Shareholder Protection and Shareholder Intervention in Kenya: A Study on Shareholder Activism

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Quote

'Shareholder activism is not a privilege - it is a right and a responsibility. When we invest in a company, we own part of that company and we are partly responsible for how that company progresses. If we believe there is something going wrong with the company, then we, as shareholders, must become active and vocal.'

- Mark Mobius

DECLARATION

I, **Caroline Musango** of Registration Number **G62/67465/2011**, do hereby declare that this project paper is my original work. I further declare that this work has never been submitted to any university, college or other institution of learning for any academic or other award. Other works cited or referred to are accordingly acknowledged.

Signed: ………………………………………………………………..

Date: …………………………………………………………………..

Supervisor's Approval

This dissertation has been submitted for examination with my approval as University supervisor.

Signed…………………………………………………………………

Prof. Kiarie Mwaura

University of Nairobi

Date……………………………………………………………………..

DEDICATION

I dedicate this work to my family which constantly inspires me to move to the next level

ACKNOWLEDGEMENT

I would like to acknowledge that this work would never have been a success without the support and assistance of many. I am particularly grateful to my supervisor, Prof. Kiarie Mwaura, for his invaluable guidance without which this paper would not be what it is today. I am also indebted to my family, colleagues and friends who supported and encouraged me throughout the period I was undertaking the LL.M course. Any inadequacies and errors that may subsist in this paper are solely mine and are regretted.

Above all I acknowledge that nothing is possible without the will and grace of God, may He receive glory for this achievement.

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ABSTRACT

The traditional model of corporate governance precludes shareholders from directly participating and/or intervening in the management of companies. If a shareholder or shareholders in a group, felt aggrieved by the actions of the company's management, the main route available to them was to vote against the director's involved or the action complained of. If that action also constituted an actionable wrong, then he shareholder(s) could bring a derivative claim.[1]

This is the model that is currently prevalent in Kenya. This proposed research seeks to question the traditional model of corporate governance and trace the rightful place of shareholders in the management of the companies in which they invest. In essence, the author will argue that directors and senior managers should not be allowed to unilaterally make major decisions and corporate policy with minimal involvement of the investor or shareholder.

The aim is to initiate debate around the whole area of shareholder protection against shortcomings of company directors and management and put across a case for shareholder activism in an attempt to further the author's hypothesis that shareholders, being the owners of the companies in which they invest, should directly and significantly influence decision and policy making in the those companies.

[1]Needless to say, the bringing of such action was limited by the rule in *Foss v Harbottle*. According to this rule, an individual shareholder could only bring a derivative action on behalf of the company if the action complained of had not been ratified, and was not ratifiable, by the company. See also Frank Wooldridge and Liam Davies, 'Derivative Claims under UK Company Law and Some Related Provisions of German Law' [2012] 1(90) Amicus Curiae.

LIST OF ABBREVIATIONS AND ACRONYMS

CMA	Capital Markets Authority (Kenya)
CMC	Cooper Motor Corporation
KES	Kenyan Shillings
NSE	Nairobi Securities Exchange (Kenya)
SEC	Securities Exchange Commission (United States of America)
UK	United States
USA	United States of America
USD	United States Dollar

LIST OF STATUTES AND STATUTORY INSTRUMENTS

1. Capital Markets Act Chapter 485A Laws of Kenya
2. Capital Markets (Securities)(Public Offers, Listing and Disclosure) Regulations 2002.
3. Code of Corporate Governance Practices for Issuers of Securities to the Public 2015.
4. Companies Act 2015.
5. Companies (General) Regulations 2015.
6. Companies Act Chapter 486 Laws of Kenya (now repealed).
7. Securities Exchange Act 1934, United States of America.

LIST OF CASES

1. *Aron Salomon* v *Salomon & Company Limited* (1897) AC 22.
2. *Foss v Harbottle [1843]2* Hare 461.
3. *Gundelfinger v African Textile Manufacturers Ltd* [1939] AD 314.
4. *Geoffrey Makana Asanyo v Nakuru Water and Sanitation Services Company & 6 others* [2014] eKLR.
5. *David Langat v St. Lukes Orthopeadic & Trauma Hospital Ltd & 2 Others* [2013] eKLR.
6. *Edwards v Halliwell* (1950) All ER 1064.
7. *Republic v Commissioner of Insurance, Insurance Regulatory Authority and B.C. Patel & Company, ex parte Geminia Insurance Company Limited* (HC Misc. App. 172 of 2011).

CHAPTER ONE
INTRODUCTION

1.0 Background to the Research

A member or shareholder of a company can be defined in various ways- s/he is a person who subscribes to the company's constitution; a person having the right to attend and participate at general meetings of the company; or a person entitled to receive such benefits as dividends from the company if and when declared.

Most importantly for this study, a member is a person holding shares in a company; in principle therefore, members are proprietors, owners, investors, with each share they hold in a company representing a unit of ownership in that business known as the company.

Corporate law has long precluded shareholders from directly participating in corporate decisions and the day-to-day running of the company. This is traditionally left to the board of directors and senior management. In other words, there is a well-settled principle in corporate law that major corporate decisions must be made, or at least initiated, by the board. Shareholders may not initiate any such decisions, and they can change the course of the company only by replacing the board with a new board that will do so.[2]Often, however, shareholders feel that their interests as investors and proprietors of the company are not best represented in good faith by the men and women selected to sit in the board of directors.

Two options are usually open to these shareholders: aggressively lobbying other shareholders to vote with them against the errant directors; and purchasing such numbers of shares as will give them absolute voting, and therefore decision-making power. More often than not, neither of these options is viable. In such cases the shareholders, motivated by an understanding that board members have no monopoly of wisdom and that though boards meant to oversee the members may

[2] See generally Robert Charles Clark, Corporate Law (Little Brown 1986).

themselves be in need of oversight, fall back to what this study considers to be the default setting of most if not all investors: shareholder activism[3].

In Kenya, as is the case in Africa generally, incidences of fraud, maladministration and dishonesty perpetrated by directors of companies are not uncommon.[4] Needless to say, this is partially a direct and yet inevitable consequence of the current rules and practices that essentially insulate directors and managers from direct shareholder intervention. This state of affairs leaves a major question begging for answers: all the benefits of doing business through a limited company notwithstanding, what is to motivate an investor to let disinterested men and women (in the name and style of a board of directors) manage his/her investment?

Recent changes in Kenyan corporate law have seen directors being forced to be more accountable in their management of companies, and penalties enhanced for irresponsible and illegal behavior. The new Companies Act[5] clearly sets out duties of company directors and imposes penalties ranging fromKES100,000[6] to KES10,000,000[7] for breach of these duties.

However, the author in this paper will argue, this is only a half measure. The traditional problem posed by preclusion of investors or shareholders from direct intervention in company affairs, aptly described as long ago as 1776,[8] still begs for a

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[3] In this proposed research, the author will adopt the definition given to 'shareholder activism' by with slight modifications. Defined 'shareholder activism' as 'any action(s) of any shareholder or shareholder group with the purpose of bringing about change within a public company without trying to gain control.' See Paul Rose and Bernard Sharfman, 'Shareholder Activism as a Corrective Mechanism in Corporate Governance' [2014] 1015(1) BYU Law Review.

[4] Several companies that have nearly collapsed under allegations of mismanagement, dishonesty and fraud by directors come to mind including CMC Holdings Limited, Imperial Bank Limited, Dubai Bank Kenya Limited, and Chase Bank Kenya Limited.

[5] Act Number 17 of 2015.

[6]About USD 1,000.

[7]About USD 10,000.

[8] Adam Smith described the problem best. See Adam Smith, Wealth of Nations (1st edn, Methuen & Company Limited 1776).

solution. Fortunately, incidences of shareholder activism[9] are reported to be increasingly prevalent in Africa generally and Kenya in particular.[10]

1.1 Statement of the Research Problem

The legal and regulatory framework on corporate governance and shareholder influence in Kenya[11], as in the rest of the Commonwealth states, seems to be in favour of restriction and limitation of shareholder influence or power and encouragement of clear separation of roles/power between the Board of Directors on the one hand and shareholders in General Meetings on the other hand, giving corporate policy and decision-making power almost exclusively to the former.

As will be argued in this study, giving directors this kind of power presumes that directors are going to act in the best interest of the shareholders or investors. The sad truth is that many times they do not. Acting in self-interest, and sometimes fraudulently, directors have been known to not only make reckless and misadvised corporate decisions but also misappropriate large amounts of company funds leading to huge losses to shareholders' capital and profits.

While incompetence of directors may contribute to this state of affairs, the author argues that the main cause of the same is what Adam Smith set out as the problem facing corporate governance, namely that directors of companies, being mere managers and not proprietors of the company, may not be sufficiently motivated to

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[9] As will be described in relevant parts of this study, the term 'shareholder activism' is used in a very wide sense to refer to the whole spectrum of actions that shareholders may take to protect their interests but focusing on the specific possibility of shareholders taking direct and positive actions aimed at influencing not only company policy but also the day-to-day decision making within the company.

[10]Kimani Njoka, 'Kenya: Dawning of the Age of Shareholder Activism' *Business Daily* (Nairobi 20 December 2004). See also Nuru Mugambi, 'Why firms should encourage investor activism at AGMs' *Business Daily* (Nairobi 27 September 2015). See also Rufus Mwanyasi, 'Activism now needed to shake up sleeping boards of NSE firms' *Business Daily* (Nairobi 5 April 2016). See also George Kinyua, 'It's Our Money!' Shareholder Activism and Vigilant Investing' Mboya Wangong'u & Waiyaki Advocates website <http://www.lexgroupafrica.com/its-our-money-shareholder-activism-and-vigilant-investing/> accessed 14 July 2016.

[11]This framework includes the Companies Act, the Capital Markets Regime as well as case law.

take all steps and do all things necessary to ensure the collective success of the company.[12]

Besides, directors may not be sensitive to (and will often ignore) shareholders', especially minority shareholders', intellectual input in corporate policy and decision making.[13]

These twin problems of (1) director disinterest or indifference towards shareholders' economic interests and (2) directors' insensitivity to shareholders' opinions and input in corporate governance are the exact problem that this study seeks to address. In particular, this study is an investigation on whether these problems can be solved through shareholder activism.

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[12] *Adam Smith (n 7).*

[13] Indeed, the author argues that how sensitive the Board is to shareholder input will usually depend on how easily the shareholder(s) in question can vote them out. This will become a little more obvious in cases of directors appointed under the auspices of influential shareholders, and who will normally have pledged exclusive loyalty to those shareholders. It is precisely for this reason that proceedings at Annual General Meetings in Kenyan public companies have been aptly described thus:

> …10 minutes to the start, the board is whisked in and head straight to the stage. The meeting commences with the formal proceedings and voting followed by brief remarks from the chief executive and chairperson. After 4 minutes of shareholder feedback and questions, the meeting ends. … The board is happy with the level of engagement. On the other side, the minority shareholders, who seem to be the only investors with time to attend these meetings, are satisfied with the dividend announcement and free merchandise; and if either were unsatisfactory, well, there's always next year.

> See Nuru Mugambi, 'Why firms should encourage investor activism at AGMs' (Business Daily Africa, 27 September 2015) http://www.businessdailyafrica.com/Opinion-and-Analysis/-/539548/2887600/-/139bs3fz/-/index.html accessed 11 May 2016.)

1.2 Research Objectives

This research guided by the following objectives:

i. To investigate what the role of shareholders in corporate governance ought to be in the modern commercial environment.
ii. To enquire whether shareholder activism has the potential to produce value for companies and investors and, if it does, establish the right balance between the current law on separation of management from ownership of companies on the one hand and the right of shareholders to determine how their investment is managed on the other hand.
iii. To make recommendations on changes in the legal, regulatory and institutional framework on corporate governance in Kenya to reflect the role of shareholder activism in corporate policy and decision-making.

1.3 Research Questions

In this study the author seeks to find answers to these questions:

i. What ought to be the role of shareholders or investors in modern corporate governance?
ii. Does shareholder activism have the potential to increase value for companies and what experiences does the capital market in the United States have in that regard?
iii. Where do we strike the balance, if we should, between the current law on separation of management from ownership of companies on the one hand and the right of shareholders to determine how their investment is managed on the other hand?
iv. If we accept shareholder activism as an integral part of corporate governance practice in Kenya, what changes need to be made in the legal, regulatory and institutional framework on corporate law in Kenya?

1.4 Research Hypotheses

This research will proceed on the following three hypotheses:

i. While shareholders' relationship with the management of a company takes centre-stage in corporate governance, there are serious concerns on the effect and desirability of having (often disinterested) men and women controlling the wealth of the proprietors of that wealth (shareholders).

ii. Directors' shortcomings (including absenteeism, lack of interest in shareholders' interests, ignoring shareholders' intellectual input in corporate decision-making, mismanagement and dishonesty) often lead to losses on company profits and shareholders' capital.
iii. There is need to put in place mechanisms to ensure direct shareholder intervention in the making of policy and decisions affecting their investment.

1.5 Theoretical Framework

The relationship between shareholders and the management of companies takes centre-stage in corporate governance research and practice. In particular, while the phenomenon is relatively new in Kenya and Africa in general, shareholder activism has formed the main framework of many studies around the world especially in the United States, the United Kingdom and a few European and Asian countries.

Different theories have been advanced either in support or in opposition to shareholder activism and control. Of note, and perhaps one of the most cross-cutting, is Henry Manne's theory of corporate control that there is in fact a 'correlation between corporate managerial efficiency and the market price of shares of that company.'[14] What this means is that, at least for public companies, a highly effective board of directors will result in more valuable shares and, consequently, more wealth for the shareholder.

For this reason, Manne proceeds, corporate control is of itself a valuable asset if the aim of the controller is to improve the management of the company and improve managerial inefficiencies.[15]Manne further argues that corporate control can be thought of as a valuable asset in and of itself, provided that the person(s) seeking such control has the aim of improving the effectiveness of the company's management. This theory inevitably makes at least three assumptions:

[14]*Manne (n 12 at 112).*
[15]*Manne (n 12).*

a. That the activist holds sufficient shares in the company to get a significant increase in return if the management of the company is improved[16];

b. The activist shareholder is willing to make his activism a public good; in other words, he is ready to absorb all the costs and displeasures of his activism but at the same time share the benefits thereof with other shareholders; and

c. The shareholder has sufficient insider information regarding the management of the company that they will know exactly where, when and at whom to target their activism.

Professor Lucian Bebchuk[17]dismisses possible arguments that shareholder power can in fact hurt rather than benefit shareholders. Belchuk advises that management can still make recommendations to shareholders, given that the former may have superior expertise and information which might otherwise be unused if shareholders make all major decisions. He insists that 'paternalistic hand-tying' is unlikely to benefit shareholders. Further, he categorises the decisions which shareholders should be given power to initiate into three.

Firstly, 'rules-of-the-game' means decisions to alter the corporate constitution. This basically speaks to decisions going into the corporate governance of the company. He figures that this power will ensure that corporate governance arrangements within the company tallies with what the shareholders desire. Secondly, 'game ending' decisions comprising decisions to restructure the company by merging, selling-out, buying-off or dissolution. Thirdly, he considers that shareholders should have power to make 'scaling-down' decisions, viz, decisions to reduce the size of the business by ordering a distribution.

Professor Stephen M. Bainbridge[18] on the other hand puts forward equally convincing arguments against shareholder empowerment and, therefore, activism. Firstly, using economic theories of market behaviour, he claims that if shareholder

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[16] Professor Bernard S. Sharfman attempts to bring this out. See Bernard Sharfman, 'A Theory of Shareholder Activism and its Place in Corporate Law' [2015] 82(4) Tennessee Law Review.

[17] Lucian Arye Bebchuk , 'The Case for Increasing Shareholder Power.' *Infra*

[18] Stephen M. Bainbridge, 'Director Primacy and Shareholder Disempowerment,' [2006] Research Paper No. 05-25, University of California, Los Angeles, School of Law, Los Angeles, California

empowerment was as important as Bebchuk claims, shareholders would be seen either making resolutions to give themselves the power or lobbying Parliament to give them power through legislation.
Secondly, he introduces what he calls a 'director primacy model' of corporate governance. In this model, he suggests that the present regime of limited shareholder power (limited to voting rights) is 'the majoritarian default and therefore should be preserved as the statutory off-the-rack rule.' Thirdly, he argues that it is doubtful that shareholders would make effective use of their power even if they had it.

An examination of these theories will form the starting point of this research. Most importantly, and noting that shareholder activism is hardly practiced in Kenya, the proposed research will borrow heavily from theories developed and studies advanced in other jurisdictions around the world, most notably the United States of America.

More particularly, this paper will apply the concepts of shareholder power, shareholder influence and shareholder protection in attempting to come up with a model of shareholder activism that not only tallies with best international practice but also fits in the circumstances of corporate governance practice in Kenya.

1.6 Research Methodology

This research paper will use three main sources of information; library research (including books, statutes, journal articles, research papers, and newspaper articles), the World Wide Web and spoken speeches by experts in the topic of research.

The research method adopted consists of literature review of relevant sections of published articles and books relating to the objectives of this research around the world as well as a contextual analysis of the potential impact of application of these publications to modern corporate governance in Kenya.

