CODIFICATION OF DUTIES OF DIRECTORS UNDER THE COMPANIES ACT, 2015: AN ANALYSIS OF THEIR CLARITY, ACCESSIBILITY AND CERTAINTY

BY

STANLEY MULUVI KIIMA

G62/87207/2016

RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF THE DEGREE OF MASTER OF LAWS (LLM) OF THE UNIVERSITY OF NAIROBI

SEPTEMBER, 2020

SCHOOL OF LAW

UNIVERSITY OF NAIROBI

DECLARATION

I declare that this research project is my own account of my own research and that the same has not been presented for examination in any other university.

Signed ……………………………………….. Date ……………………………..

Stanley Muluvi Kiima

SUPERVISOR'S APPROVAL

This Project has been submitted for examination with my approval as a University Supervisor.

Signed ……………………………………….. Date ……………………………..

Dr. Lois Musikali

School of Law

College of Humanities and Social Sciences

University of Nairobi

DEDICATION

I dedicate this research project to my dear wife Christine Muriuki and my sons Nathan Muluvi and Jason Muluvi for their unfailing support and encouragement.

ACKNOWLEDGEMENTS

I thank God for His grace as I went through this course.

Special thanks to my dear wife, Christine Muriuki and my Sons Nathan Muluvi and Jason Muluvi who endured my absence as I worked on this project. I will always treasure the encouragement they gave me and all the moral support they gave me at the most difficult times in writing this research project.

Sincere thanks to my classmates who gave me lots of insights and continuous support. May God bless you all and may you continue with the same spirit.

My deepest appreciation to my supervisor Dr. Lois Musikali who tirelessly and continuously guided me throughout the writing of this research project.

TABLE OF CONTENTS

DECLARATION---**(i)**

DEDICATION---**(ii)**

ACKNOWLEDGEMENTS---**(iii)**

ABSTRACT--**(iv)**

CHAPTER ONE--1

1.1 Background of the Study--1

1.2 Problem Statement---5

1.3 Objectives of the Study--6

1.3.1 General Objective---6

1.3.2 Specific objectives ---6

1.4 Research Questions--6

1.5 Justification of the Study--6

1.6 Scope---8

1.7 Research Methodology---8

1.8 Literature Review--10

1.9 Theoretical Framework---12

1.9.1 Shareholder Primacy Theory--13

1.9.2 Enlightened Shareholder Theory--14

1.10 Chapter Breakdown---15

CHAPTER TWO--17

2.1 Introduction---17

2.2 Common Law Duties--17

2.2.1 Duty to Act with Care, Skill and Diligence---18

2.2.2 Duty to Loyalty---18

2.2.3 Additional Duties---19

2.3 The Hard Law---19

2.3.1 The Companies Act, 2015---20

2.3.1.1 Duty to act with Powers--21

2.3.1.2 Duty to Promote the Success of the Company-----------------------------------23

2.3.1.3 Duty to Exercise Independent Judgement--24

2.3.1.4 Duty to Exercise Reasonable Care, Skill and Diligence------------------------24

2.3.1.5 Duty to Avoid Conflict of Interest---25

2.3.1.6 Duty not to accept Benefits from Third Parties-----------------------------------26

2.3.1.7 Duty to Declare Interest in Proposed or Existing Transaction or Arrangement---27

2.3.1.8 Other Duties Imposed on Directors--27

2.3.2 The Penal Code---28

2.4 The Soft Law---29

2.5 Conclusion--32

CHAPTER THREE---35

3.1 Introduction---35

3.2 Functions and Forms of Regulation --37

3.2.1 Soft Regulation (Soft law) --37

3.2.2 Hard Regulation (Hard law) --39

3.3 Effectiveness versus Compliance--40

3.4 Conclusion--42

CHAPTER FOUR --43

4.1 Introduction---43

4.2 Case of the United Kingdom---44

4.3 Case of the United States--46

4.4 The Effect of Codification and Application of Common Law on the Duties of Directors in Kenya--49

4.5 Conclusion---51

CHAPTER FIVE: --52

5.1 Summary ---52

5.2 Key Findings--53

5.3 Recommendations---54

5.4 Conclusion---55

List of Statutes--57

List of Cases--58

References--59

ABSTRACT

There has been widespread corporate collapse in Kenya both in the private and state-owned corporations. Many of the scandals witnessed in the past have mainly been linked to poor corporate governance and weak regulatory systems. In 2015, the new Companies Act was enacted codifying the duties of directors and thus bringing them squarely under the legal framework for corporate governance in Kenya. Before the codification, directors' duties were found under common law that were haphazard and restricted in application in Kenya. As such, they were not clearly spelt out, easy to access and their application was not certain. The question that begs for answers is whether codification of these duties has enhanced their clarity, accessibility and certainty for improved standards of corporate governance in Kenya. To achieve this, the researcher employed the shareholder primacy theory and the enlightened shareholder theory to guide the study. Doctrinal research was adopted as the most appropriate methodology for the research. The study analyzed director's duties under the common law and the duties as codified under the Companies Act, 2015. It also examined regulation as a concept in corporate governance and it emerged that two forms of regulation being hard law and soft law through soft codes or self-regulation are essential in regulation of corporate governance.

The study found that codification has enhanced clarity, accessibility and certainty in the application of directors' duties in Kenya. It also found that continued application of common law rules on the duties especially the general duties is still permissible; and that a complementary application of codified law and regulation through soft codes and best practices in Kenya is essential. The study will be beneficial for policy makers in corporate governance and provides a good body of knowledge on regulation in corporate governance.

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

This study sought to analyze the extent to which codification of duties of directors under the Companies Act, 2015[1] has enhanced their clarity, accessibility and certainty in their application in Kenyan. Prior to their codification in 2015, corporate governance and particularly matters pertaining to duties of directors in Kenya were largely left out to common law rules and principles of equity together with piecemeal legislative provisions and the Sample Code of Best Practice for Corporate Governance in Kenya. The Companies Act, Chapter 486 being the primary statute then did not give spell out what duties directors were seized with and as such many problems arose in the regulation of corporate governance in Kenya. Some of the other statutes that came in handy at the time included the Constitution of Kenya,[2] State Corporations Act,[3] Penal Code[4] and the Capital Markets Act.[5] Even after developing and adopting a code of corporate governance, issues of enforcement to check excesses by directors has led to widespread mismanagement of many corporate entities in Kenya.

The widespread collapse of major corporates in the world has brought about significant attention to matters of corporate governance. The discourse of corporate governance in the United Kingdom took significant importance especially as regards public companies in the early years

---

[1] Act No. 17 of 2015.
[2] The Constitution of Kenya, 2010 was promulgated on 28th August 2010.
[3] Cap 446 Laws of Kenya. The State Corporations Act is the main Act that establishes and regulates parastatals in Kenya.
[4] Cap 63, Laws of Kenya.
[5] Cap 485A Laws of Kenya.

of 1990 after the downfall of Maxwell Communications Corporation.[6]It has been observed from developed jurisdictions that success of codes of corporate governance depends mainly on the pivotal legal and regulatory structure.[7] It has been said that the ineffectiveness of the governing regulatory framework of corporate governance in Kenya over time is characteristic of the reluctance or incapability by the Capital Markets Authority to implement them, notwithstanding the failure by public listed companies to embrace the culture of corporate accountability.[8] Kenya's Companies Act, 2015 has borrowed heavily from the 1948 English Companies Act. Therefore, decided cases in such jurisdictions as England would be of immense insight as we attempt to understand the effect codification of directors' duties has on Kenya's corporate governance.

The private sector in Kenya has also sought to regulate corporate governance by developing Principles for Corporate Governance and also a code of best practice, both primarily aimed at guiding the board of directors of companies in Kenya.[9] The code outlines responsibilities of boards of directors requiring that companies be headed by boards of directors, who are required to take the company's best interest at their fore front and to act in a responsible, accountable, and transparent manner.[10]However, the code is not binding on the companies but is seen as just enabling guideline as will be discussed later in the study.

---

[6] Cadbury, A. (1992). *Committee on the Financial Aspects of Corporate Governance Report*. London, Gee. Vol. 1. Committee on the Financial Aspects of Corporate Governance, Code of Best Practice (Gee, 1992).

[7] Gakeri, J. (2013). *Enhancing Kenya's Securities Markets through Corporate Governance: Challenges and Opportunities*. International Journal of Humanities and Social Science Vol. 3, 6, 96.

[8] Moeen Cheema & Sikander Shah, (2009). *Corporate Governance in Developing Economies: The Role of mutual funds in Corporate Governance in Pakistan*, Hong Kong Law Journal, Vol. 36, 341.

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

[10] Ibid.

There has been widespread collapse of corporate entities in Kenya with nearly 70% of the scandals associated with poor corporate governance and weak regulatory and supervisory systems among other factors.[11] The collapse of banks in Kenya since the 1980s with the latest culprits being Chase Bank Limited and Imperial Bank has largely been occasioned by decisions by directors of these banks. Other companies like Uchumi supermarket[12] and Nakumatt supermarket and several insurance companies collapsed out of poor decisions made by their directors and directors' failure to promote the success of the companies including mismanagement of finances. Other reasons cited for major corporate collapses in Kenya include management dishonesty, director's conflict of interest and lack of director independence.[13]

Clearly decisions of directors have far reaching consequences on the performance of companies they lead. This means that their duties must be well spelt out if any meaningful enforcement is to be achieved. Codification is one way of bringing duties of directors under the legislative platform that ensures better understanding of the duties, enhanced accessibility with attendant sanctions for breaches hence ensures certainty in their application. This serves to deal with issues of corporate malfeasance as has been witnessed in Kenya in the past. The period prior to the enactment of the 2015 Companies Act, directors' duties were understood in the context of rules of *common law principles* whose application in Kenya is through section 3(2) of the Judicature Act[14] and are subject to limitations specified therein. The hierarchy created in the Judicature Act meant that the rules of *common law and principles of equity* were subservient to statute law and

---

[11] Rotich, G. & Gachoki, S. (2013). *Influence of Corporate Governance on the Performance of Public Organizations in Kenya (a Case of Kenya Ports Authority).* Research Journal of Finance and Accounting. Vol. 4, 6. www.iiste.org Accessed 22 May 2019.

[12] Eshiwani, A. (2006). *Director Liability in the Wake of Uchumi (Collapse)".* Institute of Directors (Kenya). Papers.ssrn.com. Accessed 22 May 2019.

[13] Some of these corporates include Cooper Motors Corporation, East Africa Portland Cement Company Limited, Kenya Meat Corporations.

[14] Chapter 8, Laws of Kenya, s. 3(2).

thus were relegated to peripheral application. The Judicature Act also created a number of constraints to the application of *common law rules* and doctrines of equity thus; their application is conditional on the Constitution and all other written laws. Section 3 of the Act provides that

> … the application common law rules and doctrines of equity is only in instances where written laws do not extend or apply the substance of common law, the doctrines of equity and the statutes of general application and their application ought to be permissible in the circumstances of Kenya and its inhabitants…

and may be qualified accordingly in this regard.

Codification was seen as a solution to this problem and was aimed at bringing clarity as to what directors duties were and also to enhance their accessibility with a further need to ensure certainty of their application in the Kenyan context. The Companies Act, 2015 thus codifies directors' duties under common law in order to augment the concept of corporate governance by entrenching it in Kenya's legal framework. This study seeks to find out if codification of duties of directors has thus brought this clarity, enhanced their accessibility, and hence brought certainty in the application of these duties and improve the standards of corporate governance in Kenya.

Key concepts like regulation, clarity, accessibility, certainty, effectiveness, compliance needs to be explained here. Regulation, effectiveness and compliance are terms which will be elaborately defined and discussed in chapter two. The term clarity has been used in this study as a noun meaning the quality of being clear, coherent, distinct, and easily perceived or understood. The term accessibility is a derivative of the term accessible which is itself an adjective that qualifies access as a noun. With its varied uses, the tem access here connotes retrieval of information.

Accessibility has been used in this study in two senses; of something capable of being reached and capable of being understood or appreciated. In the second sense it also complements the term clarity as used in the study. Certainty is used as a noun that stems from the word certain with the meaning that something is able to be firmly relied on to happen or be the case. It denotes the ability of something being beyond the possibility of doubt. These terms are used in this study in the sense explained herein and not in their other general meanings not contemplated in this study.

