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**MERITS AND DEMERITS OF INTRODUCING NON-SHAREHOLDER DIRECTORS
IN THE GOVERNANCE OF ETHIOPIAN SHARE COMPANIES**

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LL.M DEGREE IN BUSINESS LAW**

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Declaration

I, Alemayehu Yismaw, hereby declare that this work is an original work and has not been presented in any other institution before. All refereed materials are duly acknowledged.

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List of Acronyms

ALI: American Law Institute

AMEX: American Stock Exchange

Art: Article

BIS: Bank for International Settlement

CEOs: Chief Executive Officers

CII: Confederation of Indian Industry

CSR: China Securities Regulatory Commission

D&O: Directors and Officers liability insurance policies

EPRDF: Ethiopian People Revolutionary Democratic Front

FDRE: Federal Democratic Republic of Ethiopia

GTP: Growth and Transformation Plan

IPOs: Initial Public Offer of shares

JSE: Johannesburg Stock Exchange

NASD: National Association of Securities Dealers

NBE: National Bank of Ethiopia

NYSE: New York Stock Exchange

OECD: Organization for Economic Cooperation and Development

OHADA: Organisation pour harmonisation en Afrique du droit des affaires

SEC: Securities and Exchange Commission

SOA: Sarbanes-Oxley Act

SSE: Shanghai Securities Exchange

WTO: World Trade Organization

Abstract

Share companies are practiced and operated in many sectors of the economy. They play paramount role to satisfy the taste, demand and interest of human beings as well as to bring a wide range of developments and structural transformations in a country. Their roles are also not easily replaceable across places, economic statuses and political standings.

In Ethiopia, these days, the general public as well as the business community begins to come out from kiosk mentality and engages in share companies which require cooperation and large investment. The numbers of share companies which are being formed are dramatically increased. They are also brought benefit to the people, the business community and the country in many aspects. However, Ethiopian share companies are surrounded by many problems and their relevance is not to the level expected. The Commercial Code and other relevant legislations specify share companies to be managed by boards comprised of shareholder directors only. This prevents share companies to be managed by qualified, skilled and professional independent, stakeholders and non-executive non-shareholder directors. It also poses practical difficulty to maintain and enhance sound corporate governance, values and performances of share companies although there are scholars who argue that non-shareholders directors do negatively affect share companies. Hence, the thesis tried to point out the legal as well as the practical problems; studied different theories, research results, international documents and experiences of foreign countries; and consequently assessed the merits and demerits that non-shareholder directors would bring to Ethiopia share companies. Accordingly, the thesis recommended that non-shareholder directors should be introduced in the governance of Ethiopian share companies to exploit the benefits would be gained fully.

Chapter One

1. Introduction

1.1. Background of the Study and Literature Review

Every person on the globe engages in different activities to get something for his life and remains survive. Of these activities, she/he may work a business. A business is “an activity of providing goods and services might be in financial, commercial or industrial aspects. It is an employment, occupation, profession or commercial activity take on for gain, benefit, advantage or livelihood. It is an enterprise in which a person willingly invests his/ her capital, time, labor, attention and effort.”¹ A business may be formed and run either by a single person in a form of Sole Proprietorship or by group of persons in a form of Business Organization. A business is run by a sole proprietorship or trader if it is carried out by a physical person alone professionally and for gain or livelihood.²In a business run by a single person, all the assets, profits, losses, and risks are in fact faced by the trader himself.³

On the other hand, a Business Organization is a contractual association arising out of partnership agreement made between two or more persons to bring in contribution with the view to carry out a certain activity for profit.⁴ Business Organizations, different from sole proprietorship, have their own peculiar features. First, they, with the exception of joint venture, deem to have legal personality.⁵ That means they, like natural persons, do have their own independent existence, property, right and duty. Second, Business Organizations are formed by partnership agreement undertaken between two or more persons.⁶ Article 211 of the Commercial Code defines partnership agreement as a contract and hence shall be in conformity with Article 1675 and followings of the general contract law. However, it is different from other types of contracts since it involves the agreement of the parties to work together with cooperation typically shown in the form of bringing in contribution. Besides, the agreement focuses on activities which have

¹ Henry C. Black, Black's Law Dictionary (5thed, West Publishing Co. St Paul, 1979)

²Commercial Code of the Empire of Ethiopia, 1960, Extra Ordinary Issue, Nagaret Gazeta, Year. 19th, No. 3, Art 5(herein after called Commercial Code)

³ Dennis Keenan and Sarah Riches, Business Law(8thed, Pearson Education Limited: England, 2007), p.75

⁴ Commercial Code, Art 210 and 211

⁵ Commercial Code, Art 10(2)

⁶ Commercial Code, Art 211

economic effects; rather than human rights, charities or religious activities.⁷ The parties to the agreement also share the profits gained and the loss incurred together. Third, Business Organizations, with the exception of joint venture, shall be registered before the concerned authority.⁸

Business organizations are classified into partnerships and companies. Partnerships are association of persons⁹, not association of capital. They are firms established among persons who have trust and confidence each other. They require intimate personal collaboration. Their existence depend on the very existence of persons bring them into life, so that they dissolve when one of the partners die or insolvent.¹⁰ Partners are also agents for each other¹¹ and hence, they are jointly and severally liable for the acts of each other.¹² They have also unlimited liability to thirds parties' claim against the firm. Partners may not transfer or assign their interests in firms without the consent of other partners. According to Article 10, 212 and 213(1) of the Commercial Code, Ordinary Partnerships, Joint Ventures, Limited and General Partnerships are identified as partnerships in Ethiopia.

Companies, unlike partnerships, are associations of capital¹³ and any intimate /personal relations do not matter on the very existence and functioning of the firm. They do have their own corporate existence different from shareholders. Companies do have their own property and may sue or be sued by their names. Moreover, shareholders may transfer their shares freely without getting permission from other members unless the Memorandum or Articles of Association stipulates otherwise.¹⁴ Companies are managed by board of directors, shareholders meeting and auditors and hence, shareholders may not manage in their individual capacity unless they are appointed as a director of the company.¹⁵ In Ethiopia, according to Article 212 of the Commercial Code, Private Limited and Share Companies are recognized. Although Private Limited Companies are not allowed to engage in banking, insurance and other similar activities,

⁷ Ibid

⁸ Commercial Code, Art 222

⁹ The Association of Business Executives, Principles of Business Law, p.96

¹⁰ Alemayehu Fantaw and Kefene Gurmu, Law of Traders and Business Organizations: Teaching Material(unpublished, JLSRI, 2009),p.44

¹¹ Ibid

¹² Fekadu Petros, Ethiopian Company Law (Fareast Trading: Addis Ababa, 2012), p.25

¹³ Ibid, p.36

¹⁴ Alemayehu Fantaw and Kefene Gurmu , Supra note 10, p. 45

¹⁵ Ibid

they are the most popular companies and found in greatest number than share companies.¹⁶ Private Limited Companies do have their own corporate existence and bring limited liability to their shareholders, but, on the other hand, shares may not be freely transferred or assigned without the consent other members.

Share Companies are capitalized firms and whose capital shall be fixed before their formation and compulsorily divided into shares.¹⁷ Share Companies do have their own unique features. First, they are legally formed when they are registered before the concerned authority and come into being from the date mentioned on the certificate of incorporation.¹⁸ Second, they are artificial persons which do exist in the eye of the law, so that they may not act in their own.¹⁹ They are managed by directors elected by shareholders. As stated in *Bates Vs Standard Land Co* “the board of directors is the brains and the only brains of the company, which is the body and the company can and does act only through them.”²⁰ Third, they have their own independent legal personality.²¹ They do have their own asset, rights, and duties and may sue or be sued different from shareholders.²² Fourth, they are created and dissolved by the law. Their existences do not depend on the death, insolvency or retirement of shareholders.²³ They are perpetual. Fifth, they bring limited liability to shareholders.²⁴ Hence, shareholders are liable up to the extent of the face value of the share they subscribed, and creditors could not bring any direct claim against shareholders. Sixth, unless otherwise stipulated in the Memorandum or Articles of Association, shareholders may freely transfer their shares²⁵ and this is advantageous to the companies as well as to the investors. Seventh, they are established by contribution of members.²⁶ However, Share Companies do have their own independent corporate existence and property different from

¹⁶Fekadu Petros, “Emerging Separation of Ownership and Control in Ethiopian Share Companies: Legal and Policy Implication,” **Mizan Law Review**, Vol. 4, No.1 (2010), p. 13

¹⁷ Commercial Code, Art 304(1)

¹⁸ Stephen Judge, **Business Law** (2nded, Macmillan Press Ltd: London, 1999), p.162

¹⁹ Ewan Macintyre, **Business Law** (2nd ed, Pearson Education Limited: England, 2005), p.479

²⁰ Internet Source. Meaning, characteristics and types of a Company , p.4. Available at <http://www.ddegjust.ac.in/studymaterial/bba/abba-201.pdf> ≥ visited on march 08, 2013

²¹ Ewan Macintyre, Supra note 19, p.475

²² David Kelly, Ann Holmes and Ruth Hayward, **Business Law** (4thed, Cavendish Publishing Limited: UK, 2002), p.344

²³ Stephen Judge, Supra note 18, p.169

²⁴ David Kelly, Ann Holmes and Ruth Hayward , Supra note 22, p.343

²⁵ Ibid , p.344

²⁶ Commercial Code, Art 304

shareholders. So, they have the right to enjoy, control or dispose of their property.²⁷ Thus, Share Companies are real persons vested with all of their properties.

In Ethiopia, Share Companies may be formed in two ways, i.e. among founders or by public subscription. Share companies are formed among founders when the whole of the capital is prefixed and divided in to share is fully and totally subscribed by the founders alone.²⁸ Share Companies may also be formed through public subscription where the whole capital prefixed and divide in to shares is fully subscribed by the public,²⁹ not only among founders only. In this mode of formation, there would be an invitation to be made to the public with the view to have the shares sold and raise the prefixed capital. Per Article 318 of the Commercial Code, this invitation is made through a document known as prospectus.

Share Companies may not be expected to be run by shareholders in their individual capacity. Rather; they do have their own corporate governance system and managed by different bodies such board of directors, general assembly of shareholders and auditors.³⁰

Corporate governance was used for the first time by Robert Tricker in 1984.³¹ Corporate governance is a multidisciplinary concept and is used, in addition to the field of law, in accounting, economics, finance, sociology and political science.³² It is a fluid concept and is defined from different perspectives. In Ethiopia, the term corporate governance is not defined in the Commercial Code or in any other law. However, it is the system by which companies are controlled and directed.³³ It is about

determining the vision, mission and strategies of the company in consistent with the terms and conditions of memorandum of association; setting future directions and long term strategic consideration of a company; formulation of policies; effective functioning and performance of a company; providing ongoing professional direction and guidance; overseeing and superintending

²⁷ David Kelly, Ann Holmes and Ruth Hayward , Supra note 22, p.344

²⁸ Commercial Code, Art 316

²⁹ Commercial Code, Art 317-322

³⁰ Fekadu Petros, Supra note 12, p.53

³¹ Fekadu Petros, Supra note 16, p.3

³² Minga Negash, "Corporate governance and ownership structure in Sub Sahara Africa: The case of Ethiopia," **Ethiopian Electronic Journal for Research and Innovation Foresight**, Volume 5, No 1 (2013), p.4

³³ Peter Zollinger, "Stakeholder Engagement and the Board: Integrating Best Governance Practices," **Global Corporate Governance Forum**, Focus 8(2009),P.5

*of the activities of officers and agents; periodic reassessment of strategies of the company; seeing a code of conduct is in place and adhered to.*³⁴

Corporate governance is not about the day to day running of the company. It is also different from corporate management which is about the running of the day to day affairs of the company.³⁵

These days, in Ethiopia, a number of Share Companies are being formed. However, their corporate governance is not efficient and supported by modern and workable share company provisions. Regarding this, Hussein Ahmed Tura argues that “the Commercial Code does not provide adequate legislative responses to the complex issues of the day and the new draft law has not been finalized. Key international conventions, codes and standards are not ratified or adequately incorporated in the proclamations and that the decrees and directives lack coherence and foresights and at times suffer from poor drafting.”³⁶

Thus, the Commercial Code does not have sufficient provisions protecting the rights of shareholders.³⁷ It does protect the rights of shareholders inadequately.³⁸ It does not make distinction between corporate governance and corporate management. It does not also properly address the issues of board of directors. For instance, it does not specify whether the board is one or two tier, separate the role of CEO and board chair person, etc. The term director is not also defined under the Commercial Code. However, an effort to define it is made under article 2(6) of the Banking Business Proclamation 592/2008 which says “any member of the board of directors of a bank, by whatever title he may be referred to.” But, this definition is irrelevant because it focuses on nature of the office and duties as parameter to identify director.

Moreover, in Ethiopia, directors are inefficient, because they are less independent and face interference from other government controlling agencies especially in financial sectors from the National Bank of Ethiopia; i.e. appointment, remuneration, etc of directors. Directors do not also receive proportional payment for their service especially in the financial sectors due to the

³⁴Zekarias keneea, Lecture note on Corporate Governance(Course on Company Law and Finance, Addis Ababa University, Addis Ababa, January, 2013)

³⁵Ibid

³⁶Hussien Ahmed Tura,” Overview of Corporate Governance in Ethiopia: The Role, Composition and Remuneration of Board of Directors in Share Companies ,” **Mizan Law Review**, Vol.6, No.1(2012), p.49-50

³⁷Ibid , p.50

³⁸ Commercial code, Art 398 and 352.

draconian order of the National Bank of Ethiopia which states that directors are only eligible to receive 50,000 birr annually and 2,000 birr monthly allowances.

Further, in Ethiopian Share Companies, it is only shareholders who can be elected as director.³⁹ Other outsiders and non-shareholders have not any chance to be appointed as a director yet. This situation makes share companies to lose professionals who have well knowledge and experience on the field. It could also affect the independence of the board too. Non-shareholder directors are important to ensure sound corporate governance practices in Share Companies. For instance, the OECD principles of corporate governance specify the role of incorporating non-shareholder directors such as stakeholder, independent and non-executive directors on the board as core value to ensure good corporate governance.⁴⁰ As we know Share Companies have always had relationships with their stakeholders such as shareowners, customers, suppliers, employees, regulators, and local communities. These stakeholders are affected or affect Share Companies, so that they are necessary for the very existence of Share Companies. Hence, it would be difficult for Share Companies to stay in business if they are not managed in the interests of these key groups. Different researchers also evidenced the incorporation of independent directors on board of directors would serve to maintain good governance and enhance corporate performance.⁴¹ However, it does not mean that these all hold true. There are also different arguments and theories which discourage the relevancy of introducing non-shareholder directors such as stakeholders, independent and non-executive directors on board of governance.

There are also subjects need careful attention in introducing non-shareholder directors on boards such as appointment, proportion, roles and responsibilities, remuneration and liability of non-shareholder directors within share companies and their interaction with other member directors.

As it is known, non-shareholder directors have not shares in Share Companies. Thus, it is difficult to fix the liability of a director who is not a member. There are also tough disagreements on whether non-shareholder directors should incur out-of-pocket liability among scholars and countries.

³⁹ Commercial Code, Art 347(1)

⁴⁰ Peter Zollinger, *Supra* note 33, p.4

⁴¹ Renee B. Adams, Benjamin E. Hermalin, and Michael S. Weisbach, "The Role of Boards of Directors in Corporate Governance: A Conceptual Framework & Survey," (2009), p.45

The issue of remuneration is not easy too. To make non-shareholder directors perform the task entrusted to them properly and formally, Share Companies have to provide fee proportional to their service, but companies are reluctant and most often, the payment awarded to non-shareholder directors is less than expected.⁴² This situation discourages non-shareholder directors to work effectively and enhance good governance.⁴³ There are also some companies which recruit non-shareholder directors with lucrative remuneration and do make non-shareholder directors to love to their position forgetting their main task of monitoring the conducts of managers.⁴⁴

The number of non-shareholder directors on a board of directors' also matters on the effectiveness of the board to enhance company's performance. Typically, it has been suggested that when the number of non-shareholder directors increases, the board would be more efficient and independent in running the day to day affairs of the company. However, there is no any uniform guideline as what extent it is wise to incorporate non-shareholders on a board. The same is true regarding the responsibilities to be assumed by non-shareholder directors within Share Companies.

1.2. Statement of Problems

A board of directors is the ultimate managing body of Share Companies. It enjoys extensive rights and powers as per the Commercial Code and Memorandum or Articles of Association. The role of a board of directors becomes vital especially in Share Companies with dispersed ownership because shareholders are unable to closely monitor, supervise and manage their company for lack of information and resources. Thus, a board of directors fills the gap that exists between the uninformed shareholders as principal and the fully informed executive managers as agents in Share Companies. It is identified as vital to bring Share Companies effective and enhance their performance. However, this does not mean a board of directors is always efficient; rather, it may incur different challenges.

⁴²Peter J. Wallison, "All the Rage: Will Independent Directors Produce Good Corporate Governance?" (January 06, 2006), p.2 . Accessed at http://www.legislation.gov.uk/ukpga/2006/46/pdfs/ukpga_20060046_en ≥ visited on December 27, 2012

⁴³ Ibid

⁴⁴ Donald C. Clarke, "the Independent Director in Chinese Corporate Governance," **Delaware Journal of Corporate Law**, Vol. 31(2006), p.110

First, as stated under Article 347(1) of the Commercial Code, Share Companies are required to comprise their boards' with shareholders only. Thus, in Ethiopia, board of directors is a board of shareholders. Although shareholder directors are efficient in managing companies in the interests of shareholders and bring company performance, they have their own demerits at the same time. They would forget the interests of stakeholders who are essential for the existence of share companies too. Moreover, shareholder directors are insiders and do have strong ties with CEOs and other officers, so that they lack independence, reluctant in performing activities which benefit the community as well as the country economy, and prone to conflict of interests which pull back Share Companies profitability and enhancement. However, it is possible to prevent or reduce these evil effects by introducing non-shareholder directors on boards. Non-shareholder directors enable share companies to be lead by professional outside experts. These can be learnt from different, researches, theories, international documents and best practices. In fact, it is difficult to hold non-shareholder directors are totally advantageous; they do have their own demerits too. Thus, assessing the merits and demerits would follow from introducing non-shareholder directors on boards of Ethiopian share companies is crucial.

Second, no matter how non-shareholder directors treated differently in different theories, international documents and experiences of countries, there might be different situations in Ethiopia. There might be situations which facilitate and create conducive environment to introduce non-shareholder directors on boards of Ethiopian share companies. For instance, Ethiopia scores one of the fastest economic growing on the globe, the 1960 Commercial Code is under revision, Ethiopia filed an application to join WTO, etc. At in the same, there might be circumstances which challenge this system not to be introduced in the country such as the trend of the business community, the newness of the concept and the fear it would create, etc. So, it wise to pay attention to all prospects or challenges surrounding the introduction of non-shareholder directors on boards of Ethiopian share companies.

Third, although non-shareholder directors are introduced in Ethiopia, there might be fear among shareholders on their loyalty to manage companies because they have not any share/ interest within those firms. Moreover, determination of the liability of non-shareholder directors is difficult too. On this issue, there are two extreme poles. The first side is stipulating non-shareholder directors to assume out-of-pocket liability and this is discouraging and hard to find

any non-shareholder director willing to assume directorship. The other side is specifying non-shareholder directors to incur near zero personal liability and this is also not promising because they may be reluctant and ineffective to manage companies.

Fourth, how the remuneration of non-shareholder directors shall be addressed is the other problem. As it is known directors of Ethiopian share companies are not awarded fee proportional to their service. It has been observed especially in the financial sector, the remuneration of directors is fixed by National Bank of Ethiopia. Thus, it is easy to cast what would happen to non-shareholder directors.

Finally, the proportion of non-shareholder directors on boards is still the other issue which needs attention. It has been said that a more non-shareholder director included on a board, there would be a more independent and effective board that would enhance company performance. Thus, it is vital to set the proportion of non-shareholder directors which shall be included on boards.

1.3. Research Questions

- ❖ What is the status of non-shareholder directors in the governance of Ethiopian share companies? Did the concept of non-shareholder directors recognize under the Commercial Code and other relevant legislations?
- ❖ What are the merits of introducing non-shareholder directors in the governance of Ethiopian share companies?
- ❖ What are the demerits of introducing non-shareholder directors in the governance of Ethiopian share companies?
- ❖ Are there prospects which are helpful to change the present situation and facilitate the introduction of non-shareholder directors in Ethiopian share companies or challenges, if any?
- ❖ What are the experiences on non-shareholder directors in foreign countries and what we learn from them for Ethiopian share companies?
- ❖ If we shall introduce non-shareholder directors in Ethiopian share companies, how we have to introduce it?
- ❖ What standards should be employed to appoint non-shareholder directors and what kind of non-shareholder directors are needed?

- ❖ To what extent the number of non-shareholder directors on a board should be?
- ❖ How the roles and responsibilities of non-shareholder director should be determined?
- ❖ How the remuneration of non-shareholder directors within share companies to be settled and rewarded?
- ❖ How the liabilities of non-shareholder directors shall be determined?

1.4. Objectives of the Study

The general objective of this research is to assess the merits and demerits of introducing non-shareholder directors in the governance of Ethiopian share companies taking national laws and practices as well as theories, research results, international documents and best experiences in to account. Within this general objective, the research has the following specific objectives:

- ❖ To examine national laws and practices on non-shareholder directors in Ethiopian share companies;
- ❖ To provide information on the practices and experiences of foreign countries on non-shareholder directors in share companies;
- ❖ To assess the merits and demerits that non-shareholder directors would bring to Ethiopian share companies specifically and to the economy of the country in general;
- ❖ To recommend how non-shareholder directors shall be introduced and integrated with the domestic system to be workable and farther the performance of Ethiopian share companies;
- ❖ To suggest what standards shall be set to appoint non-shareholders in share companies; and
- ❖ To enquire the roles, responsibilities, remuneration, liabilities and composition of non-shareholder directors shall be in Ethiopian share companies.

1.5. Methodology of the Study

The research emphasized on qualitative research approaches. Thus, it uses reasons, justifications or logical arguments on practices and laws of both Ethiopia and foreign countries on non-shareholder directors and their respective merits and demerits qualitatively. It also used different foreign or national literatures, internet sources, survey, interviews of experts from Ministry of

Trade and National Bank of Ethiopia, interviews of directors as well as shareholders of different share companies found in Ethiopia.

1.6. Significances of the Study

This research examined issues related with introducing non-shareholder directors in the governance of Ethiopian share companies and its consequent impact on the efficacy of share companies. It assessed the merits and demerits of introducing non-shareholder directors in Ethiopian share companies in the view of national laws and practices as well as different theories, research works, foreign country experiences and international documents. In addition, this study recommended the way non-shareholder directors should be introduced and integrated with the corporate governance system of Ethiopian share companies and other related issues.

Thus, it would have contribution to different stakeholders. It offers a chance to appreciate the current trend towards non-shareholder directors in Ethiopia, foreign countries and international laws. It may contribute much for the forthcoming amendment of the Commercial Code of the country on introducing non-shareholder directors and other related issues. It provides relevant and research based information for judges, practitioners as well as for academician. It creates awareness for those who are interested to invest in the area of share companies. It will also serve as a basis and may call the attention of those who want to conduct further research in the field.