The research will also be based on a comparative study of Kenya and the United States of America with the aim of proving or disproving the hypotheses. In this regard, the author will aim at demonstrating that shareholder activism can and indeed does lead to not only increased accountability in the management of companies but also enhanced shareholder value. This will be exemplified by a study of the capital markets in the United States of America, a market which has largely been successful in not only effecting change in management and boosting accountability of directors but also improving shareholder value through shareholder intervention or activism.

1.7 Limitations of the Research

The scope of this study is an inquiry into the role of shareholders in corporate governance and the potential of shareholder activism to not only increase profitability of companies but also improve corporate governance practice in Kenya. Although shareholder intervention or activism has the potential to improve the welfare of shareholders in all types of companies in which it is practiced, the author argues that such intervention is likely to achieve optimal results in public rather than private companies. The reasoning is that private companies are mostly owned by few individuals who are also directors and employees of the company and are therefore sufficiently involved in the day to day running of the companies. Public companies on the other hand are characterized by diverse ownership with management confined to the board of directors and management. For this reason, this study will be limited to public companies, both listed and unlisted. Geographically, the research is limited to Kenya but with short comparative study on other parts of the world particularly the United States of America.

The study also faces the limitation of insufficiency of academic and other material specifically focused on the shareholder activism in Kenya but this challenge has been overcome by reference to material focused on the subject in other jurisdictions especially the United States of America.

1.8 Literature Review

There is an apparent scarcity of literature on corporate governance, and specifically on shareholder activism, in Kenya. However, there exists a wealth of literature from other jurisdictions especially the United States of America.

From the onset, it will be noted that the literature reviewed hereunder, and indeed this research paper in its entirety, derives its relevance from Berle and Means' 1939 work *The Modern Corporation and Private Property*[19] in which they highlighted the separation of the owners (shareholders) from the control of the company, which vests in the managers or directors.

Professor Lucian Arye Bebchuk[20], perhaps the leading proponent of shareholder empowerment, in what he calls a reconsideration of the whole idea of allocation of power between shareholders on one hand and company management on the other hand, begins by bringing out the fact that traditional corporate law 'has long excluded shareholders … from directly intervening in any major corporate decisions.' He then argues that such exclusion is unwarranted and puts forward a case for moving against management's monopoly in initiation of major corporate decisions and embracing shareholders' power to initiate and pass such decisions. Further, he figures that giving shareholders the power to intervene in corporate affairs can help address major governance problems being faced by companies. His aim is to give shareholders much more power than the power to appoint and remove directors.

In his model, Belchuk categorises the decisions which shareholders should be given power to initiate into three. Firstly, 'rules-of-the-game' decisions consisting of decisions to alter the corporate constitution. This basically speaks to decisions going into the corporate governance of the company. He figures that this power will

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[19]Adolf Berle and Gardiner Means, The Modern Corporation and Private Property (Macmillan 1939).
[20]Lucian Arye Bebchuk , 'The Case for Increasing Shareholder Power' [2005] 118(1) Havard Law Review 833.

ensure that corporate governance arrangements within the company tallies with what the shareholders desire. Secondly, 'game ending' decisions comprising decisions to restructure the company by merging, selling-out, buying-off or dissolution. Thirdly, he considers that shareholders should have power to make 'scaling-down' decisions, viz, decisions to reduce the size of the business by ordering a distribution.

Dismissing possible arguments that shareholder power can in fact hurt rather than benefit shareholders, Belchuk advises that management can still make recommendations to shareholders, given that the former may have superior expertise and information which might otherwise be unused if shareholders make all major decisions. He insists that 'paternalistic hand-tying' is unlikely to benefit shareholders.

In an earlier book co-authored with Jesse Fried[21], Bebchuk had proposed, consistent with his arguments for shareholder empowerment, significant changes to corporate governance and in particular allowing what he calls 'a significant group of shareholders,' who he defined as shareholders holding 5% ownership for at least one year, to be allowed to make complete overhauls of boards of directors and elect a complete fresh slate of directors.

Professor Stephen M. Bainbridge[22], in a 2006 reply to Professor Bebchuk's Article, makes at least three claims. Firstly, he claims that if shareholder empowerment was as important as Bebchuk claims, then shareholders would be seen either making resolutions to give themselves the power or lobbying Parliament to give them power through legislation. Since neither has happened, he concludes that investors do not value these powers or rights.

[21]Bebchuk Lucian Arye and Fried Jesse, 'Pay Without Performance: The Unfulfilled Promise Of Executive Compensation' [2004].

[22] Stephen M. Bainbridge, 'Director Primacy and Shareholder Disempowerment,' [2006] Research Paper No. 05-25, University of California, Los Angeles, School of Law, Los Angeles, California.

Secondly, he introduces what he calls a 'director primacy model' of corporate governance. In this model, he suggests that the present regime of limited shareholder power (limited to voting rights) is 'the majoritarian default and therefore should be preserved as the statutory off-the-rack rule.'

Thirdly, he argues that it is doubtful that shareholders would make effective use of their power even if they had it. In support of this, he claims that 'even institutional investors have strong incentives to remain passive.' To buttress his claim, Bainbridge borrows from economic theories of market behavior and suggests that if shareholder empowerment were as value-enhancing as Bebchuk claims, then we should be seeing it in the marketplace- we should be seeing shareholders clamouring for it. After all, he argues, corporate governance terms should be considered goods in the corporate market and free markets, after all, produce only goods that consumers (in this case shareholders) actually want.

In other words, Bainbridge uses economic theories of free market. He considers 'corporate governance' to be a market, shareholders to be consumers and corporate governance terms as goods. He then puts forward the argument that if consumers of the goods needed the goods as much as Bebchuk claims, then we should be seeing those consumers actively seeking the goods.

Bainbridge in fact agrees with Bebchuk to the extent that both company law and securities law serve to limit shareholder involvement in corporate decision making. He adds, however, that these myriad rules and laws are what constitute his regime or model of 'director primacy.' Notably, Bainbridge is merely reiterating his contractarian philosophy that: 'corporate law is generally comprised of default rules, from which shareholders are free to depart, rather than mandatory rules. As a normative matter, … this is just as it should be.'

This view, which seems to suggest that dissatisfied shareholders have the option of selling out and exiting the company, has been advanced in Bainbridge's earlier works especially his 1997 work *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*.[23] In furtherance of this philosophy he insists that when a company offers its shares to the public, investors are provided with detailed information about the company's management and decision-making structure and arrangements. A rational investor, he continues, will weigh these terms and decide whether to invest in the company or not.

Further, Professor Bainbridge suggests that an argument for shareholder empowerment runs the risk of creating 'collective action problems inherent in attempting to involve many thousands of decision makers.'

YaronNili in his article *Missing The Forest For The Trees*[24] proposes a novel approach to shareholder activism research. Treating shareholder activism as a more complete phenomenon or model than a study of 'specific occurrences,' he seeks to show that different models of shareholder activism exist around the world. Yaron acknowledges that the question of the rightful role of shareholders in public companies is indeed complex. He then observes that the debate around that question has in fact shifted from the argument that directors need to maximize the interests of shareholders to the more complex question of 'how governance, regulation and participation by shareholders can achieve that goal more efficiently.'[25]

Further, he argues, the importance of shareholders in companies is recognized across the globe regardless of the legal systems. Moreover, he continues, the debate is not on whether shareholders should be involved in corporate governance but on 'how much power shareholders should have.' For, even the strictest oponents to Professor

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[23]Stephen Bainbridge, 'Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship' [1997] 82(1) Cornell Law Review 856, 860.
[24]YaronNili, 'Missing the Forest for the Trees: A new Approach to Shareholder Activism' [2014] 4(1) Havard Business Law Review 158.

[25]*Yaron (n 21 at 159).* See also generally Margaret M Blair and Lynn A Stout, 'A Team Production Theory of Corporate Law' [1999] 85Virginia Law Review 247-328.

Bebchuk's suggestions agree that there is need for at least some level of shareholder participation or involvement.[26]

Yaron then suggests that there are two factors that determine the probability of shareholder activism playing a material role in the corporate governance of a company, that is to say:
Shareholders' incentive of to be active, in other words, what benefits do shareholders expect to receive fro activism and are those benefits greater than the costs of activism?

Exogenous factors or the 'pre-determined rules of the game.' Notably, Yaron distinguishes his use of the term from that by Bebchuk. Bebchuk's use of the phrase 'rules of the game' revolves around the rules that govern the particular company. Yaron, on the other hand, takes a wider approach and uses the phrase to refer to the entire politico-legal environment surrounding corporate governance and participation of shareholders therein. For instance, Yaron gives the presence of 'legal and economic obstacles' that affect shareholders' willingness to be active.
He notes, however, that these two factors do interact with each other and cannot therefore be viewed independently.

Finally for this proposed research, Yaron suggests that shareholder participation in corporate affairs may be viewed as a 'continuum of possibilities.' On the one end, he continues, is the average investor who is not involved in company affairs and whose 'activism is summed up by holding or selling his [shares].'[27] On the other hand, there is the 'aggressive' shareholder to whom 'voting with the feet' is not enough. This latter shareholder tries to not only affect 'rules of the game'[28] decision-making but also wishes to take an active role in the day-to-day business of the company.

[26] See Martin Lipton and Steven Rosenblum, 'Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come' [2003] 59Business Law Review.
[27] This is what is referred to as 'voting with the feet' or, as is the case in the US, 'the Wall Street Walk.'
[28]Lucian Arye Bebchuk , 'The Case for Increasing Shareholder Power.' *Supra.*

Yaron warns against treating shareholder activism to mean the later and ignoring the more modest type of activist, condemning him as a 'non-activist'.

Related to that, Yaron advices that one needs to be clear as to the scope of a 'shareholder' for purposes of shareholder activism. In other words, does one limit his definition to the traditional shareholder or does the term include bondholders, holders of convertible loans, and nominee shareholders (who hold no beneficial economic interest)? He recommends a broad definition.

Irene-marie Esser and Michele Havenga[29] focus their study on institutional shareholders, examining the perceived difficulties to involvement of such shareholders in company management. They acknowledge that shareholders' power of intervention 'has a preferred and beneficial impact on corporate governance' but also that the board of directors has wide powers with regard to management of the company. Such powers include appointment and remuneration of the Chief Executive, setting company goals monitoring management's performance and business results, and setting performance strategies.[30]

They then present that given their size, institutional shareholders have the potential to play a large role in ensuring good corporate governance standards as they usually own large blocks of shares and have an incentive (and invariably the resources) to develop specialised expertise in making and monitoring investments. Nevertheless, they continue, shareholders are mostly inactive when it comes to the management of a company. Put differently, the writers suggest that shareholders prefer to distance themselves from management of the company.

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[29] Irene-marie Esser and Michele Havenga, 'Shareholder Participation in Corporate Governance' [2008] Department of Mercantile Law, School of Law, College of Law and Justice, University of South Africa.

[30] See also Austine Robert and Ramsay Ian, Company Directors: Principles of Law and Corporate Governance (Lexis Nexis Butterworths 2005) 60. See further Kenya's Companies Act 2015on the general functions of the board of directors.

Among the reasons for tendency against shareholder activism (which Esser and Havenga refer to as 'shareholder apathy') are lack of knowledge concerning the legal rights and powers available to them; the perception that their efforts will not bring about any change or compliance with corporate governance principles; the fact that shareholders do not have a fiduciary obligation towards other shareholders or to the company in which they hold shares[31] and therefore shareholders will rather sell their shares than get involved in the management of a company and ensure good corporate governance principles; and the costs involved in pursuing shareholder activism also discourages shareholder activism. Besides, shareholders are afraid that if they influence company management, they could end up being shadow directors.[32]

Institutional shareholders, the authors advise, should set a policy on shareholder activism. Further, they should not only monitor the performance of the directors, review company accounts, attend company meetings and be satisfied that the board structure of a specific company is effective but also they should not hesitate to get involved with company management when necessary, for example, when they are concerned about a company's board structure. Besides, they should evaluate and report on the outcomes of their shareholder activism.[33]

However, they warn that shareholder activism should be practiced with caution. In particular, mechanism should be put in place to regulate potential conflict of interest

[31] See also the case of *Gundelfinger v African Textile Manufacturers Ltd* [1939] AD 314 in which this principle was upheld.

[32] A shadow director is defined as a person who is not validly appointed as a director, but accustomed to act in accordance with the instructions of a director. Institutional investors who are actively involved in the management of a company are afraid that they could be seen as shadow directors and hence be subject to the duties of directors. *Cf* The definition of a 'director' under section 3 of Kenya's Companies Act 2015 to include '(a) any person occupying the position of a director of the body(by whatever name the person is called)' and (b) '*any person in accordance with whose directions or instructions (not being advice given in a professional capacity) the directors of the body are accustomed to act*.' (Emphasis added)

[33] See also Christine Mallin, Corporate Governance (4th edn, Oxford University Press 2012)82.

such as dominance by a large shareholder or significant group of shareholders at the expense of the other shareholders, so as to ensure and maintain objectivity.

Olufemi Amao and Kenneth Amaeshi, in their study *Galvanizing Shareholder Activism*,[34] offer an African twist to the shareholder activism story. They acknowledge that shareholder activism has been largely neglected or ignored in the few available studies on corporate governance in Sub-Saharan Africa. The writers then attempt an examination of shareholder activism and offer what they call 'strategic opportunities associated with shareholders' empowerment.' Amao and Amaeshi trace the doctrine of separation of management from shareholders[35] in Africa back to British colonial rule and the subsequent introduction of common law rules in Nigeria (as in Kenya).

They further report that shareholder association and block voting is taking root in Nigeria as a mode of exercising minority shareholder vigilance against dominance by majority shareholders.[36] The emergence of these associations has led to shareholders challenging actions of management, oppose accounts published by management and reject mergers in court.[37]

Amao and Amaeshi conclude that 'if properly channeled, shareholder activism is a potential force for shaping the direction corporate decision making takes.'

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[34]Olufemi Amao and Kenneth Amaeshi, 'Galvanising Shareholder Activism: A Prerequisite for Effective Corporate Governance and Accountability in Nigeria' [2008] 82(1) Journal of Business Ethics 119-130.

[35] See the case of *Aron Salomon* v *Salomon & Company Limited* (1897) AC 22.

[36]*Lucian Bebchuk(n 20 at 17).*

[37]*Lucian Bebchuk(n 20 at 20)*. See also for instance the Cadbury Nigeria Plc suit by investors over accounting. See Tosin Sulaiman, 'Cadbury Nigeria sued by investors over accounting ' (The Times, 12th March) <http://www.thetimes.co.uk/tto/business/industries/consumer/article2166760.ece> accessed 11 May 2016.

The Australian Parliament, in a report of a Joint Committee on Corporations and Financial Services published in 2008[38], aptly summarises the traditional model of corporate governance and shareholder involvement, viz, that company directors are responsible for overseeing the direction and management of the company. Further, the report notes, although shareholders may have such powers as that of amending the company constitution, in reality this power is exercised by the board and implemented by company management under the guidance of the Chief Executive Officer.

The Committee however reports that shareholder participation and engagement is crucial as the means by which 'shareholders are able to improve the value of their share ownership and minimise risk.'[39]Importantly, in an instance that seems to promote shareholder activism, the report indicates that the annual general meeting as an opportunity for shareholders to raise issues, question the board and express views on company performance has limitations.

In an independent report on *New Age of Shareholder Activism*,[40] Javier Castellanos, Gabriel Craft, Erick Goihman, Brandon Meloche, Erica Sivertson, and Tim Zepp attempt to track the historical development of shareholder activism in the United States. Tracing its origin in the Securities Exchange Act of 1934 which established the Securities and Exchange Commission (SEC) and thus marking the first instance of shareholder protection in publicly traded companies. Initially, if shareholders were dissatisfied with a company's strategy, corporate governance or executive compensation, they would simply exit the company by selling their shares.[41]

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[38] Commonwealth of Australia, 'Better shareholders – Better company Shareholder engagement and participation in Australia' [2008] Parliamentary Joint Committee on Corporations and Financial Services, Australia Parliament, Canberra.
[39]*Commonwealth of Australia (n 38 at 4)*

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[40] Javier Castellanos *et al*, 'New Age of Shareholder Activism: Description, Analysis and Prescriptive Recommendations for Executives and Directors' [2015] Independent Study Project Report, Michigan Ross School of Business. Sponsored by Adjunct Professor Dr. William K. Hall

[41] This was known as the 'Wall Street Walk.'

In the 1970's there came a second phase of shareholder activism characterized by 'corporate raiders.'[42]Then came the age of the 'white knights' in the 1980's.[43]

Javier Castellanos *et al* indicate that modern shareholder activism involves acquiring a small stake in a company (usually 3-10%), and then attempting to influence management to adopt the shareholder's proposals. This type of activism is encouraged by at least two factors. One, tactics employed by management and boards to fight activism in previous decades fell out of favour with institutional investors and thus limiting the barriers to entry for activist interventions. Two, various economic events (including corporate scandals and financial crises) have changed the public perception of the company and capitalism in general.[44]

On the question why shareholder activism is on the rise, they give a simple answer: 'because it works.' Besides, academic studies support the theory of shareholder activism.[45]They do not stop there though. They go ahead and ask why activism works and then give these answers: divergence of interests between shareholders and managers.