1.2 STATEMENT OF THE PROBLEM

The Companies Act, 2015 has codified duties of directors to be observed by directors of companies in Kenya therefore bringing these duties squarely into the Kenyan legal framework. Prior to this enactment, directors were expected to observe duties which existed under the common law regime as applied in Kenya through the Judicature Act. As such the duties were not clearly spelt out and their true nature and extent was amorphous. For directors to clearly understand what duties they are seized with it is important that there is clarity on what precisely these duties entail; they also need to be easily accessible and some level of certainty as to how the duties should be applied is vital.

Now that the duties have been codified, it becomes necessary to evaluate if codification has made them clear and easily accessible by directors. This study seeks to find out if codification has enhanced clarity of the duties, whether they are easily accessible to directors and the extent to which they are certain to enable directors to apply and abide by them in their roles as directors of companies in Kenya. In doing so, the study will seek to analyze the essence of codification as a form of regulation vis-à-vis other forms of regulation in corporate governance so as to establish

whether codification as envisaged has enhanced clarity, accessibility and hence certainty in the duties of directors in Kenya.

1.3 OBJECTIVES OF THE STUDY

1.3.1 GENERAL OBJECTIVE

To establish if codification of directors' duties under the Companies Act, 2015 has enhanced clarity, accessibility and certainty in the application of the duties in Kenya.

1.3.2 SPECIFIC OBJECTIVES

(i) To examine if codification of duties of directors under the Companies Act, 2015 has enhanced their accessibility.

(ii) To find out if codification has enhanced certainty in the application of duties by directors in Kenya.

1.4 RESEARCH QUESTIONS

(i) To what extent has codification of duties of directors enhanced their clarity and accessibility in Kenya?

(ii) To what extent has codification enhanced certainty in the application of duties of directors in Kenya?

1.5 JUSTIFICATION OF THE STUDY

In the background of the study it has been observed that before the Companies Act, 2015 was enacted directors' duties in Kenya were founded on rules of common and equitable principles

and their application was subject to the provisions of the Judicature Act.[15] The repealed Companies Act cap 486 did not spell out these duties. Other challenges brought by common law arose with the interpretation of the duties. It thus becomes important to analyze this codification as a form of regulation vis-à-vis other forms of regulation I corporate governance. This study assist the reader in understanding the concept of codification of the duties of directors under the Companies Act and specifically if codification deals with the challenges that came with common law especially as regards their clarity, accessibility and certainty in their application in Kenya.

The study will be useful as it will enlarge the academic body of knowledge on the issue of regulation of corporate governance, particularly duties of directors. The analysis of different types of regulation that exist vis a vis various modes of regulating corporate governance and accountability of directors in Kenya has been done in this study. This will be of great assistance to policy makers when addressing challenges emerging in corporate governance n Kenya.

The study will also assist in benchmarking the regulation of corporate governance in Kenya against international best practice in corporate governance. It will also help in advancing a case for progressive interpretation of the duties as they are applied in Kenya.

The study recommends for induction and continuous training of directors and this will result in enhanced performance by boards of companies and focused directing of companies by boards of directors.

It will also assist in the quest for harmonization of corporate governance regulatory framework by providing important literature and analysis on regulatory mechanisms in corporate governance.

---

[15] Section 3 of the Act.

1.6 SCOPE OF THE STUDY

This study will mainly examine if codification of duties of directors under the Companies Act, 2015 has brought clarity and enhanced accessibility of the duties to directors in Kenya. It will also assess whether it has enhanced understanding of the duties in order to enable better application in Kenya's corporate scene.

In doing so the researcher will attempt to define and analyze forms of regulation aiming at examining if codification is the best form of regulation Kenya has achieved or other forms of regulation like the use of codes of best practice are any better. The main focus here will be to understand how we can regulate effectively. The researcher will ultimately observe and compare these forms of regulation with the governing framework appertaining in Kenya in the corporate governance scene.

The research will briefly appreciate the experience of codification in other comparable jurisdictions with the aim of drawing lessons with the aim of better understanding of the Kenyans case.

1.7 RESEARCH METHODOLOGY

Research design is the blueprint researchers use to guide their research so as to ensure that it addresses the research problem. Mugenda and Mugenda[16] observes that a research design is the technique a researcher uses to carry out research. This study will adopt doctrinal research methodology. Black's Law dictionary defines doctrine to mean a rule, tenet, principle or theory

[16] Mugenda, O and Mugenda, A. (2003) *Research Methods: Quantitative and Qualitative Approaches,* Nairobi, Kenya-Acts Press.

of the law. The term is believed to stem from a Latin word "doctrina" meaning knowledge or learning and it also encompasses principles and legal concepts.

According to Mark Von Hoecke, doctrinal legal research entails many things including direct descriptions of laws and even practical problem-solving. He further observes that it deals with related comments in interpretations and theory building.[17] He sees it as a two-step process that at first involves locating the sources law and secondly giving interpretations and analysis of the text. In the first step the researcher identifies the legal provision as enacted or as a principle engrained in common law.[18]

Doctrinal research method can be distinguished from empirical research or evidence-based methods. This is because empirical data is obtained by observing or measuring social phenomena. Although some aspects of facts and ideas within doctrinal research including laws and judicial decisions can be taken as social realities, they indeed are different because these are legitimized by the sovereignty of their source being Legislature or the courts of law as opposed to them naturally occurring.

Doctrinal method is preferred because it allows for an in-depth analysis of the phenomenon under study because it applies the proper tools of legal research as opposed to qualitative and quantitative methods. The scope of the study is also limited to descriptive aspects of regulation as opposed to enforcement aspects which would require raw statistics from real happenings in the field.

---

[17] Hoecke, V.M. (2011) *Methodologies of Legal Research: Which Kind of Method for What Kind of Discipline*? (ed) Hart Publishing.
[18] Hutchinson, T.C.M. (2018) *Researching and Writing in Law*. 4th ed. Pyrmont, NSW : Lawbook Co.

The research will be library based. The researcher will use materials from the library, materials from online sources, reported cases and statutes from the Kenya and elsewhere. Proper acknowledgement and citations will be adopted in order to avoid instances of plagiarism.

1.8 LITERATURE REVIEW

McLennan[19] argues that directors are supposed to observe two categories of common law duties in discharging their responsibilities. The first one he calls fiduciary duties which he describes as "*duty of loyalty to the company*" and that directors are obligated to do nothing which goes against the interests of the company. He refers to the second category as the *"duty of skill and care"* and describes it as dictatorial competence, and that implies directors have a primary role of separately and collectively exercising powers vested in them for the best interest of the company. He seems to rely on the common law standards in assessing the duties in question. He does not contemplate situations of statutory intervention in the form of codification of these duties. His analysis is merely a description of the nature of directors duties.

Santow J.[20] examines the directors' duty of care post codification of the common law duties of directors. He observes that directors are called upon to familiarize themselves with the basic operations of the company's business and should constantly be informed of the company's undertakings.

Esser and Coetzee[21]examines directors duties relating to stakeholders protection in South Africa. Their analysis of the code of best practice as contained in the South Africa's King II Report show that directors were therein required to not only conform to the law but also to their duties

[19] McLennan, S. (1996). *Duties of skill and care of Company Directors and their liability for negligence*. South African Merchantile Law Journal 94-102.
[20] Santow, K. (1999). *Codification of Directors Duties*, 73 ALJ 336.
[21] Esser, I. M. & Coetzee, J. (2004). *Codification of directors' duties,* Juta's Business Law, 12.

regardless of their absence in the law. The arguments in their article agree that contemporary principles in corporate governance have been significant in informing the need to shape the content of the contemporary standard expected of directors.

Musikali[22] observes that there is a linkage between corporate governance and laws in Kenya. She suggests adoption of a dual standard of liability akin to the one in UK. She argues that such would ensure deeper scrutiny of directors' accountability. She advocates for increased criminal sanctions under the repealed companies Act and the Penal Code.[23]These arguments were advanced before codification of directors' duties under the new Companies Act.

Karugor Gatamah[24] highlights the challenges faced by Kenyan firms in promoting good governance. He argues for the adoption of international principles to suit different needs and to address peculiarities of different economies, sectors and types of organizations. The author brings interesting arguments to the table since international best practice in corporate governance is an essential element in this study.

Wairimu, J.[25] has analysed the role of the Capital Markets Authority as the regulator and the role of Nairobi Stock Exchange (NSE) in ensuring proper compliance with laws and guidelines on corporate governance in Kenya. Her book has also examined legislation and the enforcement procedures within CMA and NSE. Further analysis has been done on the role of institutions such as KASIB[26], ICIPAK[27] AND CCG[28] in dealing with corporate irregularities in Kenya. The

---

[22] Musikali, L. M. (2009). *Why criminal sanctions matter in corporate governance*. International Company and Commercial Law Review 133-141.

[23] Chapter 63 of the Laws of Kenya.

[24] *Corporate Governance in Africa: Anew Strategy.* A paper presented at the conference titled *"Corporate Citizenship: The Challenge for Africa*" held at the Nairobi Serena Hotel, Nairobi on January 18-22, 2004.

[25] Wairimu. J. (1910). *Corporate Governance Irregularities in Kenya's Financial Markets*. https://www.scribd.com/doc/31603577/Corporate-Governance-Irregularities-in-Kenya-s-Financial-Markets. Accessed on 9 May 2019.

[26] Kenya Association of Stockbrokers and Investment Bank.

author wrote before the codification of the duties of directors under the current Companies Act. Therefore, her analysis is outdated and although she gives important insights into the workings of these institutions, she fails to capture the essence of statute law and its enforcement mechanisms.

According to Jacob Gakeri[29] (2013) the principles applied in corporate governance in Kenya for listed companies usually apply the enforcement scheme of "comply or explain", which has not been particularly effective. He attributes corporate failures in Kenya largely on ineffectiveness of modalities used in dealing with corporate governance and the underlying legal framework which he terms as weak. He further observes that the Capital Markets Authority has been unwilling or unable to enforce the guidelines in force and that public listed companies have failed to embrace corporate culture of accountability. The author's observations are acceptable to the extent that they espouse the challenges bedeviling Kenya's corporate governance scene. He however, does not appreciate the effect of statutory intervention in this arena and the weight express law would have in solving the problems being faced.

1.9 THEORETICAL FRAMEWORK

The research will be anchored on the shareholder primacy theory and the enlightened shareholder theory.

---

[27] Institute of Certified Public Accountants of Kenya.
[28] Centre for corporate governance.
[29] Gakeri, J.K. *Enhancing Kenya's securities markets through corporate governance challenges and opportunities.* http://www.ijhssnet.com/journals/Vol_3_No_6_Special_Issue_March_2013/11.pdf http://hdl.handle.net/11295/81972. Accessed on 9 May 2019.

1.9.1 SHAREHOLDER PRIMACY THEORY

According to Friedman, “there is one and only one social responsibility of business … to increase profits so long as it stays within the rules of the game”[30]This theory advances the thinking that the primary responsibility of corporate management is to uphold the economic interest of shareholders.[31] It rejects any regard to the other various company’s constituents that are non-shareholders including the suppliers, workers, consumers, creditors and the community where the company operates noting that these must generally not comprise the primary obligation to its shareholders. This conception places the shareholder at a privileged position as opposed to the other many stakeholders.

The theory stands in contrast to the other models that advocate for the balancing of the interests (that are potentially conflicting) of different stakeholder groups.[32] Others have advocated for corporate social responsibility arguing that companies have a duty to add to the improvement of the society.

This theory must be distinguished from the agency theory in that according to the agency theory, job of the agent is to simply perform the task as assigned by the principal, acting on his behalf.[33]It has been argued that this could in effect mean several things including nurturing productive, efficiency-increasing relationships with other stakeholders, which shareholder primacy theory in its essence rejects.[34] With the agency theory, wealthy maximization concept does not necessarily negate from the agency idea, but is rather implied.

---

[30] Milton Friedman, (1970). *Social Responsibility of Business if to Increase Profits*. New York Times, 30.
[31] Millon, D. *Radical Shareholder Primacy*. (2013). University of St. Thomas Law Journal. Vol. 10, 1013.
[32] Margaret M. Blair & Lynn A. Stout. (1990). *A Team Production Theory of Corporate Law*. Virginia Law. Review, Vol. 85, 247.
[33] *Restatement of the Law of Agency* (2006) 3rd Edition. American Law Institute.
[34] Friedman (n 30).

