¹⁰¹ Jonathan R Macey, 'Fiduciary Duties as Residual Claims: Obligations To Non-shareholder Constituents from a Theory of the Firm Perspective' (1999) 84 *Cornell Law Review* 1266.

¹⁰² *Ibid.*

¹⁰³ R Edward Freeman, *Strategic Management: A Stakeholder Approach* (Pitman Publishing 1984) 46.

value.¹⁰⁴ Fiduciary duties of directors are therefore default mechanisms for allocating property rights between shareholders and other stakeholders.¹⁰⁵

An important issue for law and economic theorists is whether directors' duties should be mandatory or optional. Those who advocate for optional enforcement are of the view that corporate law should be enabling rather than mandatory as it will enable different participants to meet their optimal expectations.¹⁰⁶ In any case, a corporation is a nexus of contracts and the different players are allowed to craft their rules of engagement. Further, the market for corporate control will force corporations to act in a manner that is pleasant to majority of stakeholders else the corporation will lose out on market control resulting in the fall in share price and low returns to shareholders.

However, the mandatory rules arm posits that the law should provide a minimum optimal standard that is applicable to most organizations and individual corporations would be allowed to opt out of mandatory rules by adopting their own charters.¹⁰⁷ This is the point towards which this study is aimed, that corporate law should prescribe minimum standards for compliance and it will be upon the individual companies to opt out by prescribing its own rules in the articles of association of the company. This mandatory approach aims at protecting vulnerable stakeholders who may have no recourse after the company is insolvent. It further ensures that companies adhere to good corporate governance for existence of efficient markets which is essential for a thriving economy and competitive business environment.

¹⁰⁴ *Supra* n 102.

¹⁰⁵ *Ibid.*

¹⁰⁶ See Stephen G Marks, 'The Separation of Ownership and Control' in Boudewijn Bouckaert and Gerrit De Geest (eds), *Encyclopedia of Law and Economics* (Edward Elgar Publishing 1999) 692 <<http://www.encyclo.findlaw.com/5630book.pdf>> accessed 13 July 2013.

¹⁰⁷ *Ibid.*

The third theory that is central to this discussion is the stakeholder theory which became prominent in 1930 through publication of Professor E. Merrick Dodd's article: For Whom Are Corporate Managers Trustees?¹⁰⁸ The theory has changed throughout the corporate history and continues to evolve. For instance, the development of the theory in its organized form is normally traced to R. Edward Freeman and his influential book, *Strategic Management: A Stakeholder Approach*, published in 1984.¹⁰⁹

A stakeholder is defined as any person or group of persons who contribute towards a corporation's objectives and who are affected by the way a corporation is managed or run.¹¹⁰ Stakeholders are of three categories; those who have ownership, those who have a right or claim on the corporation and those who assert an interest in the outcome of the corporation's business.¹¹¹ Stakeholders include employees, customers, suppliers, financiers, creditors, government, environment and the general public or society. Shareholders are also regarded as stakeholders as they have a right or claim in the outcome of the corporation's activities.¹¹²

Keay asserts that the theoretical framework for corporate law underpins corporate governance and dictates the kind of corporate governance system that exists.¹¹³ The stakeholder theory seeks to explain the purpose of the firm and what the responsibility of the corporation's management is towards various stakeholders. Proponents of the theory therefore advocate that stakeholders should be treated as ends in themselves and not as a means to an end as they are inherently

¹⁰⁸ E Merrick Dodd, Jr, 'For Whom Are Corporate Managers Trustees?' (1932) *Harvard Law Review* 1145.

¹⁰⁹ Andrew Keay, 'Stakeholder Theory in Corporate Law: Has It Got What It Takes?' (2010) 9 (3) *Richmond Journal of Global Law & Business* 249, 288.

¹¹⁰ *Ibid*; *Supra* n 104.

¹¹¹ *Supra* n 110.

¹¹² See R Edward Freeman, Andrew C Wicks and Bidhan Parmar, 'Stakeholder Theory and the Corporate Objective Revisited' (2004) 15 (3) *Organization Science* 364.

¹¹³ *Supra* n 110.

valuable to the corporation by improving its overall efficiency and success and the corporate law should be arched towards this end.¹¹⁴

In stakeholderism, the role of directors is twofold:¹¹⁵ Firstly, the duty of directors is to create an optimal value for the various stakeholders by balancing their competing and often conflicting interests to achieve the best for the corporation. In this regard, the role of directors is viewed as that of mediators where they mediate between different stakeholders by balancing their interests in recognition of the fact that not all claims and interests are equal.¹¹⁶ As such, directors must be aware of the effect of their decisions on stakeholders and then act accordingly.¹¹⁷ Secondly, directors in a stakeholding system are perceived as trustees of the stakeholders' interests.¹¹⁸ Directors act as stewards of all that they manage and they are to be trusted and relied upon to make professional decisions.

Consequently, if the board of directors is to consider the interests of all stakeholders and the standards expected of directors were more clearly defined in law, the position would become simpler overall.¹¹⁹ Directors' duties in this regard are seen as an important corporate governance mechanism in balancing the various stakeholders' interests. Ramsay posits that the duties address conflicts between shareholders and directors by focusing upon the possibility of shirking by directors (addressed by the duty of care, skill and diligence) and the possibility of a lack of loyalty by directors (addressed by the duty to act honestly and in the best interests of the company).¹²⁰

¹¹⁴*Ibid.*

¹¹⁵*Ibid.*

¹¹⁶*Ibid.*

¹¹⁷*Ibid.*

¹¹⁸*Ibid.*

¹¹⁹*Ibid.*

¹²⁰*Supra* n 15.

Ultimately, several interdependencies exist between the different stakeholders and the corporation and if the legitimate expectation of these stakeholders is not met, the long-term profitability of the firm will suffer. In addition, the economic and social purpose of the corporation is to create and distribute wealth and value to all its various stakeholder groups without favouring one group at the expense of the other.¹²¹ Corporations therefore require modernized regulation in order to keep them honed toward their central purpose of creating wealth for society through social responsibility.¹²²

With globalization, e-commerce and changing international trends, reform in law is inevitable if businesses are to remain relevant in modern society. It is therefore important to facilitate the directors' role to its stakeholders through appropriate regulation and it is against this backdrop that statutory codification of directors' duties is proposed as it is expected to improve corporate governance in Kenya with proportionate benefit to the society and country as a whole.

1.8 Literature Review

This study will be enriched by a number of articles and publications on corporate governance and duties of company directors in Kenya. There are several authors who have reviewed the position of Kenyan corporate law and made a case for its review. This study will be premised on the works of these authors and in addition it identifies several evident gaps that form the basis of this research study.

¹²¹*Supra* n 110.

¹²² Kent Greenfield and Gordon Smith, "Debate: Saving The World With Corporate Law" (2008) 57 *Emory Law Journal* 947, 964.

KiarieMwaura, *Regulation of Directors in Kenya: An Empirical Study*,¹²³ seeks to establish whether the regulatory framework for directors adversely affects performance of directors and companies and whether reform is needed to improve corporate governance. In his study, he points at various shortcomings in the regulatory framework. Firstly, he observes that the courts assess directors' liability subjectively as there is no statutory requirement for directors to have expertise and experience in the management of companies and this may have the effect of undermining good corporate governance in Kenya. Secondly, he notes that enforcement of directors' duties is complex as the duties are owed to the company and therefore only the company has locus standi to sue a miscreant director.

He further notes that in Kenya, directors of multinational companies are not required to have regard to stakeholders' interests unlike in other countries where they are required to do so. This is because although this may be discriminatory, the Constitution does not proscribe pursuit of discriminative practices but only proscribes the making of discriminatory laws.¹²⁴ Further, that it proscribes the performance of discriminative practices by a public office or public authority but not a private body. He also states that disregard of social responsibilities by multinational companies is not actionable at international law as multinational companies can only be subjected to international rights and duties by virtue of a convention between states.

He concludes that poor corporate governance results from the nature of the laws and the political and regulatory environment in the country and he calls for statutory and institutional reforms.¹²⁵

¹²³KiarieMwaura, 'Regulation of Directors in Kenya: An Empirical Study' (2002) 13 (12) *International Company and Commercial Law Review* 465.

¹²⁴*Ibid.*

¹²⁵*Ibid.*

His study also revealed that majority of the respondents advocated for statutory control of directors rather than a self-regulatory system presented by the corporate governance code.

However, it is noteworthy that this article was written in 2002 before the promulgation of the Constitution of Kenya, 2010. The position has now changed with the introduction of Article 2 (5) and (6) which recognize that the general rules of international law form part of the law of Kenya as well as any treaty or convention ratified by Kenya. Further, the Constitution provides that the bill of rights applies to all law and binds all state organs and all persons and any aggrieved person can apply to the High Court for redress.¹²⁶ It further interprets a person to include a company, association or other body of persons whether incorporated or unincorporated.¹²⁷

Accordingly, this research study will endeavor to illustrate the extent to which the Constitution of Kenya 2010 promotes good corporate governance in Kenya and the performance of company directors. The research further advocates for review of the corporate governance regulatory framework to align the provisions of the relevant statutes to those of the Constitution, and thus protect all the stakeholders' interests.

Lois M. Musikali, *The Law Affecting Corporate Governance in Kenya: A Need for Review*,¹²⁸ posits that poor corporate governance in Kenya is largely to be blamed on the underlying weak legal system. She reviews the law relating to director disqualification, derivative action and shareholder protection, director liability and penalties and the board structure and remuneration as presented by the Companies Act, Corporate Governance Code and the Capital Markets Authority (CMA) guidelines.

¹²⁶*Supra* n 76; Article 22.

¹²⁷*Supra* n 77.

¹²⁸Musikali n 20.

Lois suggests that the legislation, guidelines and code are inadequate for achieving effective corporate governance in Kenya as they have been directly lifted from developed countries and as such, they do not necessarily reflect the situation in Kenya, and as long as they continue to be used, then the efforts to improve corporate governance in Kenya will fail. She argues that the relationship between law and corporate governance needs to be appreciated, and therefore advocates for reform of the regulatory framework to adopt codes that fit the Kenyan situation.

However, it is imperative to note that her research is majorly informed by the Companies Act, CMA Guidelines and Corporate Governance Code and focuses on the general provisions therein that affect corporate governance in Kenya. This study conversely focuses on the law on directors' duties in Kenya as presented by a wide array of statutes, subsidiary legislation and codes of best practice. This study further observes that the guidelines and self-regulatory codes contain extensive provisions on directors' duties and advocates for consolidation of the dispersed directors' duties in the Companies Act which is the primary statute that regulates private and public companies and other business associations.

This study also notes that it is commendable to borrow from other jurisdictions to enrich the legal and regulatory framework for corporate governance in Kenya and legal reform presents an opportunity for Kenya to amend the substantive law to adapt to the local situation thus creating an enabling environment for the transplanted corporate governance codes to thrive in Kenya.

Jacob K. Gakeri, *Enhancing Kenya's Securities Market Through Corporate Governance: Challenges and Opportunities*,¹²⁹ looks at the regulatory framework for corporate governance in Kenya and its role specifically in promoting securities markets in Kenya and enhancing investor confidence. He argues that the internal and external corporate governance structures are largely dysfunctional in safeguarding investor interest going by the large number of corporate scandals in listed companies.

He examines the role of the board, auditors and shareholders in corporate governance while focusing on the provisions of the Companies Act, Penal Code,¹³⁰ CMA guidelines and Corporate Governance Codes and concludes that generally, the manner in which these legislations were lifted from other jurisdictions and adopted in Kenya is wanting. The same were adopted without regard to the existing Kenyan circumstances and hence their implementation and enforcement is weak.

He also posits that the underlying legal system is inadequate and neither enabling nor facilitative to promote corporate governance and protect investor interests and calls for statutory intervention especially for public listed companies. He further observes that the regulatory framework is unsupportive in failing to comprehensively provide for the explicit roles of executive and independent directors, their qualification, appointment, remuneration and disqualification and calls for reform in the law to curb corporate malfeasance.

This research study concurs with Gakeri's views and observes that his article focuses mainly on good corporate governance in the securities market for listed companies. On the other hand, this

¹²⁹ Jacob K Gakeri 'Enhancing Kenya's Securities Market Through Corporate Governance: Challenges and Opportunities' (2013) 3 (6) International Journal of Humanities and Social Science 94 <http://www.ijhssnet.com/journals/Vol_3_No_6_Special_Issue_March_2013/11.pdf> accessed 15 August 2013.

¹³⁰ Cap 63 Laws of Kenya.

study compares the corporate governance regulatory framework for both public and private companies as well as state corporations and specifically makes proposals for statutory codification of directors' duties and consolidation of the dispersed duties in the Companies Act to facilitate enforcement of the directors' duties and thus enhance good corporate governance practice in Kenya for both listed and non-listed companies.

Paul MusiliWambua, *Corporate Governance and Corruption in Kenya*,¹³¹ looks at the reasons for poor corporate governance and collapses in Kenyan companies. He majorly analyzes public corporations and concludes that poor corporate governance is attributable to political patronage, corruption, lack of transparency and accountability. He concludes that good corporate governance in the public sector can be enhanced through separation between governance of state entities and political control so as to insulate the operations of corporations from political patronage.

Conversely, this research study recognizes that private and public companies face governance challenges which may differ from those faced by their counterparts in state corporations. Nevertheless, the research makes propositions relevant and applicable to public and private companies and state corporations across the board. The research also acknowledges that many state corporations in Kenya are and continue to be privatized and as such, it is necessary to monitor their governance.

Accordingly, this research advocates for prescribing precise duties of directors in statute as well as commensurate penalties for breach for purposes of certainty and clarity to enhance good corporate governance in both public and private companies. The research also emphasizes on

¹³¹ Paul MusiliWambua, *Corporate Governance and Corruption in Kenya* (Claripress Nairobi 2008).

state and non-state corporations to embrace good corporate governance practice by observing the principles of transparency, accountability, responsibility, effectiveness and integrity in their governance.

Austin Ouko, *Management of Parastatals in Kenya: A Critique in Light of the New Constitution*,¹³² posits that many of the problems facing public corporations can be solved by having more effective boards and quality management and this can be achieved by having a structured and transparent board nomination process and parastatals should also offer attractive remuneration packages for the board. Only then will the board members be obliged to act solely in the interest of the parastatal thereby fulfilling their fiduciary duties.¹³³

This article was written after the Constitution of Kenya, 2010 came into effect and the new Constitution requires all appointments to public corporations to be based on fair competition and merit and the values and principles of public service require them to observe high standards of professional ethics.¹³⁴ While this study concurs with Ouko's propositions that the appointment of public companies board members is flawed and should be done transparently to improve the management of corporations, this research study in addition, advocates that duties of the board members should be codified in statute so that the board members appointed on merit may also know their obligations under the law, breach of which will lead to liability. This study also proposes reform of the current corporate law to align the provisions of the Companies Act to conform to the Constitution for purposes of enhancing good corporate governance practice in Kenya.

¹³² Austin Ouko, 'Management of Parastatals in Kenya: A Critique in Light of the New Constitution' (2011) 7 (1) Law Society of Kenya Journal 47.

¹³³ *Ibid.*

¹³⁴ Article 73 (2) (a).

Chief Justice David Malcolm, *Corporate Governance and Directors Duties*¹³⁵ looks at the duties of company directors at general law and how English Courts have interpreted the duties. He notes that there are three principles which have guided the Courts in their approach to corporate law, both in terms of the development of the general law and the interpretation of legislation.

Firstly, the principle of non-interference with the management of the company whereby the Courts are reluctant to interfere with the internal management of the company on ground that it is not the business of the court to manage the affairs of the business.¹³⁶ Secondly, the where courts have taken into account the ‘commercial reality principle’ insofar as it reflects changing reasonable expectations of participants in the corporate world. Thirdly, the non-prescriptive principle which reflects awareness that courts cannot prescribe in great detail the boundaries within which they will exercise jurisdiction over the affairs of the companies.¹³⁷

The article enriches this study by revealing the problem inherent in case law which undermines good corporate governance practice in Kenya. It further helps to demonstrate that the common law problems can be resolved through legislation which is clear, unambiguous, explicit and definite. However, his article focuses on English Courts interpretation of directors duties owed to the company. This research study on the other hand will analyze how the Kenyan Courts have interpreted the duties of directors and how the same can be helpful in codifying the duties in statute.

¹³⁵*Supra* n 15.

¹³⁶Scrutton LJ in *Shuttleworth v Cox Brothers & Co* [1927] 2 KB 9.

¹³⁷Lord MacNaughten in the case of *Dovey v Covey* [1901] AC 477, 488.

1.9 Methodology of the Study

This research will be developed through analysis of cases applicable to the subject and evaluation of relevant statutes, subsidiary legislation and law reports. In addition, review of secondary sources of data such as books, local and international journals and articles, research papers, newspaper articles and internet sources will be utilized.

Research materials shall be accessed from the Office of the Attorney General's Library, the University of Nairobi Parklands School Of Law Library, the National Council for Law Reporting website,¹³⁸ Nation Media Group Library, Capital Markets Authority Resource Centre as well as other internet search engines.

1.10 Scope of the study

The study is limited to review of directors' duties in Kenya and evaluating the gaps in the Kenyan corporate governance regulatory framework that impede responsible conduct of company directors and thus good corporate governance. In that regard, the research primarily aims at proposing amendments to the Companies Act and as such, will only consider in passing other substantive laws and regulations that regulate directors in Kenya.

1.11 Limitations of the study

The probable limitations to the study are that this research will only adopt a qualitative approach in data collection due to resource and time constraints and therefore a quantitative approach will not be assumed.

Besides, the non-publication of many cases heard and determined by the Kenyan courts is likely to limit the objective study of this research.

¹³⁸ www.kenyalaw.org

CHAPTER TWO

CORPORATE GOVERNANCE AND DUTIES OF DIRECTORS IN KENYA: A REVIEW OF THE REGULATORY FRAMEWORK

2.0 Introduction

Corporate scandals in both developed and developing countries have aroused a keen interest in corporate governance globally. This is evidenced by the increasing number of countries that have adopted voluntary codes of corporate governance in an effort to reduce corporate failures, improve economic efficiency and protect investors. Such countries include the United Kingdom, Brazil, Caribbean, China, Germany, Malaysia, South Africa and Kenya.

Since corporations raise funds and labour from the public to carry on business, they assume an obligation of public trust to act in a manner that protects the public interest and in so doing, they make full and fair disclosure of relevant information such as financial results for accountability to shareholders and the public.¹³⁹ This is the basis of corporate governance, and the primary responsibility for ensuring good corporate governance rests squarely with the board of directors and top management of the organization.

Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders.¹⁴⁰ Sir Adrian Cadbury defines corporate governance as the system by which companies are directed and controlled and further recognizes that the board of directors is responsible for the governance of their companies.¹⁴¹ The Private

¹³⁹ Benjamin James Inyang, 'Nurturing Corporate Governance System: The Emerging Trends in Nigeria' (2009) 4 (2) Journal of Business Systems 1 <<http://www.jbsge.vu.edu.au/issues/vol04no2/Inyang.pdf>> accessed 19 August 2013.

¹⁴⁰ Organisation for Economic Co-operation and Development, *OECD Principles of Corporate Governance* (OECD France 2004) 11.

¹⁴¹ Committee on the Financial Aspects of Corporate Governance, *Report of the Committee on the Financial Aspects of Corporate Governance* (London: Gee & Co 1992) <<http://www.ecgi.org/codes/documents/cadbury.pdf>> accessed 1 July 2013.

Sector Corporate Governance Trust Kenya (PSCGT) defines corporate governance as the manner in which the power of a corporation is exercised in the stewardship of the company's assets and resources with the objective of realizing shareholder value while taking into account the interest of other stakeholders.¹⁴² The Capital Markets Authority Guidelines on Corporate Governance Practices adopt more or less the same definition as the PSCGT.¹⁴³

The United Kingdom Corporate Governance Code states that the purpose of corporate governance is to facilitate effective entrepreneurial and prudent management that can deliver the long-term success of the company.¹⁴⁴ Good corporate governance therefore dictates that the board of directors governs the corporation to meet these objectives of maximizing shareholder long-term value while taking into account the best interest of society and other stakeholders by observing the core principles of transparency, accountability, integrity and responsibility.

The board of directors in Kenya is a creature of statute and the Companies Act provides that the business of a company shall be managed by the board.¹⁴⁵ At common law, the general duties of directors are recognized as the duties of care, skill and diligence and fiduciary duties.¹⁴⁶ The Principles for Corporate Governance in Kenya recognizes the board as a catalyst prompting, implementing, evaluating and monitoring strategic decisions and actions of management and one that holds management accountable.¹⁴⁷ Self-regulatory codes of corporate governance such as the OECD Principles of Corporate Governance and the Cadbury Report provide that the

¹⁴²Private Sector Initiative for Corporate Governance, *Principles for Corporate Governance in Kenya and a Sample Code of Best Practices for Corporate Governance* (Centre for Corporate Governance Kenya, 1999) 1.

¹⁴³Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya, 2002. These guidelines were issued vide Gazette Notice No. 3362 and were developed by the Capital Markets Authority primarily for public listed companies in Kenya <<https://www.nse.co.ke/regulatory-framework/category/27-capital-markets-authority-cma.html?download=475%3Acorporate-governance-guidelines-2002>> accessed 20 July 2013. All public listed companies must comply with these guidelines as a pre-requisite to trading in the stock exchange.

¹⁴⁴ Financial Reporting Council, UK Corporate Governance Code (Financial Reporting Council Limited, 2010) 1.

¹⁴⁵ Article 80 of Table A.

¹⁴⁶*Re City Equitable Fire Insurance Company* [1925] Ch 407.