For example, managers may pursue projects or acquisitions that interest or benefit them personally but do not necessarily maximize shareholder value; difference in risk appetite between shareholders and managers- while most shareholders have the ability to treat their investment in a company as one of a diverse range of investment holdings, the typical manager's/director's livelihood and interest is more

[42] These were, mostly individual, investors who upon identifying a company that was underperforming would buy majority shareholding in the company and use that position to replace management or force the company to implement their strategic proposals.

[43]*Supra* note 22 at 13. In contrast to the Corporate Raider, this involved leveraged buyout ('LBO') companies who often chose to side with management to take a troubled company private, make necessary operational changes, and then re-emerge leaner and more.

[44] See also for instance major instances in which the public has vilified corporate practice, most notably the 'Occupy Wall Street' Movement in the US in 2011.

[45]*Stephen Bainbridge (n 22 at 17).*

concentrated in the company they are managing; and asymmetry of information between shareholders and managers- this limits the ability of shareholders to effectively monitor management performance. The writers conclude that 'shareholder activism is here to stay and likely to continue its rise, so long as the macroeconomic and policy conditions allow it.'

Professor Kiarie Mwaura acknowledges the need to protect investors from potentially harmful conduct by those in a position to influence decision-making in a company.[46] This protection may be achieved by the adoption of a system that guarantees equitable treatment of all shareholders, including minority shareholders. Professor Kiarie, however, notes that while international standards require that shareholders be able to commence and maintain lawsuits whenever their rights are infringed, the same standards require that such lawsuits be checked to avoid excessive litigation.

Importantly, he recognizes that the existing regimes (both common law and statutory) offer inadequate protection to shareholders.[47] He reckons that 'the lack of sufficient control or judicial intervention in the internal management of companies could deprive both the minority investors and the company of their rights and profits.'

The literature reviewed reveals that there is need to ensure protection of shareholders from directors and managers who might not have the shareholders' best interests at heart. Further, there is a debate on the merits and demerits of shareholder activism. Proponents and opponents of the concept and practice of shareholder activism have emerged with opposing views on the suitability of the same. There however appears to be general consensus that the idea has both a positive and negative impact on not only corporate governance of companies but

[46]Kiarie Mwaura, 'The plight of minority shareholders under the Companies Bill 2010: Oppressed or simply abandoned and forgotten?' *University of Nairobi Law Journal* 2012.

[47] It will be noted that Professor Kiarie was writing before the Companies Act 2015 was enacted.

also the main aim of every company; maximization of profits and, therefore, shareholder wealth.

This literature will form the beginning, but not the end, of wisdom in this proposed research. The author will use it to assist in conducting a critical analysis in pursuit of its objectives and in answering the research questions. However, there is a gap in this literature in that efforts are yet to be actively and adequately undertaken to measure the extent of these benefits and costs and the extent to which they influence the growth of companies and corporate governance in particular and more so in Kenya. Besides, strategies for improvement of the efficacy of this principle are yet to be explored conclusively, if at all. Filling this gap is the niche that this research proposes to occupy.

1.9 Chapter Outline

The research paper has been broken down into the following five chapters.

1.9.1 Chapter One: Introduction

Chapter one begins with a background to the study. It then states the problem statement and demarcates the scope and objectives of the study. It also identifies the research questions, the hypothesis and limitations of this study. Finally, it covers the theoretical framework, research methodology and literature review.

1.9.2 Chapter Two: Historical Background to Shareholder Activism

Chapter two critically analyzes the historical background to shareholder activism and discusses the nature of shareholder activism. It also examines the theoretical basics that provide the legitimacy for shareholder activism in corporate governance. This theoretical framework is then opened to critical legal debate, which will aid in assessing the utility of shareholder activism in Kenya.

1.9.2.1 Chapter Three: Shareholder Activism and Protection of Minority Shareholders in Kenya

In Chapter Three the study will critically explore the provisions in Kenya's corporate law embodying the protection of minority shareholders especially in public companies in order to identify the problems associated with application of the concept of shareholder protection in its current form. It will then investigate the role of shareholder activism, especially minority shareholder activism, in protection of shareholders' rights including the right to a profitable business.

1.9.3 Chapter Four: Shareholder Activism in the United States of America

This chapter will be a comparative study of shareholder activism in the United States. It will cover not only the relevant laws in the US but also a study of corporate governance practice and the role of shareholder activism therein. Towards the end of the chapter, lessons drawn from this comparative study will be summarised.

The author chose to study the United States of America for the following reasons:

a. The US offers a wide collection of activism models. These range from activism by savvy, informed investors, to activism by individual shareholders, to activism by groups of shareholders. This variety would very well serve the Kenyan corporate governance scenario;

b. The motives behind shareholder activism differ. Unlike the UK where shareholder activism is mainly for economic gain, the US has demonstrated on numerous occasions that it is possible for shareholder activism to be for social agendas like improving corporate social responsibility. This model can be utilised in Kenya to push companies away from such evils as reckless dumping, destruction of public infrastructure and political partisanship;

c. Shareholder activism in the US is event-triggered. Put differently, shareholder activism often results from events such as corporate scandals and economic suppression of shareholders. This sharply contrasts countries such as the UK where shareholder activism is a repeated constant occurrence. For this reason, and taking Kenya's circumstances into account, the US model has the potential to chock corporate scandals, fraud, insider trading, incompetence and incidences of corporate mal-administration while at the same time avoiding constant shareholder-management wrangling that has the potential to cripple entire companies; and

d. Finally, the US has a long and well documented history with shareholder activism and empowerment.

1.9.4 Chapter Five: Conclusions and Recommendations

Chapter five will sum up the conclusions of the study and make recommendations on how Kenya can beneficially apply the concept and practice of shareholder activism to improve not only shareholder protection but also the general corporate governance practice in the country.

CHAPTER TWO
HISTORICAL BACKGROUND TO SHAREHOLDER ACTIVISM

2.0 Introduction

In this Chapter, the author attempts to conceptualise the term 'shareholder activism' in relation to shareholder value. As part of a brief description of the theoretical basics that inform the motivation for activism among shareholders, the author looks at the potential benefits of shareholder activism.

Besides, the Chapter outlines the history of shareholder activism by tracing its origin in the United States of America in the early twentieth century and subsequent development around the world up to its current nature, which, arguably, revolves around minimising shareholder-director agency costs.

Towards the end, the author analyses the status of shareholder empowerment in Kenya, giving a brief status of corporate governance in Kenya in relation to shareholder activism and empowerment.

2.1 Conceptualising Shareholder Activism

At this stage, it is important to answer the question: what is shareholder activism and who are shareholder activists? These twin concepts are wide, complex and potentially confusing. Any attempts at offering a comprehensive and conclusive definition of them are not only pretentious and ambitious but will be met with obvious frustration. This is because, while attempting such a feat, one is likely to be influenced by own bias as well as the conditions prevailing in a particular country or sector of study.

Indeed, different scholars on corporate governance have attempted to answer the question, coming up with different answers. Chee Keon Low describes shareholder activism as 'the exercise and enforcement of rights by minority shareholders with the objective of enhancing shareholder value over the long term.'[48]

Notably, Chee limits his definition to only one type of shareholder activism namely, minority shareholders' activism. As will be seen in subsequent parts of this study, there are several types of shareholder activism.

Maria and Lori on the other hand define shareholder activism as actions taken by shareholders with the explicit intention of influencing corporations' policies and practices.[49] Admittedly, their purpose for this definition is to distinguish acts of shareholders that may be regarded as deliberately focused on influencing corporate policy from what the writers call 'latent intentions implicit in ownership stakes or trading behaviour.'

The prevailing definition, and which will be adopted for purposes if this paper, seems to be that shareholder activists are investors who are dissatisfied with the company's management and governance and therefore take active steps to effect change in the management and control of the company.[50] Consequently, shareholder activism includes all active steps taken by shareholder activists in order to correct what they believe to be wrong in the management of the companies in which they invest.

While this definition is easy to comprehend and effectively captures the concept of shareholder activism, it is noted that a clear and comprehensive conceptualisation of the term needs much more than that. Shareholder activism is an entire phenomenon. It could be viewed as a continuum of factors with, at one extreme end,

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[48]CheeKeong Low, 'A Road Map for Corporate Governance in East Asia' [2004] 25 *Nw. J. Int'l. Bus. Law* 165, 185-86.

[49] MariaGoranova and Lori Verstegen Ryan, 'Shareholder Activism: A Multidisciplinary Review' [2014] *Journal of Management* 67.

[50]*Stuart L. Gillan and Laura T. Starks (n 2 at 5)*. See Brian R. Cheffins, *The History of Corporate Governance* (Oxford University Press 2011).

shareholders who simply take an active role in company affairs (such as attending and voting at meetings) and on the other end shareholders who are interested in corporate control and therefore initiate takeovers and overhaul entire boards.

In between these two extremes are several variables of shareholder activism, for instance 'block holders' are minority shareholders who purchase minority stake and gradually accumulate shares in the company with an intention to influence decision-making. On the other hand, there is what is known in the US as 'the Wall Street walk'-whereby dissatisfied shareholders simply sell their shares and exit the company. Indeed, studies have shown that the latter practice can have disciplinary effects on companies leading to improved governance practices.[51]

Shareholder activism can be either offensive or defensive in nature. Defensive activism refers to a scenario where shareholders with a pre-existing shareholding in the company in question become dissatisfied with the management of the company and react by lobbying for changes. This may be done 'behind the scenes' or publicly for instance by demanding changes in directorship.

A shareholder acting in this sort of defensive manner will typically not own enough shares to secure boardroom control or dictate corporate policy, but will be able to use their stake as an important departure point in garnering support for the changes they advocate.[52]
An important feature of defensive activism is what is known as 'initial endowment'.[53] In other words, the activist must already have a sizeable stake in the

[51]*Ibid.*

[52]John Armour and Brian Cheffins, 'The Rise and Fall (?) of Shareholder Activism by Hedge Funds' [2009] Law Working Paper N°.136/2009, European Corporate Governance Institute Working Paper Series in Law. (Incorporating feedback received at various seminars and conferences held at Havard Business School, Vanderbilt Law School, the University of Virginia Law School, and Wharton Business School).

[53]For a deeper description of this term, see *John Armour and Brian Cheffins (n 23 at 3).*

company whose value s/he now seeks to defend by seeking correctional changes in management of the company.

Offensive shareholder activism on the other hand occurs where an investor, or investors, with a small stake in the company actively and purposively build up their ownership stake. In doing so, they assume that changes will be made to rectify past failures and intend to actively agitate for management changes in order to maximise their returns.[54] Put differently, offensive shareholder activists are basically minority shareholders who gradually increase their ownership portions in the company with a view to agitating for changes in the company's management in future.

It is important to distinguish offensive shareholder activists from what is known, especially in the US, as 'vultures'. Offensive shareholder activists must of necessity be pre-existing shareholders, albeit minority, of the company. Vultures on the other hand are, usually investment funds, funds which are not shareholders of the company but suddenly purchase a big number of equity or debt securities of the company with a view to effecting changes in management of the company and, occasionally, taking over the company.[55]

What comes out clearly from the foregoing is that dissatisfied shareholders have two options: sell their shares and exit the company or hold on to their shares and take steps to effect changes in the control and management of the company. This research paper concerns itself with this latter group of shareholders. In particular, this chapter looks at the options available to dissatisfied shareholders who choose not to sell their shares. In doing this, the author looks at the history and practice of shareholder activism around the world, with specific focus on the United States of America, and in Kenya.

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[54]*John Armour and Brian Cheffins (n2)*.

[55]For a better and more detailed understanding of vulture funds, see generally Thomas H. Noe and Michael J. Rebello, 'Reputation and the Market for Distressed Firm Debt' [2003] 38 *J. Fin. Quantitative Analysis* 503, 504-5. See also Mike Spector and Jeffrey McCracken, 'Distressed Takeovers Soar' *Wall St. J.* [Aug. 11 2009].

More importantly, the author will refer to the term shareholder activism as any instance where any shareholder, or group of shareholders, uses any of their rights under the law or the company's constitution to enhance value for their investment in the company. In other words, the term 'shareholder activism' will refer to the idea that investors or shareholders should and do influence the day-to-day running or management of companies in which they invest. This is achieved ideally through strategic and deliberate voting, but also through direct participation in appointment of directors and hiring of senior managers as well as speaking out (including calling press conferences) to influence company policy and decision-making.[56]

2.2 Motivations for shareholder activism

Shareholder activism is, at a basic level, an attempt to maximise the potential gains of addressing the age-old conflict between company ownership and management. In public companies, for instance, shareholders effectively delegate decision-making responsibility to managers whose interests can diverge from those of shareholders.[57] Around the world, company law enjoins directors to act in the best interests of shareholders and the company in general. In Kenya for instance, section 143 of the Companies Act[58] states in relevant part that:

'A director of a company shall act in the way in which the director considers, in good faith, would promote the success of the company for the benefit of its members as a whole.'

Having this in mind, directors have wide powers including influencing the hiring, firing, compensation and monitoring of top management. This means that the directors not only control the company but also its success and overall performance. The demand for shareholder activism comes when directors fail to perform their

[56]See generally George Kinyua, 'It's Our Money!"Shareholder Activism and Vigilant Investing' Mboya Wangong'u &Waiyaki Advocates website http://www.lexgroupafrica.com/its-our-money-shareholder-activism-and-vigilant-investing/ accessed 14 July 2016.

[57] Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' [1976] *Journal of Financial Economics* (3)4.

[58]Act number 17 of 2015.

duties in accordance with the duty to promote the success of the company for the benefits of shareholders.

It may be argued that, especially for listed companies, shareholder activism may not be necessary, as the quality of management of a company will be reflected in the share prices. As Bengt Holmstrom and Jean Tirole have argued, the stock market may be the most reliable monitor of managerial performance because stock prices incorporate a variety of information about future performance and value that cannot be found in financial statements alone.[59] This means that, since listed shares are freely tradable, if a shareholder notices a drop in the price of shares that is attributable to poor management, they may easily sell their shares and exit the company or hold fewer shares. However, this argument is flawed in at least one way; it fails to take into account shareholders who may not want to exit the company for one reason or another.

As Macey has put it, 'savvy investors' will generally decline to invest in poorly performing companies.[60] It is cheaper and more efficient for an investor to avoid investing in poorly performing companies. If they have already invested in such companies, it would be understandable if they 'voted with their feet' or took 'the Wall Street walk'. A few questions therefore quickly come to the mind of a student of corporate governance and investment law, *viz*:

a. What motivates an investor to step forward and agitate for changes in the management of the company in which s/he invests?

b. Given the time, financial, reputational and other costs of shareholder activism, how is it that investors would perceive that its benefits outweigh such costs? For instance, an offensive activist shareholder who targets a

[59]Bengt Holmstrom and Jean Tirole, 'Market Liquidity and Performance Monitoring'[1993] *Journal of Polictical Economy* (101)4 at 26.

[60]Jonathan Macey, *Corporate Governance: Promises Kept, Promises Broken* (Princeton University Press 2008) 241 - 247.

particular company in a particular sector of the economy like, say tele-communication, foregoes the benefit of spreading of risk[61] necessarily available to passive, diversified investors.

While these are complex questions answerable only by the investors themselves, the author argues that there are at least three benefits of shareholder activism. These benefits, the author believes, are even more profound in countries like Kenya where corporate governance is at its formative stages.

First and most obvious is the potential increase in value of shares occasioned by better management of the company as a direct or indirect result of activism by shareholders. Combined with this is the resultant increase in dividend returns consequent on the company becoming more profitable due to an improvement in its corporate governance. These twin benefits are available to all investors of the company, regardless of whether they participated in the activism efforts or they remained passive while their colleagues actively agitated for change.

To fully understand this argument, one must keep in mind Henry Manne's theory of corporate control that there is in fact a 'correlation between corporate managerial efficiency and the market price of shares of that company.'[62]What this means is that, at least for public companies, a highly effective board of directors will result in more valuable shares and, consequently, more wealth for the shareholder.

Secondly, there are private benefits[63] to be gained by the activist. A quick example comes to mind. One of the aims of, at least some, activists is to gain some control over decision making by the company's board. It is a known concept of corporate law that directors, sitting in the board of directors, have the power to make decisions

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[61] See generally Steven Huddart, 'The Effect of a Large Shareholder on Corporate Value" [1993] 39 Management Science 1407, 1407, 1413, 1415. See also Ian Ayres and Peter Cramton, 'Relational Investing and Agency Theory' [1994] 15 *Cardozo L. Rev.* 1033at 1037

[62]Henry G. Manne, 'Mergers and the Market for Corporate Control' [1965] Journal of Political Economy (73)2 110-120.

[63]The author calls them private for they are not necessarily shared with non-activist shareholders of the company.

on strategy and investment on behalf of the company. Therefore, a shareholder(s) who gains control over the board of directors therefore has immense power on the direction the company takes, including the power to prompt the company to enter into particular transactions that confer private benefits to the activist.[64]

Thirdly, shareholder activism and empowerment has the potential to solve the age-old problem of incompetent and disinterested directors acting contrary to shareholders' interests. The current corporate governance practice world-wide encourages separation of power and functions between the board and shareholders, giving corporate policy and decision-making power almost exclusively to the former.