1.7. Scope of the Study

As mentioned above, the research assessed the merits and demerits of introducing non-shareholder directors in the governance of Ethiopian share companies. Thus, the research is all about share companies engage both in financial or non-financial activities and more specifically about the composition of board of directors. It recommended boards of Ethiopian share companies to be composed of non-shareholder directors too; rather than being consisted of shareholders only. Hence, it delimited its scope to non-shareholder directors like professional and experienced outside, non-executive, stakeholder or independent directors. In addition, the research addressed issues related with the manner of integrating and introducing of non-shareholder directors and examined the issues of standard of appointments of non-shareholders directors, roles and responsibilities, remuneration and liabilities of non-shareholder directors.

The experiences of some selected foreign countries on the issue of non-shareholder directors in share companies are made part of the research. Thus, the experiences of USA, Great Britain, France, China, South Africa and the Francophone West African countries (OHADA) have been dealt with. The international laws such as OECD are also get part of the study. The research, for the purpose of clarification, also came across concepts such as Business Organization and its types, corporate governance and board of directors both internationally and in Ethiopia as well. However, geographically the research is limited with share companies situated in Addis Ababa.

1.8. Limitations of the Study

The research emphasized on a recent issue of introducing non-shareholder directors on boards of share companies. Thus, it is obvious that it would be challenged by diverse ups and downs. Initially, it was difficult to have published materials especially on Ethiopian part. The only way was to search for electronic sources and even in this case majority of the materials are not freely accessible. The other serious limitation was the focus of this research is new to Ethiopia, *inter alia*, not recognized and had not any established legal frame work. Thus, there was no published book or article deals on this phenomenon. The study also aimed at collecting different data and information through interviews of experts, public officials, directors and shareholders of share companies. But, it was impossible to have access to this information and data to the extent needed may be because of fear, lack of motive or knowledge of these persons.

Chapter Two

2. General Overview on Companies

Introduction

Human beings do have individual taste, demand and interest on objects so far as they exist on the globe. For that, they engage in different business activities. A business is an institution organized and operated to provide goods and services to the society in financial, commercial or industry aspects with the objectives of earning profits, benefits, advantages or livelihoods. It is “an incorporeal movable consisting of all movable property brought together and organized for the purpose of carrying out any of the commercial activities specified in Art.5 of Commercial Code.”

Companies are one aspects of businesses in which human beings engage to earn profits, benefits, advantages or livelihoods. Hence, under this chapter an attempt is made to discuss the meaning, nature, distinguishing natures, formation and types of companies.

2.1. Companies

Companies are the mostly known and frequently operated forms of business organizations. They are also named as ‘corporations’. However; they are named differently, companies are separate entities and different from partnerships. Companies are defined as “an artificial being, invisible, intangible and existing only in contemplation of law.”⁴⁵ They are artificial organizations created by the law; are separated from their owners and managers; have their own rights, duties and powers; and have the capacity to exist perpetually.⁴⁶ They are business entities owned by individuals or juristic bodies and operate with names different from their owners. They own property, may conclude contract and commit crime. Companies are “the succession or collection of persons having at law an existence, rights and duties, separate and distinct from its members who vary from time to time.”⁴⁷

⁴⁵ Angela Schneeman, The Law of Corporations and Other Business Organizations(5thed,Cengage Learning: USA, 2010), p.246

⁴⁶ Peter Nayler, Business Law in the Global Marketplace (Elsevier Butterworth-Heinemann: UK, 2006), p.148

⁴⁷ Charles Wild and Stuart Weinstein, Smith and Keenan’s Company Law(14thed, Pearson Education Limited: England, 2009), p.2

When we see the Commercial Code, it is hard to find any provision which defines what companies are. However, companies are set up by Partnership Agreements of two or more persons, i.e. in Ethiopian case they need at least five persons to establish share companies⁴⁸ and two persons to form private limited companies.⁴⁹ The agreement between the partners shall be to join together, to bring in contributions and share losses and profits. Companies are also the association of capital. This can be understood from the readings of Article 304 which says “a Company whose capital is fixed in advance and divided into shares and whose liabilities are met only by the assets of the company” and Article 512 of the Commercial Code. So, the Article of Associations of companies focus on bringing together capital and do not target the identity of the contributors (which is the case in Partnership business). Companies operate and exist perpetually irrespective of the death, incapability and bankruptcy of the shareholders.

2.2. Formation of Companies

Companies are formed due to certain arrangements done by promoters.⁵⁰ In fact, the role of promoters or founders in the formation process of companies is essential and critical. It is difficult to have a single acceptable definition of who are promoters? However, promoters are “persons who undertakes to form a company with reference to a given project and to set it going and who take the necessary steps to accomplish that purpose.”⁵¹

It is obvious that companies which are on the way to formation have no any legal ground to enter in to juridical acts and perform activities necessary for their formation.⁵² It is promoters who replace companies under formation and perform what is necessary for their formation. According to Article 307(2),(3)&(4) of the Commercial Code, promoters(founders) prepare the legal documents of the firms such as the Memorandum and Article of Association, nominate initial directors, issue shares, and enter in to pre-incorporation contracts, etc.

⁴⁸Commercial Code, Art.307(1)

⁴⁹ Ibid , Art.510(2)

⁵⁰ The 1960 commercial code of Ethiopia uses this term with a different name called ‘founder’. However, I do not see any distinction on the meaning of the two terms and possible to use them interchangeably.

⁵¹Cuckburn CJ said in *Twycross v garnt*(1872) 2 CPD 469, cited in Janet Dine, *infra* note 53 , p.86

⁵² Ibid, p.87

Founders are not agents to the companies they are setting up.⁵³ However, they assume duties analogous to agents owe to their principals. They do have fiduciary duties that are similar to the duties owed to unborn child as no company is formed yet.⁵⁴ Thus, founders are required to fully disclose the whole profits, either collateral or direct profit, gained in the arrangement of the formation of companies to shareholders, actual or potential, or as alternative to the companies' directors.⁵⁵ This requirement prevents promoters from engaging in fraud and other wrongful activities that would affect companies and future shareholders.⁵⁶

However, promoters may sometimes fail to observe their fiduciary duties and in such case companies can reverse (rescind) the contract, i.e. give back the property or money.⁵⁷ Article 309 of the Commercial Code provides that “the founders shall be jointly and severally liable to the company as well as the third parties for any damage in connection with the subscription of the capital and the payments required for the formation of the company; for the contributions in kind as provided under Art. 315; and for the accuracy of statements made to the public in respect of the formation of the company.”

So far I indicated that companies are come in to existent by certain arrangements performed by founders. This includes:

First, the founders should inquire the business idea to be carried out and it's economic feasibility, and bring together the human and material resources necessary to run the business.⁵⁸ However, the founders to bring together the required human and material resources for the company, they may perform promotional activities through broadcast, print, or others medias.⁵⁹ They may enter in to pre-incorporation contracts with investors, accountants and others.⁶⁰ An invitation to pre-incorporation of contracts have often been made via a document known as prospectus and it informs the investors perfectly about the natures as well as prices of shares, debentures or other

⁵³Janet Dine, Company Law (4thed, Palgrave: New York, 2001), p.87

⁵⁴Ibid

⁵⁵ Nicholas Bourne, Principles of Company Law(3rded, Cavendish Publishing Limited: UK, 1998), p.26

⁵⁶Janet Dine, supra note 53, p.87

⁵⁷Nicholas Bourne, supra note 55 , p.27

⁵⁸Seyoum Yohannes, “On Formation of a Share Company in Ethiopia”, Journal of Ethiopian Law, Vol.22 ,No.1 (July,2008), p.102

⁵⁹Roger Leroy Miller and Gaylord A. Jentz, Business Law Today text and cases: E-commerce, Legal, Ethical and Global Environment (8thed,Cengage Learning: USA, 2010), p.776

⁶⁰Ibid

securities issued and about the company under formation. As stated under Article 318 of the Commercial Code, we do observe the same in Ethiopian Companies which are formed through public subscription.

Second, the founders shall also prepare the constitution of the company, i.e. Article and Memorandum of Association. These documents regulate the relationships of companies with outside world or shareholders.⁶¹

A Memorandum of Association is a basic document for incorporation of companies and includes the name of the original investors who initially subscribe the shares of companies⁶² This document defines the relationship between companies and the outside world and specifies the scope (objectives) of companies, so that it is not possible for companies to depart from this document and enter into juridical acts. It is, traditionally, required to include five clauses such as the name of companies, the location of the registered office/s, the objectives of companies, the liability of the members and the total shares of companies, the number of shares and the manner how profits and dividends are distributed.⁶³

An Article of association is subordinate to Memorandum of Association. It focuses on internal management of companies affairs.⁶⁴ It accepts the conditions set up under a Memorandum of Association and defines various rights, powers and duties of members involved in the Company. For instance, it incorporates rules on issuance, allotment and transfer of shares and basic regulations and procedures on general meeting, the voting rights of members, rights and duties of shareholders, directors and distribution of dividends and profits.⁶⁵

Third, the founders shall register and publicize the company under formation. The Ethiopian Commercial Code requires both the Memorandum and Article of Association to be deposited in the commercial registrar.⁶⁶ It also requires the notice to be published in a newspaper circulating at the palace where the head office is situated.⁶⁷ However, the requirement of publication in a

⁶¹ Denis Keenan, *Law for Business* (12th ed., Pearson Education Limited: England, 2003), P. 49

⁶² Commercial Code, Art.313 and 517

⁶³ Ibid, Art.313 and 517

⁶⁴ Denis Keenan, supra note 61, P. 49

⁶⁵ Commercial Code, Art .314 and 518

⁶⁶ Ibid, Art 219(2)(b), 221, 323 and 520

⁶⁷ Ibid, Art 87 ,219, 220, 223,224 and 323(3)

newspaper has now been abolished and a company shall acquire legal personality by being registered in the commercial register.⁶⁸

2.3. Distinguishing Features of Companies

Companies have their own distinct features which makes them different from partnerships and sole traders. So, a business person who is interested to form a company has to consider these distinguishing features.

Accordingly, companies have their own legal personality apart from their owners. Their identity is different from the identity of owners. So, if something wrong has been done by companies, it is the Companies which are questioned, not the owners and vice versa.⁶⁹ Companies, like natural persons, have their own properties, rights, and duties. They also incur liabilities and all of their liabilities are met by their assets as specified under Article 304(1) of the Commercial Code.

Shareholders of companies are also incurred limited liability.⁷⁰ This limited liability follows from separate legal personality of companies.⁷¹ Thus, shareholders, different from partners of partnerships, are not jointly and severally liable to each other. They have limited liability to satisfy the whole debts and obligations of the companies' business. It is companies themselves which are obliged to satisfy their debts and obligations.⁷² So, the creditors shall not bring and pursue their claim against the shareholders⁷³

The other essential characteristic of companies is perpetual succession. Companies are association of capital and not an association of persons. They do also have their own legal existence and identity apart from their shareholders. Thus, companies exist and operate for a long period of time despite the death, incapability, bankruptcy or the transfer of shares by shareholders.⁷⁴ These situations do not bring companies to an end because their assets remain

⁶⁸Commercial Registration and Business Licensing Proclamation No 686/2010, supra note 69

⁶⁹ David Sagar, Larry Mead and Philippa Foster Back, Fundamentals of Ethics, Corporate Governance and Business Law (Elsevier Ltd: USA, 2006), p.182

⁷⁰Commercial Code, Art.304(2) and 510(1)

⁷¹ John E. Moye, The Law of Business Organizations (6th ed, Delmar Cengage learning: USA, 2004), pp.158-159

⁷² Richard A. Mann and Barry S. Roberts, Smith and Roberson's Business Law (15th ed., Cenegage Learning: USA, 2011), p.669

⁷³Keith Owens, Law for Non-Law Students(3rd ed, Routledge-Cavendish: London, 2001), p.654

⁷⁴ William F. Blake, A Basic Private Investigation: A Guide to Business Organization, Management and Basic Investigation Skills for the Private Investigator(Charles C Thomas Pub Ltd, 2011), p.17

intact⁷⁵. To say more, in western countries, the shares of large companies are sold and bought in stock markets every minute, but that does not alter the ownership of assets of companies. Their existences remain perpetual due to the succession of new persons who replace those who die, became incapable, go bankrupt or transfer their shares.

Due to the public policy of preserving and protecting the interests of third parties and maintaining a safe transaction system, the laws of government seriously regulate the capital of corporations.⁷⁶ So, the law requires companies to be established with a minimum capital as opposed to partnerships and sole proprietors (which are not required to have minimum capital because the partners owe unlimited liability).⁷⁷ For instance, the Commercial Code under its Articles 306(1) and 512(1) fixes the minimum capital for share companies to be 50,000 Birr and for private limited companies to be 15,000 Birr.

Shares of companies are also freely transferable and can be sold or purchased. This is one of the reasons why people prefer to form companies than partnerships. Transferability of companies' shares adds advantages both to the institution of the company as well as to the investors. Companies' share capital becomes permanent and stable because shareholders cannot withdraw anything out of it.

2.4. Types of Companies

Companies are classified in to different forms. However, the experience of countries on classification of companies reveals that there are different traditions on categorizing companies. In most western countries, we find that companies, traditionally, are classified as public and private. But the Commercial Code of Ethiopia specifies two types of companies, i.e. share and private limited companies. Herein below each company is discussed.

2.4.1. Share Companies

Most of the times, share companies are appropriate for business activities which are capital intensive. The history of formation of share companies also proves this practice. The same concept is also found under the statement made by prof. Escara, who is one of the drafter of the

⁷⁵ Richard A. Mann and Barry S. Roberts , supra note 72, p.669

⁷⁶Fekadu Petros, supra note 12, p.37

⁷⁷ Ibid

1960 Commercial Code and argues” I recommend a minimum capital in order to reserve share companies for important transactions.”⁷⁸ Share Companies are defined under Article 304 (1) as, “the companies whose capital are fixed in advance and divided into shares and whose liabilities are met only by the assets of the companies.” Thus, Share Companies are the association of capital and this capital shall be fixed in advance and divided into shares. They are not the association of persons. Their existents do not depend on the identity of shareholders, so that they remain function despite the death, became incapability, etc of shareholders. Share Companies have their own legal existents and identity apart from the identity of their shareholders. Like other forms of companies, share companies involve shareholders who have limited liability.⁷⁹ As stated under Article 304(1) of the Commercial Code, the debts and liabilities of the companies are met by the assets of companies.

Share Companies have their own unique natures. Share Companies are most often involved in capital intensive business activities. So, share companies require more capital than private limited companies. For instance, Article 306 of the Commercial Code requires share companies to be established with a minimum 50, 000 Birr, but the minimum capital for private limited companies is 15,000 birr.⁸⁰ Further, we can see the minimum and maximum number of shareholders required to form and operate the business, i.e. at least five⁸¹ and no maximum limit in share companies and two to fifty in private limited companies as stated under Article 510 (2). Share Companies are capitalized organizations whose capital are fixed in advance and divided into shares that can be easily transferred to third parties or to another shareholder as stated under Article 333 of the Commercial Code. Hence, the identity of shareholders who form share companies may be changed over time. Share companies may collect capital necessary for its formation and operation through different mechanisms including issuing debenture bonds.⁸² When we come to formation, Share Companies may be formed in two ways. i.e. formation by public subscription and formation as between founders.

⁷⁸ Peter Winship(ed), Background Document of The Ethiopian Commercial Code of 1960(Artistic Printers: Addis Ababa, 1974), p.61

⁷⁹ Commercial Code, Art.304(2)

⁸⁰ Ibid , Art.512

⁸¹ Ibid , Art.307(1)

⁸² Fekadu Petros, supra note 12, p.52

2.4.2. Private Limited Companies

Private limited companies are largely appropriate for small and medium size business activities. When we come to the Commercial Code, it is hard to find any provision that deals with the definition of private limited companies. However, they are companies subject to the formation of Business Organizations. Private limited companies have both company and partnership natures.⁸³ In fact, the provisions of the Commercial Code show that private limited companies are capitalized organization.⁸⁴ So, they do share the unique features of companies. But, the maximum number of shareholders in private limited companies may not exceed fifty. This makes people to focus on their identities to form private limited companies and this is one of the natures of partnerships.⁸⁵ Thus, private limited companies are capitalized organizations and at the same time they are enterprises set up on the basis of the intimate bond of members. To sum up, private limited companies are formed and operated with less capital; need not to be run by a board of directors; are not required to be subject to audit unless the numbers of members is over twenty; and are regulated less rigorously than share companies.⁸⁶

⁸³ Le Gall, French Company Law(Oyez publishing Ltd: London), p. 43

⁸⁴ Betre Dawit, The Law of Business Organizations: A Comparative Study of General Partnerships and Private Limited Companies (1991, Unpublished, AAU Law Library, faculty of law, Addis Ababa University), p.36

⁸⁵ Nigussie Tadesse, Major Problems Associated With Private Limited Companies in Ethiopia: The Law and Practice (March 2009, unpublished, Library, Faculty of Law, Addis Ababa University), p.35

⁸⁶ Commercial Code, Art.512(1), 532 and 538

Chapter Three

3. Corporate Governance of Share Companies

Introduction

Although the history of corporate governance is complex and hard to get its definitive treatment,⁸⁷ it comes into picture as a result of corporate failures and systematic crisis.⁸⁸ So, it evolved over centuries and has been in existence since the time when modern corporations came in to existence.⁸⁹ However, it appeared in academic literatures for the first time in 1984.⁹⁰

Corporate governance is a multidisciplinary concept and does not have any single acceptable definition.⁹¹ In Ethiopia, the Commercial Code does not define the term corporate governance. Neither does it clearly address it. Corporate governance issues in Ethiopian share companies are dealt with under different laws; however, the Commercial Code is the primary one. Corporate governance is concerned with issues involving shareholders rights, powers and liabilities of directors, financial reporting, transparency and audit. However, these issues are inadequately dealt by the Commercial Code as well as other legislations on corporate governance of share companies. They are not addressed in compliance with best international documents and practices.⁹² Further, these days, the idea of non-shareholder directors system has stirred a worldwide interest and is adopted in different jurisdictions. However, in Ethiopia, the Commercial Code and other relevant laws prohibit share companies from being comprised of non-shareholder directors.

In this chapter, discussion will come first on cross cutting issues about the conceptual overview of corporate governance such as meaning, significances, principles and models of corporate

⁸⁷Brian R. Cheffins, “ The History of Corporate Governance,” **ECGI Working Paper Series in Law** , No. 184(2012), p.1

⁸⁸International Finance Corporation, Corporate Governance Manual (2nded, Hanoi, Vietnam: BACSON, 2010), p.9

⁸⁹ Brian R. Cheffins, supra note 87, p.1

⁹⁰ According to Professor Andrew Chambers (2003) Tottel’s Corporate Governance Handbook, Tottel Publishing, Haywards Heath Cited in Alan Calder, Corporate Governance: A Practical Guide to the Legal Frameworks and International Codes (London: Kogan Page Limited, 2006), p.10

⁹¹ A. C. Fernando , Corporate Governance: Principles, Policies, and Practices (Pearson Education, 2006), p.12

⁹² USAID, Ethiopian Commercial Law and Institutional Reform and Trade Diagnostic (January, 2007), pp.19-20

governance. Finally, discussion will be made on board composition and independence in Ethiopian share companies and the experiences of foreign countries on composition of boards with particular emphasis on introducing non-shareholder directors on boards.

3.1. Meaning and Nature of Corporate Governance

Corporate governance is one of the most commonly used phrases in recent businesses and commercial life. The term was used for the first time by Robert Tricker in his work 'International corporate governance' in 1984.⁹³ However, corporate governance is a multidisciplinary concept and does not have any single acceptable definition.

The OECD principles of corporate governance (2004) states "corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined."⁹⁴ Bob Garrat argues that corporate governance involves "the appropriate board structures, process and values to cope with the rapidly changing demands of both shareholders and stakeholders in and around their enterprises."⁹⁵ Parkinson expresses corporate governance as "the process of supervision and control intended to ensure that the company's management acts in accordance with the interests of shareholders."⁹⁶ Tricker argues that "the governance role is not concerned with the running of the business of the company per se, but with giving overall direction to the enterprise, with overseeing and controlling the executive actions of management and with satisfying legitimate expectations of accountability and regulation by interests beyond the corporate bodies."⁹⁷ Cannon on his part provided that "the governance of enterprise is the sum of those activities that make up the internal regulation of the business in compliance with the obligations placed on the firm by legislation, ownership and control. It incorporates the trusteeship of assets, their management and their deployment."⁹⁸ Shleifer and Vishny also

⁹³Fekadu Petros, supra note 16, p.3

⁹⁴ Organization for Economic Co-operation and Development (OECD), Principles of Corporate Governance (2004)(herein after , I used it as OECD)

⁹⁵ Bob Garratt, Thin on Top: Why Corporate Governance Matters and How to Measure and Improve Board Performance (London: Nicholas Brealey Publishing, 2003), p.12

⁹⁶ Parkinson(1994) cited in infra note 101, p13

⁹⁷Tricker(1984) cited in infra note 101, p13

⁹⁸ Cannon(1994) cited in infra note 101, p13

mention that corporate governance “deals with the ways in which supplier of finance to corporations assure themselves of getting a return on their investment.”⁹⁹ Finally, David Larcker and Brian Tayan define corporate governance as “the collection of control mechanisms that an organization adopts to prevent or dissuade potentially self-interested managers from engaging in activities detrimental to the welfare of shareholders and stakeholders.”¹⁰⁰

These definitions of corporate governance are either broad or narrow. A definition is narrow if its focus is on the relationship between a company and its shareholders or it is broad if it includes employees, customers, suppliers and other stakeholders in addition to the relationship between a company and its shareholders.¹⁰¹ Certainly, the narrow definition stands on the traditional agency theory and the broad definition involves the proposition of stakeholder theory.¹⁰²

Moreover, from the above definitions, we can learn that accountability is one of the basic characteristics of corporate governance.¹⁰³ So, the narrow definitions focus on the accountability of companies to shareholders whereas the broad ones focus on ensuring the accountability of companies to stakeholders. The definitions also show that protecting shareholders’ interests,¹⁰⁴ stakeholders’ interests¹⁰⁵ and enhancing companies’ performance¹⁰⁶ are also the purposes of corporate governance. However, these objectives can be achieved only when there is good corporate governance¹⁰⁷ and exercised within the limit of mandatory rules such as national laws,

⁹⁹ Benton E. Gup (ed), Corporate Governance in Banking: A Global Perspective (UK: Edward Elgar Publishing Limited, 2007), p.18

¹⁰⁰ David Larcker and Brian Tayan, Corporate Governance Matters: A Closer Look at Organizational Choices and Their Consequences (New Jersey: Pearson Education, Inc., 2011) , p.8

¹⁰¹ Jill Solomon and Aris Solomon, Corporate Governance and Accountability (England: John Wiley & Sons Ltd, 2004), p.12

¹⁰² Ibid, p.12

¹⁰³ Ibid, p.14

¹⁰⁴ Ahmed Nacri (ed), Corporate Governance Around the World (London: Routledge, 2006), p.3. See also Benton E.Gup (ed), Corporate Governance in Banking: A Global Perspective (UK: Edward Elgar Publishing Limited, 2007),, p.22

¹⁰⁵ Charles P. Oman (ed), Corporate Governance in Development: The Experiences of Brazil, Chile, India and South Africa(center for international private enterprise and OECD development center, 2003), p.3

¹⁰⁶ Ibid

¹⁰⁷ Dan A. Bavly, Corporate Governance and Accountability: What Role for the Regulator, Director and auditor?(London; Quorum Books,1999), p.3

regulations and self-regulatory rules reflecting the economic goals and expectations of shareholders and stakeholders.¹⁰⁸

In Ethiopia, the Commercial Code does not define the term corporate governance. Moreover, it does not deal clearly with the concept of corporate governance. It instead deals with corporate management. However, corporate governance is different from corporate management and has its own functions.