Shareholder primacy theory fits well in this study where the primary consideration is the accountability bestowed upon the management in fulfilling their core mandate of maximizing wealth for the advantage of the owners of the company, the shareholders.

1.9.2 ENLIGHTENED SHAREHOLDER THEORY

This theory concerns itself with the question that when the concern for particular stakeholders does becomes a necessary to the company; and when does such concern become detrimental to shareholders and beneficial to other stakeholders? This theory is based on the works of Jessen[35] who gave a critique to stakeholder theories for not giving criteria for identifying different stakeholders.

The theory argues that a company will not be able to maximize value if it ignores the interests of these particular stakeholders, and in so doing managers must satisfy and enroll the backing of the important stakeholders who include customers, employees, suppliers, managers, and even local communities.[36] It assumes the arrangement of the stakeholder theory although it focusses on the maximizing the value of firm in the long-run as the gauge for ascertaining the diverse stakeholders. Other theories that underpin this theory include the cognitive and behavioral theories. In essence, the theory argues that the firm's ultimate objective is to value maximization, but in achieving that objective, the firm must meet the needs of all its essential corporate constituencies.[37]

According to Jessen, the utmost interest of the firm forces companies to deliberate about their stakeholders. He says that "We cannot maximize the long-term market value of an organization

[35] Jensen, M. (2001). *Value maximization, stakeholder theory and the corporate objective function*. Journal of applied corporate finance, Vol.14, No3, pp.8-21.
[36] ibid.
[37] ibid.

if we ignore or mistreat any important constituency. We cannot create value without good relations with customers, employees, financial backers, suppliers, regulators and communities."[38]

From this theory it is seen that the obligations of the board directors becomes clear and that they must at all times protect the welfare of the company in the long-run. The idea is to set the duties of directors firmly but also giving them some room for maneuver in their exercise of their duties. It is well spelt out under section 143 of the 2015 Companies Act directors should act within powers. These powers are to be exercised only as delegated to them by the shareholders in consonance with the constitution of the company.

It will serve as a good theory in explaining the call upon directors to adhere to the responsibilities for which they are appointed to serve. It will therefore, be a befitting theory to guide this study.

1.10 CHAPTER BREAKDOWN

This study will be structured in the form of chapters. Chapter one will encompass the background of the study, problem statement, objectives of the study, study questions, justification of the study, scope, research methodology, literature review, theoretical framework, and finally the breakdown of chapters in the study.

Chapter two will attempt to define regulation and to analyze different types of regulation including hard and soft regulation and why they one is chosen over the other, the pros and cons of these types of regulation with the aim of understanding how to regulate effectively. This will help in accessing if codification has any significance over other forms of regulation like using codes of corporate governance.

---

[38] ibid.

Chapter three will give an overview of legal frameworks used in Kenya with respect to corporate governance. Common law duties will be briefly discussed here in order to juxtapose them with the codified duties and find out whether the clarity, enhanced accessibility and certainty envisaged in the study was attained. An attempt will be made to assess if the regulatory frameworks adopted in Kenya fits well with the descriptions done in chapter 2.

Chapter four analyzes the complementary application of the hard and soft law with a bit of comparative analysis of the UK and USA experiences. It also looks into the effect of codification and the continued application of common law to general duties of directors.

Chapter five will give the conclusions, key findings and recommendations.

CHAPTER TWO

LEGAL FRAMEWORK FOR CORPORATE GOVERNANCE IN KENYA

2.1 INTRODUCTION

Regulation of corporate governance in Kenya is somewhat mixed. We can say it is mixed in the sense that there is the hard law that is to be found in the form of laws enacted by parliament and also application of soft law to be found in codes of best practice.

This chapter will start by appreciating the aspect of codification and then discuss the codified duties of directors. An attempt will be made at highlighting common law duties in order to enable the reader to appreciate the essence of codification of these duties. It will also briefly discuss soft regulation in the way of codes of best practice adopted in Kenya in a bid to regulate corporate governance and close by appreciating the concept of effectiveness and compliance of statutory enactments as against self-regulation through codes. Hard law is a term that is used in the chapter to mean statutory provisions enacted through formal legislation while soft law is used to mean codes of best practice that are ordinarily non-binding in nature as opposed to formal law. These terms are extensively defined and well conceptualized elsewhere in chapter three of this study.

2.2 COMMON LAW DUTIES

Common law otherwise referred to as 'fiduciary duties' were first expounded by the judges of common law who at the time operated without the benefit of help of written law. In Cyberscene Ltd and Others v i-Kiosk Internet and Information (Pty) Ltd[39] the court held that a director stands

[39] 2000 (3) SA 806 (C).

in a fiduciary relationship with the company where he serves as a director and it does not matter whether he is a non-executive director. They are not spelt out at all in any formal enactment but they continue to evolve without formal law. In the case of Howard v Herrigel and Another[40]the Court stated that it '*is a long-established principle of South African law that such a fiduciary duty exists and that the breach thereof is remediable by means of an interdict'* They manifest themselves as duties that directors owe to the shareholders by virtue of their fiduciary relationship with the shareholders and mainly entail two core duties of loyalty and duty of care. In essence behooves a director to perform the functions and exercise powers of a director in good faith and also in the best interest of the company.

2.2.1 DUTY TO ACT WITH CARE, SKILL AND DILIGENCE

This duty calls on directors to inform themselves "*prior to making a business decision, of all material information reasonably available to them.*"[41]Over and above the mere facts given to the board, directors are called upon to proceed with a attentiveness when evaluating any information in order to guard the interest of the company and shareholders. A two pronged test is applied here; a subjective test where the skill of the particular director is called to question as well as an objective test where reasonable man test is applied.

2.2.2 DUTY TO LOYALTY

This duty requires that director to put the interests of the corporation and its shareholders over and above his own personal interests.[42]This is what traditionally is called duty to avoid conflict

[40] NNO 1991 (2) SA 660 (A) at 678B - C.).
[41] *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (quoting Aronson, 473 A.2d at 812).
[42] *Cede & Co. v. Technicolor, Inc*., 634 A.2d 345, 361 (Del. 1993).

of interest and includes an obligation by a director not to obtain a benefit personally that is not for the collective good of the corporation.[43]

2.2.3 ADDITIONAL DUTIES

Additional duties arise from this duty and they include duty of good faith, duty of confidentiality and duty of disclosure. Duty to loyalty means that a director is under the onus to act in good faith. The duty to act in good faith though does not create an independent fiduciary duty in the same level as duty of care and loyalty. A director is deemed to breach this duty when he

> … intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.[44]

The duty of confidentiality bars a director from using confidential corporate information in furthering his own interests and that he may not disclose such information of confidential nature to others who may use the same for their own benefit.[45] The duty of disclosure would require a director to act be completely sincerity. In particular circumstances the duty requires full disclosure of all material facts and information to the board making a decision.[46]

The place of common law is well preserved under the Companies Act of 2015 as regards general duties where the Act requires that these duties be applied under common law.

2.3 THE HARD LAW

This entails legislative enactments and includes the following:

[43] *Gantler v. Stephens*, 965 A.2d 695.
[44] *In re Walt Disney Co. Derivative Litig*., 906 A.2d 27, 67 (Del. 2006).
[45] *Brophy v. Cities Serv. Co.,* 70 A.2d 5, 7-8 (Del. Ch. 1949).
[46] *Lynch v. Vickers Energy Corp.,* 383 A.2d 278, 279 (Del. 1977).

2.3.1 THE COMPANIES ACT OF 2015

This is the primary legislative enactment for regulation of corporate governance in Kenya. Prior to the Companies Act of 2015, the repealed Companies Act[47] did not specifically spell out the duties of directors and their proper accountabilities. Directors' duties were understood in the context of rules of Common law principles whose application in Kenya is through section 3(2) of the Judicature Act[48] and are subject to limitations specified therein.

Taking cue from the UK and Australian jurisdictions in effecting corporate law reforms, Kenya enacted the Companies Act of 2015 as a contemporary legal framework on corporate governance and to deal with existing gaps therein.[49] This Act codifies duties of directors prescribed under common law squarely bringing them under the Kenyan legal framework. The concept of codification is not new. It was done in Rome for example in order to bring legal principles available to its citizens and to also affirm them.[50]

The Kenyan Act aforesaid codifies seven duties of directors based on the common law rules and equitable principles as they relate to directors[51]. The Act further states that

> The general duties of directors are to be interpreted and applied in the same way as common law rules or equitable principles, and those interpreting and applying those rules and principles are required to have regard to the corresponding common law rules and equitable principles.[52]

While general duties are enforceable through civil action, specific duties are generally enforceable through criminal sanction. The Companies Act imposes sanctions for non-

---

[47] This is the law that existed before the enactment of the present Companies Act of 2015.
[48] Chapter 8, Laws of Kenya, s. 3(2).
[49] Mwaura, K. *Company Directors' Duty of Skill and Care: A Need for Reform.* 2003 24 (9). Company Lawyer 283: Musikali, L. *The Law Affecting Corporate Governance in Kenya: A need for Review.* (2008) 19 (7) International Company and Commercial Law Review 21.
[50] Van Niekerk and WildenBoer. 2009. *The Origins of South African Law.* 63.
[51] The Companies Act, 2015, s 140 (3).
[52] ibid, s 140 (4).

compliance with specific duties. For instance, failure to file annual financial statement and reports each director commits an offence punishable by a fine of not less than Kenya Shillings Five Hundred Thousand, but it remains sufficient defense that one took reasonable steps to comply.[53] However, Kenya‘s justice system has exhibited weaknesses in prosecuting and punishing perpetrators of corporate crime. Besides, companies find it difficult to report offences committed by their directors and this is even more true where directors double as shareholder the company‘s management.[54]

Prior to codification of directors' duties in Kenya, Professor Kiarie Mwaura[55]carried out a survey where majority of the respondents said that directors breach their duties because important common law principles were not codified into law. This finding is an indication that a majority of directors were not aware what their duties entails so that they could be obliged to act accordingly.

The duties will be enumerated and discussed independently as follows;

2.3.1.1 DUTY TO ACT WITHIN POWERS

A director is required to be guided by company's constitution and act accordingly and is further required to only exercise powers for the purposes for which they are conferred.[56]

Directors are given powers to enable them to them to do the job of running the company. To do a director should act in consonance with the company's constitution and utilize powers for the

---

[53] Section 692 of the Companies Act, 2015.

[54] 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.

[55] Kiarie Mwaura, 2002. *Regulation of Directors in Kenya: An Empirical Study*, I.C.C.L.R., 13(12), 465-479.

[56] The Companies Act, 2015, s 142.

benefit of the company and not for any other purpose. In *Harlowe's Nominees Pty v. Woodside,*[57] the High Court of Australia held that a director was guided by an improper purpose when he allotted a large number of new stocks to defeat a potential takeover bid instead of aiming to raise capital.

What sums up to proper purpose was decided by the Privy Council in *Howard Smith Ltd v. Ampol Ltd*[58]where the matter concerned the power of the directors to issue new shares. In the instant case the allegation was that the directors alloted a big number of new shares to purposely dispossess a certain shareholder of his voting majority. The court found that it would be a proper exercise of the director's powers to allot shares to a larger company to ensure the financial stability of the company. Even if in doing so it deprived a majority shareholder of his majority shareholding or it defeated a take-over bid, it did not by its own make the share allotment inappropriate. If the singular drive was aimed at defeating the majority shareholding or block a take-over attempt, then it would have amounted to an improper purpose.

Acts that are done outside of the powers given are voidable. In *Hogg v. Cramphorn Ltd*[59] the court held that the decision by the directors to issue new shares invalidated them. In this famous case in the UK, the directors allotted shares with the aim of preventing the takeover attempt by Mr. Baxter hence they violated their duties.

---

[57] [1968] HCA 37, (1968) 121 CLR 483.
[58] [1974] UKPC 3, [1974] AC 832, Privy Council (on appeal from NSW).
[59] [1967] Ch 254; [1966] 3 All ER 420.