Inevitably, giving directors this kind of power presumes that directors will act in the best interest of the shareholders or investors.[65] The sad truth is that many times they do not. Acting in self-interest, and sometimes fraudulently, directors have been known to not only make reckless and misadvised corporate decisions but also misappropriate large amounts of company funds leading to huge losses to shareholders' capital and profits.

While incompetence of directors may contribute to this state of affairs, the author argues that the main cause of the same is what Adam Smith set out as the problem facing corporate governance practice thus:
'The directors of such [limited] companies ..., being the managers rather of other people's more than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion,

[64]*John Armour and Brian Cheffins(n23 at 10).*
[65]Indeed, the law requires directors to act in the best interests of shareholders. See section 143 of the Companies at 2015.

therefore, must always prevail, more or less, in the management of the affairs of such a company.'[66]

Besides, directors may not be sensitive to (and will often ignore) shareholders', especially minority shareholders', intellectual input in corporate policy and decision-making.[67]

These twin problems namely: director disinterest or indifference towards shareholders' economic interests; and directors' insensitivity to shareholders' opinions and input in corporate governance are the exactly what shareholder activism is intended to address.

At this point, a cautionary note is important. Shareholder influence can, if exercised excessively and recklessly, in fact hurt rather than benefit shareholders or the company as a whole. It is important to balance the interests of shareholders on the one hand with the need to ensure that the board and management are allowed

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[66] Adam Smith described the problem best. See Adam Smith, *Wealth of Nations* (1st edn, Methuen & Company Limited 1776), 575.

[6767] Indeed, the author argues that how sensitive the Board is to shareholder input will usually depend on how easily the shareholder(s) in question can vote them out. This will become a little more obvious in cases of directors appointed under the auspices of influential shareholders, and who will normally have pledged exclusive loyalty to those shareholders. It is precisely for this reason that proceedings at Annual General Meetings in Kenyan public companies have been aptly described thus:

> …10 minutes to the start, the board is whisked in and head straight to the stage. The meeting commences with the formal proceedings and voting followed by brief remarks from the chief executive and chairperson. After 4 minutes of shareholder feedback and questions, the meeting ends. … The board is happy with the level of engagement. On the other side, the minority shareholders, who seem to be the only investors with time to attend these meetings, are satisfied with the dividend announcement and free merchandise; and if either were unsatisfactory, well, there's always next year.
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> See Nuru Mugambi, 'Why firms should encourage investor activism at AGMs' (Business Daily Africa, 27 September 2015) http://www.businessdailyafrica.com/Opinion-and-Analysis/-/539548/2887600/-/139bs3fz/-/index.html accessed 11 May 2016.

enough leeway to exercise their power and perform their functions under the law and the constitution of the company for the benefit of the company.[68]

It is for this very reason that Professor Bebchuk[69]advises that even as shareholders get empowered, management can still make recommendations to shareholders, given that the former may have superior expertise and information which might otherwise be unused if shareholders make all major decisions. He insists that 'paternalistic hand-tying' is unlikely to benefit shareholders or the company as a whole.

2.3 Brief history of shareholder activism

Shareholder activism may be traced back to the 1900's United States. In the early 1900's, American financial institutions actively participated in corporate governance of companies in which they invested. However, certain Securities Laws were enacted[70] which limited the power of these shareholders and thus their role in governance.[71]Later in 1942, the US Securities and Exchange Commission passed a rule(the predecessor to the current Rule 14a-8) which enjoined companies to include shareholders' proposals in proxy statements and to put such proposals to a vote in the company's general meetings.[72]This rule effectively gave birth to shareholder activism in the United States of America.

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[68]The Author reminds the reader of section 143 of the Companies Act 2015 which obliges directors to promote the success of the company for the benefit of all shareholders and not just the most influential or the most outspoken.

[69]*Lucian Arye Bebchuk*(n44).

[70]These included the Securities Act of 1933, the Securities Exchange Act of 1934 which created the SEC and the 1935 Public Utility Holding Company Act which did away with holding companies more than twice removed from the utilities whose stocks they held.

[71]Stuart L. Gillan and Laura T. Starks, 'The Evolution of Shareholder Activism in the United States'[2007] 19(1) Journal of Applied Corporate Governance 3. http://ssrn.com/abstract=959670 accessed 13 September 2016.

[72]United States Government Publishing Office, 'Proxy Proposals'https://www.gpo.gov/fdsys/pkg/CFR-2013-title17-vol3/pdf/CFR-2013-title17-vol3-sec240-14a-8.pdf on 15/08/2016accessed 18 August 2016.

In the subsequent three decades, shareholder activism was characterised by individual investors.[73]This kind of shareholder activism, otherwise known as entrepreneurial activism[74], generally involves activism by individual shareholders who act individually and not on behalf of, for instance, hedge funds or other corporate investors. The wave went through several wavelengths, eventually culminating in the current version of shareholder activism, which is the interest of this paper.

Since its inception, shareholder activism has not only grown in frequency, prevalence and magnitude but it has also evolved from incidences of individual majority shareholders targeting small, poorly performing companies to large groupings of shareholders making their presence known in big public companies.[75]

Today, shareholder activism revolves around what has been referred to as the principal corporate governance problem, *viz*, minimising shareholder-director-agency costs.[76] The focus is to provide a mechanism for transforming *de jure* shareholder power into *de facto* corporate control.[77]

2.4 Shareholder activism in Kenya

As elaborated in previous parts of this Chapter, today's focus for scholars on shareholder activism, and corporate governance in general, is to provide a mechanism for transforming *de jure* shareholder power into *de facto* corporate

[73]*Stuart L. Gillan and Laura T. Starks (n 2 at 3).*

[74]See generally Prof. Didier Cossinand Dr. Jose Caballero, 'Shareholder Activism Background Literature Review' [2013] International Institute for Management Development.

[75]Bloomberg, 'The Evolution of Shareholder Activism' (Bloomberg, 20 February 2015).http://www.bloomberg.com/professional/blog/shareholder-activism/ accessed on 14 August 2016.

[76]See generally Magdalena Jerzemowska, 'The Main Agency Problems and Their Consequences' [2006] ActaOeconomicaPragensia(2006)1 9-17. See also John Armour, Henry Hansmann and Reinier Kraakman, 'Agency Problems, Legal Strategies and Enforcement' [2014] *Harvard John M. Olin Center for Law, Economics, and Business Discussion Paper* No. 644.

[77]John C. Coates, 'The Contestability of Corporate Control: A Critique of The Scientific Evidence' [1999]Harvard Law School Cambridge Discussion Paper No. 265.

control. In other words, the aim is to transmute the rule that shareholders, being the company's proprietors or owners, are the ultimate decision makers in a company into a mechanism by which those shareholders can practically influence day-to-day corporate decision-making while maintaining the statutory balance of power between shareholders on one hand and directors on the other.

In many countries around the world, including the US and Kenya, shareholder litigation has become an important tool for delivering this mechanism, not in the least by delivering compensation to injured shareholders as well as preventing and deterring directors and managers from using their power for their own selfish interests.[78]

In Kenya, shareholder activism is not as old as is in the US or other Western countries. Indeed, some commentators have argued that shareholder activism is virtually non-existent in Kenya and East Africa in general.[79]However, this view might have been informed by the fact that the very concept of shareholder activism in Kenya is not only poorly documented but also not as popular as it is in developed countries. Thus, commentators and reporters may not recognise that certain actions taken by shareholders of Kenyan companies actually fall within the definition of one form or another of shareholder activism.

Indeed, Kenya has recently experienced some degree of shareholder activism with varying levels of success. Shareholders, especially of listed companies, have come of age and no longer want just to hold shares and wait for annual dividends but to

[78] Dan W. Puchniak, 'Multiple Faces of Shareholder Power in Asia: Complexity Revealed' [2014] Working Paper 2014/005, National University of Singapore. See also Brian R. Cheffins and Bernard S. Black, 'Outside Director Liability Across Countries' [2006] Texas Law Review (84) 1385-1480.

[79]Jacob Gakeri, 'Enhancing Kenya's Securities Markets through Corporate Governance: Challenges and Opportunities' [2013] International Journal of Humanities and Social Science 3(6)94-117 at 114.

participate in and influence the way the companies they invest in are run and managed.[80]

While there have been a few instances of shareholders in Kenya making the 'Wall Street Walk',[81]shareholder activism in Kenya has mainly taken two forms. Firstly, shareholder protests at general meetings with complaints ranging from low dividend pay-outs by Kenya Airways shareholders despite increased profits in the company[82] to corporate mismanagement and non-payment of dividends by Uchumi Supermarkets shareholders.[83]In the latter instance, shareholder activism triggered the chain of events leading to a re-structuring of the company. [84]

Secondly, certain shareholders have actively increased their shareholding in the companies they invest in with a view to changing, first, the way companies are managed and, second, corporate policy including environmental and social policy. For instance, a previously minor shareholder in Kakuzi Limited was recently reported to be gradually but significantly raising his shareholding in the company with a view to influencing the treatment of squatters on the company's farms.[85]

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[80]Kimathi Njoka, 'Dawning of the Age of Shareholder Activism' *The East African* (Nairobi, 20 December 2004).

[81]See for instance Victor Juma, 'Kidero exits list of Uchumi's top individual shareholders' *Business Daily Africa* (Nairobi, 5 April 2015).

[82]*Kimathi Njoka, 'Dawning of the Age of Shareholder Activism' (n 33).*

[83]*Ibid.*

[84]Shareholder activism was also witnessed when Equity Bank bought shares in HFCK. Activism on the part of Equity was utilized to change the Board ofHFCK. See Cyrus Ombati and James Anyanzwa, 'Shake-up due in HF board following chairman's exit' Standard Digital (Nairobi April 8, 2010) http://www.standardmedia.co.ke/article/2000007207/shake-up-due-in-hf-board-following-chairman-s-exit/?pageNo=1 accessed November 7 2016.

[85]Victor Juma, 'Billionaire squatter raises stake in Kakuzi to 25 per cent'(Business Daily Africa, 6February 2015).

Besides, statutory shareholder empowerment and protection, which is the predecessor to, or at least a close relative of, shareholder activism, has been enhanced over the years. Indeed, the repealed Companies Act,[86] which came into force on 1st January 1962, gave shareholders several significant powers including:

a. The power to requisition a general meeting;[87]
b. The right to demand a poll at a general meeting on any question;[88]
c. The right to requisition circulation, at the company's expense, circulation of notice of any resolutions proposed to be voted on in the next general meeting;
d. The right to inspect the company's minute book at any time during business hours at no charge and to be furnished, within 14 days after requesting so, with a copy of the minute book;[89]
e. The right to receive the company's accounts in annual general meetings;[90]
f. The power to apply to court for an investigation to be carried out on the affairs of the company;[91]
g. The power to remove a director before the expiration of his period of office notwithstanding anything in the articles or in any agreement between the company and such director[92]
h. More significantly, section 211 of that Act allowed any shareholder who felt that the affairs of the company are being conducted in a manner that is oppressive to some shareholders to apply to the High Court to make an appropriate order including an order:

'…. regulating the conduct of the company's affairs in future, or for the purchase of the shares of any members of the company by other members of the company or by

[86]Chapter 486 Laws of Kenya.

[87]Section 130.

[88]Section 137.
[89]Section 146.
[90]Section 148.
[91]Section 165 ff.
[92]Section 185.

the company and, in the case of a purchase by the company, for the reduction accordingly of the company's capital, or otherwise.'[93]

Notably, the above provisions went short of sufficiently protecting shareholders against acts and practices by directors and managers that were against their interests. It is perhaps with this state of affairs in mind that the following pieces of legislation have recently been passed, *viz*:

a. The Companies Act 2015 together with the Companies (General) Regulations 2015; and
b. The Code of Corporate Governance for Listed Companies 2016

These latter pieces of legislation will be analysed in detail in subsequent chapters of this paper. It is, however, important to note here that they represent significant steps towards shareholder empowerment in Kenya and facilitation of shareholder activism. More importantly, they give directors of companies rather strict duties and responsibilities and heavily penalise errant directors. For instance, the Companies Act imposes the following duties on directors of companies:

a. The duty to avoid situations in which the director's interests conflict or may conflict with the interests of the company; with regard particularly to exploitation of property, information or opportunity;[94]
b. The duty to declare interest in a proposed or existing transaction of the company;[95]and
c. Duty to seek and obtain shareholders' approval to significant transactions of the company including:

i. Substantial property transactions[96]which include; transactions where a director of the company or of its holding company acquires or is to acquire from the company a substantial non-cash asset (section 158); or where the company acquires or is to

[93]Section 211 subsection 2.
[94]Section 146.
[95]Section 151.
[96]Section 158.

acquire a substantial non-cash asset from a director (section 158).[97] Transactions or arrangements entered in contravention of these provisions are **<u>voidable at the instance of the company.</u>**

ii. Loans, quasi-loans, or guarantees to directors of the company or of its holding company (section 164). If the director is a director of the company´s holding company, the transaction also needs to have been approved by a resolution of the members of the holding company.

iii. Security guarantees in favour of any person with regard to a loan given by such person to a director of the company or of its holding company (section 164);

iv. With regard to public companies, quasi-loans to directors of the company or its holding company and security guarantees with regard to such quasi-loans (section 165).

v. Directors' long-term service contracts: These are service contracts where the director's employment is guaranteed for a period exceeding, or that could exceed, 2 years (section 157);

vi. Credit transactions by public companies: A company may not enter a credit transaction as creditor or guarantor for the benefit of its director(s) or a director(s) of its holding company unless the transaction has been approved by shareholders (section 167);

vii. Payments to directors as compensation for loss of office (section 182).

2.5 Shareholder Activism and Corporate Governance in Kenya

Despite attempts at corporate governance reform[98], corporate accountability has remained both an elusive and a moving target. Consequently, shareholder activism (both in its traditional form as well as in the modern form as shareholder lawsuits) has been on the rise[99] both in Kenya and in other countries around the world.

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[97]For these purposes, an asset is a substantial non-cash asset if its value exceeds 10% of the company's asset value and is more than Kshs. 5,000,000 or exceeds Kshs. 10,000,000.

[98]In Kenya, for instance, the most significant attempts are personified in the appointment of a taskforce to reform corporate law in the early 2000's, culminating in various Bills that have eventually resulted in the Companies Act 2015.

[99] See Stuart Gillan and Laura T. Starks, 'The Evolution of Shareholder Activism in the United States' [2007] *Journal of Applied Corporate Finance* (19)1 55-73. See also Maria L. Goranova and Lori Verstegen Ryan, 'Shareholder Activism: A Multidisciplinary Review' [2014] *Journal of Management* 40(5) 1230-1268. See also Renzo Comolli andSvetlana Starykh, 'Nera Economic Consulting' (Recent Trends in

Corporate governance is inextricably tied to shareholder empowerment (and subsequent activism).Indeed, the very definition of corporate governance as 'roles, responsibilities, and balance of power among executives, directors, and shareholders'[100] hinges on the question of corporate power and its distribution and use.

Shareholder activism, on the other hand, focuses on ensuring not only that directors do not misuse that power but also that the shareholders, as business owners, get to exercise some of it for the good of their business.

Recently Kenya's Capital Markets Authority published a Code of Corporate Governance for listed companies which require such companies to adopt standards that go beyond the minimum prescribed by legislation with regard to management of companies and maximisation of shareholder value. Among these recommendations are requirements that:

a. Information relating to persons nominated for Board positions be availed to shareholders in advance of any decision making. Besides, as the information is disseminated, the Company should ensure the use of a wide variety of communication channels so as to cater for shareholders' diverse media consumption habits[101];

b. Appointments to the Board be subject to shareholder approval[102];
c. Persons proposed by shareholders, including majority shareholders, for appointment to the Board be considered for such appointment[103];

Securities Class Action Litigation, 2014)http://www.nera.com/publications/archive/2015/recent-trends-in-securities-class-action-litigation--2014-full-y.html>accessed 23 August 2016.

[100]Lori Verstegen Ryan, Ann K. Buchholtz and Robert W. Kolb, 'New Directions in Corporate Governance and Finance: Implications for Business Ethics Research' [2010] *Business Ethics Quarterly* (20)4.
[101]Guideline 2.1.1.(a).
[102]Guideline 2.1.1.(c).
[103]Guideline 2.1.2.(b).

d. In instances where there is no major shareholder but there is a substantial shareholder, the Board should exercise judgment in determining the representation on the Board of such shareholder and of the other shareholders that effectively reflects the shareholding structure of the Company[104];
e. The Board be accountable to shareholders in the exercise of its functions[105];
f. In deciding on the remuneration of executive directors, the company should keep in mind the need to ensure the maximization of the shareholders' value[106]; and
g. The Board shall cause an annual governance audit of the company in order to check on the level of compliance with sound governance practices.
h. Additionally, and perhaps in recognition of Professor Bebchuk's arguments in favour of shareholder empowerment[107], the Guidelines recognise that:
i. 'Shareholder rights and investor protection are key factors to consider when determining the ability of companies to raise the capital they need to grow, innovate, diversify and compete effectively. If the legal and governance framework does not provide such protection, investors may be reluctant to invest unless they become the controlling shareholders. It is critical that the governance framework ensures the equitable treatment of all shareholders, including the minority. '[108]

2.6 Conclusions

Shareholder activism as we know it today has been in the making for more than a century. Today, shareholder activism revolves around what has been referred to as the principal corporate governance problem, *viz*, minimising shareholder-director agency costs. The focus is to provide a mechanism for transforming *de jure* shareholder power into *de facto* corporate control.

