

**THE LEGAL PROTECTION OF MINORITY SHAREHOLDERS: A COMPARATIVE
ANALYSIS OF THE REGULATORY FRAMEWORKS OF KENYA AND THE UNITED
KINGDOM**

BY:

THOMAS MABERA MOCHA

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DECLARATION

I **Thomas Maber Mocha** do **CERTIFY** that this is my original work which has been done according to the requirements and regulations of the University of Nairobi for the degree of Master of Laws (**LLM**).

Signature í í í í í í í í í í í í í .. Date í í í í í í í í í

THOMAS MABERA MOCHA

G62/69288/2011

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

Signature í í í í í í í í í í í í í .. Date í í í í í í í í í

Ms. Naomi N. Njuguna

School of Law

University of Nairobi

DEDICATION

This project is dedicated to my beloved wife and children for their love, care, understanding and support. May the good Lord continue to bless all of them.

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LIST OF ABBREVIATIONS

- GAAPÍ í í í .Generally Accepted Accounting Principles
- ICPSKÍ í í í .Institute of Certified Public Secretaries
- KSHÍ í í í í .Kenya Shillings
- MNCÍ í í í í Multi-national Corporation
- NSEÍ í í í í .Nairobi Securities Exchange
- NYSEÍ í í í ..New York Stock Exchange
- OECDÍ í í í .Organization for Economic Co-operation and Development
- PSCGTÍ í í í Public Sector Corporate Governance Training Securities

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5. *Andy Forwarders Services Limited v Capital Markets Authority and Another* [2011] eKLR, Republic of Kenya in the High Court of Kenya at Nairobi Petition No. 216 of 2011.
6. *Cook v Deeks* (1916) (Privy Council).
7. *Dadan v. Manji and 3 Others* High Court (Nairobi), Civil Case No 913 of 2002.
8. *Daniels v Daniels* (1978) Ch. 406 (UK).
9. *Edwards v Halliwell* (1950) CA.
10. *Ferguson v Wallgridge* (1935) 3DLR 66,83.
11. *Foss v Harbottle* (1843), 2 Hare 461.
12. *Grant v UK Switchback Railways Co Ltd* (1888) 40 Ch D 135.
13. *Macaura v Northern Assurance Co. Ltd* (1994)1 All ER 1.
14. *Musa Misango v Eria Musigire and Others*, 1966] EA 390.
15. *North –West Transportation Co. Ltd v Beatty* (1887) 12App CAS 589 (PC).
16. *Smith v Croft*(No 2) [1988] Ch 114.
17. *Pender v Lushington* (1877), Court Of Chancery.
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19. *Paolo Murri v Gian Battista Murri and Anotherr*, Civil Appeal 59 of 1999, [2000] eKLR;
20. *Prudential Assurance Co. Ltd v Newman Industries Ltd* (No.2) (1982) Ch 204.
21. *Regal (Hastings) Ltd v Gulliver* (1967) 2 AC 134 N.
22. *S K Macharia and Another v Samuel Njoroge Muchiri and 2 Others*, Civil Application 218 of 2006
23. *Salomon v Salomon and Co. Ltd*, [1897] AC 22.
24. *Scottish Co-operative Wholesale Society v Meyer*, (1959) AC 324.
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26. *Wood v.Odessa Waterworks Co. Ltd* (1889).
27. *O’Neill v Philips* (1999) 1WLR 1092.

ABSTRACT

Minority shareholders in Kenya find it difficult to protect themselves against excesses of majority shareholders because of a number of reasons. First there is an inability to enforce criminal and civil laws against directors who use their office to expropriate members' investment. Second is the continued reliance on common law which places a high threshold on minority shareholders who wish to exercise their rights against majority shareholders. Third is a weak and obsolete legal framework coupled with corruption and political interference in the management of corporations. Fourth is the existence of a corporate governance code that was copied from other jurisdictions but not harmonized to reflect local conditions.

This has been compounded by the restrictions imposed by the rule in *Foss v. Harbottle* and its exceptions which have tended to control the extent to which English and Kenyan courts could interfere in the internal management of registered companies for close to 170 years. Although the courts have been reluctant to intervene in the internal management of companies, there has been a tendency to strike a balance between excessive interference on the one hand and protection of minority shareholders' rights on the other hand. The courts' intention has been to find an appropriate balance between majority rule and the protection of minority shareholder rights and interests.

This study examines the extent to which minority shareholders are protected against the nefarious conduct of controlling majority shareholders and the company's directors in Kenya as compared to the United Kingdom. It also explores the agency problems affecting CMC Holdings; a company incorporated in Kenya, to illustrate how the oppressive conduct of the controlling majority shareholders in Kenya has the ability to injure a prosperous company and the interests of minority shareholders. It also makes a comparative analysis of the existing legal remedies under the common law, principles of equity and the Companies Act, 2006 of the UK and the Capital Markets Act (Cap 485) and the Companies Act of Kenya, 1962 to identify best practices that can be used to reform corporate law in Kenya.

The findings can be adopted to reform the regulatory framework for protecting minority shareholders in Kenya. Some of these recommendations include the amendment of the Companies Act to: relax the rules of procedure for filing derivative action; enable minority shareholders to file for an action for an equitable remedy to wind up a company, on just and equitable grounds; and, provide for use of alternative dispute resolution mechanisms to resolve conflicts in corporate governance.

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CHAPTER ONE

INTRODUCTION

1.1 Introduction

The protection of minority shareholders from oppressive controlling majority shareholders is an issue that is common not only in developing countries but developed ones as well.¹ In many jurisdictions, minority shareholders are often viewed as an unnecessary burden by the controlling majority shareholders.² The collapse of corporations is often a symptom of poor corporate governance and demonstrates the havoc that can be caused by concentration of power by the controlling majority shareholders.³ In all the scandals, the biggest losers are minority shareholders.⁴ In the view of majority shareholders, minority shareholders tend to increase transaction costs through slowing down of crucial investment related decisions, they do not take part in restructuring discourses while placing unreasonable demands on management.⁵ While this could be true of developed economies, minority shareholders are the only insurance against management self-interest in emerging markets which tend to have weak capital markets, more especially, where ownership and control is not separated.⁶

This research examines the legal challenges minority shareholders face in trying to protect their investments against those who have capacity to influence the board of directors or minority shareholders. To do so a comparative analysis of the regulatory frameworks for the protection of minority shareholders in Kenya and the United Kingdom (UK) will be used

¹ Aleksandr Shkolnikov, *Protecting Minority Shareholders in Emerging Markets* (Center for International Private Enterprise: Washington, 2006) at 19.

² *Ibid.* at 19.

³ William Sun et al, *Rethinking Corporate Governance-Lessons from the Global Financial Crisis*, in William Sun et al, *Corporate Governance and the Global Financial Crisis: International Perspectives* (Cambridge University Press: Cambridge, 2011) at 15.

⁴ Jensen M C and Meckling W, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 *Journal Financial Economics* 305.

⁵ *Ibid.* at 302.

⁶ *Ibid.*

with Cooper Motors Corporation Ltd as a case study. The two jurisdictions have been chosen because Kenya's legal system in corporate law is derived from the English law. The English common law,⁷ Companies Act,⁸ principles of equity⁹ and case law¹⁰ form a regulatory framework for corporations in Kenya as provided for by the Judicature Act.¹¹ Kenya's legal system has not reformed to embrace modern trends in protecting minority shareholders like the British corporate law. Dispersal of shareholding in the UK gives oppressed minority shareholder the option of selling off his share as compared to the concentrated shareholding in Kenya, which gives minority shareholders fewer options.¹²

Protection of minority shareholders is an important aspect of good corporate governance. This is because the mechanical application of the majority rule, without restrictions, as the cornerstone of modern company law, has serious detrimental effects to the interests of minority shareholders for various reasons.¹³ Firstly, it is harmful to minority shareholders as it reduces their overall investments. Secondly, whereas corporations are generally created to maximize shareholder value, the board of directors rather than the shareholders become centers of power in concentrated shareholding. With such power, the board gets leeway to use unethical conduct to violate shareholder interests. If this practice is not closely monitored or rectified, it could lead to the collapse of the firm and thus end the perpetual existence of an entity.¹⁴

⁷ Section 3 (2), Judicature Act (Chapter 8, Laws of Kenya).

⁸ Chapter 486 of the Laws of Kenya.

⁹ Section 3 (2), Judicature Act.

¹⁰ Ibid.

¹¹ Chapter 8, Laws of Kenya.

¹² Sam Nganga, "Corporate Governance in Africa: A Survey of Publicly Listed Companies" (2003) *Corporate Governance Practices in Africa* 4.

¹³ Ibid.

¹⁴ Ibid.

1.1.1 Definition of Minority shareholder

The Companies Act does not define the term minority shareholder. Black's Law Dictionary defines a minority shareholder as "a shareholder who owns less than half the total shares outstanding and thus cannot control the corporation's management or single handedly elect directors."¹⁵ There are various statutory minorities which have been created by statute to deal with the different situations or circumstances that may affect their rights and lead to litigation during the conduct of the company's affairs. A good example is the minority created by section 3 of the Capital Markets Authority listing rules¹⁶ which requires every issuer or listed company to reserve twenty five per centum of its ordinary shares for investment by local investors.

1.1.2. Majority Shareholders

A majority shareholder is a shareholder who owns or controls more than half of the corporation's stock. He/she can use the holding to influence the corporation's activities because the shareholder either owns majority outstanding shares or owns a smaller percentage but a significant number of the remaining shares are widely distributed among many others. In this way the shareholder is left with a controlling stake in a corporation.¹⁷ The strict application of the general majority principle laid down in *Foss v Harbottle*¹⁸ is harsh and unjust with regard to minority shareholders. Although a substantive right has been accrued to them, they are still barred from obtaining justice under the rule and have to submit to the wrongs done by the majority. This is because the majority shareholders control the company and the minority shareholders have very little say in the running of the corporation.

¹⁵ Bryan A Garner (ed.), *Black's Law Dictionary 9th ed.* (West Publishing Company: San Diego, 2009) at 1500.

¹⁶ The Capital Markets Act, Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya, Gazette Notice No. 3362 of 2002 guideline 3.1.3

¹⁷ Garner op.cit. note 15 at 1500.

¹⁸ *Foss v Harbottle*, (1843) 2 Hare 461.

However, in order to mitigate this harshness, a number of exceptions have been introduced to the general principle.¹⁹

The application of the majority rule continues to be the guiding principle of decision making in most corporations in Kenya. For example, in throwing out a petition by a minority shareholder seeking to stop the proposed ksh.20 billion Kenya Airways (KQ) rights issue, Justice Musinga said that:

“The airline had invested heavily in the rights issue and if the exercise is suspended at this stage, there would be far reaching consequences not only to the company but to more than 75,000 shareholders and other interested parties. I am not satisfied that the shareholder has demonstrated an arguable case with a likelihood of success and the case is a clear abuse of the court process and only intended to stall the rights issue.”²⁰

Oppression of minority shareholders by majority shareholders takes many forms and leads to shareholder dilution and expropriation of minority shareholders' investment. For example in 2009, Safaricom called shareholders to ratify a dividend of ten cents, to which minority shareholders with less than 100,000 shares protested but lost. A few illustrations will suffice: a minority shareholder at Express Kenya asked at the annual general meeting why the Managing Director's wife was a member of the board, he never received an answer. At Williamson Tea Ltd, shareholders were apprehensive about the company stock piling of real estate across the country while off-loading it would have boosted the company's bottom-line.²¹ At Kakuzi Holdings Ltd, the board forced the sale of a crucial factory against the wishes of the minority shareholders. At Cooper Motors Corporation, a minority shareholder moved to court to compel the holding of an annual general meeting so that the company's

¹⁹ Ibid: The four exceptions are: where the alleged act is *ultra vires* or illegal, the alleged matter was such that could only have been validly done or sanctioned, in violation of a requirement in the articles, by some special majority of members, an alleged act which has caused the invasion of the claimant's personal and individual rights in his capacity as a member and where a 'fraud on the minority' has been committed by the majority who themselves control the company.

²⁰ Morris Aron and Jevans Nyabiage, 'The Curse of the Minority Shareholders in Kenya', *The Standard*, September 4, 2012.

²¹ Ibid.

shares could resume listing on the Nairobi Stock Exchange (NSE) but lost.²²

1.2. Background

Corporate governance has since its inception been pre-occupied with the conflict between ownership and control and has often overshadowed the relationship between the controlling majority and minority shareholders.²³ This has been at the core of the agency problem where dispersal of shareholding or ownership has been known to herald conflicting goals between the owner or principal and the management.²⁴ The only two jurisdictions with a majority of companies with dispersed shareholding are the USA and the UK.²⁵ The majority of corporations even in other developed countries such as Germany, Japan, Korea, Sweden, France and those in the emerging economies, such as Kenya, are characterized by dominant ownership or concentration of power and an inadequate protection of minority shareholders.²⁶ This corporate structure changes the nature of conflict from the classic principal/agent to that of majority/minority shareholder.²⁷ Empirical evidence has shown that any time large owners gain nearly full control of the corporation they prefer to generate private benefits of control that are not shared by minority shareholders.²⁸ In Kenya the problem of protecting minority shareholders is exacerbated by a weak legal framework among other factors as is illustrated by the scandal at the Cooper Motors Corporation.

²² Ibid.

²³ Berle, A., and Means, G, *The Modern Corporation and Private Property* (McMillan: New York, 1933) at 19; Jensen, M. C., and Meckling, W. Theory of the firm: Managerial behavior, agency costs, and ownership structure (1976) 3 *Journal of Financial Economics* 305.

²⁴ Shleifer, A., and Vishny, R, 'A survey of corporate governance', (1997) 52 *Journal of Finance* 737.

²⁵ La Porta, R. et al, 'Corporate ownership around the world' (1999) 54 *Journal of Finance* 498.

²⁶ Dharwadkar, R. et al, 'Privatization in Emerging Economies: An Agency Theory Perspective' (2000) 25 *Academy of Management Review* 650.

²⁷ Michael N. Young, 'Principal-Principal Agency' (2003) 6 (1) *Journal of Chinese Management Review* 19.

²⁸ Shleifer op. cit. note 24.

Cooper Motors Corporation Company Limited was a listed limited liability Company, incorporated in December 1948 in Kenya.²⁹ The Company is engaged in the sale and service of motor vehicles, tractors, associated spare parts and accessories and specialized engineering equipment. The major activity of the company was investment in subsidiaries, property and hire-purchase financing.³⁰ Its shareholding comprised 15,000 minority shareholders who owned about 37% stake in the firm and majority shareholders who controlled 63% of the Company.³¹

The scandal at Cooper Motors Corporation began when majority shareholders used their controlling power to engage in activities that amount to conflict of interest.³² This illustrates a familiar phenomenon, where concentration of power and control in voting majorities among shareholders and directors creates scope for abuse.³³ It is in such a context that the protection of minority shareholder rights concern the courts.

When disputes between, minority and majority shareholders occur, the losers are normally minority shareholders. This is because minority shareholders are out-manoeuvred at the annual general meeting.³⁴ The result is that minority shareholders feel oppressed and exploited by the controlling majority shareholders. Good corporate governance envisages equality between and among shareholders because companies should be seen as avenues of investment and not as avenues of power-play and exploitation.³⁵

²⁹ CMC Annual Report 2011.

³⁰ Nganga op. cit. note 12.

³¹ Report and Resolutions of the Board of the Capital Markets Authority Regarding the Investigation into the Affairs of CMC Holdings Limited, August 3, 2012 at 3.

³² Victor Joffe et al, *Minority Shareholders: Law, Practice and Procedure* 4th ed. (Oxford: Oxford University Press, 2011) at 7.

³³ Ibid. at 1.

³⁴ In the Matter of *CMC Holdings Limited* [2012] EKLK Republic of Kenya, High Court at Nairobi (Nairobi Law Courts), Miscellaneous Civil Case 273 of 2012.

³⁵ Berle op. cit. note 23 at 25.

In September 2011, when irregularities in the corporate governance of Cooper Motors Corporation first broke out, the Capital Markets Authority received notification that Joel Kibe had been appointed the Board Chairman to replace Muthoka. The conflict of interest involved Muthoka as the Managing Director of Andy Forwarders and major shareholder had business interests with Cooper Motors Corporation where Muthoka was Chairman of the Board.³⁶ Minority shareholders of Cooper Motors Corporation petitioned the capital markets regulator to compel directors of the troubled motor dealer to convene an annual general meeting as they sought to find a voice at the firm.³⁷ The Capital Markets Authority granted Cooper Motors Corporation a three-month extension of the date to hold the statutory meeting. This was viewed by the minority shareholders as denying them a voice in the running of the firm.³⁸ Another attempt by the minority shareholders to institute a derivative action in the matter of CMC Holdings Limited [2012]³⁹ was not allowed as the High Court declined to grant them leave to sue on behalf of the company.

In the report prepared by the board of the Capital Markets Authority, directors of Cooper Motors Corporation were implicated as having failed in their directorship either individually or collectively to various extents.⁴⁰ The most serious allegation of misconduct was made against Mr. Peter Muthoka who was the former Chairman of the company. Among other things, he was accused of having breached the Capital Markets (Take-over and Mergers) Regulations, 2002 by holding more than 25% shares of a listed company – Muthoka was the single largest shareholder of Cooper Motors Corporation with a 24.72 percent stake.