¹⁴⁷*Supra* n 142

responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising and monitoring the management of the business and accounting to shareholders and the company on their stewardship.¹⁴⁸

This demonstrates that the board of directors is central to the governance of every corporation and it is therefore essential that the underlying legal framework is facilitative, supportive and enabling for directors to discharge their functions. In this regard, the Principles for Corporate Governance in Kenya acknowledge that good corporate governance requires that the State maintains and ensures an enabling environment in which efficient and well-managed firms can thrive.¹⁴⁹ Even so, several authors have argued that the current regulatory framework for Kenya is generally insufficient to promote good corporate governance in the country.¹⁵⁰ This chapter analyzes the corporate governance regulatory framework in Kenya and makes an inquiry into the appropriateness or otherwise of the law in promoting corporate governance with specific regard to duties of company directors.

In general, the legal framework regulating corporate governance and directors' duties in Kenya is governed by the Constitution of Kenya, Companies Act, State Corporations Act, Capital Markets Act, Capital Markets Authority Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya and the Principles for Corporate Governance in Kenya. Further, other

¹⁴⁸*Supra* n 141 and 142.

¹⁴⁹*Supra* n 143.

¹⁵⁰See 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' (2007) 31 (1) *Fordham International Law Journal* 34 <<http://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=2080&context=ilj>> accessed 15 August 2013; See Kiarie Mwaura, 'Company Directors' Duty of Skill and Care: A Need For Reform' (2003) 24 (9) *Company Lawyer* 283; See also Lois M Musikali, 'The Law Affecting Corporate Governance in Kenya: A Need for Review' (2008) 19 (7) *International Company and Commercial Law Review* 213; Also see Jacob K Gakeri, 'Enhancing Securities Markets in Sub-Saharan Africa: An Overview of the Legal and Institutional Arrangements in Kenya' (2011) 1 (9) *International Journal of Humanities and Social Science* 134 <<http://ir.library.strathmore.edu/fileDownloadForInstitutionalItem.action?itemId=373&itemFileId=327>> accessed 1 September 2013.

pieces of legislation and regulations govern different sectors for instance banking and insurance, in addition to the Kenyan Courts which have been instrumental in defining directors' duties and promoting corporate governance.¹⁵¹

2.1 Constitution of Kenya

The search for a new Constitution in Kenya had long been outstanding and it culminated in the promulgation of the Constitution of Kenya, 2010.¹⁵² The Constitution is the supreme law of the land and it binds all state organs, state officers and all persons whenever any of them enacts, applies or interprets any law or implements any public policy decisions.¹⁵³ It is therefore imperative that enactments or amendments to any law adhere to the provisions of the Constitution.

The Constitution further obligates every person to respect,¹⁵⁴ uphold and defend the Constitution and it interprets a 'person' to include a company, association or other body of persons whether incorporated or unincorporated.¹⁵⁵ As such, the governance of private and public companies and corporations should ultimately be consistent with the spirit and letter of the Constitution. Company directors in this regard are therefore required to observe the provisions of the Constitution in their actions or inactions; else, they can be held liable under the Constitution.

The Constitution further embraces various national values and principles to wit good governance, integrity, openness, transparency and accountability and sustainable

¹⁵¹ For instance, the Central Bank of Kenya Prudential Guidelines of 2013 incorporate Guidelines on Corporate Governance for all institutions licenced under the Banking Act Cap 488 Laws of Kenya, aimed at promoting sound banking practices and proper standards of conduct.

¹⁵²The Constitution of Kenya, 2010 was promulgated on 27th August 2010 and it repealed the 1963 Constitution.

¹⁵³Article 10.

¹⁵⁴Article 3(1).

¹⁵⁵Article 260. However, in the recent case of *Nairobi Law Monthly Ltd v KENGEN & Edward Njoroge*[2013] eKLR, the High Court of Kenya, in dismissing the Plaintiff's case, held that the right to access of information is only available to natural persons.

development.¹⁵⁶ Integrity dictates that public officers exhibit honesty, uprightness and soundness of moral principles and character in the discharge their functions.¹⁵⁷ Transparency on the other hand denotes the degree of clarity and openness in a corporation's dealings and it entails enabling outsiders to analyze a company's actions, economic activities as well as non-financial aspects by availing honest, accurate and timely information to them.¹⁵⁸ Accountability refers to the notion that public officials should be held responsible for their actions while in office and as such, there must be certain norms and values that they will be required to observe.¹⁵⁹ Accountability also denotes that any person authorized to act for or on behalf of a company must be held legally responsible for their actions or decisions.

These values and principles recognized under the Constitution are essential and central to corporate governance and are widely acknowledged as core principles of good corporate governance.¹⁶⁰ It is unfortunate that they have not been recognized in the Kenyan statutes and undoubtedly this is a major setback to good corporate governance in Kenya noting that these pillars and principles such as accountability and transparency are generally key determinants of

¹⁵⁶Article 10 (2) c and Article 73.

¹⁵⁷Henry Campbell Black, MA *Black's Law Dictionary* (4thedn, West Publishing Co 1968).

¹⁵⁸Lucian MihaiCarciumaru, 'An Assessment of the Impact of Corporate Governance Codes and Legislation on Directors and Officers Liability Insurance in South Africa' (Master of Commerce Thesis, University of Witswatersrand January 2009) <http://wiredspace.wits.ac.za/bitstream/handle/10539/8757/Dissertation_Complete.pdf?sequence=1> accessed 28 January 2013.

¹⁵⁹Dr C Odhiambo-Mbai, 'Public Service Accountability and Governance in Kenya since Independence' (2003) 8 (1) African Journal of Political Science 113-145 <<http://erepository.uonbi.ac.ke/bitstream/handle/11295/38889/Fulltext?sequence=1>> accessed 1 February 2014.

¹⁶⁰*Supra* n 141. Indeed, the OECD principles of good corporate governance are transparency, accountability, responsibility and fairness; Also see Dr Catherine L Kutcha-Helbling and Dr John D Sullivan, 'Instituting Corporate Governance in Developing, Emerging, and Transitional Economies' in John D Sullivan et al (eds), *In Search of Good Directors: A Guide to Building Corporate Governance in the 21st Century* (3rd Ed, The Centre for International Private Enterprise 2003) 9 <http://hawkama.net/files/toolkit/content/corporategovernancebasics/In_Search_of_Good_Directors_CG_in_the_21st_Century_English.pdf#page=349> accessed 28 August 2013.

governance and thus strict observance of the same promotes good governance while the lack of it is a major cause for bad governance.¹⁶¹

The Constitution also requires public appointments to be done through an open, transparent, competitive process and this would also incorporate appointments of parastatal board of director's members.¹⁶² This provision impacts positively towards enhancing good corporate governance in state corporations by requiring recruitment of highly skilled and competent persons and consequently ensuring professionalism and integrity in the board. It is therefore regrettable that the State Corporations Act which is the primary statute for state-owned enterprises in Kenya is yet to be amended to reflect the provisions of the Constitution.

Most importantly, the Constitution, being the supreme law of the land, its role in enhancing good corporate governance in management of Kenyan companies cannot be overlooked and it is vital to amend the existing legislation to conform to the provisions of the Constitution.

2.2 Companies Act

The Companies Act¹⁶³ is the primary statute that regulates the incorporation, regulation and winding up of companies and other business associations in Kenya. Both public and private companies in Kenya are registered under this Act which is based on the English Companies Act of 1948. The Act was introduced in Kenya in 1959 and adopted in 1962 with few amendments to date.

The Act provides that the business of the company shall be managed by directors subject to the provisions of the Act and any provisions contained in the Articles of Association of the

¹⁶¹ *Supra* n 159.

¹⁶² Article 232.

¹⁶³ Cap 486 Laws of Kenya.

company.¹⁶⁴In the case of *J.S.K (Cargo) Ltd v Kenya Airways Ltd*¹⁶⁵ the Court held that a managing director is the principal officer of a corporation who may speak on behalf of the corporation and who is permitted by law to act for the corporation in legal proceedings. This shows that directors occupy a very core position in the company and their actions and inactions determine the success or failure of the company.

The Act provides that a public company shall have a minimum of two directors while a private company shall have a minimum of one director.¹⁶⁶It also provides for the manner of appointment and election of directors,¹⁶⁷ minimum age,¹⁶⁸ statutory duties and liabilities,¹⁶⁹ disqualification,¹⁷⁰ and removal of company directors.¹⁷¹

The Act defines a “director” to include any person occupying the position of director by whatever name called.¹⁷²The expression “director” is therefore not defined with specificity taking into consideration the central position they occupy in a corporation and this is a major setback in the governance of corporations in Kenya. In fact, the first directors of the company in most instances are the initial subscribers to the memorandum of association who have no

¹⁶⁴*Supra* n 146.

¹⁶⁵*JSK (Cargo) Ltd v Kenya Airways Ltd* [2008] eKLR.

¹⁶⁶S 177; S 179 prohibits certain persons being sole directors of the company. The rationale for this is to safeguard against arbitrary decisions by a sole director. See Clive M Schmitthoff, *Palmer’s Company Law* (24th Ed, Stevens & Sons 1987) 877 where the author states that the purpose of the Act setting a minimum number of directors as two is to maintain a dual control in the management of the affairs of the company and to prevent fraudulent machinations by a one-man management.

¹⁶⁷ S 184 provides that the appointment of every director shall be voted individually.

¹⁶⁸ Under S 186, the minimum age required of directors is twenty one years. Directors are under a statutory duty to disclose their age to the company under S 187 of the Companies Act.

¹⁶⁹ Liability of directors to third parties often arises from breach of contractual duty or statutory duty, for instance fraudulent trading, omissions or misstatements in the prospectus.

¹⁷⁰S 189.

¹⁷¹S 185.

¹⁷²S 2.

particular credentials as the Act does not prescribe any specific qualifications for a person willing to act as a director of a company.¹⁷³

Further, the Act provides that the acts of a director or manager shall be valid notwithstanding any defect that may afterwards be discovered in his appointment or qualification.¹⁷⁴ The Court of Appeal at Nairobi in the case of *R v Ivan Arthur Camps*¹⁷⁵ upheld this position and stated that a person who acts as, and performs the functions of a director, although not duly appointed as a director, is occupying the position of a director. Such a provision exposes the management of companies to rogue directors with no recourse for shareholders. In fact, the shareholders' control over management is limited to hiring and firing directors which is ineffective where the company has become insolvent.

The Act contains several statutory duties of directors and they include the duty to keep proper books of accounts,¹⁷⁶ duty to register charges created by the company with the registrar,¹⁷⁷ duty to disclose directors' shareholding, salaries and loans¹⁷⁸ and duty to disclose any interest in contracts.¹⁷⁹ Nevertheless, enforcement of these duties is weak mainly due to lack of an effective monitoring system and limited capacity in the office of Registrar General to monitor the large number of companies across the country.¹⁸⁰ Further, non-emphasis on the principles of good corporate governance facilitates non-accountability in many corporations. For instance, corporate

¹⁷³ Under S 182, a proposed director of an intended company is only required to deliver to the registrar a written and signed consent to act as such and to take up his share qualification.

¹⁷⁴ S 181.

¹⁷⁵ *R v Ivan Arthur Camps* [1962] E.A 403.

¹⁷⁶ S 147.

¹⁷⁷ S 97.

¹⁷⁸ S 196-198.

¹⁷⁹ S 200.

¹⁸⁰ There is only one Companies registry in Nairobi that serves the whole country and efforts have been made to improve service delivery by introduction of online services known as Huduma Kenya. See Winsley Masese, 'HudumaCentres To Start Offering 18 Services From 10 Government Agencies' *The Standard* (Kenya, 8 November 2013).

accountability and transparency is usually through annual financial reporting and while listed companies are required strictly to publish their annual reports; it is not the same case for private companies.

More so, the penalties prescribed in the Act for breach of any of these duties are too low to deter miscreant officers.¹⁸¹ In addition, directors who have been responsible for the insolvency of companies are not precluded from acting as directors and they may do so with the leave of the Court.¹⁸² In some instances, directors who have been responsible for scams in some companies have been appointed to boards of other companies or senior management positions which show that director liability is treated casually in Kenya.¹⁸³ Luckily, sanity in the management of listed companies has been re-established owing to the introduction of stringent listing rules and conditions which public companies must adhere to.¹⁸⁴ However, non-listed and private companies are left exposed to mismanagement with the high risk of being made bankrupt.

The enforcement of these directors' duties is also hardly exercised for the reason that only the company has the legal capacity to sue a miscreant director. The High Court of Kenya in the case of *Affordable Homes Africa Ltd v Henderson & 2 others*¹⁸⁵ held that directors owe their fiduciary duties to the company and in the event of any breach of those duties, therefore, the company

¹⁸¹ For instance, the penalty prescribed for non-disclosure of interest in company contracts as per S 200 (4) is a fine not exceeding Kenya Shillings Two Thousand. This fine is clearly too low in comparison to the benefits derived by an individual from such a contract.

¹⁸² S 189 (1); See Paul Juma, 'Kiereini Cleared For Boardroom Return' *Daily Nation* (Kenya, 22 August 2013), The former Cooper Motor Corporation (CMC) Chairman Mr. Jeremiah Kiereini was cleared by the Court in August 2013 after the CMC Boardroom wars saga which saw the Capital Markets Authority bar several directors from acting as directors in other companies.

¹⁸³ See Yvonne Awour Atieno, 'Corporate Governance Problems Facing Kenyan Parastatals: A Case Study of the Sugar Industry' (MLB Thesis, Bucerius/WHU July 2009) <<http://www.gbv.de/dms/buls/631006060.pdf>> accessed 1 August 2013. One of the receiver managers in Muhoroni Sugar Company was a former director of Uchumi supermarkets which had collapsed in 2006 because of a dysfunctional board that failed to exercise proper business judgment resulting in careless expansion strategies and collapse.

¹⁸⁴ *Supra* n 144.

¹⁸⁵ *Affordable Homes Africa Ltd v Henderson & 2 others* [2004] 2 KLR 473.

alone, is the proper plaintiff that can sue to redress the wrong. In addition, as Justice Mwera notes, the relief sought must be intended for the benefit of the company and if the suit succeeds the benefit accrues to the company: itself, all shareholders including even the wrongdoers.¹⁸⁶ In the case of *Kamau & others v Maina & others*,¹⁸⁷ the Court held that in an action to redress a wrong done to a company, the company is the only proper plaintiff but its name should only be used as plaintiff only by the direction of the company or its directors.

However, this position has changed with the promulgation of the new Constitution, 2010 which stipulates that any person aggrieved by the actions of any person can seek redress in the High Court in case of breach of fundamental rights.¹⁸⁸ Nevertheless, the corporate law practice and more so the courts have been slow to reflect this new constitutional provision. It is also recommended that the Companies Act be amended to conform to the new constitutional dispensation.

In addition, the Act does not codify the common law duties of care and fiduciary duties expected of company directors, which would go a long way in promoting corporate governance in the country. Common law derives from case law which is largely extensive, diverse and generally inaccessible to an ordinary company director. In light of the foregoing, Mwaura argues that poor corporate governance results from the weak nature of the laws and the political and regulatory environment in the country and he calls for statutory and institutional reforms.¹⁸⁹ His survey on the regulatory framework for directors in Kenya revealed that majority of the respondents

¹⁸⁶*Dadani v Manji & 3 others* [2004] 1 KLR 95.

¹⁸⁷*Kamau & others v Maina & others* [2008] 1 E.A 151.

¹⁸⁸Article 22.

¹⁸⁹Kiarie Mwaura, 'Regulation of Directors in Kenya: An Empirical Study' (2002) 13 (12) *International Company and Commercial Law Review* 465.

advocated for statutory control of directors for purposes of enhancing good corporate governance practice rather than a self-regulatory system presented by the corporate governance code.¹⁹⁰

2.3 State Corporations Act

The State Corporations Act¹⁹¹ makes provision for the establishment of state corporations, their control and regulation. The Act was enacted to streamline the management of state corporations or public enterprises in Kenya.¹⁹² Koigi defines a public enterprise as one established by government and in which the government has majority control with the responsibility for appointing a board of directors.¹⁹³ However, it is important to note that while some state corporations are exempted from the operations of the Act,¹⁹⁴ other state corporations are established by specific Acts of Parliament.¹⁹⁵

State corporations were initially established during the colonial era in Kenya mainly to offer essential services to the public in areas such as agriculture, electricity, transport and communication at an affordable cost.¹⁹⁶ After independence, the government took rapid policy

¹⁹⁰ *Ibid.*

¹⁹¹ Cap 446 Laws of Kenya. S 3 recognizes that a State Corporation can be established by the President or by virtue of an Act of Parliament.

¹⁹² See generally Republic of Kenya, *Privatisation of State Corporations and Investments* (Draft Sessional Paper, 2005) 5 <http://siteresources.worldbank.org/INTKENYA/Resources/sp_Privatization.pdf> accessed 28 August 2013.

¹⁹³ Alice Nyambura Koigi, 'Improving Organisational Effectiveness of Public Enterprises in Kenya' (Ph.D Thesis, Nelson Mandela Metropolitan University, January 2011) 34 <<http://dspace.nmmu.ac.za:8080/jspui/bitstream/10948/1316/1/Alice%20Nyambura%20Koigi.pdf>> accessed 1 February 2014.

¹⁹⁴ Some State corporations such as Kenya Commercial Bank, National Bank of Kenya and Kenya Re-Insurance Corporation have been exempted from the operations of the State Corporations Act vide Legal Notice No. 59 of 25 February 1987. S 5A of the State Corporations Act states that the President can by gazette notice exempt any state corporation from the provisions of the Act subject to the limitations set out therein.

¹⁹⁵ The Court in the case of *J Wambugu & 8 Others v Kenya Railways Corporation* [2005] eKLR held that where a corporation is established by a specific Act of Parliament, the provisions of that Act of Parliament take precedence over the provisions of the State Corporations Act.

¹⁹⁶ Martin Brownbridge and Charles Harvey, *Banking in Africa: The Impact of Financial Sector Reform Since Independence* (Africa World Press 1998) 84.

measures to facilitate its direct participation in economic activities and social development.¹⁹⁷ However, under-performance of state corporations over time has led to privatization of many of them and introduction of performance contracts to improve efficiency and service delivery as most parastatals have been a drain on the economy of Kenya.¹⁹⁸

Under the State Corporations Act, the Board is empowered to carry out functions relating to the overall direction and management of a state corporation.¹⁹⁹ Several authors have argued that directors of state owned enterprises do not administer the assets of the corporation effectively and the factors that affect their performance include mismanagement, bureaucracy, incompetence and irresponsibility by directors, corruption, conflicts of interest and political interference which lead to state corporations being ineffective and unable to achieve their objectives.²⁰⁰

Transparency and accountability in the management of parastatals is also undermined by overlapping regulations and bureaucracies which characterize state corporations leading to poor corporate governance and underperformance. For instance, state corporations are usually placed under a Ministry and funds to the state corporations are issued through the Ministry. As such, the Minister is responsible to Treasury and Parliament for accountability of the parastatal's financial probity. Further, the board is composed of members appointed by a political authority which

¹⁹⁷ *Supra* n 159. These measures include introduction of policies such as Kenyanization to increase the participation of Kenyan nationals in the economy and establishment of more commercial and non-commercial parastatals.

¹⁹⁸ Mwaura n 150; See also Mwaura n 188; Also see S Muindi, 'Public Enterprises in Reform and Privatisation in Kenya' (UNPAN 1992) 1 <<http://unpan1.un.org/intradoc/groups/public/documents/AAPAM/UNPAN028231.pdf>> accessed 1 February 2014; Also see Centre for Governance and Development, *A Decade of Parastatal Waste: A Study of the Audited Accounts of State Corporations over the Period From 1993-2002* (CGD 2005) <<http://www.cgd.or.ke/documents/Parastatal%20Waste.pdf>> accessed 28 August 2013.

¹⁹⁹ S 15(1).

²⁰⁰ See Mwaura n 150; Also see Alice N Miringu and Esther T Muoria, 'An Analysis of the Effect of Corporate Governance on Performance of Commercial State Corporations in Kenya' (2011) *International Journal of Business and Public Management* 90 <<http://www.mku.ac.ke/journals/images/Vol1No1/an%20analysis%20of%20the%20effect%20of%20corporate%20governance%20on%20performance%20of%20commercial%20state%20corporations%20in%20kenya.pdf>> accessed 31 August 2013.

makes board members susceptible to pledging allegiance to the appointing authority rather than the corporation's in the discharge of their functions.²⁰¹

The Act requires directors to exercise their duties in national interest but the constituents of 'national interest' are not defined.²⁰² Such an omission has led to the grave effect of many state corporations going under or otherwise being put under statutory management given that it is delusional to hold board members accountable to abstract duties²⁰³ Further, directors who are responsible for the collapse of such corporations have in the past been appointed to other positions of directorship or to the Cabinet.²⁰⁴ What's more, parastatals have often been used as a soft-landing ground for civil service retirees and politicians who fail to clinch elective posts.²⁰⁵ The problem is aggravated by the fact that the power of running parastatals is shared between multiple structures to wit, principal secretaries, ministers, board of directors, treasury and office of the President and it is therefore difficult for directors to ascertain whom to obey and to whom they owe their duties.²⁰⁶

The Act requires any board member who has a potential or actual interest in a corporate contract to disclose the same in the meeting considering the contract upon which the interested board

²⁰¹ The members of the board established under S 6 are all appointed by the President either directly or indirectly, subject to the provisions of the individual corporation's establishing Act and its articles of association. S 7 empowers the President to issue directives to the board on the performance and management of the corporations and the board is required to give effect to the directions.

²⁰² *Ibid.*

²⁰³ Some of the corporations affected include Kenya Meat Commission, Kenya Creameries Commission (KCC), National Bank of Kenya (NBK), Kenya National Assurance Company (KNAC) and National Housing Corporation (NHC). However, this position has changed lately with several state corporation boards being held to account for misappropriation of funds and corruption in corporations. See Dominic Wabala, 'Police Arrest Five Former NHC Managers Over Graft Claims' *The Star* (Nairobi, 17 October 2013).

²⁰⁴ *Supra* n 183.