2.3.1.2 DUTY TO PROMOTE THE SUCCESS OF THE COMPANY

This duty requires a director of a company to act in the way in which the director considers would promote the success of the company and would work to the benefit of its members as a whole, and in doing so the director is also required to consider the following;

(i) the long term consequences of any decision of the directors;
(ii) the interests of the employees of the company;
(iii) the need to foster the company's business relationships with suppliers, customers and others;
(iv) the impact of the operations of the company on the community and the environment;
(v) the desirability of the company to maintain a reputation for high standards of business conduct; and
(vi) the need to act fairly as between the directors and the members of the company.[60]

The test projected in assessing this duty is a subjective one as Lord Greene MR in ***Re Smith & Fawcett Ltd*** [61]expounded thus;

> The principles to be applied in cases where the articles of a company confer discretion on directors are, for present purposes, free from doubt. They must exercise their discretion bona fide in what they consider – not what a court may consider – is in the interests of the company, and not for any collateral purpose. The question, therefore, simply is whether on the true construction of the particular article the directors are limited by anything except their bona fide view as to the interests of the company.

This duty therefore requires directors of a company to act in "*good faith"* in what they consider to be in the best interest of the company. This calls upon the directors to direct their minds in deciding if a transaction is truly in the best interest of the company.[62]However, it has been said that *bona fides* cannot be the only test in evaluating compliance with this duty. In the case of *Hutton v. West Cork Railway Co*, Bowen, LJ rightly observed

> … Bona fides cannot be the sole test, otherwise you might have a lunatic conducting the affairs of the company, and paying away its money with both hands in a manner perfectly bona fide yet perfectly irrational… It is for the directors to judge, provided it is a matter which is reasonably incidental to the carrying on of the business of the company… The law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company.[63]

---

[60] The Companies Act, 2015 s 143.
[61] [1942] Ch 304.
[62] *Re W & M Roith Ltd* [1967] 1 WLR 432.
[63] (1883) 23 Ch D 654.

2.3.1.3 DUTY TO EXERCISE INDEPENDENT JUDGEMENT

Directors are required to exercise independent judgment.[64] Subsection 2 thereof qualifies the duty by adding that a director will not violate the duty if he acts in pursuance of an agreement entered into by the company that tends to restrict the future exercise of discretion of its directors; or otherwise acts in a way sanctioned by the company's constitution.

This duty means that as a director you cannot simply follow the decision of another person, even that of a colleague, but you must consider the welfare of the company and thereby make your decision. A director thinking for himself here is a legal duty. This duty requires a director who does not agree with the decision of the rest of the board to have his dissenting views well minuted. And if the board entirely refuses to listen to him, then resignation is an option open to him. In the Carlyle case[65] the learned judge ruled that a director,

> ... *will therefore* breach this duty if he merely does what he is told by others for whatever reasons, or acquiesces without question or consideration in what he is asked to do or told by others.

He went on to qualify the duty thus:

> A duty to exercise an independent judgement does not mean a duty to act entirely alone, nor to act without taking into account any views expressed or even decisions which are made by his fellow director. A director must exercise his own judgement according to his own assessment of the facts but where, for example, a director does not possess a particular expertise but is aware that one of his fellow directors does, there is nothing in this duty which obliges the first director either to make a decision without ascertaining the views of the expert director or without having regard to them, or to make himself a sufficient expert in the area that he can assess the opinions of the expert director from a position of expertise.

2.3.1.4 DUTY TO EXERCISE REASONABLE CARE, SKILL AND DILIGENCE

The Act requires a person performing the functions of a director to apply the same care, skill and diligence that a reasonable and diligent person would exercise. This would mean a person with

---

[64] The Companies Act, 2015, s 144.

[65] Lerner, Josh, and Alexey Tuzikov. "The Carlyle Group and Axalta." Harvard Business School Case 818-040, September 2017. (Revised October 2017).

the general skill, knowledge and experience that would ordinarily be expected of a person performing the functions of a director in relation to the company (OBJECTIVE TEST); and also the general skill, knowledge and experience that the particilar director has (SUBJECTIVE TEST).[66]

In the Carlyle case the court stated that the test for standard of care is

> That of a reasonably diligent person having both (a) the general knowledge skill and experience that may reasonably be expected of a person carrying out the same functions as those of the relevant director with regard to the company and (b) the actual knowledge skill and experience of that director. … It is further common ground that this is therefore a combined objective and subjective test, and that the subjective element is capable of raising, but not lowering, the standards to be expected of an individual director.

On the subjective element to the test the Judge stated that it *"refers to the particular attributes which a director is expected to bring to the Board for the benefit of the company"*.[67]

2.3.1.5 DUTY TO AVOID CONFLICTS OF INTEREST

A director of a company is required to avoid a situation in which the he has, or can have, a direct or indirect interest that conflicts, or may conflict, with the interests of the company. This conflict relates particularly to the utilization of any property or information of confidential nature belonging to the company, the position he holds and opportunities therein. It is immaterial whether the company can take advantage of the property, confidential information or opportunity.[68]It is sufficient to prove that the issue has been authorized by the rest of the directors.[69] The section refers to a conflict of interest to also include a conflict of interest and a conflict of duties.[70]

---

[66] The Companies Act, 2015 s 145.
[67] Supra n.65.
[68] The Companies Act, 2015 s 146 (1)(2)
[69] The Companies Act, 2015 s 146 (3)
[70] ibid, s 146(7).

Subsection 8 thereof defines instances when conflict of interest arises to include when the director or member of his family takes part in the transaction or bears financial interest in the transaction; or if they possess material financial interest in the transaction which could affect their judgment unfavorably to the company.

A breach of this duty renders any transaction entered into voidable at the behest of the company. However, the Act limits the voidance of such transaction or arrangement if restitution is not an option or if the company has been indemnified for the loss or damage suffered or if such voidance is likely to affect rights acquired in properly by a third party.[71]

Liability for breaching this duty continues to accrue to the director or other persons involved notwithstanding voidance of the transaction to account for the profit made and also to indemnify the company from the loss or damage suffered.[72]Breach of this duty is an offence and the concerned director is liable if convicted to be disqualified for a period of not less than five years.[73]

2.3.1.6 DUTY NOT TO ACCEPT BENEFITS FROM THIRD PARTIES

The duty requires a director to avoid receiving benefits from third parties if the benefits are attributable the him being a director of the company or to his acts or omissions as a director thereof.[74]

This duty is however qualified in that if the benefits are rendered to the company, it is immaterial if they were received by the director as a director or otherwise from a third party. The section

[71] ibid, s 146(9).
[72] ibid, s 146(10).
[73] ibid, s 146(11).
[74] The Companies Act, 2015 s 147.

refers to a conflict of interest to also include a conflict of interest and a conflict of duties.[75] A breach of this duty is an offence punishable if convicted to a fine of not less than one million shillings.[76]

2.3.1.7 DUTY TO DECLARE INTEREST IN PROPOSED OR EXISTING TRANSACTION OR ARRANGEMENT

This duty requires that a director who is directly or indirectly interested in a proposed transaction with the company or who is interested in a transaction that the company has already entered into to declare the nature and extent of his interest within seventy two hours. Declaration of interest should be addressed to the fellow directors for a private company and to members of the company in case of a public company.[77] The manner how the declaration is to be made is specified therein.[78]

However, a director is exempt from making declaration interest if he is not aware such interest or does not know the particular transaction to which such interest relates.[79]A director is presumed to be aware of matters of which the director ought reasonably to be aware.[80]A breach of this duty attracts a fine not exceeding one million Kenya shillings.[81]

2.3.1.8 OTHER DUTIES IMPOSED ON DIRECTORS

The Companies Act places upon directors a duty to prepare company's annual and business review report which contains information about the company's financial position, environment,

---

[75] ibid, s 147(4).
[76] ibid, s 147(5).
[77] ibid, s 151.
[78] ibid, s 151(2)(3)(4), 152, 153, 154.
[79] ibid, s 151(6).
[80] ibid, s 151(7).
[81] ibid, s 151(10).

employees of the company, director's remuneration, their disclosures to auditors among others. The Act provides sanctions for failing to comply with the reporting requirements,[82] but it continues to permit directors to avoid liability if they give a report that clearly indicates the information that misses from the report.[83]

Failure to file annual financial statements and reports renders each director liable if convicted to a fine of not less than Kenya shillings five hundred thousand, but it is sufficient defense that one took reasonable steps to comply.[84]

2.3.2 THE PENAL CODE

The Penal Code makes it an offence for a director who intentionally makes untrue statements or accounts with the aim of deceiving or to defraud and provides for imprisonment of seven years.[85]Such suits are likely to be successful if they are initiated by the board of the company concerned. This makes it highly unlikely since it is inconceivable that directors can bring a suit against themselves.

Criminal sanction against rogue directors has not been very effective in Kenya since shareholders are required to prove dishonest by the concerned director. To prove this is usually a tall order. Again the rule against derivative actions by minority shareholders makes it difficult to pursue this legal route for redress. However, there are clear exceptions to the rule in the case Foss vs Harbottle[86] which apply to allow derivative actions in this case.

---

[82] ibid, Part xxv – Company Accounting Records and Financial Statements.
[83] ibid, s 646 - 648.
[84] ibid. The penalties are provided in the respective sections of the Act.
[85] Sections 328 and 329 of the Penal Code, chapter 63 of the laws of Kenya.
[86] (1843) 67 ER 189

In her Article, Musikali has argued that criminal sanctions are not essential in the regulation of business and corporate governance in particular. To support this argument she identifies the high burden of proof required in criminal cases and lack of restitution as a remedy as some of the key elements why this route would not be an effective regulation in corporate governance.[87]

2.3 THE SOFT LAW

The soft law on corporate governance in Kenya largely entails guidelines formulated to govern conduct of stakeholders, codes of best practice and the like. Serious steps towards formulation of governance tools for corporate governance in Kenya started in earnest in the year 1998. In that year the Private Sector Initiative for Corporate Governance held a workshop for non-executive directors which laid the foundation for the movement of corporate governance in Kenya. Participants included the Institute of Certified Public Accountants (ICPAK), the Capital Markets Authority, the Nairobi Stock Exchange, the Kenya Chapter of the Association of Certified Accountants (ACCA), and many leading corporate organizations in Kenya. A discussion on corporate governance in Kenyan companies was considered significant and a further workshop was organized in 1999 to further deal with the topic of corporate governance.

It is at this second workshop that the idea of an interim committee conceived with a primary role of developing a code of best practice for corporate governance in Kenya and disseminating awareness about corporate governance in Kenya. The proposed Code was drafted and in a further workshop in 1999 the refined Code[88] was adopted to guide corporate governance in Kenya.

---

[87] Supra n 22.

[88] Principles for Corporate Governance in Kenya and a Sample Code of Best Practice for Corporate Governance, Prepared by: Private Sector Initiative for Corporate Governance.

In the year 2002, the Capital Markets Authority placed in the gazette the now repealed Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya, 2002.[89] These guidelines had adopted the approach of "complain or explain" meaning all public companied were to state in their annual reports if they had conformed with the 2002 guidelines or in the alternative they explain the reasons for not complying and state the steps taken towards compliance. This approach did not gain much and was later seen as ineffective due to wide spread non-compliance with the guidelines. Also witnessed during the period between 2002 and 2015 many companies collapsed and others ran into financial and management problems mainly seen as resulting from poor corporate governance. Some of these companies include Uchumi supermarket, Imperial Bank, Kenya Airways, Chase Bank among others.

In 2015, CMA gazetted the successor to the 2002 Code being the Code of Corporate Governance Practices for Issuers of Securities to the Public, 2015.[90] This Code came into force on 4th June 2016. It applies to all the companies that issue debt and equity securities to the public, without regard to their being listed on the stock exchange. The Authority advocates for companies to adopt standards that rise above the minimum ones set in legislation. The Authority is tasked with the responsibility of enforcing these guidelines under the Act.[91]

In adjacent regulations, boards of Issuers to are required to "establish and review on a regular basis, the adequacy and integrity of the company's internal control systems for acquisitions and divestitures and management of information systems including compliance with applicable laws,

[89] The 2002 Guidelines.
[90] The 2015 Code.
[91] Chapter 485A of the Laws of Kenya.

regulations, rules and guidelines."[92] This is meant to guard the welfare of shareholders, and other crucial participants.

The 2015 Code has significantly enhanced the standards from those set by its predecessor. For instance it replaced the earlier "complain or explain" with the "Apply or Explain" approach as one among the many major changes adopted in the new Code. The new rule requires boards of companies to wholly comply with this Code and failure to which they should reveal to CMA the reasons for not complying and specify clearly the timelines they need and the plans they have laid to achieve full compliance.[93] This latter approach is more stringent and calls for a more definite compliance by boards of companies. A non-complying company is required to give concise reasons why it cannot comply. For instance, a board could explain that applying a particular section of the code would not be in the company's welfare. However, the board could show the steps taken to deal with the mischief the Code was addressing by either applying the recommendation differently or adopting a different practice to address the intended end. This notwithstanding, there are some provisions of the Code that are mandatory and there is no room left for non-observance by listed companies.