³⁶ Ibid.

³⁷ Shareholders want CMC to hold meeting, *‘Daily Nation’* July 27 2012, available at www.nation.co.ke/business/news/Shareholders-want-CMC, accessed on 22 November 2014.

³⁸ Ibid.

³⁹ High Court at Nairobi (Nairobi Law Courts) Miscellaneous Civil Case 273 of 2012.

⁴⁰ Ian Gachichio, ‘CMA Report Reveals Allegations on CMC Directors’, *Business Daily*, August 2012.

Several allegations were also made against Charles Njonjo, Henry Forster, and Richard Kemoli, for fraud, money laundering and tax evasion.⁴¹

The fall-out of the scandal led to the capital markets regulator blacklisting former Attorney General Charles Njonjo, among seven other directors of the troubled motor dealer. Among those barred from being appointed directors were: the former head of Civil Service and the board chairman (Jeremiah Kiereini) and (Martin Forster) and Finance Director (Sobakchand Shah). Peter Muthoka (the company's largest shareholder), accused of overbilling the company by over Sh1.5 billion through Andy Forwarders was also disqualified alongside Richard Kemoli, and Andrew Hamilton.⁴²

This meant that those blacklisted directors who were serving on any other board, would be banned from ever being directors in Kenya. "We are also going to pursue the said directors with the help of government agencies to refund up to three-fold the amount they have stolen from the company given that it has been earning interest."⁴³

1.3. Statement of the Problem

This study examines the legal challenges minority shareholders face in trying to protect their investments against those who have capacity to influence the board of directors or majority shareholders. Minority shareholders are protected by several sections of the Companies Act such as Sections 131,⁴⁴ 132,⁴⁵ 135,⁴⁶ 140,⁴⁷ 219,⁴⁸ 211⁴⁹ and 170⁵⁰ of the Companies Act.

⁴¹ Ibid.

⁴² Ibid.

⁴³ Ibid. Comments attributed to CMA board chairman Kungu Gatabaki.

⁴⁴ Section 130, Companies Act: "Every company shall in each year hold a general meeting as its annual general meeting in addition to any other meetings in that year" "

⁴⁵ Ibid. Section 132: Convening of extraordinary general meeting on requisition.

⁴⁶ Ibid. Section 135: Power of court to order meeting.

⁴⁷ Ibid. Section 140: Circulation of members' resolutions, etc.

⁴⁸ Ibid. Section 219: Circumstances in which company may be wound up by the court.

⁴⁹ Companies Act (Cap 486 of the Laws of Kenya), Section 211 (1): "Any member of a company who complains that the affairs of the company are being conducted in a manner oppressive to some part of the members

However they generally find it difficult to protect themselves against the oppressive conduct of majority shareholders. This is because as majority shareholders they have a definite advantage in annual general meetings where decisions are made by the majority. The majority rule means that majority shareholders can vote in support of any wrong doing on their part against the interests of minority shareholders. The majority rule is binding to courts which are reluctant to intervene in the internal management of companies especially where majority shareholders have taken a position.

Minority shareholders find it difficult to move to court under Sections 170 and 211 on account of the courts holding that the proper plaintiff in a suit by minority shareholders is the company.⁵¹ Section 211 of the Companies Act is too restrictive as it fails to protect members who are unable to show that the affairs of the company are run in such a bad manner as to justify the making of a winding up order.⁵² The requirement of depositing security for costs in Section 170 further makes it difficult for minority shareholders to file a derivative action due to excessive demands.⁵³

1.4. Key Issues Raised by the Research

This research raises a number of issues relating to the protection of minority shareholders. Ownership concentration is common in companies listed on the Nairobi Stock Exchange

(including himself) or, in a case falling within subsection (2) of section 170, the Attorney-General, may make an application to the court by petition for an order under this section.ö

⁵⁰ Ibid. Section 2: If, in the case of any body corporate liable to be wound up under this Act, it appears to the Attorney-General, from any such report as aforesaid that it is expedient so to do by reason of any such circumstances as are referred to in subparagraph (i) or subparagraph (ii) of paragraph (b) of section 166, the Attorney-General may, unless the body corporate is already being wound up by the court, present a petition for it to be so wound up if the court thinks it just and equitable that it should be wound up or a petition for an order under section 211 or both.

⁵¹ *Salomon v. Salomon*(1897) AC 22.

⁵² *Mohamed Mitha and Others v Ibrahim Mitha and Others*,[1967] EA 575; *Re Eryeza Bwambale and Co ltd*, [1969] EA 430.

⁵³ In *Paolo Murri v Gian Battista Murri& Another*, Civil Appeal in Nairobi 59 of 1999: minority shareholders contend with insurmountable difficulties in proving the element of a ðfraud on the minorityö in a common law derivative action.

(NSE) mainly by State Owned Enterprises (SOE), multinational and family interests.⁵⁴ Five of the top multinational companies (Barclays Bank, Standard Chartered Bank, Safari-com and British American Tobacco (BAT) control over 50% of the investment on the NSE and have managed to overcome the problems affecting ownership and control by acquiring a controlling shareholding in their respective companies.

Minority shareholders who invest in multinational companies, government controlled state corporations and family controlled businesses still require legal and institutional agencies to protect their investments.⁵⁵ Protection becomes necessary due to concentrated ownership without much regard for the minority shareholders. The controlling shareholders dominate the boards and have sufficient financial and human resources to carry out their wishes at the board and general meetings without regard to the minority. Consciously there is need to have a legal and institutional framework for protecting the minority shareholders to bring equitable treatment for the shareholder. The failure to protect minority shareholders in Kenya is caused by three main factors namely a weak legal framework, an obsolete Companies Act and low level shareholder and director awareness.

1.4.1. Weak legal Enforcement

The Capital Markets Authority created under the Capital Markets Act⁵⁶ regulates the Securities market. However the enforcement of this law is still weak and inefficient as demonstrated by the manner the Authority handled the problems at the CMC holdings. The poor enforcement of corporate law in Kenya is caused by impunity and reliance on an archaic legal framework and a court system that is slow, inefficient and in some instances corrupt.⁵⁷

⁵⁴ Nganga op. cit. note 12 at 4.

⁵⁵ Ibid.

⁵⁶ Chapter 485A of the Laws of Kenya.

⁵⁷ A Report of the Advisory Panel of Eminent Commonwealth Judicial Experts dated 17th May, 2002 submitted to the Constitution of Kenya Review Commission.

The courts have a huge backlog of criminal and civil cases which combined with a shortage of judges and lawyers with a strong commercial expertise, makes a speedy disposal of minority oppression cases difficult to achieve.⁵⁸ The notoriety of the Goldenberg and Anglo-leasing companies' cases lends credence to this level of difficulties pointed out by the Panel of Eminent Commonwealth Experts⁵⁹ and the Kwach Committee on Administration of Justice.⁶⁰ The Goldenberg scandal is the longest running case of high level corruption that the Judiciary is yet to conclude to date. Minority shareholders are hesitant to use the courts due to the increasing prevalence of corruption and integrity problems bedeviling the Judiciary. This is further compounded by the length of time it takes to reach judgment and the high costs involved.⁶¹

1.4.2. Companies Act

Compared to the UK Companies Act, 2006, Kenya's Companies Act, 1962 is archaic and obsolete as the legislative framework for the protection of minority shareholders.⁶² This legislation is however identical to the English Companies Act 1948 which has been repealed to provide relief to minority shareholders in the UK. The latest amendment to the English Companies Act was done in 2006. Despite these many changes by the UK, Kenya's Companies Act is still based on the English Companies Act of 1948. It has clearly been overtaken by events and therefore overdue for reform in Kenya.

⁵⁸ International Commission of Jurists (ICJ), *State of the Rule of Law in Kenya: Report 2006* (ICJ: Nairobi, 2006) at 8.

⁵⁹ Report Of The Advisory Panel Of Eminent Commonwealth Judicial Expert, May 2002.

⁶⁰ The Kwach Committee Recommendations on Corruption in the Judiciary, 1988.

⁶¹ Ibid.

⁶² Chapter 486, Laws of Kenya.

1.4.3. Low Level of Awareness

Kenya's corporate governance has experienced a steady growth as demonstrated by the publication of the corporate governance code,⁶³ but there is still an awareness gap amongst the shareholders and directors on their rights. Shareholders have many rights which according to La Porta et al,⁶⁴ include: entitlement to one-share one-vote, ability to vote by proxy, anti-dilution pre-emptive rights and the ability of minorities to compel the firm to call an extraordinary general meeting. Some of these rights are also provided for in the Companies Act of Kenya.

Majority of the minority shareholders, remain unaware of these entitlements owing to the information asymmetry between the controlling majority shareholders and minority shareholders.⁶⁵ Although the Commonwealth Secretariat has supported shareholder training and established the Institute of Directors, not many shareholders and directors have been reached by these training programmes in Kenya.⁶⁶

There is widespread shareholder apathy and ignorance as most individual shareholders are -happy to receive their dividend cheque and leave management alone⁶⁷ Even institutional investors are unwilling to -be proactive and take management to task^ø at Annual General Meetings. One investor described her unsuccessful attempts to organize large shareholders to

⁶³ Private Sector Initiative for Corporate Governance, *Principles for Corporate Governance in Kenya and a Sample Code of Best Practice for Corporate Governance* (Private Sector Corporate Governance Trust: Nairobi, 1999).

⁶⁴ La Porta op. cit. note 25 at 1113.

⁶⁵ Ibid.

⁶⁶ Vincent Okoth Ongore, -The Relationship between Ownership Structures and Firm Performances: An Empirical Analysis of Listed Companies in Kenya^ø (2011) 5 *African Journal of Business Management* 16.

⁶⁷ Ibid. at 19

press management on specific issues as the course of minority shareholders in Kenya.⁶⁸ This underscores the difficulty minority shareholders go through in articulating their issues.

1.5. Objectives

The objectives of this research are as follows:

1. To show the extent to which minority shareholders are protected by Kenya's legal framework in publicly held companies;
2. To make a comparative study of minority shareholder protection between Kenya and the United Kingdom;
3. To make recommendations on the best way to protect minority shareholders in Kenya.

1.6. Research Questions

1. To what extent are minority shareholders in publicly held companies protected by Kenya's legal framework?
2. How well does the legal framework for protecting minority shareholders in Kenya compare with that of the UK and what lessons can be learnt?
3. What are the recommendations on the best way to protect minority shareholders in Kenya?

1.7. Hypothesis

Minority shareholders find it difficult to protect themselves against wrongful conduct of majority shareholders because they have to content with insurmountable difficulties in proving fraud on the minority in a common law derivative action.

⁶⁸ Aron op. cit note 20.

1.8. Theoretical Framework

The theoretical foundation of this research is the agency theory. The agency problem was identified by Adam Smith⁶⁹ in the 18th century and later by Berle and Means⁷⁰ as being at the core of separation of ownership and control of a company's assets. The Agency theory is concerned with contractual relationship between two or more persons where an agency relationship is defined as "a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent."⁷¹ Three agency problems affecting business firms: vertical agency problems between shareholders and managers, horizontal agency problems between the majority shareholders and minority shareholders and the third agency problems between a firm itself and the other parties with whom it has contracts.⁷² The agency problems at the core of this thesis are the ones relating to the controlling majority shareholders, directors and minority shareholders (vertical and horizontal agency problems).

Agency problems at Cooper Motors Corporation, involved a conflict between, on the one hand, owners who possess the majority or controlling interest in the firm with ability to elect directors of their choice and, on the other hand, the minority or non-controlling owners.⁷³ In this relationship, non-controlling owners can be thought of as the principals and controlling owners who were doubling as directors as the agents. The difficulty here lies in assuring that the former are not expropriated by the latter.⁷⁴

An agency relationship arises when one partner in a transaction (the principal) delegates

⁶⁹ Adam Smith, *The Wealth of Nations* (1776): "The directors of such companies however being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance which the partners in private copartnership frequently watch over their own. Negligence and profusion, therefore, must always prevail, more or less."

⁷⁰ Berle and Means op. cit. note 23 at 19.

⁷¹ Jensen and Meckling, op. cit. note 23 at 308.

⁷² La Porta op. cit. at note 25 at 479.

⁷³ John Armour et al, Agency Problems and Legal Strategies, in Reiner Kraakman et al, *The Anatomy of Corporate Law A Comparative Approach* 2nd ed. (Oxford University Press: Oxford, 2009) at 36.

⁷⁴ Ibid.

authority to another (the agent) and the welfare of the principal is affected by the choices of the agent.⁷⁵ The delegation of decision making authority from principal to agent becomes problematic when the interests of the principal and agent diverge, the principal cannot perfectly monitor the actions of the agent, and likewise the principal cannot monitor and supply the information available to the agent.⁷⁶ The combination of these three problems at Cooper Motors Corporation led to opportunistic behavior (conflict of interest, fraud and tax evasion) by the agent, and eventually worked against the interests of the principal. The gist of the agency problem at Cooper Motors Corporation rested in the abuse of power by corporate elites, some of whom abused it to their personal benefit. This eventually proved to be damaging to the shareholders as the company was suspended and delisted from the stock exchange.⁷⁷

The search for the perfect corporate governance structure that optimizes and reduces agency costs is at the root of most corporations and Cooper Motors Corporation in particular. In discussing separation of ownership from control, Berle and Means,⁷⁸ postulated that an intricate series of relationships are formed in situations where the returns for the company's shareholders depends on the performance of the company's managers who in turn depend on the employees of the company. Agency costs in this case are higher owing to the increased monitoring of the board.⁷⁹ But in cases where ownership and control are not separated there are new sets of problems which are associated with self-interest. These agency problems

⁷⁵Devanie Hutton, *Corporate Governance and Director's Duties: 2003 -PLC Global Counsel Handbooks* (Practical Law Company: London, 2002) at 22.

⁷⁶ Ibid.

⁷⁷ Ibid.

⁷⁸ Berle op. cit. note 23 at 13.

⁷⁹ Ibid. at 25.

include non-disclosure of information, dilution of shares and fraud that ultimately leads to expropriation of minority shareholders.⁸⁰

The Agency theory has emerged as a dominant model in corporate governance, and is widely discussed in business ethics texts.⁸¹ The Agency theory suggests that the firm can be viewed as a nexus of contracts (loosely defined) between resource holders. An agency relationship arises whenever one or more individuals, called principals, hire one or more other individuals, called agents, to perform some service and then delegate decision-making authority to the agents.⁸² The primary agency relationships in a business are those: between shareholders and managers and between majority shareholders and minority shareholders.⁸³ The Cooper Motors Corporation comprised a similar set of agency relationships, with the chairman being the controlling majority shareholder. The agency relationship is not necessarily harmonious since it often creates conflicts of interest between agents and principals. These conflicts affect the governance and business ethics of companies and have a tendency to increase agency costs.⁸⁴ These costs are incurred in order to sustain an effective agency relationship by, for example, offering management performance bonuses to encourage managers to act in the shareholders' interests.⁸⁵

1.9. Literature Review

The legal protection of minority shareholders is an important aspect of corporate law. This is because the extent to which a country protects its minority shareholders determines how

⁸⁰ Ibid.

⁸¹ Fernando Lefort and Eduardo Walker, "Do Markets Penalize Agency Conflicts Between Controlling and Minority Shareholders? Evidence from Chile," 2007) 45 (3) *The Developing Economies* 2836314.

⁸² Ibid.

⁸³ Bruno Meyerhof Salama and Viviane Muller Prado, "Legal Protection of Minority Shareholders of Listed Corporations in Brazil: Brief History, Legal Structure and Empirical Evidence," (2011) 4 *Journal of Civil Law Studies* 149.

⁸⁴ Ibid.

⁸⁵ Jensen and Mecklin op. cit. note 23 at 326.

much investment it will attract and the maturity of the economy.⁸⁶ Yet in Kenya there is a dearth of information on protection of minority shareholders because many legal scholars have not taken a lot of interest in this area. This study endeavors to change that perspective and contribute to literature in the area of minority shareholder protection.

1.9.1 Kenya's Legal Framework in the Protection of Minority Shareholders

According to Musikali,⁸⁷ a country's legal system determines the success of its corporate governance. This has been shown by jurisdictions with effective and efficient legal systems also display good corporate governance.⁸⁸ The blame in the view of the author is the aspect of Kenya having borrowed corporate governance codes from various developed countries without establishing the market dynamics under which the codes operate. Musikali is doubtful whether Kenya can achieve good corporate governance with the existing law and corporate governance code. This is illustrated by the corporate scandals that occurred at Kenya Co-operative Creameries, National Housing Corporation, Kenya National Assurance Company⁸⁹ and the collapse of 33 banks in the 1980s.⁹⁰ What this illustrates is that self-regulation through corporate governance codes is not tenable. The Goldenberg scandal for example cost Kenya government approximately \$4 billion or an estimated 10% of the country's gross domestic product.⁹¹ Prosecution for the directors of these corporations was not possible as they were appointed to head other corporations.⁹²

⁸⁶ Kiarie Mwaura, "The Plight of Minority Shareholders under the Companies Bill 2010: Oppressed or Simply Abandoned and Forgotten?" (2012) 1 *University of Nairobi Law Journal* 4.