²⁰⁵ See Benson Okundi, 'Breathing New Life into State Corporations' *The Star* (Nairobi, 10 October 2013); See also Lilian Aluanga-Delvaux and Jacob Ng'etich, 'Muthaura Back as Uhuru Appoints 26 Heads of Parastatals' *The Standard* (Kenya, 27 December 2013); Also see Isaac Ongiri, 'Protest as Jubilee Election Losers and Cronies Picked to Head Parastatals' *Daily Nation* (Kenya, 28 December 2013)

²⁰⁶ Mwaura n 150 and 188.

member shall retire and shall not be entitled to vote on the matter.²⁰⁷ However, the board is not prohibited from taking up the contract and there is an inherent risk that the interested member may influence other board members to vote in its favour. Some authors are of the view that personal interest in corporate transactions is not wrong per se but they are harmful to the company if they are unfair.²⁰⁸ However, prudence dictates that proper mechanisms are put in place to facilitate full disclosure of the nature and extent of the interest to enable the authorized body make an informed decision on the matter.

Mwaura notes that directors of parastatals are not able to perform efficiently because the government does not practice effective corporate governance.²⁰⁹ He advocates for the need to streamline the multiple regulations that govern parastatals and reform the corporate governance regulatory framework of the private sector in order to raise standards of corporate governance and, as a result, ensure that the privatized services are managed prudently.²¹⁰ He also advocates for the government to adopt policies that support good corporate governance with an emphasis on directors and their duties and this is expected to promote better service delivery, profitability and good corporate governance thereby saving taxpayers money through clearly defining the board of directors' roles in the management of state corporations.

Overall, there is need to revise the provisions of the Act to conform with the Constitution of Kenya, 2010, which has gone a long way to align the interests of directors to those of the

²⁰⁷S 8 (1) (h).

²⁰⁸ See Luca Enriques, 'The Law on Company Directors' Self-Dealing: A Comparative Analysis' (2000) 2 (3) *International and Comparative Corporate Law Journal* 297, 299 <<http://web.mmc.edu.cn/shekebu/faxue/legal%20english/LinkedDocuments/The%20law%20of%20company%20director.pdf>> accessed 11 December 2013.

²⁰⁹Mwaura n 150.

²¹⁰*Ibid.*

organization through introduction of governance values and principles.²¹¹ Also, the Constitution requires public appointments to be done by merit through a fair, competitive and transparent process taking into account the guiding principles of leadership and integrity recognized under the Constitution and this should in turn be reflected in the governance of state corporations.²¹²

2.4 Capital Markets Act and Corporate Governance Guidelines for Public Listed Companies in Kenya

The Capital Markets Act is the statute that regulates the Kenya securities market.²¹³ The purpose of the Act is primarily to establish the Capital Markets Authority (CMA) which is the regulatory body for capital markets in Kenya.²¹⁴ The Act adopts the same definition of ‘director’ as the Companies Act²¹⁵ which is not defined with specificity and which is a drawback for good corporate governance in Kenya, as earlier discussed.

The objectives of the CMA are to facilitate and maintain an efficient and effective securities market that protects investor interests. In that regard, the CMA is empowered *inter alia* to prescribe rules or guidelines on corporate governance for listed companies in Kenya.²¹⁶ Accordingly, the CMA introduced Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya in 2002 in a move to enhance good governance in corporate performance, maximize shareholders value and protect investors’ rights.²¹⁷ The guidelines adopt both a prescriptive and a non-prescriptive approach to allow for flexibility in governance of

²¹¹*Supra* n 162.

²¹²Article 232.

²¹³Cap 485A Laws of Kenya.

²¹⁴ The Nairobi Stock Exchange (NSE) for instance operates under the heavy oversight of CMA through the Capital Markets Act and the Licensing Regulations. The CMA is also empowered under S 33A of the Act to interfere with the management of a licensee. Further, the Authority must consent to a change in the membership of the board of directors of a licensee as per S 20.

²¹⁵*Supra* n 172.

²¹⁶S 11.

²¹⁷*Supra* n 144. Although the Guidelines are mainly for public quoted companies, their provisions are also applicable to private companies.

listed companies.²¹⁸ As such, public listed companies are required to disclose in their annual reports the extent of compliance with the guidelines and to explain the reasons for non-compliance.²¹⁹

The guidelines state that the key to good corporate governance practice is an effective corporate board to lead and offer strategic guidance to the company and to be accountable to shareholders.²²⁰ The Capital Markets Act does not prescribe duties of directors but the Corporate Governance Guidelines provide for the role and responsibilities of the board of directors.²²¹ They provide that the board of directors has a primary responsibility to foster the long-term business of the corporation, define the company's mission, strategy, goals and risk policies, oversee the corporate management and operations, develop an appropriate staffing and remuneration policy, review the company's internal control, establish and implement a communication policy, monitor the effectiveness of the company's corporate governance practices and take into account shareholder's interests. Regrettably, these directors' duties are not enshrined in statute and consequently enforcement remains doubtful and lax.

Nevertheless, it is imperative to note that even though the guidelines are generally non-statutory, the CMA has power to impose sanctions for contravention of the provisions of the Act or of any rules and regulations made thereunder.²²² AfriCOG asserts that the corporate governance regulations, while well intentioned, are couched as guidelines rather than regulations and the overall effect is that they appear visionary and seem to leave a large margin of discretion to the

²¹⁸*Ibid* at Para 1.5.

²¹⁹*Ibid* at Para 1.7. The UK Combined Code adopts the "comply or explain" approach which allows for flexibility as opposed to the US Sarbanes-Oxley Act which contains mandatory compliance provisions.

²²⁰*Ibid* at Para 2.1.

²²¹*Ibid* at Para 3.1.1.

²²²S 25A. Such sanctions include suspension from trading, reprimand, restrictions on the use of licence, revocation of licence, recover of monies and financial penalties.

market intermediaries.²²³ Gakeri in addition argues that the guidelines are inadequate in that they were lifted from other jurisdictions with little or no regard to the local situation.²²⁴ Further, he posits that for the guidelines to be effective the statutory provisions should be facilitative and supportive in the first instance and that it was a serious omission to fail to align the guidelines with the underlying framework.²²⁵ He further opines that their implementation has been unenthusiastic since most of the guidelines are not based on any binding principles and listed companies have implemented them out of necessity not choice.²²⁶

As such, he attributes poor corporate governance in Kenya to the weakness in the underlying legal framework, inability by the Capital Markets Authority to enforce the guidelines and the failure of public companies to voluntarily embrace good corporate governance practices and accountability.²²⁷ The researcher concurs with the said authors' assertions and opines that these inadequacies can be remedied through statutory reform of corporate law to recognize the provisions of the guidelines in statute and thus ensure that both listed and non-listed companies participate more actively in corporate governance.

²²³AfriCOG, *Review of Securities Regulations, Comments on the Draft Capital Markets Regulations* (Economic Governance Program 2010) <http://www.africog.org/reports/AfriCOG_comments_on_the_Capital_Markets_Authority_regulations.pdf> accessed 30 August 2010.

²²⁴*Supra* n 144 at Para 1.3 acknowledges that the Corporate Governance Guidelines for Public Listed Companies in Kenya have been developed taking into account the extensive work carried out in other jurisdictions such as the United Kingdom, Malaysia, South Africa, the Commonwealth Association for Corporate Governance as well as the OECD.

²²⁵Jacob K Gakeri, 'Enhancing Kenya's Securities Markets through Corporate Governance: Challenges and Opportunities' (2013) 3 (6) *International Journal of Humanities and Social Science* 94, 101 <http://www.ijhssnet.com/journals/Vol_3_No_6_Special_Issue_March_2013/11.pdf> accessed 15 August 2013.

²²⁶*Ibid.*

²²⁷*Ibid.*

2.5 Principles for Corporate Governance in Kenya and a Sample Code of Best Practice for Corporate Governance

The Private Sector Initiative for Corporate Governance Trust (PSCGT) developed principles for corporate governance and a sample code of best practice for corporate governance in Kenya in 1999 in recognition of the role of corporations in promoting economic development and social progress.²²⁸ Gakeri observes that codes of corporate governance first emerged in countries with dispersed share ownership to facilitate professionalism, effectiveness and accountability of corporate boards of directors in the discharge of their functions.²²⁹

The code outlines various principles of corporate governance which are mainly aimed at the board of directors in corporations for purposes of ensuring proper management.²³⁰ It affirms that good corporate governance is necessary in order to enhance accountability and performance of those entrusted to manage corporations and to promote efficient and effective use of limited resources. The code recognizes that the country needs well governed and managed business enterprises that can attract investments, create jobs and wealth and remain viable, sustainable and competitive in the global market place.

The code identifies the obligations of the board of directors as to provide and ensure effective leadership, ensure corporate compliance, effective communication with stakeholders, accountability to shareholders, effective internal control procedures, adoption of technology,

²²⁸ *Supra* n 143.

²²⁹ *Supra* n 87.

²³⁰ These principles include the rights and duties of shareholders, strategic leadership of the board and manner of appointments to the board, development of corporate strategy and values, organizational structure, performance, culture, communication, technology, risk management, compliance and internal control systems and accountability to all stakeholders.

management of corporate risk, promotion of good corporate culture, appointment and development of executive management, social and environmental responsibility.²³¹

However, although the code provides for a detailed and wider range of directors' duties than the traditional common law duties, it observes that the principles therein are neither prescriptive nor mandatory and they are only designed as a basis to assist individual companies formulate their own specific and detailed codes of best practice.²³² Accordingly, the code is non-binding upon corporations and the principles have not been adopted in statute which is a drawback to good corporate governance in the country.

Further, the Code makes provision for independent non-executive directors which is a creature advanced by corporate governance to ensure a balance of power in the board. It recognizes that the role of independent directors is to bring independent judgment on issues such as strategy, corporate performance, resources, key appointments and standards of conduct and in cases of potential conflicts of interest. Regrettably, the role of independent directors has not been recognized under any statute and it is only found in the codes of best practice which are non-mandatory.

Gakeri observes that in reality the effectiveness of these codes is largely dependent on the underlying legal and regulatory framework and which is inadequate in Kenya.²³³ Further, countries such as the United Kingdom and South Africa have continuously updated and improved their corporate governance codes to ensure that the provisions are relevant and effective in enhancing good corporate governance practice. Unfortunately, no improvements have been made to the Kenyan code since inception.

²³¹*Supra* n 225.

²³²*Ibid.*

²³³*Ibid.*

2.6 Guidelines for Good Corporate Governance in State Owned Corporations

These guidelines were developed by the Private Sector Corporate Governance Trust (PSCGT) in 2002 in recognition of the role of state corporations in national development. State Owned Corporations (SOCs) have been established by the government mainly with financial resources from tax payers which means that members of the public are the main shareholders in these corporations.²³⁴

However, SOCs are faced by several legal and structural complexities that undermine their performance. These complexities include elaborate reporting structures and bureaucracies, wide and often conflicting political, economic and social interests, dispersed and diverse nature of stakeholders with varied demands and lack of enabling and supportive legislation for corporate governance. Further, the decisions of the Board are subject to approval by government and this inhibits the discretion of the board in decision making and subsequently, their efficiency.²³⁵ It is in this light that these Corporate Governance Guidelines for SOCs were introduced in recognition of the importance of enhancing implementation of good corporate governance principles and practices in order to make SOCs more effective and enable them contribute to national development.

The guidelines regard good corporate governance in corporations as encompassing accountability, stewardship, leadership and effective control exercised in corporations.²³⁶ They provide that SOCs should be led by an effective board which exercises leadership, enterprise, integrity and judgment in directing the corporation and which acts in the best interest of the

²³⁴ Private Sector Corporate Governance Trust, *Guidelines for Good Corporate Governance in State Owned Corporations* (Oakland Media Services Ltd 2002) 1. The guidelines refer to SOE as those corporate bodies in which the Government of Kenya holds more than 50% share capital or which are controlled by and report to the State.

²³⁵ *Supra* n 201.

²³⁶ *Supra* n 234.

corporation in a transparent, accountable and responsible manner. In this regard, directors must act honestly and exercise the expected reasonable degree of care and diligence in the discharge of their duties. They should also give necessary attention to the affairs of the corporation and disclose any actual or perceived conflicts of interest.²³⁷ The guidelines also recommend that directors must be held solely liable for all acts arising from the performance of their duties.

However, it is unfortunate that the provisions of these guidelines have not been adopted in statute and therefore they remain unenforceable guidelines only. Further, boards of SOCs are encouraged to approve a written code of best practice setting the expectations of directors but the researcher is not aware of any state corporation that has developed its own code and this is unlikely to be so in the near future noting the bureaucracies and strict rules and procedures that characterize state corporations.

2.7 Common Law

The duties of directors have traditionally been formulated by English common law, which are rules and doctrines initially developed by judges of the English royal courts. Traditional legal realists view law as a prediction of what the courts will decide and argue that even statute is not law until the court interprets it.²³⁸ These proponents aver that judges inevitably make law, at least incidentally, due to the imprecision of statutory language as well as evolution of society and societal demands resulting in judge-made law.²³⁹

²³⁷ *Ibid.*

²³⁸ See generally, MDA Freeman, *Lloyd Introduction to Jurisprudence* (7th Ed, Sweet & Maxwell Ltd 2001) 799, 846.

²³⁹ *Ibid.* The critics of judge made law thus argue that law is uncertain as one cannot predict the decision of a particular judge noting that judicial decisions are largely influenced by emotions, intuitions, prejudices and other irrational factors of individual judges.

The Judicature Act,²⁴⁰ which provides for jurisdiction of the Kenyan courts, permits the application of the common law and doctrines of equity in force in England as at 12th August 1897.²⁴¹ However, the courts have held that common law is complementary to the written law and it is only applicable in the circumstances that Kenya and its inhabitants permit and subject to such qualifications as those circumstances may render necessary.²⁴²

The common law duties of directors are duties of care, skill and diligence and fiduciary duties. The directors' fiduciary duties entail duty of good faith and honesty and this implies that a director must refrain from placing his self-interests ahead of the corporate interest.²⁴³ A company director must therefore ensure that there is no conflict between his duty to the company and his own self-interest. The duty of care, skill and diligence on the other hand requires a director to act in what he believes to be in the best interest of the company and with the standard of care of a prudent man in like circumstances.²⁴⁴

The general principles governing the duties of directors were stated by Romer J in *RE City Equitable Fire Insurance Co*²⁴⁵ as follows: "...of what value is the particular degree of skill and diligence required of him, the authorities do not, I think, give any clear answer. It has been laid down that so long as a director acts honestly he cannot be made responsible in damages unless

²⁴⁰ Cap 8 Laws of Kenya.

²⁴¹ *Ibid* at S 3 (1) c.

²⁴² *Otieno v Ougo & another* [1986-1989] E.A 468.

²⁴³ Joseph F Johnston Jr, 'Natural Law and the Fiduciary Duties of Business Managers' (2005) 8 (1) *Journal of Markets and Morality* 27 <www.marketsandmorality.com/index.php/mandm/article/.../365/355> accessed 16 January 2014.

²⁴⁴ *Ibid*.

²⁴⁵ *Supra* n 147.

guilty of gross culpable negligence in a business sense.” The foregoing statement elaborates a subjective test also enumerated in the Companies Act.²⁴⁶

Thus, a company director can be excused from liability where it appears to the Court that he acted reasonably and honestly in what he believed to be in the best interest of the corporation. While this may be a desirable test to propel business activity and dynamism of directors in decision making, some authors have argued that such provision signifies that directors can go unpunished as a result of negligence arising from their ignorance or inexperience.²⁴⁷ They therefore opine that a subjective test is undesirable in modern Kenya as it is prone to abuse by company directors. Mwaura for instance, advocates for a dual standard of liability with both objective and subjective elements of liability to curb against corporate wrongdoing by directors.²⁴⁸ In addition, the challenge for corporate governance is aggravated by the fact that courts in many common law jurisdictions are reluctant to review company management decisions and they appear to uphold the business judgment rule.²⁴⁹

2.8 Conclusion

The foregoing discussion clearly points to a weak corporate governance regulatory framework in Kenya resulting inter alia from lack or limited codification of directors’ duties. This consequently inhibits good corporate governance practice in Kenya as directors’ duties are uncertain, ambiguous, spread, blurred and vague. It is for this reason that this research study advocates for statutory codification of directors duties to streamline the same and enhance

²⁴⁶S 402.

²⁴⁷Mwaura n 150; Musikali n 150.

²⁴⁸*Ibid.*

²⁴⁹ See Stephane Rousseau, ‘Directors’ Duty of Care After Peoples: Would It Be Wise To Start Worrying About Liability?’ (2005) 41 Canadian Business Law Journal 223, 232 <<https://papyrus.bib.umontreal.ca/xmlui/bitstream/handle/1866/3020/CBLJ41-2%263Rousseau.pdf?sequence=1>> accessed 1 March 2013. Business Judgment Rule (BJR) has been defined as a doctrine that protects officers and directors from personal liability if it is proved that they acted in good faith, with due care and within powers.

certainty and clarity to promote good corporate governance practice in Kenya. Mwaura notes that Kenya has all the elements necessary to achieve good corporate governance but it lacks a strong legal framework to enforce the same.²⁵⁰ Gakeri conversely notes that Kenya is unable to cope with self regulation as advanced by the corporate governance codes and as such, self-regulation remains illusionary thus calling for statutory course of action.²⁵¹

The duties of directors have also evolved in the modern business world to include other stakeholder interests and many Kenyan statutes are yet to recognize this development. Accordingly, if Kenya is to be competitive globally, attempts should be made towards reviewing the law to incorporate the interests of the corporation's employees, customers, creditors, suppliers, financiers, environment, society and government.

Additionally, the guidelines developed by various institutions are non-statutory, non-mandatory, unenforceable and merely prescriptive and the implementation of good corporate governance therefore depends on the goodwill of various market players. Efforts are being made by several civil society groups and Non-Governmental Organizations (NGOs) to hold corporate boards accountable but this is unlikely to have a major impact until the law is revised.²⁵²

Needless to say, the effectiveness of legislation is dependent on the existence of an effective legal enforcement mechanism and as such, the need to educate directors on their duties and prescribe stiff penalties for breach of the same as well as strengthen the Office of the Registrar of Companies cannot be gainsaid.

²⁵⁰Mwaura n 150.

²⁵¹Jacob K Gakeri, 'Regulating Kenya's Securities Markets: An Assessment of the Capital Markets Authority's Enforcement Jurisprudence' (2012) 2 (20) International Journal of Humanities and Social Science 265 <<http://ir.library.strathmore.edu/fileDownloadForInstitutionalItem.action?itemId=376&itemFileI>> accessed 1 September 2013.

²⁵² The various civil society organizations involved include Transparency International, AfriCOG, Centre for Governance and Development and Mars Group.

CHAPTER THREE

SHOULD DIRECTORS' DUTIES BE CODIFIED? AN INQUIRY INTO THE CORPORATE GOVERNANCE FRAGILITY IN NATIONAL BANK OF KENYA

3.0 Introduction

Corporate scandals that have been witnessed across the globe and the collapse of major corporate organizations in the United States, Europe, Africa and other parts of the world have made corporate governance to take on the centre stage for academic and professional discourse.²⁵³ In Kenya, discussion on corporate governance has been influenced by corporate failures and poor performances of public and private companies.²⁵⁴ Poor corporate governance has often resulted in corporate failures with far-reaching effects on individual investors and the society in general. Consequently, good corporate governance is largely recognized as an important governance element for countries, organizations and corporations.²⁵⁵

The concept of separation of ownership and control necessitates the presence of a board of directors, which is a key participant in corporate governance, to manage and oversee the proper running of the corporation on behalf of the shareholders.²⁵⁶ The directors are entrusted with corporate assets to manage and account to the owners and though they may sometimes be shareholders, they need not be. This position of trust facilitates the director as an agent of the shareholders to take advantage of the opportunity and appropriate shareholders' property since

²⁵³OtuoSerebourAgyemong, Emmanuel Aboagye and Aaron Yao OfoeAhali, 'Prospects and Challenges of Corporate Governance in Ghana' (2013) 3 (5) International Journal of Scientific and Research Publications I <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2271533> accessed 27 July 2013.

²⁵⁴ See generally Dulacha G Barako, Phil Hancock and H Y Izan, 'Factors Influencing Voluntary Corporate Disclosure by Kenyan Companies' (2006) 14 (2) Journal Compilation 107.

²⁵⁵ See generally Maria Maher and Thomas Anderson, 'Corporate Governance: Effects on Firm Performance and Economic Growth' (1999) Organization for Economic Co-operation and Development <www.oecd.org/sti/ind/2090569.pdf> accessed 4 August 2013.

²⁵⁶Anant K Sundaram and Andrew C Inkpen, 'The Corporate Objective Revisited' (2004) 15 (3)Organization Science 350.

the owners will bear any loss.²⁵⁷ Jhering posits that it is this position that the directors occupy that warrants greater measures through legislative sanctions to curb misfeasance arising from conflicts of interest.²⁵⁸

Consequently, in order to enhance good corporate governance, agency theorists advocate the importance to rein in directors against self-dealing transactions as such transactions hurt the corporation in the long run.²⁵⁹ They also advance the importance of aligning directors' interests to those of the company to improve corporate governance. The law and economics theorists view corporate law as an enabling framework for corporation contracts where it defines various contracts and the rights and duties of each participant in corporate governance.²⁶⁰ The stakeholder theorists on the other hand explain the purpose of corporate law as to balance competing interests between the company and its stakeholders. The role of directors in this regard is to act as mediators between the different stakeholder interests and trustees or stewards of stakeholder interests.²⁶¹ Accordingly, statutory codification of directors' duties is expected to enhance good corporate governance in the country by precisely and concisely stipulating directors' duties as well as penalties for breach of the duties.