Corporate governance is concerned with setting appropriate policies, initiatives, strategies, plans, practices and directing companies to meet their visions, missions, and objectives and develop their infrastructures.¹⁰⁹ It ensures accountability and transparency within companies as well as works to the effect that shareholders and stakeholders are kept informed about the business affairs of companies including the financial status of companies, their level of profitability, etc.¹¹⁰ Governance manages risks, conflict of interests and ensures the integrity of companies through independent auditors.¹¹¹ Corporate governance is all about “doing the right thing.”¹¹²

On the other hand, corporate management focuses on the day to day operation of companies and is concerned with performing appropriate activities within companies; rather than setting right policies, guidelines and directions.¹¹³ It is about “doing things right” or running companies in conformity with their policies, strategies or process. Management works with tools required to operate the business affairs of companies, so that it involves functions of executive management like making decision, control and other operational management activities.¹¹⁴

¹⁰⁸ Catherine Turner, Corporate Governance: A Practical Guide for Accountants (Oxford: Elsevier Ltd, 2009), p.10

¹⁰⁹ Governance versus Management, p.1. Accessed at <http://www.health.qld.gov.au/health-reform/docs/factsheet-govn-mgmt> visited on august 13, 2013

¹¹⁰ Jonathan Lister, Functions of Corporate Governance accessed at http://www.ehow.com/info_8044296_functions-corporate-governance.html visited on august 13, 2013

¹¹¹ Ibid

¹¹² Robert I. Tricker, 1998, Pocket Director, p. 8 cited in Governance and Management, p. 81. Accessed at http://siteresources.worldbank.org/EXTGLOREGPARPROG/Resources/grpp_sourcebook_chap12.pdf visited on august 13, 2013

¹¹³ Ibid

¹¹⁴ International Finance Corporation, supra note 88, p.15

3.2. Significances of Corporate Governance

Corporate governance is an effective policy instrument used to exacerbate diverse economic activities. It has become an issue of global importance, so that policy makers, companies, shareholders and investors are now aware of its contribution to the economy.¹¹⁵ It also attracted the attention of scholars and popular presses on the globe.¹¹⁶

Good corporate governance is essential to share companies these days, particularly, due to separation of ownership and control, control of block shareholders as opposed to minority shareholders and decision making processes,¹¹⁷ and relationships among participants such as institutional investors, creditors, employees and other stakeholders in the governance system.¹¹⁸

A good practice of corporate governance is an essential instrument to create trust and confidence in share companies.¹¹⁹ Following the formation of share companies with dispersed shareholders, the ownership and control of share companies is separated. Consequently, shareholders (principals) delegate the management of share companies to managers (agents), expecting that the managers act in the best interests of shareholders. But, the managers may engage in some wrongful or fraudulent activities forgetting the interests of shareholders. So, shareholders require assurance that the managers run companies in their interests¹²⁰ and this can be achieved through good corporate governance.¹²¹ This is because good corporate governance establishes different legal and institutional mechanisms which facilitate shareholders to monitor the actions of the managers and make strategic decisions that reduce the potential losses of shareholders. So, good corporate governance helps to generate trust and confidence in share companies.¹²² It also provides proper incentives for managers to pursue the objectives that are in the interests of shareholders.

¹¹⁵ OECD

¹¹⁶ Fernando cited in Fekadu Petros, supra note 12, p.51

¹¹⁷ OECD

¹¹⁸ Ibid

¹¹⁹ Ajith Nivard Cabraal, "Importance of Corporate Governance for the Banking and Financial Sector" (24-25 February, 2007) p.3. Accessed at <http://www.bis.org/review/r070314c.pdf?frames=0> viewed on December 3, 2013

¹²⁰ Ibid, p.1

¹²¹ Ashenafy Beyene Fanta, Kelifa Srmolo Kemal and Yodit Kassa Waka, "Corporate governance and impact on bank performance," **Journal of Finance and Accounting**, Vol.1, No.1(2013), p.1

¹²² Ibid

Sound corporate governance is also crucial to address ownership issues.¹²³ Controlling shareholders, who may be individuals, family holdings, bloc alliances, or other corporations acting through holding companies or cross shareholdings, can significantly influence corporate behavior. However, good corporate practice is essential to overcome the ill-effects of concentrated ownership through diverse mechanisms, i.e. regulatory limits on ownership in share companies.¹²⁴

Good corporate governance is important to prevent corporate scandals and frauds, and maintain financial system stability.¹²⁵ The massive corporate scandals and failures that rocked the business world, namely Enron, World Com, etc in the dawn of 21st century were mainly caused by weak corporate governance.¹²⁶ In fact, weak corporate governance reduces the capacity of share companies to determine and manage their business risks and leads to financial instability.¹²⁷

Practicing good corporate governance helps to enhance the reputation of share companies through making them more attractive to customers, investors and suppliers.¹²⁸ Recent research works also reveal that investors are more interested to invest their capital in share companies that practice good corporate governance and have good reputation.¹²⁹

A good system of corporate governance enhances the capacity of countries to attract investment.¹³⁰ Sound corporate governance practices have marginal advantage in attracting international capital because they set clear minimum standards of responsibility, governance, inspection and thereby produce a lower market risk.¹³¹ It assures to investors that their

¹²³ Ajith Nivard Cabraal, supra note 119, p, 2.

¹²⁴ Ibid .

¹²⁵ Frederick D. Lipman and L Keith Lipman, *Corporate Governance Best Practices: Strategies for Public, Private, and Not-for-Profit Organisations*(2006) at 3 cited in Hussien Ahmed Tura, "Approaches to Reform Corporate Governance in Transition Economies: The Case of Ethiopia," p, 5. Available at SSRN:≤ <http://ssrn.com/abstract=22933031> ≥ viewed on November, 11, 2013)

¹²⁶ Ibid, p, 4

¹²⁷ Ajith Nivard Cabraal, supra note 119, p, 3

¹²⁸ Frederick D. Lipman and L. Keith Lipman, *Corporate Governance Best Practices: Strategies for Public, Private, and Not-for-Profit Organizations*(New Jersey: John Wiley & Sons, Inc., 2006), p.3

¹²⁹ Felton, F. R., Hudnud, A. and van Heeckeren, J. (1996) cited in . Frederick D. Lipman and L. Keith Lipman, supra note 128, p.3

¹³⁰ Shingirirayi Gona, *The Role of the Independent Director in Maintaining Good Corporate Governance* (2009, unpublished , library, University of Cape Town), p.7

¹³¹ Lutgart Van den Berghe and Liesbeth De Ridder, *International Standardization of Good Corporate Governance: Best Practices for the Board of Directors*(Springer Science+ Business Media Dordrecht, 1999), p.17

investment will be secured and efficiently managed in a transparent and accountable process. It obliges share companies to respect the rights of creditors, bondholders and non-controlling shareholders, so that individual and institutional investors are committed to invest their capital.¹³² On the other side, we can also say that investment is paramount importance to encourage good corporate governance practice in share companies.¹³³

Sound corporate governance improves economic efficiency and growth.¹³⁴ The practice of good corporate governance, within individual companies and across the economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. It lowers the cost of capital and encourages firms to use resources more efficiently and there by underpins growth. It creates competitive and efficient companies which are essential to create wealth.

Although share companies do not primarily rely on foreign sources of capital, practicing corporate governance in accordance with internationally accepted principles increases access to external financing or widens the sources of capital.¹³⁵ So, sound corporate governance practices enable share companies to reap the full benefits of global capital market and attract long-term patient capital.¹³⁶

The presence of effective corporate governance in transition economies brings more effective privatization of state-owned share companies¹³⁷ and the development of vibrant private sectors with fewer problems. It helps share companies whose shares are traded on the stock market¹³⁸ to raise their capital by selling shares at a price worthwhile to their owners by devising mechanisms

¹³² Justine Tumuheki, Towards Good Corporate Governance: An Analysis of Corporate Governance Reforms in Uganda(2007, unpublished , library, University of Cape Town), p.6

¹³³Shingirirayi Gona, supra note 130, p.7

¹³⁴ OECD. see also Ashenafy Beyene Fanta, Kelifa Srmolo Kemal and Yodit Kassa Waka, supra note 121

¹³⁵ Ashenafy Beyene Fanta, Kelifa Srmolo Kemal and Yodit Kassa Waka, supra note 121, p.1

¹³⁶ OECD

¹³⁷ Alexander Dyck, “Privatization and Corporate Governance: Principles, Evidence and Future Challenges”(2000), p.2. Accessed at <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.202.286&rep=rep1&type=pdf> viewed on November 12, 2013

¹³⁸ Justine Tumuheki, supra note 132, p.7

which subject them to observe their promise, respect mandatory laws and to pay incentives to the managers.¹³⁹

Finally, good corporate governance also helps to establish an appropriate legal, economic and institutional environment that allows firms to organize, grow and survive as an institution.¹⁴⁰ It is an essential instrument to establish an effectively organized management structure and activity system in share companies to meet the needs of shareholders, stakeholders and the society.¹⁴¹ But, it needs state to put in place and maintain an environment that enables efficient and well-managed companies to grow, thrive and survive in contrast to environment that permits government related firms or rent seeking firms to work and survive.

Although corporate governance has much significance, it was not considered as important in developing countries so far. It remained invisible and ignored in those countries for a long period of time. However, recently, developing countries began to consider their poor corporate governance systems and the problems of crony capitalism basically due to the East Asian Financial Crisis of 1997-1998.¹⁴² Developing countries are now working to improve their corporate governance as the threat to global financial markets has risen. But, there are countries especially the small and the poor ones that have given little attention to corporate governance till now.¹⁴³

The tendency to ignore the quality of corporate governance in the developing world is a mistake because good corporate governance matters in national development.¹⁴⁴ It plays an important role in the long term process of development of a country. Moreover, corporate governance creates competitive and efficient companies, efficient and effective use of limited resources,¹⁴⁵ etc. The research works carried out in Brazil, Chile, India and South Africa show that effective corporate governance is essential to increase the flow of financial capital to share companies in

¹³⁹ Ibid

¹⁴⁰Private Sector Initiative for Corporate Governance, Principles for Corporate Governance in Kenya and a Sample Code of Best Practice for Corporate Governance(2012)

¹⁴¹ Sanjay Anand, Essentials of Corporate Governance (New Jersey: John Wiley & Sons, Inc., 2008), p.87

¹⁴² Charles P. Oman (ed), Supra note 105 , p.2

¹⁴³ Ibid

¹⁴⁴Stijn Claessens, Corporate Governance and Development,(The World Bank: Washington DC, 2003), p.1

¹⁴⁵Private Sector Initiative for Corporate Governance, supra note 140, p.3

developing countries as well as to improve financial development of those countries.¹⁴⁶ These researches also specify that corporate governance is crucial to attain continued productivity growth in developing countries' real economies.¹⁴⁷ So, corporate governance has become an issue of worldwide importance and is the engine of growth. It is of a national importance, and "the government must explicitly adopt the policy that commercial competitiveness is a national priority and that an effective governance system is a necessary precondition."¹⁴⁸

Ethiopia, like other developing economies, has now recognized that good corporate governance is an essential instrument for prosperity and growth. It specified corporate governance under the GTP as a crucial element to eradicate poverty in the country. So, Ethiopia also enjoys a number of significance of good corporate governance discussed above.

3.3. Principles of Good Corporate Governance

It is hard to find uniform principles of good corporate governance on the globe. The basic principles of good corporate governance vary from country to country, even among firms within a country. So far, a number of codes of corporate governance principles have been enacted worldwide.¹⁴⁹ However, none of these codes are complete and most of them focus on board of directors.¹⁵⁰ They do not also include uniform principles. This variation on basic principles of good corporate governance may be attributed to the legal, economical, socio-cultural structures, political perception, companies' structures and¹⁵¹ fluid concept of corporate governance. So, it seems quite difficult to have similar principles that can be applied to all countries.

The OECD principles of corporate governance, which was published in 1999 and revised in 2004, accepts this difficulty of formulating uniform principles stating that "one does not fit all".¹⁵² However, OECD, considering the problem of not speaking common language and its consequence,¹⁵³ it determines basic principles that would address both policy makers and

¹⁴⁶ Charles P. Oman (ed), supra note 105 , p.1

¹⁴⁷ Ibid

¹⁴⁸ Lutgart Van den Berghe and Liesbeth De Ridder, supra note 131, p.16

¹⁴⁹ International Finance Corporation, supra note 88, p.13

¹⁵⁰ Ibid

¹⁵¹ Selim Serbetic, Corporate Governance: Manufacturing Companies; Performance During the Financial Crisis in Turkey (Saarbrucken, Germany; LAP LAMBERT Academic publishing GmbH and Co.KG, 2011), p.22

¹⁵² Ibid

¹⁵³ Ibid

businesses. The principles focus on the entire governance frameworks ¹⁵⁴(shareholders rights, stakeholders, disclosures and board practices). They may also be applied in every country and in fact, they have been used widely as a framework and reference point for corporate governance. The principles are:

First, OECD requires ensuring the basis for an effective corporate governance framework.¹⁵⁵ This principle focuses on establishing appropriate and effective legislations, regulations, self-regulatory arrangements, voluntary commitments and business practices up on which all market participants can rely in establishing their private contractual relations.¹⁵⁶ The corporate governance frameworks established should maintain and strengthen the market integrity and economic performance. For that, it would be wise to conduct an effective continuous consultation with the public, consider the need for and the results from international cooperation and dialogue, take in to account the interactions between different elements of corporate governance and its ability to enhance ethical and transparent corporate governance practices.¹⁵⁷

Second, OECD requires the rights of shareholders and key ownership functions to be recognized and protected.¹⁵⁸ Shareholders as investors in firms do have certain property rights. So, the corporate governance framework should protect and facilitate the exercise of shareholders rights. It shall entitle shareholders the right to transfer their shares, participate in the profits of the corporation, information, participation at general shareholders meetings and voting, etc.¹⁵⁹

Third, OECD requires equitable treatment of shareholders.¹⁶⁰ The corporate governance framework shall ensure equal attitude and treatment towards all shareholders holding same category of shares,¹⁶¹ including minority and foreign shareholders. It shall adopt mechanisms that provide for shareholders, particularly for minority shareholders, to bring law suit or initiate administrative proceedings when they have reasonable grounds showing that their rights are

¹⁵⁴ International Finance Corporation, supra note 88, p.14

¹⁵⁵ OECD, principle I

¹⁵⁶ Annotation to OECD , Principle I

¹⁵⁷ Ibid

¹⁵⁸ OECD, principle II

¹⁵⁹ Annotation to OECD , Principle II

¹⁶⁰ OECD, principle III

¹⁶¹ NASDAQ OMX RIGA, Principles of Corporate Governance and Recommendations on their Implementations(2010), p.5

violated.¹⁶² The corporate governance framework shall also protect the rights of shareholders from misuse or misappropriation by the managers. All shareholders shall also have the opportunity to obtain effective redress for violation of rights.¹⁶³

Fourth, OECD requires the role of stakeholders in corporate governance to be recognized.¹⁶⁴ Stakeholders are vital for growth, competitiveness and sustainability of firms.¹⁶⁵ They contribute much in firms-specific human and physical capital. They also provide wide range of valuable resources to companies. So, the corporate governance framework shall recognize the rights of stakeholders established by commercial law or mutual agreements.¹⁶⁶ They must be able to access to adequate, accurate and regular information.

Fifth, OECD requires efficient disclosure and transparency mechanisms.¹⁶⁷ A strong disclosure regime promotes transparency; enhances the ability of shareholders to exercise their ownership rights on an informed basis; attracts capital; maintains confidence; and improves public understanding of the structure, activities, policies and performances of firms.¹⁶⁸ So, the corporate governance framework shall ensure that a timely, accurate, honest and independent disclosure¹⁶⁹ is made on all material matters regarding firms. However, disclosure shall neither bring any unreasonable administrative cost or burden nor does it requires the revelation of information that may endanger the competitiveness of companies.¹⁷⁰

Finally, the desired corporate governance framework shall clearly and expressly determine the responsibilities and authorities of boards, thereby ensuring a successful work of boards.¹⁷¹ The corporate governance framework shall clearly specify the responsibilities of boards to exercise an objective and independent judgment as well as to oversee firms observe laws and standards.¹⁷² It shall ensure the strategic guidance of companies and the effective monitoring of

¹⁶² Annotation to OECD , Principle III

¹⁶³ Ibid

¹⁶⁴ OECD, principle IV

¹⁶⁵ Selim Serbetic, supra note 151, p.42

¹⁶⁶ Ibid

¹⁶⁷ OECD, principle V

¹⁶⁸ Annotation to OECD , Principle V

¹⁶⁹ Selim Serbetic, supra note 151, pp.42-43

¹⁷⁰ Supra note 168

¹⁷¹ OECD, principle VI

¹⁷² Annotation to OECD , Principle VI

managements by boards.¹⁷³The corporate governance framework shall also devise mechanisms that make boards work in the interests of shareholders and give due regard to other stakeholders.¹⁷⁴

3.4. Models of Corporate Governance

So far, I have discussed the multi significances of corporate governance. Sound corporate governance is a powerful instrument to enhance the growth, competitiveness and sustainability of companies as well as to bring overall economic development. However, what is not measured cannot be improved, so we need to develop a model to measure the quality of corporate governance or a model that evaluates how the crafted principles are applied to the logic of governance.¹⁷⁵ But, as we can learn from experiences, there are two models of corporate governance practiced all over the world due to differences in political perception, firms' structure, and corporate governance culture of countries. These two models of corporate governance are the shareholders' and stakeholders' model of corporate governance.

3.4.1. A Shareholders' Model of Corporate Governance.

A shareholders' model of corporate governance is practiced widely in Anglo-Saxon polities.¹⁷⁶ Its' concept is associated with the agency theory.¹⁷⁷ A shareholders' model of governance stands that companies are the extension of their owners, and so that share companies shall be run to the interests of shareholders.¹⁷⁸ It holds that corporate governance must reflect shareholders ownership in terms of both means and end. It states that companies must be owned by

¹⁷³ Ibid

¹⁷⁴ Selim Serbetic, supra note 151, p.43

¹⁷⁵ Yilmaz Arguden, "A Corporate Governance Model: Building Responsible Boards and Sustainable Business", **Private Sector Opinion**, Issue 17, p.5

¹⁷⁶ Mihaela Ungureanu, "Models and Practices of Corporate Governance Worldwide", **CES Working Paper**, pp. 626-627

¹⁷⁷ Gerard Charreaux, "Corporate Governance Theories: From Micro Theories to National Systems Theories"(2004), JEL Classification : G300 ; P500, p.6

¹⁷⁸ Stefan Andreasson, Shareholder and Stakeholder Interests: the Politics of Corporate Governance Reform in South Africa (2006), p.4 . Accessed at

http://bisa.ac.uk/index.php?option=com_bisa&task=download_paper&no_html=1&pass ≥ viewed on December 6, 2013

shareholders, and then must be run in the interests of shareholders.¹⁷⁹ It stands on the inviolability of private ownership of companies.¹⁸⁰

A shareholders' model of governance entrusts shareholders the ownership of companies, and an exclusive rights to determine how and for what purposes the companies' property may be used as well as the right to determine companies' priorities and profits that may generate.¹⁸¹ Further, it holds that the pursuit of shareholders' interests is the only end of corporate governance and on this issue Friedman says "there is one and only one social responsibility of business - to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud..."¹⁸² But, it is wise to consider that the interests of shareholders may not always limited to wealth maximization.¹⁸³ It may go beyond wealth maximization which includes charitable conducts or notions of justice.¹⁸⁴

To sum up, a shareholders' model of governance insists that, as Adolph A. Berle says, companies exist only to make profit for their shareholders¹⁸⁵ and "all powers of the management are at all-time exercisable only for retable profits of all the shareholders as their interest appear".¹⁸⁶ It mandates companies' managements to devote their energies to the advancement of shareholders interests, so that they should disregard any stakeholders' interest that is in conflict with one of the objectives of the companies.¹⁸⁷ It is also a model followed in the corporations in which shares are owned by dispersed shareholders.¹⁸⁸

3.4.2. A Stakeholders' Model of Corporate Governance

¹⁷⁹ Julian Velasco, "Shareholder Ownership and primacy," University of Illinois Law Review, No.3(2010), p.944

¹⁸⁰ Stefan Andreasson, supra note 178, p. 4

¹⁸¹ Ibid

¹⁸² Daniel K. Saint and Aseem Nath Tripathi, "the Shareholder and Stakeholder Theories of Corporate Purpose." P.2 . Accessed at <<http://www.knowledgeworkz.com/samatvam/newsletter/The%20Shareholder%20and%20>> viewed on December 9, 2013.

¹⁸³ Julian Velasco, supra note 179, pp.945-946

¹⁸⁴ Ibid

¹⁸⁵ See generally D. Gordon Smith, "The Shareholder Primacy Norm", Journal of Corporation Law, Vol.23, No.2 (1998).

¹⁸⁶ Adolph A. Berle, "Corporate Powers as Powers in Trust," Harvard Law Review(1931), p. 1049

¹⁸⁷ D. Gordon Smith, supra note 185, p.282

¹⁸⁸ Yuan Dujuan, "Inefficient American Corporate Governance under the Financial Crisis and China's Reflections," International Journal Law and Management(2009), pp. 140-141

A stakeholders' model of corporate governance is common in social market polities such as Germany and Japan. Its' concept is also based on stakeholder theory. A stakeholders' model of corporate governance, unlike a shareholders' model of governance, holds companies as a social entities that are accountable to stakeholders beyond shareholders.¹⁸⁹ It takes shareholders as one set of stakeholders and does advocate companies to be operated in the interests of all stakeholders.¹⁹⁰ It involves the vision of social responsibility of firms, so that it takes the whole society as stakeholders.¹⁹¹

A stakeholders' model of governance is interested that corporate governance frameworks to be designed in the way to make firms to be run in the interests of all stakeholders beyond economic value creation for shareholders alone.¹⁹² It says the interests of all stakeholders must be integrated into the very purposes of firms, and stakeholders relationships must be managed in a coherent and strategic fashion. In fact, a stakeholders' model of governance accepts that companies shall be operated primarily to maximize wealth. However, it believes that wealth production shall not be in the interests of shareholders alone. It insists wealth production to be in the interests of all stakeholders.¹⁹³

A stakeholders' model holds equal treatment among stakeholders and opposes any stakeholder group to receive preferential treatment.¹⁹⁴ Dodd also argues that the objective of companies should not be limited to making of money to shareholders; rather, it should be extended to providing social services and securing job for employees, quality services and products for

¹⁸⁹Steve Letza and Xiuping Sun, "Corporate Governance: Paradigms, Dilemmas and Beyond," **Leeds Law School**, Vol. 2, No.1(2002),pp. 49-50

¹⁹⁰ Alberto Chilosi and Mirella Damiani, "Stakeholders vs Shareholders in Corporate Governance"(2007), P.2. Accessed at <http://mpa.ub.uni-muenchen.de/2334/>

¹⁹¹ Ibid

¹⁹²Daniel K. Saint and Aseem NathTripathi, supra note 182, P.5

¹⁹³ Donna Card Charron, "Stockholders and Stakeholder: The Battle for Control of the Corporation," **Cato Journal**, Vol.27, No.1 (2007), p.10

¹⁹⁴ Ibid

customers, and welfare to the society.¹⁹⁵ Moreover, a stakeholders' model does not accept shareholders as the owner of companies with rights to control.¹⁹⁶

The central idea of a stakeholders' value theory is that business organizations are dependent upon stakeholders for success, and stakeholders have some stake in organizations.¹⁹⁷ So, the managers are required to pursue interests that go beyond shareholders and care for the interests of others involved in the activities of companies.¹⁹⁸ The roles of managers are limited to keeping the support of all stakeholders, balancing their interests and making companies a place where stakeholders' interests can be maximized.¹⁹⁹

To sum up, a stakeholders' model of corporate governance provides a single strategic framework flexible enough to deal with any changing environment and a strategic management deals with how the environment affect companies and vice versa.²⁰⁰ It also works for the survival of firms and encourages managements to develop strategies that manage and integrate the relationships and interests of all stakeholders.²⁰¹ It is characterized by close relationships between the corporations and its capital providers, including shareholders and bankers and other financial institutions.