⁸⁷ Lois M. Musikali, "The Law Affecting Corporate Governance in Kenya: A Need for Review" (2008) *International Company and Commercial Law Review* 213.

⁸⁸ R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R.W. Vishny, "Legal Determinants of External Finance" (1997) 52(3) *Journal of Finance* 1131.

⁸⁹ A. Eshiwani, "Director Liability in the Wake of Uchumi (Collapse)" *Institute of Directors (Kenya)*, July 14, 2006 (Nairobi, 2006).

⁹⁰ D.C. Barako, P. Hancock and H.Y. Izan, "Factors influencing Voluntary Disclosure by Kenyan Companies" (2006) 12(2) *Corporate Governance: An International Review* 107.

⁹¹ P. Warutere, "The Goldenberg Conspiracy" (2005) *Institute for Security Studies Papers*.

⁹² J.K. Mwaura, *The Kenyan Regulation of Company Directors: An Analytical Study* (Wolverhampton: University of Wolverhampton, 2003).

The scandals were possible due to the inefficiency of the legal system, corruption and political interference. Investigations into these scandals bore no results while the beneficiaries enjoyed the fraud committed. Musikali gives various scenarios where protection of minority shareholders is not possible so long as nothing exists to deter management from acting against the interests of the company. Section 402 (1) suggests that it is possible for directors to go unpunished arising from negligence, ignorance or inexperience on their part.⁹³ In *Flagship Carriers Ltd v Imperial Bank*,⁹⁴ The Court held that directors are only required to exhibit a degree of skill and care that may reasonably be expected from a person of their knowledge or experience, but they are not liable for errors of business judgment.⁹⁵ Section 329 of the Penal Code provides for imprisonment for 7 years for directors who knowingly give false statements with the intention to deceive or defraud the corporation. This is equally difficult because prosecution on behalf of the minority shareholders can only be brought by the company and not its members.⁹⁶ In a nutshell Musikali is of the view that penalties provided for in the Penal Code and the Companies Act effectively exonerate directors from liability by requiring shareholders to prove directors' dishonest conduct.

According to Mwaura,⁹⁷ inadequate protection of minority shareholders in Kenya is a serious anomaly, considering that protecting investors is a sure way for the country to boost capital investment. This is because left on their own, majority shareholders have the tendency to use their voting power to influence the board and general meetings for abuse and advancement of

93 Section 402, Companies Act: "If in any proceeding for negligence, default, breach of duty or breach of trust against an officer of a company it appears to the court hearing the case that that officer is or may be liable but that he has acted honestly and reasonably he ought fairly to be excused" [emphasis added].

94 Civil Case No.1643 of 1999, unreported, High Court.

95 These rules were originally formulated by Romer J. in *City Equitable Fire Insurance Co, Re* [1925] Ch. 407.

96 *Musango v Musigire* [1966] E.A. 390. This ruling originates from the English decision in *Foss v Harbottle* (1843) 2 Hare 461.

⁹⁷ Mwaura op. cit. 92.

personal interests. Mwaura views two problems as being critical to the protection of minority shareholders' rights. First is the common law and second is statutory law.

Common law is inherited law from England and applied in Kenya by virtue of the Judicature Act.⁹⁸ Common law maintains that courts should not interfere in the management of companies unless there is an irregularity that cannot be rectified by the general meeting. In *Dadani v Manji and 3 Others*, the court was of the opinion that the only time a minority shareholder could bring a derivative action against the company is when there is an illegality rather than a mere irregularity that can be rectified at the general meeting.⁹⁹

Two areas that concern the author is the gist of section 211 and 170 of the Companies Act that purport to protect the rights of minority shareholders while at the same time making it very difficult for them to get a remedy in court. Mwaura is however alive to the dangers of too much litigation or what he terms 'excessive law suits' anytime investors feel an infringement has been committed, since such law suits would affect company performance. He recommends that minority shareholders should be granted the *locus standi* to enable them file derivative action without such extreme preliminary requirements to enable them protect their rights.

Gakeri,¹⁰⁰ views corporate scandals as having provided an opportunity to reshape the way corporations are directed and controlled in Kenya. This is because scandals are a symptom of poor corporate governance. This is because good corporate governance practices ensure integrity, transparency, accountability and enforceability of the law. Good corporate

⁹⁸ Section 3 (2), Judicature Act.

⁹⁹ High Court (Nairobi), Civil Case No 913 of 2002, (Judgment, Mwera J, 5 February 2004).

¹⁰⁰ Jacob K. Gakeri, 'Enhancing Kenya's Securities Markets through Corporate Governance: Challenges and Opportunities' (2013) 3 (6) *International Journal of Humanities and Social Science* 94.

governance also facilitates allocation of resources and investor confidence on their level of investment.¹⁰¹ This is in addition to protecting investors together with their investments. Generally, corporations with good corporate governance structures attract more investors and foreign direct investments. It is for this reason that corporate governance systems were established in developed countries to address the interests of investors and management especially those touching on agency costs. This was relatively possible in developed countries because they have effective legal and regulatory frameworks. Besides, the corporations are characterized by dispersed share ownership.

In developing countries such as Kenya, share ownership is concentrated. The challenges brought by concentration of shareholding include expropriation of the minority by the majority and the extraction of benefit of private control.¹⁰² The Companies Act and Code have not been effective as earlier envisaged. There has also been a systemic failure to enforce the law. The corporate governance codes that were adopted from other jurisdictions have not been aligned to meet the country's local conditions.

1.9.2 Best Practices in Minority Shareholders' Rights Protection

According to Rafael,¹⁰³ the phenomenon of controlling shareholders is not just found in developing countries, but common in developed countries as well. In the latter, controlling shareholders in publicly traded firms are able to designate and monitor managers, a practice which benefits both majority and minority shareholders. The problem that arises in this scenario is not an agency problem since the controlling majority shareholders are able to dilute minority shareholding within the limits of the law. With the dilution, majority

¹⁰¹ Victor C.S. Yeo, "Corporate Governance in the Information age: The Impact of Information Technology and Emerging Legal Issues" (1999) 29 *HONG KONG Law Journal* 184.

¹⁰² Gakeri op. cit. note 100 at 96.

¹⁰³ Global Corporate Governance Forum Secretariat, *A survey of Worldwide Corporate Governance Activity* 2nd Edition (1999).

shareholders increase their power at the expense of the minority shareholders which could then be used as a tool to oppress minority shareholders.

Rafael takes a global view of the effect of legal protection of minority shareholders and cash flow ownership by a controlling shareholder on the valuation of firms. Using a sample of 539 large firms in 27 developed economies, it was found that higher valuation of firms was experienced in countries that espoused better protection of minority shareholders accompanied by higher cash flow ownership by the controlling shareholder.

These findings are consistent with similar studies done elsewhere showing that protection of investors in a country is an important determinant of the development of its financial market. This is because, when investors and creditors are better protected, they are willing to pay for financial assets in the form of equity and debt. This protection translates to better profits on their investment. These findings were, however, made in an advanced state (USA) where the rights of minority shareholders are well protected and may not necessarily be applicable in Kenya, but have valuable lessons for the country.

1.10. Research Methodology

This is a qualitative research that will use desktop review of primary and secondary data to make a comparative study of the Kenyan and UK legal frameworks for minority shareholder protection. Primary sources will include the Constitution, legislation, company's Annual Reports, decided cases relevant to the study, OECD and CMA Guidelines on corporate governance. Secondary sources of information used include textbooks, relevant newspaper articles, and commentaries on the CMC scandal, Journal Articles, and on-line sources.

1.11. Chapter breakdown

Chapter one introduces the study by stating what it intends to achieve namely: a legal framework for the proper protection of the rights of minority shareholders in listed and unlisted registered companies. It also consists of the background, statement of the problem, theoretical framework, hypothesis, and literature review and research methodology.

Chapter Two is a case study of CMC, historical background and a demonstration of the gaps in the regulatory framework for protecting minority shareholders in Kenya.

Chapter Three will analyze the Kenyan corporate legal framework for protecting the rights of minority shareholders in accordance with the common law, the principles of equity, the Companies Act, the Capital Markets Act and Guidelines, the Constitution and the Companies Bill, 2014

Chapter Four makes a comparative analysis of the UK model for protecting minority shareholders and draws on it for a possible application in Kenya.

Chapter Five makes conclusions and recommendation on the way forward.

CHAPTER TWO

MINORITY SHAREHOLDERS' OPPRESSION: CASE STUDY OF COOPER MOTORS CORPORATION

2.1. Introduction

The boardroom wars at the Cooper Motors Corporation in the year 2009/2010 brought to light how the ownership structure and management of corporations in Kenya are used to expropriate minority shareholders' investment.¹⁰⁴ According to Barako,¹⁰⁵ promoters set up a companies where they wield immense power which they use to steer the company towards a direction of their own choice, view shared the chairman of the Capital Markets Authority.¹⁰⁶

This chapter is an appraisal of how the controlling majority shareholders at Cooper Motors Corporation used their superior controlling majority shareholding to, among other things, engage in corruption, stealing, tax evasion, money laundering and conflict of interest. The effect of which turned out to diminish minority shareholders' investments at the Nairobi Securities Exchange through diminished profits. This was made possible through the support of the controlling majority shareholders (Peter Muthoka, Charles Njonjo and Paul Ndungu). The three controlled 50.6% of the company that has been delisted from the NSE and sold to a strategic foreign investor called Al-Futtaim Auto Machinery Company at a cost of ksh.7.5 billion (or at Sh13 per share).¹⁰⁷

¹⁰⁴ Peter Kiragu, "CMC Saga Proves Rot in Corporate Leadership" *The Nairobi Star*, 23 September 2011.

¹⁰⁵ Dulacha G Barako, "Determinants of Voluntary Disclosures in Kenyan Companies Annual Reports" (2007) 1 (5) *African Journal of Business Management* 118.

¹⁰⁶ Ibid.

¹⁰⁷ David Herbling, *Business Daily* February, 17, 2014: Despite being assured of the 50.6 per cent by the controlling majority, the Dubai based company is still seeking support from minority shareholders owning 10.7 per cent shares to ensure it does not co-own the company with minority shareholders. Being a family owned company their intention is to own 90 per cent of CMC's shares to enable them compulsorily acquire the remaining shares on a full buyout.

2.2. Historical background

The Cooper Motor Corporation, also known as Cooper Motors Corporation, is the largest importer car-assembly company of Kenya.¹⁰⁸ It was founded in 1912 by Mr. Clement Hirtzel under the company name Nairobi Motor Garage. The firm was founded in Nairobi, in what was formerly known the Protectorate of British East Africa. Over the decades, the company developed into a major importer for several different brands. The company started its activities with the import of the Ford Model T. It was the first company to distribute vehicles in British East Africa, today known as Kenya.¹⁰⁹

The Cooper Motors Corporation was incorporated under the Companies Act in 1948 as a private company with a total share capital, at the time of £10,000.¹¹⁰ This was equivalent to Ksh. 1.36 million at the time, but could now be equivalent to Ksh. 29.4 million today. The Cooper Motors Corporation became a public corporation¹¹¹ in 1956 with the sole mandate of providing vehicles parts, sales service and administration. As a public corporation, its duties were clearly cut out.

2.3. Nature of Shareholding at Cooper Motors Corporation

Shareholding at the Cooper Motors Corporation was characterized by majority shareholders who controlled the direction the company would take using the board of directors and the Annual General Meeting. Minority shareholders helplessly stood by as things went from bad to worse. At the time, Cooper Motors Corporation had a total of 15,558 shareholders out of which 12, 000 shareholders owned less than 500 shares. On the whole, 13,456 minority shareholders owned between 1-10,000 shares which represented only 3.28% of all the shares

¹⁰⁸ Kiragu op. cit. note 104.

¹⁰⁹ Ibid.

¹¹⁰ CMC Annual Financial Report 2011.

¹¹¹ Ibid.

issued.¹¹² In another class of minority shareholders, 38 shareholders owned over 1 million shares each and controlled 20% of the total shares issued.¹¹³

Individuals who owned majority shareholdings at Cooper Motors Corporation also held top positions at the company. For example Muthoka (chairman) owned 24.73% shareholding, Kiereini with 12.5% shareholding. Even before he was appointed as chairman, Muthoka had been increasing his shareholding at Cooper Motors Corporation and became the second highest controlling majority shareholder. He used his company known as Andy Forwarders Ltd where he was majority shareholder and chairman to entrench his control. Andy Forwarders Ltd owned 24.73% stake in Cooper Motors Corporation while at the same time it supplied a large segment of Cooper Motors Corporation's chain logistics. Other shareholders (Ndungu, Shah and Kibe) jointly controlled another 20.7% of Cooper Motors Corporation shares.¹¹⁴ It is therefore evident that 4 individuals had a controlling shareholding at Cooper Motors Corporation (of over 80%) and therefore had the capacity to out vote minority shareholders in the board and annual general meeting by a wide margin.

2.4. Expansion of Cooper Motors Corporation Portfolio

The regional expansion of Cooper Motors Corporation was necessitated by its role as the biggest supplier of vehicles to the Governments of Kenya, Tanzania and Uganda with the consequence that branch networks were established in those countries.¹¹⁵ Expansion involved acquiring already established smaller businesses onto its stable. This led to its restructuring in 1971 and the creation of a holding company known as Cooper Motors Corporation. Today apart from being a leading motor vehicle dealer, the Cooper Motors Corporation owns 8 subsidiaries within motoring and aviation services and has the largest distribution network for

¹¹² Africa Centre for Open Governance, *Kenya: Governance Report 2011* at 36.

¹¹³ *Ibid.*

¹¹⁴ *Ibid.*

¹¹⁵ Mwaniki Wahome, 'CMC Engages Forward Gear After Crippling Rows', *Daily Nation*, June 11, 2013.

sales, parts and service in East Africa. The performance of the company had steadily declined over the years despite the fact that it remained the official supplier of vehicles to the government and maintained a close trade relationship.¹¹⁶

2.5. Manifestations of Poor Corporate Governance

As a public listed company Cooper Motors Corporation was required to comply with the Capital Markets Authority Guidelines developed in 2002 to strengthen corporate governance practices and promote the standards of self-regulation by public listed companies in Kenya to international standards. The Guidelines adopt a prescriptive and non-prescriptive approach in order to provide for flexibility and innovative dynamism to corporate governance practices by individual listed companies like Cooper Motors Corporation.¹¹⁷ The Guidelines require companies to nurture and encourage certain aspects of governance standards maintained and promoted as part of their continuing listing obligations.¹¹⁸

The guidelines require companies to publicly disclose the extent of a company's compliance to the guidelines. Cooper Motors Corporation did not disclose the offshore secret accounts annual reports and therefore was in breach of the guidelines. Disclosure on an annual basis is a requirement for every public listed company as an indicator of the directors' integrity.¹¹⁹

The company's prosperity and large market share spanning the whole of Eastern Africa can be attributed to the effective leadership by its directors.¹²⁰ This demonstrates that the company had an effective board that met regularly (6 times a year), committees with independent non- executive directors (INEC), separation of the post of chairman and chief executive officer as required by the listing regulations.

¹¹⁶ Ibid.

¹¹⁷ Section 1.5 of the CMA Guidelines.

¹¹⁸ Section 1.6 Section 1.8 Gazette Notice No. 3362 the Capital Markets Act Cap 485A Guidelines On Corporate Governance Practices By Public Listed Companies In Kenya

¹¹⁹ Ibid. Section 1.8

¹²⁰ CMA Guidelines, Section 2.1.

The scandal that occurred at Cooper Motors Corporation between 2009 and 2012 leading to its suspension from the Nairobi Securities Exchange is indicative of deep rooted problems at the Cooper Motors Corporation board. By Cooper Motors Corporation's own admission, a forensic investigation which was disclosed in its 2011 Annual Report and Financial Statements revealed the existence of offshore bank accounts. The disclosure showed that Cooper Motors Corporation suffered from poor corporate governance leading to its poor performance in profitability and declining market share at the peak of its board room problems. According to the chief executive officer the business of Cooper Motors Corporation was suffering:

“From gross negligence and lack of basic business controls... Information was given to specific directors for specific reasons on a selective basis.¹²¹ This resulted in situations where executive directors sought protection from certain specific members of the board. In seeking protection, some board members were able to flaunt all business ethics...”¹²²

It is clear that the board turned a blind eye to an executive that was running down the company but only acted when the interest of one director was threatened.¹²³ Conflict of interest was demonstrated by the decision to award a contract to Muthoka's transport company, Andy Forwarders Ltd, at a time when Muthoka was the acting board chairman. Although the board knew Muthoka was a long time supplier of the company it nevertheless decided to make him the chairman.¹²⁴ This constituted a conflict of interest pursuant to the Companies Act which was exploited by a controlling majority shareholder to expropriate the company's resources.¹²⁵

¹²¹ Peter Kiragu, “CMC Says Kiereini Hid Millions in Jersey” *The Star*, 31 October 2011.

¹²² Bill Lay, CEO for CMC.

¹²³ Africa Centre for Open Governance op. cit. note 112.

¹²⁴ Ibid.

¹²⁵ Section 200, Companies Act: makes it a mandatory duty for a director of a company who is in any way directly or indirectly interested in a contract or proposed contract with the company to declare the nature and the extent of his interest at a meeting of the board of directors of the company.