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[104]Guideline 2.1.3.(b).
[105]Guideline 2.3.
[106]Guideline 2.9.2.(d).
[107] See Lucian Arye Bebchuk , 'The Case for Increasing Shareholder Power' [2005] 118(1) *Havard Law Review* 833. Professor Bebchuk's arguments are discussed more comprehensively in Chapter One.

[108]Overview to Chapter Three of the Guidelines

In Kenya, the phenomenon is not as old as in the USA or other Western countries. However, the same cannot be said of the concept and practice of shareholder empowerment, which is the predecessor to, or at least a close relative of, shareholder activism. There have been recent legislative enactments that represent significant steps towards shareholder empowerment in Kenya and facilitation of shareholder activism.

Shareholder activism has the potential to disrupt effective management of companies and interfering with the separation of powers between the board of directors and shareholders. However, the author argues that purposive and disciplined shareholder activism has various benefits that far outweigh its potential demerits, not least because it potentially enhances shareholders' returns and boosts public confidence in corporate governance.

Be that as it may, there must be a balance between the need to take to account shareholders' interests and the equally compelling need to have order in the way companies are managed. If this balance can be reached, the benefits of shareholder activism and empowerment are immense not only to individual shareholders but to the company as a whole and, ultimately, to the Kenyan economy.

CHAPTER THREE
SHAREHOLDER ACTIVISM AND PROTECTION OF MINORITY SHAREHOLDERS IN KENYA

3.0 Introduction

In this chapter, the author critically explores the provisions in Kenya's corporate law embodying shareholder protection and empowerment especially in public companies and the extent to which this law permits or inhibits shareholder activism in Kenya. This largely entails an analysis of the new company law regime following enactment of the Companies Act, 2015 vis-a-vis the earlier regime. The aim is to examine the extent to which the Kenyan law protects minority shareholders against the oppressive and otherwise improper conduct of majority shareholders; and shareholders in general against oppressive and otherwise improper conduct of directors.

Thereafter, the chapter examines the adequacy of that protection and, more importantly, offers shareholder activism as a potentially effective supplement to and curative remedy the inadequacies of such protection.

3.1 Shareholder Protection in Kenya

Shareholder protection in Kenya, as in many other common wealth countries, takes the form of shareholder empowerment, which is the predecessor to, or at least a close relative of, shareholder activism. Statutory law in Kenya empowers shareholders by offering them various rights as members of the company.[109]

The, now repealed, Companies Act of 1959[110] afforded shareholders several significant rights which, put together, were meant to enable shareholders safeguard their investment in the company. More importantly, these rights and powers, at least to some extent, provided shareholders with protection against oppressive and other

[109] See Chapter Two of this paper.
[110]Chapter 486 Laws of Kenya

improper conduct of directors and, in the case of minority shareholders, controlling majority shareholders.

Among these rights were:

a. The power to requisition a general meeting; That Act provided in relevant part that:
b. 'the directors of a company, notwithstanding anything in its articles, shall, on the requisition of members of the company holding at the date of the deposit of the requisition not less than one-tenth of such of the paid-up capital of the company as at the date of the deposit carries the right of voting at general meetings of the company, or, in the case of a company not having a share capital, 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, forthwith proceed duly to convene an extraordinary general meeting of the company'[111]
c. If the directors failed to comply with the requisition, section 132 (3) allowed the requisitionists to convene a meeting. This right could be used by shareholders in instances where directors deliberately exclude shareholders from decision-making in the company by refusing to call for general meetings.
d. The right to demand a poll at a general meeting on any question; The Act presumed that members in a general meeting have the right to demand a poll on any issue put to a vote in such meeting. Indeed, section 137 made void any provision in a company's articles that had the effect of excluding this right or its exercise;
e. The right to requisition, at the company's expense, circulation of notice of any resolutions proposed to be voted on in the next general meeting;[112]
f. The right to inspect the company's minute book at any time during business hours at no charge and to be furnished, within 14 days after requesting so, with a copy of the minute book;

[111]Companies Act section 132(1).
[112]Companies Actsection140.

g. The right to receive the company's accounts in annual general meetings. In this regard, the Act obliged directors to, at least once a year, lay before a general meeting the company's financial statements.[113] It is important to note that failure to take all reasonable steps do so amounted to a crime on the part of the directors;[114]
h. The power to apply to court for an investigation to be carried out on the affairs of the company; The Act provided that at least two hundred shareholders or shareholders holding at least one-tenth of the companies issued share capital may apply to court to for inspectors to be appointed to investigate the affairs of a company and to report thereon;[115] and
i. The power to remove a director before the expiration of his period of office, notwithstanding anything in the company's articles or any agreement between the company and such director, unless the director is holding the office for life.[116]
j. More importantly, the repealed Act[117] allowed any shareholder who felt that the affairs of the company were being conducted in a manner that is oppressive to some shareholders to apply to the High Court for an appropriate order including an order regulating the conduct of the company's affairs in future, or for the purchase of the shares of any members of the company by other members of the company or by the company and, in the case of a purchase by the company, for the reduction accordingly of the company's capital, or otherwise.[118]

Besides, the repealed Act made certain conditions that a company had to meet before it could lawfully reduce its capital. Such reduction had to be authorised by the company's articles of association[119]; the company had to pass a special resolution to that effect[120]; and the company had to apply for and get confirmation of the

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[113]Companies Act section 148.
[114]Companies Act section 148(3).
[115]Companies Act section 165.
[116]Companies Act section 185.
[117]Section 211.
[118]See generally section 211 of the repealed Act.
[119]Companies Act section 168(1).
[120]*Companies Act (n 12).*

reduction by the High Court.[121]These conditions protected minority shareholders by preventing situations where controlling majority shareholders unilaterally decide to reduce the company's share capital by 'buying off' minority shareholders. This protection was enhanced by the requirement that a company could only buy back its share capital by cancelling the shares reflecting the amount of the reduction.

It is noted that the above provisions fell short of sufficiently protecting shareholders against acts and practices by directors and managers, and majority shareholders in the case of minority shareholders. Recently, however, two pieces of legislation have been enacted which, the author argues, not only enhance the protection of shareholders' rights and protection but also offer better prospects for shareholder empowerment and activism in Kenya.

3.1.1 The Companies Act 2015

This Act, which was signed into law on 11th September 2015 and came into force on diverse dates thereafter, describes itself as:

'an Act of Parliament 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.'

Arguably, the Act modernizes Company Law in Kenya. It is without doubt a culmination of many years of attempts to reform company law in Kenya. More significantly, for this paper, it protects shareholders from the excesses of directors in numerous ways, the most outstanding ones being enhancement of, and additions in, the Duties of Directors and their enforcement; and making clear provisions for the derivative action.

3.1.1.1. Duties of Directors and their enforcement

The Act imposes numerous duties on directors of companies. While most of these are designed to protect the public in general from the potentially devastating effects

[121]Companies Act section 169.

of mismanagement of companies, especially public and listed companies, the end effect of such provisions is that shareholders are empowered to not only sanction certain actions by directors before they are taken, but also to speak out against actions taken against their interests.

While the Act is still quite new and the effects of most of its provisions yet to be experienced, it is important to outline here the most significant of the duties imposed on directors of companies. The author categorises these into two, *viz*, general duties and specific duties.

3.1.1.1.1. General duties

These are what used to be known as common law duties of directors. In other words, these are duties that were, before 11th September 2015, administered under the common law of England.[122]Among these duties are, first**,** the duty to act within powers, which requires a director to act within the company's constitution and to only exercise powers for the particular purpose for which they are given.[123] Second is the duty to promote the success of the company which enjoins directors to act in the way that they consider in good faith to be in the best interest of shareholders as a whole. In so doing, they are required to consider, *inter alia*, the long-term effects of any decision they make and, more importantly, the need to act fairly as between the directors and the shareholders of the company.[124]

Third, directors are required to exercise reasonable care, skill and diligence or, in other words, to exercise, in performing their functions, the same care, skill and diligence that would be exercised by a reasonably diligent person with the general knowledge, skill and experience that the director possesses.[125] Fourth is the duty to avoid conflicts of interest or a situation where the director has, or can have, a direct or indirect interest that conflicts, or may conflict, with the interest of the company,

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[122]They are set out at sections 140 to 150 of the Companies Act 2015.
[123]Companies Act,2015section 142.
[124]Companies Act, 2015 section 143.
[125]Companies Actsection 145.

particularly with regard to exploitation of any property, information or opportunity. It does not matter whether the company could take advantage of the property, information or opportunity.[126]

These duties are enforceable, and breach thereof is actionable by civil suit.[127] As will be argued in subsequent parts of this paper, these duties are owed by directors to the company. However, where the company is unable or unwilling to institute the necessary proceedings, the shareholders may come in by either instituting a derivative action or by exercising shareholder activism, whether offensively or defensively.

3.1.1.1.2. Specific duties

Unlike the general duties outlined above, these duties require directors to take, or refrain from taking, particular acts. The author will expound on some of these duties.

First, directors are required to avoid a conflict between their interests and those of the company.[128] This means that if a director is in any way interested in a transaction or arrangement that the company has entered into or is about to enter into, that director has a duty to declare the interest and extent of his interest to the other directors; and where the company is a public company, to the shareholders of the company.

In any case where the transaction is for an amount, or goods or services, exceeding 10% of the value of the company's assets, then the declaration must in addition be made to the shareholders in a general meeting.

[126]Companies Actsection 146.
[127]Companies Act section 148.
[128]Companies Actsection 151.

Second is the duty to obtain shareholders' approval before entering into certain transactions, which include:

a. Transactions where a director of the company or of its holding company acquires or is to acquire from the company a substantial non-cash asset;[129]
b. Transactions where the company acquires or is to acquire a substantial non-cash asset from a director;[130]Notably, transactions or arrangements entered in contravention of these provisions are voidable at the instance of the company.
c. Loans, quasi-loans[131]or guarantees to directors of the company or of its holding company[132]. If the director is a director of the company´s holding company, the transaction also needs to be approved by a resolution of the members of the holding company;[133]
d. Directors' long-term service contracts. These are service contracts where the director's employment is guaranteed for a period exceeding, or that could exceed, two years;[134]
e. Insider credit transactions by public companies. A company may not enter a credit transaction as creditor or guarantor for the benefit of its director(s) or a director(s) of its holding company unless the transaction has been approved by shareholders;[135]

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[129]Section 158. For these purposes, an asset is a substantial non-cash asset if its value;
- Exceeds 10% of the company's asset value and is more than Kshs. 5,000,000; or
- Exceeds Kshs. 10,000,000.

[130]Companies Act section 158.

[131]Under the Act, a quasi-loan is a transaction under which a creditor agrees to pay (or pays) an amount for the borrower, or the creditor agrees to reimburse (or reimburses) expenditure incurred by another party for another person (also a borrower) on terms that the borrower will reimburse the creditor or in circumstances giving rise to a liability on the borrower to reimburse the creditor.

[132]Companies Act section 164.

[133]However, the Act gives exceptions to this requirement. One such exception is with regard to money-lending companies which is allowed by section 174, but on condition that;
i. That the loan, quasi-loan or guarantee is given by the company in the ordinary course of the company's business; and

The value of the transaction is not greater, and the terms are not more favourable, than what the company would have offered to a person of the same financial standing but unconnected to the company. In other words, the amount and terms of the loan must be such as the bank would give to an ordinary customer in the circumstances. However, this condition does not of itself prevent a company from making home loans to its directors or those of its holding company.

[134]Companies Act section 157.

[135]Companies Act section 167.

f. Payments to directors as compensation for loss of office;[136]

It may be argued that since the foregoing transaction by their very nature have substantial impact on the company's financial status, the Act indirectly gives shareholders the power to participate in or influence such transactions by requiring prior approval where shareholders can also question certain aspects of the deal .

Other specific duties include the duty to convene general meetings requisitioned by members[137]; duty of directors of a private company not to allot shares except in accordance with sections 328[138] or as authorized by the company's articles or by a resolution of the company; duty to ensure the company keeps proper accounting records; duty to prepare individual financial statements[139], send the financial statements and reports to persons entitled to receive notice of general meetings and present the same in general meetings; and duty to include in the notes to the company's financial statement details of individual director's benefits other than remuneration.[140]

Unlike the general duties, which are enforceable by a civil suit, the specific duties outlined above are backed by criminal sanctions for non-compliance. Indeed, one of

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[136]Companies Act section 182.
[137]Companies Act section 277.

[138]Section 328 allows Directors with only one class of shares to allot shares or grant subscription rights unless they are prohibited from doing so by the articles.

[139]Sections 628 and 635.

[140] Further, Regulation 21 of the Companies Act General Regulations 2015 prescribes that the directors include in the notes the following information;

a. the aggregate amount of the remuneration paid to or receivable by the directors of the company in respect of their qualifying services; and

if any such remuneration consists of a benefit otherwise than in cash, the nature of that benefit.

Besides, the information is required to distinguish between the remunerationpaid or receivable in respect of a person's services as a director, and the remuneration paid or receivable in respect of that person's other services in connection with the management of the affairs of the company.Regulation 22 has similar provisions with regard to directors' retirement benefits.

the salient features of the Act is the heavy penalties imposed on directors for offences related to compliance with the provisions thereof.[141]

The general duties, as noted above, are enforceable by civil suit brought by the company. Needless to say, errant directors may not be willing to authorise suit by the company against themselves. As a result, many times the only way to enforce these duties will be through the derivative action or claim. That claim, as demonstrated below,[142] has major shortcomings.

The specific duties on the other hand are generally enforceable by criminal sanction. The weakness of Kenya's justice system in prosecuting and punishing perpetrators of corporate crime cannot be over emphasized. Besides, companies may be slow to report crimes committed by directors against the company, more so in situations where directors are also shareholder and part of the company's management.[143]

3.1.1.2. The Derivative Action

It is a generally accepted principle in corporate law that a company is a person, albeit juristic, with the capability to wrong, be wronged and seek remedy for such wrongs.[144]Further, whenever that juristic person is wronged, they and they alone have the right to institute proceedings to remedy such wrong.[145] However, it is also a settled principle that a company has no brain or soul and therefore cannot make

[141]The penalties include elements of monetary fines and imprisonment for varying terms depending on the seriousness of the offence.

[142]See part 3.2.1.2.

[143]See generally Serah Akelola, 'Prosecuting Bank Fraud in Kenya: Challenges faced by the Banking Sector' [2015]14(1)*Journal of Finance and Management in Public Services.* See also Patricia Kameri Mbote and Migai Akech, 'Kenya: Justice Sector and the Rule of Law' [2011] *A review by AfriMAP and the Open Society Initiative for Eastern Africa*.

[144]See *Salomon v Salomon & Company Limited*[1897] AC 22.

[145]*Foss v Harbottle* (1843) 2 Hare 461.

decisions of its own. For this reason, it makes decisions and acts on them through its directors.[146]

With this background in mind, situations arise when the company is unable or unwilling to institute a suit to enforce one or more of its rights. To remedy this, the courts in England came up with what has come to be known as the derivative action or, in other words, an action brought by the shareholders to enforce the rights of the company on its behalf. The effect of this is to give shareholders *locus standi* otherwise vested exclusively in the company.

The Companies Act 2015 contains express provisions on derivative action.[147] Under that Act, a derivative action may be brought either directly under the Act or as a result of a court order in proceedings for protection of shareholders against unfair prejudice.[148] Further, such action may be brought in respect of a cause 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 the company.[149] Importantly, the

[146]In *Lennard's Carrying Company –Versus- Asiatic Petroleum Company Limited* (1915) AC 705 at 713, it was observed that:

> 'a corporation is an abstraction. It has no mind of its own any more than it has a body of its own; its active and directing will must consequently be sought in the person of somebody who for some purposes may be called an agent, but who is really the directing mind and will of the corporation, the very ego and centre of the personality of the corporation.'

In *H.L Bolton (Engineering) Co. Limited –Versus- T.L Graham & Sons Limited* (1957)CA 159 at 172 (Lord Denning) commented thus:

> '...A company may in many ways be likened to a human body. It has a brain and nerve centre which controls what it does. It also has hands which hold the tools and act in accordance with directions from the centre. Some of the people in the company are mere servants and agents who are nothing more than the hands to do the work and cannot be said to represent the mind or will. Others are directors and managers who represent the directing mind and will of the company, and control what it does. The state of mind of these managers is the state of mind of the company and is treated by the law as such.'

See also Ongaya J in *Geoffrey Makana Asanyo v Nakuru Water and Sanitation Services Company & 6 others* [2014] eKLR.

[147]Section 238 defines a derivative claim as proceedings by a member of a company in respect of a cause of action vested in the company and seeking relief on behalf of the company.