Although the Code requires full compliance, it does not have sanctions for non-complying companies. The question of enforcement has been left open. Ideally the code is meant for self-regulation of the companies it covers. Implementation of the Code largely rests on the goodwill of the companies agreeing to abide by the Code.

State-owned corporations or parastatals as they are commonly referred to were not covered by the Code. These corporations have been characterized by perennial inefficiencies,

[92] The Capital Markets (Securities) (Public Offers, Listing And Disclosures) (Amendment) Regulations, 2016.
[93] Introduction notes 1.8 -1.10 to the Schedule of the Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya, 2015.

misappropriation of resources, poor services and goods, abuse of office and recording massive loses among others. A task force, "the Presidential Taskforce on Parastatal Reform" to look into among other issues, the governance and reform of parastatals gave its report indicating that state owned corporations operated under a complex governance structure.[94] The involvement of Parliament, ministries, Boards and CEOs in the management of parastatals complicates and would bring confusion in the allocation of responsibility and accountability in state corporations.

Further findings of the taskforce included lack of a definite framework for the recruitment, selection and orientation of parastatals Boards, missing skills together with the understanding of roles by directors, bloated boards and combining of the roles of the chief executive officer and the Secretary to the Board into one person.[95] This gave way to the development of the Code of Governance for State Corporations (the Mwongozo) and consequently the President directed that all Boards of state-owned corporations should implement the provisions of Mwongozo.[96]

The spirit of Mwongozo draws heavily from the Constitution of Kenya which outlines the national values and principles of governance.[97] The Constitution further demands state offices to uphold trust, honour, respect and confidence in the performance of their duties,[98] and further outlines the values and principles of public service in Article 232.

2.4 CONCLUSION

The main objective of this study underlies an examination of the duties of directors as codified under the Companies Act of 2015 in order to evaluate their clarity, accessibility and certainty.

[94] *Presidential Taskforce on Parastatals Reforms* as captured in the Introduction and Background section of Mwongozo, p.xi.
[95] ibid.
[96] Executive Order No. 7 of 2015.
[97] Article 10 of the Constitution of Kenya, 2010.
[98] Article 73.

This chapter began with a brief analysis of common law duties and it can be seen that these duties were not precise statements to be found in any formal document, but rather judicial decisions on particular cases brought before courts of law. As such it can be observed that the duties themselves cannot be clearly identified with precision. They are also not easily accessible because one has to comb through judicial pronouncements, some of which are differing in their interpretation of particular circumstances. As such the common law duties cannot be applied with certainty due to the differing circumstances predicating different judicial interpretations. However, it was found that common law duties are still applicable in Kenya as general duties where a duty is not covered by the statute.

It was found that codified duties under the Companies Act of 2015 are precise enacted provisions of law with particular wording and with attendant sanctions for breaches thereof. This chapter answers the question on clarity and accessibility in that the law is clear and laid out for all to read and understand what is requires to be done or omitted. In that regard it follows that the duties can be applied with certainty because they are deemed clear and accessible to all directors to abide by with sanctions for breach.

In the latter part of the chapter was discussed the soft law as an appreciation of the efforts of different stakeholder in regulating corporate governance in Kenya. It was found that the Capital Markets Authority guidelines discussed are grounded in the supposition that the Authority will observe compliance of the Code by companies and sanction non-observance. It has not been stated what and how penalties are to be imposed on errant companies. It can be noted that enforcement of the earlier Code of 2002 was a fallacy with the massive scandals and non-compliance by several listed companies. It is hoped that the 2015 Code remedies some of the shortcomings of its predecessor. The Code offers some level of flexibility for companies to

formulate strategies and adopt policies that can ensure best performance of companies. However, the success of the code mainly depends on companies agreeing to apply it and abide by its provisions. Therefore, use of codes is seen here as a weaker form of regulation, but a more effective one if the regulated choose to adhere to the prescriptions.

CHAPTER THREE

REGULATION IN CORPORATE GOVERNANCE

3.1 INTRODUCTION

Regulation is seen as a necessary tool in corporate governance for a number of reasons. For the management, if left unmonitored they are likely to pursue matters that are not in the interest of shareholders including embezzlement and misappropriations as is evident in the studies on the divergence of interests of between principals and agents.[99] This can be argued on the basis of agency costs and for instance the just mentioned diversion by managers in form of stealing and even managerial mistakes including ineptness of individual directors. Again the presence of different regulatory mechanisms in corporate governance field including corporate law emphasize mandatory rules[100] and soft codes[101] of governance that possess standardized reporting based on principles of "comply or explain" for instance. State intervention through national regulatory systems and this coming in the wake of global wave of privatization and liberalization of markets cannot be overemphasized.

The term regulation has many conceptions and is increasingly difficult to define due to the varied understanding of the term. Julia Black[102] has differentiated the functionalist, essentialist and conventionalist denotations of regulation. Two terms become central in the definition of the term – "hard law" and "soft law". Many scholars have tended to differentiate hard from soft law on

---

[99] Bearle, A. and Means, G. (1932). *The Modern Corporation and Private Property.* New York, Commerce Clearing House.
[100] Gordon, J.N. (1989). *The Mandatory Structure of Corporate Law.* Colombia Law Review, 89: 1549-98.
[101] Hopt, K. (2011). *Comparative Corporate Governance: The State of the Art and International Regulation.* The American Journal of Comparative Law, 59(1): 1-73.
[102] Black, J. (2002). *Critical Reflections on Regulation.* Australian Journal of Law Philosophy 27, 1-35.

the basis of their binding/non-binding aspects of each. For instance, Snyder[103] argues that "soft law entails of "rules of conduct which, in principle, have no legally binding force but which nevertheless may have practical effects." Positivists have tended to reject the idea of soft law arguing that law properly defined must have a binding effect.[104] To constructivists there is minimal attention to the obligatory nature of law at the stage of legislation but argues that more focus should be had on its effectiveness thus the coinage "*law-in-the-books and the law-in-action*". They further argue that the discrepancies between hard law and soft law based on their respective binding nature are illusory.[105]

Without moving into the many contradictory aspects of definition of the term, a functional definition is adopted here. Anthony Ogus has defined regulation to mean "… I take it to refer to obligations imposed by public law designed to induce individuals and firms to outcomes which they would not voluntarily reach." He continues to argue that regulation is largely enforced by public officials and the treat or imposition of some sanction aid compliance thereto.[106] According to John Braithwaite and his associates, regulation processes involve continuing interaction among many actors (the regulators, the regulated and often times it also involves public interest groups) and the apparent costs and benefits of substitute strategies are considered.[107] It has been argued that cooperation between players is good for mutual benefits but when cooperative

[103] Snyder, F. (1993) *Soft Law and the Institutional Practice in the European Community*. European University Working Paper LAW No. 93/5, 198.
[104] Klabbers, Jan (1996). "*The Redundancy of Soft Law*," Nordic Journal of International Law, Vol. 65, pp. 167-182.
[105] Goodrich, Peter (2000). "*Law-Induced Anxiety: Legalists, Anti-Lawyers and the Boredom of Legality*," Social and Legal Studies, Vol. 9, pp. 143-163.
[106] Ogus, A. *Regulation revisited.* (2009). Sweet and Maxwell, London. Public Law Issue 2.
[107] Ian Ayres, I. and Braithwaite, J. (1992). *Responsive Regulation: Transcending the Deregulation Debate*. New York Oxford. Oxford University Press.

approach fails to achieve the desired outcome, then more formal legal approaches become necessary.[108]

3.2 FUNCTION AND FORMS OF REGULATION

Corporate governance has two broad forms of regulatory mechanisms to wit hard and soft law.[109] Hard law encompasses statutory rules which prohibit certain behaviours and are largely used to address common corporate governance problems. Soft law constitutes standards of best practice whish are not legally binding by nature.[110]

3.2.1 SOFT REGULATION (Soft Law)

Snyder defines soft laws as *"rules of conduct which, in principle, have no generally binding force but which nevertheless may have practical effects."*[111] Andrew Guzman posits a rational institutionalist angle, arguing "soft law represents a choice by the parties to enter into a weaker form of commitment."[112]He argues this in relation to international treaty arrangements by states.

Some of the advantages of soft regulation include its ability to be used to guide official conduct; that it encourages uniformity in beaucratic decision-making; that it also enlightens the public of policy attitudes; that its flexibility makes it faster to issue than legislation; that it can deal with philosophical issues of regulation and the larger policy issues which may challenging to communicate through the more formal legal mechanisms; and that it can be used in regulation where it would not be permissible to otherwise use regulation.

---

[108] Ogus, A. (1995). *Rethinking Self-regulation.* Oxford Journal of Legal Studies. 15(1):97-108.
[109] Supra n.100.
[110] Kraakman, R. et al. (2004). *The Anatomy of Corporate Law: A Comparative and Functional Approach.* Oxford: Oxford University Press.
[111] Supra n. 103.
[112] Guzman, Andrew (2005). "*The Design of International Agreements*", The European Journal of International Law, Vol. 16, No. 4, pp. 579-612.

According to Baldwin & Houghton, soft regulation "… give a flexibility that primary legislation does not offer; they are largely immune from judicial review."[113] Soft law has been seen to provide a good alternative to hard forms of regulation.[114]From a historical point of view the concept of soft law could be essential in appreciating how practical measures have gradually evolved into binding forms of law.[115]

The disadvantages of soft law are that it is generally not legally binding hence its application rests solely on the willingness of those agreeing to be affected by it. This includes lack of binding third-party mechanisms for dispute settlement to sort out gaps that arise from incomplete contracts. It creates good avenues for evading responsibility.[116]

Soft law has been argued to invite skepticism as to its effectiveness because its content is usually vague, lacks teeth, is largely symbolic and non-justiciable.[117] It can be incongruent with existing legislation and in such cases the primary legislation takes precedence over it. It tends to be inaccessible and since parliaments are by-passed it allows for limited latitude for public input.

Soft law can be described as a distinct method of regulation denoting a soft system of governance. In this sense it can be viewed as a substitute to the more orthodox primary legislation. On the reverse, its application can also be seen as a foothold towards the adoption of

---

[113] Baldwin, R. and Houghton, J. (1986), *Circular Arguments: The Status and Legitimacy of Administrative Rules*. Public Law, 239,-84.

[114] Flynn, B. (1987). *Subsidiarity and the Rise of Soft Law in EU Environmental Policy:Beyond who does what , to what it is they actually do? The European Policy Process*. The Human Capital and Mobility Network Final Workshops, University College Dublin, Occasional Paper No. 40.

[115] Dehousse, R. and Weiler, J.H.H. (1990). *EPC and the Single Act: From Soft Law to Hard Law?.* European University Institute Working Paper, European Policy Unit. EPU No. 90/1.

[116] Abbott, Kenneth W., and Duncan Snidal (2000). "*Hard and Soft Law in International Governance*," International Organization, Vol. 54, No. 3, pp. 421-456.

[117] Raustiala, Kal (2005). "*Form and Substance in International Agreements*," American Journal of International Law, Vol. 95, pp. 581-614.

hard law. In this case it can be seen hardening into binding legislative forms, having somewhat an ephemeral life-span.

3.2.2 HARD REGULATION (Hard Law)

The United States' Sarbanes Oxley Act[118] of 2002 is a good example of hard law in corporate governance. The Act has created enhanced penalties for violations of the provisions of the Act so as to safeguard investors interests and the public.[119] In Kenya, the Companies Act, 2015 comprises the primary codification of corporate laws which regulate corporate governance in the country. UK has codified the common law principles into law but puts more reliance on best practice codes in its corporate governance. These laws come with strict rules of prohibition and attendant penal sanctions for non-compliance.

Soft regulation through codes may not lead to optimal corporate governance because they may not ensure strict compliance, but merely reduce the worst instances of corporate malpractice.

In her examination of the legal regime for corporate governance in Kenya, Musikali appeals for more criminal sanctions in order to effectively address the challenges being faced in dealing with rogue directors.[120]

Advantages of hard law include: it is binding in nature therefore calls for strict observance due to the backing by sanctions to deal with defaulters. It is clear and therefore easier to enforce. It uses established systems of enforcement or arbitration hence easy to administer.