Awarding of a contract to Andy Forwarders Ltd, a company closely linked to the chairman raises several legal issues. Firstly, as to whether the director had disclosed to the board at its meetings the extent of his direct or indirect interest in the contract awarded to company. This is because the duty to declare a director's interests is a statutory duty provided for under section 199 of the Companies Act.¹²⁶ This duty which extends to all transactions is meant to enable directors take appropriate steps to protect the interests of the company.

Secondly, as a fiduciary the director (chairman) should have avoided putting himself directly or indirectly in a position which could create a conflict of interest between the duties of the company and his own interests or duties to other third parties. At common law a director is required to demonstrate good faith, which must not only be manifestly done but also be seen to be done. The no conflict rule formerly under common law is currently statutory in nature. First a director shall not make personal use of the company's property, information or opportunities.¹²⁷ Secondly, a director shall not engage in insider dealings.¹²⁸ The major purpose of the no conflict of interest principle is to discourage directors from putting their personal interests ahead of those of the company.

In self-dealing transactions for example, the trustee position of directors is liable to vitiate any contractual obligations created with a fellow director by the board on behalf of the company.¹²⁹ This was illustrated in the case of *Aberdeen Railway Co. Ltd v Blaikie*¹³⁰ where a contract of a director was voided at the instance of the company despite the terms being perfectly fair to the company. Lord Cranworth held that so strictly is this principle adhered

¹²⁶ Ibid. section 199: It shall be the duty of any director of a company to give notice to the company of such matters relating to himself as may be necessary for the purposes of sections 196 and 197, and of section 198 except so far as it relates to loans made, by the company or by any other person under a guarantee from or on a security provided by the company, to an officer thereof.

¹²⁷ Davies P, *Gower and Davies Principles of Modern Company Law*^{8th ed.} (Sweet and Maxwell: London, 2008) at 530.

¹²⁸ Ibid.

¹²⁹ Section 33 of the Capital Markets Authority Act (cap.485A of the laws of Kenya) prohibits insider dealings and imposes criminal and civil liabilities.

¹³⁰ (1854) 1 Macq.H.L.461 HL Sc.

to that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into. This is therefore a strict rule of law which applies whether there is proof that the company could have negotiated and obtained exactly the same terms even if there had been no conflict of interest. Such a defense will not save the director or the contract from being vitiated. Though strict, this rule makes the task of courts easier where complaints have been raised on grounds of conflict of interest by directors of a company.

Thirdly, the governance problems perpetrated by the directors of Cooper Motors Corporation raise legal issues on the facts laid bare by the audit on the way directors were profiting from their fiduciary positions. At common law the non-profit rule has its origins in the leading Trust case of *Keech v Sandford*¹³¹ which was restated and applied in company law in the case of *Regal (Hastings) Ltd v Gulliver*.¹³² The facts of the case indicate that a company which owned a cinema wanted to buy two more cinemas in order to be able to resell the three of them as a group on better terms. The directors of the company formed a subsidiary to acquire the two additional cinemas for the company. Although the owner of the two cinemas was willing to lease them out to the company on condition that the authorized and fully paid share capital of the subsidiary company was sterling pounds 5,000 or if the directors gave personal guarantees. Instead the board decided that the directors and other investors would subscribe to the remaining shares after the company managed to raise 2,000 sterling pounds. They subscribed and eventually managed to sell the cinemas by selling shares in Regal and the subsidiary where the directors personally made a profit of 3 sterling pounds per share sold. The new controllers of Regal Company successfully sued the former directors to recover those profits.

¹³¹ (1726) SelCas Ch. 61.

¹³² (1942)1 All ER 378, HL.

The House of Lords held that the directors had obtained their profits by reason of and in the course of their duties as directors of the company. They participated in the transaction in the course of their directorships and utilized the opportunities and special knowledge accorded to them as directors. The directors were therefore made to account despite the fact that they had acted bona fide throughout the transactions. In his ruling Lord Russell stated:

“the rule of equity which insists on those who by use of a fiduciary position make a profit, being liable to account for that profit in no way depends on fraud, or absence of bona fides ;or upon such questions or considerations as whether the profit would or should otherwise have gone to the plaintiff ,or whether the profiteer was under a duty to obtain the source of the profit for the plaintiff, or whether he took a risk or acted as he did for the benefit of the plaintiff, or whether the plaintiff has in fact been damaged or benefited by his action.”¹³³

The liability for the directors arises by the mere fact that a profit has been made in the circumstances of the case. However honest the profiteer is or well intentioned he cannot escape the risk of being called upon legally to account for his actions. However the situations that create possibilities of a conflict of interest are endless and not necessarily limited to the foregoing three elements only.

The legal question the contracts by Andy Forwarders Ltd raised is whether the benefit or gain resulting from it over the period of its contract with Cooper Motors Corporation was derived from the director's fiduciary position or from exploiting opportunities and knowledge resulting from his position. To answer the question, it will require a variety of factors to be taken into account. The first factor is, as directors of Cooper Motors Corporation, they are trustees of the company's property, knowledge and opportunities. This duty is expressed as a fiduciary duty under common law for directors not to profit from their position or opportunities or knowledge resulting from it. Liability will arise from exploiting the fiduciary position, knowledge and opportunities emanating from the position. The question of whether

¹³³*Regal (Hastings) Ltd v Gulliver* (1942)1 All ER 378 at 386.

the company could or could not have exploited the opportunity is irrelevant as held in *Regal (Hastings) v Gulliver*.¹³⁴

A director's liability for breach of a non-profit duty can also be brought against him on grounds of being a constructive trustee. On appointment to office a director of a company assumes the duties of a trustee in relation to the company's property and his obligations to the company to its property thereafter is judged in accordance with this trust. His liability as a constructive trustee ensures that the company has proprietary claims against the director and it is not limited to a personal liability for the defendant to account for his profit. In *A-G for Hong Kong v Reid*¹³⁵ it was held that where a director receives a secret profit in the form of a bribe or a commission the director will hold the bribe or commission as a constructive trustee for the company.

2.5.1. Separation of Powers Doctrine

Although shareholders ordinarily feel that they nominally own the company, in reality they have virtually no decision making powers once they have ceded their powers through delegation to the elected board of directors.¹³⁶ The ordinary shareholder is entitled to elect the company's directors to serve for a considerable period and vote for exceedingly limited, though not unimportant, number of company actions. The net result of this holding is that all secret profit making however it is called, will make the director indulging in it liable as a constructive trustee. This will therefore entitle the company to claim for a proprietary remedy concerning the benefit or gain received by a director of a company. Such a holding will ensure that the company recovers from wrong doing directors and reinforces the director's

¹³⁴ (1967) AC 134n, (1942)1 All ER 378, HL.

¹³⁵ (1994) 1 All ER 1.

¹³⁶ Bainbridge S.M. *Corporate Governance after the Financial Crisis* (Oxford University Press: Oxford, 2012) at 2.

fiduciary obligations as to which directors are accountable while protecting the company against an insolvent defendant.

Arising from this state of affairs any dishonest collusion or agreement to impede a company from realizing its right of recovery of any secret profits made by them will constitute a conspiracy to defraud.¹³⁷ Section 200 of the Companies Act and Article 84 of the articles of association require a director to declare the nature and extent of interest to the board in a meeting. In the case of *Re Neptune (vehicle washing equipment) Ltd*¹³⁸ the court held that a sole director was under a duty of disclosure. He was required to call for a meeting of the company to which he is a sole director. In the presence of an officer of the company preferably a secretary, and formal declaration recorded in the company's minute book to the effect that he has an interest in contracting with the company. The effect of the decision is to compel the sole director to spend time to consider the consequences of the intended action. Compliance with corporate governance principles helps to entrench the separation of powers doctrine within the body corporate.

This model is found in the Sarbanes Oxley Act and in the principles of Corporate Governance Codes which Kenya and the CMC have adopted. Through this model monitoring and management are separated under the separation of powers doctrine. Thus, making the board and management individual branches of the corporate government with clearly delineated responsibilities.

2.5.2. A Culture of Absence of Transparency and Accountability

The Audit Report revealed deep seated problems of corruption, theft and tax evasion through offshore accounts allegedly perpetrated by some of the directors and senior management of

¹³⁷ *Adams v R* (1995) 2 BCLC 17, (1995) 1 WLR 52 PC: In the UK the claim can be pursued under the unfairly prejudicial remedy.

¹³⁸ *Re Neptune (vehicle washing equipment) Ltd v. Fitzgerald* (1995) 3 All ER 811; (1996) Ch 274.

the company, spanning very many years.¹³⁹ The audit found that two directors (Kiereini and Forster) had stashed Ksh. 255 million in offshore accounts since 1996. This is a fact that was not revealed to its shareholders in the annual financial statements. The money was accumulated by colluding with suppliers to overcharge Cooper Motors Corporation on invoices. The monies would be paid back to the two along with other employees for more than 26 years. For instance, in March 2011, Kiereini was paid £5,000, Forster £18,500 and similar amounts in September of the same year. Since 2008, payment schedules reveal that Kiereini received £20,000 and Forster got £77,750. The money was not taxed.¹⁴⁰

Official documents, including audited accounts and disbursement schedules, reveal that, in the previous 20 years, Kiereini and Forster had operated three secret offshore trust accounts by adding half a percentage point to the invoiced cost of every car purchased from Jaguar Land Rover and Nissan UD. The two dealerships were at one point the ‘rainmakers’ for the company. During the Presidency of Jomo Kenyatta and Moi, Land Rover was the official face of government transport when the Britain was the favorite import destination. The way the scheme was carried through involved Cooper Motors Corporation ordering Land Rover and Nissan Diesel vehicles at a particular price negotiated at arm’s-length.¹⁴¹ This is the legitimate contract price that would go to the British and Japanese manufacturers. They would then ask the manufacturer to pad the bill by half per cent and present this as the full invoice to Cooper Motors Corporation.¹⁴²

The fraud at Cooper Motors Corporation was operated through three trust accounts, namely: the Fair Valley established in Jersey; Corival formed in 1996; and Cooper Motors Corporation,

¹³⁹ Africa Centre for Open Governance op. cit. note 112.

¹⁴⁰ Benson Wambugu, ‘Tobiko Takes on Kiereini and Njonjo over Loss of CMC Funds’, *Business Daily* 23 October 2012.

¹⁴¹ Peter Kiragu, ‘CMC Says Kiereini Hid Millions in Jersey’, *The Star*, 31 October 2011.

¹⁴² Ibid.

incorporated on December 22, 1999 in the British Virgin Islands, another tax haven.¹⁴³ It prejudicial to the interests of minority shareholders who expected to get dividends from what could have contributed to the profitability of the company but was stolen by some of the controlling majority shareholders and directors managing the company. In *R v Philippou*,¹⁴⁴ Philippou and Panayides were sole directors and shareholders of the company which went into liquidation due to unpaid debts of £11.5million. This followed withdrawal of £369,000 in sixteen transactions to purchase property for themselves in Spain shortly before the company became insolvent. They were charged in a criminal action for theft from the company. The court held that:

“Whether a man in total control of a limited liability company, by reason of his shareholding and directorship, is capable of stealing the property of a company; and whether two men in total control of a limited liability company, by reason of their shareholding and directorships, are while acting in concert, capable of jointly stealing the property of a company.”¹⁴⁵

The court held that the appellant and Panayides, who fell ill and was left out of the trial, as sole shareholders and directors were the mind and will of Sunny Tours Limited who gave instructions to the bank to transfer money to Spain. While the instructions to the bank could be said to be the instructions of the company because they showed that the company had consented to the transfer the cash, the transfer itself cannot be said to be adverse to any right of the company.

The second issue concerned the issue of tax evasion brought about by the secret profits earned without being declared in the company's accounts or in the directors' personal tax declarations from the earnings made from the company. Under section 190 (1) of the Companies Act it is unlawful for a company to pay a director and fail to tax the income.

¹⁴³ Ibid.

¹⁴⁴ *R v Philippou*, (1989) 89 Cr App R 290, Court of Appeal.

¹⁴⁵ Ibid.

2.5.3. Inadequate Disclosure of Information

Full disclosure of information is the hall mark of good corporate governance and best practice. The essence of disclosure is to ensure all relevant information is readily available to all shareholders and all those who wish to deal with the company and more so for listed companies.¹⁴⁶ The contents of a disclosure regime are financial and non-financial information, such as, the legal affairs and asset evaluation of the company during the period under review. Disclosure of information is meant to prevent the monopolization of information and expanded investment requirements.

Audit Reports reveal that there was lack of disclosure at Cooper Motors Corporation with majority shareholders getting beneficial interest at the expense of the minority shareholders. By violating disclosure requirements, the Cooper Motors Corporation not only undermined the integrity of the company's image but also damaged the interests of the investors and healthy development of the country's stock exchange.¹⁴⁷ This is illustrated by the existence of off-shore accounts that were neither disclosed to the board of directors nor in the Company's annual financial statements.¹⁴⁸ The controversy afforded a troubling insight into the conflict of interest that was rife in the corporation.

There are two reasons that underlie the regulators' disclosure requirements for listed companies.¹⁴⁹ Listed companies must be required to make full public disclosures of their financial and business affairs to enable investors make good decisions if the NSE is to function properly. Secondly, a Company it is allowed to trade freely without their members incurring liability. The corresponding downside is that they should not enjoy any privacy but publicly disclose all aspects of their company's affairs and financial position for the benefit

¹⁴⁶ Gakeri op. cit. note 100 at 279.

¹⁴⁷ Ibid.

¹⁴⁸ Africa Centre for Open Governance op. cit. note 112.

¹⁴⁹ Ibid. at 158.

of third parties such as their creditors. Since a limited liability is a privilege where shareholders invest a minimum sum and are at no further risk to potential creditors, the price to pay for it, is disclosure, and by complying with a mass of statutory disclosure requirements.

2.5.4. Weak Regulatory Framework

Although the Cooper Motors Corporation has statutory powers to regulate and prosecute licensees the law,¹⁵⁰ there was an apparent overlap and confusion of roles that negatively impacted on the performance and enforcement of its statutory mandate. This problem mainly affected the Chief Executive Officer and the chairman of the Capital Markets Authority portraying the underlying corporate governance problems within Capital Markets Authority. It has been observed that central to this is Capital Markets Authority Chairman, Kungu Gatabaki, who took centre stage in the Cooper Motors Corporation saga by overshadowing the one person on whom the Capital Markets Act bestows executive authority, the acting Chief Executive Officer.¹⁵¹ Capital Markets Authority lost its impartiality when at one time it appointed three directors to Cooper Motors Corporation Holdings notwithstanding its status as a private entity.¹⁵²

Besides, as a publicly listed company limited by liability, the board exclusively owed a fiduciary duty to its shareholders.¹⁵³ In so doing, Capital Markets Authority was infringing on the rights of the shareholders to elect their directors thereby opening themselves up for legal challenges. Since Cooper Motors Corporation was not under receivership, Capital Market Authority's involvement should have been purely limited to an advisory role.

¹⁵⁰ Gakeri op. cit. note 100 at 279.

¹⁵¹ How CMA Failed CMC's Minority Shareholders in Time of Need, *The Standard*, March 21, 2012.

¹⁵² Ibid.

¹⁵³ John Joseph Ogola, *Company Law* 3rd ed (Focus Publishers: Nairobi, 2010) at 177.

2.5.5. Poor Financial Performance

What triggered the scandal at Cooper Motors Corporation was a cumulative series of negative financial reporting that showed that despite the fact that the company experienced a strong economic growth in the year 2009/2010, its net profit reduced drastically from a high of Ksh. 927 million the previous year (2008) to a low of Ksh. 406 million in 2009.¹⁵⁴ Worse still, its market share in the motor vehicle sector dropped from 15.4% in 2009 to 13.7% in 2010. A majority of shareholders were not happy with this state of affairs which sparked off a shareholder led restructuring in the company's board and management structure.¹⁵⁵

In order to turn around the corporation's fortunes, in March 2011, the board chairman (Jeremiah Kiereini) was sacked and replaced by Peter Muthoka as the new chairman.¹⁵⁶ The long serving chief executive officer for 33 years, Martin Forster was dismissed alongside the chairman and replaced by Bill Lay.¹⁵⁷ The new chief executive officer was recruited specifically for his international experience at the General Motors (GM) East Africa where he had developed a reputation for being a strong Government lobbyist. This was seen as a big asset to facilitate in pushing through Government contracts. At GM, he had led a turn around that spearheaded GM overtaking Toyota East Africa to the crown of controlling the largest vehicle market share in Kenya. As a turnaround manager, the new chief executive officer he mooted plans to spend Ksh. 1 billion from Cooper Motors Corporation's cash reserve to grow the company's waning fortunes.¹⁵⁸

¹⁵⁴ Victor Juma, South Africa Auditors Dismiss PWC's Forensic Report on Motor Dealer's, *Business Daily* April 4, 2012

¹⁵⁵ "CMA Directs CMC to Release Audit Report", *The Nairobi Star*, March 26, 2012.

¹⁵⁶ Ibid.

¹⁵⁷ "CMC sacked CEOs Spill the beans: footage available on you tube at www.youtube.com/watch?v=hclchYgLUew, accessed on 26 July 2014.