[148]Companies Act section 238(2)
[149]Companies Act section 238 subsection 3.

Act protects the company from former directors and therefore precludes a scenario where a director wrongs the company and resigns to avoid liability. In that regard, subsection 6 of section 238 defines 'director' to include a former director.

The statutory derivative claim under the Act has several weaknesses. First, the derivative claim under the Act is not purged of the cumbersome and rather restrictive requirements or conditions inherent under the common law. The Act requires that the following conditions be adhered to before a claim may be heard:

a. The underlying cause of action must strictly be one arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director[150];
b. In order to continue the claim, the shareholder has to apply to court for leave to so continue[151]; and
c. If a shareholder applies for such leave, the court is by law required to refuse that leave if:
    - A person acting under section 144[152] of the Act would not seek to continue the claim;
    - The action complained of has been authorised or ratified by the company.[153]
    - Further, the common law exceptions to the rule in *Foss v Harbottle* are, unfortunately for shareholders, still material because the above conditions laid down for obtaining the court's permission to continue the claim are rooted in the common law requirements.

The end result of this is that the Act presents at least two hurdles to the commencement and maintenance of derivative actions by shareholders, that is to say:

a. Limiting the type of causes of action that may be subject of such claims;

[150]Companies Act section 238 subsection 3.

[151] Companies Act section 239subsection 1.

[152]The section requires directors to exercise independent judgment.

[153]See the Companies Act section 241.

b. Requiring that such a shareholder must obtain leave from the court; and
c. Requiring that the court denies leave is the action complained of has since been ratified by the company, regardless that the action may be, in spite of the ratification, be against the best interests of the company and the shareholders at large.
d. Second, section 238 of the Act defines a 'derivative claim' as an action brought by a member of a company. This means that any shareholder, including majority shareholders, have the liberty to bring such a claim. Further, section 242 of the Act allows a member to apply to court to take over proceedings brought by another member. This means that a majority shareholder has the leeway to take over proceedings brought by a minority shareholder. Therefore, it can hardly be said that these provisions provide protection of minority shareholders from oppression by majority shareholders.[154]As argued in other parts of this paper, this is one of the main aims of shareholder activism.

Third, the Act limits derivative claims to cases involving negligence, default, breach of duty or breach of trust by directors. This is deficient in at least two ways. First, it is difficult for a shareholder to prove negligence or breach of trust or duty by directors since shareholders will not usually have access to the company's records and day-to-day management. Second, the Act does not set out the standards of proof that a shareholder must satisfy.

3.1.2 The Code of Corporate Governance for Listed Companies 2016

As indicated in Chapter two of this paper, this Code does not bind all companies in Kenya, but only those public companies whose shares are listed at an approved securities exchange.

The Code makes numerous recommendations and guidelines on how boards of directors of companies should treat their shareholders with the aim of enhancing the value of the shareholders' investment in the company.[155] In other words, the Code

[154]See also Kiarie Mwaura, 'The Plight of Minority Shareholders under the Companies Bill 2010: Oppressed or Simply Abandoned and Forgotten?' [2012] *University of Nairobi Law Journal*11.
[155]For a detailed outline of the provisions of this Code, see Chapter Two of this paper.

requires boards of directors to go beyond the minimum prescribed by legislation with regard to management of companies and maximisation of shareholder value.

While this Code does not bind companies in general, it is anticipated that the guidelines and recommendations in the Code will eventually form customary best practices with regard to corporate governance and that companies, especially public companies, will therefore adopt its recommendations and guidelines as industry best practice.

More importantly for this paper however, the Code provides a 'call to action' for shareholder activists and potential shareholder activists. It recognises that:
'Shareholder rights and investor protection are key factors to consider when determining the ability of companies to raise the capital they need to grow, innovate, diversify and compete effectively. If the legal and governance framework does not provide such protection, investors may be reluctant to invest unless they become the controlling shareholders. It is critical that the governance framework ensures the equitable treatment of all shareholders, including the minority.'[156]

This statement accurately captures and supports one of the hypotheses and indeed the main argument of this paper that directors' shortcomings (including absenteeism, lack of interest in shareholders' interests, ignoring shareholders' intellectual input in corporate decision-making, mismanagement and dishonesty) often lead to losses on company profits and diminish shareholders' capital or value and that, therefore, there is urgent need to put in place mechanisms to ensure direct shareholder participation in the making of policy and decisions affecting their investment.

It is notable that while the Code clearly acknowledges the rightful role of shareholders as investors or proprietors in a company, it does not set out the mechanisms that those proprietors may resort to when the rights that attach to that

[156]See Chapter Overview to Chapter Three of the Code.

role are breached or ignored either by directors or by other shareholders. A mere recognition that 'shareholder rights and investor protection are key factors to consider when determining the ability of companies to raise the capital they need to grow, innovate, diversify and compete effectively' is insufficient to protect shareholders.

Besides, the Code offers mere guidelines and recommendations. It sets standards of good practice in corporate governance. It is debatable whether the Code is legally enforceable by shareholders against errant directors. Further, it is silent on protection of minority from majority shareholders.

3.2 A Case for Shareholder Activism in Kenya

Justification for shareholders' direct action and intervention, through shareholder activism, is based on several arguments. First, the insufficiency of the current legal protection of shareholders (both statutory and common law), calls for direct and active action by shareholders to protect their investment from both indifferent, incompetent, dishonest and outright fraudulent boards of directors and oppressive and exploitive controlling shareholders.

For instance, the Companies Act 2015 has retained the right of 'squeezing out' or 'buying out' of minority shareholders in an acquisition. Section 611 of that Act provides that where an offeror has acquired not less than ninety percent of the company's shares, s/he may give notice to the holder or holders of the remaining ten percent of his/her intention to acquire those shares. This effectively allows an incoming majority shareholder to annex the shares of minority shareholders even though the latter may not be ready or willing to exit the business. As noted by Hodge O'Neal, 'damage to a minority (share)owner caught in a [squeeze-out] may be catastrophic.'[157] For, O'Neal, continues:

[157]F. Hodge O'Neal, 'Arrangements Which Protect Minority Shareholders Against "Squeeze-Outs"' [1961] 45 *Minnesota Law Review*537, 537-557, 538.

'If he has put practically everything he owns into the enterprise and expects to support himself from the [dividends] he receives from the company-as is frequently the case-he may find that he has been deprived of his principal means of livelihood by discharge from company.'

Besides, the court in *Foss v Harbottle*, a case that is largely celebrated as a major milestone in corporate law,[158] stated, in complete disregard of minority shareholders, that with regard to complaints by minority shareholders against excesses or alleged excesses by majority shareholders:
'If the thing complained is a thing which, in substance, the majority of the company are entitled to do, or something has been done irregularity which the majority of the company are entitled to do regularly or if something has been done illegally which majority of the company are entitled to do legally, there can be no use in laying litigation about it, the ultimate end of which is only that a meeting has to be called, and then ultimately the majority gets its wishes.'

Second, directors are bound by law to act in the interests of the shareholders, the latter being the proprietors of the business that is the company.[159]Directors may, and often do, not honour this duty. Indeed, directors by virtue of their position may trade on inside information and therefore act outside of the best interests of the company and for their own individual benefits. Besides, while failure to so act is actionable by civil suit, including derivative claims, seeking court intervention may not always be the best choice for shareholders, not least because it is both costly and time consuming and may taint the image of the company to the public. This paper suggests that direct shareholder intervention will offer better prospects for improvement of management and ultimately enhancement of shareholder value.

[158]See for instance the Kenyan case *of David Langat v St. Lukes Orthopeadic& Trauma Hospital Ltd & 2 Others* [2013] eKLR.

[159]For an elaboration of the various duties owed to the company and shareholders by directors see earlier parts of this chapter.

Third, there has recently been an increase in both in the number of companies listing or wishing to list their shares for public trading at the Nairobi Securities Exchange.[160]Public trading of company shares exposes the value of those shares to price fluctuations caused by factors beyond the shareholders' control. One of those factors is the public perception of mismanagement of such companies.[161] Besides, publicly traded companies often enter into complex investment and other arrangements including mergers, acquisitions and joint ventures, which the average shareholder will not have the expertise to understand. For these reasons, it is important that shareholders remain vigilant to ensure that all investment decisions of the company are made in the best interest of the company and the shareholders as a whole.

3.3 Conclusions

For a long time, Shareholders in Africa, and Kenya in particular, have found it difficult to protect themselves from oppressive conduct by, on the one hand, majority shareholders and, on the other hand, Directors and Management of the companies they invest in. This state of affairs is attributable to several factors. First is the requirement both in the law and companies' constitutions that whenever a decision is to be made by the shareholders of a company, the same shall be made by a resolution. A resolution, whether ordinary or special, is made by a simple or special majority as the case may be. In either instance, a majority of vote is needed. This makes it difficult for shareholders holding minority numbers of shares in the company to influence decisions of the company.

Second, criminal and civil sanctions prescribed by the law for directors and majority shareholders who use their power to oppress minority and other shareholders are

[160]Currently Kenya has the largest securities exchange in East and Central Africa, the Nairobi Securities Exchange (NSE), which has sixty-one out of the eighty five listed companies in the East African region. (Capital Markets Authority, 'Capital Market Master Plan 2014-2023', 3).

[161]To understand the impact that public perception may have on a company's success, please see media reports on the recent insolvency of a major bank in Kenya which was caused mainly by certain public perceptions about the bank which, although not listed at the NSE, served a large portion of Kenya's population.

inadequate. In any case, oppressed shareholders have largely been unable to enforce those sanctions. For this reason, directors and majority shareholders, in collaboration with senior management, have continued to use their power and influence to misappropriate and, in some instances squander, shareholders' investment.

Thirdly, there exists no corporate governance code that binds all companies in Kenya.[162] Fourth is the set of restrictions imposed by the rule in Foss v. Harbottle[163] on shareholders who would wish to bring to account directors engaging in misconduct against the company.

Ideally, the legal and corporate governance framework in Kenya should ensure the equitable treatment of all shareholders, including minority shareholders. This may be done through passing industry codes of corporate governance, and company policies, ensuring that boards of directors adopt a shareholders' perspective when making corporate decisions;

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[162]This paper, however, acknowledges the existence of a code of corporate governance for companies listed at an approved securities exchange.

[163]*Foss v Harbottle* (1843) Hare 461. The rule in *Foss v Harbottle*, otherwise known as the rule of majority rule, is to the effect that where a company is wronged, the company and not its shareholders can bring an action against the wrongs. In that case, two minority shareholders in a company alleged that its directors were guilty of buying their own land for the company's use and paying themselves a price greater than its value. This act of directors resulted in a loss to the company. The minority shareholders decided to take action against the directors, but the majority shareholders in a meeting resolved not to take any action against the directors alleging that they were not responsible for the loss which had occurred. The court dismissed the suit on the ground that the acts of the directors were capable of confirmation by the majority members and held that the proper plaintiff for wrongs done to the company is the company itself and not the minority shareholders and the company can act only through majority shareholders. For further elaboration of the rule, see also *Edwards vs Halliwell* (1950) All ER 1064 where the court (Jenkins L.J) observed that:

> 'the rule in *Foss v Harbottle*, as I understand it, comes to no more than this. First, the proper plaintiff in an action in respect of a wrong alleged to be done to a company or association of persons is prima facie the company or the association of persons itself. Secondly, where the alleged wrong is a transaction which might be made binding on the company or association and on all its members by a simple majority of the members, no individual member of the company is allowed to maintain an action in respect of that matter for the simple reason that, if a mere majority of the members of the company or association is in favour of what has been done, then majority of the members of the company or association are in favour of what has been done, then *caditquaestio*.'

See also Munyao Sila J in *David Langat v St. Lukes Orthopeadic& Trauma Hospital Ltd & 2 Others* [2013] eKLR

a. Companies improving communications and interactions between minority shareholders, majority shareholders and board; and
b. Ensuring shareholders, and minority shareholders in particular, are duly accorded the most basic of their rights. In the estimation of this paper, these are: the right to seek and receive information; the right to voice opinion and to have that opinion taken into consideration in the making of major corporate policy and decisions; and the right to have an effective and efficient internal complaint and complaint redress mechanism.
c. Ensuring that directors in all circumstances act in the best interests of the company for the benefit of shareholders

   Should this be done effectively, it will lead to a more efficient and competitive corporate environment, a healthier capital market and, most importantly, enhanced shareholder value.

If on the other hand the above steps are not taken companies and boards of directors voluntarily, shareholders must not be left without remedy. Shareholder activism then comes in to promote the protection of the shareholders', including minority shareholders', interests. It is for this very reason that this paper presents shareholder activism as an integral part in the development of the capital market in Kenya.

CHAPTER FOUR
SHAREHOLDER ACTIVISM IN THE UNITED STATES OF AMERICA: A CASE STUDY

4.0 Introduction

The influence that shareholders have, or should have, over the running of the companies they invest in varies from one jurisdiction to another. A study of such influence in one jurisdiction, such as Kenya, therefore requires justification. In this Chapter, the author attempts to offer such justification by undertaking a study of shareholder activism in the United States.

The ultimate aim is to flag out the form, practice and impact of shareholder activism in the United States. The purpose for this is to draw lessons for Kenya's infant attempts at shareholder activism from a country where the same has been practiced for close to a century.

The roots of shareholder activism in the United Sates can be traced in the early 20th century. It was triggered by the passing of the Securities Exchange Act of 1934 which created the Securities and Exchange Commission ("SEC") and therefore marked the first step in governing public trading of shares the protection of the interest of shareholders in companies whose shares were so traded.[164] Soon enough, shareholder activism had gained a life of its own.

This was best exemplified when Henry Ford revoked a dividend in the company, choosing to instead spend the money on corporate social activities. Shareholders

[164] Javier Castellanos, Gabriel Craft, Erick Goihman, Brandon Meloche, Erica Siverts on& Tim Zepp, 'New Age of Shareholder Activism' [2015] Independent Study Project Report, Ross School of Business at the University of Michigan (Report sponsored by Professor Dr. William K. Hall) 3.

protested and a shareholder suit ensued, with the court ultimately siding with the dissident shareholders.[165]

By the late 1980's, shareholder activism had taken a more aggressive turn with corporate raiders like T. Boone Pickens[166] taking the centre stage. Shareholders schemed and executed hostile takeover and leveraged-buyouts in a bid to control the management of poorly performing companies. In the 1990's, shareholder activism was mainly orchestrated by institutional investors, namely pension funds and insurance companies. Their modus operandi was 'quiet' activism or 'behind the scenes'[167], viz, abstaining from voting and withholding their votes as shareholders in important matters that required shareholder approval.[168]

Today, the face of shareholder activism is personified by hedge funds. Indeed, Carl Icahn, the legend investor and icon of shareholder empowerment, observes that hedge funds are in the United States 'the activist's ally'.[169]As has been observed, this age of shareholder activism by hedge funds, which the author will refer to as hedge fund activism, was initiated or steered by Carl Icahn and Ed Lampert but quickly

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[165] Bryan Armstrong, 'The New Crisis: Shareholder Activism' (Ashton Partners) 1. http://files.shareholder.com/downloads/CHIN/0x0x120665/58235c4d-9a1c-4080-abeb-6bb710b2b876/The-New-Crisis-Shareholder-Activism.pdf accessed 20 October 2016.

[166] A good example of this is the Getty Oil takeover orchestrated by such players as T. Boone Pickens, and Ivan Boesky and Martin Siegel. See Debra Whitefield, 'The Deal: How Getty Ended Up With Texaco' *Los Angeles Times* (Los Angeles January 1986). http://articles.latimes.com/1986-01-19/business/fi-1170_1_gordon-getty accessed 20 October 2016. See also generally John Armour and Brian Cheffins, 'Offensive Shareholder Activism in U.S. Public Companies' [2009] University of Cambridge Faculty of Law Research Paper No. 09/2011.

[167] Stuart L. Gillan and Laura T. Starks, 'The Evolution of Shareholder Activism in the United States' [2007] 19(1) Journal of Applied Corporate Governance 3.

[168]*Bryan Armstrong 'The New Crisis: Shareholder Activism' (n2p2).* See, for instance, California Public Employees' Retirement System's (CalPERS') push for the repeal of staggered boards and poison pills in several companies in the late 80's to late 90's.

[169]*Bryan Armstrong 'The New Crisis: Shareholder Activism' (n2 p).*

picked up by smaller hedge funds.[170]It is this latter version of shareholder activism that this paper will focus on, being the most significant in the United States.

4.1 Models of Shareholder Activism in the United States of America

The United States capital market offers a collection of shareholder activist models ranging from savvy profit-oriented corporate activists, to individual activists, to non-profit organisations seeking to advance social goals.[171] Their motivations and intentions vary accordingly as has been aptly cited thus;

'Some activists are interested in value-maximizing activities and improving governance by supervising managerial activity, while others have economic interests in mind but not necessarily the interests of the corporation or their fellow shareholders.'[172]

Nevertheless, the means of intervention by the various activists is less different; although the use of media and public relations gestures by activists (especially social-oriented activists) plays a fair part, most activism in the United States take the form of voting against certain decisions or voting-out directors.[173]

Having said that, it is important to briefly outline the models of activism adopted by different players in the shareholder activism arena. First are the so called 'new kids on the block' - the hedge funds. They tend to magnify their equity stake in a particular company by using sufficiently sophisticated investment structures like derivatives.[174]

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[170]See for instance *Bryan Armstrong 'The New Crisis: Shareholder Activism' (n2p2).*

[171]Yori Nili, 'Missing The Forest For The Trees: A New Approach To Shareholder Activism' [2014] 4 *Harvard Business Law Review* 158-212, 177.