¹⁹⁵ E. Merrick Dodd, "For Whom are Corporate Managers trustee?," **Harvard Law Review**, Vol. XLV, No.7 (1932)

¹⁹⁶ Steve Letza and Xiuping Sun, supra note 189, p.51. Ownership is by definition where the owner has exclusive rights of possession, use, gain and legal disposition of a material object. Yet shareholders merely own their shares in a company and trade their shares with others in the stock market. They do not have rights to possess and use the assets of the company, to make decision about the direction of the company, and to transfer the assets of the company to others. The residual claims of the shareholders are determined by the company and if the company's performance does not satisfy the shareholders requirements, the shareholders are left with a single option of 'exit' rather than 'voice' as shareholders in general are in no way able to monitor the management effectively and neither are they interested in running corporate business. In this sense, the assumption that the corporation is owned by the shareholders is in fact meaningless.

¹⁹⁷ R. Edward Freeman and Robert A. Phillips, "Stakeholder Theory: A Libertarian Defense," **Business Ethics Quarterly**, Vol. 12, No.3(2002),p.333

¹⁹⁸ Elena F. Perez Carrillo, "Corporate Governance : Shareholders' Interests' and Other Stakeholders' Interests'," **Corporate Ownership and Control**, Vol.4, No.4(2007), p.99

¹⁹⁹ R. Edward Freeman and Robert A. Phillips, supra note 197, p.333

²⁰⁰ R. Edward Freeman and John McVea, "A Stakeholder Approach to Strategic Management,"(2002), p. 9 .

Available at SSRN : http://papers.ssrn.com/paper.taf?abstract_id=263511

²⁰¹ Ibid, p. 10

A close examination of share company's provisions on corporate governance in Ethiopia show that Ethiopian share companies are following the shareholders system of corporate governance. I argue so for a number of reasons:

First, there is no Law, Memorandum or Articles of Association which endorses departure from a profit maximizing objective and empowers firms to engage in corporate social responsibility activities. Second, share companies provisions have entirely failed to address the interests of employees, suppliers, customers, the community and environment. In fact, some rights of creditors are recognized under the Commercial Code. However, these rights of creditors are not sufficient. Moreover, Article 347(1) of the Commercial Code allows only shareholders to manage companies. Article 5 of the Ethiopian National Bank Directives No.SBB/49/2011 also unequivocally prohibited bank employees from being represented in boards.²⁰² Further, there are no substantive or procedural rights set for stakeholders, so that they may not involve in corporate governance of Ethiopian share companies. Third, the Commercial Code provisions on share companies provide that directors are accountable to the general meetings of shareholders, not to stakeholders. Directors are appointed, replaced, removed by general meetings of shareholders. They do have a duty to submit an annual report of companies operation including financial statement to the meetings of shareholders.²⁰³ The remuneration of directors is also determined by general meetings of shareholders.²⁰⁴ All these provisions incorporated in the Commercial Code seem to ensure share companies to be run for the benefits of shareholders. So, the rights of stakeholders are not recognized and hence they may not claim companies to be operated in their interests.

However, this situation needs to be changed. Share companies provisions should recognize the roles of stakeholders and allow them to participate in the corporate governance system of share companies. If so, it could be possible for share companies to generate wealth, secure job for employees, produce quality product and service for customers, maximize shareholders profit and ensure financial stability.

²⁰² Directives No.SBB/49/2011, Licensing and Supervision of Banking Business, Limits on Board Remuneration and Number of Employees Who Sit on Bank Board Directives, NBE.

²⁰³ Commercial Code, Art 362(2)

²⁰⁴ Commercial Code, Art 353(1)

3.5. Organs of Corporate Governance and their Role

Share companies, once they are registered, have their own independent legal existence and identity separate from the identity of shareholders. They have their own assets, rights and duties and may sue or be sued. But, share companies are artificial persons,²⁰⁵ and do not natural persons. So, they cannot exercise their own rights, satisfy their obligations and operate their business by themselves. Rather, share companies are functioning through the actions of natural persons. For that, they do have their own management structure that involves shareholders, directors, managers and auditors.

3.5.1. Shareholders

Shareholders are persons who subscribe shares of a company.²⁰⁶ These shareholders may be individuals or juristic persons and shall have a relationship with a company that emanates from partnership agreement which is different from other forms of contracts shareholders may have with a company.²⁰⁷ So, they are owners of a company. However, shareholders due to lack of information, time, resource and other reasons may not be in a position to closely follow up the acts of the managements of their firm. This situation would make the managers to use the assets of the company to farther their interests. In order to avoid this agency cost and maintain trust on shareholders, the Commercial Code of Ethiopia specifies provisions which enable shareholders to participate in the management of their companies. Accordingly, shareholders have the right to information,²⁰⁸ the right to inspect documents²⁰⁹ the right to participate and vote at the shareholders meetings,²¹⁰ the right to appoint and remove directors as well as determining their remuneration, etc²¹¹

The Commercial Code also recognizes one share on vote system.²¹² However, the weight accorded to each share depends on the amount that share represents in the capital of the company

²⁰⁵ Stephen Griffin, Company Law: Fundamental Principles (4th ed, Pearson Education: England, 2006), p.1

²⁰⁶ Angela Schneeman, *supra* note 45, p.364

²⁰⁷ *Ibid*, pp. 364-365

²⁰⁸ Commercial Code, Arts 392(1-3) , 395 and 396

²⁰⁹ Commercial Code, Arts 406, 417, 422 and 427

²¹⁰ Commercial Code, Arts 389, 407, 419(1), 400, 408,409, 336(3) and 342(7)

²¹¹ Commercial Code, Arts 350(2), 351(2), 354, 368(1), 369(1&2), 371 , 353(1), 372 and 419(2)

²¹² Commercial Code, Arts 345(3) and 407(2)

according to Art 347(1) of the Commercial Code. If limitation on the number of shares which shareholders exercise in a meeting is necessary, it must be equal to all shareholders without distinction according to Art 408 of the Commercial Code. In fact, there are also shareholders who have not the right to vote at shareholders meetings.²¹³

In addition, shareholders have rights specified under the Commercial Code that includes the right to authorize or prohibit directors to be partner with joint and several liabilities in competitor companies or to compete against the company on their own behalf or third parties,²¹⁴ the right to prior approval on director's direct or indirect business transactions with the company approved by boards,²¹⁵ the right to pass a resolution to institute proceedings against directors whether such issue was on the agenda or not,²¹⁶ the right to share the profits or proceeds of the company;²¹⁷ and the right to transfer of shares or withdraw of the company, etc.²¹⁸

The Commercial Code also specifies provisions which aim to protect shareholders, particularly, minority shareholders from other shareholders. Accordingly, Art 352 of the Code provides for minority shareholders to elect at least one representative on boards of directors where there are several groups of shareholders with different legal status.

3.5.2. The Board

The board is the other organ which is in charge of managing share companies. It fills the gap that exists between shareholders as principals and managers as agents by closely follow up the conducts of managers. It is central to share companies and works to meet their vision and goals. For that, the Ethiopian Commercial Code recognizes the board as the governing organ and full responsibility is placed on directors for leading the company. So, directors do have the duty to act with due care and diligence in their overall directing of the company as powers given by the law, company's statutes and decisions made by the general shareholders meetings.²¹⁹ They are

²¹³ Commercial Code, Art 336(3), 342(7) and 409(1)

²¹⁴ Commercial Code, Art 355

²¹⁵ Commercial Code, Art 356

²¹⁶ Commercial Code, Art 365(1)

²¹⁷ Commercial Code, Arts 345(1&2)and 458

²¹⁸ Commercial Code, Arts 333and 463

²¹⁹ Commercial Code, Arts 363 and 364

also responsible to prepare management and meeting minutes, to keep accounts and books,²²⁰ to convene meetings of shareholders, to set reserve funds required by law and statutes, to apply to the court in case where the company failed to pay its debts.²²¹ However, the board when it discharges its duties, it has to be independent and free from the influence of CEOs. This version of the board is discussed deeply in the next section under the board of directors.

3.5.3. The Manager

A manager is a person who is appointed by share companies to run and perform the day to day activities. The Ethiopian Commercial Code does not deal sufficiently with the managers. Art 348(3) of the Code specifies that “a general manager shall be appointed by the board.” Art 348(4) states that “the general manger is an employee of the company and the general manager may not be a director.”

So, the Code fails to specify the rights, powers, duties of managers and their relationship with the company. However, since they are employees, it seems that they would be governed by the terms of employment contract.

3.5.4. Auditors

Auditors are appointed by the company to perform an audit activity. The appointment, remuneration and removal process of auditors are similar to directors.²²² However, there are some issues of auditors separately addressed by the Commercial Code. So, auditors have the duty to audit the company’s account, certifying and preparing reports which are submitted to shareholders general assembly.²²³ They have also the duty to inform to shareholders or public prosecutors for directors’ breach of legal and statutory obligations²²⁴ and the duty to convene shareholders meetings in directors’ failure.²²⁵

3.6. Board of Directors of Share Companies

²²⁰ Commercial Code, Arts 445-447

²²¹ Commercial Code, Art 362

²²² Commercial Code, Arts 368, 369, 371 and 372

²²³ Commercial Code, Art s 374 and 375

²²⁴ Commercial Code, Art 376

²²⁵ Commercial Code, Art 377

3.6.1. Meaning and Nature of Board of Directors

The Ethiopian Commercial Code does not define what board of directors is. But, Board of Directors is central and performs many essential functions to meet the vision and goals of Share Companies. It is a governing body and thereby monitors the conducts of the managements to make sure that they are carrying out their legal and financial obligations in the right way.²²⁶ Board of Directors is one of the constituent parts in corporate governance arrangements and its performance affects the supervision and operation of share companies. Board of Directors is “the link between the people who provide capital (shareholders) and the people who use the capital to create value (the managers)”²²⁷ or it is “the liaison between concentrated or dispersed shareholders of different identities (individuals, funds, companies, banks, so on) who exert the residual rights and executives who, as a matter of fact, constitute the powerful group that runs and controls the company.”²²⁸

Board of Directors is also defined as governing body comprising of directors who “have control over the direction, conduct, management or superintendence of the affairs of the company.”²²⁹ Directors are individuals who are appointed and their powers are determined by law, Memorandum or Article of Association, or resolution of general meetings of shareholders.²³⁰

Board of Directors has different core powers and performs diverse types of functions. It is also of paramount importance in the operation of share companies to enhance performance. The Bank for International Settlement (BIS) states that:

the Board should ensure that senior management implements policies that prohibit activities and relationships that diminish the quality of corporate governance, such as conflicts of interest, self-dealing and preferential dealings with related parties. Board should set and enforce clear lines of responsibility and accountability throughout the organization. Keeping in view their oversight

²²⁶ Sanjay Anand, supra note 141, p.40

²²⁷ Monks and minnow(2004), cited in Guler Aras and David Crowther (ed), Handbook of Corporate Governance and Social Responsibility (England : Gower Publishing Limited, 2010), p.154

²²⁸ Roe(1994), cited in Guler Aras and David Crowther(ed), supra note 227, p.154

²²⁹ Hussein Ahmed, supra note 36, p.56

²³⁰ Internet source. Duties of Directors (2006). P.1. Accessed at http://www.deloitte.com/assets/DcomSouthAfrica/Local%20Assets/Documents/za_audit_directorsduties07_140507 viewed on December 28, 2013.

*role, Board of Directors should feel empowered to recommend sound practices, provide dispassionate advice, and avoid conflict of interests.*²³¹

The UK Combined Code also stipulates that “every company should be headed by an effective Board, which is collectively responsible for the success of the company.”²³²

Thus, share companies need to have an effective Board comprised of honest, hardworking, loyal and interested directors to maintain good corporate governance practices, preserve the interests of shareholders and stakeholders and enhance performance. So, they have to adopt diverse codes and principles which are in conformity with best international documents such as OECD and international best practices.

3.6.2. Board Composition and Independence

In recent periods, there is an inclination in different countries and share companies towards introducing non-shareholders on the composition of board of directors in addition to shareholders. However, the situation is different in Ethiopia. The idea of non-shareholder director is unknown and has not been practiced so far. On the top of that the Commercial Code and other relevant laws prohibit share companies from establishing boards that comprised of non-shareholders. For instance, Article 347(1) of the Commercial Code states that “only members of a company may manage the company.” Hence, boards are obliged to be constituted of shareholders only, and non-shareholders directors are not recognized. Moreover, the Commercial Code does not clearly specify additional competitive qualifications which have to be satisfied to appoint shareholders as directors. The only requirement specified in the Commercial Code is being a shareholder. So, there are cases in which incompetent shareholders may assume directorship in Ethiopian share companies. This is too bad and pushes us to argue apparently that it would better to appoint external professional, senior employees and experts having technical, financial and legal knowledge or specialization in the sector.²³³ Further, the Commercial Code

²³¹ Basel Committee on Banking Supervision, Principles for Enhancing Corporate Governance, (Bank for International Settlement (BIS), Oct. 2010), Available at <<http://www.bis.org/pub/bcbs/68.pdf>> Last visited on December 13, 2013.

²³² London Stock Exchange (LSE): Committee on Corporate Governance, Hampel: The Combined Code, Section 1A, Main Principle, (London, July 2003). <<http://www.frc.org.uk/documents/pagemanager/frc/Web%20Optimised%20Combined%20Code%203rd%20proof.pdf>> December 13, 2013.

²³³ Hussein Ahmed, supra note 36, p.65

does not stipulate any provision to ensure the independence of boards from influences of CEOs and block shareholders. In fact, Article 348(4) of the English version of the Commercial Code states that “the general manager may not be a director.” However, this article is in discrepancy with the equivalent Amharic version of the Code which says “አስተዳዳሪ ላይሆን ይችላል.” But, the Amharic version is the authoritative one, and Article 348(4) is not mandatory and managers may be appointed as director of companies simultaneously.

When we come to the financial sectors particularly Banks, the situation becomes more rigorous and no possibility of thinking to introduce non-shareholders on boards. In the financial sectors, in addition to the Commercial Code, there are Proclamations and Directives which provide for shareholder directors only. For instance, the NBE enacted Directives No SBB/49/2011 which prohibits employees of Banks from being members of boards of directors of any other banks. Actually, this directive works to alleviate “conflict of interests; apply appropriate chain of command; and check and balance.”²³⁴ But, the Commercial Code, the Proclamations as well as the Directives of the NBE have to be updated and take current situations and practices seen on the globe in to account. This unduly disregarding of non-shareholders from the membership of board of directors results in share companies to lose the services of professional and experienced experts and other crucial benefits.²³⁵ Further, the Draft Commercial Code of the Federal Democratic Republic of Ethiopia does not recognize non-shareholders to be member of board of directors of share companies.²³⁶

3.6.3. Experiences of Foreign Countries on Board Composition with Particular Emphasis on Including Non-shareholder Directors in Boards

Traditionally and in many countries it is stockholders who are eligible to be appointed as directors. But, these days, it has also become common to see non-stockholders assume directorship in firms. The term ‘non-shareholder’ is more tied with the status a person has in relation to a company. The status is determined on the basis of whether a person owns stock in a firm or not. If a person owns stock in a firm, he or she is a shareholder; otherwise, he or she is

²³⁴Capital, (Addis Ababa), February 26, 2011 cited in Hussein Ahmed, supra note 36, p.64

²³⁵Ibid , p.65

²³⁶ Article 347(1) of the draft commercial code of the Federal Democratic Republic of Ethiopia specified that “only members of company manage the company.” This shows that there is no any amendment to the existing commercial code and is a direct copy paste.

designated as non-shareholder. Hence, non-shareholder director is a director who assumes directorship and monitors the conducts of managers in a firm in which he or she does not own any share. Non-shareholder director takes diverse names in different countries such as non-executive director, stakeholder director, independent director, etc. However, I would like to remind readers that I used the designation ‘non-shareholder director’ in this paper to mean ‘qualified, expertise and professional stakeholder, non-executive or independent director’. But, here it would be wise to give some clue on the meaning of stakeholder, independent or non-executive directors as stated below.

The word ‘stakeholder’ has been used for the first time in 1930’s by prof, E.Merrick Dood when he worked on the groups of stakeholders, but first appeared in academic literatures and discussions at the Standard Research Institute in 1963.²³⁷ Different academicians tried to define the word stakeholder from different angles and perspectives. It is also observed that diverse definitions are given to this word by same scholars. For instance, in 1984, Freeman defined stakeholder as “any group or individual who can affect or is affected by the achievement of the organization objectives”.²³⁸ Again, in 2004, he defined stakeholder as “those groups without whose support the organization would cease to exist” and later on, he modified this one and put a statement as “those groups who are vital to the survival and success of the organization.”²³⁹

Stakeholder is also defined by Peter Zollinger as “those groups who have a stake in the company and have the possibility of gaining benefits or experiencing losses or harm as result of a company operation”.²⁴⁰ Silvia Ayuso and Antonio Argandona also defined stakeholder in their paper as “individuals or constituencies that contribute , either voluntarily or involuntarily, to the company’s wealth creating capacity and activities, who are therefore company’s potential beneficiaries and /or risk bearers.”²⁴¹

²³⁷Peter Zollinger, “Stakeholder Engagement and the Board: Integrating Best Governance Practices,” **Global Corporate Governance Forum**, Focus 8(2009), p.5

²³⁸Amy J. Hillman, Gerald D. Keim and Rebecca A. Luce, “Board Composition and Stakeholder Performance: Do Stakeholder Directors Make a Difference?,”**Business & Society**, Vol. 40 No. 3(2001), p.299

²³⁹ Charles Fontaine, Antoine Haarman and Stefan Schmid, “The Stakeholder Theory,” **Stakeholder Theory of the MNC**(2006),p.6

²⁴⁰Peter Zollinger, supra note 237, P.5

²⁴¹ Silva Ayuso and Antonio Argandona, “Responsible Corporate Governance: Towards a Stakeholder Board of Directors?,” **IESE Business School – University of Navarra**, WP no 701(2007), p.2

To sum up, there are, including the above definitions, more than seventy five definitions of stakeholder, and of these definitions, twenty of them share common logic with the first definition of Freeman which describes stakeholder as “any group or individual who can affect or is affected by the achievement of the organization objectives.”²⁴² Though there are controversies on the scope of this definition, I took this one as working definition of stakeholder for this paper. Accordingly, stakeholders include customers, suppliers, distributors, employees, managers (though this is debatable), local communities and shareholders.²⁴³

Similar to stakeholder, ‘independent director’ is defined differently. Sarbanes-Oxley Act (SOA) defines an independent director as "a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship which, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of directors."²⁴⁴ New York Stock Exchange (NYSE) rule also specifies that a director is deemed independent," when the director has no material relationship with the listed company (directly or as a partner, shareholder or officer of an organization that has a relationship with the company)".²⁴⁵

The definitions mentioned above connote similar concepts and specify many of the characteristics of independent directors. However, these days, there are more roles which are assumed by independent directors, so that it would be wise to have a definition that includes those tasks too. So, independent director is described as “one who has no need or inclination to stay in the good graces of management, and who will be able to speak out, inside and outside the boardroom, in the face of management misdeeds in order to protect the interests of shareholders”²⁴⁶ and this one is seen as typical definition of independent director in this paper.

Non-executive director is defined under New Companies Act No.71/2008 of South Africa as a director who is not involved in the day-to-day management of the company and has not been in

²⁴² Amy J. Hillman, Gerald D. Keim and Rebecca A. Luce, *supra* note 238 , p.299

²⁴³ Charles Fontaine, Antoine Haarman and Stefan Schmid, *supra* note 239, p.6

²⁴⁴ Sarbanes-Oxley Act of 2002, passed by 107th Congress of the United States of America at the Second Session on 23rd January, 2002

²⁴⁵ New York Stock Exchange Rules of 2003, approved by SEC on November 4, 2003

²⁴⁶ Donald C. Clarke, “*supra* note 44, p.154

full-time employment with the company in the last three years.²⁴⁷ In addition, such a director should not be a material supplier or customer of the company, and he should also not be a member of the immediate family of any individual who has been involved in the day-to-day management or been a full-time employee in the past three years.²⁴⁸ The Stock Exchange of Hong Kong Limited defines the term non-executive director as “directors who do not have the administrative or management responsibilities in a company, without any direct relations which could interfere with the exercise of independent judgment with the management and do not have any interests other than the remuneration paid by the company.”²⁴⁹ We do have also the same meaning of non-executive director in the UK.²⁵⁰

3.6.3.1. Non-shareholder Directors in the USA

In the USA, the development of non-shareholder directors system was voluntarily endorsed as an efficient solution for the manager-shareholders agency problems of the time.²⁵¹ In the USA, before 1950, boards were largely engaged in managing and advising managements of firms and were dominated by shareholder directors though they include certain outside directors who do not have any link with companies.²⁵² However, starting from 1950, diverse reformative activities have been accomplished on boards’ composition which has begun to include more non-shareholder directors²⁵³ hoping that “a board with some level of independence will introduce objectivity in decision making, adds to the diversity and advisory capabilities of the board and

²⁴⁷ The Company Act No. 71/ 2008 of South Africa , section 94(4)(i-ii)

²⁴⁸ Ibid, section 94(4)(iii)

²⁴⁹ K.vethanayagam S/O Kanapathy, “Independent Non-executive Directors, Managerial Ownership and Firm Performance in Malaysian Public Listed Companies,” (2005), p.5. Accessed at http://eprints.usm.my/25587/1/INDEPENDENT_NONEXECUTIVE_DIRECTORS,_MANAGERIAL_OWNERSHIP_AND_FIRM_PERFORMANCE_IN_MALAYSIAN_PUBLIC_LISTED_COMPANIES.pdf viewed on December 27, 2013

²⁵⁰ Derek Higgs, “Review of the Role and Effectiveness of Non-executive Directors: A Consultation Paper”(2002), p.3. Available at: www.dti.gov.uk/cld/non_exec_review

²⁵¹ Silbao Shen & Jing Jia, Will The Independent Director Institution Work In China?, 27 Loy. L.A. Int’l & Comp. L. Rev. 223, 230 (2005) cited in Matthew Weinstein, “The Independent Director Requirement and Its Effects on the Foreign Investment Climate in China: Progress or Regress?,” **Business Law Brief** (spring 2008), p.36. It is particularly adopted for two reasons: First, to act as securities law monitors as the result of the massive securities frauds of the 1920s and 1930s; and second, to provide profit-seeking shareholders with more adequate controls over the performance and reliability of management.