In Kenya, the regulatory framework governing the conduct and accountability of company directors is generally deficient to warrant good corporate governance practices and its reform is long overdue. Traditionally, the boards of directors of many listed companies in Kenya for

²⁵⁷*Supra* n 253. Rudolf asserts that directors do not care whether they pay for goods and services in excess of their value since they pay out of another's pocket; after all, the owner will bear the loss. He says that for directors they seem to shrug off management thus, "What is another's money? Seed that is scattered; if it sprouts, very good, a brilliant speculation...if it does not sprout, the owner bears the loss."

²⁵⁸*Ibid.*

²⁵⁹ Jonathan R Macey, 'Fiduciary Duties As Residual Claims: Obligations To Non-shareholder Constituents from a Theory of the Firm Perspective' (1999) 84 Cornell Law Review 1266.

²⁶⁰ Frank H Easterbrook and Daniel R Fischel, 'The Corporate Contract' (1989) 89 Columbia Law Review 1416, 1428.

²⁶¹ Andrew Keay, 'Stakeholder Theory in Corporate Law: Has It Got What It Takes?' (2010) 9 (3) Richmond Journal of Global Law & Business 249, 288.

instance, have consisted of friends, club members, relations and political associates of government officials and it has continued to be so and little or no regard is paid to their qualifications or competence.²⁶² This is due to the historical backgrounds of many companies in Kenya which start off as family businesses and once they expand and even list on the stock exchange, the family members are unwilling to relinquish their majority shareholding.²⁶³ In state corporations, it has been used as a soft-landing for election losers and a way to reward political loyalties.²⁶⁴

As a result of such legal and regulatory inadequacies, Kenya has suffered numerous corporate failures involving banks, financial institutions, stock brokers and state corporations which have either collapsed or been put under statutory management majorly due to poor governance and mismanagement.²⁶⁵ This research examines the general corporate governance practice in Kenya with a bias on financial institutions and it utilizes the National Bank of Kenya (NBK) as the case study to illustrate the need for codification of directors' duties in statute.

²⁶² Jacob K Gakeri, 'Enhancing Securities Markets in Sub-Saharan Africa: An Overview of the Legal and Institutional Arrangements in Kenya' (2011) 1 (9) *International Journal of Humanities and Social Science* 134 <<http://ir.library.strathmore.edu/fileDownloadForInstitutionalItem.action?itemId=373&itemFileId=327>> accessed 1 September 2013; See article by MwauraKimani, 'Trouble in the Empire: An Inside Look at Tuskys Supermarkets Family Drama' *The East African* (Nairobi, 28 April 2012). The Tuskys Supermarket boardroom is dominated by family members which offers a ground for personal interests to filter into the business. Mwaura reports that the five brothers who inherited the company from their father are all directors of the company and there is no external director.

²⁶³ See Kevin Mwanza, 'Somen Leaves AccessKenya Board After 10 Years in Chair' *Business Daily* (Nairobi, 9 July 2010). It is reported that the Somen family owns a combined stake of 26% in the company and has three family members on the board. AccessKenya listed on the Nairobi Stock Exchange (NSE) in 2007 but some shareholders have complained that decision-making in the company has remained in the grips of the Somen family to the exclusion of independent directors.

²⁶⁴ See Isaac Ongiri, 'Protest as Jubilee Election Losers and Cronies Picked to Head Parastatals' *Daily Nation* (Kenya, 28 December 2013).

²⁶⁵ For instance, 33 banks in the country collapsed in 1984-1986, the first in a cycle of corporate collapses. These banks include Trust Bank, Kenya Finance Bank, Bullion Bank, Charterhouse Bank. Examples of other affected companies and state corporations are Kenya Creameries Commission (KCC), Kenya Meat Commission (KMC), Nyaga Stockbrokers, NgenyeKariuki Stockbrokers Ltd and Uchumi Supermarkets. Most state corporations have been revived by the government with an aim of protecting investor interests.

3.1 Corporate Governance in Financial Institutions

The collapse and failure of many banks and financial institutions globally has been a major cause for public concern in the governance of corporations generally and financial institutions in particular. The contribution of banks and financial institutions to both national and international economies necessitates the need to keep them under close surveillance as they are part of the corporate governance system.²⁶⁶

More so, in developing countries, the importance of banks is more pronounced because financial markets are underdeveloped and banks are typically the major source of finance for many firms as well as the main depository for savings.²⁶⁷ Economic liberalization and technological advancements have also prompted an upsurge in the number of banks and financial institutions in Kenya and other global regions.²⁶⁸ Therefore the growth, role and importance of banks in economic development cannot be gainsaid.

The failure and crises in the banking sector during the 1980s-90s exposed the deficiency and degeneration in the general regulatory framework for corporate governance in Kenya. Studies demonstrate that many corporations and banks collapsed due to weak internal controls, severe under-capitalization, insider lending, excessive borrowing of institutions, corruption, political interference, lack of competent management, bad governance and management practices and in

²⁶⁶Tobias Olweny and Themba Mamba Shipho, 'Effects of Banking Sectoral Factors on the Profitability of Commercial Banks in Kenya' (2011) 1 (5) Economics and Finance Review 1 <<http://www.businessjournalz.org/articlepdf/efr1504e1.pdf>> accessed 8 October 2013.

²⁶⁷*Ibid.* See also Winifred Mary Tarinyeba, 'Corporate Governance in Uganda: The Role of Bank Finance' (Ph.D Thesis, Stanford University May 2006) <<http://www.law.stanford.edu/sites/default/files/biblio/108/138004/doc/slspublic/TarinyebaWinifredM-tft2006.pdf>> accessed 28 August 2013. She asserts that in developing countries, the capital markets are underdeveloped and market for corporate control has not played a significant governance role. As such, banks have been instrumental in shaping the corporate governance system in these countries through bank finance.

²⁶⁸ This is in addition to the increasing number of bank agents, branchless operations and pervasive mobile banking technology in Kenya.

some instances, outright fraud.²⁶⁹ Cheserek, for instance, posits that the factors that led to collapse of banking institutions in Kenya are attributed to or related to weak corporate governance practices, poor risk management strategies, lack of internal controls, and weaknesses in regulatory and supervisory systems and conflicts of interest amongst others.²⁷⁰

3.2 The Role of Central Bank of Kenya in Enhancing Corporate Governance of Banks

The Central Bank of Kenya (CBK) is established by the CBK Act²⁷¹ and it is mandated to licence and supervise banking institutions in Kenya. Overall, it was observed that the high number of bank collapses during the 1980-90s was clear evidence that the Kenyan legal, regulatory and supervisory framework was grossly inadequate and needed strengthening.²⁷² The CBK for instance, was accused of not supervising the banking sector adequately thus calling for major legal, institutional and regulatory changes. Consequently, the CBK Act was amended to give CBK greater autonomy and the Banking Act also enhanced significantly the role of CBK in supervision of banks.

For instance, the Banking Act was amended to provide that persons proposed to manage or control a banking institution must be certified as professionally and morally suitable by the CBK before an institution can be licenced to conduct business in Kenya.²⁷³ In this regard, the CBK is mandated to have regard to the person's possession of adequate professional credentials or experience, ability to recommend sound practices and to make sound decisions as well as ability

²⁶⁹ Martin Brownbridge and Charles Harvey, *Banking in Africa: The Impact of Financial Sector Reform Since Independence* (Africa World Press 1998) 84.

²⁷⁰ Benedicto Kosgei Cheserek, 'The Determinants of Bank Failures: A Survey of Commercial Banks in Kenya' (MBA Thesis, University of Nairobi 2007) <<http://erepository.uonbi.ac.ke/bitstream/handle/123456789/7842/The%20determinants%20of%20bank%20failures%20a%20survey%20of%20commercial%20banks%20in%20kenya.pdf?sequence=1>> accessed 30 August 2013; See also Micah Cheserem, *The Will to Succeed, An Autobiography* (Jomo Kenyatta Foundation 2006).

²⁷¹ Cap 491 Laws of Kenya.

²⁷² Central Bank of Kenya, *KENYA Portrait of a Country-Heritage and Diversity* (CBK 2008) 128.

²⁷³ S 4 of the Banking Act Cap 488 Laws of Kenya.

to avoid conflicts of interest. If uncertified, such a person is deemed to be disqualified from holding office. In addition, the Banking Act was amended to empower the CBK to issue directions, advise and make recommendations on measures to be taken to improve management methods or to secure compliance by the bank with the requirements of the Act in order to protect investors and members of the public.²⁷⁴

These legislative reforms were aimed at enhancing good corporate governance standards in financial institutions as the CBK is empowered to regulate the banking industry in Kenya and enforce compliance with good corporate governance practice. The CBK has also developed CBK Guidelines for Directors of Banks in Kenya²⁷⁵ and it has been involved in designing training courses for directors to ensure that they are informed of their duties and responsibilities.

This chapter explores the case of National Bank of Kenya, which has been a key player in the banking sector in Kenya since 1968 and whose stability was threatened in the 1980-90s due to mismanagement, board interference and lack of clear guidelines on directors' duties and responsibilities.

3.3 Background Information on National Bank of Kenya (NBK)

Commercial banking was established in Kenya at the end of the 19th century following the establishment of the British authority in the region.²⁷⁶ Consequently, most banks at independence were either foreign-owned or foreign-controlled with minor participation by local banks. After independence, the Government of Kenya introduced a policy known as Kenyanisation or Africanisation to enable Africans take over and control the economy and the commercial

²⁷⁴S 33.

²⁷⁵Central Bank of Kenya, *Guidelines for Directors of Banks in Kenya* (Bank Supervision Department 1996).

²⁷⁶*Supra* n 269.

industries and agricultural farms from the former white population.²⁷⁷ Africans therefore required credit to finance their trade and the Government of Kenya established parastatal commercial banks in Kenya because of the perception that the existing foreign owned banks were failing to serve credit needs of African businesses.²⁷⁸

To this end, the Co-operative Bank was registered in January 1968 to look after the interests of the co-operative movement.²⁷⁹ The government also established the National Bank of Kenya (NBK) in June 1968 as a public sector bank to look after national interests with the main objective of facilitating the financing of African business and the transfer of productive assets to Africans.²⁸⁰ NBK was therefore formed to help Kenyans gain access to credit and control their economy after independence.

National Bank of Kenya is incorporated under the Companies Act.²⁸¹ Since the incorporation of the bank in 1968, the shares in the bank owned by the Government of Kenya have been held in the name of the Permanent Secretary to the Treasury.²⁸² The initial directors of the bank were the then Treasury Permanent Secretary John Michuki who was the board chairman,

²⁷⁷ C Odhiambo-Mbai, 'Public Service Accountability and Governance in Kenya Since Independence' (2003) 8 (1) African Journal of Political Science 1 <<http://erepository.uonbi.ac.ke/bitstream/handle/11295/38889/Fulltext?sequence=1>> accessed 1 February 2014. Initially, most Africans only provided cheap labour on the white-owned farms where they also lived as squatters; See also Benson Okundi, 'Breathing New Life into State Corporations' *The Star* (Nairobi, 10 October 2013). Okundi writes that the period after independence was marked by a deliberate policy by the government of Kenya to participate in the economy such as in agriculture, commercial and non-commercial industries, and service delivery as well as to help accelerate economic and social development and increase participation of Kenyan nationals in the economy; Also see Alice Nyambura Koigi, 'Improving Organizational Effectiveness of Public Enterprises in Kenya' (Ph.D Thesis, Nelson Mandela Metropolitan University, January 2011) 34 <<http://dspace.nmmu.ac.za:8080/jspui/bitstream/10948/1316/1/Alice%20Nyambura%20Koigi.pdf>> accessed 1 February 2014.

²⁷⁸ *Supra* n 272. NBK was exempted from the operations of the State Corporations Act vide Legal Notice No. 59 of 25 February 1987.

²⁷⁹ *Supra* n 269.

²⁸⁰ *Ibid.*

²⁸¹ Cap 486 Laws of Kenya.

²⁸² National Bank of Kenya, 'Offer for Sale by the PS to the Treasury of Kenya' (NBK 1994). This is pursuant to the Cabinet Secretary to the Treasury (Incorporation) Act Cap 101 Laws of Kenya.

EliudMatuWamae, Patrick Mwangola and KipkiruiCherono.²⁸³ The government initially held 100% of the shares but has been selling off its shareholding to the public pursuant to the government's policy of privatisation and disengagement from industrial and commercial enterprises.²⁸⁴ At an extra-ordinary general meeting of the bank held on 13th September 1994, a special resolution was passed converting the bank from a private to a public company and adopting new Articles of Association.²⁸⁵ At present, the government of Kenya holds 22.5% stake and NSSF owns 48.06%. The rest is owned by the general public.²⁸⁶

3.4 An Inquiry into the Corporate Governance Fragility at National Bank of Kenya

NBK was doing well during the 1970s but became one of the poorly performing parastatals in the 1980s and early 1990s prompting it to become the subject of privatization in forums like the Parliamentary Public Investments Committee.²⁸⁷ The indicators of poor performance by the bank were low profitability resulting in non-payment of dividends to shareholders, huge non-performing loans, severe financial distress, bad public image as well as non-compliance with reporting and auditing requirements.²⁸⁸

²⁸³See Kenya Bankers Association, 'A History of Banking in Kenya' <www.demonationmedia.com/historyofbanking/?p=155> accessed 7 June 2014.

²⁸⁴ In 1994, the government reduced its shareholding by 32% and in 1996, GoK further reduced its shareholding. See Kenya Commercial Banking Report Q2 Including 5 year Industry Forecasts, Business Monitor International (London, June 2009); See also Chris Musyoka, 'Sell Shares, Moi Tells State Banks' *Daily Nation* (Kenya, 27 August 1987). President Moi told state-owned KCB and NBK to float up to 30% of their total share capital for the public to buy.

²⁸⁵ *Supra* n 283.

²⁸⁶ www.nationalbank.co.ke.

²⁸⁷ See AfriCOG, *Review of Securities Regulations, Comments on the Draft Capital Markets Regulations* (Economic Governance Program 2010) <http://www.africog.org/reports/AfriCOG_comments_on_the_Capital_Markets_Authority_regulations.pdf> accessed 30 August 2010; See also Peter Warutere, 'What Ails the NBK' *Daily Nation* (Kenya, 23 February 1992). NBK is lumped with inefficient parastatals meaning that it has been experiencing operational difficulties and was named as one of the parastatals to be restructured according to a report published by the Parastatal Reform Programme Committee; Also see Chris Musyoka, 'Sell Shares, Moi Tells State Banks' *Daily Nation* (Kenya, 27 August 1987).

²⁸⁸ See MatharaKellen, 'The Response of National Bank of Kenya Limited to the Challenge of Non-Performing Loans' (MBA Thesis, University of Nairobi School of Business November 2007) <http://www.uonbi.ac.ke/faculties/turntopdf.php?project_id=6622> accessed 1 September 2013; See also NATION

Being an initially state-owned bank, there was a lot of government interference in the management of NBK resulting in mismanagement.²⁸⁹ For instance, parastatals were pressured to deposit large sums with government-owned banks and Swami notes that there was a close link between parastatals and distressed indigenous banks such as NBK.²⁹⁰ Such banks held an estimated 85% of all parastatal deposits pursuant to a government directive that required parastatals to place their deposits with indigenous banks.²⁹¹ As a result, huge parastatal deposits transferred to the bank were often issued as unsecured loans to senior politicians and on-lent to particular borrowers in some instances.²⁹²

Political connections were also used to secure public sector deposits and in several cases to circumvent the requirements of the banking laws.²⁹³ The bank would be directed to lend money to politicians and politically connected people who had no intention of repaying the loans and the situation was worsened by the ever-changing management in the bank.²⁹⁴ Often, NBK would at the request of the government, extend credit to parastatals or co-operatives for strategic reasons in circumstances where lending would not have been justified on a purely commercial basis.²⁹⁵

Government guarantees were regularly given to public corporations which did not meet

Reporter, 'Major State Bank in Financial Crisis' *Daily Nation* (Kenya, 8 July 1992). NBK is reported to have always published its financial results late.

²⁸⁹Cheserem n 270.

²⁹⁰GurushriSwamy, *Kenya Structural Adjustment in the 1980s, Policy Research Working Paper 1238* (The World Bank, January 1984).

²⁹¹*Supra* n 269. Such parastatals included the National Social Security Fund (NSSF), Kenya National Trading Corporation (KNTC) and the National Health Insurance Fund (NHIF).

²⁹²*Ibid.*

²⁹³ See also NATION Reporter, 'Major State Bank in Financial Crisis' *Daily Nation* (Kenya, 8 July 1992).

²⁹⁴Cheserem n 270; See also Kiarie Mwaura, 'Constitutional Restructuring of Corporate Governance in State Owned Enterprises: Dynamism or Distraction' (2011) 1 *Journal of Mount Kenya University Law School* 5; See also Nation Team, 'Fire Bank Debtors, Leaders Tell Moi' *Sunday Nation* (Kenya, 29 November 1998) The Vice-President Mr. Kibakisaid that politically-correct friends of the Government have been obtaining NSSF money through NBK owing to the fact that NSSF owns more than 37% of NBK's total shares and the bank management has been without over a say over this; See also NATION Reporter, 'Ngei Bankrupt, Court Declares' *Daily Nation* (Kenya, 11 July 1981). The Ministry of Works Minister Paul Joseph Ngei was declared bankrupt by the High Court for failing to repay creditors Kshs. 4.6M. Among the major creditors was NBK which was claiming Kshs. 1.8M. Justice Hancox noted that NBK had been owed money for many years.

²⁹⁵Cheserem n 270.

commercial criteria. As a consequence, many loans were issued to non-performing parastatals and companies owned by politicians and these loans were hardly re-paid.

In some instances, the bank borrowed billions on behalf of other individuals and corporations and the money was channelled through NBK.²⁹⁶ This was because the corporations did not have direct access to parastatal lenders. Later, these corporations failed to promptly repay the monies leading to non-performing loans running into millions of shillings and a liquidity crisis in NBK when the creditors recalled their money.²⁹⁷ At some point, NBK had non-performing loans to the tune of Kshs 19billion which were written off.²⁹⁸ The then Managing Director, Mr. Marambii threatened to sell off Kenya Meat Commission which owed the bank Kshs 2.7billion, a loan that had been guaranteed by the government.²⁹⁹ NBK also lent heavily to the public sector without adequate ascertainment of the credit worthiness of the individual borrowers.

At one point, the then Minister for Finance, Mr. Simeon Nyachae tabled a long list of NBK loan defaulters in Parliament and this prompted the removal of the then Chief Executive Officer, Mr. John Simba.³⁰⁰ Most of the defaulters were politicians who had invested the money in amassing political power in elections. Their loans were often unsecured and made upon pressure from those in authority.

Further, the judicial system and corruption escalated the problem since these defaulters obtained endless Court injunctions against NBK when the bank sued for recovery of money.³⁰¹ As such, the amount of non-performing loans was huge and growing by the day. Political donations by the

²⁹⁶*Supra* n 269; See also NATION Reporter n 288.

²⁹⁷Cheserem n 270.

²⁹⁸ See Ben Kinyanjui, 'National Bank of Kenya Gets New CEO As Marambii Retires' *Daily Nation* (Kenya, 8 June 2012).

²⁹⁹*Ibid.*

³⁰⁰*Supra* n 269.

³⁰¹*Ibid.* See also KipkoechTanui, 'Government Bails Out Troubled NBK' *Sunday Nation* (Kenya, 22 November 1998).

directors of NBK were also common in an effort to appease the appointing authority and it is doubtful that such donations were made within a laid down transparent and accountable regulatory framework.³⁰²

In 1998, the NBK shareholders in an extra-ordinary general meeting sacked the entire board of directors. The bank at this time had accumulated losses of Kshs 26billion and was facing ruin.³⁰³

It was unable to pay dividends to its shareholders for several years as the profits were retained to keep the bank afloat and to cover old losses back to when the bank was plundered by the political elite who took up loans and failed to repay.³⁰⁴ In fact, the shareholders were to receive their first dividend in 2011 for the first time since the last dividend payout in 1997.³⁰⁵

Although the financial problems of NBK had already become apparent by the late 1970s, major restructuring was delayed until 1993 when the government realized that the bank was going to fail and the repercussions of a major bank like NBK falling would have resulted in a run on the banking sector.³⁰⁶ Consequently, a re-structuring plan to recapitalize the bank was adopted and the government injected Kshs. 0.5billion in equity and provided Kshs. 1.5billion in loan guarantee repayments, a combined sum which amounted to 16% of NBK's total assets.³⁰⁷

National Social Security Fund (NSSF) also a major shareholder converted deposits held with the bank into NBK shares. By this time, the accumulated losses were substantial and to revive it, the

³⁰² See NATION Reporter, 'Watch Out, Moi Tells Parastatal Heads' *Daily Nation* (Kenya, 21 July 1988). The President was speaking at State House when he received donations for the 10th Nyayo Era and the 25th Independence Anniversary Celebrations where NBK donated Kshs. 1M through its chairman Mr. Raphael Gitau. NBK's subsidiary Kenya National Capital Corporation Ltd also donated Kshs. 100,000/-.

³⁰³ See James Mbugua, 'Kenya: Marambii's Last Stand-Avoid Spin and Say It Like It Is' *The Star* (Nairobi, 22 June 2013).

³⁰⁴ *Ibid.*

³⁰⁵ See Luka Mulunda, 'A Battle for Control of National Bank Boardroom' *Business Daily* (Nairobi, 23 May 2011).

³⁰⁶ See Tanui n 301.