[172] Henry T.C. Hu & Bernard Black, 'Equity and Debt Decoupling and Empty Voting II: Importance and Extensions' [2008] *University of Pennsylvania Law Review* 625, 640–42.

[173]*Yori Nili, 'Missing the Forest for The Trees: A New Approach to Shareholder Activism' (n 8 p178).*

[174]Marcel Kahan& Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control' [2007] *University of Pennsylvania Law Review* 1021, 1026

Once they have sufficient control on the company's equity, they use various mechanisms to influence the company's management and governance control, most significantly seeking court injunctions against proposals by directors and requesting public declarations of intent by directors as well as forcing public discussions over certain issues relating to the target company's management or policies.[175] It is important to note that the ultimate aim of hedge funds is short-term profit maximisation.[176]

Second is a different modus operandi offered by private equity funds. They buy a company, convert it into a private company, eliminate current management and install their own.[177] Unlike hedge funds which, as observed above, are more concerned with short-term profit as opposed to the long-term welfare of the company, private equity activists are said to be more long-term focused.

Third, pension schemes and mutual funds (traditional institutional investors) offer a different mode of activism; they work 'behind the scenes' to influence the management and governance of their target companies. This they do by informally interacting with the management and directors.[178] Notably, these investors are often motivated by political as well as economic considerations in making their activist moves.[179]

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[175] See for instance William Alden, 'Einhorn's Apple Suit Fits a History of Public Calls' New York Times (New York 7 February 2013). See also the general debate surrounding the law suit bringing into question Apple's decision to combine several issues in one resolution and the hedge fund's attempts at initiating a public debate over certain of the company's policies.

[176]*Yori Nili, 'Missing The Forest For The Trees: A New Approach To Shareholder Activism' (n 8 p175).*

[177] See generally Guy Fraser-Sampson, Private Equity as an Asset Class (2007).

[178]*Yori Nili, 'Missing The Forest for The Trees: A New Approach To Shareholder Activism' (n 8 p176).*

[179]See generally Roberta Romano, 'Less Is More: Making Shareholder Activism a Valued Mechanism of Corporate Governance' [2001] 18 *Yale Journal on Regulation* 174, 187–219.

Fourth, and finally, there are activists whose motives are purely or largely social agenda. These include non-governmental organisations (NGOs) seeking to advance certain social-oriented proposals by influencing corporate decisions and policies. Their main mode of operation is using the media to conduct public campaigns to influence the making of such decisions and policies.

An example of this form of activism is the campaign by Friends of the Earth to have Exxon held accountable for environmental problems relating to the Valdez oil spill.[180] The campaign offers a particularly good example of activism as it utilised both public campaigns (protests outside Exxon's offices) as well as various corporate governance-related mechanisms such as sponsoring shareholders' resolutions, pressuring Exxon's governance to take certain decisions as well as sponsoring discussions at Exxon's annual general meeting.[181]

4.2 Hedge Fund Activism in the United States

Hedge fund activism is currently the dominant mode of shareholder activism in the United States. Typically, hedge fund activists begin their activism by purchasing a significant number of shares in the target company.[182] They then try to pressure management, through telephone calls or writing letters, to make certain changes in the company.[183] Usually, the changes proposed are designed to increase shareholder value.

[180] The Exxon Valdez oil spill occurred in Prince William Sound, Alaska, on Good Friday, March 24 1989 when Exxon Valdez, an oil tanker bound for Long Beach, California, hit Prince William Sound's Bligh Reef. See Terrence Guay et al, 'Non-Governmental Organizations, Shareholder Activism, and Socially Responsible Investments: Ethical, Strategic, and Governance Implications' [2004] *Journal of Business Ethics* 125, 134–35.

[181]*Id.*

[182]This is otherwise known as block purchasing.

[183] John Armour and Brian Cheffins, 'The Rise and Fall (?) of Shareholder Activism by Hedge Funds' [2009] Working Paper N°.136/2009, ECGI Working Paper Series in Law, 6.

In other words, hedge fund activism is almost always profit-oriented, for instance proposals that the company improves its profitability by spinning off underperforming brands that do not form the company's core business or that the company utilises its surplus by paying a dividend or buying back shares from the shareholders at a significant premium. As such, hedge funds in the United Sates normally engage in offensive shareholder activism, with their usual targets being underperforming companies.[184]

The emergence of hedge funds and private equity firms has created a surge in the activism movement in the U.S.[185]According to Cheffins and Armour:

> 'The readiness to take a hands-on role to shake things up is the crucial additional dimension to hedge fund activism. Activist hedge funds, rather than merely adopting the passive approach that characterizes value investing and waiting for the market to self-correct—which may well never happen if a company's shares do not get noticed and instead drift lower—are prepared to take the initiative and accelerate matters by lobbying for changes calculated to boost shareholder returns.'[186]

For an example of this business model, Coniston Partners, a hedge fund formed way back in 1982, has been described by the Wall Street Journal thus;
'Coniston typically would buy 10% to 20% of the stock of the target company, then use that block of stock as a club to press for drastic action – a breakup, asset sale, or even a takeover that would enable Coniston to sell out at a profit."[187]This model describes the typical modus operandi of activist hedge funds in the United States today.

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[184]*John Armour and Brian Cheffins, 'The Rise and Fall (?) of Shareholder Activism by Hedge Funds' (n34p17).*

[185]Yori Nili, 'Missing The Forest For The Trees: A New Approach To Shareholder Activism' [2014] 4 Harvard Business Law Review 158-212, 165.

[186]Brian R. Cheffins& John Armour, 'The Past, Present, and Future of Shareholder Activism by Hedge Funds' [2011]37 Journal of Corporate Law 51, 58.

[187]Randall Smith, 'Top Raider Coniston to Disband' *Wall Street Journal* (New York 22 June 1990)

Hedge funds have assumed prominence in the activist arena in the United States in the past decade and a half. These funds have become increasingly important players in financial markets, particularly in their capacity as monitors of corporate performance and agents of change.[188] They have a variety of goals in their activism, the most common ones being changing management strategy or board decisions; seeking a board seat for either input, control, or information purposes; effecting corporate governance changes; forcing a buyout or sale of a division; and increasing cash distributions to shareholders through dividends or share repurchases.[189]The bottom line of their activism, however, is that they seek unlocking and maximisation of shareholder value in undervalued and underperforming companies.

A number of questions have arisen about the effectiveness of hedge fund activism. For example, have hedge funds really succeeded in adding value to the companies they have targeted; or have most of the returns to hedge funds been short-term profits at the expense of other, longer-term shareholders? Do hedge funds have the appropriate organizational structure to bring about change in the underlying target firms?

Whereas the success of hedge fund activism in increasing shareholder value is unquestionable, the same may not be true of their impact in improving corporate governance of the company in the long run. This is largely because, as observed above, hedge fund activism is aimed at the short-term maximisation of shareholder value or profits as opposed to the long term wellbeing of the company. As a matter of fact, it is not unusual for hedge funds to exit shareholding of a company once they have achieved the short term aims of their activism.[190]

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[188]*Stuart L. Gillan and Laura T. Starks, 'The Evolution of Shareholder Activism in the United States' (n4p4)*

[189] Any long-term relationship between large shareholders and companies can be termed relationship investing. For studies on block shareholders, see for example Jennifer E. Bethel, Julia Porter Liebes kind and Tim Opler, 'Block Share Purchases and Corporate Performance' [1998] Journal of Finance 605-634.

[190]In the United States, this is achieved, for instance, by having a share buy back as one of the proposals in the activist's package.

4.3 A Report Card on Shareholder Activism in the United States of America

It has been observed in earlier parts of this paper that shareholder activism's main aim is to remedy the problems brought about by the agency-costs issue. That issue has been explained by Adolfe Berle and Gardiner Means as follows. Essentially, the main theory behind the agency costs problem is that a shareholder's share of profits due to improved efficiency and profitability occasioned by shareholder monitoring of management would be too small to cover the sunk costs of such monitoring.[191] Thus, the theory continues, the shareholder would be unlikely to supervise management in the first place since it would be unprofitable for him to do so.

This led to a director-dominated corporate structure. Further, since the directors and managers were not subjected to shareholder monitoring (due to the agency costs problem), they had no removal concerns and therefore they could misappropriate corporate funds, receive incredibly high remuneration not correlated with their performance,[192] and engage in generally inefficient activities, such as inefficient empire building, at the expense of shareholders.[193]

Over the years, a movement for shareholder empowerment and involvement in management has led to shareholders deciding to take a more active role in the corporate governance of the companies they invest in. [194]

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[191] See generally Adolf A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property* (1st edn Transaction Publishers, New Brunswick 1932). See also Eugene F. Fama & Michael C. Jensen, Separation of Ownership and Control' [1983]26 *Journal of Law, Economics and Policy* 301, 304.

[192] Lucian Bebchuk & Jesse Fried, *Pay Without Performance: The Unfulfilled Promise Of Executive Compensation* (Blackwell Publishing, New Jersey 2004) 159–64.

[193] See Sharon Hannes, 'Private Benefits of Control, Antitakeover Defenses, and the Perils of Federal Intervention' [2005]2 *Berkeley Business Law Journal* 263, 283. See also David J. Denis et al., 'Agency Problems, Equity Ownership, and Corporate Diversification' [1997]52 *Journal of Finance* 135, 135–36 (1997). But see also Paul Gompers et al., 'Corporate Governance and Equity Prices' [2003]118 *Quarterly Journal of Economics* 107, 136–37, 145.

[194]The main proponent of this movement is Professor Bebchuk. See previous chapters of this study. See also generally Lucian A. Bebchuk, 'Letting Shareholders Set the Rules' [2006]119 *Harvard Law Review* 1784 and Lucian A. Bebchuk, 'The Case for Increasing Shareholder Power' [2005]118 *Harvard Law Review* 83.

That said, the important question for this paper begs an immediate and urgent answer is: has shareholder activism led to improved corporate governance and profitability of companies in the United States? The answer to this question is important for at least two reasons, viz:

a. It will help us assess the success of shareholder activism in the United States in achieving the goals which it is said to have set out to achieve; and
b. By assessing such success, this paper will help determine not only the utility of shareholder activism but also its desirability in Kenya's corporate law and practice.

   It is a fait accompli that shareholder activism does generally lead to increased accountability in companies. It is also agreed that in an ideal world, the aim is to have the market forces reward the well-governed companies.[195] Therefore, for shareholder activism to be worth its costs, it must achieve not only increased accountability but also improved corporate governance in the target company.

It has been argued that in a bid to 'correct or prevent the errors resulting from poor managerial decisions', the 'genuine values of authority' will be lost.[196] Indeed, it has further been noted;

> 'if every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem.'[197]

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[195]Jeff Gramm (the author of 'Dear Chairman: Boardroom Battles and The Rise of Shareholder Activism') in an interview at Bloomberg on 20 August 2016.

[196]See for instance *Compaq Computer Corp. v. Horton*, 631 A.2d 1, 3–4 (Del. 1993). In that case, the right of shareholders to inspect company books is asserted as a matter of public policy, even though it may be adverse to the company's well-being and success.

[197] Kenneth J. Arrow, The Limits of Organization (W.W. Norton & Company, New York 1974), 78. See also Paul Rose and Bernard S. Sharfman, 'Shareholder Activism as a Corrective Mechanism in Corporate Governance' [2015]2014 *BYU Law Review* 1015-1052, 1028.

In other words, were shareholders allowed to influence every decision of the directors, the directors' ability to make efficient wealth maximisation decisions would be lost. Besides, the very principle upon which corporate governance rules are based – separation of roles between management and shareholders – would inevitably be lost. Put differently, as Sharfman has advised;

> '[i]n such a scenario, accountability can be understood to cross over the line to where a new and competing locus of authority is created - a locus of authority, such as uninformed shareholders, that does not benefit from the informational advantages of the original authority." [198]

Shareholder activism in the United States has largely been successful in not only effecting change in management and boosting accountability of directors but also improving shareholder value. A classic example is the 1929 success by John Rockefeller in a proxy fight to effect changes in directorship in Standard Oil of Indiana, where he held 15% shareholding.[199]

A more recent example is offered by an examination of the activism of Relational Investors LLC (a hedge fund) in Timken Co, a company whose shares are publicly traded at the New York Stock Exchange (NYSE:TKR).[200] Between January and September 2012, the hedge fund gradually accumulated its shareholding in Timken. In August 2012, the hedge fund made a proposal to the board that the business of the company be split into steel production and ball bearing manufacturing.[201]The proposal was opposed to by Timken's board. The edge fund then sponsored a resolution (introduced by the California State Teachers' Retirement System, another

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[198] Bernard S. Sharfman, 'Shareholder Wealth Maximization and Its Implementation Under Corporate Law' [2014]66 *Florida Law Review* 389, 406.

[199] Carter F. Henderson and Albert C. Lasher, *20 Million Careless Capitalists* (Doubleday & Company, Garden City, New York 1967), 75-77.

[200]For a detailed explanation of the events, see *Paul Rose and Bernard S. Sharfman, 'Shareholder Activism as a Corrective Mechanism in Corporate Governance' (n25p1015).*

[201] Timken Co., Exhibit B (Form SC 13D/A) (Feb. 19, 2013). available at www.sec.gov/Archives/edgar/data/98362/000110465913011766/a13-5429_1ex99db.htm. accessed 20 October 2016.

shareholder of Timken) to pass the proposal. The resolution was passed by a 53% majority at Timken's shareholders' meeting of 7th May 2013. [202]As a result, the business of the company was split by way of spin off. The company's shares responded by rising in value by 2.9% to USD 62.02, the highest price since January 1978.[203]

4.4 Lessons for Kenya

'But who will monitor the monitor?' This question was posed by Armen and Harold in their 1972 paper[204] and has since then been at the centre of economic debates around team efforts.[205] In particular, the question brings to bear the real possibility of shareholder activism being a problem rather than a solution to corporate governance problems, not least because shareholders are not subject to oversight.

Indeed, the fundamental question for shareholder activism is whether it really creates value. More importantly for this paper is whether shareholder activism would not only create value for the Kenyan shareholder but also offer an improvement in corporate governance practice. As indicated in previous parts of this paper, Kenya does not have much experience with shareholder activism.

Therefore, to understand the potential benefits of shareholder activism and the models of shareholder activism that should be adopted to achieve those benefits, one has to borrow from the practice in countries such as the United States. That is the aim of this chapter, viz, to borrow from the experiences of the United States and set

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[202] Timken Co., Current Report (Form 8-K) (May 8, 2013), available at http://www.sec.gov/Archives/edgar/data/98362/000119312513207498/d534241d8k.htm. accessed 20 October 2016.

[203] Leslie Picker & Thomas Black, 'Timken Jumps After Agreeing to Spin Off Steel Unit' *Bloomberg* (New York, September 6, 2013), http://www.bloomberg.com/news/2013-0906/timken-jumps-after-agreeing-to-spin-off-steel-unit.html.Accessed 20 October 2016.

[204]Alchian, Armen A. and Harold Demsetz, 'Production, information costs, and economic organization' *American Economic Review* [1972], 777-795.

[205] Matthew R. Denes, Jonathan M. Karpoff and Victoria B. McWilliams, 'Thirty years of shareholder activism: A survey of empirical research' [2015] *Journal of Corporate Finance* 307-332.

out, which the author does below, lessons that Kenya may learn from those experiences.

First, the common thread that runs through the various models and examples of shareholder activism in the United states, be it by individual shareholders or by hedge funds, is the need to enhance shareholder value.[206]Kenyan shareholders are no exception, they too need to adopt practices whose purpose is to hold directors and managers accountable for actions that have diverse effects on their investment value.

Second, this chapter notes that, as has been indicated elsewhere in this paper, the origin of shareholder activism was the passing of certain legislation that not only gave shareholders certain rights and directors certain duties but also gave shareholders the means to enforce or seek the enforcement of those rights. Consequently, section 14a-8 of the Securities and Exchange Act of 1934 has enabled shareholders in the United States to exercise activism by way of shareholder proposals as well as and direct negotiations with directors and managers.[207]

Similarly, the Capital Markets Authority (CMA), being the regulator of the capital market in Kenya, needs to pass regulations or guidelines to better facilitate shareholder activism. It will be remembered that one of the things that makes proxy battles in the united states successful is the requirement by SEC that listed companies issue proxy statements prior to shareholders'' meetings.[208] To further augment this, the CMA could make it mandatory that listed companies must take into account or implement reasonable proposals brought forward by shareholders of a certain percentage of the total issued share capital of the company, even though the

[206]For more general debates on the correlation between corporate governance and shareholder value, see generally Cuñat, Vicente, Mireia Gine, and Maria Guadalupe, 'The vote is cast: The effect of corporate governance on shareholder value' [2012]67 *The Journal of Finance* 1943-1977. See also previous chapters of this paper for explanations on motivations for shareholder activism.
[207]The latter is more common with hedge funds than with individual and small institutional shareholders.