²⁵² Jeffrey N. Gordon, “The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices,” **Stanford Law Review**, No.74(2007), pp.1472-1473

²⁵³ Ibid, pp.1474-1475

hence improves performance of the company.”²⁵⁴ This voluntary movement of introducing non-shareholder directors in boards got judicial acceptance later and judicial interpretations of state law started to accept decisions of independent boards and, place considerable attention in their reviewing of corporate actions.²⁵⁵ This movement had been followed by the legislature and other self-regulatory bodies,’ stock exchanges and law review bodies such as the American Law Institute (ALI).²⁵⁶ The situation continued till 1990s. However, the collapse of Enron, World Com and other companies triggered a wave of reforms in U.S which resulted in the enactment of the Sarbanes-Oxley Act and the revision of the listing rules of NYSE and NASDAQ that introduced mandatory board composition requirements for the first time.²⁵⁷

The Sarbanes-Oxley Act does not specify whether boards of firms should have been comprised of non-shareholder directors, but in its dealing with public companies requires members of audit committee to be non-shareholder directors.²⁵⁸ However, NYSE and NASDAQ make it mandatory for all listed companies to be comprised of majority of non-shareholder directors.²⁵⁹ They also try to define non-shareholder director and its unique features. They require the nomination or selection process of non-shareholder directors to be controlled by independent directors to enhance the independence and quality of nominees as well as to save boards from the dominance of shareholder directors.²⁶⁰

In the US, the idea of non-shareholder directors system was designed to efficiently solve the issue of manager-shareholders conflict of interests and not made mandatory in controlled companies where there is no agency problem. This is because:

A shareholder who controls a company does not need an external rule maker to protect him from a management team that he has the power to appoint. Minority shareholders may need protection from controlling shareholders, but the exchanges are apparently willing to leave this task to other

²⁵⁴Umakanth Varottil, “Evolution and Effectiveness of Independent Directors in Indian Corporate Governance,” **Hastings Law Journal**, Vol.6 No.2 (2010), p.16

²⁵⁵Jeffrey N. Gordon, supra note , p.252, p. 1481

²⁵⁶ Ibid

²⁵⁷ Ronald W. Masulis, Christian Ruzzier, Sheng Xiao and Shan Zhao, “ Do Independent Directors Matter?,” **Journal of Economic Literature**, No: G32(march,2012), p.1

²⁵⁸Umakanth Varottil, supra note 254, P.24

²⁵⁹ Jeffrey N. Gordon, supra note 252, p.1468

²⁶⁰Umakanth Varottil, supra note 254, p.25

*bodies of law, such as federal securities law requiring disclosures, and state corporate law mandating certain fiduciary duties.*²⁶¹

Thus, it is possible to deduce that non-shareholder directors and manager-shareholders agency problem go hand-in-hand.

In the USA, after the enactment of Sarbanes-Oxley Act, the effects of non-shareholder directors on firms' performance became a hot topic. Many researchers criticized non-shareholder directors as being harmful for the investors, while others encouraged this act. The findings of Abdullah Dah, Nouri Beyrouti and Michel Showeiry showed that when management is highly entrenched, an increase in proportion of non-shareholder directors on boards will lower the negative impact compared to a lower entrenched firm.²⁶² Further, they evidenced that an increase in non-shareholder directors positively affected the firm value.²⁶³ Thomas Ritchie, in his study conducted in the USA, Australia and Europe, argues that non-shareholder directors help to improve corporate governance.²⁶⁴ Moreover, Steven T. Petra concluded that non-shareholder directors do play an important role in controlling management (i.e. decision control) in the context of specific settings such as takeover threats, CEO compensation, and individual nominations to the firm's board.²⁶⁵ Jeffrey N. Gordon²⁶⁶ and Christian Stadler, et al²⁶⁷ addressed that non-shareholder directors have become a complementary institution to economy of firms directed to maximize shareholders wealth.

²⁶¹ Donald C. Clarke, "Setting the Record Straight: Three Concepts of the Independent Director," **George Washington University Law School**(2006), p.94

²⁶² Abdullah Dah, Nouri Beyrouti and Michel Showeiry, "The Effects of Independent Directors on Firm Value," pp.8-9 . Accessed at <<http://www.aabri.com/OC2012Manuscripts/OC12090.pdf>> viewed on December 16, 2013

²⁶³ Ibid, p.9

²⁶⁴ Thomas Ritche, "Independent Directors: Magic Bullet or Band-Aid?," **Corporate Governance eJournal**(2007), p. 9 . Available at <<http://epublications.bond.edu.au/cgej>>

²⁶⁵ Steven T. Petra, "Do Outside Independent Directors Strengthen Corporate Boards?," **Corporate Governance**, Vol. 5, No.1(2005), p.61

²⁶⁶ Jeffrey N. Gordon, supra note 252, p.90

²⁶⁷ Christian Stadler, *et.al*, "The CEO's Attitude Towards the Shareholder Value and the Stakeholder Model. A Comparison Between the Continental European and the Anglo-Saxon Perspectives," **Problems and Perspectives in Management**, Vol. 4, No.3(2006), p.46

On the other hand, Bhagat and Black found a negative relationship between boards' independence and shareholders' wealth.²⁶⁸ They argue that insiders do have a positive effect on firm value than non-shareholder directors due to their knowledge and expertise about the corporation. Another study by Bhagat and Bolton added that non-shareholder directors negatively affect firm value²⁶⁹ and shareholders' wealth. Roman Horvath and Persida Spirollari also examined the relationship of selected boards' characteristics and firms' financial performance using a sample of large USA firms between 2005-2009. Their results also showed that non-shareholder directors worsen firm performance.²⁷⁰ Rather, they concluded that shareholder directors are important for firms' performance because they represent powerful incentive mechanism and limit issues related to information asymmetry between managers and owners.²⁷¹

3.6.3.2. Non-shareholder Directors in the UK

In the UK, non-shareholder directors system is almost similar with that of the USA due to the similarity of corporate problems experienced in their respective firms. However, the history of non-shareholder directors in the UK is shorter and only old less than 23 years.²⁷² In the UK, the basis for non-shareholder directors was laid down by Cadbury Committee Report.²⁷³ This report empowered non-shareholder directors to examine the performance of boards and executives as well as to take the lead in decision making involving issues of conflict of interests with goals of attaining independent judgments on matters of strategy, performance, appointments and standards of conduct.²⁷⁴ As a subset of non-shareholder directors, independent directors are made independent of any businesses or relationships which would have impact on free exercise of

²⁶⁸Sanjai Bhagat and Bernard Black, "Board Independence and Long-term Firm Performance,"(2000), p.33 .
Accessed at <<http://leeds-faculty.colorado.edu/Bhagat/bb-022300.pdf>>

²⁶⁹Sanjai Bhagat and Brian Bolton, "Corporate Governance and Firm Performance," **Journal of Corporate Finance**, Vol.14(2008), p. 271

²⁷⁰Roman Horváth, Persida Spirollari, " Do the Board of Directors' Characteristics Influence Firm's Performance? The U.S. Evidence," **Prague Economics Papers**, Vol.4 (2012), p.482

²⁷¹Ibid

²⁷²UmakanthVarottil, supra note 254, P.27

²⁷³Ibid

²⁷⁴ Financial Reporting Council, Report of the Committee on the Financial Aspects of Corporate Governance(1992) available at <http://www.ecgi.org/codes/documents/cadbury.pdf> [hereinafter the Cadbury Committee Report]., at para. 4.11

independent judgment.²⁷⁵ In addition, like the USA system, the Cadbury report adopted a non-shareholder director system which has nothing to do with controlled companies, so that they are designed for manager-shareholder agency problems.²⁷⁶ It also required companies to have at least three executive directors of which at least two of them would be independent.²⁷⁷

There are other subsequent reports which also form the UK Combined Code on Corporate Governance in 1999, i.e. the Greenbury Committee Report that required the establishment of remunerations committee²⁷⁸ and the Hampel Committee Report that confirmed the role of non-shareholder directors.²⁷⁹

The Higgs report, which is the other subsequent report and which has been incorporated in the Combined Code later, suggested at least half of the members of boards be composed of non-shareholder directors.²⁸⁰ It also provided advisory and monitoring functions to non-shareholder directors. The boards' independence which has been established by the Higgs report continues and has also been reflected even in the current version of the UK Combined Code issued in 2008. This movement towards non-shareholder directors was not limited to law and policy makers and had also been joined by the judiciary as well.²⁸¹

Like the USA, in the UK, there are diversities on the effects of non-shareholder directors on firms' performance. A study conducted by Charlie Weir, Oleksandr Talavera, and Alexander Muravyev on UK companies over 2002-2008 showed that there is a positive relationship between the presence of non-shareholder directors and the accounting performance of appointing companies. They also argue that the effect is stronger if non-shareholder directors are directors in firms that are performing well or are members of the audit committee.²⁸² Roberto Mura also made investigation on the same issue using an original, large and hand collected panel

²⁷⁵ Cadbury Committee Report, at para. 4.12.

²⁷⁶ Umakanth Varottil, supra note 254, P.28

²⁷⁷ Cadbury Committee Report, at para. 4.12.

²⁷⁸ Richard Greenbury, et.al., Directors Remuneration :Report of a Study Group Chaired by Sir Richard Greenbury, Jul. 17, 1995, available at <http://www.ecgi.org/codes/documents/greenbury.pdf>.

²⁷⁹ Ronnie Hampel, Final Report of the Committee on Corporate Governance, Jan.1998,available at http://www.ecgi.org/codes/documents/hampel_index.htm.

²⁸⁰ Derek Higgs, supra note 250

²⁸¹ Umakanth Varottil, supra note 254, P.30

²⁸² Charlie Weir, et al, "Performance Effects of Appointing Other Firms' Executive Directors to Corporate Boards: An Analysis of UK Firms," **Journal of Economic Literature**, No. G34 and G39 (2008), pp.25-26

data set of UK firms for the period 1999-2001. The result indicated that the proportion of non-shareholders on boards have a positive impact on firms performance.²⁸³ This finding may have a direct bearing on policy decisions being made by regulators in the UK, as they formulated the Cadbury Code. This result also suggested that the boards of UK firms have been more effective monitors on behalf of other shareholders. However, there are also empirical literatures providing for support on ineffectiveness of independent non-shareholder directors.²⁸⁴ Claudio Becagli, Sara De Masi and Andrea Paci studied whether the presence of independent directors correlates with firm performance and firm growth in Italy, Spain, France, and the United Kingdom from 2002 to 2009. Hence, they also found evidence that independent directors do not influence present and future firms' performance, and firms' growth.²⁸⁵

3.6.3.3. Non-shareholder Directors in France

In France, the non-shareholder directors system has also been introduced due to the existence of determinants such as ownership concentration, size of the company and institutional investors' activism.²⁸⁶ According to Ibtissem Chouchene, the size of companies and involvement of institutional investors in firms motivated the appointment of non-shareholder directors in French listed companies.²⁸⁷

In France, the basis for non-shareholder directors system rests on the first Viénot report (1995), second Viénot report (1999) and the Bouton report (2002). All three reports defined the concept of non-shareholder director and specified the necessity of composing French companies' boards with non-shareholder directors. Particularly, the 1999 Viénot report defined non-shareholder director as a director who does not have any relationships with companies or their groups to save his or her mind from interferences affect his or her free judgment.²⁸⁸ The report also suggested all boards of French listed companies to comprise 1/3 of their boards with independent

²⁸³ Roberto Mura, "Do Non-Executive Directors and Institutional Investors Have Minds Of Their Own? Evidence on Performance of UK Firms," p, 25 . Available at SSRN: <http://ssrn.com/abstract=676971>

²⁸⁴ Goergen (2012, p.282), cited in Charlie Weir, *et al*, supra note 282, p.3

²⁸⁵ Claudio Becagli, Sara De Masi and Andrea Paci , "Are Independent Directors Good Monitors of Public Utilities? Evidence from Europe," **Journal of Economic Literature**, G30; L94; L95(2013), pp. 12-13

²⁸⁶ Ibtissem Chouchene , " The determinant of the Presence of Independent Directors in French Board Companies", **International Journal of Business and Management**, Vol.5, No.5(2010), p.144

²⁸⁷ Ibid, p.149

²⁸⁸ Viénot Committee (Conseil National du Patronat Français and Association Française des Entreprises Privées), The report on the Boards of Directors of Listed Companies in France(1999)

directors.²⁸⁹ However, in France, the awareness of the people on the relevancy of non-shareholder directors continually get up and later on, the Bouton report recommended all French listed companies with dispersed capital and without controlling shareholders to comprise their boards with half of non-shareholder directors.²⁹⁰ This has also been recommended by Afep-Medef Code.²⁹¹

In France, there are limited studies conducted on the impact of non-shareholder directors on performance of firms. Likewise, in France, there are diversities on the importance of non-shareholder directors. Daniel Zeghal and Raef Gouiaa conducted a study on the effects of board of directors' characteristics on the financing strategies of group French companies. The research is based on a sample of 87 French companies taken from the French index SBF 120 during 2005.²⁹² The results of the research found out that the high the percentage of non-shareholder directors on boards have a positive effect on the debt ratio of financing strategies and enable companies to pursue their own financing strategies.²⁹³ So, it was noticed that the weaker the debt ratio, the greater firms profitability and was further concluded that the boards that comprised of non-shareholder directors among French companies are effective in the governance system particularly they are based on equity capital than debt.²⁹⁴ Ramzi Benkraiem also studied whether the presence of non-shareholder directors influence and limit earnings management practices in France. The analysis, conducted over a period of 4 years from 2001 to 2004, is based on a sample of 239 different French companies listed on the Paris stock exchange. The finding showed that non-shareholder directors are negatively associated with earnings management and limit the managerial latitude to maximize their own interests, sometimes at the expense of

²⁸⁹Ibid

²⁹⁰Bouton Committee, [the Report on Promoting Better Corporate Governance in Listed Companies](#)(2002)

²⁹¹ French Corporate Governance in Listed Companies, Driving Growth and Attractiveness: A guide Book for Investors, p.10. Accessed at http://www.ifa-asso.com/download.php?module=actualites&file_id=202&fichier_nom=actualite-202.pdf. Visited on November 11, 2013. Afep-Medef Code(Code de gouvernementd'entreprise des societies cotées (Corporate governance practices of listed companies)) states the number of independent directors to be half of the board in dispersed ownership companies and one third in controlled firms.

²⁹² Daniel Zéghal and Raef Gouiaa, "The Effect of the Board of Directors' Characteristics on the Financing Strategies of French Companies," p.9 . Available at <http://www.jimsjournal.org>

²⁹³Ibid

²⁹⁴ Ibid

shareholders, creditors and other stakeholders' wealth.²⁹⁵ This supports the recommendation of the Viénot 1999 report.

On the other hand, Claudio Becagli, Sara De Masi and Andrea Paci analyzed the effects of non-shareholder directors up on firms performance and firms growth in Italy, Spain, France and United Kingdom from 2002-2009. The research showed that non-shareholder directors have limited knowledge and are reliant on the information they receive from the CEOs and other executive directors which may be influenced or filtered by its sources, so that they may be ineffective of monitoring and do not influence firm performance.²⁹⁶ Sandra Cavaco, Edouard Challe, Patricia Crifo, Antoine Reberieux and Gwenael Roudaut also conducted a study on French listed companies and reached that there is a significant negative relationship between accounting performance and independence.²⁹⁷

3.6.3.4. Non-shareholder Directors in China

In China, a non-shareholder director system was laid down as a response to problems that resulted from the dominance of large shareholders.²⁹⁸ China has made different movements to develop non-shareholder directors' norms. Initially, the Shanghai Securities Exchange enacted a Draft Guidelines on Corporate Governance (SSE Guidelines) in November 2000 which stipulated that listed companies have to comprise at least two non-shareholder directors, the number of non-shareholder directors within boards not to be less than 20 % as well as all subcommittees of boards are to be comprised and chaired by non-shareholder directors.²⁹⁹

Thereafter, different reformative activities were taken on including non-shareholder directors by different regulatory bodies, stock exchange markets and local governments.³⁰⁰ Later on, the

²⁹⁵Ramzi Benkraiem, "Does The Presence Of Independent Directors Influence Accruals Management?," **The Journal of Applied Business Research**, Vol.25, No.6(2009), p.85

²⁹⁶Claudio Becagli, Sara De Masi and Andrea Paci, supra note 285, p.12

²⁹⁷ Sandra Cavaco, *et.al.*, "Board Independence and Operating Performance: Analysis on (French) Company and Individual Data,"(2013), p. 25 . Accessed at http://hal.archives-ouvertes.fr/docs/00/91/94/08/PDF/cahier_2013-31.pdf ≥ viewed on December 20,2013

²⁹⁸Minkang Gu, "Will an Independent Director Institution Perform Better than a Supervisor? Comments on the Newly Created Independent Director System in the People's Republic of China," **Journal of Chinese and Comparative Law**, (2003), p.60

²⁹⁹Sibao Shen and Jiang Jia, "Will the Independent Directors Institution Work in China," **Loyola of Loss Angeles International and Comparative Law Review**, Vol. 3, No.1 (2005), p.231

³⁰⁰ Donald C. Clarke, supra note 44, pp.177-181

CSRC (China Securities Regulatory Commission) addressed the issue of non-shareholder directors by enacting various guidelines and substantive regulations. In fact, the CSRC's first regulation "Guidelines for Articles of Association of Listed Companies" that was enacted in 1997 and provided that companies may appoint non-shareholder directors in accordance with their actual needs.³⁰¹ Again on August 2000, CSRC enacted "Draft Rules for Companies Seeking Listing on a Secondary Board" required 2/3 of the directors to be non-shareholders directors.³⁰²

Subsequently, CSRC also enacted series of guidelines and regulations and finally, in August 2001, it enacted "Guideline on the Introduction of the Independent Directors System in Listed Companies" which required directors "to be independent of the company and its major shareholders, employees and major professional services providers."³⁰³ Listed companies were also required to have at least two non-shareholder directors by June 30, 2002, and such directors were to constitute at least 1/3 of boards by June 30, 2003.³⁰⁴ At the end of 2004, more than 1,300 listed companies of China had succeeded in having non-shareholder directors in their boards and each company had, on average, three non-shareholder directors.³⁰⁵ This continued with essentially no growth through 2011.³⁰⁶ Further, Article 123 of the New Company Law (2006) provides a new legal basis for non-shareholder directors.³⁰⁷

Like the western countries, there are also diverse arguments on the relationship between non-shareholder directors and firms' performance. A study held by Li, Wang, and Deng tested a sample of several Chinese companies that encountered financial distress in years 1985 through 2005. Accordingly, they found out that companies with higher portion of non-shareholder directors are less likely to encounter financial distress as outsiders enjoy "monitor and control"

³⁰¹Sibao Shen and Jiang Jia, supra note 299, p.230

³⁰² Donald C. Clarke, supra note 44, p. 185

³⁰³Yurong Chen & Weixing Wang, "Study on the Independent Director System in Corporate Governance," **Asian Social Science**, Vol.5, No.7 (2009), p.65

³⁰⁴Donald C. Clarke, supra note 44, p.191

³⁰⁵ Jiang Yu Wang, "The Strange Role of Independent Directors in a Two-tier Board Structure of China's Listed Companies", **Compliance and Regulatory Journal**, Issue.3 (2007) , P.51

³⁰⁶ Juan Ma and Tarun Khanna, "Independent Directors' Dissent on Boards: Evidence from Listed Companies of China," **Harvard Business School**, working Paper. 13-089(October 24, 2013), p.10

³⁰⁷ The New Company Law (2006) of China, Article 123. This very article simply state that a company has to set up independent directors according to applicable regulations, and delegating to the State Council the power to stipulate detailed rules concerning independent directors. But it officially provides the independent director a legal basis in Company Law and alleviates it to the level of law from administrative regulation.

power over the management.³⁰⁸ Mike W. Peng also reached similar finding using an archival database covering 405 publicly listed firms and 121 company-years.³⁰⁹ In addition, on the basis of the study conducted on 139 financial services companies, it has been discovered that non-shareholder directors from academic institutions and law firms have significant positive impacts on corporate performance.³¹⁰

On the other hand, Shan-hui and Qi-Shen Zhou conducted an empirical study on the effect of non-shareholder directors on firms' performance from the view of environmental regulation, using the mixed cross-sectional data of listed companies in Shanghai and found that the ratio of non-shareholder directors are significantly negatively related to firms performance irrespective of the environmental legislation.³¹¹ Wei Wu also assessed whether there is any correlation between boards composition and firms performance among listed companies in China and did not find any significant correlation between the proportion of non-shareholder directors on boards and firms performance, which means there are not enough evidence to prove that independent boards have any positive impact on improving firms' performance.³¹²

3.6.3.5. Non-shareholder Directors in South Africa

The current corporate governance practices which put South Africa at the forefront of good governance on the international stage are the results of three reports of King's Committee on Corporate Governance, i.e. King I (1994), King II (2002) and King III(2009). The king's reports on corporate governance are the ground-breaking code of corporate governance in South Africa and are the most effective summary of best international practices in corporate governance.³¹³ They are non-legislative codes different from the Sarbanes-Oxely Act of US where there are legal sanctions for non-compliance.³¹⁴ They also follow a different approach "apply or explain",

³⁰⁸ Hong-xia Li, Zong-jun Wang and Xiao-lan Deng, "Ownership, independent directors, agency costs and financial distress: evidence from Chinese listed companies," **Corporate Governance**, Vol.8, No. 5 (2008), p.633

³⁰⁹ Mike W. Peng, "Outside Directors and Firm Performance During Institutional Transitions," **Strategic Management Journal**, Vol.25(2004)p.466

³¹⁰ Yan Guo and Lei Lu, "Backgrounds of Independent Directors and Corporate Performance: An Empirical Study on Chinese Listed Financial Services Companies,"(2012), p,293

³¹¹ Ibid, p.34

³¹² Wei Wu, Board Composition and Firm Performance: A Quantitative Study on Chinese Listed Companies (2009, unpublished, library, Umea School of Business), pp.66-67

³¹³ Steve Banhegvi, management : Fresh Perspectives(South Africa: Pearson education, 2007), p.317

³¹⁴ Institute of Directors, King Report on Corporate Governance for South Africa(2008). (herein after King III), p.5

which is unique to the Netherlands until King and now also found in the 2010 Combined Code from the United Kingdom.³¹⁵

King report I which was published in 1994 aimed at establishing sound standards of corporate governance for boards and directors of listed companies in South Africa.³¹⁶ King I incorporated principles on non-shareholder directors. Accordingly, it provided that boards needs to be comprised of at least two non-shareholder directors; non-shareholder directors to be nominated and appointed by boards; non-shareholder directors' remuneration to be determined through remuneration committee; and specified that non-shareholder directors are important because they bring an independent judgment on the issues of strategy, performance, resources, etc.³¹⁷

Again in 2002, King report II was published. King II gave more emphasis to multiple concerns of companies' activities such as the economic, environmental and social aspects beyond working for the profits of shareholders adopted so far.³¹⁸ However, it also recommended boards to comprise shareholder and non-shareholder directors, preferably with a majority of non-shareholder directors, of whom a sufficient number should be independent of management in order to ensure the protection of minority shareholders' interests.³¹⁹ It also defined non-shareholder directors.

Finally, the current king report III was published in 2009. King report III is more or less similar to the previous king report II. However, it is different for its provisions which have practical implication for boards, directors, managements, assurance providers and stakeholders.³²⁰ For instance, king II adopted "comply or explain" approach whereas king III follows "apply or explain" approach.³²¹ Thus, it would be in the best interest of directors to pay attention to the principles in King III or be able to explain why they did not follow best practice. King III became necessary because of the New Company Act No.71 of 2008 and changes in international governance trends. The New Company Act focuses on the duties and responsibilities of directors

³¹⁵ King III, p.6

³¹⁶Cliffe Dekker, King Report on Corporate Governance for South Africa 2002: What it means to you?.P. 2. Available at <http://www.mervynking.co.za/downloads/CD_King2.pdf >

³¹⁷ Institute of Directors, King Report on Corporate Governance for South Africa(1994).(herein after King I)

³¹⁸Cliffe Dekker, supra note 316,_P.2

³¹⁹ King II

³²⁰ KPMG, Corporate Governance and King 3(South Africa, 2009), p.1

³²¹ KPMG, King III Summary (South Africa, 2009), p.2

and also gives clarity regarding performance obligation. The act does not differentiate between an executive and a non-executive director which means that the act applies to all directors, irrespective of whether they are involved full-time or part-time.