¹⁵⁸ Nick Wachira, "Intriguing Battle for the Control of CMC: A Saga of Unbridled Greed, Ambition, Deceit and Corporate Skulduggery Marks One of Kenya's Biggest Corporate Scandal", *Sunday Nation* November 13, 2012.

2.5.6. Scandal at CMC

The new chief executive officer was convinced that if Cooper Motors Corporation was to reclaim its past glory, drastic measures had to be taken in terms of infusing good corporate governance principles into the day today running of the company. As a first step he instituted an audit to look into the financial health of the company. This is in part what sparked off the scandal. The release of an audit report on Cooper Motors Corporation on 14th September 2010 revealed that Andy Forwarders Ltd had traded with Cooper Motors Corporation and in the process over-billed it to the tune of Ksh. 300 million to 500 million every year for logistic services rendered. The Audit Report recommended that Cooper Motors Corporation should recover between Ksh. 1.5 billion to 2 billion, being the total amount of money paid to Andy Forwarders since 2005.¹⁵⁹

2.6. Remedy for Minority Shareholders

The boardroom wrangles at Cooper Motors Corporation were set off by the ouster of Muthoka on September 8 as Chairman of Cooper Motors Corporation after he was accused of breaching corporate governance standards by being the head of the auto firm's boards and a Cooper Motors Corporation supplier through Andy Forwarders Ltd.¹⁶⁰ As the single largest shareholder, he called for an extra-ordinary general meeting through his company Andy Forwarders Services Ltd. The purpose of the extra-ordinary general was to oust the new Chief Executive Officer and the board in general. The Capital Markets Authority declined to give permission for the extra-ordinary meeting to take place leading to Muthoka's court action.¹⁶¹

¹⁵⁹ CMC op. cit. note 157 at 150.

¹⁶⁰ CMC Seeks to Postpone Shareholders Meeting *Business Daily* may 10, 2012.

¹⁶¹ Ibid.

In *Andy Forwarders Services Limited v Capital Markets Authority and Another*,¹⁶² the petitioner, among other things, sought the declaration of a forensic report by PricewaterhouseCoopers, which found him culpable for breaching corporate governance standards, through conflict of interest, null and void. Further the petitioner asked the court to declare the:

- Respondent's decision dated 11th October, 2011 purporting to require the Cooper Motors Corporation board not to hold an extra-ordinary general meeting in direct breach of statutory duty imposed upon Cooper Motors Corporation Directors by virtue of Shareholders' interest under section 132 of the Companies Act was in violation of Article 40 of the Constitution and therefore invalid.
- That the Respondent's decision and direction for Cooper Motors Corporation or its shareholders not to hold an extra-ordinary meeting, thereby compelling the Petitioner as a shareholder in Cooper Motors Corporation to undertake not to exercise its right which is attached to and exercisable only by virtue of its shareholding in Cooper Motors Corporation, was in violation of Article 40 of the Constitution and therefore invalid.¹⁶³
- The Petitioner also sought a declaration that the Respondent's decision and direction that Cooper Motors Corporation and each Board member who was a shareholder in Cooper Motors Corporation to undertake not to requisition for or hold an extra-ordinary meeting was in excess of jurisdiction. It asked the Court to issue an order of certiorari to remove and quash the decision and direction of the Respondent dated 11th October, 2011 and issued an injunction to restrain the Respondent from interfering with any meeting of shareholders of Cooper Motors Corporation called,

¹⁶² [2011] eKLR.

¹⁶³ *Andy Forwarders Services Limited v Capital Markets Authority and Another* [2011] eKLR, High Court Petition Number 216 of 2011 and HC Misc 909 of 2011.para. 2.

or to be held pursuant to, in connection with or as a consequence of the Petitioner's requisition dated 12th September, 2011 issued in accordance with section 132(1) of the Companies Act, scheduled to be held on 21st November, 2011.¹⁶⁴

The court dismissed the petitioner's application and ordered that the *status quo* be maintained.

2.7. Conclusion

The Cooper Motors Corporation saga highlighted a number of key deficiencies in the protection of minority shareholders in Kenya. First, is an obsolete Companies Act that makes it very difficult for minority shareholders to obtain a remedy in a court of law. Second is a poor corporate governance and regulatory oversight over companies listed on the NSE. Third and more importantly is the inability of the Capital Market Authority to enforce violations of the provisions of the Companies Act.¹⁶⁵

¹⁶⁴ Ibid. para. 3

¹⁶⁵ Moses Michira, "Regulator seeks more power to rein in errant directors," available at <http://www.businessdailyafrica.com/Regulator+seeks+more+power+to+rein+in+errant+directors+//539552/1309268/-/97j61iz/-/index.html>, accessed on 20 May 2013.

CHAPTER THREE

THE LEGAL FRAMEWORK IN KENYA ON THE PROTECTION OF MINORITY SHAREHOLDERS

3.1. Introduction

This chapter analyzes the legal framework for protecting minority shareholders in Kenya with a specific focus on statutory law and common law. Similarly, the chapter explores the effectiveness of Kenya's legal framework in protecting the minority shareholders. Admittedly however, the law has evolved over time to legally protect the minority shareholders in some special circumstances.¹⁶⁶ Such a law includes the common law, principles of equity, the Capital Markets Act, the Constitution and the Companies Act. To this end we shall also focus on the Companies Bill 2014 to evaluate the reforms envisioned in the Bill.

3.2. Statutory Protection of Minority Shareholders

3.2.1. Companies Act

Section 211 of the Companies Act allows a member to apply to court through a petition for alternative remedy. The member has to prove that the affairs of the company are being conducted in a manner oppressive to some of part of the members of the company. This would justify the winding up of the company based on just and equitable grounds the winding up of the company would nevertheless unfairly prejudice the group of members.¹⁶⁷

The court, if satisfied that the conditions have been met, may make an order to regulate the company's future dealings or require other members or the company to purchase shares held by the oppressed members.¹⁶⁸ If the company purchases the oppressed members shares, then there must be a reduction of the share capital of the company. Further, if the court makes an order altering the articles or memorandum of association of a company on its discretion, the

¹⁶⁶ John Joseph Ogola, *Company Law 2nd Edition* (Focus Publications: Nairobi, 2006) at 235.

¹⁶⁷ Section 211, (2) (b), the Companies Act (CAP 486 of the Laws of Kenya).

¹⁶⁸ *Ibid.*

company is not allowed to make an alteration to the amended articles or memorandum contrary to the order without the leave of the court.¹⁶⁹

Section 211 does not define the meaning of oppression, however, in *Scottish Co-operative Wholesale Society Ltd v. Meyer* Lord Denning stated that the court has wide discretion in determining oppression. This discretion should be used by the court to ensure the oppressed receives redress from the oppressor.¹⁷⁰ The Cohen Report¹⁷¹ listed examples of oppression to include controlling directors' refusal to register minority transfers in order to buy them at lower prices and controlling directors paying themselves excessively leaving nothing for distribution to other shareholders. The Jenkins Committee Report¹⁷² included issuing of shares to directors on beneficial terms and non-declaration of dividends on minority shareholders non-cumulative shares.

The conditions to be met for an alternative remedy to be granted to minority shareholders under section 211 of the Companies Act were collated and summarized by Jenkins L.J. in *Re: H.R. Harmer Ltd.*¹⁷³ Firstly, the oppression brought before the court by minority should be oppression of members as members and not as directors. Secondly, the member should prove an oppression that would justify winding up of the company on just and equitable grounds. Thirdly, the conduct of affairs of the company should be by officers, directors or members of the company and lastly, the oppression should be given its meaning in the ordinary sense.¹⁷⁴

This is not very effective as the proper scope of ordinary sense is not very clear.

¹⁶⁹ Ibid. Sec 211(3).

¹⁷⁰ *Scottish Co-operative Wholesale Society Ltd v. Meyer* [1959] AC 324.

¹⁷¹ Report of the Committee on Company Law Amendment, 1945 available at http://www.takeovers.gov.au/content/Resources/other_resources/Cohen_Committee.aspx, accessed on 5 September 2013.

¹⁷² Report of the Company Law Committee 1962 available at www.takeovers.gov.au/content/Resources/other.../jenkins_committee.pdf, accessed on 5 September 2013.

¹⁷³ [1958] All ER 689.

¹⁷⁴ Ogola op. cit. note 166 at 242.

The rule in *Foss v Harbottle* therefore established two key principles: the proper plaintiff principle holding that the proper plaintiff in an action alleging a wrong done to a company is *prima facie* the company itself. The majority rule principle enables majority shareholders to ratify the misconduct of directors. This denies minority shareholder entitlement to succeed in initiating an action on behalf of the company.

3.2.2. Alteration of the objects of the company

Companies are bound to operate within the objects listed in the memorandum of association. However, a company can change its objects by passing a special resolution. This was meant to carry out business more effectively, to attain its purpose by new or improved means, to enlarge or change operations, to restrict or abandon objects in the memorandum.¹⁷⁵

The controlling majority may thus use their ability to change the memorandum of association without regard to the wishes of the minority shareholders. Notwithstanding this however, section 8(2) of the Companies Act offers protection to minority shareholders. It provides that holders of not less than fifteen percent of nominal value of the issued capital or company's entitled to object to alterations of the memorandum may apply to court to oppose the amendment of the objects provided they did not vote in favor of the alteration. The application to oppose such amendments must however be made within thirty days of the passing of the special resolution amending the objects.

The court may make a decision cancelling or confirming the alteration in whole or in part. It may also attach conditions as it thinks fit. In addition, the court may adjourn proceedings to allow the purchase of shares of dissenting members. It may also give directions and conditions relating to the purchase of the minority shares. Thus section 8(2) of the Companies Act gives minority shareholders recourse when they are forced to contend with the voting power of the majority. It gives them the option to oppose the majority decision as the court

¹⁷⁵ Section 8(1), Companies Act (Cap. 486).

may annul or vary the special resolution passed by the majority shareholders. In addition, the court may order the majority to buy out the shares of the minority if the minority shareholders can no longer continue to be members of the company.

In addition to this, the controlling majority shareholders can neither alter the articles nor the memorandum of association in order to increase liability to contribute share capital by a member without the member's agreement.¹⁷⁶ This, however, is not the case if the member(s) agrees in writing either before or after the alteration to be bound by it. This offers protection to minority members because the controlling majority members cannot increase the liability payable on shares held by the minority members without their consent. Section 24 of the Companies Act also requires any such agreement to be bound to be made in writing. This ensures that such an agreement is formal and that there is evidence of agreement in case of a dispute.

3.2.3. Variation of class rights

The memorandum or articles of association of a company may allow for the variation of class rights if a company has different classes of shares. The two may provide for the proportion of holders of that class required to pass a resolution varying that class's rights. However, holders of fifteen per cent of that class of share who objected to the variation of class rights may apply to have the variation cancelled. If such an application is made, then the variation shall not take effect until it is confirmed by the courts.¹⁷⁷ If the court is satisfied that the variation would unfairly prejudice the applicants, it will cancel the variation or otherwise confirm it. The decision of the court on any such application will be final.¹⁷⁸

The meaning of variation is partly explained in Section 74(6) of the Companies Act to include abrogation. The Act leaves the court to construe the meaning of 'varied' accordingly.

¹⁷⁶ Section 24, Companies Act (Cap. 486).

¹⁷⁷ Ibid. Section 74(1).

¹⁷⁸ Ibid. Sec 74(4).

In *Re Salt dean Estate Co. Ltd*¹⁷⁹, the court held that reduction of capital by paying out the preference shareholders did not amount to variation or abrogation. Thus, it is for the court to determine whether there is a variation of class rights or not. Nonetheless, a variation that is proved to be unfairly prejudicial to the minority shareholders would be cancelled by the courts if the minority shareholders apply and prove that the variation would be unfairly prejudicial to them.

3.2.4. Other Modes of Minority Protection

The other modes of protecting minority shareholders under the Companies Act relates to the manner of holding general meetings and extra ordinary meetings. Members have a right to be given notice in advance of general meetings under Section 133. In the event there is failure to hold an annual general in the prescribed period, any member of the company is empowered to apply to the registrar for direction. One of the directions to be given by the registrar would be for the member to constitute the meeting after issuing adequate notice in writing. This gives a leeway to any member including a minority shareholder to discuss matters in the form of abuse on the minority.¹⁸⁰

Section 132 (1) allows a member or members of the company representing not less than one tenth of the total voting rights of all the members having at the said date a right to vote at general meetings of the company, to convene an extra ordinary meeting. This is on requisition of all members having at the said date a right to vote at a general meeting of the company. Failure by a company to hold a meeting in any of the ways prescribed by the articles or the Companies Act attracts court action. In section 135 (1), any director or member of the company is empowered to move to court and get orders compelling a company to call for such a meeting. Further section 140 grants members of a company certain rights that

¹⁷⁹ [1968]1 WLR 1844.

¹⁸⁰ Section 131 (2).

relate to notice of annual general meeting and resolutions thereof. This is in addition to section 219 (f) which gives a minority shareholder the right to apply to a court of law for a company to be wound up on just and equitable grounds.

3.3. Capital Markets Act

The Capital Markets Authority is mandated to protect investors' interests especially in listed companies.¹⁸¹ The Capital Markets Authority is mandated to create, maintain and regulate the market where securities are traded in a fairly, orderly and efficient manner and to allow members to be as self-regulated as possible.¹⁸² It is also charged with the duties of protecting investors and minority shareholders' interests¹⁸³ and where its powers and functions conflict with other written laws it prevails.¹⁸⁴ When the Authority is satisfied that a listed company is being run in a manner that would be unfair to investors, it may take measures to remedy the wrong or to commence investigations. Thus majority shareholders in listed companies cannot act in a manner that would injure other shareholders without expecting the Authority to come in to protect the investors.¹⁸⁵

In *Andy Forwarders Services Ltd v. Capital Market Authority and Another*,¹⁸⁶ the High Court at Nairobi balanced the constitutional right to property against public interest in relation to protection of minority shareholders. This was after the Capital Markets Authority had barred Andy Forwarders Ltd from holding an extra-ordinary meeting at Cooper Motors Corporation where it held majority shares. The petitioner sought to bar Capital Market Authority from interfering with the planned extraordinary general meeting on grounds that the right to property was enshrined in the constitution and that parliament was prohibited

¹⁸¹ Section 11(d), Capital Markets Act (Chapter 485A of the Laws of Kenya).

¹⁸² Ibid. Preamble.

¹⁸³ Ibid. Section 11(c).

¹⁸⁴ Ibid. Section 37.

¹⁸⁵ Ibid. Section 38.

¹⁸⁶ Republic of Kenya in the High Court of Kenya at Nairobi Commercial and Admiralty Division Misc. Civil Case No.273 of 2012.

from making laws that arbitrarily deprive a person of his/her right to property.¹⁸⁷ The respondents' argument was that the right to property was not an absolute right. The respondents stated that a shareholder was not entitled to exercise the mandate as majority shareholder in a way he/she pleased. The right was subject to equitable considerations which make it unjust to exercise it in a particular way.¹⁸⁸ The respondent further argued that the Capital Marketing Authority had a duty to protect investors' interests and that section 37 of the Capital Market Authority, the Authority's functions were given precedence against other statutes. The respondent further argued that the plaintiff (through Cooper Motors Corporation) had submitted to be under the regulation of the Authority as a pre-condition for listing at the NSE.

The High Court granted the Authority's request for a conservatory order maintaining the status quo and barring Andy Forwarders from continuing with the planned extra-ordinary meeting. The Court stated that since there were allegations of fraud against the petitioner, allowing it to proceed with the extraordinary general meeting which would enable the petitioner to change directors who had already commenced investigations against the petitioner.

3.4. The Companies Bill 2014

The essence of the Companies Bill 2014 is to...to consolidate and reform the law relating to the incorporation, registration, operation, management and regulation of companies; to provide for the appointment and functions of auditors; to make other provision relating to companies and to provide for related matters.¹⁸⁹ The Bill is an attempt to address the plight of minority shareholders that are not adequately taken care of in the Companies Act.¹⁹⁰ This

¹⁸⁷ Article 40 (2), Constitution of Kenya, 2010.

¹⁸⁸ *Ebrahimi v. Westhouse Galleries Ltd* [1970] 3 All ER.374.

¹⁸⁹ Preamble, The Companies Bill 2014.

¹⁹⁰ Chapter 484 of the Laws of Kenya.

is reflected in the provisions relating to the director's duties, allotment of shares, investigations of companies, production and inspection of documents, derivative actions and creation of new criminal offences.

3.4.1. The Statutory Rights of Members

The Companies Bill, 2014 has provided for statutory rights of members in a company. This has been done in Part VIII of section 115 which lists the rights entitling a member or his nominee the: right to be sent proposed resolutions; the right to require circulation of a proposed resolution; the right to require directors to call a general meeting; the right to receive notices of a general meeting; the right to be sent a copy of annual financial statements and reports; and the right to require circulation of a statement among others. The Bill also bestows members' rights to information and to receive all communications in hard and soft copy that a trading company sends to its members.