---

[118] Also known as the "Public Company Accounting and Reform and Investor Protection Act" and "The Corporate and Auditing Accountability, Responsibility, and Transparency Act. Commonly known as Sarbanes Oxley, SOX.
[119] Section 802 and 1102 of SOX.
[120] Musikali, L. *The Law Affecting Corporate Governance in Kenya: A need for review. (*2008) 19 (7) Internantional Company and Commercial Law Review 213-227.

Its binding effect and the attendant sanctions could be its undoing because it tends to coerce obedience rather that woo people to willingly obey. It can be costly to monitor obedience and in enforcing it. It can create commitments that restrict natural behaviour of those it affects. Hard law is usually inflexible and difficult to acclimatize to changing circumstances. Its review or amendment to suit emerging trends involves lengthy processes that are costly and tidious.

3.3 EFFECTIVENESS VERSUS COMPLIANCE

It has been argued that it would be a mistake to take hard law as always preferable to soft law from the standpoint of effectiveness. To Raustalia, the concepts of compliance especially with the obligations of hard law and effectiveness must be distinguished.[121] He further argues that effectiveness is directly related to causality and thus to argue that a rule is 'effective' means that it has caused some behavior or outcomes, which need not necessarily measure to the legal standard of compliance."[122]

Ogus has observed that most developed countries employ "*regulatory impact analysis*" as an essential part of their process of law-making.[123]In terms of achieving policy goals, effectiveness tends to be of more significance than formal compliance since in practice effectiveness reflects more on policy change. Soft law is seen to be more effective in practice than hard law. According to Ogus, soft regulation is more effective in corporate governance than hard law. Professor Hart also argues a case for governments to impose statutory interventions on corporate

---

[121] Raustalia, Kal. (2000). "*Compliance and Effectiveness in International Regulatory Cooperation*," Case Western Reserve Journal of International Law Vol. 32, pp. 387, 398.
[122] ibid.
[123] Supra n.106.

governance because the changing world does not allow firms to adapt governance mechanisms to their contingencies in an efficient manner.[124]

These two forms of law offer different advantages depending on the context of their application and factors in play. A pragmatic approach has been encouraged with selective application of hard and soft regulation depending on the prevailing circumstances. Sometimes argument for a combination of both hard and soft regulation for greater effectiveness has been advocated for.[125]

The norm is that directors are to be held liable for negligence in the performance of their duties, which now calls for an evaluation as to the degree to which directors will be held liable for loss occasioned by their actions.[126]However, the prevailing circumstances must be put into consideration in evaluating the breach. The UK Law Commission raised the issue of clarity in the nature of the standard of care and skill to be exercised by directors when they examined the codification of their duties.[127] This led to the altering of the content of the duty of care to provide clarity on the standard of conduct expected from directors.[128]

In Kenya, the collapse of firms like Uchumi supermarket portrays the problems experienced by Kenya's corporate governance scene, with lack of adequate legal and infrastructural mechanisms of dealing with corporate governance malfeasance.[129] Kenyan laws have proved inadequate in dealing with challenges arising out of corporate governance. This was well exemplified in the

---

[124] Hart, O. (1995). *Corporate Governance: Some Theory and Implications.* The Economic Journal. 105(430): 678-89.
[125] Supra n.115.
[126] Scott, G. *A Look at the Causes, Impact and Future of the Sarbanes-Oxley Act"* Journal of International Business and Law: (2004) Vol. 3: Iss. 1, Article 2. http://scholarlycommons.law.hofstra.edu/cgi/viewcontent.cgi?article=1024&context=jibl accessed on 6 May 2019.
[127] *Modern Company Law for a Competitive Economy: Final Report* (London: DTI, July 2001).
[128] ibid.
[129] Kethi D. Kilonzo. *Uchumi case sheds light on corporate governance gaps in public companies June 10 2011.* http://www.businessdailyafrica.com/Opinion-and-Analysis/-/539548/1177842/-/mr6wgu/-/index.html accessed on 24 May 2019.

acquittals that followed after Uchumi scandal was exposed.[130] A charge of insider trading against the former Uchumi general manager, Bernard Kibaru and Terry Davidson who sold his shares before the collapse of the supermarket failed.

On the other hand, the Enron scandal in the United States ended with successful convictions for wrongdoing of the directors and staff involved including serious sanctions placed upon its Auditors, Arthur Andersen.

3.4 CONCLUSION

The hard law call into strict obedience through its coercive nature backed with sanctions against defaulters. Although it is costly to monitor obedience, it is more effective in terms of enforcement. However, it can restrict the flow of natural obedience and also ensure that companies only adhere to minimum standards it sets thus constricting pursuit of best standards in any given circumstances.

It is yet to be seen the effectiveness of the 2015 Code. But with codification of the duties of directors in the 2015 Companies Act, complimentary application of the Code alongside the provisions of the Act is likely to bear fruit as is argued in the next chapter.

---

[130] *Republic –Vs- Terrence Davidson & another Criminal case no. 1338 of 2008*.

CHAPTER FOUR

COMPLEMENTARY APPLICATION OF HARD AND SOFT LAW IN CORPORATE GOVERNANCE

4.1 INTRODUCTION

Having appreciated that we have two main form of regulation in corporate governance as discussed in chapter three, we now embark on an evaluation of the application of these forms of regulation in Kenya's corporate governance perspective. In doing so the researcher has sought to understand what happens in jurisdictions with established corporate governance regulatory mechanisms.

A comparative study of the United Kingdom (UK) and the United States of America (US) have been chosen. First because Kenya's Companies Act has borrowed heavily from the UK 1948 Companies Act especially as regards duties of directors which forms the primary focus of this study. Again the UK jurisdiction offers key lessons in complementary application of statutory forms of regulation and self-regulation in corporate governance. The US case was found important because it gives a good history of statutory interventions in corporate governance. It also gives key perspectives on more reliance on formal interventions as opposed to self-modes of regulation.

4.2 CASE OF THE UNITED KINGDOM (UK)

The English Companies Act was enacted in 1948[131] codifying duties of directors. Reported corporate scandals have heralded reforms taking place in corporate governance of entities in the UK by exposing inadequacies in the system of corporate governance. The collapse of Polly Peck in 1990 necessitated the inception of the Cadbury report that formed the foundation of modern corporate governance in UK. The report recommended split-up the roles of chairman and that of the chief executive officer.[132]

The inception of the Cadbury Committee arose from the erosion of confidence in disclosure standards of accounts published by companies and the inability of accounting firms to placate the anticipations of reported corporate financial statements.[133] This committee ended up with a wide mandate of looking into broad corporate governance issues like responsibility of executive and non-executive directors, how to nurture the flow of information between the board with shareholders and other stakeholders and to appraise and report on corporate performance.[134]

The Maxwell Empire debacle made significant contribution to the Cadbury Committee recommendations by way of a strong validation for centering on board responsibility and composition,[135] which subjects they considered more on corporate governance than in audit and accounting. The Collapse of the Barrings Bank followed later in 1995 after suffering losses of £827 resulting from fraudulent investments orchestrated by Nick Leeson, an employee in its

[131] The Companies Act 1948 was an Act of the Parliament of the United Kingdom, which regulated UK company law. It was repealed and replaced with the Companies Act 2006.
[132] Committee on the Financial Aspects of Corporate Governance, *Report*, (Gee, 1992) Committee on the Financial Aspects of Corporate Governance, *Code of Best Practice* (Gee, 1992).
[133] Laura F. Spira and Judy Slinn, *The Cadbury Committee: A History* (OUP, 2012).
[134] Simon Holberton, 'DTI Will Back In-Depth Review of Companies', *Financial Times* (London, 31 May 1991) 7.
[135] Spira, L.F. & Slinn, J. *The Cadbury Committee: A History.* (OUP, 2012).

subsidiary in Singapore. The bank was run on deficient internal control and weak risk management practices. If these financial dealings had been uncovered then, the imminent collapse might have been thwarted.[136]

These noted scandals among others have heralded reforms in corporate governance of entities in the UK by exposing deficiencies in the system of corporate governance. The 1992 Cadbury Report recommended self-regulation by using codes of corporate governance rather than through legislation, the argument being that formal methods would levy minimum standards and that would bring about a risk of boards merely conforming with the letter, instead of the target of the requirements.[137]Successive committee reports and amendments to the code have continued the reforms culminating with the current Combined Code on Corporate Governance which was issued after the Higgs Report[138] of 2002 laying the emphasis of the role of non-executive directors.

The direction taken by the UK is that corporate governance is not as issue for legislation and the route of a Code that was non-binding was adopted to be monitored by the shareholders. This became the genesis of the "comply or explain" paradigm. The mandatory disclosure rule by the London Stock Exchange founded on the "comply or explain" paradigm[139] has brought more transparency in UK companies and has forced companies to strict compliance, since deviations from the Code warrants public justification.[140]

[136]*"Implications of the Barings Collapse for Bank Supervisors" (PDF). Reserve Bank of Australia. 1995.*
[137] Supra n 8.
[138] Supra n 9.
[139] Supra n 10.
[140] Supra n 11.

The Code is not applied exclusively, but conjunctively with the very supportive legal framework largely through the Companies Act.[141] The UK government has also played an important role with occasional threats to use statutory interventions whenever necessary. Listing rules[142] have also played a significant role in reinforcing the legislative framework. Firms listed in the London Stock Exchange are obliged to strictly comply with these rules as policed by the Financial Services Authority. For instance the requirement to include a corporate governance statement in annual reports specifying the extent to which the firm has applied the Combined Code of Corporate Governance.[143]

UK pioneered the codification of duties of directors in Europe. The main aim was to enhance directors' understanding of their duties so that they could comply with them effectively. It was commonly believed that directors did not fully grasp what their duties entailed and they also did not understand to whom those duties were owed.[144] Therefore, codification of these duties was aimed at enhancing certainty, accessibility and consistency in their application. This has been evident in the South African experience where codification of duties of directors arose from the need to facilitate clear and efficient guidelines for directors.[145]

4.3 CASE OF THE UNITED STATES (US)

The Sarbanes Oxley Act (SOX)[146] was enacted as a United States federal law in reaction to several major corporate besides accounting scandals that included Enron, Tyco International and

---

[141] 1948. An Act of Parliament of the United Kingdom.
[142] Financial Services Authority, 2002. www.fsa.gov.uk. Accessed 22 May 2019.
[143] *UK Corporate Governance Update: New Reporting Requirements and the Wales Principles.* Companies extracts from the (Miscellaneous Reporting) Regulations 2018 (the "Regulations").
[144] Cassim Farouk, Maleka Femoda Cassim, Rehana Cassim, 2012. *Contemporary Company Law.* 2nd edn, Juta Law. 43.
[145] Monray Botha, 2009. *The Role and Duties of Directors in the Promotion of Corporate Governance: A South African Perspective,* 39.
[146] Supra 118.

Worldcom.[147] It introduced the requirement for independent oversight over public accounting firms offering audit services, and the taking of singular responsibility by senior executives for the correctness and completeness of companies' financial reports among other measures aimed at curbing corporate malpractices[148]. It created the Public Company Accounting Oversight Board to work in tandem with the Securities and Exchange Commission to oversee all public accounting firms and public companies. The Act required the chief executive officer and the chief financial officer to individually take personal responsibility by personally certifying financial statements and disclosures.[149] The Act also created higher penalties for violating the provisions of the Act so as to protect the welfare of investors and the larger public.[150]Governments and regulators the world over have thereafter considered wide ranging reforms to govern fundamental issues of corporate government.[151]

The Enron Corporation scandal in the United Stated was publicized in October 2001 with the subsequent declaration of the insolvency of Enron Corporation followed by the dissolution of Arthur Andersen.[152] Through the chief financial officer of the corporation one Andrew Fastow and other executives misled the board and the audit committee on high-risk accounting practices and further pressured its auditors, Arthur Andersen to overlook the issues.[153]

---

[147] Kuschnik, Bernhard; *The Sarbanes Oxley Act: "Big Brother is watching" you or Adequate Measures of Corporate Governance Regulation?* 5 Rutgers Business Law Journal [2008], 64–95; available at http://businesslaw.newark.rutgers.edu/RBLJ_vol5_no1_kuschnik.pdf. Accessed on 17 May 2019.

[148] Supra 126.

[149] Section 302 of SOX.

[150] Section 802 and 1102 of SOX.