The king report III recommends boards members to be appointed through a formal process³²² and comprise a balance of power, with a majority of non-shareholder directors, of which the majority to be independent.³²³ It also states that at least one third of non-shareholder directors should rotate every year. Moreover, it empowers boards to review the independence of independent non-shareholder directors serving for more than 9 years. Principle 2.16 of the report also provides that the chairman of boards should be an independent non-shareholder director and not to be the CEO of the entity. Moreover, committees, other than risk committee, should comprise a majority of non-shareholder directors of which the majority should be independent.³²⁴

In addition to the king's committee reports, the New Companies Act No.71/2008 recognizes non-shareholder directors. In fact, this new company act does not define non-shareholder directors directly. The closest attempt to define non-shareholder directors found under section 92(4)(i-iii) of the Companies Act No.71/2008 is the one that deals with members of the audit committee. According to the later provision, a non-shareholder director is a director who is not involved in the day-to-day management of the company and has not been in full-time employment with the company in the last three years.³²⁵ In addition, such a director should not be a material supplier or customer of the company³²⁶ as well as should not be a member of the immediate family of any individual who has been involved in the day-to-day management or been a full-time employee in the past three years.³²⁷

Although there are diverse views on the relationship between independent non-shareholder directors and companies' performance around the world, there is, practically, a different experience in South Africa. Different scholars suggest there are positive relationships between

³²²King III, Principle 2:19

³²³ King III, Principle 2.18

³²⁴ King III, Principle 2.23.7

³²⁵The Company Act No. 71/ 2008 of South Africa, Section 94(4)(i-ii)

³²⁶Ibid , Section 94(4)(iii)

³²⁷Ibid , Section 94(4)(b)

independent non-shareholder directors and firms' performance. Collins G. Ntim examined the association between the presence of independent non-shareholder directors and firms' valuation using a sample of 169 firms listed in Johannesburg Stock Exchange (JSE) from 2002 to 2007 in South Africa. Accordingly, he stated that more independent non-shareholder directors on boards tends to have increased capacity to effectively advise, monitor and discipline corporate executives and thereby enhance firms' valuation.³²⁸ He also evidenced that a higher proportion of non-shareholder directors enhance the ability of boards to monitor and lower executive remuneration, so that corporate boards in South Africa show high level of efficacy.³²⁹ Selilo B. Semosa, in his research work on South African Platinum Mining Industry, found that there is positive relationship between the proportion of independent non-shareholder directors and companies' performance provided that there is a significant but no excessive representation of independent non-shareholder directors with industry operational experience.³³⁰ Kerry C. Jenkins also determined that non-shareholder directors experience (include skills or other attributes such as industry, specific company, or transactional knowledge that may be associated with added board and company value) is positively associated with companies value in South Africa.³³¹ Therefore, all these studies bring evidences which support the recommendations of king report III on independent non-shareholder directors.

3.6.3.6. Non-shareholder Directors in Francophone West African Countries (OHADA)

Economic development in west and central Africa has challenged development economists and legal scholars for decades.³³² However, since 1993, sixteen French speaking West and Central African countries are taking a ground-breaking measure and jointly addressing their problems

³²⁸ Collins G. Ntim, "The King Reports, Independent Non-executive Directors and Firm Valuation on the Johannesburg Stock Exchange," Corporate Ownership and Control, Vol. 9, No. 1(2011), p.21

³²⁹Internet source. The Effect of Company Performance and the Structure of the Board on the Remuneration of Executive Directors. P. 17 . Accessed at <http://world-finance-conference.com/papers_wfc2/365.pdf> Viewed on December 15, 2013

³³⁰Selilo Bethuel Semosa, Impact of Board Composition on Performance in the South African Platinum Mining Industry(2012, unpublished, library, University of Pretoria), p.77

³³¹Kerry Claire Jenkins, Outside Directors Experience and the Effect on Company Value: A South African Study (2012, unpublished, library, University of Manchester), p.190

³³² Martha SimoTumnde, *et. al*, Unified Business Laws for Africa: Common Law Perspectives on OHADA(London: GMB Publishing Ltd, 2009), p.1

themselves.³³³ These countries agreed to give up some of their national sovereignty in order to establish a single, cross boarder regime of uniform business laws, immediately applicable as the domestic laws of each country.³³⁴ These are the OHADA (in English, the Organization for Harmonization in Africa of Business Laws) laws, adopted pursuant to the 1993 OHADA treaty.³³⁵ The treaty aims at providing a modern and western style set of business law which makes the members states more attractive for foreign investors.³³⁶

Currently, there are more than eight OHADA statutes; of which the Uniform Act to Commercial Companies and Economic Interest Groups is mentioned. This Uniform Act provides two alternative methods of management for public limited companies (in the Ethiopian case share companies), i.e. a sole managing director or a board of directors.³³⁷ Article 495 of the Uniform Act provides that “public limited companies with not more than three shareholders need not form a board of directors and may appoint a managing director who shall be responsible for managing the company.” In such case, the managing director may be chosen from among the shareholders or may be a non-shareholder.³³⁸ On the other hand, public limited companies may be managed by board of directors. However, Article 417 of the Uniform Act provides that “not more than one-third of the members of the board shall be non-shareholders of the company.” Hence, directors do not necessarily have to be shareholders of a company and in any case, no more than one third of the members of the board may be non-shareholders. Therefore, in public limited companies having three directors, two directors would have to be shareholders and only one could be a non-shareholder.

³³³ These countries are commonly known as francophone countries and include west and central African countries such as Benin, Burkina Faso, Cameroon, Central African Republic, Comoros, Congo, Côte d'Ivoire, Gabon, Guinea, Guinea Bissau, Equatorial Guinea, Mali, Niger, Senegal, Chad and Togo.

³³⁴ Martha SimoTumnde, et. al, supra note 332, p.1

³³⁵ Ibid

³³⁶ Ibid

³³⁷ Secretariat of the Organization for the Harmonization of Business Law in Africa(OHADA), Uniform Act Relating to Commercial Companies and Economic Interest Groups(April 1997),Art .414

³³⁸ Ibid, Art .495

Chapter Four

4. Merits and Demerits of Introducing Non-shareholder Directors in the Governance of Ethiopian Share Companies

Introduction

The failure of Enron Corp, World Com Inc, Global Crossing Ltd, and other big firms in 1990's and the financial crisis experienced since 2008 press countries on the globe to look at corporate governance seriously and take reformative measures on composition of boards, i.e. began to introduce non-shareholder directors to improve the capability of boards to oversee the conducts of managers and run firms to the interests of shareholders and stakeholders.

Following these corporate scandals and financial crisis, there have been various discourses, debates, opinions and perspectives from different corners of the globe on causes of the outrages, so that the atmosphere became electric. To calm down the situation and establish rock basis, many researches have been conducted on the issue. Eventually, these researches came out with findings which showed that weak corporate governance systems exacerbated the incidence of the outrages. Consequently, various reformative actions on composition of boards have been proposed and taken by governments, stock exchange markets and shareholders with their own motivation. For example, in the USA, we may mention Sarbanes-Oxley Act of 2002 (Sarbanes-

Oxley) and the introduction of rules of the Securities and Exchange Commission (SEC) on November 4, 2003 to the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) and on December 1, 2003 to the American Stock Exchange (AMEX).³³⁹ Similar reformatory actions have also been taken in the UK, Germany, France, China, South Africa and others; however, the crisis remained to be of global interest to date. Thus, all these reformatory actions required companies to modify the existing boards' composition and include majority non-shareholder directors on boards hoping that they would strengthen the ability of corporate boards of directors above and beyond improving the ability of honest and well intentioned directors, managers and employees.³⁴⁰ Again, there is also public perception that non-shareholder directors would enhance corporate and companies finance performance, so that they farther the confidence of stockholders and investors.

Different scholars, also on the basis of diverse theories or empirical evidences, express their feelings, perspectives and suggestions on this issue. Accordingly, scholars like Freeman and Friedman are interested to see professional stakeholders such as employees, customers, suppliers, distributors and managers on boards because companies have often links with these individuals or groups and could not exist without them or vice versa.³⁴¹ They argue that the benefits of these individuals or constituencies are met only when companies succeed in comprising them on boards of governance.³⁴² Moreover, stakeholders add diversity to boards in terms of knowledge, experience, perspectives vital to enhance boards quality to pass appropriate decisions. In addition to Freeman and Friedman, there are also scholars who support non-shareholders to assume directorship in firms such as Lawrence J. Trautman, , Silva Ayuso and Antonio Argandona, etc .

In contrast, there are also scholars such as Lisa M. Fairfax, J. Wallison, Joseph Heath, Wayne Norman and others who are disinterested on the inclusion of non-shareholders on boards. These scholars challenge the presence of these individuals or groups on boards blaming that non-shareholder directors exacerbate corporate problems rather than giving solution. They argue that non-shareholder directors bring conflict of interests on boards, affect boards' cohesiveness, and subject boards to multiple principals, etc.

³³⁹Ran Duchin, John G. Matsusaka, and Oguzhan Ozbas , “ When are Outside Directors Effective,” (2009), p.1

³⁴⁰ Steven T. Petra, supra note 265, p.56

³⁴¹ Edward Freeman, “Stakeholder Theory of The Modern Corporation” , **General Issue in Business Ethics**, p.39

³⁴²Ibid

Hence, the discussion in this chapter will start with determining the merits and demerits of introducing non-shareholder directors on boards of Ethiopian share companies. Then, it will continue with the discussion of the prospects and challenges of introducing non-shareholder directors in Ethiopia. Finally, it will address the issue that the subject matters need careful attention even if it is decided to introduce non-shareholder directors.

4.1. Merits and Demerits of Introducing Non-shareholder Directors in the Governance of Ethiopian Share Companies

It is obvious that after the collapse of Enron, World com, and other corporations, the idea of non-shareholder directors became a matter of world interest. So, many countries have already reformed their governance system and the rest are preparing to take reformative measures on composition of their boards. Different from this, Ethiopia did not take any serious measure on the area so far. This situation drives one to question whether the idea of non-shareholder directors system is incompatible and disadvantageous or there are determinate factors that do not necessitate the presence of non-shareholder directors in the country's corporate governance. Obviously, the Ethiopian Commercial Code under Article 347(1) and other legislations require only shareholders to be members on boards of share companies and hence there is no place for non-shareholders. In fact, there are no big share companies in the country so far. We have not experienced any corporate scandals hitherto. But, Ethiopia has to think for a while and take strong reformative measures towards reforming corporate governance including introducing non-shareholder directors on board of directors.

However, there are activities to be done before any reformative measures are taken on the issue. *Inter alia*, studying the merits and demerits of introducing non-shareholder directors on boards of Ethiopian share companies would be one. Different theories, research works and experiences of foreign countries reveal that non-shareholder directors system is valuable. So, it may be useful to adopt the system in Ethiopia. In contrast, the non-shareholder director system may not be fully beneficial and compatible to our regime. It may have its own disadvantages and there may also be scholars who argue against it. To that effect, the sections below show the merits and demerits that introducing non-shareholder directors system on boards would have on Ethiopian share companies on the basis of different theories, research findings, opinions of scholars and other international documents.

4.1.1. Merits of Introducing Non-shareholder Directors in the Governance of Ethiopian Share Companies

As mentioned above, the non-shareholder directors system has been loved and adopted by many countries. Different scholars also argue in favor of the system displaying the various benefits it would bring to share companies as well as to the overall economy of a country. As part of the international community and in addressing the current problems, introducing non-shareholder directors in the governance of Ethiopian share companies would bring the following advantages.

1. Boards which are composed of non-shareholder directors would look at stakeholder concerns as a governance mechanism. A stakeholder theory argues for companies to consider the interests of stakeholders who may be individuals or groups can affect or are affected by the firms' activities.³⁴³ Stakeholders, in one or another way, voluntarily or involuntarily, contribute something to the wealth, values or activities of companies and hence are either the beneficiaries or risk bearers.³⁴⁴ The same is true for companies because they may not be able to create wealth, enhance their values and continue operating without stakeholders. So, it is argued that companies have to pay attention to these individuals and constituencies and for that matter, introducing non-shareholder directors enables boards to consider and look at the issues of stakeholders around the table as well as ensure companies to continue functioning. This should be so for two reasons. First, the demands of stakeholders have intrinsic value in firms and hence firms have the responsibility to satisfy their legitimate claims and secondly, addressing stakeholders' claims increase the profitability of firms.³⁴⁵

The stakeholder theory has two subparts, i.e. the normative and instrumental theories. The normative theory states that it is ethical to consider the concerns of stakeholders in boards.³⁴⁶ So, the introduction of non-shareholder directors capacitates boards to consider the claims of

³⁴³R. Edward Freeman, Andrew C. Wicks and Bidhan Parmar, "Stakeholder Theory and The Corporate Objective Revisited," **Organization Science**, Vol.15, No.3(May-June 2004), p.365. See also Michael C. Jensen, "Value Maximization, Stakeholder Theory, and the Corporate Objective Function," **European Financial Management**, Vol.7, No.3(2001), p.299

³⁴⁴Charles W.L. Hill and Thomas M. Jones, "Stakeholder Agency Theory," **Journal of Management Studies**, Vol. 29, No. 2 (1992), p.133.

³⁴⁵ Silva Ayuso and Antonio Argandoña, supra note 241, p.2

³⁴⁶ Salma Damak-Ayadi, "Stakeholder Theory in Perspective," **Corporate Governance**, Vol.2 (2005), p.7. The various approaches of this kind have in common is the fact that they treat stakeholders both as an end and also as having interests that possess an intrinsic value.

stakeholders in corporate decision making and to legitimize as well as protect their interests.³⁴⁷ However, to fetch these benefits, bringing in stakeholders on boards by itself is not sufficient. They have to be included on boards in sufficient numbers and get the chance to participate in monitoring or oversight of boards' committees.³⁴⁸

The instrumental theory also provides for economic arguments of the merits of introducing non-shareholder directors on boards. It argues that companies have responsibilities to give recognition to all company-specific investments and contributions made by stakeholders.³⁴⁹ In fact, these contributions or specific-investments³⁵⁰ of stakeholders to the companies may be of little (have no value); may not be assessed apart from companies' functions; or may not be protected by full contracts ex-ante. But, if they are not recognized and thereby expropriated by some forms of companies' constituencies, it may cause conflict of interests among stakeholders and consequently, exacerbates companies' failure and loss of values.³⁵¹ Thus, to save companies from such type of incidence, the instrumental theory argues that it would be better for boards to include non-shareholder directors who may add value, assume unique risks and possess strategic information for companies.³⁵² Non-shareholder directors add value to companies in terms of their specific human capital investments, hold tacit knowledge relevant to companies, provide strategic information to companies about new product market opportunities and current technological research, etc.³⁵³

2. Including non-shareholder directors on boards would help companies to enhance their performance.³⁵⁴ Companies have their own objectives, and to fulfill their objectives, they should have the support of those individuals or groups who can affect companies and know how the

³⁴⁷Mohamed Belkhir, "Board Structure, Ownership Structure, and Firm Performance: Evidence from Banking," **Journal of Economic Literature**, Classification No. G21, G32 and G34, P.6

³⁴⁸Donald E. Pease, "Outside Directors: Their Importance to the Corporation and Protection from Liability," **Delaware Journal of Law**, Vol. 12, No.1 (1987), p.31

³⁴⁹Salma Damak-Ayadi, supra note 346, p.5. Instrumental stakeholder theory was advanced by T. M. Jones in 1995 and its main idea is that everything else being equal, firms that practice stakeholder management will perform better in profitability, stability, growth, etc. terms.

³⁵⁰By specific asset investment I mean assets that cannot be redeployed to alternative use without a loss of value.

³⁵¹Charles W.L. Hill and Thomas M. Jones, supra note 344, p.133.

³⁵²Kaufman and Englander(2005) cited in Silva Ayuso and Antonio Argandona, supra note 241, p.4

³⁵³Renee Adams, Benjamin E. Hermalin and Michael S. Weisbach, "The Role of Board of Directors in Corporate Governance: A Conceptual Framework and Survey," Working Paper (2008), pp. 28-30

³⁵⁴Prashanth Beleya, "Independent Directors and Stakeholders Protection: A Case of Sime Darby," **International Journal of Academic Research in Business and Social Sciences**, Vol.2, No.4(2012), p.425

companies will affect theirs. Hence, understanding their relationships, significance and bringing in them on boards facilitate both non-shareholder and shareholder directors to work together in achieving firms' objectives and ensuring their continuing survival.³⁵⁵ It saves boards from thinking and relying on a single objective of maximizing shareholders wealth; rather, it qualifies them to aim at multiple relationships, objectives (involving stakeholders) and ensuring long term success.³⁵⁶

3. The introduction of non-shareholder directors enhances the quality and performance of boards as well as companies.³⁵⁷ Yoseph Alemu has the opinion that introducing non-shareholder directors on Boards of share companies is vital and enhances the performance of boards.³⁵⁸ This has something to do with agency theory.³⁵⁹ As we know the primary function of boards is to monitor the engagements of managers to ensure that companies are running for shareholders benefits. However, their effectiveness may vary on the basis of the degree that boards' members are dependent on firms. Boards which are primarily composed of members (shareholders) may be reliant on firms and thereby ineffective because of their strong link with the organization whereas boards primarily composed of non-shareholder directors are thought effective in monitoring managers because their incentives may not be negotiated by reliance on companies.³⁶⁰ Biniyam Terfa also agrees to this proposition and insists an introduction of non-

³⁵⁵Gebeyaw Simachew Bekele, A Critical Analysis of the Ethiopian Commercial Code in Light of OECD Principles of Corporate Governance Framework (2011-2012, Unpublished, Library, School of Advanced Study, University of London), p.18 and p p.33-34

³⁵⁶Ibid

³⁵⁷Sajid Hussain Awan and Aamir Khan, " Effects of Board Composition on Firm's Performance: A Case of Pakistani Listed Companies," **Interdisciplinary Journal of Contemporary Research in Business**, Vol. 3, No.10 (2012), pp. 859-60

³⁵⁸ Interview with Ato Yoseph Alemu, Senior Legal Expert, Counseling and Information Service Department, Ministry of Trade, December 31, 2013

³⁵⁹ Aguilera, Filatotchev, Gospel, and Jackson, 2008; Bushman and Smith, 2001; Coles and Hesterly, 2000 cited in Raymond K. Van Ness, Paul Miesing and Jaeyoung Kang, "Understanding Governance and Corporate Boards: Is Theory a Problem?," **European Journal of Management**, Vol.7, No.9(2009), p.3. Agency theory suggests an inherent imperfection in the relationship between capital providers (principals) and fiduciaries (agents) of that capital. It is a long-held concept that argues when corporate ownership is separated from corporate management, behaviors, decisions, and actions by managers will deviate from those required to maximize shareholder value. In other words, it assumes an imminent divergence between the interests of corporate managers and those of shareholders.

³⁶⁰Silva Ayuso and Antonio Argandona, supra note 241, p.5

shareholder directors in the governance of Ethiopian share companies hoping that they are independent and professional, so that they may not be easily influenced by others.³⁶¹

4. The introduction of non-shareholder directors helps boards to get the business experience, working knowledge of strategic decision making and internal firms operations, alternative view points and information on how similar issues and concerns are dealt with in other companies from each non-shareholder director.³⁶² This has been supported by resource dependency theory.³⁶³ Obviously, non-shareholders are working either inside or outside firms and hence have different exposures, information, skills and potential linkages. So, their presence on boards enhances the quality of boards to provide comprehensive and wide-ranging resources, i.e. to advice and counsel, communicate information between companies and external organizations or to have support from elements outside the companies effectively.³⁶⁴ Non-shareholder directors do also stimulate innovation and creativity in boards.³⁶⁵

5. Comprising boards from various constituencies either stakeholders, non-executive or independent directors increases boards capital, i.e. human capital³⁶⁶ such as expertise, experience, knowledge, reputation and skills; and relational capital like links to strategically relevant enterprises.³⁶⁷ It qualifies boards to provide relevant resources and facilitates companies to interact, create business and expand their jurisdiction. It also enables companies to provide adequate and efficient responses as well as to legitimize voices that they face.

³⁶¹Interview with Ato Biniyam Terfa, Attorney and Consultant at Law and Director in Awash International Bank, November 20, 2013

³⁶²Krishna Udayasankar, "The Foundations of Governance Theory: A Case for the Resource Dependence Perspective," **Corporate Ownership and Control**, Vol. 5(2008), p.6. See also Lawrence J. Trautman, infra note 364, pp.5-6 and Biserka Siladi, **The Role of Non-executive Directors in Corporate Governance: An Evolution** (2006, unpublished, Library, Faculty of Business and Enterprise, Swinburne University of Technology), p.33

³⁶³ The resource-dependence view of corporate governance stems from the fundamental logic that various elements of corporate governance can act as critical resources for a firm. It allows for stakeholder interests to be captured, by treating various stakeholder groups as sources of legitimacy, and other resources, including capital. Stakeholders potentially supply vital resources to the firm. Managing their interests effectively results in rewards to the firm, in the form of enhanced access to these resources. Different stakeholders are likely to control or supply different resources.

³⁶⁴Lawrence J. Trautman, "Boardroom Diversity: Why it Matters", **Journal of Economic Literature**, D63, D70, D71, G30, G34, J16, J44, J70, K22, K40, L20, M10, M14, M40 and M50 (2008), pp.5-6.

³⁶⁵Ibid, p.6

³⁶⁶Chun-Yao Tseng and Chun-Yi Lin, "The Relationship Between Corporate Governance and Intellectual Capital: Empirical Study of Taiwanese Electronics Manufactures," **East Management Review**, Vol.13, No.1 (2011), p.271

³⁶⁷Ibid, p.272.

6. The introduction of non-shareholder directors brings heterogeneity on boards and hence, there will be cognitive diversity.³⁶⁸ Non-shareholder directors may be from important external constituencies, so that they provide firms with significant resources which are otherwise unavailable or may have critical contacts with essential elements of firms and thus, serve as a bridge with the external environment.³⁶⁹ Therefore, it is these stakeholders and shareholders who form boards. This situation brings cognitive diversity which is relevant to perform the functions of boards effectively because it promotes discussion of diverse viewpoints, reduces the probability of self-satisfaction and narrow-mindedness, and provides for wide range of solutions to problems and decision criteria to evaluate corporate strategies other than facilitating directors to share their diverse experiences and views.³⁷⁰ It also “ensures the continued operation of companies through access to valued information and resources, facilitation of inter-firm commitments and establishes and maintains the firms’ legitimacy.”³⁷¹

7. The presence of non-shareholder directors on boards reduces the possibilities of formation of polarization of attitudes and opinions among directors of boards or depolarizes attitudes and opinions of directors.³⁷² Group polarization is the tendency for groups to take more extreme positions following group discussion than the positions originally held by individual members.³⁷³ That means group polarization represents intensification of preexisting initial group preferences.³⁷⁴

8. The existence of non-shareholder directors on boards is also significant to overcome Egocentrism.³⁷⁵ Egocentrism refers to the tendency of individuals to give more concern to their interest and welfare than others and thereby involves “a lack of differentiation between some

³⁶⁸Daniel P. Forbes and Frances J. Milliken, “Cognition and Corporate Governance: Understanding Board of Directors as Strategic Decision Making Groups,” **Academy of Management Review**, Vol. 24(1999), p.9

³⁶⁹Ibid

³⁷⁰Internet Source. Daniel Ferreira, Board Diversity(July9, 2010), pp.227-228. Accessed at <http://personal.lse.ac.uk/FERREIRD/Board%20Diversity%20version%201.pdf> visited on November 13, 2013 ,

³⁷¹ Nancy Averill, **Diversity Matters: Changing the Face of Public Boards** (Canada: Myatree), P.5

³⁷² Lynne L. Dallas, “The New Managerialism and Diversity on Corporate Board of Directors”, **Tulane Law Review**, Vol.76 (2002),p.26

³⁷³Hongquan Zhu, **Group Polarization on Corporate Boards: Theory and Evidence on Board Decision About Acquisition Premiums, Executive Compensation and Diversification** (2009, Unpublished, Library, Faculty of Business Administration, University of Michigan), p.14

³⁷⁴Susan G. Straus, *et.al*, “The Group Matters: A Review of the Effects of Group Interaction on Processes and Outcomes in Analytic Teams”, **RAND working paper series**, WR-580-USG (April, 2009), p. ix

³⁷⁵ Lynne L. Dallas, *supra* note 372 , p.27

aspects of self and others.”³⁷⁶This individual decision making bias has its own impact on the decisions of boards, particularly when individual decision makers decide issues in which they have to assess the preferences and views of others.³⁷⁷ However, having non-shareholder directors on boards reduces this tension because it is composed of directors who have diverse views and sets of values of paramount importance to enhance the quality of decisions of boards.