3.4.2. Appointment of Directors and their Duties

The Bill provides that a private company is required to have at least one director while a public company should have at least two directors one of whom should at least be a natural person.¹⁹¹ It provides procedures for the appointment of directors and the requirement that a quoted or public interest company shall appoint a board nomination committee on which at least two thirds of its members are shareholders of the company who together represent two thirds of the share capital of the company.¹⁹² This, however, does not explain the composition of the remaining one third as to whether it should include a proportion of the minority shareholders or independent persons with no connection to the company. Since this nomination committee will be responsible for nominating candidates for appointment as directors, the controlling majority shareholders still wield considerable power in influencing who becomes a director in the company.

¹⁹¹ The Companies Bill 2014, part ix ss129-130

¹⁹² Ibid. s.134

The Bill prescribes the general duties owed by a director to a company based on the common law to include a former director.¹⁹³ This provision overcomes the hurdles created by the common law that required a minority member to prove that the miscreant director was in control of a company in order to succeed in a common law derivative action on allegations of a "fraud on the minority". The Bill makes a former director to be under a duty to avoid a conflict of interest with regard to the exploitation of any property, information or opportunity which he became aware of while he was a director.¹⁹⁴ The former director should not accept benefits from third parties in respect of things done or omitted to be done by the director before he ceased to be the company's director.

The Bill provides that the general duties of directors are to be interpreted and applied in the same way as the common law rules or equitable principles with regard to the corresponding common law rules and equitable principles.¹⁹⁵ The Bill upholds the common law rules and equitable principles as part of the statute. A director of a company is required to act in accordance with the constitution of the company and should exercise his powers for the purpose for which they are intended.¹⁹⁶

A director of a company is required to act in a way which "the director considers, in good faith, would promote the success of the company for the benefit of its members as a whole".¹⁹⁷ The director's actions shall have regard to the following factors: the long-term consequences of his decision; the interests of the employees; the need to foster the company's business relationships with the company's stakeholders; the impact of the company's operations on the community and the environment; the company's desire to maintain a

¹⁹³ Ibid. s.142

¹⁹⁴ Ibid.

¹⁹⁵ Ibid.

¹⁹⁶ Ibid. s.144.

¹⁹⁷ Ibid. s.145.

reputation for high business standards and the need to act fairly to the members of the company.¹⁹⁸

Though this section is new, it has been borrowed word for word from s.172 of Companies Act 2006 UK which imposes a duty on a director to promote the success of the company for the benefit of its members as a whole. Similarly, like the Companies Act 2006 of the UK, the Bill neither defines the concepts of "good faith" which precedes the action of a director nor its consequential objective of achieving "success" for the company, but delineates the boundaries delimiting the consequences of the director's actions. The success of a company is therefore difficult to ascertain given the risky environment under which business decisions have to be made by a director. The precise implications of good faith in the context of the varied business decisions a director has to make on a continuous basis can be contentious. It is for this reason that a court is most likely to accept the existence of good faith in a case where a company has benefited from the action being contested as opposed to where the actions of the director turn out not to be in the company's interests.¹⁹⁹

The Bill provides that a director of a company shall exercise independent judgment²⁰⁰ and the same care, skill and diligence that would be exercised by a reasonable diligent man.²⁰¹ It also provides that a director is duty bound to avoid a conflict of interest and a conflict of duties with those of the company which he serves. A director is therefore prohibited from exploiting any property, information or opportunities of the company. These sections have been borrowed from section 175 and 176 of the Companies Act, 2006 UK to protect the interests of the company and by extension the members of the company as a whole.

¹⁹⁸ Ibid s.145

¹⁹⁹ Shaowei L, *Derivative Actions in the UK: Revised Yet Unimproved* (KSLR University of Edinburgh: Edinburgh, 2013) at 7.

²⁰⁰ Companies bill, 2014 s.146 where a director is mandatorily required to exercise independent judgment

²⁰¹ Ibid s.147-148 a director shall exercise care, skill and diligence. It is the duty of the director to avoid conflict of interest with those of the company. This relates to the exploitation of property, information or opportunity and it matters less whether the company could take advantage of the property, information or opportunity.

The Bill upholds the majority rule principle by providing that only members *qua* member have statutory authority to ratify irregular or wrongful misconduct of a director amounting to negligence, default, breach of duty or breach of trust in relation to the company at the general meeting.²⁰² Whereas the director, if a member and those connected with him, are allowed to attend the meeting and form part of the quorum they are ineligible to vote for the resolution ratifying the misconduct. The provision therefore excludes the miscreant director and any members connected with the director from voting at the general meeting. This however does not affect a decision taken by a unanimous consent of the members of the company to ratify misconduct or any power of the directors to agree not to sue or to settle or release the claim made by them on behalf of the company. Such position will continue be so unless there is any enactment or rule of law imposing additional requirements for ratifying acts which are incapable of being ratified by the company.

3.4.3. Derivative Actions

Derivative action is provided for in Part XI sections 241-245 of the Bill. A derivative claim may be brought in respect of a cause of action vested in the company seeking relief on behalf of the company.²⁰³ A derivative claim can only be brought in two ways: either under Part XI s.241 or in accordance with a court order issued during proceedings for protecting minority members against unfair prejudice. The scope of *locus standi* in bringing a derivative action has been widened to allow actions to be initiated either by a member or by a person to whom shares have been transferred or transmitted by operation of law. Such persons include personal representatives and trustees in bankruptcy. In addition, the bill has not created any threshold for share ownership hence making it theoretically possible for a claimant with one share to commence a derivative action.

²⁰² Ibid s.211

²⁰³ Ibid s.241

The causes of derivative action have been extended by the Bill. A shareholder is allowed to seek relief on behalf of the company even when the cause of action is vested in the company itself. It proposes new causes of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of a company or another person or both. This statutory procedure enables a shareholder to initiate a derivative action where the general duties of a director are violated. The inclusion of negligence will broaden the scope of the application of this procedure for a derivative claim.

At common law, no derivative action could lie where directors were accused of negligence or error of judgment.²⁰⁴ Previously a common law derivative action could only be granted against those directors who used their powers intentionally or unintentionally, fraudulently or negligently to benefit themselves at the expense of the company.²⁰⁵ The Bill makes it immaterial whether the cause of action arose before or after the applicant seeking to continue a derivative claim became a member of the company.²⁰⁶ The new statutory rule retains the common law position that a shareholder is entitled to file an action even if the litigation arose before he or she became a member of the company for the benefit of the company and members as a whole. A derivative claim commences with an application by a member to the court for permission to continue with the case. The court must be satisfied that the evidence adduced in support of the claim discloses a case before granting permission to continue.²⁰⁷ This stage of the proceeding is important to ensure that the company is protected against vexatious litigations.

This is a low threshold compared to the two stage procedural requirements an applicant has to go through before succeeding in continuing with a derivative claim under the Companies Act

²⁰⁴ *Pavlides v Jensen* (1956) ch.565 at 576.

²⁰⁵ *Daniels v Daniels* (1978) ch.406 at 414.

²⁰⁶ *Ibid* s.241 (5).

²⁰⁷ *Ibid* s.242(2).

2006 of the UK. The proposed court procedural application is advantageous to claimants since all they are required to do is to provide supporting evidence that discloses that there is a case and not whether there is a prima facie case requiring a court to sit and listen to arguments of facts and law being adduced as was the case before. The UK procedures for establishing whether an applicant has a prima facie case involve preliminary proceedings which lead to considerable losses of time and money.

The Bill has given the court a wide discretion to dismiss the application unless it satisfies itself that the evidence adduced in support of the claim discloses a case. The court is empowered to make any consequential order it considers appropriate and to give directions as to what kind of evidence is to be provided by the company if the application is not dismissed. It may even adjourn the proceedings to enable the parties to obtain the evidence required. Once it is satisfied that the applicant has a case, the court has power to give permission to continue the claim on the terms it considers appropriate or refuse the applicant permission and dismiss the claim altogether.

The Bill proposes that an application which is brought to court by the company but is not disposed of may be continued as a derivative claim under Part XI.241 by a member.²⁰⁸ This new provision is beneficial to minority shareholders as the costs are borne by the company rather than the individual shareholders or members. A member may therefore apply for permission to continue the suit as a derivative action on two grounds. Firstly, that the manner in which the company commenced or continued the claims amounts to an abuse of the process of court. Secondly, the company has failed to prosecute the claim diligently and it is therefore appropriate for the member to prosecute the claim as a derivative action.

²⁰⁸ Section 241-245, Companies Bill, 2014.

The scope of prospective defendants has also been extended in two distinct respects. Firstly the new statutory rule provides that a cause of action may be brought against a director (includes former directors or shadow director), or another person or both. This situation will only apply to a person who has assisted a director in the breach of his duties to the company.

The Bill has provided for circumstances under which permission to commence or continue a derivative action must be refused. If a member applies for permission to continue a derivative claim under s.242 or makes an application to court under s.243 to continue a claim as a derivative claim: how disposed of, the court shall refuse permission if it is satisfied that a person acting in accordance with s.145 (duty to promote the success of the company) seeks to continue the claim. The court shall also refuse permission where the cause of action arises from an act or omission that is yet to occur or where the act or omission has been authorized or ratified by the company. Further, the court shall refuse permission where the cause of action has arisen from an act or omission that has already occurred and that the act or omission was authorized before it occurred or has been ratified by the company since it occurred. These three factors act as a mandatory bar on a grant of permission to continue a derivative claim. Where the court is not required to refuse a derivative claim under s. 243(2) it should exercise its discretion to decide whether the application for permission to continue can be granted.

Section 243 (3) sets out a list of the factors which the court is required to take into account while exercising its jurisdiction. Firstly, whether the member is acting in good faith and the importance a person acting in accordance with s.145 (duty to promote the success of the company) would attach to continuing the suit. Secondly, where the cause of action is a result of an act or omission that is yet to occur, and whether the act or omission could be authorized before it occurs or ratified by the company after it occurs. Thirdly, in a matter where the cause of action arises from an act or omission that has already occurred, whether the act or

omission could be ratified by the company. Fourthly, whether the company has decided not to pursue the claim and finally whether the act or omission in relation to the claim gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company.²⁰⁹

It will be difficult to anticipate the impact of this new statutory derivative action once it is enacted and enforced by courts in practice. Much will depend on how the courts interpret the new rules given the immense powers that have been conferred on them to determine whether to grant a derivative claim or not.

3.4.4. Protection of Members against Oppressive Conduct and Unfair Prejudice

The Companies Bill 2014 provides that a member of a company may apply to court for an order under s.796 on the grounds that the company's affairs are being or have been conducted in a manner that is oppressive or is unfairly prejudicial to the interests of members generally or of some part of its members, including the applicant or that an actual or proposed act; or omission of the company, including an act or omission on its behalf is or would be oppressive or so prejudicial²¹⁰

The Bill provides that after an investigation instituted by the Attorney General in accordance with its provisions or by the capital markets authority under the provisions of the Capital Markets Act, the Attorney General may make an application for an order under section 796 if satisfied that the affairs of the company are being or have been conducted in a manner that is oppressive or unfairly prejudicial to the interests of its members generally or to a section of its members; or omission of the company, including an act or omission on its behalf is or

²⁰⁹ Companies Bill, 2014.

²¹⁰ Ibid Part xxix s.794: for application to court by a company member under s.796 which the procedural.

would be oppressive or so prejudicial. The Attorney General may make such an application in addition to or instead of making an application for the liquidation of the company.²¹¹

The Bill has not made any attempt to define what the concept of 'unfairly prejudicial' or 'oppressive' conduct means. These concepts have been deliberately crafted with ambiguity and vagueness. They have been left for the court to interpret as it thinks appropriate so as to allow as many circumstances appertaining to the affairs of the company to fall into this broad but vague and ambiguous conceptual framework..

The court has been given a broad jurisdiction to deal with the applications and give appropriate relief in respect of the matters complained of by either a member under s.794 or by the Attorney General under s.795 as it considers appropriate. The remedies the court is empowered to grant include its power to regulate the conduct of the affairs of the company in the future, or require the company to refrain from doing or continuing an act complained of or to do an act that the applicant has complained it has omitted to do. The court may authorize civil proceedings to be commenced on behalf of the company by members on such terms as the court may direct. The court has power to order the company to make any specified alterations in its articles without the leave of court.

It has jurisdiction to provide for any purchase of the shares of any members of the company by either the company or other members. Where it orders purchase of shares by the company it will also sanction the reduction of the company's capital accordingly in all these applications the company is entitled to be served as a respondent at the hearing of the application. The court has been given a wide jurisdiction to order for alteration of a

²¹¹ Ibid s.795.

company's constitution or authorize or direct the company to make any or any specified alterations to its constitution²¹² and lodge the alterations with the Registrar of Companies.²¹³

3.4.5. Right of Minority to Raise Audit Concerns

Members representing five per cent of the total voting rights are entitled to raise audit matters at which a financial statement of the company is to be presented.²¹⁴ This right is however subject to a request being sent to the company in hard copy or electronic form by clearly identifying the audit statement it relates to, be authenticated by the persons making it and delivered to the company for at least seven days before the general meeting to which it relates. The issues raised enhance transparency in the governance of quoted Kenyan companies.

3.5. Common Law and Judicial Interpretation of the Protection of Minority Shareholders

The board of directors has a number of duties in common law. This includes the duty to exercise care and skill in the care of management functions. The second is to use discretionary powers in good faith and for proper purposes. The third duty is the fiduciary duty to act loyally in the interest of the company.²¹⁵

3.5.1. The Rule in *Foss v Harbottle*

In *Foss v Harbottle*,²¹⁶ a case that represents minority protection at common law, the court feared that it would open floodgates of suits between shareholders. The restriction of bringing a case in the name of the company where the company is wronged has been referred to as the

²¹² Ibid s.796 Gives the court wide powers to make orders as it considers appropriate.

²¹³ Ibid s.797 filing of alterations with the Registrar of companies within fourteen days of complying with the court order.

²¹⁴ Ibid s.770.

²¹⁵ Devanie Hutton, *Corporate Governance and Director's Duties: 2003 -PLC Global Counsel Handbooks* (Practical Law Company: London, 2002) at 22.

²¹⁶ *Foss v Harbottle* (1843) 2 Hare 461: Foss and Turton were shareholders in Victoria Park Company. They brought an action against the directors of the company accusing the directors of selling their own land exorbitantly to the company and therefore occasioning losses to the company. They sought to have the directors make good the losses suffered through a court appointed receiver. Their action was dismissed by the court on the grounds that the proper plaintiff was the company. This is because the company is a separate legal entity from its owners.

Rule in *Foss v Harbottle* or the proper plaintiff principle. A suit on behalf of the company but not in the name of the company would invariably be thrown out as incompetent.²¹⁷

3.5.2. Exception to the Rule in Foss v Harbottle

Exceptions to the Rule in *Foss v Harbottle* have been developed. In *Edwards v Halliwell*,²¹⁸ Jenkins LJ set out the exceptions to the Rule in *Foss v Harbottle*. These exceptions were in relation to personal actions, ultra vires decisions, actions requiring special majority but which only a simple majority was obtained and actions which constitute a 'fraud on the minority'.²¹⁹ Grievances against personal rights can be remedied by the affected shareholder bringing up a personal action for remedies before the courts. *Ultra vires* decisions are considered to be null and void for not being within the ambit of the company's constitution.

3.5.3. Fraud on the Minority

The 'fraud on the minority' exception is allowed when two requirements are met. First, there must be a fraud on the minority. Second, the wrong doers must have been in control of the company. The reason for allowing the exception is that the controlling majority, who are the wrong doers and are in control of the company as directors, will not allow the matter to be brought to the courts in the name of the company.²²⁰ Thus through this exception, minority shareholders are protected from the fraud or wrongdoing of the controlling majority shareholders.

Equitable fraud in this context includes the majority appropriating the company's money, property and benefits that should rightly accrue to the company.²²¹ Fraud also extends to

²¹⁷ Ibid.

²¹⁸ [1950] 2 All ER 1064.

²¹⁹ Ibid.

²²⁰ *Prudential Assurance Co Ltd V Newman Industries* [1982] Ch 211.

²²¹ *Burland V Earle* [1902] AC 83 (PC) 93.

negligent decisions of directors for their own benefit. For example if the directors buy a piece of land from a company at a lower value, minority shareholders would be allowed to sue.²²²

However, if the directors do not benefit from their negligence it does not amount to fraud on the minority. In *Pavrides v Jensen*²²³ the majority directors sold a mine below its value. A minority shareholder sought to bring an action on the fraud exception to the Rule in *Foss v Harbottle*. The suit was dismissed since the directors had not benefitted from the sale. It seems that in fraud, the judge has to rely on his own innate sense of right or wrong and then make a decision which he considers to be the correct one.²²⁴

3.5.4. Wrongdoer Control

The court allows minority shareholders to bring a suit to remedy a wrong done to the company if the wrongdoers are the controlling majority. The rationale is that should the minority be refused access to the courts, the wrong will go without redress.²²⁵ This is against equity which will not suffer a wrong without a remedy. The procedural way in which the minority is allowed to approach the court is known as derivative action. It is a way through which the end of justice can be met when the majority is unwilling to prosecute in the name of the company. It therefore follows that if the controlling majority shareholders are not the wrongdoers, then the proper plaintiff will be the company itself.