³⁰⁷ *Ibid.* See also Francis Makokha, 'Bank Weathers Lack of Confidence Crisis' *Daily Nation* (Kenya, 15 June 1993); See also Francis Makokha, 'Government to Pump More Funds into National Bank' *Daily Nation* (Kenya, 22 June 1993).

government also replaced NBK's top management and strengthened internal controls. The Government also stepped in to repay some of the non-performing loans it had guaranteed and appointed an advisor to facilitate the recovery of the loans.³⁰⁸

NBK has since made efforts to enhance customer service and corporate image by rebranding and diversifying its business portfolio beyond the traditional government-related element.³⁰⁹ The government has also been selling off part of its shareholding in the bank to the general public with the main aim of reducing its stake.³¹⁰ Brownbridge suggests that arguably NBK will only be able to attain sufficient independence from political interference if the government sells off all its equity in the bank to private sector.³¹¹

3.5 What Was Ailing National Bank of Kenya Limited? An Appraisal of the Corporate Governance Challenges

Several reasons have been advanced as to why NBK was at the brink of collapse in the early 1990s.³¹² This research submits that part of the explanation for underperformance of NBK's board may be attributable to political patronage and lack of board autonomy, poor regulatory and supervisory framework, lack of clear and concise statutory statement on directors' duties, lack of a corporate code of ethics for directors and a generally deficient corporate governance regulatory framework.

³⁰⁸ *Supra* n 15.

³⁰⁹ See Press Release, *Announcement of Half Year Financial Results for the Year Ended 30th June 2013* by National Bank (National Bank of Kenya 6August 2013) <http://www.nationalbank.co.ke/images/uploads/h1_2013_press_release2.pdf> accessed 22February 2014.

³¹⁰ In 1994, the government of Kenya reduced its shareholding by 32% (40 million shares) to members of the public. In 1996, it further reduced its shareholding by 40 million shares to the public. The current shareholding now stands at NSSF 48.0%, General Public 29.44% and the Government 22.5%, information <www.nationalbank.co.ke> accessed 10August 2013.

³¹¹ *Supra* n 269.

³¹² *Ibid.*

3.5.1 Political patronage and lack of board autonomy

The performance of NBK was undermined by several internal and external corporate governance issues related to top management and government interference in the governance of the bank. To start with, the directors and management of NBK was appointed by the President often on the basis of close friendship, political allegiance and patronage to the President.³¹³ This largely contributed to the directors' conflict of duty as they were appointed to serve the interests of the ruling elite. The presence of non-executive directors notwithstanding, their role was ceremonial and superficial and the operations at NBK were subject to political control. As such, the bank's directors could hardly exercise independent judgment as there was no legal or regulatory framework to guide them or protect them from sack and victimization.³¹⁴

Further, the rampant and haphazard political hiring and firing during the Nyayo era in turn affected their discharge of corporate duty to the bank prompting the pursuit of personal and political interests and fraudulent transactions. This involved abuse of office since one was no longer sure when he or she would be shuffled to another assignment or dismissed altogether.³¹⁵ Mbai opines that when one is appointed into a high position without due regard to merit, it is only natural that he or she is similarly likely to ignore meritocracy and regulations

³¹³ See generally NATION Reporter, 'Big Shake-up in Parastatals' *Daily Nation* (Kenya, 9 May 1980). President Moi appointed a new chairman of NBK in the changes that took place with immediate effect; Also see Chesherem n 271, Chesherem, a former Central Bank of Kenya Governor recounts how he was appointed the CBK governor by the then President Daniel ArapMoi through the Kenya Broadcasting Corporation (KBC) national radio broadcasting station on 23July 1993 during the 3pm news. He further reveals that the job was not advertised, the required credentials were also not disclosed and there was no interview for the job.

³¹⁴ See Mbai n 277, Mbai writes that from the early 1980s, it became quite frequent to shuffle permanent secretaries and other senior civil servants from organizations to organizations without due regard to their suitability for the positions.

³¹⁵ *Ibid.*

when appointing or recommending promotion of junior staff leading to poor governance and management.³¹⁶

Further, in parastatals such as NBK where the government of Kenya had controlling equity interests, the government exercised immense control through issuing Ministerial circulars and politically motivated directives which in turn undermined the zeal and performance of the board of directors.³¹⁷ For instance, the government directive requiring parastatals to place their deposits with indigenous banks led to NBK being used as a “cash cow” during the KANU regime by politicians, parastatals and public sector borrowers leading to non-payment and large non-performing loans. Consequently, these loans to parastatals formed a source of huge losses for NBK and the bank was on several occasions forced to file winding up petitions against these parastatals and politicians to recover their money thus resulting in further loss of funds through civil suit costs.³¹⁸

3.5.2 Poor regulatory and supervisory framework

Further, the lack of a strong legal, regulatory and supervisory framework contributed to under-performance of NBK as a banking institution.³¹⁹ NBK was characterized by risky, reckless and improper lending policies as well as weak banking supervision resulting in low profitability and huge non-performing loans. NBK would also in some instances borrow large sums of money on

³¹⁶*Ibid.*

³¹⁷ See S 5, 6 and 7 of the State Corporations Act Cap 446 Laws of Kenya; See also Mwaura n 292. The GoK and NSSF are the major institutional shareholders in NBK and they exercise immense control over the operations of the board and influence board appointments; See JaindiKisero, ‘Balance of Power at National Bank of Kenya Shifting to NSSF’ *The East African* (Nairobi, 2 June 2012); See also Michael Omondi, ‘NSSF Sparks Board Coup at National Bank’ *Business Daily* (Nairobi, 11 June 2012).

³¹⁸ See Kenneth Mwema, ‘Nassir Faces Bankruptcy Charge’ *Daily Nation* (Kenya, 8 February 1983). The Assistant Labour Minister Mr. Nassir was issued with a seven (7) day bankruptcy notice to pay Kshs. 713,178/30 owed to NBK; See also Paul Muhoho and GichuruNjihia, ‘Continental Bank Under Receivership’ *Daily Nation* (Kenya, 8 August 1986). The Continental Bank of Kenya Ltd was placed under receivership following a winding up petition by NBK for defaulting in repaying debt of Kshs. 33,185,709.05.

³¹⁹*Supra* n 269, Brownbridge notes that the extent of the fragility within the financial system in NBK has exposed deficiencies in the regulatory and supervisory framework in Kenya.

behalf of other parastatals leading to a liquidity crisis when the money was recalled. For instance, as at the end of 1991, NBK had borrowed Kshs2.3billion from NSSF on behalf of other commercial banks and financial institutions and more than Kshs 1billion was still outstanding.³²⁰

Unfortunately, the directors involved in this irresponsible conduct were only sacked from the board and civil litigation against them was not pursued. These miscreant directors went unpunished majorly due to the existing weak legal framework relating to liability of directors for negligence and lack of political goodwill to bring them to book.³²¹ Furthermore, during this time, the judiciary was also characterized by corruption, inefficiency and heavy political control which frustrated the loan recovery process by NBK.³²² In other instances, politicians who owed the bank millions of shillings were declared bankrupt leaving the bank exposed and unable to recover its debts.³²³

In addition, during the 1980s and 1990s, the Central Bank of Kenya had few regulatory and supervisory powers.³²⁴ The CBK and the political arm of government were closely inter-linked and CBK would not make independent decisions.³²⁵ As a result, most of the state powers were exercised by senior officials in parastatals who became more powerful than the legislature and judiciary and it was therefore difficult to control them.³²⁶

³²⁰*Supra* n 288.

³²¹Mbai n 277.

³²²Cheserem n 270.

³²³ See NATION Reporter, 'Ngei Bankrupt, Court Declares' *Daily Nation* (Kenya, 11 July 1981). The Ministry of Works Minister Paul Joseph Ngei was declared bankrupt by the High Court for failing to repay creditors Kshs. 4.6M.

³²⁴ Charles Hornsby, *Kenya: A History Since Independence* (I. B. Tauris Co. Ltd 2003) 429.

³²⁵Cheserem n 270.

³²⁶Mbai n277.

In an effort to stabilize the banking sector, the government undertook several legislative, regulatory and policy reforms.³²⁷ The rescue plan for NBK included a request to the Attorney General and Chief Justice of Kenya to expedite the hearing of suits involving debt recovery and lifting of court injunctions imposed against the bank.³²⁸ The CBK Act of 1966 was also amended to give CBK a greater autonomy and restore public confidence in the financial system.³²⁹ The Banking Amendment Act of 1991 was also passed to enhance the role of CBK in supervision of banks. Additionally, the Capital Markets Act (CMA)³³⁰ was amended to establish the Capital Markets Authority which is the watchdog for the securities market in Kenya.

Over time, the benefits of these watchdogs have been demonstrated through improved service delivery and protection of investor interests in the securities markets and financial sector.³³¹ However, much remains to be done with regard to enforcing the provisions of the Companies Act under which NBK is incorporated in addition to regulating the conduct of individual directors especially of private and non-listed companies.

3.5.3 Lack of a concise statutory statement on directors' duties

NBK was initially established as a parastatal bank and its operations were subject to the provisions of the State Corporations Act,³³² directives and circulars from the President, Ministers and Treasury. The State Corporations Act requires the powers of the board to be exercised in

³²⁷*Supra* n 272. These measures included raising of minimum paid-up capital requirements for institutions, tightening banking regulation, directing non-bank financial institutions to convert into banks in order to bring them under the direct supervision of CBK and encouraging small banks to merge so as to enjoy economies of scale

³²⁸*Supra* n 269.

³²⁹*Supra* n 272.

³³⁰Cap 485A Laws of Kenya.

³³¹ The CBK has on several occasions placed a number of underperforming banks under statutory management. These include City Finance Bank, Trust Bank and Prudential Bank; See Tanui n 299. The CMA has also suspended several directors from acting in any directorship. See Joshua Masinde, 'Tsavo Securities Stripped of Licence Over Bonds Fraud' *Daily Nation* (Kenya, 15 April 2014); The Deposit Protection Fund Board (DPFB) successfully brought a suit on behalf of the depositors of Trust Bank against two directors of the bank which collapsed in 1999. See Paul Ogemba, 'Two Former Bank Directors To Pay Shs. 1.5bn for Breach of Trust' *Daily Nation* (Kenya, 31 May 2013).

³³² Cap 446 Laws of Kenya.

national interests but the Act does not define the meaning of national interest.³³³ Rather, the Minister in charge of a state corporation is responsible for setting the objectives of the parastatal.³³⁴ This is through exercise of discretion as there is no laid down procedure or guidelines to be considered in setting the objectives. Regrettably, these Ministerial directives and objectives were not subjected to any scrutiny or question before implementation by the board.

Further, owing to the fact that the government owned a controlling share in NBK, politically correct friends of the government obtained money from NBK without sufficient security. The government also ordered money to be given to its supporters and friends and in some instances money from NSSF and channelled through NBK was lent to individuals.³³⁵ The bank's management had no say over this owing to lack of a clear statutory statement on directors' duties.

Nevertheless, NBK was subsequently converted to a public listed company incorporated under the Companies Act thus making it subject to the Companies Act and several other statutes such as the Banking Act,³³⁶ Central Bank of Kenya Act,³³⁷ and the Capital Markets Act.³³⁸ However, it is regrettable that these statutes do not also prescribe the common law duties of directors to exercise reasonable care, skill and diligence as well as exercise of fiduciary duties in the interest of the bank and its investors. As a result, the duties of directors have for a long time been only enforceable through the courts which interpret the directors' duties to the company based on

³³³ S 7 (3) of the State Corporations Act Cap 46 Laws of Kenya.

³³⁴ Mwaura n 294.

³³⁵ Sunday Nation Team, 'Fire Bank Debtors, Leaders Tell Moi' *Sunday Nation* (Kenya, 29 November 1998).

³³⁶ Cap 488 Laws of Kenya.

³³⁷ Cap 491 Laws of Kenya.

³³⁸ *Supra* n 330.

common law principles and this has only been successful in winding up petitions and liquidation suits.³³⁹

However, several subsidiary legislation and guidelines such as the Corporate Governance Guidelines for Public-Listed Companies³⁴⁰ and the CBK Guidelines for Directors of Banks in Kenya³⁴¹ have subsequently been adopted to guide directors of public companies and financial institutions in the discharge of their functions. Unfortunately, the recognized directors' duties and responsibilities are extensive and diverse and there is need to merge and harmonize these duties in statute.

3.5.4 Lack of a corporate code of ethics for directors

In Kenya, company directors are not governed by a code of ethics save for directors of banks who must adhere to the CBK Guidelines for Directors of Banks in Kenya.³⁴² Generally, codes of ethics promote the values of integrity, honesty, efficiency, effectiveness and impartiality of officials when exercising discretion or when acting in public good.³⁴³ They are also aimed at checking corruption, misappropriation of company assets, embezzlement, political patronage and abuse of office.³⁴⁴ Therefore, lack of codes of standards to regulate conduct of directors prompts poor corporate governance through non-accountability, partiality, inefficiency, ineffectiveness and corruption.

³³⁹ See Ogemba n 331, The High Court of Kenya at Nairobi found two former directors of Trust Bank guilty of misfeasance, failing to discharge their duties diligently, transparently and non-fraudulently leading to the bank's closure in 1999. They were also found to be in breach of their fiduciary duties to the bank.

³⁴⁰ Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya, 2002. They were introduced vide Gazette Notice No. 3362.

³⁴¹ *Supra* n 275. The Guidelines provide that the duties and responsibilities of directors of the bank are to oversee the conduct of the bank's business, to select and retain competent management, to establish the bank's long-term and short-term objectives, monitor operations, oversee the bank's business performance, ensure bank meets societal credit needs and to exercise diligence, independent judgment and loyalty.

³⁴² *Ibid.*

³⁴³ Mbai n 277.

³⁴⁴ *Ibid.*

An instantly recognizable example was the National Bank of Kenya Annual Financial Report of 1991 which was qualified by the bank's auditors, Messrs Bellhouse Mwangi Ernest and Young. Yet, the bank's management failed to disclose this qualification in its report to the public which amounted to material non-disclosure.³⁴⁵ Further, during the period when the bank was deeply distressed financially, the management tried to conceal this anomaly and in fact issued a press statement denying the media allegations that the bank was nearing closure, a clear indication of non-transparency and non-accountability to stakeholders.³⁴⁶

In addition, the requirement for induction of new board members and for continuous training of directors is not mandatory in Kenya. As such, many directors are unaware of their duties to the company especially directors of small private companies. In view of that, a standard written code of conduct for all directors in Kenya would go a long way in enhancing good corporate governance in Kenya.

3.5.5 Poor corporate governance regulatory framework

The foregoing corporate governance challenges at NBK point to a generally poor corporate governance regulatory framework with underlying weak legal system and poor enforcement mechanisms. A good corporate governance system ensures that directors and managers of corporations carry out their duties within a framework of accountability and transparency.³⁴⁷

However, the existing legal and regulatory framework fails to promote and place emphasis on the principles of transparency, accountability, integrity, effectiveness and efficiency in the governance of corporations in Kenya and this largely contributed to NBK's near-collapse. This is

³⁴⁵ See NATION Reporter, 'Major State Bank in Financial Crisis' *Daily Nation* (Kenya, 8 July 1992).

³⁴⁶ *Ibid.* See also Waihenya Kabiru, 'NBK is in Good Shape-Simba' *Daily Nation* (Kenya, 26 May 1993).

³⁴⁷ Lai Oso and Bello Semiu, 'The Concept and Practice of Corporate Governance in Nigeria: The Need for Public Relations and Effective Corporate Communication' (2012) 3 (1) J Communication 1 <<http://www.krepublishers.com/02-Journals/JC/JC-03-0-000-12-Web/JC-03-1-000-12-Abst-PDF/JC-03-1-001-12-039-Oso-L/JC-03-1-001-12-039-Oso-L-Tt.pdf>> accessed 19 August 2013.

evidenced by the fact that the rogue NBK board members have never been held to account for the mismanagement and poor governance. They were neither investigated nor prosecuted and the government only came in to revive the bank by pumping in more funds to keep the bank afloat.

Whereas the private sector has actually introduced the Principles for Corporate Governance in Kenya and a Sample Code of Best Practice for Corporate Governance³⁴⁸ as well as the Guidelines for Good Corporate Governance in State Owned Corporations,³⁴⁹ legislation is yet to be enacted to give effect to the private sector's efforts. The existing voluntary codes therefore remain visionary and their provisions are yet to be implemented fully owing to a non-supportive legislative framework. Furthermore, there has been no attempt to align the guidelines with the underlying legal framework and make them part of a comprehensive and sustainable corporate culture and hence companies are yet to internalize the same.

3.6 What is the Importance of Statutory Codification of Directors' Duties in Enhancing Good Corporate Governance in Kenya?

The underlying cause of NBK's financial and governance fragility, was not addressed during the 1980s and the problems intensified in the 1990s. The general public being the major shareholder bore the blunt of the devastating and adverse effects. The media, for nearly a decade in the 1990s, was awash with stories of NBK and rumours of its collapse. The public lost confidence in the bank and there was general panic among the investors. Depositors made panic withdrawals for fear of the bank collapsing with their money.³⁵⁰ At some point, the government injected

³⁴⁸Private Sector Initiative for Corporate Governance, *Principles for Corporate Governance in Kenya and a Sample Code of Best Practices for Corporate Governance* (Centre for Corporate Governance Kenya, 1999).

³⁴⁹Private Sector Corporate Governance Trust, *Guidelines for Good Corporate Governance in State Owned Corporations* (Oakland Media Services Ltd 2002).

³⁵⁰ See Kabiru n 346. Depositors with NBK and Kenya Post Office Savings Bank made panic withdrawals following the liquidation of Post Bank Credit Ltd because there were rumours of financial crisis at NBK and the Kenya Post Office Savings Bank; See also MishaelOndieki, 'NBK on a Firm Path' Daily Nation (Kenya, 25 November 1998). The author reports that the cash-flow problems in NBK came from a run of the bank.

Kshs2billion into NBK following panic withdrawals by depositors of Kshs1.6billion in one week.³⁵¹ NBK was even forced to borrow billions from the inter-bank market to cover daily liquidity requirements.³⁵² NBK, a major bank, was immediately the subject of widespread public concern and general criticism as a result of mismanagement. This also affected the delivery of services to citizens and investors as long queues could be witnessed in the banking halls when members of the public went to withdraw their monies. Further, when the Government of Kenya and other major institutional shareholders such as NSSF stepped in to revive the bank, public funds was involved.³⁵³ The consequences were of course serious at both a personal and national level.

Perhaps, the NBK board members were not entirely to blame for their failure to understand their duties to the corporation. The lack of board independence from political influence led to conflicts of interest; they were of course appointed to serve the interests of the political bigwigs and ultimately, they were expected to owe allegiance to them for their appointments else they would suffer sack. The underlying root cause was the legal framework that provided for board appointments to be made by the president and ministers who were also political appointees.³⁵⁴ Since the State Corporations Act did not impose any limit on Ministerial and Government directions to the board, the board of directors was not able to question or review undesirable directives.³⁵⁵ Furthermore, as a result of lack of clear statutory lines on duties, the directors' duty

³⁵¹Tanui n 301.

³⁵²*Ibid.*

³⁵³ The majority shareholder in NSSF is the general public. NSSF is a social security fund for workers in the formal and informal sector in Kenya and it draws its finances from the workers' contributions.

³⁵⁴ See S 3 of the State Corporations Act Cap 446 Laws of Kenya.

³⁵⁵Mwaura n 294.

of good faith to the parastatal was overshadowed by other overriding interests, including pursuit of personal and political interests.³⁵⁶

Moreover, the problem was and continues to be escalated by the numerous and overlapping laws and regulations that govern the operations of NBK's board of directors. It is regrettable that despite the existence of several statutes, none of the statutes in fact clearly embrace the common law duties of directors, the evolving duties to stakeholders or the duties recognized under corporate governance. In addition, the provisions of the subsidiary legislation enacted pursuant to these statutes are as diverse as the Acts themselves with regard to duties of directors and no attempt has been made to harmonize the same.

Further, the existing legal and regulatory framework has been non-emphatic on the principles of good corporate governance such as transparency, accountability, integrity, effectiveness and efficiency. The Constitution of Kenya has attempted to remedy this deficiency in the law by providing that the national values and principles of governance are binding upon every person, whether incorporated or unincorporated.³⁵⁷ However, the existing statutes are yet to be amended to conform to the provisions of the Constitution and this is a major setback to enforcing good corporate governance practice in corporations in Kenya.

In addition, good corporate governance is essentially linked to good conduct and ethics. In fact, some authors and theorists underpin corporate governance in ethics where directors of companies are required to adhere to ethics and socially responsible behaviour.³⁵⁸ It is observed that ethical

³⁵⁶*Ibid.*

³⁵⁷Article 10.

³⁵⁸ See Mark S Schwartz, Thomas W Dunfee and Michael J Kline, 'Tone at the Top: An Ethics Code for Directors' (2005) 58 Journal of Business Ethics 79 <http://foxrothschild.com/uploadedfiles/newspublications/Kline_ToneAtTheTop_111005.pdf> accessed 19 June 2013.

behaviour especially on the part of the corporate leaders leads to the best long-term interests of the corporation.³⁵⁹ It is therefore unfortunate that our corporate governance system does not embrace a national code of ethics for directors in Kenya thus undermining good corporate governance in Kenya.

A lot remains to be done with regard to strengthening the regulatory, supervisory and enforcement mechanisms. The government should embrace public-private partnerships to alleviate the problem. For instance, the Institute of Directors, Kenya (IoD-K) can be empowered and mandated under the Companies Act to regulate the conduct and ethics of directors in Kenya.³⁶⁰ This would supplement the efforts of the Office of the Registrar of Companies in enforcing ethics.

Overall, conflicts of interest and duty of the directors and managers result in poor governance and mismanagement of the corporation's assets and compromise transparency, accountability, integrity, effectiveness and efficiency which are the core principles of good corporate governance. This therefore demands taking of preventive and corrective measures to align directors' interests to those of the company considering the adverse effects of mismanagement and poor governance on the society and country as a whole.³⁶¹

The case of NBK is not unique and many public and private companies have suffered at the hands of miscreant directors. Directors hold a very core position in the company and are charged with the responsibility of making major decisions for the company. As the primary governing body therefore, the board of directors exercises the most important functions in a corporation.

³⁵⁹ *Ibid.*

³⁶⁰ Currently, the IoD-K is a professional body of individual corporate directors. As is the case in Kenya and in many other jurisdictions, the Institute of Directors is a non-governmental and private sector initiative.