9. Non-shareholder directors on boards are also significant in reducing the efforts of searching for and forming confirmation bias among directors.³⁷⁸ This is because in diversified boards, there are divergent views and hence it is not easy for directors to initially agree or engage in biased search process. Actually, confirmation bias is the observed tendency of group members to seek information that confirms their initial opinions.³⁷⁹ Thus, diversifying board members helps to enhance the quality of boards’ decision. It also makes boards less prone to overconfidence.³⁸⁰

10. Non-shareholder directors improve the quality of decisions of boards on matters which are complex, require creativity and judgment.³⁸¹Yoseph Alemu argues that introducing non-shareholder directors on Boards of share companies is vital and enhances the decision of boards.³⁸²In a heterogeneous boards, there is cognitive conflict, i.e. member directors are with different backgrounds, so that they bring in different conflicting ideas, views and knowledge which capacitate boards to see problems and challenges from different perspectives, alternatives view points and in different arrays of interpretations.³⁸³ So, this situation improves the quality of thinking of boards.

³⁷⁶Internet source. Patrick L. Hill and Daniel K. Lapsley, Egocentrism, p.1. Accessed at http://www3.nd.edu/~dlapsle1/Lab/Articles%20&%20Chapters_files/Egocentrismv. Visited on November 14, 2013,

³⁷⁷Lynne L. Dallas, supra note 372, p.27

³⁷⁸Susan G. Straus, *et.al*, supra note 374, p.ix

³⁷⁹J. Edward Russo, Victoria Husted Medvec & Margaret G. Meloy, The Distortion of Information During Decisions, 66 *org. behavior & human decision processes* 102 (1996) cited in Lynne L. Dallas, supra note 372 , p.28

³⁸⁰Susan G. Straus, *et.al*, supra note 374, p. x

³⁸¹ S. Barsade, et al., To your heart’s content: A model of affective diversity in top management teams, 45 *Administrative Science Quarterly*, (2000); cited in Frank Dobbin and Jiwook Jung, “Corporate Board Gender Diversity and Stock Performance: The Competence Gap or Institutional Investor Bias?”, p.4. Accessed at http://www.wjh.harvard.edu/~dobbin/cv/workingpapers/Board_Diversity_and_Performan.visited on November 13, 2013.

³⁸² Interview with Ato Yoseph Alemu, supra note 358

³⁸³Donald C. Hambrick, et al., The Influence of Top Management Team Heterogeneity on Firms' Competitive Moves, 41 *Administrative Science Quarterly*, (1996) cited in Frank Dobbin and Jiwook Jung, supra note 381, p.5

11. The presence of non-shareholder directors on boards equips companies to interact with different peoples, cultures, ideas, viewpoints, talents and ensure their continued growth.³⁸⁴ As we know the number of directors on boards is too few and may not have lots of exposures, experiences, perspectives and other talents. This remains intact if boards are comprised of shareholders who have similar perspectives, interests and ideas. However, boards consisting of non-shareholder directors get many advantages, because they are comprised of directors from different backgrounds and enable boards to interact with different ideas, perspectives, peoples and cultures as well as to expand the firms' markets and remain competitive.³⁸⁵ Further, non-shareholder directors enable companies to have efficient employees, to reach out to the entire population, to be innovative and to tap new sources of talent relevant to their existence and expansion.³⁸⁶

12. Boards which are comprised of non-shareholder directors have the capacity to produce quality products or services needed by different communities; reach out a wider range of customers and clients; and thereby increasing the sales performance and ultimate profitability to their companies.³⁸⁷ Non-shareholder directors have the ability to assess the demands of markets, appreciate diverse clients and customers, produce new products and services at the particular interests or needs of diverse societies, employ attractive strategies and thereby increase the financial position of their companies in the market place and remain profitable.³⁸⁸

13. Introducing non-shareholder directors on boards is appropriate to prevent or reduce discrimination or stereotyping that takes place in companies.³⁸⁹ Diversified boards are comprised of individual directors who have different backgrounds, experiences, cultures, ideas, etc and hence, they may experience discrimination or stereotyping either inside or outside boards' room.

³⁸⁴Jiang Liao, Martin R. Young and Qian Sun, "Independent Directors Characteristics and Performance: Evidence from China," **Journal of Economic Literature**, G34; G38 (2009), p.17.

³⁸⁵Richard A. Johnson and Daniel W. Greening, "The Effects of Corporate Governance and Institutional Ownership Types on Corporate Social Performance," **Academy of Management Journal**, Vol. 42(1999), p.568

³⁸⁶Mohammed Boussouara and David Deakins, "Trust and the Acquisition of Knowledge from Non-executive Directors by High Technology Entrepreneurs," **International Journal of Entrepreneurial Behavior and Research**, Vol.6, No.4 (2000), pp. 209-210

³⁸⁷Pillar non-profit network, **Board Diversity Training: A Toolkit** (March, 2008). Available at www.pillarnonprofit.ca, p.8

³⁸⁸ Ibid

³⁸⁹Lisa M. Fairfax, "The Bottom Line on Board Diversity: A Cost-Benefit Analysis of the Business Rationales for Diversity on Corporate Governance", **Wisconsin Law Review** (2005) , p.826

Thus, they are likely to contribute to a positive working environment by preventing or decreasing employment conflicts, discrimination, stereotyping and the consequence costs related to these issues.³⁹⁰ They provide proactive attention to diversity issues and create a climate in which all members of companies can work effectively. Otherwise, turnover, miscommunication and interpersonal conflicts may bring lower productivity and ultimate lower performance on profit, market share or other strategic goals of firms’.

14. Boards which are composed of non-shareholder directors are efficient in creating good relationships between boards and companies, diverse employee populations, shareholders and other individuals and corporate constituencies.³⁹¹ Boards composed of non-shareholder directors understand the diversity and concerns of its multiple employees, shareholders or other individuals and groups and are likely to adopt or facilitate the adoption of different policies and strategies which increases their satisfaction.³⁹² They enhance companies’ ability to work with these diverse groups or individuals which in turn leads to a greater productivity and profitability of firms.³⁹³ They also enhance the social capital and social cohesion of those communities.³⁹⁴

15. Boards made up of non-shareholder independent, non-executive or stakeholder directors are efficient in enhancing the quality of financial reporting, lowering the probability of fraudulent financial reporting and issuing more accurate earnings forecasts, so that they are suitable in mitigating agency costs.³⁹⁵ I came across also the same merits of introducing non-shareholder directors on boards of companies in my interview with Befikadu Gashaw. Befikadu argues that it would be wise to introduce non-shareholder directors in Ethiopian share companies in the current

³⁹⁰ Daniel Ferreira, supra note 370, pp.227-228

³⁹¹Martha A. Gelekancy and Donald C. Hambrick, , “ The External Ties of Top Executives: Implications for Strategic Choice Performance,” **Administrative Science Quarterly**, Vol. 42, No.654(1997), p.662

³⁹²Ibid

³⁹³Lisa M. Fairfax, supra note 389 , pp.828-829

³⁹⁴Nancy Averill, supra note 371, p.6. Social capital is the value of those networks and relationships which satisfy social needs and produce outcomes such as a sense of belonging, compliance with the law and trust in public institutions. Social cohesion is the capacity for cooperation and participation in a society.

³⁹⁵Stefaanescu Cristina Alexandrina, “How do Board of Directors Affect Corporate Governance Disclosure ?-The Case of Banking Sytem,” **The Romanian Economic Journal**, year XVI, No.47(march, 2013),p.130. See also Anis Mnif, “Corporate Governance and Mngament earnings Forcast Quality: Evidence from French Ipos”(February, 2010) , pp. 5-6. Accessed at <http://hal.inria.fr/docs/00/45/91/71/PDF/p61>.Pdf on visited November 11, 2013

situation particularly to follow up financial reports, auditing activities, etc.³⁹⁶The appointment of non-shareholder directors “will provide more resources, information, and legitimacy to boards.”³⁹⁷ Non-shareholder directors are more knowledgeable about the concerns of diverse stakeholders; responsive to the needs of the society;³⁹⁸ and courageous to face even costly and unpopular compliance issues.³⁹⁹ Thus, they push the concerns, interests and benefits of shareholders, stakeholders and the society farther.

16. Introducing non-shareholders, like knowledgeable employees, assists boards to be better informed about the issues, concerns, and problems of companies’ business and thereby mitigates the dependence of boards on CEOs for receiving information.⁴⁰⁰ Boards have, most often, received information about the companies’ business from CEOs. It is also obvious that the agenda of meetings are at mostly prepared by CEOs and it is rarely that boards hold meetings without the presence of CEOs.⁴⁰¹ Further, CEOs may have their own path or may be rent-seekers and the information supplied by CEOs to boards may be filtered and presented losing its originality. However, if stakeholders such as knowledgeable workers are become directors, they supply original information to boards on different affairs of the companies.⁴⁰²

17. The presence of non-shareholder directors on boards helps to mitigate the manager-shareholders conflict of interests and operate companies to the benefits of shareholders in share companies with dispersed ownership.⁴⁰³ As we know in share companies with dispersed

³⁹⁶Interview with Ato Befikadu Gashaw, Director, Domestic, Economic Analysis and Publication Directorate and Economic Modeling and Statistical Analysis Directorate, National Bank of Ethiopia, November 25, 2013

³⁹⁷Nor Raihan Mohamad, et al, The Effects of Board Independence, Board Diversity and Corporate Social Responsibility on Earnings Management(University of Malaysia: Faculty of Management and Economics, 2010), p.5

³⁹⁸ The Institute of Chartered Accountants of Scotland, Non-Executive Directors : Their Role and Responsibilities in a Private Company(The Institute of Chartered Accountants of Scotland, 2009) , p.4

³⁹⁹ Ibid

⁴⁰⁰Dilek Demirbas and Andrey Yukhanaev, “Independence of Board of Directors, Employee Relation and Harmonization of Corporate Governance: Empirical Evidence from Russian Listed Companies,” **Employee Relations**, Vol. 33 , No. 4(2011), pp. 461-462

⁴⁰¹ Margit Osterloh and Bruno S. Frey, “Shareholders Should Welcome Employees as Directors,” **Institute for Empirical Research in Economics- University of Zurich**, working paper serious ISSN: 1424-0459, No: 228(2005),p.8

⁴⁰²Dilek Demirbas and Andrey Yukhanaev, “supra note 400, pp. 461-462

⁴⁰³Jeffrey Lawrence and Geof Stapledon, Do Independent Directors Add Value? (Melbourne: Center for Corporate Law and Securities Regulation, 1999), pp. 4-5

ownership, it is hard for shareholders to control and manage their companies. Consequently, they provide the power to manage their firms to managers retaining their ownership. However, shareholders are, due to lack of information or resources, unable to closely monitor the managements, their strategies and performance.⁴⁰⁴ This opens an opportunity for managers of companies to break their fiduciary duties they owe to shareholders and use the assets of companies to farther their interests.⁴⁰⁵ They may abuse their authority by engaging in self-dealing, fraud or otherwise shirking their responsibilities. But, if boards are composed of non-shareholder directors, they can fill the gap between the uninformed shareholders as principals and the fully executive managers as agents by monitoring the managers more closely.⁴⁰⁶ Non-shareholder directors control the situation through diverse mechanisms. For instance, non-shareholder directors by closely examining conflict of interests transactions to the interest of firms would be able to protect them from self-dealings; through active oversight of managers succeed in preventing or reducing managers wrongdoings or frauds; and by proactively examining firms affairs save managers from shirking which in turn capacitate managers to be productive and more effective in making decisions relevant to companies.⁴⁰⁷

18. Non-shareholder directors are also important to protect minority shareholders from greedy conducts of block shareholders.⁴⁰⁸ Alebachew Sitotaw states that shareholder directors, these days, are in many cases, especially in passing decisions, influenced by block holders, and he has the opinion that non-shareholder directors are vital to protect the rights of minority shareholders from block holders.⁴⁰⁹ Likewise, in companies with dispersed ownership and in controlled companies, it is block holders who have information and resource about the management, financial status and performance of the companies. So, they may use the assets of companies for

⁴⁰⁴ Dragan Radonjic, "Independent Directors and New Corporate Governance Paradigm (Pros & cons of Independent Directors)," **Annals FLB – Belgrade Law Review**, Year LX, No. 3(2012), p.101

⁴⁰⁵ Stephen M. Bainbridge, Independent Directors and the ALI Corporate Governance Project, **61 Geo. Wash. L. Rev. 1034**, 1034 (1993) cited in Umakanth Varottil, "Evolution and Effectiveness of Independent Directors in Indian Corporate Governance," **Hastings Law Journal**, Vol.6, No.2 (2010), p.13

⁴⁰⁶ Dragan Radonjic, supra note 404, p.101

⁴⁰⁷ M. Habbash, A. Salama, R. Dixon, "The effects of Non-Executive Directors' Commitment and Chairman Independence on Earnings Management: UK Evidence", **Journal of Applied Accounting Research**, (2008), p.20

⁴⁰⁸ Donald C. Clarke, "Three Concepts of the Independent Director," **Delaware Journal of Corporate Law**, Working Paper No.256 (2007), p.80.

⁴⁰⁹ Interview with Ato Alebachew Sitotaw, Expert, Trade Registration and licensing Directorate, Ministry of Trade, December 31, 2013

their interest to the disadvantage of minority shareholders. However, non-shareholder directors safeguard minority shareholders by checking block shareholders.⁴¹⁰

19. Non-shareholder directors impartially monitor matters such as “the nomination of directors, the remuneration of directors and the audit of the accounting for companies’ performance in which executive directors have conflict of interest.”⁴¹¹ These areas are very sensitive because they were among drivers which result in corporate scandals in the last decades. Non-shareholder directors also improve decisions of boards with regard to replacement, acquisitions and compensation of CEOs.⁴¹²

20. Non-shareholder directors bring and maintain good corporate governance into share companies.⁴¹³ They also contribute much to boards as well as firms from different perspectives.⁴¹⁴ They monitor “the performance and actions of executives; are less dependent on CEOs; are more sensitive to external assessment of their performance as directors; are less devoted to inside accounts of companies prospectus; are less worried about the disclosure of potentially competitively sensitive information; have credibility in the checking of market signals; create significant value in the allocation of resources; and thereby, maintain managerial accountability.”⁴¹⁵

⁴¹⁰Stefano Caselli and Stefano Gatti, “Corporate Governance and Independent Directors: Much Ado about Nothing? The Evidence behind Private Equity Investment Performance,” **Journal of Economic Literature**, No. G34, G24 and G11, p.12

⁴¹¹Serena Scarabotti, “The Independent Directors’ Role in Europe: Developments and Open Debates in Italy,” **The Columbia Journal of European Law Online**, Vol.15 (2009) , p.78.

⁴¹² Karen Lin, et al, “Exit as Voice: The Unintended Consequence of Independent Director Resignations in an Emerging Economy” (April 2, 2011), p. 6. Accessed at <http://areas.kenan-flagler.unc.edu/Accounting/Documents/2011%20GIA%20Conference/Exit%20as%20Voice.pdf> ≥ visited on November 11, 2013. Weisbach (1988) finds that CEO turnover is more (less) sensitive to firm performance when boards are dominated by outside (inside) directors. In the takeover market, Byrd and Hickman (1992) show that while on average, there is a negative price reaction to the announcement of acquisitions, the price drop is significantly lower for firms with a board containing a majority of outside directors. Analyzing target firms in acquisitions, Cotter, Shivdasani, and Zenner (1997) find that when target’s board has a majority of outside directors, the target receives a return about 20% higher than that of an otherwise similar firm without a majority of outside directors on the board. Lastly, Core, Holthausen and Larcker (1999) examine the relationship between board independence and CEO pay. Their results suggest that CEOs earn higher pay when the board of the firm contains more outside directors appointed during their tenure.

⁴¹³ Jeffrey Lawrence and Geof Stapledon, supra note 403, p.6

⁴¹⁴Dragan Radonjic, supra note 404, p.102

⁴¹⁵Jeffrey N. Gordon, supra note 252, p.1471.

21. The presence of non-shareholder directors on boards promotes transparency and disclosure within companies.⁴¹⁶ Noticeably, the basic functions of directors are overseeing the activities of CEOs. Since non-shareholder directors are independent from management and corporation, they are under no obligations and hence they critically examine each and every conducts, records, data, etc.⁴¹⁷ Thus, non-shareholder directors enable boards to prevent managers from withholding or otherwise distorting information.⁴¹⁸

22. Introducing non-shareholder directors on boards also brings important transformations into the political economy settings like maximizing the stock prices of companies, promoting the interests of shareholders and allocate firms capital efficiently.⁴¹⁹ As we know, non-shareholder directors are less dependent on CEOs and the organization, less committed to management and less captured by the internal perspectives of companies.⁴²⁰ Hence, they are not interested in the current prices which disvalue companies and their strategies, and they pass appropriate decisions which safeguard companies as well as shareholders.

23. Non-shareholder directors are impartial and viewed as ‘the best arbiters’ of corporate conduct.⁴²¹ Non-shareholder directors impartially assess the conducts of managers and other officers within firms and reach on decisions that satisfy the interests of shareholders.⁴²² Alebachew Sitotaw shares this impartiality of non-shareholder directors and argues that they bring objective decisions.⁴²³ Thus, non-shareholder directors are the best arbiters on matters of corporate governance and are ideal substitutes for external regulators and courts.⁴²⁴ They reduce “the need for government to play a significant role in the area of corporate

⁴¹⁶Christopher Pass, “Corporate Governance and the Role of Non-executive Directors in Large UK Companies: An Empirical Study,” **Corporate Governance**, Vol.4, No. 2(2004), p.53

⁴¹⁷Ibid

⁴¹⁸ Lisa M. Fairfax, “The Uneasy Case for the Inside Director”, **Iowa Law Review**, Working Paper No.538(2010), p.139

⁴¹⁹Dragan Radonjic, “supra note 404, p.111

⁴²⁰Ibid

⁴²¹Eugene F. Fama and Michael C. Jensen, “Separation of Ownership and Control”, **Journal of Law and Economics**, Vol.26, No.2 (1983), p.315

⁴²²Thomas Clarke, “The Contribution of Non-executive Directors to the Effectiveness of Corporate Governance,” **Career Development International**, Vol.3, No.3 (1998), p.119

⁴²³ Interview with Ato Alebachew Sitotaw, supra note 409

⁴²⁴ Donald C. Clarke, supra note 408, p.78

accountability.”⁴²⁵ This is because courts and external regulators are not business people and hence, are not best suited to judge business decisions neither are they proactive in monitoring business decisions.⁴²⁶

24. Non-shareholder directors equip boards to prove that certain standards have been observed in firms.⁴²⁷ For instance, non-shareholder directors are appropriate to follow up whether the annual report is accurate; the balance sheet has been prepared in conformity with the accepted accounting standards, etc.⁴²⁸

25. Non-shareholder directors are central to maintain standards of professionalism as well as best practices on boards which in turn build shareholders trust and confidence.⁴²⁹ Yoseph Alemu states that introducing non-shareholder directors makes boards perform their roles and responsibilities systematically and in organized manner.⁴³⁰ Non-shareholder directors enhance the ability of honest and motivated directors, managers or employees, so that they promote the confidence of stockholders and other investors.⁴³¹

26. Non-shareholder directors secure the rights and interests of companies. As we know, one of the mechanisms through which shareholders control the activities of boards is via derivative suit. But, for shareholders to bring suit against any director in the name of a company, they shall first demand and receive the approval of board of directors. However, this may be challenging because directors may decline to permit their fellow director to be sued particularly when boards are composed of insiders. But, this might be alleviated by incorporating non-shareholder directors on boards.⁴³²

27. Non-shareholder directors also “counterbalance management weaknesses, ensure legal and ethical behavior, extend the reach of a company through contacts, expertise, and access to debt or

⁴²⁵ E. Norman Veasey, “Should Corporation Law Inform Aspirations for Good Corporate Governance Practices or Vice Versa?,” **U. PA. L. REV**(2001), p.2182.

⁸⁹ Lisa M. Fairfax, supra note 418, pp.140-141

⁴²⁷ Prashanth Beleya, “Independent Directors and Stakeholders Protection: A Case of Sime Darby,” **International Journal of Academic Research in Business and Social Sciences**, Vol.2, No.4(2012), p.425

⁴²⁸ Ibid

⁴²⁹ Vikramaditya Khanna and Shaun J. Mathew, “The Role of Independent Director in Controlled Firms in India: Preliminary Interview Evidencer,” **National Law School of India Review**, Vol.22, No.1(2010), p.46

⁴³⁰ Interview with Ato Yoseph Alemu, supra note 358

⁴³¹ Steven T. Petra, supra note 265, p.56

⁴³² Vikramaditya Khanna and Shaun J. Mathew, supra note 429, p.22

equity capital as well they can be a source of well-conceived, binding, long-term decisions for a company.”⁴³³

4.1.2. Demerits of Introducing Non-shareholder Directors in the Governance of Ethiopian Share Companies

In the above section, an attempt has been made to list out the merits that would be enjoyed by Ethiopian share companies if non-shareholder directors system is introduced to their boards. But, there are also disadvantages that would be incurred with its introduction. Herein below are some of the disadvantages which would be faced with the introduction of non-shareholder directors in the governance of Ethiopian share companies.

1. Boards comprised of non-shareholder directors may not be suitable to solve matters that necessitate verifiable or correct answers.⁴³⁴ Non-shareholder directors are directors who are from different backgrounds and have different sets of perspectives and values. Hence, they may not be issue relevant expertise; rather, they may be qualified more with presenting and sharing different ideas, views and experiences which help to consider issues from different angles and sides than searching for a direct correct answer.

2. Boards which are composed of diversified non-shareholder directors would have impact on ensuring boards' cohesiveness.⁴³⁵ Cohesiveness is “the personal attraction among group members, that is, the positive feelings that group members feel for other members of the group.”⁴³⁶ As we know boards constituted of diversified non-shareholder directors have members from different backgrounds and exposures, wide range of information, ideas and perspectives. This will result in cognitive conflict within boards, and directors may not be attracted to and feel good about other fellow members. Consequently, there may not be boards' cohesiveness and directors may not give attention to boards tasks.