The minority shareholders would, however, not be allowed to pursue a derivative action if the act complained of is an effective decision of an organ of the company. This is because derivative actions are premised on the company having a legitimate claim to some remedy.²²⁶ Derivative actions are allowed only if the action complained of is ultra vires, invades a personal right, fails to comply with the company's constitution or any other law or

²²² *Daniels V Daniels* [1978] Ch 406.

²²³ [1956] Ch 565.

²²⁴ Ogola op. cit. note 166 at 244.

²²⁵ Ibid.

²²⁶ Worthington, Sarah (2000). *Corporate governance: remedying and ratifying directors' breaches*. London: London Research Online Available at <http://eprints.lse.ac.uk/archive/00000235>, accessed on 26 July 2014.

is a fraud on the minority. The rule in *Foss v Harbottle* represents the court's view that as a matter of public policy the circumstances for bringing an action on behalf of the company should be strictly limited.²²⁷

The exceptions to the rule are where personal rights have been infringed; where the alleged wrong is *ultra vires* the corporation or illegal; where the conduct complained of requires a resolution by a special majority; where what has been done is a fraud on the minority.²²⁸ The minority shareholders could only bring an action under one or more of these exceptions to the rule.

3.6. Conclusion

Minority shareholders are protected by the common law rule in *Foss v Harbottle* and the exceptions to the rule, which have their foundations in equity. Sections 8, 24, 74 and 211 of the Companies Act protect minority shareholders and their rights. Article 40 of the Constitution guarantees every person a right to property and establishes safeguards against arbitrary actions on property. The Capital Markets Act also establishes the Capital Markets Authority which is tasked under section 11(c) and (d) with the mandate to fairly and efficiently run the capital markets and protect the investors' interests. Attempts to reform the companies law through the Companies Bill 2010 fails to offer any meaningful protection for minority shareholders and their rights. It needs to be amended to protect minority shareholders.

²²⁷ Law Commission, 'Shareholder Remedies' (Consultation Paper No. 142, 1996) Para 4.35.

²²⁸ *Edwards v. Halliwell* (1950) 2 All ER 1064, 1066-1069.

CHAPTER FOUR

MINORITY SHAREHOLDER PROTECTION IN THE UNITED KINGDOM

4.1. Introduction

This chapter is an assessment of minority shareholder protection in the UK as best practiced and the lessons Kenya can learn. This is because the UK has close historical links and a legal affinity which is entrenched in section 3 (1) (b) and (c) of the Judicature Act.²²⁹ The reception clause permits Kenyan courts to apply the common law, the doctrines of equity and the statutes of general application in force in England on the 12th August, 1897, and the procedure and practice observed in courts of justice in England at that date.

Before the introduction of section 210 of the English Companies Act, 1948, there was no statutory provision to protect minority shareholders against the oppressive, discriminatory, prejudicial or unfair conduct by controlling shareholders or the company's directors in the Kenyan colony and the UK.²³⁰ Instead, the only available cause of action for aggrieved minority shareholders was to rely on the available but limited remedy for winding up the company on just and equitable grounds under common law. It is in this regard that the Committee on Company Law Amendment popularly known as the Cohen Committee²³¹ of 1945 and the Jenkins Committee²³² which replaced it in 1962 were established by Her Majesty's Government to investigate and make recommendations for reform and improvement of the Companies Act.

4.2. The “Explosive and Revolutionary”²³³ Effects of s.459-461 CA, 1985

The courts are reluctant to intervene in the internal management of a company except in very exceptional circumstances.²³⁴ This claim to revolution mainly depended upon the comparison

²²⁹ Chapter 8 Laws of Kenya.

²³⁰ ChoongYeow Choy and SujataBalan .Charting the Course for Shareholders' Recourse: Observations on the Malaysian Response at 13-14.

²³¹ Report of the Committee on Company Law Amendment (Cohen Committee) (cmd 6659) (HMSO, 1945).

²³² Report Of The Company Law Committee (Jenkins Committee) (cmd 1749) (HMSO,1962).

²³³ Victor Joffe et al, *Minority Shareholders: Law, Practice and Procedure* 4th ed. (Oxford: Oxford University Press, 2011) at 7.

made between the court's interpretation and application of section 210 of the CA, 1948 and of its successor, section 459 and 461 of the Company Act, 1985.²³⁵ The enactment of Sections 459-461 helped provide a practical and flexible remedy because it had the potential to supersede the concept of "fraud on the minority" by replacing it with the more flexible concept of "fairness". These sections provided a simpler procedure than the common law because they empower the court to give authority for legal proceedings to commence in the company's name thereby making it easier for minority shareholders to use it than the common law rules. The court had been given a wide ranging jurisdiction under section 461 of CA, 1985 which gave the court discretionary powers to make any orders it thinks fit.

Section 459 of CA, 1985²³⁶ provided a remedy for a member of a company to sue in his capacity without setting a minimum percentage of shares to be held or number of members who must join in the action. The conduct complained of must however be unfairly prejudicial to the members in their capacity as members and not in their capacity as directors, creditors or employees. To succeed in an action under this section the plaintiff must prove that the defendant's conduct was unfair and prejudicial. It is however not necessary to show that the act complained of is improper or illegal and even where a legal right is properly exercised it can have an unfairly prejudicial effect.

The most important aspect of the unfair prejudice rule is its definitions of the concepts of unfairness and prejudice. This is because a petition may only be granted where the conduct complained of is unfairly prejudicial to the interest of minority shareholders. These terms are not defined by the statute that uses them but have been left to the courts to make an

²³⁴ Davies, P. *Gower and Davies' Principles of Modern Law 7th ed* (Sweet and Maxwell: London, 2008) at 527.

²³⁵ *Ibid.*

²³⁶ Part XVII of the Companies Act, 1985: provides that a member of a company may apply to court for an order on the grounds that "the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or some part of its members (including at least himself) or that an actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be prejudicial

interpretation of what is meant by these two terms. The initial efforts to define fairness concentrated on its objectivity but recent cases have cast doubt on whether such an approach is the most appropriate test. Hoffmann L. J described the phrase “unfairly prejudicial” as being a deliberately imprecise language which was chosen by Parliament in response to the historical difficulties experienced by courts in restrictively interpreting the word “oppression” under section 210 of CA, 1948.²³⁷

He further stated that a member could not be allowed to complain of unfair prejudice unless there has been some breach of the terms agreed on as to how the affairs of the company should be conducted or use of rules in a manner that is contrary to good faith. Although this test has encountered some difficulties, it has been widely used and accepted as an authority in other jurisdictions.²³⁸ Some of the factual situations in which section 459 has been successfully used in litigations in the UK include the following.

4.2.1. Exclusion from Management

The first factual situation is where a minority shareholder is excluded from the management of the company by the majority shareholders. The courts have held in a number of cases that the petitioner had a legitimate expectation of being able to participate in the management of the company. In order for exclusion to be considered unfair, the court will look at the conduct leading up to the exclusion to establish if it was justified and whether the terms leading to the exclusion were fair.²³⁹

4.2.2. Failure to Provide Information

One of the most common allegations found in minority shareholder claims of exclusion from management cases is the allegation that the majority shareholder failed to provide information concerning the way the company is being run. These complaints of unfairly

²³⁷ *O’Neill v Philips* (1999) 1WLR 1092.

²³⁸ *Ibid.*

²³⁹ Cohen Committee at para 9.34.

prejudicial conduct arise where the majority shareholders pursue a deliberate policy of not consulting the minority shareholders when making major decisions. However in most cases these allegations are used to embellish more serious allegations because there is no legitimate expectation that the petitioner would receive particular information about the management of the company.²⁴⁰

4.2.3. Increase of Issued Share Capital

For any increase of issued share capital a petitioner must prove that they were issued and allotment in accordance with the Companies Act, 1985 but there was a breach of duty by the directors of the company. Secondly, the allotment was proposed or carried out in breach of statutory requirements.²⁴¹ A petitioner may succeed in proving, in the first situation, that the board acted in breach of its fiduciary duty in carrying out the allotment of shares if an ulterior motive is established indicating that the board went beyond the terms of the bargain between the shareholders and the company.²⁴² The court examines the motive of the majority shareholders to determine if the major purpose was to reduce the petitioner's shareholding owing to the inability of the petitioner to exercise pre-emptive rights.²⁴³ The court will hold the existence of unfair prejudice where there is a substantial breach of a statutory provision as opposed to a situation where shares are issued and allotted but the breach of the legal requirements is merely technical in nature.²⁴⁴

4.2.4. Alteration of Articles of Association

A not so common complaint relates to a situation where the majority attempts to alter the Articles of Association of a company by a special resolution. In *Allen v Gold Reefs of West Africa Ltd*,²⁴⁵ it was held that a resolution must be passed bona fide for the benefit of the

²⁴⁰ Ibid at Para 9.35.

²⁴¹ Ibid at para 9.36.

²⁴² Ibid at para 937.

²⁴³ Ibid.

²⁴⁴ Ibid at para 9.38

²⁴⁵ (1900) 1 Ch.

company as a whole without discriminating between the majority and the minority shareholders so as to give the majority an advantage against the minority shareholders. It has been held in *Greenhalgh v Arderne Cinemas Ltd*²⁴⁶ that where there is a legitimate expectation, a valid special resolution could amount to unfair prejudice under section 459.

4.2.5. Excessive Remuneration and Non-Payment of Dividends

The Cohen Committee and the Jenkins Committee considered the problem of excessive remuneration and the resulting effects of such payments on the shareholders' dividends as being unfairly prejudicial to the minority shareholders.²⁴⁷ This is because there is always a link between the excessive remuneration and the failure to pay dividends.²⁴⁸ In *Re Saul D. Harrison and Sons PLC*,²⁴⁹ the modern remedy for protecting individual shareholders was held to be contained in section 994 of the Companies Act.

The popularity of section 459 as a remedy for the minority shareholders caused considerable problems due to the complexity of the court proceedings. The petitioners found it necessary to make wide ranging allegations of unfairly prejudicial conduct covering the entire history of the company. Such practice had the effect of prolonging the proceedings and radically increasing the costs of litigation.

4.3. Unfair Prejudice

The defining feature of section 994,²⁵⁰ which is the identical successor to section 459 of the Companies Act, 1985, is that it has been deliberately crafted to be completely vague and

²⁴⁶ (No 2) [1946] 1 All ER 512.

²⁴⁷ *Ibid* para 205.

²⁴⁸ *Re a Company* (No. 002612 of 1984) where it was held that remuneration of an estimated British pound 365,000 paid to the respondents over fourteen months was in excess of anything that he had earned and was so large as to be unfairly prejudicial to the petitioner's interests.

²⁴⁹ (1995) BCLC 14, Court of Appeal: the petitioner held 8 per cent of class C shares in a family run company that was established in 1891. She alleged that her cousins who were directors deliberately allowed the company to trade at a loss in order to pay themselves excessive remuneration as opposed to closing down the company and distributing its assets to the shareholders. The director managed to have the court strike out the petition and when she appealed the Court of Appeal dismissed her petition.

²⁵⁰ Section 994 (1) allows members to file an action on the grounds that the affairs of the company are being or have been conducted in a manner that is unfairly prejudicial to the interests of members generally or some part

ambiguous to allow a court to make such order as it thinks fit pursuant to section 996 of the same Act. This wide discretion enables the courts to decide each case on its own particular unique facts without relying so heavily on previous case law. In the case of *Re Saul D Harrison Plc.*²⁵¹ Hoffmann was of the view that the concept of 'unfairly prejudicial' was decidedly crafted by parliament in a deliberately imprecise language to avoid the pitfalls of section 210 of the CA, 1948 which was construed too restrictively by the courts to make it for all practical purposes a dead letter. Sections 994-996 were introduced to implicitly instruct the courts to liberalize and broaden the law so as to facilitate a more robust judicial interpretation to allow minority shareholders seek redress for wrongs done to a company and to themselves individually.

To bring an action one must be a member or a group of members so long as they are not the majority shareholders who would otherwise be able to control the company without relying on the court to solve the problem of the company.²⁵² Shareholder nominees and legal representatives to whom shares have been transferred by operation of law can also bring an action under the unfair prejudice remedy.

Some of the remedies that are available for the court to give²⁵³ include: regulation of the future conduct of the company's affairs; requiring the company to do or to refrain from doing certain acts. Company would be barred from altering its articles without the leave of the court. Courts may authorize civil proceedings to be commenced in the name of the company. Orders may be granted for the purchase of the shares of any member of the company by the other members or by the company. Orders could be given for the reduction of the company's capital.

of the company's members (including at least himself) or that an actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.

²⁵¹ [1994] BCC 475.

²⁵² Section 112, Companies Act 2006.

²⁵³ Ibid. Section 996, Companies Act.2006 .

4.3.1. The Popularity of the Unfair Prejudice Remedy

Although the unfair prejudice remedy has encountered some challenges and uncertainties, it has proved to be a very popular legal device for protecting minority shareholder's interests.²⁵⁴ It now dominates minority shareholder litigations because of its ability to cover a wide range of conduct as well as its flexibility on the kind of relief it offers.

Its major attraction is the fact that the concept of unfair prejudice can be broadly applied to all kinds of complaints arising from section 994 so long as they meet the objective test of fairness and prejudice. The unfair prejudice remedy has now overshadowed the other derivative actions and now leads in the number of cases filed under section 994 in protecting minority shareholder interests in the UK.²⁵⁵

The rights under section 994 CA, 2006 can be used to seek redress for the wrongs done to a company without the need to go through a statutory derivative process. The section stipulates that a company's members are entitled to protection if their interests are unfairly prejudiced, thus protecting their interests as well as their rights. Courts have now taken a new approach in dealing with petitions filed by minority shareholders. They assess the alleged prejudicial conduct objectively taking into account all relevant circumstances that merit consideration in order to give section 994 its natural meaning without bringing in any technicalities.²⁵⁶

In deciding whether an act is unfairly prejudicial, the court will consider such factors as the petitioner's conduct; prior knowledge of the matters complained of; any offer made to buy out the petitioner's shares; the motives of the oppressor; any delay in petitioning and other relevant factors.²⁵⁷ Although it was initially a requirement that only a member or members could bring an action on a claim of unfair prejudice, though not in his capacity as a

²⁵⁴ Abbot op. cit. note 231 at 426.

²⁵⁵ Dignam, Alan, *Hicks and Goo's Cases and Materials on Company Law 7th ed.* (Oxford University Press: London, 2011) at 13.

²⁵⁶ Ibid. at 447.

²⁵⁷ Ibid.

director, this requirement has been relaxed. This is because the court recognized that members have different interests based on their common understanding or agreement which is not stated in the articles.²⁵⁸ Therefore the enactment of the CA, 2006 section 994 has proved to be a powerful weapon for minority shareholders who suffer the injury of being excluded from their positions of management in a closely held company.²⁵⁹

The court's jurisdiction has been widened under section 996 which empowers it to make orders with regard to claims brought under section 994 as it thinks fit.²⁶⁰ The most commonly sought out remedy is an order that the plaintiff's shares be bought for good value.²⁶¹ The issue of contention usually pleaded by petitioners is for the court to determine the basis and date for valuation of shares once this order is made. The court has discretion to order third parties to be enjoined where it is appropriate to buy the shares of a petitioner. Where circumstances demand the court may also make an order requiring a majority shareholder to sell his shares to the petitioners.²⁶² Unlike other derivative actions, the court has no jurisdiction to indemnify the petitioners as to costs because the company's funds should not be used to finance the costs of the petitioners.²⁶³

4.4. Statutory Derivative Action

A 2002 White Paper on Modernizing Company Law²⁶⁴ also made similar proposals recommending that further investigations be done to find out if a better workable scheme could be devised to bring changes to establish a new statutory basis for derivative action. When the new statutory derivative action was introduced through the enactment of the CA, 2006, it effectively replaced the rule in *Foss v Harbottle* and its exceptions as an exclusive

²⁵⁸ *Re Company* (No. 004779 1986) (1986) BCLC 376; *O'Neil v Phillips* (1999) 1 QLR 1092.

²⁵⁹ Dignam op. cit. note 256 at 448.

²⁶⁰ *Ibid.*.

²⁶¹ Section 996 (2) (e), Companies Act, 2006.

²⁶² *Brenfield Squash Racquets Club Ltd* (1996) 2 BCLC.184.

²⁶³ *Re: Crossmore Electrical and Civil Engineering Ltd* (1989) BCLC 137.

²⁶⁴ White paper of modernizing company law (2002) at 79.

legal device for bringing derivative actions. Minority shareholders wishing to bring a derivative action no longer needed to prove to the court that the wrongdoers were in control of the company in question. This is because the 2006 Act had adopted the Law Commission's proposal for a new derivative procedure with modern, flexible and accessible criteria for determining whether a shareholder can pursue an action.²⁶⁵

Lin²⁶⁶ has rightly argued that the new statutory rule has extended the boundaries of the application of derivative actions in three ways. Firstly, the new derivative action has broadly widened the scope of the *locus standi* required in bringing a derivative action. In section 260 (5) (c), a derivative action can be initiated either by a shareholder or a person who is not necessarily a member of the company but to whom shares have been transferred or transmitted by operation of law. This would include a trustee or a personal representative managing the estate of a deceased shareholder.²⁶⁷

Besides, there is no threshold on the number of shares a member should own in order to qualify to bring an action, hence, theoretically opening up the opportunity for a shareholder with even one share to bring a derivative action. It has also retained the common law position that a shareholder is entitled to commence a derivative action to seek redress even where the cause of action took place before he became a member of the company. The rationale for extending the *locus standi* and allowing such an action is that the derivative action will benefit the company as a whole as opposed to an individual shareholder.