[151] *Commonwealth Association for Corporate Governance Guidelines, Principles For Corporate Governance In The Commonwealth Towards global competitiveness and economic accountability* (1999) http://www.ecseonline.com/PDF/CACG%20Guidelines%20%20Principles%20for%20Corporate%20Governance%20in%20the%20Commonwealth.pdf accessed on 6 May 2019.

[152] This was one of the five largest audit and accountancy partnerships in the world at the time.

[153] ibid.

Worldcom filed for bankruptcy in 2002 as a consequence of disclosure of the accounting fraud.[154] The major corporate governance failures in Worldcom included an inept board, lack of transparency and internal control and the external auditor's failure to detect fraud. The board of directors abdicated their responsibility of monitoring, policy formulation, strategic thinking for the company, management supervisory, advisory and accountability to shareholders and other stakeholders. They had little or did not get involved in running the company and merely attended board meetings. This way, the chairman Ebbers over-controlled and manipulated the board decisions.[155] The company had overstated total assets by about $11 billion and eventually a fraud worth over $3.8 billion was unearthed.[156]

Several measures have been introduced to deal with the outcomes of these and other corporate scandals which have occurred in the United States. Interventions by the Senate Committee[157] and scandals that ensued led to the enactment of the Sarbanes-Oxley Act (SOX)[158] on the 30th July 2002.[159]Through this legislative enactment major reforms have occurred in the management of corporate entities in the United States and particularly with regard to responsibility by directors exercising their duties.

---

[154] 'Mail&Guardian. *Multi-billionWorldCorn fraud unveiled*. 26 June 2002. M72. https://www.theguardian.com/business/2002/aug/09/corporatefraud.worldcom2. Accessed 22 May 2019.

[155] Worldcom Scandal, (2007 Feb 20). https://phdessay.com/worldcom-scandal/. Accessed 22 May 2019.

[156] Pulliam, S. & Solomon, D. *How Three Unlikely Sleuths Exposed Fraud at WorldCom: Firm's Own Employees Sniffed Out Cryptic Clues and Followed Hunches*. *The Wall Street Journal* 30 Oct. 2002. Retrieved May 22 2019.

[157] The United States Senate Committee on Banking, Housing and Urban Affairs has jurisdiction on matters related to banks, banking, price controls, federal monetary policy, financial aid to commerce and industry among others.

[158] Also known as the "Public Company Accounting and Reform and Investor Protection Act" and "The Corporate and Auditing Accountability, Responsibility, and Transparency Act. Commonly known as Sarbanes Oxley, SOX.

[159] Chhaochharia, Vidhi; Yaniv Grinstein (March 2007). *"Corporate Governance and Firm Value: the Impact of the 2002 Governance Rules"* (PDF). *Johnson School Research Paper Series No. 23-06*. Johnson School of Management: 7–9.

4.4 THE EFFECT OF CODIFICATION AND APPLICATION OF COMMON LAW ON DIRECTORS' DUTIES IN KENYA

In his article, Botha argues that an essential facet of corporate governance is the creation of structures and processes that allow directors to discharge their legal tasks.[160]For South Africa codification of directors' duties was necessitated by the need for ensure a clear and efficient guidelines for directors. Further, codification was a shift from traditional to modern approaches adopted by many countries.[161] This study does not intent to delve into conceptualizing totality or partiality of codification of duties of directors. However, what is important here is the classification of codified law into hard and soft regulation and their attendant effect on observance by the target group in society.

It is noted that not all duties of directors found their way into the Companies Act, 2015. Indeed section 140(3) states thus

> The general duties of directors are based on common law rules and equitable principles that apply in relation to directors and have effect in place of those rules and principles with respect to the duties owed to a company by a director.

In effect the Act recognizes a category of duties that have not been codified and thereby gives direction on how these duties are to be dealt with. As per section 140(4),

> The general duties of directors are to be interpreted and applied in the same way as common law rules or equitable principles, and those interpreting and applying those rules and principles are required to have regard to the corresponding common law rules and equitable principles.

This shows that the 2015 companies law has adopted a partial codification of the directors' duties. The Act seems to give courts of law the leeway to develop the law by having recourse to common law and equitable principles to close gaps and find solutions to grey areas in the

[160] Botha, M. (2009). *The Role and Duties of Directors in the Promotion of Corporate Governance: A South African Perspective.(30) Obiter702*.
[161] ibid.

codified law. This takes cognizance of the fact that some duties may not be well settled as the law continues to develop and thus having them in statutory form might inhibit the development of the law. These provisions appear to accept the fact that there must be sort of co-existence between codified law and the principles of common law. In the English case of *Phillip Towers vs Premier Waste Management Limited*, the Court of Appeal applied the conflict of interest duty in the Companies Act 2006 although the facts of the case had occurred prior to the codification of the duty when the common law tests still strictly applied.[162]

Now that directors' duties have been codified, does it therefore mean that it is sufficient to have recourse to the Companies Act alone as regards the said duties? It has been seen that duties of directors as they appear in the statute must be understood also in the context of common law and equitable principles. It should be noted that the Act can only provide clarity to a certain extent.[163] Care must be exercised that codification does not occasion confusion when it is aimed at bringing clarity. Courts should have room to decide cases based on their circumstances. It has been observed that;

> …codification does not entail a rigid fixation of law, but a proposed code with provisions that, if used correctly by the courts, can ultimately lead to development of the law, based on the existing principles of South African common law.[164]

In agreeing with Sauveplanne, Kiggundu and Havenga have argued that directors are required to be well conversant with their duties, and they must be alive to the expectations from them because the level of their conduct has serious bearing on the success of the company.[165]

---

[162] (2011) EWCA Civ 923.

[163] Michele Havenga M. (2000). *The Business Judgment Rule: Should we follow the Australian Example?* 12 SouthAfrican Mercantile Law Journal. 25.

[164] Sauveplanne, J.G. (1982). *Codified and Judge Made Law: the role of courts and legislators in civil and common law systems.* Amsterdam: North-Holland, Icsh 45(4) 113.

[165] Kiggundu & Havenga. (2004). *The Regulation of Directors' Self-serving Conduct: Perspectives from Botswana and South Africa.* CILSA 272, 290.

4.5 CONCLUSION

This chapter sought to discuss complimentary application of soft and hard forms of regulation in corporate governance. In the earlier chapters was discussed different forms of regulation applied in corporate governance. It was appreciated that both hard and soft forms of regulation can be used depending on the outcomes expected to be achieved. In this chapter, a comparative approach was adopted and two cases being the case of the United Kingdom and the United States of America were discussed. The reasons for choosing these two jurisdictions were explained in the introduction to the chapter.

It emerged from the discussions that the path to be taken in any jurisdiction is depended on the prevailing circumstances therein. In the UK was seen more reliance on soft forms of regulation which was found to have more effect. However, the success of these forms of regulation in the UK was largely depended on the supporting framework of statutory laws and government support. In the US was found more reliance on statutory forms of regulation with the Sarbanes Oxley Act being the main statute in operation therein.

The chapter also concludes that Kenya has taken the route of complementary application of both statutory forms of regulation in conjunction with soft forms. It was also seen that complementary application of the law with common law and equitable principles is permissible and good for the success of corporate governance in Kenya.

CHAPTER FIVE

SUMMARY, KEY FINDINGS, CONCLUSION AND RECCOMENDATIONS

5.1 SUMMARY

The main objective of the study was to find out whether codification of directors duties under the Companies Act 2015 has brought clarity, enhanced their accessibility and certainty in their application in corporate governance in Kenya. The chief question is whether this has been achieved.

In chapter one, the researcher outlined the background and the problem statement. The objectives of the study were laid out, the scope as well as the significance the study will have. A theoretical framework was outlined setting out that directors' core mandate is value maximization for shareholders under the Shareholder primacy theory and in so doing they can ascertain which constituent elements can be incorporated in achieving this long-term goal as propounded under the enlightened shareholder theory. Doctrinal research method was adopted as the most appropriate methodology to guide the study.

In Chapter two, the study focused on the legal framework for corporate governance in Kenya. This entailed a brief analysis of common law rules and an elaborate discussion of codified duties under the Companies Act of 2015. Other duties of directors as they are found in other legislative enactments were also appreciated. The chapter also discussed soft regulation as applied in Kenya through soft codes and best practice. It was seen that corporate governance regulation in Kenya is two-pronged. I encompasses statutory interventions as well as self-regulation through soft codes.

Chapter three examined the concept of regulation in corporate governance. Regulation was conceptualized and understood in terms of hard law and soft law where hard law was seen as the formal forms of law with binding force as opposed to soft law that lacks the binding nature. It was further conceptualized in terms of effectiveness and compliance. This was done in order to understand the reason different jurisdictions would choose one form of regulation over the other and while others would combine both and the resultant effect. This chapter laid the basis for evaluating what the preceding chapter had discussed and what the next chapter four discusses.

Chapter four has done a comparative analysis of the application of hard law and soft law in corporate governance. Two jurisdictions being the UK and US were discussed in order to draw lessons for evaluating Kenya's experience as a young jurisdiction in matters of corporate governance and codification of directors' duties in particular.

5.2 KEY FINDINGS

The research found that the common law regime that existed prior to the codification of directors' duties under the Companies Act of 2015 was haphazard since the duties were not spelt out in any particular formal document for ease of access. As a result, heir application was also not certain.

The study found that Codification has indeed brought clarity to the duties of directors, enhanced their accessibility and hence certainty in their application in corporate governance Kenya. The study also found that codification of directors' duties has in itself not ousted the application of common law particularly the general duties and that continued use of common law principles will be beneficial especially in interpretation and application of these duties.

Based on the theories adopted in the study, it was found that directors' primary duty is to value maximization in the long-term for the benefit of shareholders who own the company. But in their pursuit of this primary goal, they also need to appreciate, assess, and manage the broader interests of other key constituents.

The study that a complementary application of codified duties and other forms of regulation particularly self-regulation through codes, regulations and best practice is good for the success of corporate governance in Kenya.

5.3 RECCOMMENDATIONS

Good corporate governance practice requires directors of companies to be competent, accountable and skilled in their roles. A good appraisal of the duties they are seized with is a good starting point in achieving this end. The Companies Act, 2015 does not prescribe for induction and continuous training of directors in order to appraise them on their duties and related competences. This study recommends amendment of the Act to include a requirement for induction of directors on appointment and continuous training on their duties and related competences so that the objectives of codification are fully met.

The penalties prescribed under the Act for breach of the duties of directors are very low, as appertains the prevailing economic standards and are unconnected to the benefits that would accrue to a director obtaining a benefit in breach of the duties. This study recommends for enhancement of the penalties taking into consideration the contemporary economic circumstances in order to ensure sufficient deterrence.

This study also recommends institutional strengthening to enhance corporate governance regulation and oversight. Key institutions like the Institute of Certified Public Accountants of

Kenya (ICPAK), Institute of Directors, Kenya (IoD), Central Bank of Kenya (CBK), Centre for Corporate Governance (CCG), the Capital Markets Authority (CMA), and other important institutions such as the Ethics and Anti-Corruption Commission (EACC) and the Judiciary are key in safeguarding good corporate governance in the country through oversight, enforcement and investigative roles. These institutions should be empowered with the necessary capacity, skills and knowledge on these duties so as to ensure collective efforts and success in attaining the objectives of the Act.

The study recommends for further research especially on the adequacy of penal sanctions in the Companies Act, 2015 and other statutes like the Penal Code on corporate governance in Kenya.

It is also recommended that whenever the courts of law are called upon to interpret these duties, they should avoid strict positivist interpretation of the law that does not leave room for the application of other forms or regulation. Rules of interpretation that will also encourage application of other forms of regulation (soft law) will be important in achieving complementary existence and efficient regulation of corporate governance in Kenya.

5.4 CONCLUSION

This study sought to establish whether codification of duties of directors under the Companies Act of 2015 has enhanced their clarity, accessibility and certainty in their application in Kenya. The research established that prior to the codification aforesaid, directors' duties were not spelt out in any particular formal document for ease of access and the only recourse was had to common law hence the regime at the moment was haphazard.

The study has addressed the research problem and concludes that Codification has indeed brought clarity to the duties of directors, enhanced their accessibility and hence certainty in their

application in corporate governance Kenya. However, codification of directors' duties has in itself not ousted the application of common law especially as regards the general duties. Continued use of common law principles will be beneficial especially in interpretation and application of these duties.