³⁶¹ Such effects include loss of public confidence in capital markets and management of companies, loss of investor confidence, poor corporate image as well as loss of taxpayers' money.

Corporate governance recognizes the responsibilities of the board of directors to include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship.³⁶² For a board to discharge these functions effectively, it must have certain qualities which include acting in good faith and with due diligence in the best interests of the company, applying high ethical standards, exercising independent objective judgment and defining clear working procedures of the board based on the principles of transparency, accountability, integrity, effectiveness and efficiency.³⁶³

Consequently, many corporate collapses and scandals result from failure of the board to observe their conventional duties and clearly, the legal and regulatory framework in Kenya largely contributes to these corporate failures by failing to define the precise roles and responsibilities of the corporations' top governing organ as well as failing to emphasize on the observance of the core corporate governance principles.

Accordingly, reform of the law is inevitable to circumvent future corporate collapses noting the negative image that such scandals present for local and foreign investors. Any losses that result from mismanagement are passed on to innocent shareholders in the case of a private company and to the public in the case of public companies and state corporations. As such, this research regards a statutory statement of directors' duties as a necessary and vital tool for promoting performance of company directors in Kenya and thus good corporate governance practice.

³⁶² Committee on the Financial Aspects of Corporate Governance, *Report of the Committee on the Financial Aspects of Corporate Governance* (London: Gee & Co 1992) <<http://www.ecgi.org/codes/documents/cadbury.pdf>> accessed 1 July 2013.

³⁶³ Mwaura n 294.

3.7 Conclusion

Ultimately, all aspects of the management of an institution are corporate governance issues. Corporate governance arrangements include inter alia issues of transparency of the corporate structure, power of shareholders to exercise the right to demand accountability of managers, disclosure of the authority and power of directors as well as sound internal audit arrangements.³⁶⁴ From the foregoing, it is evident that the mismanagement in NBK and other companies is as a result of the underlying weak legal system that fails to define directors' duties concisely and clearly resulting in directors' ignorance of duty, non-accountability, and corruption, abuse of power, negligence and want of care.

This research accordingly advocates for reform of the Companies Act to codify duties of company directors in statute in addition to prescribing stiff sanctions and liabilities for breach of the duties as a way of enhancing good corporate governance practice in Kenya. The codification of directors' duties is expected to address the legislative inadequacies that have been the major cause for poor performance, liquidation and collapse of many corporations in Kenya. Such a concise statement is also expected to promote good corporate governance, transparency and accountability by clearly stating to whom the directors' duties are owed, why they are owed, the penalties and consequences for breach and the benefits of compliance thus curbing incidents of corporate failures and loss of investors' money.

This research further submits that good corporate governance and modern duties of directors encompass taking into account other stakeholders' interests through socially responsible business practices. Some authors actually believe that corporate governance is ineffectual without

³⁶⁴Hans Falkena, Roy Bamber, David Llewellyn and Tim Store, *Financial Regulation in South Africa*, (2nded, South Africa Financial Sector Forum 2001).

effective corporate social responsibility (CSR).³⁶⁵ The enacted legislation should acknowledge this development noting the evolving corporation's duty to the community and other stakeholders.

The next chapter explores a detailed comparative study on the emerging jurisprudence and the applicability of best practice from other jurisdictions particularly the United Kingdom and South Africa.

³⁶⁵Kabiru n 346. However, codification of duty to stakeholders needs to be supported by clear statements relating to its enforcement to avoid blurring directors' duties thus making them less accountable to shareholders.

CHAPTER FOUR

CODIFYING DIRECTORS' DUTIES: LESSONS FROM UNITED KINGDOM AND SOUTH AFRICA

4.0 Introduction

Cross-jurisdictional views and practice of good corporate governance usually informs the design and implementation of corporate governance law and regulation across the countries of the world.³⁶⁶ The UK Cadbury Report for instance, set a global standard on corporate governance which has influenced the evolution of corporate governance in the UK and other countries. As a result, there have been global attempts around the world to reform corporate law in the wake of corporate misfeasance and many jurisdictions have embraced legal, institutional and policy reforms in order to improve corporate governance while most jurisdictions have adopted good corporate governance codes.³⁶⁷ This is a clear indication that corporate conduct or decisions occurring in one country might still have legal relevance in another country. These changes are aimed at ensuring businesses are competitive globally by reflecting best practice in the governance of institutions.

Noting the rising number of corporate scandals, a statutory statement of directors' duties is not only desirable but also essential in enhancing good corporate governance practice in Kenya. Accordingly, this chapter aims and focuses on comparative lessons that Kenya can draw with best practice particularly from the United Kingdom and South Africa for purposes of developing

³⁶⁶Professor Bryan Horrigan, 'Directors' Duties and Liabilities-Where Are We Now and Where Are We Going in the UK, Broader Commonwealth and Internationally' (2012) 3 (2) International Journal of Business and Social Science 21 <www.ijbssnet.com/journals/Vol_3_No_2_Special_Issue.../3.pdf> accessed 15 September 2013.

³⁶⁷ Australia, for instance, passed its reformed Corporations Act in 2001 and this Act was used as a reference point by the UK legal reformers. Ghana is currently reforming its Companies Act of 1963 to conform to new business trends.

and reforming the Companies Act with regard to codification of directors' duties.³⁶⁸ The researcher has a keen interest on the SA corporate law for reasons that SA is an African country and thus its practices and laws are fairly comparable to those of Kenya, a fellow African state. In addition, SA has always been ahead of its peers in development and this is also evident by the fact that SA has continuously updated its corporate governance regulatory framework with King Report 1 to King Report II and now King Report III adopted in 2009.³⁶⁹

The choice of UK is based on the fact that Kenya is a former British protectorate and most of its laws are based on the UK laws. In fact, as it is, the Companies Bill is a replica of the UK Companies Act, 2006. The researcher acknowledges that neither of the legislations in the two jurisdictions is conclusive generally and therefore opts to borrow from the two jurisdictions for purposes of enriching the Kenya's Companies Act with an aim of making it more comprehensive.

4.1 The Evolution of Corporate Governance in United Kingdom and the Need for Reform of Corporate Law

The UK Parliament has so often amended its Companies Act with the 1948 Act being amended in 1967, 1980, 1981 and 1983 resulting in the consolidated Companies Act of 1985.³⁷⁰ The shortcomings of the Act became apparent especially in relation to directors' dealings with the

³⁶⁸ Other jurisdictions have notably codified directors' duties in their corporate statutes. Examples include the Australian Corporations Act of 2001, New Zealand Companies Act of 1993 and Singapore Companies Act.

³⁶⁹ Institute of Directors South Africa, *Draft Code of Governance Principles for South Africa* (The Business Leaders, 2009) 10 <<http://www.ru.ac.za/media/rhodesuniversity/content/erm/documents/xx..King.3.-.King.Report.pdf>> accessed 16 September 2013..

³⁷⁰ RtHon Lady Justice Arden, 'Companies Act 2006 (UK): A New Approach To Directors' Duties' (2007) 81 ALJ 162 <<http://www.hrlrc.org.au/files/lawrep-081-alj-jl-0162.pdf>> accessed 1 August 2013.

company and consequently, the UK Department of Trade and Industry held several consultative forums in the 1980s and 1990s on areas that needed particular reforms.³⁷¹

Initially, the UK did not have even the most general statement of the duties of directors in its Companies Act prior to the 2006 Act. However, with changing international trends, it was necessary to improve corporate governance and the codification of directors' duties was seen as having a role to play in this process by guiding directors to higher standards. Further, it was also imperative to make the law more accessible to directors and their advisors especially for smaller companies where directors did not often have access to legal advice.³⁷²

In 1998, the DTI set up the Company Law Review which sought to identify the guiding principles for legislation on directors' duties as well as the statutory restrictions on directors' transactions with companies.³⁷³ The Company Law Review concluded that directors' duties should be stated in statutory form to reflect best practice and in a manner that reflected the enlightened shareholder value. As a result, the UK Government in July 2002 published a White Paper incorporating the Company Law Review Steering Group recommendations and the new Companies Bill was introduced in Parliament in November 2005. Ultimately, the new UK Companies Act of 2006 received Royal Assent on 8th November 2006.

Further, with regard to improving corporate governance practice in England, several committees were held and recommendations made during the period 1992-2006. The first was the Cadbury

³⁷¹ In 1995, the DTI tasked the Law Commissions of England and Wales and the Scottish Law Commission to make recommendations on the company law review.

³⁷² Financial Reporting Council, 'The UK Approach to Corporate Governance' (October 2010) 3 <<https://www.frc.org.uk/getattachment/1db9539d-9176-4546-91ee-828b7fd087a8/The-UK-Approach-to-Corporate-Governance.aspx>> accessed 28 July 2013.

³⁷³ *Supra* n 369. The identified guiding principles on legislation are firstly, that law should be accessible and clear. Secondly, company law should be enabling rather than prescriptive and that it should be effective in its operation to enhance international competitiveness.

Report of 1992³⁷⁴ which recommended that the role of chairman and chief executive officer be separated to ensure a balance of power. It also recommended appointment of independent non-executive directors to the board and establishment of an audit committee to ensure greater accountability and transparency.

The Greenbury report of 1995³⁷⁵ aimed at setting out best practice in determining and accounting for director's remuneration. It recommended establishment of a remuneration committee and disclosure of directors' remuneration and policies in the company's annual reports. The Hampel report of 1998³⁷⁶ was concerned more in the attitude of corporate governance rather than the practice. Thus, Hampel stressed that corporate governance was a force to aid business prosperity and it required a change of approach towards that end. It also formulated several guiding principles that should govern the board and company, to wit that companies should be headed by an effective board, leading and controlling operations of the company and that appointment of directors should be transparent.

The Turnbull report of 1999³⁷⁷ emphasized on the importance and need for maintaining a sound system of internal control. The Higgs report of 2003³⁷⁸ inter alia sought to review the role of non-executive directors and recommended the establishment of a nomination committee. The Smith

³⁷⁴Committee on the Financial Aspects of Corporate Governance, *Report of the Committee on the Financial Aspects of Corporate Governance* (London: Gee & Co 1992) <<http://www.ecgi.org/codes/documents/cadbury.pdf>> 1 July 2013. The Committee was chaired by Sir Adrian Cadbury in 1992 and it produced a report famously referred to as the Cadbury Report.

³⁷⁵*Directors' Remuneration Report of a Study Group chaired by Sir Richard Greenbury* (London: Gee & Co 1995) <<http://www.ecgi.org/codes/documents/greenbury.pdf>> accessed 10 August 2014.

³⁷⁶*Committee on Corporate Governance: Final Report* (London: Gee & Co 1998) <<http://www.ecgi.org/codes/documents/hampel.pdf>> accessed 10 August 2014. The Committee was chaired by Sir Ronnie Hampel.

³⁷⁷The Institute of Chartered Accountants in England and Wales, *Internal Control Guidance for Directors on the Combined Code* (The Institute of Chartered Accountants in England and Wales 1999) <<http://www.ecgi.org/codes/documents/turnbul.pdf>> accessed 10 August 2014.

³⁷⁸Department of Trade and Industry, *Review of the Role and Effectiveness of Non-executive Directors'* (Department of Trade and Industry 2003) <<http://www.ecgi.org/codes/documents/higgsreport.pdf>> accessed 10 August 2014.

report of 2003³⁷⁹ recommended the establishment of an audit committee and set out their roles and responsibilities as oversight, assessment and review of financial reporting mechanisms, internal control systems, internal audit systems and risk management.

The codes were consolidated to form the UK Combined Code³⁸⁰ which is currently applicable. The code sets out standards of best practice in relation to board leadership and effectiveness, remuneration, directors' responsibilities and duties, accountability and relations with shareholders and other stakeholders. The review of the UK corporate law further aimed at consolidating the provisions of these various codes in the Companies Act of 2006 for greater clarity, accountability and transparency.

4.2 The Development of Corporate Governance in South Africa and the Need for Corporate Law Reform

The history of SA corporate law began with the introduction of the 1926 Union Companies Act. Since then, there had only been one significant review initiated in 1963 and it culminated in the 1973 Companies Act³⁸¹ which was still largely based on the framework and general principles of the English law.³⁸² The South African corporate law reform was necessitated by a number of legal and legislative reforms, socio-political and global economic factors, more so after 1994.³⁸³

³⁷⁹ Financial Reporting Council, *Audit Committees Combined Code Guide A Report and Proposed Guidance by an FRC-appointed Group chaired by Sir Robert Smith* (Financial Reporting Council 2003) <http://www.ecgi.org/codes/documents/ac_report.pdf> accessed 10 August 2014.

³⁸⁰ Financial Reporting Council, *The Combined Code on Corporate Governance* (Financial Reporting Council 2006) <http://www.ecgi.org/codes/documents/frc_combined_code_june2006.pdf> accessed 10 August 2014. The UK Combined Code replaced the 2003 UK Corporate Governance Code.

³⁸¹ Act No. 61 of 1973.

³⁸² Department of Trade and Industry South Africa, *'South African Company Law Review for the 21st Century Guidelines for Corporate Law Reform'* (Department of Trade and Industry 2004) <<http://www.pmg.org.za/bills/040715companydraftpolicy.pdf>> accessed 12 August 2014.

³⁸³ Though South Africa gained independence from the British colony in 1910, the non-whites were segregated through the apartheid system. This system strictly separated people by colour or race. It was not until 1994 that South Africans gained independence from the white minority after holding the first non-racial democratic elections. See Kristin Henrard, *'Post Apartheid South Africa's Democratic Transformation Process: Redress of the Past,*

Fundamental legal developments such as the adoption of a new Constitution in 1996 and other legislative enactments especially the labour laws had strong implications on the existing economic relationships and the company law in general.³⁸⁴ These legislations aimed at balancing the interests of employees and employers and to enhance equity in employment in accordance with the Government's Reconstruction and Development Programme (RDP) that set out to dismantle the apartheid system and create a democratic society.³⁸⁵ It was therefore imperative to align the company law with the new Constitution and the other laws that had been enacted. Further, the framework upon which the SA Companies Act was based was also questioned in its country of origin, to wit, England resulting in the UK Companies Act of 2006.

Additionally, the SA Department of Trade and Industry (DTI) identified globalization, rise of international trade and foreign investment and sensitivity to social, ethical and environmental concerns as major reasons for the overhaul of the existing corporate governance framework.³⁸⁶ The existing company law also undermined accountability and transparency of business enterprises as the Act did not contain clear rules regarding corporate governance and the duties and liabilities of company directors. These matters had largely been left to common law and codes of corporate practice and the DTI emphasized the need for corporate review to provide for disclosure, access to information and effective mechanisms for enforcement of prescribed statutory duties of directors.

The Department of Trade and Industry therefore recognized a need to review the regulatory framework to ensure that the corporate law was responsive to global competitiveness and

Reconciliation and Unity in Diversity' The Global Review of Ethnopolitics 1 (3) 2002 18, <http://www.ethnopolitics.org/ethnopolitics/archive/volume_1/issue_3/henrard.pdf> accessed 13 August 2014.

³⁸⁴ The labour legislations include the Law Relations Act of 1995, the Employment Equity Act No. 55 of 1998 and the Skills Development Act No, 97 of 1998.

³⁸⁵ *Supra* n 381.

³⁸⁶ *Ibid.*

sensitive to societal and ethical concerns and accordingly the South Africa Companies Act 2008 was assented to by the President on 8th April 2009.

Generally, corporate governance in South Africa was institutionalized by the publication of the King Report of 1994 which aimed at promoting corporate governance by recommending standards of conduct for boards and directors of listed companies, financial institutions and other public sector enterprises.³⁸⁷ The King Committee on corporate governance was formed with the support of the Institute of Directors South Africa (IoDSA). It was later replaced by the King Report of 2002 which contained a voluntary code of corporate practice and conduct. The third King Report was released in 2009 and this third revision was necessitated by the enactment of the new Companies Act of 2008 which incorporated many of the principles embodied in the previous King Reports. The King Codes have continued to play a significant role in promoting effective corporate governance and high standards of governance in South African companies.

4.3 Corporate Governance in Kenya and the Need for Company Law Review

The Kenya Companies Act³⁸⁸ was introduced in 1959 and adopted in 1962 with few amendments to date. The Act contains several statutory duties of directors and they include the duty to keep proper books of accounts,³⁸⁹ duty to register charges created by the company with the registrar,³⁹⁰ duty to disclose directors' shareholding, salaries and loans³⁹¹ and duty to disclose any interest in contracts.³⁹²

³⁸⁷Institute of Directors in South Africa, '*Executive Summary of the King Report 2002 King Committee on Corporate Governance* (Institute of Directors in South Africa 2002) <https://www.saica.co.za/Portals/0/documents/executive_summary_king11.pdf> accessed 11 August 2014.

³⁸⁸ Cap 486 Laws of Kenya. The Act is based on the English Companies Act of 1948.

³⁸⁹S 147.

³⁹⁰S 97.

³⁹¹S 196-198.

³⁹²S 200.

The Kenyan courts have also defined directors' duties through case law based on English common law.³⁹³ However, the deficiencies of case law cannot be gainsaid noting the varying judicial analysis and interpretations and more so in an adversarial system like ours where judicial decisions mainly depend on the circumstances of each case. By and large, case law also exhibits a lack of appreciation of prevailing trends as it is largely inflexible due to the stare decisis principle which rarely considers the changing societal expectations and economic situations.³⁹⁴ Regrettably, duties of directors in Kenya are uncodified in statute and directors have to search through these numerous court decisions to understand their roles in the governance of corporations.

Furthermore, in Kenya, the common law duties of directors have not changed to reflect global practice in spite of the fact that Kenya has witnessed an influx in the number of registered companies. The global economy has changed and with the increasing number of transnational companies and the rise of human rights activism, the expectations of society have shifted from the traditional pro-shareholder primacy to pro-stakeholderism.³⁹⁵ The Kenyan Courts also acknowledge that common law is only to be applied in special circumstances to fill up what is not provided for in the written laws in conformity with the aims of the Constitution.³⁹⁶

It is against this backdrop that the heavy reliance on common law as the source of law on duties of directors can be seen as a contributing factor to the failure and non-sustenance of good

³⁹³ Common law is recognized as a source of law in Kenya under S 3 (1) of the Judicature Act Cap 8 Laws of Kenya. The common law duties of directors are the duties of care, skill and diligence and fiduciary duties as formulated in the English case of *Re City Equitable Fire Insurance Company* [1925] Ch 407.

³⁹⁴ The stare decisis principle is the doctrine of precedent where a Court is bound by an earlier decision of a higher Court and cannot depart from that previous Ruling.

³⁹⁵ Multi-national corporations have in the recent past been sued and held liable by the Courts in connection with human rights violations. An example is the Nigeria Shell Oil case where the company was sued in connection with Shell's social and environmental impact on the Niger Delta; See also Ed Pilkington, 'Shell Pays Out \$15.5M over Saro-Wiwa Killing' *The Guardian* (New York, 9 June 2009) <<http://www.theguardian.com/world/2009/jun/08/nigeria-usa>> accessed 11 June 2014.

³⁹⁶ *Otieno v Ougo & Another* [1986-1989] EA 468, 475.

corporate governance of corporations in Kenya more so because it hinders effective enforcement of the law due to uncertainty and inaccessibility of common law. This undoubtedly necessitates the statutory codification of directors' duties to facilitate clarity, consistency, accessibility and certainty in the duties and responsibilities of company directors.

Accordingly, the Companies Bill was introduced in an effort to resolve these inherent gaps and develop a modern Companies law that supports a competitive economy, while taking into account the current globalization trends by proposing codification of the common law duties of directors with an expectation of raising corporate governance standards in Kenya. This codification is expected to steer economic growth and good corporate governance in Kenya through effective enforcement of the law. Regulation through codification of directors' duties is also expected to promote the values of good corporate governance to wit accountability, transparency, integrity and responsibility.³⁹⁷ This can be achieved through legislation that encourages corporations to adopt socially and environmentally responsible decisions and to be accountable to its citizenry.

Further, with the promulgation of the new Constitution 2010, it is imperative to review the corporate law in Kenya to conform to the provisions and the aims of the Constitution, the Bill of Rights and other legislative enactments. It is also necessary to give statutory backing to the Principles for Corporate Governance in Kenya³⁹⁸ developed by the Private Sector Corporate Governance Trust (PSCGT) in 1999 to promote corporate governance in Kenya.

Sadri opines that an effective corporate governance system should provide mechanisms for regulating directors' duties in order to restrain them from abusing their powers and to ensure that

³⁹⁷*Supra* n 372.

³⁹⁸Private Sector Initiative for Corporate Governance, *Principles for Corporate Governance in Kenya and a Sample Code of Best Practices for Corporate Governance* (Centre for Corporate Governance Kenya, 1999).

they act in the best interests of the company in its broad sense.³⁹⁹ In that regard, a close link between good governance and compliance with the law has been acknowledged with suggestions that it is entirely inappropriate to unhinge governance from the law.⁴⁰⁰ Thus, the Centre for Corporate Governance in Kenya notes that good corporate governance requires the State to put in place and maintain an enabling environment in which efficient and well-managed companies thrive.⁴⁰¹ It is for this reason that legislation in Kenya is seen as a crucial mechanism to deal with miscreant directors and to ensure that directors adhere to their duties to the corporation.

4.4 To Whom Are the Directors' Duties Owed?

Corporate Governance has been defined as 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 with the satisfaction of other stakeholders in the context of its corporate mission.⁴⁰²

In order to define in whose interest a company is governed and to whom directors' duties are owed, it is important to first evaluate the various positions that directors hold in a corporation. Directors have been said to be in a fiduciary relationship with the company. They have also been said to be trustees in relation to the company assets as well as agents of the shareholders who are the owners of the company. Some directors may be contracted to work for the company and in this case they are considered to be employees. Each of the aforesaid positions will be discussed in order to ascertain the position of company directors in corporations.