Secondly, the new statutory rule has extended the causes of derivative actions where the new statutory procedure allows individual shareholders to seek relief on behalf of the company

²⁶⁵ Dignam op. cit. note 256.

²⁶⁶ Shaowei Lin, *Derivative actions in the UK ;revised yet unimproved* (KSLR University of Edinburgh: Edinburgh, 2013) at 13.

²⁶⁷ Companies Act, 2006.

even where such a cause of action is rightly vested in the company itself.²⁶⁸ A derivative action can now arise from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of a company²⁶⁹. The effect of extending this cause of action has enabled shareholders to initiate a derivative action where directors have violated their general duties.²⁷⁰ The inclusion of negligence as a cause of action has broadly expanded the scope for applying the new statutory procedure because previously under the common law no derivative action could lie where the directors were accused of negligence or an error of judgment.²⁷¹

The requirements to prove *fraud* and *control* have been abolished because it is no longer necessary for a minority shareholder to prove that the wrongdoer is controlling the company. This change has made it possible for minority shareholders in widely dispersed shareholding companies to succeed in bringing a derivative action against non-controlling but delinquent directors. The procedure has broadened and created a new cause of action where individual shareholders can sue for any breach of a director's duties.

Thirdly, section 260 (3) has extended the scope of prospective defendants by allowing minority shareholders to file a derivative action against a third party other than a director of the company. The relevance of the third party's involvement in the suit is based on his role in assisting the director to act in breach of his duties as a director of the company. The provision does not therefore mean that any third party can be a defendant. The third party must have aided and abetted the breach of the director's duties to the company. This statutory procedure

²⁶⁸ Section 260 (1), Companies Act, 2006.

²⁶⁹ A derivative claim under part 11 of the Companies Act, 2006.

²⁷⁰ Under part 10 of the Companies Act, 2006, containing the general duties of directors of a company.

²⁷¹ *Pavlides v Jensen* (1956) Ch 565 at 576.

can also apply to a former director or a shadow director to be held liable in a derivative action.²⁷²

According to Lin,²⁷³ although the new statutory regime has widened the scope of derivative actions, the change has created concern. A liberalized policy may increase the risk of a proliferation of vexatious litigations which may be detrimental to the directors whose duties have been widened.²⁷⁴ This may however be mitigated by the fact that the plaintiff shareholders are likely to bear the burden of paying the heavy legal costs if they are unsuccessful in their litigation. Once those intending to bring a derivative action carryout a cost benefit analysis, the risk of the burden they will bear will militate against any attempt to file vexatious claims.²⁷⁵

4.4.1. The procedural requirements for filing statutory derivative actions

The Companies Act, 2006 has made it mandatory for derivative applications to go through a two stage filtering process by the courts in order to prevent applicants filing malicious and vexatious actions on behalf of the company. To an applicant must demonstrate that he has a *prima facie* case. The requirements for establishing a *prima facie* case are not strict mainly because the courts have, in practice, tended to impose a low threshold for the applicants. It left to the applicant to provide as much evidential information as necessary to help him/her prove the existence of a *prima facie* case warranting a derivative action.

The other reason that undermines the efficacy of this new statutory procedure is the way the courts have interpreted the list of factors provided for in section 263 (3) that must be considered before the court grants an applicant leave to continue with a derivative action. In

²⁷² Section.260 (5), Companies Act , 2006

²⁷³ Lin op. cit. note 266.

²⁷⁴ Widening of directors' duties under part 10 of the Companies Act, 2006.

²⁷⁵ Section 261(1), Companies Act, 2006.

*Franbar Holdings Ltd v Patel*²⁷⁶ the court held that the factors which may be considered to apply to section 172 which delimits the powers of the court and acts as a bar to continue a derivative action include : the prospects for success of the claims; the ability of the company to recover any damages awarded; the disruption caused to the development of the company's business as a result of the action; the cost of litigation involved and any possible damage to the company's reputation²⁷⁷. Evidently, this is a very wide interpretation of section 172 which still leaves uncertainty as to what the statute means by the word "success" and the extent to which the boundaries of its meaning can be stretched by the courts.

The new statutory derivative action has considerably reduced the burden borne by the plaintiff shareholders in bringing a derivative action. However it has not made the process of filing for an action materially easier because it introduces a mandatory two stage test before a case can be heard in court. Moreover, the implementation of the procedure is affected by the inherent difficulties posed by judicial interpretation of the factors listed under section 263.²⁷⁸ The varied judicial interpretations have over time given rise to contradictory decisions which have on their part tended to create uncertainty to prospective minority shareholder litigants.²⁷⁹

The other difficulty relates to the funding of derivative actions. Prospective litigants have to consider the cost of maintaining a derivative action against the wrongdoer who is in control of the company as he has to meet the resultant costs of litigation. The mere prospect of bearing the burden of paying the defendant's exorbitant costs in event of losing the case discourages minority shareholders from commencing a derivative action against the wrongdoers in the company. Despite the many changes from the common law to the new statutory derivative action it is still quite difficult for a minority shareholder to commence a

²⁷⁶ [2008] EWHC 1534 (Ch)

²⁷⁷ (2008) EWHC 1534 (Ch).

²⁷⁸ Companies Act, 2006.

²⁷⁹ *Lin op. cit.* note 266.

derivative action. The new statutory procedure has not struck the correct balance between protecting minority shareholders' interests and enhancing the efficiency of corporate management that underpins the company's interests.

4.4.2. The Inherent Deficiencies of the Statutory Derivative Actions

Although it was recently reformed, the new statutory form of derivative action in the United Kingdom suffers from inherent deficiencies that affect its effectiveness as a tool for disciplining corporate management. These deficiencies relate to the procedural difficulties inherent in applying section 172 and 263 and the court's interpretation of the same. Despite this however, derivative actions play a key role in protecting minority shareholders particularly where the other protective mechanisms are ineffective.²⁸⁰

Be that as it may, alternative protective mechanisms for protecting minority shareholders and the company's interests are quite effective in the UK to a point where they have rendered the role of derivative action unimportant.²⁸¹ This is because there are many legal and non-legal mechanisms that help to control the conduct of directors in the United Kingdom.²⁸²

4.5. Winding up on Just and Equitable Grounds Rule

Prior to 1948, the general rule was that the court could not grant a winding up order if there is an alternative remedy available to the petitioner. Section 994 of CA, 2006 allows applicants to plead section 122 (1) (g) in the alternative in conjunction with section 459. The principles developed by the courts with regard to the meaning of "just and equitable" have been extended to apply to section 459 and by extension to its identical successor, section 994 of CA, 2006.

²⁸⁰ Ibid.

²⁸¹ Ibid.

²⁸² Ibid

In *Ibrahimi v Westbourne Galleries Ltd*,²⁸³ Lord Wilberforce was of the view that the circumstances under which it would be just and equitable to wind up a company can be extremely wide indeed. This is because its occurrence is not only limited to where there is a breach of rights or obligations as defined in the Companies Act and the articles of association, but also where there is breach of equitable rights, obligations and legitimate expectations. This is significant in a company which was formed or continued on the basis of personal relationships involving mutual confidence. It is evident that although the courts have the jurisdiction to make a winding up order, this provision makes the winding up of a company on just and equitable grounds a remedy of last resort.

4.6. Conclusion

Historically, the right to bring a derivative action was highly restricted at common law and as a result only those actions which fall within the exceptions to the rule in *Foss v Harbottle* could be allowed by courts in the UK and in Kenya. The restriction has been abolished in the UK and replaced with a brand new procedure that is speedy, fair and cost effective. Its extension in the UK was expected to enable individual shareholders protect their interests and those of the company. This has failed owing to the nature of reforms in the UK. There are misgivings that the objectives of reforming the companies law to protect minority shareholders have not been fully realized.

Despite these challenges, the unfair prejudice mechanism has comparatively offered a wide range of remedies for shareholders while the just and equitable remedy to the minority shareholders is generally used as a weapon of last resort. In addition, the stock market has also developed non-legal mechanisms that help to control and bring discipline among the company's managers and controlling shareholders to the extent that any perceived problems will lead to forced corporate takeovers or a fall of the value of the company's shares in the

²⁸³ (1973) AC 360 House of Lords.

stock market. The market forces therefore provide strong alternative mechanisms for protecting minority shareholder interests. This area is, however, beyond our scope in the present study.

CHAPTER FIVE

CONCLUSIONS AND RECOMMENDATION

5.1. Conclusions

The fiduciary duty of directors is perhaps one of their most important duty in a company apart from the duty to act bona-fide in the interest of the firm. The abuse of minority shareholders by the controlling majority shareholders is therefore unacceptable because it acts as a disincentive to investment which holds the key to the development of any developing country such as Kenya. The fact that Kenya's legal framework is unable to protect minority shareholders is an issue that could derail the country's ambition to become a middle income country by the year 2030 if measures are not put in place to remedy it. Minority shareholders cannot right some of the abuses which may include corruption, expropriation of company assets, conflict of interest, money laundering, tax evasion to mention but a few even if they were to sue in a court of law. This is because a company is a separate entity from the members who create it.²⁸⁴

The necessity of protecting minority shareholders has various advantages that go beyond the individual investors to the economy as a whole. The equality of shareholders in terms of shareholding is not only a constitutional requirement but is an ethical matter. This discourse becomes even more relevant because foreign investors look at the level of protection of minority shareholders as a sign of good corporate governance and therefore increased investment. It is for this reason that the World Bank views the absence of an adequate protection regime for minority shareholders as impacting negatively on the capacity of the country to attract even more foreign investors. Further, support for minority shareholder protection is an essential part of good corporate governance which envisages a robust

²⁸⁴ *Salomon v. Salomon, Ltd* (1897) AC 22.

mechanism for the protection of the non-controlling minority. If companies can protect stakeholder interests within the prism of corporate social responsibility, it is not too much to expect them to protect minority shareholders who take a risk to invest in the company.

The Companies Bill 2014 which could have been used to bring reforms in the corporate sector and therefore raise standards of good corporate governance is still in the Committee Stage of the National Assembly. The gist of the bill is to minimize the requirements that hamper minority shareholders from being protected from majority shareholders. Minority shareholders continue to suffer the negative effects of an over bearing majority shareholders.

Despite this, all is not lost, this is because the UK that a few generations ago had similar legal provisions like Kenya has been able to successfully pass legislation with minority protection in mind. Since Kenya promotes foreign direct investments from overseas companies, there is no doubt that pressure will come to bear on the government to urgently reform the corporate sector in order to be in tandem with the changing global business environment. Kenya has, therefore, a lot of lessons to learn in providing adequate remedies to minority shareholders. The resultant good corporate governance that will follow holds the key to achieving the economic pillar of vision 2030.

The study set out to examine the extent to which minority shareholders are protected under the Kenyan legal system. It is evident that minority shareholders who invest in companies controlled by majority shareholders face many risks because the legal regime that is in existence is structured to protect the controlling majority shareholders. Following the decision in *Foss v. Harbottle*, common law has always protected the interests of the controlling majority shareholders. This situation is made worse in Kenya by the weaknesses

in the judiciary which include: obscure and antiquated laws, restrictive interpretations of the law, inefficient enforcement of the law, judicial corruption, and the low level of awareness within the ranks of shareholders and directors, leaving minority shareholders without any form of protection.²⁸⁵

These weaknesses have resulted into companies with a concentrated ownership structure devising schemes whose sole purpose is to dilute and appropriate minority shareholders investments as was the case with Cooper Motor Corporation. Because of the absence of good corporate governance, public corporations suffer from poor disclosure, absence of integrity, accountability and transparency. The consequence is that it creates avenues for fraudulent dealings, tax evasion, conflict of interest and corruption.

As a result, activities of the controlling majority shareholders reduce the value of the company which affects the dividends that are paid to minority shareholders. Majority shareholders dilute and appropriate minority shareholders equity through transfer pricing and profit sharing, capital allocation, corporate actions that devalue shares and excessive stock based executive compensation schemes among other equity devaluation schemes.

There are compelling reasons for minority shareholders to be protected in Kenya. This is because as a country that depends on foreign direct investment, domestic and foreign investors desire to have confidence in the protection of investments and minority investors in particular. Misappropriation of minority shareholder's stake is not the way to go. Apart from protecting investors the fair and equal treatment of minority shareholders also helps in the development of the country in terms of job and wealth creation.

The Cooper Motor Corporation scandal highlighted a number of key deficiencies in minority protection. First, is the inherently deficient corporate governance laws and regulatory

²⁸⁵ Mwaura op. cit. note 92 at 4.

oversight over companies listed. The failure of the Capital Markets Authority to force the resignation of the Cooper Motor Corporation board members since it came into conflict with the interim orders by the High Court.²⁸⁶ Second, there is little or no protection accorded to minority shareholders as is clearly demonstrated by the fact that even when the Capital Markets Authority sought to appoint new directors whom it thought had integrity, only the controlling majority shareholders were considered. This was done despite the fact that these were the same directors who brought about the conflict of interest in the company.²⁸⁷ It is also noted that the right to bring a derivative action is highly restricted at common law and as a result only those actions which fall within the exceptions to the rule in *Foss v Harbottle* could be allowed by courts.

Although the UK statutory action is considerably improved and is much more advanced than any legal actions in Kenya, it has been the subject of heavy criticism as stated in chapter IV of this research. As a result of the flawed nature of these reforms in the UK there are misgivings that the objectives of reforming the companies law to protect minority shareholders have not been fully met. The UK law on minority protection is quite advanced when compared to the Kenyan legal framework and could learn a lot.

The other reason for failing to meet its objectives are the different kinds of judicial interpretations made by the courts on the criteria to be met in bringing such an action. At the two ends of the spectrum for interpretation is a growing list of conservative interpretations that extend the reluctance of the courts to intervene in the internal management of companies as held in *Foss v Harbottle*. On the other extreme also lie the more liberalized decisions which have been made by courts after the enactment of section 994 in the UK. Despite its substantial revision, the role of derivative actions in protecting minority shareholders against

²⁸⁶ Regulator changes tune on CMC board ouster, *Business daily*, 9 February 2012.

²⁸⁷ Africa Centre for Open Governance, *Kenya: Governance Report 2011* at 36.

managerial misconduct still remains as difficult as it was under common law.²⁸⁸ Despite these challenges however, the unfair prejudice mechanism has comparatively offered a wide range of remedies for shareholders while the just and equitable remedy lies in the minority shareholders' armoury as a weapon of last resort.

5.2. Recommendations

5.2.1. Statutory Derivative Action

First, it is recommended that a provision for statutory derivative action be enacted to overcome the inadequacies of the common law which is presently being used in Kenya for minority shareholder protection. This will enable minority shareholders to bring actions to enforce their rights as well as those of the company. In particular a new statutory derivative action should be enacted to overcome the current problems being experienced under the common law and the Kenyan Companies Act. The new statutory derivative action will be a more effective legal tool for enforcement of minority rights. If the new procedures are codified and made user friendly these procedures would make the new statutory derivative action more feasible and practical than it is presently the case under the Common law.

5.2.2. Unfair Prejudice Remedy

Section 211 should be amended to use the words unfair prejudice as opposed to oppression. The unfair prejudice remedy currently being used by minority shareholders in the UK could be adopted in Kenya to enable individual shareholders file for actions where they have been unfairly treated.

5.2.3. Amendment of the Civil Procedure Code

Procedures for filing petitions and derivative actions should be enacted under the Civil Procedure Act. This will provide claimants with leave to sue on behalf of the company as well as giving a timely notice to the company. The experience of a highly restrictive

²⁸⁸ Abott op. cit. 231.

procedure that rendered the new UK statutory derivative action moribund is a timely lesson for Kenya to learn from. Kenya should create an amicable balance between a highly restrictive distilling mechanism and flexible user friendly derivative mechanisms.

In addition, the active use of case management procedures as provided for in the civil procedure rules²⁸⁹ should be seriously adhered to reduce the time and cost of litigation. Parties should be encouraged to narrow down and identify important issues in dispute for easier resolution by the court.

5.2.4. Promote the use of Alternative Dispute Resolution (ADR)

Majority and minority shareholders should be encouraged to use alternative dispute resolution mechanisms such as reconciliation, mediation and arbitration. This recommendation is envisaged in the Constitution of Kenya.

5.2.5. Abolish the Requirement for Security for Costs

To assist minority shareholders protect their rights, it is recommended that section 170 which requires members to leave security for costs with the registrar should be relaxed. This is informed by the fact that this requirement is out of reach for members desirous of bringing complaints about majority shareholders.²⁹⁰ This has been done Nigeria and could be employed in Kenya.

²⁸⁹ Legal Notice No.151: The Civil Procedure Act, Cap 21 Civil Procedure Rules, 2010. Kenya Gazette Supplement No.65 10th September, 2010.

²⁹⁰ Nigerian Law Reform Commission, *Working Papers on the Reform of Nigerian Company Law*: Volume 1- Review and Recommendations, 1987 at 237.

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