[208] See SEC website at https://www.sec.gov/answers/proxy.htm accessed 20 October 2016.

shares held such shareholders may not constitute enough shares to pass the proposal by usual voting.

Third, shareholders who wish to participate in shareholder activism need to be educated on the various types or modes of exercising activism and the costs associated with each. This is important because, as noted in earlier chapters of this paper, the costs of activism are one of the major potential hindrances of shareholder activism in Kenya.

For instance, making shareholder proposals to the CMA would cost the shareholder much less than, say, a proxy battle. Such proposals may be made by shareholders, or blocks of shareholders, writing letters to the CMA or by the introduction of a procedure similar the use of proxy statements in the United States. For this reason, shareholders in Kenya may borrow from examples of shareholders in the United States who have cleverly utilised combinations of various modes of activism to achieve their desired outcomes. A good example is the combination by Carl Icahn, that icon of shareholder activism, of shareholder proposals and direct negotiations with directors of target companies in 2010.[209]

4.5 Conclusions

That shareholders in Kenya need to be more vigilant about the way their investment is managed is a fait accompli. What is not so obvious, however, is how they may do this. This is because although they have been granted various rights, including the right to institute a derivative action, by Kenya's corporate law, corporate mis-governance, misappropriation of company funds and property and related frauds continue to bedevil companies in Kenya, not least publicly listed companies.

For this reason, it has been argued in chapters 2 and 3 of this paper that there is a genuine case for shareholder activism in Kenya. Granted, shareholders in Kenya

[209] See generally Venkiteshwaran, Vinod, Subramanian R. Iyer, and Ramesh P. Rao, 'Is Carl Icahn Good for long-term shareholders? A case study in shareholder activism' [2010] *Journal of Applied Corporate Finance* 22, 45-57.

need an example of the success of activism in another jurisdiction as well as how that success was achieved.

This chapter sought to offer such an example by examining the progressive development of shareholder activism, the models of shareholder activism that have been practiced, as well as an assessment of the success of activism by shareholders in the United States.

The aim is to not only offer potential activist shareholders in Kenya a best-practices checklist but also to encourage the capital markets regulator in Kenya, the CMA, to take active steps to facilitate and or promote shareholder activism in the republic.

In the end, it is hoped that this chapter will turn the pertinent question in Kenya's corporate governance from 'But who will motivate the monitor?' to the more appropriate '**But who will monitor the monitor?**'

CHAPTER FIVE

RESEARCH FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

'the shareholders own the company, and the shareholder is the forgotten man'

- T. Boone Pickens[210]

5.0 Research Findings

The legal and regulatory framework on corporate governance in Kenya has long been in favour of restriction and limitation of shareholder influence or power and encouragement of clear separation of roles/power between the Board of Directors on the one hand and shareholders in General Meetings on the other hand. The effect of this is that corporate policy and decision-making power is given almost exclusively to directors and management.

Various commentators have tried to justify this state of affairs, the most influential being Professor Bainbridge who puts across at least two arguments against shareholder empowerment. First, he uses economic theories of market behaviour to argue that if shareholders were actually interested in controlling the companies they invest in, they would be seen giving themselves that power through resolutions or lobbying. Second, he argues that it is doubtful that shareholders would make effective use of their power even if they had it.[211]

Those arguments have been countered by such corporate governance researchers as Professor Bebchuk who insists that 'paternalistic hand-tying' is unlikely to benefit shareholders and recommends that shareholders be given power to make what he calls 'rules-of-the-game' decisions, 'game ending' decisions and 'scaling-down' decisions.

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[210]This statement was made by T. Boone Pickens, that famed activist investor and head of hedge fund BP Capital Management, in the '80s referring to Phillips Petroleum and the then inferences by citizens of Bartlesville, Oklahoma, that the town 'owned' the company. See Adam Smith, *The Roaring '80s* (Summit Books, New York 1988).

[211]See Chapter One of this paper and Stephen M. Bainbridge, 'Director Primacy and Shareholder Disempowerment,' [2006] Research Paper No. 05-25, University of California, Los Angeles, School of Law, Los Angeles, California.

These debates on shareholder primacy and director primacy led this paper on a mission to find out at least three things, that is to say:

a. The extent to which the law in Kenya empowers shareholders to hold accountable miscreant directors and manager;
b. The appropriateness or otherwise, and the potential benefits and shortcomings of promoting shareholder activism in Kenya; and
c. How shareholder activism has been practised in the United States over the years and the penitential lessons for Kenya from that experience.

In the end, this paper made at least the following five major findings. First, Corporate governance is inextricably tied to shareholder empowerment (and subsequent activism). Indeed, the very definition of corporate governance as 'roles, responsibilities, and balance of power among executives, directors, and shareholders' hinges on the question of corporate power and its distribution and use.

Second, shareholders of a company are the business owners and therefore, in a debate for corporate control, they should always prevail against directors and managers. Indeed, Kenya's law recognises that:

'Shareholder rights and investor protection are key factors to consider when determining the ability of companies to raise the capital they need to grow, innovate, diversify and compete effectively. If the legal and governance framework does not provide such protection, investors may be reluctant to invest unless they become the controlling shareholders.'[212]

Third, it is agreed both by the law and commentators that corporate governance affects the profitability of a company and, therefore, reduces or enhances shareholder value. Henry Manne's theory of corporate control confirms that there is in fact a 'correlation between corporate managerial efficiency and the market price of

[212]See Chapter Two of this paper.

shares of that company.'[213] What this means is that, at least for public companies, a highly effective board of directors will result in more valuable shares and, consequently, more wealth for the shareholder.

Fourth, despite attempts at corporate governance reform, corporate accountability has remained both an elusive and a moving target. Consequently, shareholder activism (both in its traditional form as well as the modern form as shareholder lawsuits) has been on the rise both in Kenya and in other countries around the world.

Finally, shareholder activism has the potential to disrupt effective management of companies and interfering with the ideals of separation of powers between the board of directors and shareholders. However, purposive and disciplined shareholder activism has various benefits that far outweigh its potential demerits, not least because it potentially enhances shareholders' returns and boosts public confidence in corporate governance.

5.1 Research Conclusions and Recommendations

From the above findings, this paper concludes that there is a gap in Kenya's corporate governance law as far as shareholder empowerment is concerned. This manifests itself in the fact that shareholders have had little room to originate action or participate in corporate decision making. However, the situation has slightly improved with the enactment of the Companies Act 2015 which makes provision for derivative action.

Besides, their intellectual input is rarely taken into account when corporate decisions and policy are made. This has led to corporate mismanagement, misappropriation of corporate funds, non-payment of dividends even where they should be paid and other misdeeds by directors that essentially reduce shareholder value. This conclusion confirms this paper's second hypothesis that directors in Kenyan public

[213]See generally Chapter 2 and 3 to this paper.

companies have exhibited certain shortcomings, the most significant of which being that shareholders' intellectual input is not taken to account when making corporate decisions. In other words, shareholders are viewed merely as investors and not as, in addition and more importantly, owners or proprietors of the companies they invest in.

This begs the question: why can't shareholders, being the business owners, vote the miscreant directors out or use their votes to force change in corporate policy and decision making? The answers to this question, this paper concludes, are at least three.

First is the requirement both in the law and companies' constitutions that whenever a decision is to be made by the shareholders of a company, the same shall be made by a resolution. A resolution, whether ordinary or special, is made by a simple or special majority as the case may be. In either instance, a majority of vote is needed. This makes it difficult for shareholders holding minority numbers of shares in the company to influence decisions of the company against majority shareholders.

Second, criminal and civil sanctions prescribed by the law for directors and majority shareholders who use their power to oppress minority and other shareholders are inadequate. In any case, oppressed shareholders have largely been unable to enforce those sanctions. For this reason, directors and majority shareholders, in collaboration with senior management, have continued to use their power and influence to misappropriate and, in some instances squander, shareholders' investment.

Third, there exists no corporate governance code that binds all companies in Kenya.[214] This state of affairs arises due to the fact that our courts have previously ruled that even those Codes of Corporate Governance that exist are merely prescriptive or recommendatory, and not compulsory. Companies are allowed, and in fact expected, to not comply fully with them. Commenting on the nature of the

[214]See Chapter Three above.

Code of Corporate Governance for insurance companies, the High Court of Kenya in the case of *Republic v. Commissioner of Insurance, Insurance Regulatory Authority and B.C. Patel & Company, ex parte Geminia Insurance Company Limited*[215]stated that:

'On the last issue as to whether the corporate governance guidelines for Insurance and Reinsurance companies was subsidiary legislation which had the force of law, I will simply address this issue by stating that by their very title, ***these were just guidelines issued by the 1st Respondent under Section 3A of the Act to help the insurance companies to manage their affairs better or more effectively. They were not expressed to be rules or regulations. They did not amount to subsidiary legislation since they were not made by the relevant Minister*** under Section 180 or 197E of the Act. … ***the said corporate governance principles were just guidelines*** formulated by the 1st Respondent apparently with the participation of industry players who included the Applicant for the sole purpose of enforcing standards for the conduct of the insurance business in Kenya. ***They were not rules or regulations which had the force of law.***' (emphasis added)

The upshot of this is that first, there is no universally applicable set of corporate governance rules that applies to all companies in Kenya. This has led to existence of a set industry-specific codes applying only to the companies in the specified industries.

Therefore, there is the Code of Corporate Governance for Issuers of listed securities to regulate companies whose shares are traded publicly, the Code of Corporate Governance for Insurance Companies to regulate companies in the insurance and re-insurance industry and the 'Mwongozo' to regulate state corporations. Second, and more importantly for this paper, even those codes of corporate governance that exist are not mandatory and companies are given the discretion to decide whether to comply with them or not. Needless to say, companies often choose the latter.

This leads to the author's third hypothesis, namely that there is need to adopt mechanisms that will correct Kenya's corporate governance practice with a view to

[215]Miscellaneous Civil Application 172 of 2011

not only increasing shareholder value but also enhancing the confidence of new and potential investors to invest in the country's capital market. This hypothesis in turn leads to the ultimate question for this paper, *viz*: What then can be done about all the problems and shortcomings identified above? The quick answer that this paper offers is that: shareholder activism and the related practice of shareholder control and intervention. In other words, this paper recommends that shareholders of companies in Kenya need to exercise greater vigilance in safeguarding their investment.

Indeed, this paper has demonstrated on numerous occasions that shareholder activism does generally lead to increased accountability in companies.[216] This is best exemplified by a study of the capital markets in the United States of America.[217]Shareholder activism in the United States has largely been successful in not only effecting change in management and boosting accountability of directors but also improving shareholder value.

A classic example that has been offered in previous parts of this paper is the 1929 success by John Rockefeller in a proxy fight to effect changes in directorship in Standard Oil of Indiana, where he held 15% shareholding.[218] More recently, Relational Investors LLC (a hedge fund activist shareholder) used its influence as a shareholder in Timken Co, a company whose shares are publicly traded at the New York Stock Exchange, to cause the company to take major business decisions, namely separating the ball bearings and the steel businesses of the company.[219]

The aim of shareholder activism is not only to increase shareholder value at the individual-company level but also to have, at the economic or industry level, the

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[216]See generally Chapter Four to this paper.
[217]That study has been offered in Chapter Four of this paper.
[218] Carter F. Henderson and Albert C. Lasher, *20 Million Careless Capitalists* (Doubleday & Company, Garden City, New York 1967), 75-77.

[219]For a detailed explanation of the events, see Chapter Four of this Paper.

market forces reward the well-governed companies.[220] Therefore, for shareholder activism to be worth its costs, it must achieve enhanced profitability as well increased accountability and improved corporate governance in the target company.

It has been argued, against shareholder empowerment and activism, that in a bid to 'correct or prevent the errors resulting from poor managerial decisions', the 'genuine values of authority' will be lost.[221] Indeed, it has further been noted;

'if every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem.'[222]

In other words, were shareholders allowed to influence every decision of the directors, the directors' ability to make efficient wealth maximisation decisions would be lost.

Nevertheless, not even opponents of shareholder activism can deny this single fact; that:

'A business corporation is organized and carried on primarily for the profit of the sh areholders. The powers of the directors are to be employed for that end.'[223]

In the above premises, this paper suggests that there is a genuine case for shareholder activism in Kenya. However, for shareholder activism to produce the desired result without distorting the necessary notion of separation of management and governance from ownership of companies, there must be maintained a balance between the need to take into account shareholders' interest in increasing the value and return of their investment on the one hand and the equally compelling need to have order in the way companies are managed on the other hand. If this balance can

[220]Jeff Gramm (the author of 'Dear Chairman: Boardroom Battles and The Rise of Shareholder Activism') in an interview at Bloomberg on 20 August 2016.

[221]See for instance *Compaq Computer Corp. v. Horton*, 631 A.2d 1, 3–4 (Del. 1993). In that case, the right of shareholders to inspect company books is asserted as a matter of public policy, even though it may be adverse to the company's well-being and success.

[222]Kenneth J. Arrow, The Limits of Organization (W.W. Norton & Company, New York 1974), 78. See also Paul Rose and Bernard S. Sharfman, 'Shareholder Activism as a Corrective Mechanism in Corporate Governance' [2015]2014 *BYU Law Review* 1015-1052, 1028.

[223] Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).

be reached, the benefits of shareholder activism and empowerment are immense, not only to individual shareholders but to the company as a whole and, ultimately, to the Kenyan economy.[224]

In the final analysis, it remains to be seen whether shareholder activism in Kenya will be as successful as it has been in the United States. In fact, it is doubtful that shareholder activism has any chance of success in Kenya unless there is reform in the legal and regulatory framework governing the capital markets in Kenya.[225] In particular, this paper recommends at least four immediate action points for reforms in Kenya's corporate governance law and practice.

First, section 611 of the Companies Act should be amended. As pointed out in chapter three of this paper, that section retains or preserves the right of 'squeezing out' or 'buying out' minority shareholders in situations where an acquirer has acquired at least 90% of a company's shareholding but the holders of the remaining shares have rejected his offer to acquire. While this right may be intended to facilitate business and prevent situations where holders of small insignificant shares of a company's stock hold a well-intending acquirer hostage, it is hereby submitted that this right is open to abuse as the right to squeeze out minority shareholders is not subject to any conditions.[226]

Second, there needs to be put in place a code of governance that will apply universally to all companies in Kenya. Such a code needs to be drafted in such language as will make it clear that the code has the force of law and that companies are not at liberty to ignore it[227]. Most importantly, such a code must recognise that directors of companies serve at the pleasure of shareholders and that they must at all

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[224]See generally Chapter Two to this paper.
[225]See recommendations for legal reforms in chapter three of this paper
[226] The author suggests that such right should only be exercised if the minority shareholders by their acts or omissions become a hindrance to the main shareholder's plans that in the best interest of the company. Otherwise, the law should not allow minority shareholders to be forced out of their investment of choice without justifiable reasons.
[227] It is noted that a Code differs from the Act as the former will generally be more flexible and easy to adopt to commercial practice and market changes than the Act.

times act with the best interests of shareholders in mind. The result of a universally applicable code is that there will be cross-sector uniformity in corporate governance practice and possibly easier enforcement mechanism. If corporate governance practice is improved, then the problem identified by this paper's first hypothesis that companies in Kenya, including public companies, are often governed by disinterested men and women who are not sufficiently motivated to take all steps that may lead to increased shareholder value will have been solved.

Consequently, it is hoped, companies across all sectors of the economy will generally be more successful and will therefore post better profits. This will in turn widen the scope of choice for investors who wish to diversify their investment.

Third, the Companies Act must be amended, or appropriate regulations passed, to protect minority shareholders from excesses by majority shareholders. Currently, majority shareholders hold absolute power over the affairs of not only the company but also minority shareholders. As was aptly pointed out in Foss v Harbottle:[228]
'If the thing complained is a thing which, in substance, the majority of the company are entitled to do, or something has been done irregularity which the majority of the company are entitled to do regularly or if something has been done illegally which majority of the company are entitled to do legally, there can be no use in laying litigation about it, the ultimate end of which is only that a meeting has to be called, and then ultimately the majority gets its wishes.'

It is doubtful that such reforms will take place any time in the immediate foreseeable future.[229] What is beyond doubt, however, is that shareholders in Kenya need to pre-dispose themselves to become both monitors of the growth of their wealth and vehicles of corporate governance change and reform. Thus, this paper argues, the

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[228]See Chapter Three above.
[229] The author considers that the Companies Act 2015 and the Code of Corporate Governance for Listed Companies 2016 are fairly new and therefore there is need to allow sufficient time for their impact to be accessed before any suggested reforms are undertaken.

rule on separation of ownership and control of companies must be balanced with shareholders' legitimate expectation of wealth creation.

If directors will not promote this balance on their own, then shareholders must come in and exercise their ownership-derived power to effect change. In other words, this paper suggests that if the suggested reforms are not implemented, direct shareholder intervention has the potential to offer good prospects for improvement of management and ultimately enhancement of shareholder value. **After all, shareholders must at all times remember, it is their money at stake!**

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