³⁹⁹ Sadri Jayashree, 'Some Views on Corporate Governance' (Indira Management Review 2006) <http://www.indianmba.com/Faculty_Column/FC282/fc282.html> accessed 15 September 2013.

⁴⁰⁰ *Supra* n 369.

⁴⁰¹ *Supra* n 398.

⁴⁰² *Supra* n 374; See also A A Berle Jr, 'Corporate Powers as Powers in Trust' (1930-1931) 44 Harvard Law Review 1049.

4.4.1 Directors as Agents

Directors are, in the eyes of the law, agents of the company for which they act, and the general law of principal and agent regulates in many aspects the relationship of the company and its directors.⁴⁰³ Kenyan courts have held that a company, being an artificial company, can only take decisions through the agency of its organs which are primarily the board of directors or the general meeting of its shareholders.⁴⁰⁴ Further, the High Court of Kenya in Nairobi held in the case of *Ogada v Owanga & Another*,⁴⁰⁵ that a director is an agent of the company and he acts for and on behalf of the company and he therefore cannot be held liable in his personal capacity as he only acted as an agent. The effect of this is to foster business transactions and steer economic growth as a company is viewed as an entity distinct from its shareholders and its directors.

4.4.2 Directors as Fiduciaries

As agents, directors stand in a fiduciary relationship to the company and as such, they must loyally serve their principal's interests.⁴⁰⁶ The fiduciary relationship imposes upon them the duties of loyalty and good faith and they are required to exercise due care, skill and diligence in the discharge of their duties.⁴⁰⁷ The England Court of Appeal in the case of *Foster Bryant Surveying v Bryant*⁴⁰⁸ held that a director, while acting as such, has a fiduciary relationship with his company, that is, he has an obligation to deal towards it with loyalty, good faith and avoidance of the conflict of duty and self-interest.

⁴⁰³ Clive M. Schmitthoff, *Palmer's Company Law*, (24th edn, London: Stevens & Sons 1987) 929.

⁴⁰⁴ *Affordable Homes Africa Ltd v Henderson & 2 others* [2004] 2 KLR 473.

⁴⁰⁵ *Ogada v Owanga & Another* [2004] eKLR. The court therefore dismissed the suit against the 1st Defendant who had been sued in his capacity as the managing director of the company.

⁴⁰⁶ E Merrick Dodd Jr, 'For Whom are Corporate Managers Trustees?' (1932) 45 (7) *Harvard Law Review* 1145.

⁴⁰⁷ *Ibid.*

⁴⁰⁸ *Foster Bryant Surveying v Bryant* [2007] 2 BCLC 239.

4.4.3 Directors as Trustees

Directors are also recognized as trustees of stakeholders' interests in a corporation.⁴⁰⁹ Trustees have to make investment decisions taking into consideration various stakeholders' interests.⁴¹⁰ Accordingly, they owe their duties to the stockholders, employees, customers and the general public.⁴¹¹ The English court in the case of *Smith v Anderson*⁴¹² stated that directors are not only agents but they are in some sense and to some extent trustees or in the position of trustees; but their position differs considerably from that of ordinary trustees and the strict rules applicable to such trustees do not apply in all respects to directors. Directors are also considered trustees of any company assets which come into their hands or under their control.⁴¹³ The High Court of Kenya in the case of *Flagship Carriers Ltd v Imperial Bank*⁴¹⁴ held that directors have a duty to act as qua trustees of company assets.

4.5 Directors' position in Kenya

The power to manage the affairs of a company is conferred upon the body of directors as a board, and not upon any one director.⁴¹⁵ In principle, the management of the company is vested in the board of directors collectively and the directors must act as a board in the board meetings unless otherwise provided by the articles of the company.⁴¹⁶

⁴⁰⁹ *Supra* n 406.

⁴¹⁰ Andrew Keay, 'Stakeholder Theory in Corporate Law: Has It Got What It Takes?' (2010) 9 (3) Richmond Journal of Global Law & Business 249, 288.

⁴¹¹ *Ibid.*

⁴¹² *Smith v Anderson* [1880] 15 Ch D 247, 275. See also *Selangor United Rubber Estates v Craddock* [1968] 1 WLR 1555 where the Court stated that directors are not trustees strict sensu because unlike ordinary trustees whose primary obligation is to preserve trust property, directors on the other hand are bound to invest for the benefit of the company. While ordinary trustees have legal title in the property of the beneficiary, directors do not since it is vested in the company.

⁴¹³ *Re Forest of Dean Coal Mining Co. Ltd* [1978] 10 Ch. D 450.

⁴¹⁴ *Flagship Carriers Ltd v Imperial Bank* High Court Case No 1643 of 1999 (Unreported).

⁴¹⁵ *Mitchell & Hobbs (UK) Ltd v Mill* [1966] 2 BCLC 102.

⁴¹⁶ *Supra* n 403.

Directors' duties are owed primarily to and are enforceable by the company and not individual shareholders.⁴¹⁷ Thus, directors in Kenya, whether acting individually or collectively as a board, are fiduciaries and agents who act on behalf of the company and shareholders who are the owners of stocks. They are also trustees in relation to company property entrusted to them.⁴¹⁸

Directors generally derive their powers and functions from statute, shareholder resolutions and articles of association of the company.⁴¹⁹ The traditional law and practice has been that the company be run in the interest of shareholders who are the owners of the stocks and capital of the company. However, the revolving practice is that the management of corporations should take into account interests of various stakeholders.⁴²⁰ Gakeri notes that although the roots of corporate governance are traceable to the separation of corporate ownership and control, the concept has now expanded in some jurisdictions to encompass other stakeholders.⁴²¹

In general, there is a growing recognition by corporations and countries all over the world that there is need for higher standards of corporate governance and ethics and greater interdependence between corporations and the societies in which they operate. The Companies Bill in this regard aims at elucidating the position and role of directors in Kenya in keeping with

⁴¹⁷ Kenyan Courts have reinforced the rule in *Foss v Harbottle* in numerous cases like *Affordable Homes Africa Ltd v Henderson & 2 Others* [2004] 2 KLR 473.

⁴¹⁸ In a 2013 decision of a case brought by the Deposit Protection Fund against former directors of the collapsed Trust Bank Ltd, the High Court of Kenya at Nairobi held that directors were trustees of depositors' funds. Accordingly, the Court ordered the former directors of Trust Bank Ltd to pay depositors Kshs. 1.5 billion. Money was siphoned through a non-existent company and the Deposit Protection fund filed this suit to recover monies lost in an incident that occurred in 2001.

⁴¹⁹ The High Court of Kenya in Nairobi in the case of *East African Safari Air Ltd v Anthony Ambaka Kegode*⁴¹⁹ held that where the powers of management are vested in the board of directors by the articles of association, the general meeting cannot interfere with exercise of those powers.

⁴²⁰ *Supra* n 368.

⁴²¹ Jacob K Gakeri 'Enhancing Kenya's Securities Market Through Corporate Governance: Challenges and Opportunities' (2013) 3 (6) International Journal of Humanities and Social Science 94 <http://www.ijhssnet.com/journals/Vol_3_No_6_Special_Issue_March_2013/11.pdf> accessed 15 August 2013.

evolving global practice by proposing codification of duties of company directors to various stakeholders.⁴²²

However, since the Companies Bill is yet to be enacted into law, this research will not interrogate the appropriateness of the duties stipulated in the Companies Bill for obvious reasons.⁴²³ Nevertheless, the proposed duties include duty to act within powers, duty to promote the success of the company, duty to exercise independent judgment, duty to exercise reasonable care, skill and diligence, duty to avoid conflicts of interest, duty not to accept benefits from third parties and duty to declare interest in proposed transaction or arrangement.

4.6 Codifying directors' duties in statute: Lessons from South Africa and the United Kingdom

The UK reformed its Companies Act by enacting a reviewed Companies Act, 2006 on 8th November 2006.⁴²⁴ The Act is remarkably large and codifies the general common law fiduciary duties of directors in an aim to improve corporate governance and make the law more accessible to directors.⁴²⁵ Indeed, the Act states that the prescribed general duties are based on certain common law rules and equitable principles and they shall be interpreted accordingly having regard to the common law rules and equitable principles.⁴²⁶

The definition of the term “director” under the reviewed UK Companies Act, 2006 remains unchanged and includes any person occupying the position of director, by whatever name

⁴²² The Companies Bill which is dated 21st March 2014 was introduced in Parliament by the Honourable Attorney General <<http://kenyalaw.org/kl/fileadmin/pdfdownloads/bills/CompaniesBill2014.pdf>> accessed 1 October 2014. The Bill proposes codification of directors' duties in Part IX Sections 142-156.

⁴²³ The Bill is awaiting 2nd Reading in the National Assembly, after which it should pass through the committee stage and finally the 3rd reading before it is assented to by the President and receive a commencement date. See the Bill Tracker <<http://kenyalaw.org/kl/index.php?id=4250>> accessed 1 October 2014.

⁴²⁴ *Supra* n 369.

⁴²⁵ *Ibid.*

⁴²⁶ S 170 (3).

called.⁴²⁷ Notably, the UK Act clearly states that the duties of directors are owed to the company.⁴²⁸ As such, the Act does not open up the prospect of the duties being enforced by persons other than the company, or members acting on its behalf via the new derivative action procedure or by a liquidator in the event of winding up.⁴²⁹

Equally, South Africa passed its reviewed Companies Act which was assented to by the Presidency on 9th April 2009 when it came into force.⁴³⁰ The Act was enacted to provide inter alia for the incorporation, registration and management of companies and to define the relationships between companies and their respective shareholders or members and directors.⁴³¹ The Act provides that the business and affairs of a company must be managed by or under the direction of its board subject to the provisions of the Act or the company's memorandum of incorporation.⁴³² The Act further defines Memorandum of Incorporation as the document that sets out the rights, duties and responsibilities of shareholders and its directors.⁴³³

Under the SA Companies Act, the term "director" finds wide expression as to include an alternate director, shadow director, prescribed officer or a person who is a member of a committee of a company irrespective of whether or not he is also a member of the company's board.⁴³⁴ The effect of this is to bind the board members generally and any other person discharging the functions of the office of director, whether directly or indirectly. UK and SA have accordingly codified various duties of company directors in their reviewed Companies Acts which Kenya can emulate in its Companies Act reform as demonstrated hereunder.

⁴²⁷S 250. This includes a shadow director who the Act defines in S 251 as a person in accordance with whose directions or instructions the directors of the company are accustomed to act.

⁴²⁸S 170 (1). However, there is no such statement in the SA Companies Act.

⁴²⁹*Supra* n 369.

⁴³⁰ Act No. 71 of 2008.

⁴³¹*Ibid.*

⁴³²S 66 (1). This provision is similar to the provisions of Article 80 of Table A of the Kenya's Companies Act.

⁴³³*Supra* n 430.

⁴³⁴S 69 (1).

4.6.1 Duty to avoid conflict of interest

The UK Act differentiates the duty to avoid conflict of interest⁴³⁵ and the duty to disclose interests in company transactions⁴³⁶ but they can be regarded as similar duties depending on how they are couched. For example, the SA Companies Act provides for the duty to disclose personal interest in company transactions but does not expressly provide for the duty to avoid conflict of interest.

As regards the directors' duty to avoid conflicts of interest, the UK Companies Act provides that a director must avoid a situation in which he has or can have direct or indirect interest that conflicts with the interests of the company.⁴³⁷ This means that a director must avoid actual and potential situations of conflict of interest and duty irrespective of whether or not the company could take advantage of the opportunity, information or property.⁴³⁸ This covers both financial and non-financial interests and this duty binds also former directors.⁴³⁹

However, the Act provides that the duty is not infringed if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest and if it is authorized by directors.⁴⁴⁰ Such a proviso is undesirable as it gives a big leeway for the board of directors or individual director and probably the court to consider if the matter should reasonably be regarded as giving rise to a situation of conflict of interest. Further, the duty to avoid conflict of interest does not apply to a conflict arising in relation to a transaction or arrangement with the company.⁴⁴¹ This allows

⁴³⁵S 175.

⁴³⁶S 177.

⁴³⁷S 175 (1).

⁴³⁸S 175 (2).

⁴³⁹*Ibid*; S 175.

⁴⁴⁰S 175 (4).

⁴⁴¹S 175 (3).

directors to take advantage of corporate contracts and transactions subject to disclosure under section 177 thereof.⁴⁴²

4.6.2 Duty to disclose personal interest in company transactions

The UK Act provides that a director who is directly or indirectly interested in a proposed company contract must declare the nature and extent of his interest to the other directors. Such disclosure must be made before the company enters into the transaction. However, where the director realizes that the earlier disclosure was incorrect or inaccurate, a further disclosure may be made.⁴⁴³ As is the case with the duty to avoid conflict of interest, the Act provides that the director need not declare if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest.⁴⁴⁴ This proviso allows latitude for a director to breach his statutory duty and feign unawareness as his defence for negligence and non-disclosure.

On the other hand, the SA Act provides that a director must at all times disclose any personal financial interest of himself or any related person to the board or shareholders.⁴⁴⁵ A director is required to disclose the nature and extent of the financial interest before and at the board meeting where the matter is to be considered and he must not take part in the consideration of the matter.⁴⁴⁶ Such a transaction can only be valid if it is approved by the other directors or ratified

⁴⁴² Some authors are of the view that personal interest in corporate transactions is not wrong per se but they are harmful to the company if they are unfair. See Luca Enriques, 'The Law on Company Directors' Self-Dealing: A Comparative Analysis' (2000) 2 (3) International and Comparative Corporate Law Journal 297, 299 <<http://web.mmc.edu.cn/shekebu/faxue/legal%20english/LinkedDocuments/The%20law%20of%20company%20director.pdf>> accessed 11 December 2013.

⁴⁴³S 177 (3).

⁴⁴⁴S 177 (6).

⁴⁴⁵ S 2 of the Act defines the term "related person" to include *inter alia*, married individuals and in the case of a juristic person, a company is related to another if it company controls it.

⁴⁴⁶S 75 (5).

by an ordinary resolution of shareholders in the prescribed manner and after full disclosure of material information has been made.⁴⁴⁷

Accordingly, it would be desirable for the Kenya Companies Act to have a statutory statement for directors' duty to avoid conflicts of interest as well as to disclose such actual and potential conflicts for both financial and non-financial transactions at all times and provide that such a transaction can only be valid with the authorization of the other directors or ratification of shareholders. The law should also stipulate the procedure for disclosure of the nature and extent of personal interest or conflict of duty.⁴⁴⁸

4.6.3 Duty to act in good faith and for proper purpose

The UK Act provides that a director must act within powers in accordance with the company's Constitution and only exercise powers for the purpose for which they are conferred.⁴⁴⁹ The SA Act on the other hand provides that a director must exercise the powers and perform the functions of a director in good faith and for a proper purpose.⁴⁵⁰ The two Acts seem to provide for the same thing though in different terminologies and it is desirable that Kenya codifies the common law duty of good faith and proper purpose to curb against abuse of office.

⁴⁴⁷S 75 (6).

⁴⁴⁸ S 84 (1) of Table A of the Companies Act Cap 486 Laws of Kenya only provides for a director to disclose the nature of his interest in corporate contracts or transactions at a meeting of directors and not the extent of such interest.

⁴⁴⁹S 171.

⁴⁵⁰S 76 (3) a.

4.6.4 Duty to act in the best interests of the company and to promote the success of the company

The SA Act provides that a director has a duty to act in the best interests of the company.⁴⁵¹ It does not define what the best interests of the company are and it has no provision as to what considerations should be taken into account.

The UK Act in contrast provides that directors are under a duty to promote the success of the company.⁴⁵² Keay opines that this is the fiduciary duty of loyalty owed by directors to the company.⁴⁵³ Directors in this regard are required to take into consideration the interests of employees, shareholders, environment, customers and suppliers with a desire to maintain a reputation for high standards of business conduct. This is in light of the fact that running a modern corporation leads to interdependencies involving many groups of stakeholders for whom the corporation should have legitimate concern. As such, if the reasonable expectations of these groups are not realized, then the long-term profitability of the company will suffer.⁴⁵⁴

It is necessary that Kenya embraces such a pro-stakeholder approach noting that global business and regulatory conditions are pushing companies and their boards to be more economically, socially and environmentally responsible.⁴⁵⁵

4.6.5 Duty to exercise reasonable care, skill and diligence and to exercise independent judgment

Black posits that the duty of care is the duty to pay attention and to try to make good decisions.⁴⁵⁶ This is akin to the duty to exercise independent judgment recognized under the UK

⁴⁵¹S 76 (3) b.

⁴⁵²S 172.

⁴⁵³*Supra* n 381.

⁴⁵⁴*Ibid.*

⁴⁵⁵ See MuthokiMumo, 'Banks Won't Fund Projects Harmful To Environment' *Daily Nation* (Kenya, 15 September 2013).

Act.⁴⁵⁷ Regarding the duty of care, skill and diligence, the UK and SA Companies Acts assume a dual objective and subjective standard of a person reasonably expected to be carrying out the functions of director having regard to the general skill, knowledge and experience of that particular director.⁴⁵⁸

The SA Act further provides a wider scope that a director will be regarded as having exercised due care, skill and diligence if he has taken reasonable diligent steps to become informed of the matter and he has no material personal financial interest in the matter.⁴⁵⁹ Further, if he had a rational basis for believing and did actually believe that the decision was made in the best interests of the company.

The UK Act imposes a duty on directors to exercise independent judgment. The Act provides that the duty is not infringed if the director acts in a way authorized by the company's constitution or in accordance with an agreement that fetters the director's exercise of future discretion.⁴⁶⁰ This is the business judgment rule which Key asserts is designed to preserve the directors from courts using their hindsight to find directors liable as the courts will not substitute their business judgment for that of an informed, reasonable director who acts bona fide in the best interests of the company.⁴⁶¹ The rule implies that the courts will not second guess directors'

⁴⁵⁶ Bernard S. Black, 'The Principal Fiduciary Duties of Board of Directors' (2001) Presentation at Third Asian Roundtable on Corporate Governance <<http://www.oecd.org/daf/ca/corporategovernanceprinciples/1872746.pdf>> accessed 20 August 2013.

⁴⁵⁷S 173.

⁴⁵⁸S 174 of UK Companies Act, 2006 and S 76 (3) c of SA Companies Act, 2008.

⁴⁵⁹S 76 (4).

⁴⁶⁰*Supra* n 457.

⁴⁶¹*Supra* n 382.

actions and thus it protects honest directors from liability where a decision turns out to have been an unsound one and prevents the stifling of invention and venturesome business activity.⁴⁶²

With regard to the business judgment rule, the SA Act provides that a director is entitled to rely on the performance of counsel, information, opinions, recommendations, reports or statements of a company employee, legal counsel, professionals, board committee or delegate.⁴⁶³ The SA Act is more extensive and therefore the revised Kenyan Companies Act should adopt a similar approach.

4.6.6 Duty not to accept benefits from third parties

The UK Act provides that a former or current director of a company must not accept a benefit from a third party conferred by reason of his being or doing or not doing anything as director.⁴⁶⁴

It is imperative to note that the general law to account for secret profits and benefits that are likely to compromise the independence and professionalism of a director has therefore been translated into a duty. However, there is a rider stating that such duty is not infringed if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest. Such a proviso makes it susceptible to abuse and difficult to find a director culpable for breach of duty and as such, it is undesirable. Conversely, the SA Act lacks a similar statement on the duty not to accept benefits from third parties.

4.6.7 Duty to attend board meetings

Neither the UK nor SA Companies Act provides that directors must attend board meetings. In fact, the common law dictates that a director is not bound to give continuous attention to the

⁴⁶² See generally Linda Muswaka, 'Directors' Duties and the Business Judgment Rule in South Africa Companies Act: An Analysis' (2013) 3 (7) International Journal of Humanities and Social Science 81, 91 <http://www.ijhssnet.com/journals/Vol_3_No_7_April_2013/10.pdf> accessed 11 August 2013.

⁴⁶³§ 76 (4) (b) and 76 (5).

⁴⁶⁴§ 176.

affairs of a company.⁴⁶⁵ However, Mwaura advocates for statutory incorporation of the duty to attend board meetings.⁴⁶⁶ This enables a director to effectively participate in the conduct of the affairs of the company. As such, it is desirable that the duty to attend board meetings should be codified in statute to facilitate its enforcement as well as responsibility of company directors in the governance of corporations.⁴⁶⁷

4.7 Enforceability of directors' duties and liability of directors

Sadri asserts that the role of corporate governance is to ensure that the directors of a company are subject to their duties, obligations and responsibilities, to act in the best interest of their company, to give direction and to remain accountable to their shareholders and other beneficiaries for their actions.⁴⁶⁸ It would therefore be incomplete to discuss directors' duties without touching on directors' corresponding liabilities since the two go hand in hand. Negligence in the performance of duties attaches liability to a director.⁴⁶⁹

The UK Companies Act provides that the statutory duties are enforceable in the same way as other fiduciary duties owed to the company by the director and the consequences for breach are the same as would apply if the corresponding common law rule or equitable principle is applied.⁴⁷⁰ The Act does not expressly state the standard of liability but favours both the

⁴⁶⁵ See *Re City Equitable Fire Insurance Company* [1925] Ch 407, where Romer J stated that a director is not bound to give continuous attention to the affairs of the company. The same position was emphasized by Justice PJS Hewett in the Kenyan case of *Flagship Carriers Ltd v Imperial Bank* High Court Case No. 1643 of 1999 (Unreported).

⁴⁶⁶ Kiarie Mwaura, 'Company Directors' Duty of Skill and Care: A Need For Reform' (2003) 24 (9) *Company Lawyer* 283.