The research was based on two theories, to wit the Shareholder Primacy theory and the enlightened shareholder theory. It concludes that directors owe their duties to the shareholders, but they also need to appreciate, assess, and manage the broader interests in order to establish long term relationships which are essential to the long-term welfare of the company which is value-maximization for shareholders.

The study also evaluated the two forms of regulation that apply in corporate governance, being the hard law and self-regulation through soft codes. It thus concludes that a complementary application of codified duties and other forms of regulation especially self-regulation through codes, regulations and best practice is good for corporate governance to flourish in Kenya.

LIST OF STATUTES

1. The Constitution of Kenya, 2010.
2. The Companies Act (No. 17 of 2015) Kenya.
3. The Companies Act, Chapter 486 Laws of Kenya (Repealed).
4. Judicature Act Chapter 8 Laws of Kenya.
5. The Capital Markets Act, Chapter 485A.
6. The Penal Code, Chapter 63.
7. UK Companies Act, 1948.
8. Sarbanes Oxley Act of 2002.
9. The Companies (Miscellaneous Reporting) Regulations 2018 No. 860 (the "Regulations").

LIST OF CASES

1. Foss vs Harbottle (1843) 67 ER 189
2. Harlowe's Nominees Pty v. Woodside, [1968] HCA 37, (1968) 121 CLR 483.
3. Hogg v. Cramphorn Ltd [1967] Ch 254; [1966] 3 All ER 420.
4. Howard Smith Ltd v. Ampol Ltd [1974] UKPC 3, [1974] AC 832, Privy Council (on appeal from NSW).
5. Hutton v. West Cork Railway Co, (1883) 23 Ch D 654
6. Re Smith & Fawcett Ltd [1942] Ch 304.
7. Re W & M Roith Ltd [1967] 1 WLR 432.
8. Republic v Terrence Davidson & another Criminal Case No. 1338 of 2008.
9. Towers v Premier Waste Management Limited (2011) EWCA Civ 923.
10. Turquand v Marshall (1969) LR 4 Ch App 379.
11. Cyberscene Ltd and Others v i-Kiosk Internet and Information (Pty) Ltd 2000 (3) SA 806 (C).
12. Howard v Herrigel and Another NNO 1991 (2) SA 660 (A) at 678B - C.).
13. Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (quoting Aronson, 473 A.2d at 812).
14. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).
15 Gantler v. Stephens, 965 A.2d 695.

REFERENCES

Abbott K W, and Snidal D, *Hard and Soft Law in International Governance*, International Organization, (2000) Vol. 54, No. 3, 421-456.

Akelola S, *Prosecuting Bank Fraud in Kenya: Challenges faced by the Banking Sector* (2015) 14 (1) Journal of Finance and Management in Public Services; Mbote PK, and Akech M, *Kenya: Justice Sector and the Rule of Law* (2011) A review by AfriMAP and the Open Society Initiative for Eastern Africa.

Arcot S, and Bruno V, and Antoine FG, *Corporate Governance in the UK: Is the Comply or Explain Approach Working?* (July 1, 2009). International Review of Law and Economics, Forthcoming. Available at SSRN: https://ssrn.com/abstract=1532290. Accessed 25 May 2019.

Ayres I, and Braithwaite J, *Responsive Regulation: Transcending the Deregulation Debate* (1992) Oxford University.

Baldwin R, and Houghton J, *Circular Arguments: The Status and Legitimacy of Administrative Rules*. (Public Law 1986) 239, 84.

Bearle A, and Means G, *The Modern Corporation and Private Property.* New York, (1932) Commerce Clearing House.

Black J, *Critical Reflections on Regulation.* Australian Journal of Law Philosophy (2002) 27.

Blair MM, & Stout LA, *A Team Production Theory of Corporate Law* (1999) 85 VA. L. REV. 247.

Botha M, *The Role and Duties of Directors in the Promotion of Corporate Gorvanance: A South African Perspective.* (2009).

Cadbury Report (1992). Report of the committee on the financial aspects of corporate governance otherwise known as the Cadbury Report 1992.

Cassim F, et al. *Contemporary Company Law.* (2012) 2nd edn, Juta Law. 43.

Cheema M, and Shah S, *Corporate Governance in Developing Economies: The Role of mutual funds in Corporate Governance in Pakistan* (2009) 36 Hong Kong Law Journal 341.

Committee on the Financial Aspects of Corporate Governance, *Report*, (Gee, 1992) Committee on the Financial Aspects of Corporate Governance, *Code of Best Practice* (Gee, 1992).

Commonwealth Association for Corporate Governance Guidelines, Principles for Corporate Governance in the Commonwealth Towards Global Competitiveness and Economic Accountability (1999) http://www.ecseonline.com. Accessed on 6 May 2019.

Corporate Governance in Africa: Anew Strategy. A paper presented at the conference titled *"Corporate Citizenship: The Challenge for Africa*" held at the Nairobi Serena Hotel, Nairobi on January 18-22, 2004.

Dehousse R, and Weiler JHH, *EPC and the Single Act: From Soft Law to Hard Law?* (1990). European University Institute Working Paper, European Policy Unit. EPU No. 90/1.

Eshiwani A, *Director Liability in the Wake of Uchumi (Collapse)* (2006) Institute of Directors (Kenya).

Esser IM, and Coetzee J, *Codification of directors' duties (2004)* Juta's Business Law, 12.

Flynn B, *Subsidiarity and the Rise of Soft Law in EU Environmental Policy:Beyond who does what , to what it is they actually do? The European Policy Process,* The Human Capital and Mobility Network Final Workshops (1987) University College Dublin, Occasional Paper No. 40.

Friedman M, *Social Responsibility of Business is to Increase Profits*. New York Times (New York, 13 September 1970) 30.

Gakeri J, *Enhancing Kenya's Securities Markets through Corporate Governance: Challenges and Opportunities* (2013) International Journal of Humanities and Social Science Vol. 3 No. 6 pg. 96.

Gordon JN, *The Mandatory Structure of Corporate Law* (1989) Colombia Law Review, 89: 1549-98.

Guzman A, *The Design of International Agreements* (2005) The European Journal of International Law. Vol 16, No. 4.

Hart O, *Corporate Governance: Some Theory and Implications* (1995) The Economic Journal. 105(430): 678-89.

Havenga M, *The Business Judgment Rule: Should we follow the Australian Example?* (2000) SouthAfrican Mercantile Law Journal.

Higgs D, *Review of the role and effectiveness of non-executive directors* (2003). Department for Business, Enterprise and Regulatory Reform. Archived from the original (PDF) on 10 September 2008. Accessed 25 May 2019.

Hoecke VM *Methodologies of Legal Research: Which Kind of Method for What Kind of Discipline*? . (2011) (ed) Hart Publishing.

Holberton S, *DTI Will Back In-Depth Review of Companies.* Financial Times (London, 31 May 1991) 7.

Hopt K, *Comparative Corporate Governance: The State of the Art and International Regulation.* (2011) The American Journal of Comparative Law, 59(1): 1-73.

Hutchinson, TCM, *Researching and Writing in Law* (2018) 4th ed. Pyrmont, NSW : Lawbook Co.

Jensen M, *Value maximization, stakeholder theory and the corporate objective function* (2001) Journal of Applied Corporate Finance. Vol 14, No 3, pp.8-21.

Josh L, and Tuzikov A, *The Carlyle Group and Axalta* Harvard Business School Case 818-040, September 2017. (Revised October 2017).

Kerlinger FN, *Research in Education*. In R. Bell, V.Noll, & R. Bauer (Eds) (1969) Encyclopedia of Education (4th Ed) New York, Macmillan.

Kiggundu J, & Havenga M, *The Regulation of Directors' Self-serving Conduct: Perspectives from Botswana and South Africa* (2004) CILSA 37, 272-290.

Kilonzo KD, *Uchumi case sheds light on corporate governance gaps in public companies June 10 2011.* http://www.businessdailyafrica.com/Opinion-and-Analysis/-/539548/1177842/-/mr6wgu/-/index.html accessed on 24 May 2019.

Klabbers J, *The Redundancy of Soft Law* (1996) Nordic Journal of International Law, Vol. 65, 167-182.

Kraakman R, et al *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2004) Oxford: Oxford University Press.

Kuschnik B, *The Sarbanes Oxley Act: "Big Brother is watching" you or Adequate Measures of Corporate Governance Regulation?* 5 Rutgers Business Law Journal [2008], 64–95; available at http://businesslaw.newark.rutgers.edu/RBLJ_vol5_no1_kuschnik.pdf. Accessed on 17 May 2019.

McLennan S, *Duties of skill and care of Company Directors and their liability for negligence* (1996) South African Merchantile Law Journal 94-102.

Millon D, *Radical Shareholder Primacy* (2013) University of St. Thomas Law Journal. Vol. 10, 1013.

Modern Company Law for a Competitive Economy: Final Report. Great Britain. Company Law Review. Steering Group (London: DTI 2001).

Mugenda O, and Mugenda A, *Research Methods: Quantitative and Qualitative Approaches,* (2003) Nairobi, Kenya-Acts Press.

Musikali LM, *The Law Affecting Corporate Governance in Kenya: A need for review* (2008) 19 (7) Internantional Company and Commercial Law Review 213-227.

Musikali LM, *Why criminal sanctions matter in corporate governance* (2009) International Company and Commercial Law Review 133-141.

Mwaura K, *Company Directors' Duty of Skill and Care: A Need for Reform (*2003) 24 (9). Company Lawyer 283; Musikali LM, *The Law Affecting Corporate Governance in Kenya: A need for Review.* (2008) 19 (7) International Company and Commercial Law Review 21.

Mwaura K, *Regulation of Directors in Kenya: An Empirical Study* (2002) I.C.C.L.R., 13(12), 465-479.

Ogus A, *Regulation revisited* (2009) Sweet and Maxwell, London. Public Law Issue 2.

Ogus A, *Rethinking Self-regulation* (1995) Oxford Journal of Legal Studies 15 (1), 97-108.

Peter G, *Law-Induced Anxiety: Legalists, Anti-Lawyers and the Boredom of Legality* (2000) Social and Legal Studies Vol. 9.

Pulliam S, and Solomon D, *How Three Unlikely Sleuths Exposed Fraud at WorldCom: Firm's Own Employees Sniffed Out Cryptic Clues and Followed Hunches* (2002) The Wall Street Journal 30 Oct. Accessed May 22 2019.

Raustalia K, *Compliance and Effectiveness in International Regulatory Cooperation* (2000) 32 Case Western Reserve Journal of International Law.

Raustiala K, "*Form and Substance in International Agreements* (2005) 95 American Journal of International Law.

Rotich G, and Gachoki S, *Influence of Corporate Governance on the Performance of Public Organizations in Kenya: A Case of Kenya Ports Authority* (2013) 4 (6) Research Journal of Finance and Accounting www.iiste.org ISSN 2222-1697 (Paper) ISSN 2222-2847.

Santow K, *Codification of Directors Duties* (1999) 73 ALJ 336.

Scott G*A, Look at the Causes, Impact and Future of the Sarbanes-Oxley Act* (2004) 3 Journal of International Business and Law. Iss. 1 Article 2. http://scholarlycommons.law.hofstra.edu/cgi/viewcontent.cgi?article=1024&context=jibl. Accessed on 6 May 2019.

Snyder F, *Soft Law and the Institutional Practice in the European Community* (1993) European University Working Paper LAW No. 93/5, 198

Spira LF, and Slinn J, *The Cadbury Committee: A History* (OUP 2012).

The Restatement of the Law of Agency (2006) 3rd Edn. American Law Institute.

Niekerk V, and Boer W, *The Origins of South African Law* (2009) 63.

Vidhi C, and Yaniv G, *"Corporate Governance and Firm Value: the Impact of the 2002 Governance Rules." Johnson School Research Paper Series No. 23-06*. (March 2007) Johnson School of Management: 7–9.

Wairimu J, *Corporate Governance Irregularities in Kenya's Financial Markets* (2010) https://www.scribd.com/doc/31603577/Corporate-Governance-Irregularities-in-Kenya-s-Financial-Markets. Accessed on 9 May 2019.

William A F, *Meaning in Method: The Rhetoric of Qualitative and Quantitative Research*. (1987) Educational Researcher, 10(4), 16-21.

Wong SCY, *Developing and implementing corporate governance codes Private Sector Opinion* (2008) Issue 10.