⁴⁶⁷ See Mugambi Mutegei, 'Atwoli on the Spot over National Bank Board Meetings' *Daily Nation* (Kenya, 5 June 2014). The Central Bank of Kenya Prudential Guidelines require a bank director to attend at least 75% of board meetings. However, Mr. Atwoli is reported to have attended only 70% of the board meetings and he was also absent in the bank's AGM where shareholders authorised its management to use part of the Sh10 billion it expects to raise from a rights issue to redeem Sh5.7 billion in preference shares owed to the Treasury and NSSF.

⁴⁶⁸ *Supra* n 399.

⁴⁶⁹ *Supra* n 466.

⁴⁷⁰ S 178.

objective test and subjective test recognized under common law as the applicable standard.⁴⁷¹ Under the Act, a director is, over and above his knowledge and qualifications, required to possess skill and discharge his duties in the same manner as may reasonably be expected from a prudent director carrying out the functions in comparable circumstances.⁴⁷²

Similarly, the SA Companies Act favours both a subjective and objective standard while assessing the liability of directors' duty of care, skill and diligence.⁴⁷³ In addition, the SA Act is more elaborate and provides that liability attaches to a director for both commissions and omissions.⁴⁷⁴ A director can be held liable where he acts in the name of the company or signs anything on its behalf or purports to have acted on behalf of the company. Also, where he has acquiesced or authorized the taking of any action or omission of the company.⁴⁷⁵

The SA Companies Act further provides that a director will be held liable in accordance with the principles of common law relating to breach of fiduciary duties and for breach of any duty provided in the Act as in the company's memorandum of incorporation. However, a director can distance himself from any such liability by applying to the court for an order setting aside any decision of the board.⁴⁷⁶ He can also be relieved from liability either wholly or partly where it is established that the director acted honestly and reasonably in the circumstances.⁴⁷⁷

In contrast, the Kenya Companies Act assumes a subjective test as the common law while determining liability of company directors.⁴⁷⁸ Kenyan courts also adopt a subjective test in

⁴⁷¹S 174.

⁴⁷²*Ibid.*

⁴⁷³S 76 (3) c.

⁴⁷⁴S 77.

⁴⁷⁵S 77 (3).

⁴⁷⁶S 77 (5).

⁴⁷⁷S 77 (9).

⁴⁷⁸ S 402 (1); See also Romer J in the English case of *Re City Equitable Fire Insurance Company* [1925] Ch 407, stated that a director need not exhibit in performance of his duties a greater degree of skill than may reasonably be

assessing directors' liability for breach of duty where it considers the knowledge, skill and experience of the individual director.⁴⁷⁹ Under the Act, a director can be excused from liability if it appears to the Court that he acted honestly and reasonably. Mwaura argues that the application of a subjective standard presupposes that a director cannot be held liable for honest mistakes of judgment noting that the Companies Act does not prescribe expertise or qualifications of directors. This in turn makes it possible for directors to go unpunished as a result of negligence arising from their ignorance or inexperience.⁴⁸⁰ He therefore advocates for the bar to be raised to adopt an objective standard where directors will be required to adhere to a professional code and standard of care. This can be achieved through prescribing minimum standards of conduct for all directors in order to maintain high standards of skill and care and introduce professionalism to company boards. Importantly, the Kenya Companies Act should also be reviewed to reflect the aforesaid dual standard of conduct and to prescribe stringent and enhanced monetary and non-monetary penalties to ensure compliance.

4.8 Conclusion

From the foregoing, Kenya can draw strong comparative parallels from the United Kingdom and South Africa and as such, a statutory statement of directors' duties in Kenya is both necessary and desirable to enhance good corporate governance practice in Kenya. Further, the standard of directors' liability is similarly wanting in Kenya and a dual standard entailing a subjective and objective test should be adopted to raise the bar of conduct amongst company directors in

expected from a person of his knowledge and experience. However, the UK Companies Act now requires directors to act in a manner reasonably expected from a prudent director in comparable circumstances in addition to the general knowledge, skill and experience that the director has.

⁴⁷⁹*Supra* n 406.

⁴⁸⁰*Supra* n 462.

Kenya.⁴⁸¹ However, Gakeri advises that when borrowing from other jurisdictions, care and consideration should be given to existing legal and regulatory framework and existing circumstances to enhance their practicability and ease enforcement.⁴⁸² He warns that rules and institutions that function well in one country may be inappropriate in another because of the absence of supportive norms and corresponding institutions.⁴⁸³ The subsequent chapter examines the summary, recommendations and conclusion of this research.

⁴⁸¹*Supran* 421 and 466; Also see Lois M Musikali, 'The Law Affecting Corporate Governance in Kenya: A Need for Review' (2008) 19 (7) *International Company and Commercial Law Review* 213.

⁴⁸² Jacob K Gakeri, 'Enhancing Securities Markets in Sub-Saharan Africa: An Overview of the Legal and Institutional Arrangements in Kenya' (2011) 1 (9) *International Journal of Humanities and Social Science* 1 <<http://ir.library.strathmore.edu/fileDownloadForInstitutionalItem.action?itemId=373&itemFileId=327>> accessed 1 September 2013.

⁴⁸³*Ibid.*

CHAPTER FIVE

SUMMARY, RECOMMENDATIONS AND CONCLUSION

5.0 Introduction

In summary, this research study advocates for legislative measures to regulate directors' duties in order to restrain them from abusing their powers and to ensure that they act in the best interest of the company and its stakeholders. Accordingly, this chapter reviews the discussion and conclusions in the preceding chapters and proposes legislative changes aimed at addressing the gaps exposed in the existing legal and regulatory framework which hinder good corporate governance of corporations in Kenya.

5.1 Summary of Research Study

Chapter one outlined the objectives and importance of this research study by laying out the scope of the study and its significance, specifically the necessity to codify directors' duties in statute with the aim of promoting good corporate governance in Kenya.

Chapter two analyzed the provisions of the Companies Act⁴⁸⁴ and other substantive laws and regulations that regulate the management and governance of public and private corporations in Kenya with specific focus on duties of directors. The aim of the chapter was to illuminate the gaps that exist in the regulatory framework as a basis for advocating for reform of the law.

In chapter three, the researcher identified legal weaknesses in the corporate governance regulatory framework governing the conduct of directors in Kenya which in the past has resulted in mismanagement, underperformance and collapse of many companies in Kenya. A case study of National Bank of Kenya was explored to illustrate the importance and need for codification of directors' duties towards enhancing good corporate governance practice in Kenya.

⁴⁸⁴ Cap 486 Laws of Kenya.

Chapter four was a comparative study aimed at drawing lessons from South Africa and United Kingdom. It examined each of the country's corporate governance frameworks, their provisions on the duties of company directors and how the same promotes good corporate governance in each of the jurisdictions. The chapter also discussed specific duties of directors which Kenya can adopt in its Companies Act review to promote good corporate governance.

This last chapter makes appropriate recommendations towards codifying duties of directors in statute which would go a long way towards enhancing good corporate governance practice in Kenya.

5.2 Recommendations

This research study proposes the following recommendations to the Companies Act to enhance good corporate governance in Kenya.

5.2.1 Broader definition of “director”

Under the current Companies Act,⁴⁸⁵ a director includes any person occupying the position of director by whatever name called.⁴⁸⁶ This definition is vague and lacks specificity which is vital especially in the enforcement of directors' duties and liabilities. This research therefore recommends that a broader and sufficiently descriptive definition of the expression “director” should be adopted to include any person or body of persons exercising the functions of the office of the director including board committees, shadow directors and alternate directors or a person to whom such functions have been delegated by the board of directors. This proposed development is in light of the complex nature of rising modern corporations that are in form of large multinational corporations with several regional subsidiaries. In such circumstances, it is then practically impossible for the main board of directors to exercise control over the

⁴⁸⁵*Ibid.*

⁴⁸⁶S 2.

corporation without delegation. Such an inclusive definition will also limit the instances in which directors may evade liability for wrong-doing.

Further, the expression “independent director” is a creature of corporate governance to recognize the oversight and monitoring role of non-executive directors. The function of independent non-executive directors is to ensure a balance of power on the board and to guard against excesses and abuse of power by the executive directors. As such, their role in enhancing good corporate governance and management cannot be gainsaid and they have been widely embraced as necessary and important in the governance of corporations today. Consequently, the Companies Act should be reformed to expressly recognize independent directors and their role on the board to ensure compliance with good corporate governance practice. To this end, the duties should also be binding upon both executive and non-executive directors.

It is further important for the Companies Act to be reformed to recognize the collective responsibility of directors whereupon power to manage the affairs of a company is conferred upon the body of directors as a board, and not upon any one director. In this regard, the duty to attend board meetings will ensure effective participation by directors and limit the instances in which directors evade liability and responsibility by asserting absenteeism in board meetings and or dissenting decisions in corporate management.

5.2.2 Codification of common law and evolving duties of directors

The common law duties of directors have developed from English judicial decisions and they are generally uncodified. These are the duties of care, skill and diligence and fiduciary duties. The shortcomings of common law which include different judicial interpretations and analysis have generally resulted in poor corporate governance in Kenya as discussed and the same cannot be overlooked.

Overtime, emerging duties and responsibilities of directors and companies to various stakeholders have also been widely acknowledged for the good performance of corporations generally. These stakeholders include employees, suppliers, debtors, creditors, environment and the community within which the company operates. For instance, in Kenya, recent legislative enactments such as the Constitution, labour laws and environmental laws require companies and directors to recognize the interests of various stakeholders.⁴⁸⁷

In addition, there are several functions of the board recognized under corporate governance and they include providing strategic management and direction of the company, supervising and monitoring the management of the business and generally acting in the best interest of the company and accounting to shareholders and the company on their stewardship. However, these developments have not been recognized in the Companies Act.

Accordingly, the Act should be reformed to codify both the traditional duties of care, skill and diligence and fiduciary duties as well as the evolving duties owed to other stakeholders. This statutory enactment will go a long way to assist directors in clarifying their duties to the corporation and thus enable them to avoid liability. Further, the interpretation of directors' duties by courts' will be simplified.

The reviewed Companies Act should in addition endeavour to legislate on corporate social responsibility (CSR) of companies for purposes of defining clearly the duties of directors to stakeholders as well as social responsibility. The reformed Act should also require directors to formulate appropriate policies and regulations for the company's social responsibilities to ensure

⁴⁸⁷ The Constitution of Kenya and the Employment Act 2007 for instance provide for fair labour practices in the work place and equal opportunity for employees. The Constitution and environmental laws such as the Environmental Management and Co-ordination Act (EMCA)1999 require companies to conduct continuous environmental assessment impacts of the corporation's industrial actions and educate the public on the same.

that the legitimate expectations of all stakeholders are put into consideration. This will help to distinguish between stakeholder expectations and the corporate obligation or responsibility and avoid instances of conflicts of various stakeholder interests.

With regard to the duty to disclose conflicts of interest and duty, the reviewed Companies Act should provide for the mode and procedure for making such a disclosure. Further, it is important to require that directors disclose the nature and extent of their interest for both financial and non-financial transactions. The compliance by directors is expected to promote transparency and accountability to the company and other stakeholders which are core principles of good corporate governance.

In addition, the Act should be revised to provide that the directors' duties are owed to the company alone while taking into consideration other stakeholders' interests. Accordingly, the law relating to derivative actions should be reviewed to provide shareholders with an efficient dispute resolution mechanism.

In order to fully realize the purpose of corporate law review in Kenya, the proposed directors' duties in the Companies Bill should be thoroughly scrutinized to ensure that once passed into law, the provisions will be sound and practicable taking into consideration international commercial standards and the existing legal and regulatory framework so as to facilitate its enforcement and implementation.

5.2.3 Recognition of the pillars of good corporate governance in statute

The Constitution of Kenya 2010 is the supreme law of the land and it goes a long way towards promoting good corporate governance practice in Kenya by recognizing various principles and

values of good governance⁴⁸⁸ as well as requiring a competitive and open recruitment process for leaders.⁴⁸⁹ These values and principles include transparency, accountability, integrity and good governance which are also recognized as core corporate governance principles globally.

Accordingly, the Companies Act should be reviewed to conform to the provisions of the Constitution and to incorporate the key pillars of good corporate governance in order to enhance good corporate governance practice in Kenya and ensure conformity with international best practice.

5.2.4 Harmonization of the corporate governance regulatory framework

There are different statutes and subsidiary legislation that regulate the different forms of corporations be it private companies, public listed companies, or state corporations. For instance, in Kenya, private and public companies are incorporated and governed by the Companies Act.⁴⁹⁰ The operations of public listed companies are in addition, governed by the Capital Markets Act.⁴⁹¹ State corporations on the other hand are regulated by the State Corporations Act⁴⁹² or the individual statutes that establish them. Further, several corporate governance codes and guidelines have also been recommended to improve the standard of management of companies in Kenya.⁴⁹³ New legislative enactments that have been passed in the recent past also impact on the governance of corporations and the directors' duties to the company and other stakeholder groups.⁴⁹⁴

⁴⁸⁸Article 10.

⁴⁸⁹Article 232.

⁴⁹⁰*Supra* n 487.

⁴⁹¹Cap 485A Laws of Kenya.

⁴⁹²Cap 446 Laws of Kenya.

⁴⁹³ These guidelines include the Capital Markets Authority Guidelines on Corporate Governance Practices by Public Listed Companies, the Code of Best Practice for Corporate Governance in Kenya and the Guidelines for Good Corporate Governance in State Owned Corporations.

⁴⁹⁴*Supra* n 487.

As such, the directors' duties in the Kenyan corporate governance regulatory framework are widespread and often uncertain, ambiguous, non-mandatory and lack statutory backing. There is therefore an urgent need to harmonize the Companies Act with the provisions of the Constitution and other statutes and subsidiary legislation that directly or indirectly relate to corporate governance and directors' duties in Kenya. The amendments to the Act should further provide that the statutory statement of directors' duties is binding upon directors of both private and public companies to ensure compliance across the board. The Act should also be revised to embrace the provisions of various corporate governance codes thus ensuring that they are mandatory and therefore statutorily enforceable to facilitate implementation of the statutory directors' duties.

5.2.5 Qualification, induction and continuous training of directors

The Companies Act does not prescribe proper minimum qualifications of a company director. Further, it is not a statutory requirement for directors to be formally inducted, trained and developed to ensure competence in the discharge of their duties. However, good corporate governance practice dictates that there should be a competitive, transparent and formal process for nomination and appointment of company directors to ensure effective participation of directors in the management of company affairs. Further, directors should undergo induction and continuous training to ensure that they are informed of their roles and responsibilities as directors, board procedures and practice and to ensure they are abreast with the current corporate environment and stakeholder needs.

Accordingly, it is desirable that the reviewed Companies Act should provide for minimum qualifications and competencies for directors, and especially for directors of listed companies and state corporations. This will go a long way towards raising the standard of skill, competence

and integrity required of directors leading to overall good corporate governance practice in Kenya. The Constitution of Kenya also stipulates that the values of public service include fair competition and merit as the basis of appointments and promotions and affording equal and adequate opportunities for training and advancement at all levels.⁴⁹⁵ These Constitutional values should reverberate in corporations as well.

The reviewed Companies Act should also provide for mandatory induction of directors as well as continuous training and development of directors to ensure they understand and appreciate their roles and responsibilities as company directors. In addition, the standard of conduct and directors' liability should be raised to embrace a dual test comprising both a subjective and objective test and thus ensure professionalism on the board.

5.2.6 Enhancement of the penalties for breach of directors' duties

Under the Companies Act, a director may be held criminally or civilly liable for breach of statutory duties. However, the penalties prescribed under the Act are inordinately low, unconnected with prevailing economic standards and do not take into consideration the benefits derived by the director from the wrong-doing. For instance, directors who have been responsible for the insolvency of companies are not precluded from acting as directors and they may be re-appointed as directors with the leave of the Court.⁴⁹⁶

The penalties prescribed for breach of statutory duties of directors should therefore be enhanced to ensure they are deterrent and taking into account the modern economic environment. This may include suspension of a disqualified director for a given period of time during which such a

⁴⁹⁵ *Supra* n 489.

⁴⁹⁶ S 189 (1); See Paul Juma, 'Kiereini Cleared For Boardroom Return' *Daily Nation* (Kenya, 22 August 2013), The former Cooper Motor Corporation (CMC) Chairman Mr. Jeremiah Kiereini was cleared by the Court in August 2013 after the CMC Boardroom wars saga which saw the Capital Markets Authority bar several directors from acting as directors in other companies.

director should be barred from acting in any directorship capacity.⁴⁹⁷ The reviewed law should also broaden the instances in which directors can be held personally liable for the acts arising from the performance of their duties as directors. This is expected to lead to high standards of conduct by company directors and subsequently good management and performance of companies.

5.2.7 Incorporation of directors' code of ethics and conduct

As discussed in the previous chapters, poor corporate governance has often resulted from lack of a corporate code of ethics for directors. This leads to non-accountability by company directors, partiality, inefficiency, ineffectiveness and corruption, misappropriation of company assets, embezzlement, political patronage and abuse of office. However, although the Constitution requires high standards of professional ethics in public service the Companies Act is yet to be reviewed and aligned with the provisions of the Constitution to statutorily require integrity and professionalism in the management of companies. Accordingly, the revised Companies Act should require every company to endorse a mandatory code of ethics for directors and other managers of the corporation and the amended Act could indeed facilitate the same by incorporating a sample code of ethics and conduct.

5.2.8 Strengthening of corporate governance institutions

As earlier discussed, the Office of the Registrar of Companies is short of capacity and often not capable of carrying out its mandate under the Companies Act. This is because there is only one companies registry in Nairobi that serves the whole country in spite of the large number of registered companies as well as foreign companies operating in Kenya. As such, monitoring

⁴⁹⁷ For instance, S 69 of the SA Companies Act provides that a director who is disqualified must not act as a director of any company until after the expiry of five years from his removal from office or until completion of the sentence imposed under the Act for the offence. The Act further provides for extension of such period on application by the Commission if it is necessary to safeguard public interest.

corporate compliance with the regulations and laws poses a challenge and therefore many companies flout rules under the Act as no penalties are meted out against them. It is therefore necessary to strengthen the Office of the Registrar of Companies by decentralization of its functions and hiring of competent staff to facilitate enforcement.

In addition, there are several institutions that are involved with corporate governance regulation and they include the Institute of Directors, Kenya (IoD-K), the Centre for Corporate Governance (CCG), the Central Bank of Kenya (CBK), the Capital Markets Authority (CMA) and the Institute of Certified Public Accountants Kenya (ICPAK). Other institutions such as the judiciary and the Ethics and Anti-Corruption Commission (EACC) are also tasked with safeguarding good corporate behavior and enforcing ethics through their investigative, prosecutorial and enforcement roles. Accordingly, capacity in these institutions should be strengthened by building appropriate skills. They should also be empowered and mandated under the revised Companies Act to regulate the conduct and ethics of directors in Kenya in their different sectors. This would supplement the efforts of the Office of the Registrar of Companies in enforcing ethics and corporate compliance.

The Government should also undertake intensive reforms towards improving public service delivery and thus restore public confidence in government agencies such as the judiciary which has in the past been marred with corruption. The Government should further be committed towards ensuring transformational leadership, scrutiny of the qualifications and integrity of the public office holders in line with the new constitutional dispensation.⁴⁹⁸ This will restore public trust and confidence in government institutions and the entire governance process in general.

⁴⁹⁸ Chapter 6 of the Constitution of Kenya 2010 provides that the guiding principles of leadership and integrity include selection on the basis of personal integrity, competence and suitability, objectivity and impartiality in

In addition, Kenya is a member of several organizations which advocate for good governance and practice such as the African Union (AU), New Partnership for Africa's Development (NEPAD) and the African Peer Review Mechanism (APRM). The APRM for instance, is a mutually-agreed instrument for self-assessment of participating countries and the APRM's mandate is to encourage member countries to ensure their policies and practices conform to the agreed economic and corporate governance values, codes and standards as contained in the NEPAD.⁴⁹⁹ Several review reports have been presented since implementation of the NEPAD initiative in Kenya in 2002 and it is recommended that the Government should implement the findings of the APRM especially those concerning corporate governance in Kenya.

5.3 Conclusion

The importance of corporate governance has been widely appreciated in national development and international economies. Corporate governance is increasingly recognized as a significant component of sustainable development which in turn steers economic growth, opens foreign trade and investment opportunities as well as creating jobs and wealth for the citizenry. Good corporate governance practice is closely linked to efficiency and effectiveness and reduces susceptibility of emerging and developing economies to financial crisis through promoting the values of transparency, accountability, integrity and professionalism. This in turn improves the country's business environment, increases productivity and ensures competitiveness.

Having outlined the corporate governance regulatory framework for directors in Kenya and highlighted the inadequacies in the same, it is accurate to conclude that the Kenyan corporate

decision making, honesty in execution of public duties, declaration of any personal interest that may conflict with public duties and accountability to the public for decisions and actions.

⁴⁹⁹ See <<http://www.nepadkenya.org/about.html>> accessed 20th November 2014. The implementation of the NEPAD initiative in Kenya was institutionalized through a Presidential Executive Order in 2002 to spearhead Kenya's participation in the NEPAD process. The NEPAD Kenya Secretariat is a semi-autonomous agency in the Ministry of Devolution and Planning.

governance regulatory framework falls short of international standards and best practices from other jurisdictions as discussed. As such, the regulatory framework should be reviewed to provide for clear and precise roles and responsibilities of company directors and thus ensure that the milestone towards enhancing good corporate governance practice in Kenya is achieved.

This research therefore strongly recommends that the Companies Act be revised to codify the common law duties of directors and their evolving duties to various stakeholders in order to conform to international best practice and thus promote good corporate governance practice in Kenya. Codification of directors' duties is expected to enhance accountability, transparency, integrity, effectiveness and efficiency of directors and management as a whole and thus reduce instances of corporate failures. Further the Companies Act should be reviewed to align its provisions with those of the Constitution, enacted legislation and good corporate governance codes and guidelines. This is because an effective corporate governance system can certainly be guaranteed by a strong and effective legal and regulatory framework and enforcement mechanism.

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