⁴³³Dipen Chatterjee, “Independent Directors and Current Legal Perspectives in India”(2009), p.5

⁴³⁴Lynne L. Dallas, supra note 372, p.20

⁴³⁵Daniel P. Forbes and Frances J. Milliken, supra note 368, p.9

⁴³⁶Irvin Summer, Terry Coffelt and Roy E. Horton, “ Work Group Cohesion,” **Psychological Reports**, Vol.63, No.2(1988), p.1

3. Boards constituted of non-shareholder directors are susceptible to conflict of interests and agenda pushing.⁴³⁷ That means non-shareholder directors may work representing the interests of diverse individuals, constituencies or their own personal agenda at the expense of firms' assets or may be influenced and subjected to a distinct and professional agenda of fellow directors.⁴³⁸

4. Boards composed of non-shareholder directors consume more time to settle problems compared to boards comprised of shareholder directors only.⁴³⁹ Traditionally, boards have often limited time to deal with firms' issues. The situation is exacerbated if boards comprise non-shareholder directors who bring in diverse conflicting ideas, perspectives or use varied vocabularies and paradigms to solve complex and challenging problems.⁴⁴⁰ This provides a tough time for boards to negotiate, reach consensus and produce effective decisions within short period of time. Even if they succeeded in passing decisions, it is less likely that the solution is accepted by all directors and result in diminishing the confidence to rely on boards' decisions.⁴⁴¹

5. Introducing non-shareholder directors subjects boards to be accountable to stakeholders and the owners and hence it loses its substantive objectives.⁴⁴² We know, ordinarily, that companies are owned by shareholders and that boards are required to run companies in the interests of shareholders. However, if boards are obliged to involve stakeholders, they are required to balance the interests of stakeholders as well as shareholders alike. Moreover, they should be accountable to stakeholders in addition to the owners of share companies.⁴⁴³ This situation misses the substantive objectives of boards to maximize long-term owner value as well as discredits the traditional accountability of boards to investors. It is also impractical to make boards accountable to multiple masters' and to work smoothly. This is because "a manager told to serve two masters (a little for the equity holders, a little for the community) has been freed of

⁴³⁷Frank Dobbin and Jiwook Jung, "Corporate Board Gender Diversity and Stock Performance: The Competence Gap or Institutional Investor Bias?," **North Carolina Law Review**, Vol. 89, No.3(2011), p. 6.

⁴³⁸ Daniel Ferreira, supra note 370, p. 228

⁴³⁹Lynne L. Dallas, supra note 372, p.24

⁴⁴⁰Ibid

⁴⁴¹Ibid

⁴⁴² Elaine Sternberg, "The Stakeholder Concept: A Mistaken Doctrine," **Foundation for Business Responsibilities**, Issue Paper No.4(1999) , p.16

⁴⁴³ Ibid

both and is answerable to neither. Faced with a demand from either group, the manager can appeal to the interests of the other.”⁴⁴⁴

6. Composing boards with non-shareholders also undermines the right to private property of shareholders.⁴⁴⁵ Boards which are constituted of non-shareholders have to run share companies to the benefits of stakeholders too and not shareholders only. This prevents shareholders, who are the investors and owners of companies, from determining how and for what purpose their property has to be used including for charity purposes.⁴⁴⁶ Actually, companies have their own legal personality and properties different from that of shareholders. However, the properties of firms should not be used for the interests of all stakeholders who are not the investors.

7. Boards consisted of diversified non-shareholders also incur multitask problems.⁴⁴⁷ If boards are comprised of members representing different interests and missions, it will be challenging for them to discharge their roles and responsibilities. They are obliged to satisfy multiple tasks, interests and objectives. The problem is exacerbated because companies may, practically, not give boards’ bulleted tasks; rather, they tell them to do “the best they can.”⁴⁴⁸ This situation creates ambiguity for boards and pushes each director to pursue his or her own interest to the disadvantage of firms.

8. Non-shareholder directors may limit the freedom as well as time of CEOs of companies “to make innovative and profit generating business decisions.”⁴⁴⁹ Though non-shareholder directors have the responsibility to monitor executives, they may be hyperactively or excessively restless and make impatient movements.⁴⁵⁰ This has its own effect of wiring CEOs not to be innovative, creative and effective.

⁴⁴⁴ Joseph Heath and Wayne Norman, “Stakeholder Theory, Corporate Governance and Public Management: What Can the History of State-run Enterprises Teach us in the Post-Enron era?,” ***Journal of Business Ethics*** (2004), p.15

⁴⁴⁵ Elaine Sternberg, supra note 442, p.31

⁴⁴⁶ Ibid

⁴⁴⁷ Joseph Heath and Wayne Norman, supra note 444, p.14

⁴⁴⁸ Ibid

⁴⁴⁹ Dragan Radonjic, supra note 404, p.110

⁴⁵⁰ Ibid

9. Non-shareholder directors are part timers and may be too busy with other commitments, and it would be difficult for them to develop much more than a rudimentary understanding of their companies' working and barely enough to perform the essential functions of firms.⁴⁵¹

10. Qualified and professional non-shareholder directors may seek greater fee as well as get the approval of appointing share companies. This rewarding system may subject non-shareholder directors to love their position, payments, and incentives and thereby lose their independence of monitoring executives.⁴⁵² This, in turn, also affects the good corporate governance of companies.

11. Non-shareholder directors have not any ownership interest in firms, and they may be reckless, inattentive and ineffective in monitoring the conducts of managers in the interests of shareholders.⁴⁵³ Prof. Tilahun Teshome argues that non-shareholder directors may have their own merits and demerits. However, since they have not ownership interest, they may not lead boards in a meaningful way which in turn has serious impact on the profitability, competitiveness and sustainability of firms.⁴⁵⁴

12. Non-shareholder directors may face lack of information.⁴⁵⁵ Non-shareholder directors do not engage in the day to day operation of firms and may not have sufficient information about conducts done inside firms. So, they may fail to discover any concealment and deception by the management or prevent any wrongdoings and financial manipulations.⁴⁵⁶

13. Non-shareholder directors may, with the increment of time they spent on boards, be less independent and affect the interests of shareholders.⁴⁵⁷ We know that the responsibilities and functions of boards are greater and sometimes may be complex, and directors may spend more time together. This situation may push non-shareholder directors to create extensive social ties such as family or professional ties with fellow directors or with CEOs of firms. This may lead to

⁴⁵¹Reggy Hooghiemstra and Jaap van Manen, "The Independence Paradox: Impossibilities Facing Non-executive Directors in The Netherlands," **Corporate Governance: An International Review**, Vol. 12.No.3 (2004), p.317.

⁴⁵²Dragan Radonjic, supra note 404 p.110

⁴⁵³Interview with Tilahun Teshome, professor, College of Law and Governance Studies, Addis Ababa University, November 12, 2013

⁴⁵⁴Ibid

⁴⁵⁵Enrichetta Ravina and Paola Sapienza, "What do Independent Directors Know? Evidence from Their Trading," **Journal of Economic Literature**, No. G3, G34, K22,(April 13, 2009), P. 963.

⁴⁵⁶Peter J. Wallison, "All the Rage: Will Independent Directors Produce Good Corporate Governance?," **American Enterprise Institute**, Working No. 30670(2009), p.4

⁴⁵⁷G. P. Stapledon, **Institutional Shareholders and Corporate Governance** (Oxford: Clarendon Press, 1996), p.144

board cohesiveness and consequently, non-shareholder directors may be less independent and lose their ability to behave objectively and impartially, and this may weaken their courage to exercise adequate control on the conducts and activities of fellow directors and officers.⁴⁵⁸

4.2. Prospects and Challenges of Introducing Non-shareholder Directors in the Governance of Ethiopian Share Companies

Though the idea of having non-shareholder directors is not introduced so far, there are factors which would facilitate and encourage its introduction in Ethiopia. Below are some of the prospects which encourage the introduction of non-shareholder directors in the governance of Ethiopian share companies.

First, Ethiopia has adopted a free market economic policy since 1992.⁴⁵⁹ The government recognizes the private sector as an “engine” for country’s economic development and thereby promotes private investment in different sectors of the economy with some exceptions reserved wholly to the government such as telecommunications and electric power supply. To that effect, the government has made a number of reformative measures including privatizing state owned enterprises. The private sector has, using the suitable environment created, been growing extensively. For instance, we are observing that several share companies are being formed. It has been experienced that numerous people are buying stocks and becoming owners in different share companies.⁴⁶⁰ Consequently, these days, separation of ownership and control of share companies is emerging in the country. Share companies are now-a-day managed by directors and other executive officers, and agency problems and other corporate governance issues are becoming inevitable.

Ethiopian share companies, nowadays, are surrounded by a number of corporate problems such as blending of politics and business, absence of share markets, inadequate shareholder protection

⁴⁵⁸Van den Berghe and Baelden, “The Complex Relation Between Director Independence and Board Effectiveness, **Corporate Governance**, Vol. 5, No. 5(2005), p. 64.

⁴⁵⁹Information from Ministry of Finance and Economics, accessed at <http://www.mofed.gov.et> viewed on October 28, 2013

⁴⁶⁰ For instance, Buna International Bank has 11200 shareholders and Awash International Bank has 3000 shareholders.

laws, ineffective court system,⁴⁶¹ poor competitive environment,⁴⁶² inadequate risk management system⁴⁶³, etc. Thus, the prevalence of these corporate problems urges Ethiopians to search for efficient solutions and hence, in line with different theories, different researchers and best practices on the globe, introducing non-shareholder directors on boards is a wise solution. Further, the government also launched an ambitious Growth and Transformation Plan (GTP) in 2011 which has also the aim of improving commercial regulatory frameworks in the country.⁴⁶⁴ So, we can take these situations as opportunities to introduce non-shareholder directors on boards of Ethiopian share companies.

Second, the Ethiopian economy, these days, has shown progress and is referred to as one of the fastest growing economy on the globe.⁴⁶⁵ The capacity of domestic investors is increasing. The capacity as well as the size of share companies is also being strengthened. Consequently, our share companies, though little, have begun to invest in some foreign countries. However, in order to be efficient and reaching out to diverse peoples, customers, markets and remain competitive, their boards have to be composed of diverse talented and professional non-shareholder directors. This is because non-shareholder directors bring different conflicting ideas, viewpoints, experiences and skills on boards and enhance their qualities to solve complex and concrete issues and challenges as well as develop efficient strategic plans, decisions, etc. Hence, our emerging economy is one determinant factor to introduce non-shareholder directors in the governance of Ethiopian share companies.

Third, the country has also been inviting foreign investors to come and invest in the country and has promised to provide different protections and incentives. For instance, the government adopted different laws and ratified international conventions and documents.⁴⁶⁶ The government

⁴⁶¹Tessema, A.2003. Prospects and Challenges for Developing Securities Market in Ethiopia: An Analytical Review. R & D Management, 15(1), p.51 cited in Asnakech Getenet Ayele, "Revisiting the Ethiopian Bank Corporate Governance system: A Glimpse of the Operation of Private Banks," **Law, Social Justice & Global Development Journal** (2013). P. 27. See also Minga Negashe, "Rethinking Corporate Governance in Ethiopia," **Journal of Economic Literature**, No. K12, K22, L22, M14, M41, N27 (2008), p.2

⁴⁶²Seyoum, (2010) cited in Asnakech Getenet Ayele, supra note 461, P. 27

⁴⁶³Asnakech Getenet Ayele, supra note 461, P. 27

⁴⁶⁴Federal Democratic Republic of Ethiopia, **Growth and Transformation Plan (GTP)** (2011)

⁴⁶⁵The African Development Bank Group Chief Economist Complex, "Ethiopia's Economic Growth Performance : Current Situation and Challenges," **Economic Brief**, Vol.1, No. 5(2010), p.1

⁴⁶⁶Ministry of Finance, supra note 459. The government adopted different laws such as Investment Proclamation No 280/ 2002. It has also ratified the convention establishing the Multilateral Investment Guarantee Agency (MIGA) of

in its Growth and Transformation Plan (GTP) also promised to complete Ethiopia's accession to the World Trade Organization (WTO).⁴⁶⁷ Hence, all the country's activities show that it is on the way to join international transactions. So, the situation is pushing Ethiopia to introduce a standardized non-shareholder directors system taking best theories, international practices and experiences in to account. It is also advantageous because it creates a chance to establish good corporate governance system in our share companies and capacitate them to be competitive and profitable.

Fourth, though it did not happen in Ethiopia so far, the collapse of Enron corp., World com, Tyco, Adelphia, etc. and the recent financial crisis that has materialized on the globe put several countries to learn about the serious consequences of weak corporate governance problems. Thus, Ethiopia has to learn from these incidences and make itself ready, *inter alia*, by introducing non-shareholder directors on boards of share companies for the future, because it has no guarantee that financial crisis would not happened in Ethiopia in the upcoming periods. Comprising boards with non-shareholder directors is also one of the signals of good corporate governance.

Five, the 1960 Ethiopian Commercial Code has been implemented for over half of a century and some of its provisions are outdated⁴⁶⁸ and not fit for modern international commercial transactions and business systems. Thus, it cannot provide an efficient solution for corporate problems like the corporate scandals and financial crises experienced in 1990s and 2008 respectively. Moreover, this Commercial Code is under revision.

Finally, there are also scholars, officers and practitioners that argue for the introduction of the system in Ethiopia. Dr. Solomon Abay argues that these days on the globe, there are movements from corporate social responsibility to shareholders towards to corporate social responsibility to stakeholders.⁴⁶⁹ Accordingly, he says many countries (including Germany) are following the system and have introduced independent directors on boards of their firms.⁴⁷⁰ Hence, it would be wise for Ethiopia to take into cognizance of the global atmosphere and endorse the system.

the World Bank and signed bilateral promotion agreements with a number of OECD (Organization for Economic Cooperation and Development) countries.

⁴⁶⁷ GTP, supra note 464

⁴⁶⁸ Minga Negashe, supra note 461, p.2

⁴⁶⁹ Interview with Dr Solomon Abay, Lecturer, School of Law, Civil Service University, November 19, 2013

⁴⁷⁰ Ibid

Befikadu Gashaw also agrees with introducing non-shareholder directors on boards of Ethiopian share companies particularly insisting on their relevance in following financial reports, auditing activities, etc.⁴⁷¹ Befikadu also argues that he has experienced practically that some share companies are initially appointing non-shareholder professional directors on their boards though they do have mechanisms which makes these directors shareholders later, i.e. through selling or granting shares.⁴⁷² Further, he argues that there were independent persons assuming directorship in two or three financial sectors so far.⁴⁷³ Biniyam Terfa also insists on the introduction of non-shareholder directors considering their professional quality and less prone for influences and interventions.⁴⁷⁴

Alebachew Sitotaw also favors introducing non-shareholder directors. However, he argues that the necessity of introducing non-shareholder directors on boards depends on the nature of share companies.⁴⁷⁵ Accordingly, he is of the opinion that non-shareholder directors may be introduced on boards of non-financial companies. He justifies the situation of non-financial share companies as corrupted, problem fraught and surrounded by many difficulties. He states that:

- ✓ shares are offered for public subscription in limited cases and usually are subscribed among founders;
- ✓ founders are escaping steal the properties of share companies;
- ✓ there are serious disagreements and disputes between the founders or boards of directors and shareholders;
- ✓ there are cases in which incompetent shareholders are appointed as a directors ;
- ✓ directors are influenced by block holders; and
- ✓ share companies are not followed up and supervised adequately by Ministry of Trade.⁴⁷⁶

Hence, Alebachew Sitotaw states that it is wise to introduce experienced, skilled and professional non-shareholder directors on boards of share companies.⁴⁷⁷

⁴⁷¹ Interview with Ato Befikadu Gashaw, supra note 396, 2013

⁴⁷² Ibid

⁴⁷³ Ibid

⁴⁷⁴ Interview with Ato Biniyam Terfa, supra note 361

⁴⁷⁵ Interview with Ato Alebachew Sitotaw, supra note 409

⁴⁷⁶ Ibid

⁴⁷⁷ Ibid

Yoseph Alemu also argues in favor of non-shareholder directors. He mentions that the existing corporate governance problems as the basic ground to introduce non-shareholder directors on boards of non-financial share companies. He states that the governance of non-financial share companies is corrupted and there is loss or theft of property; the directors are not discharging their duties and responsibilities to the maximum; directors are not independent and do not pass objective decisions; directors work is not systematic and organized; etc.⁴⁷⁸ So, Yoseph Alemu has the opinion that introducing non-shareholder directors on boards of non-financial share companies is vital to enhance the quality, decision and independence of boards.⁴⁷⁹

On the other hand, there are also factors which challenge the introduction of non-shareholder directors in the governance of Ethiopian share companies. These are:

First, in the history of corporate governance of Ethiopia, share companies are governed by shareholder directors only. This has worked for over half of a century and the business communities as well as people are accustomed to it. It is hard to break this system. Thus, introducing non-shareholder directors in the composition of boards may not be welcomed particularly by rent-seeking executive officers, directors as well as blocks shareholders of share companies. This is because non-shareholder directors will prevent them from their shirking, sharking and other wrongful activities and ensure companies to be operated in the interests of all shareholders and stakeholders. Further, due to its newness, introducing non-shareholder directors may not be even easily accepted by shareholders, approved by the legislature and interpreted well by courts of law.

Second, non-shareholder directors do not own stocks in companies. They are neither the owners nor investors of companies. So, shareholders may not believe that non-shareholder directors will operate companies in their interests or may be perceived as reckless, ineffective, inattentive, selfish, etc. So, these situations may make shareholders to fear and challenge the introduction of non-shareholder directors in the governance of their share companies.

Third, it would be a problem to get qualified and professional non-shareholder directors. These days, we are observing that board members are paid unfair remuneration, incurred high level of

⁴⁷⁸ Interview with Ato Yoseph Alemu, supra note 358

⁴⁷⁹ Ibid

risk and surrounded by other bad circumstances. As a result, many professional and experienced shareholder directors have begun to decline assuming directorship.⁴⁸⁰ Thus, there might not be any reason which motivates qualified and expert non-shareholder directors to assume directorship in Ethiopian share companies. Moreover, the quality of professional education has also become questionable because of the increase in number of universities, colleges, etc. which offer degrees and diplomas not commensurate with the qualifications and standards demanded by external environment.⁴⁸¹

Fourth, there are also scholars and officers disinterested with introducing non-shareholder directors in the governance of Ethiopian share companies. In fact, these persons do not disregard the advantages that would be gained by the system. But, they feel more comfortable with the existing system. Prof. Tilahun Teshome argues that having independent directors system is still debatable on the globe.⁴⁸² Further, he contends that since non-shareholder directors have no ownership interest, they may be reckless, inattentive, and ineffective in leading firms, and it is not wise to introduce as a system.⁴⁸³ Merga Waqoya is also happy with existing system justifying that the existing companies are working well with the existing system; Ethiopian financial share companies may not incur problems in the coming years due to the close follow up of NBE; and non-shareholder directors are participating on advisory boards of share companies.⁴⁸⁴

4.3. Subject Matters that Need Attention in Introducing Non-shareholder Directors in the Governance of Ethiopian Share Companies

The writer of this thesis has a strong belief on the appropriateness of introducing non-shareholder directors in the governance of Ethiopian share companies. I argue so for different reasons:

It brings numerous advantages to companies, shareholders, stakeholders, society and the country.

⁴⁸⁰Interview with Tilahun Teshome, supra note 453

⁴⁸¹Minga Negashe, "supra note 461, p.2

⁴⁸² Interview with Tilahun Teshome, supra note 453

⁴⁸³ Ibid

⁴⁸⁴Interview with Ato Merga Waqoya, Principal Examiner, Directorate of Banks Supervision, National Bank of Ethiopia, November 25, 2013.

There are a number of factors suitable to introduce non-shareholder directors systems in the domestic regime.

The demerits and challenges that may be faced can be easily overcome and made suitable to the domestic environment.

However, in introducing non-shareholder directors in Ethiopia, we should not simply integrate the system by directly transplanting the experiences of foreign countries. Rather, it would be better to study and assess the environment in domestic regime, learn best theories and international practices and there by develop our own system fit with our regime. However, there are matters in non-shareholder directors system which continue to be contentious till now and need careful consideration. These subjects are several and practiced differently in many countries, but this paper is limited to the appointment mechanisms of non-shareholder directors, their expected standards and qualifications, their number on boards, their roles and responsibilities, their remuneration and the way their compensation and liability should be determined. These issues are the concerns of Ethiopia too and need to be settled appropriately in conformity with the domestic system (particularly in conformity with rules on shareholder directors) and international best practices. Under the sections below, experiences of different countries on subjects have been discussed.

4.3.1. Selection and Appointment of Non-shareholder Directors

Selection and appointment of non-shareholder directors varies from country to country as well as from share company to share company. It may also take different shapes in controlled companies and companies with dispersed ownership. USA and UK follow almost similar system in the nomination and appointment of non-shareholder directors as result of the similarities of the problems they experienced, i.e. managers-shareholders conflict of interests. Thus, both USA⁴⁸⁵ and UK⁴⁸⁶ require their listed companies to establish independent nomination committee to perform the nomination process of non-shareholder directors. In these countries, the

⁴⁸⁵ NYSE, Listed Company Manual (2003) available at <http://nysemanual.nyse.com/lcm>, Para 303A and NASDAQ RULES], available at [http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1_1_4_2&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2,r,5605\(e\)](http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1_1_4_2&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2,r,5605(e))

⁴⁸⁶ Financial reporting council, report of the committee on the financial aspects of corporate governance(19192) available at <http://www.ecgi.org/codes/documents/cadbury.pdf>, para.4.30

nomination committees evaluate various candidates of non-shareholder directors and recommend their appointment for shareholders meetings. But, the nomination committees before they choose nominees, they use diverse methods to evaluate and identify the appropriate candidates, i.e. think about the nominees recommended by external consultants such as recruitment firms, suggestions of diverse industry players and nominations made by managers of firms.⁴⁸⁷ Thereafter, the nomination committees present the nominee non-shareholder directors to shareholders for appointment.

In India, all of the reports made on reformative measures of corporate governance of controlled firms recommend that selection of non-shareholder directors to be made through nomination committee whose chairman and majority members need to be independent directors.⁴⁸⁸ This committee has the responsibility to assess and nominate non-shareholder directors for appointment by shareholders meetings. Hence, promoters or shareholders have the power to approve or reject the appointment of any nominee using their voting rights. The appointment of each director is conducted on individual basis at shareholders meetings by way of a separate resolution and has to be approved by majority of shareholders present and voting.⁴⁸⁹ This situation creates trust and confidence in the market that non-shareholder directors nominated by the nomination committee without the influence of anybody remain independent of potential promoters or block holders.⁴⁹⁰

In china, non-shareholder directors may be nominated by board of directors (the supervisory board), incumbent members of board of directors or a shareholder or shareholders (who independently or jointly have more than 1% stake in the company).⁴⁹¹ Before appointment, nominee non-shareholder directors are required to make public statement assuring that they have no financial ties with the listed company in which they are proposed to assume directorship.⁴⁹²

⁴⁸⁷ Helen Bird, "The Rise and Fall of the Independent Director," **Australian Journal of Corporate Law**(1995) ,p. 251

⁴⁸⁸Vikramaditya Khanna and Shaun J. Mathew, supra note 429, pp.56-57

⁴⁸⁹ Indian Companies Act of 1956, § 263. Available at www.mca.gov.in/ ≥

⁴⁹⁰VikramadityaKhanna and Shaun J. Mathew, "supra note 429, p.57

⁴⁹¹Niu Yuan, "A brief Analysis of the Defects and Countermeasures of the Independent Directors System in China," **International Journal of Law and Management**, Vol.51, No.4 (2009), p.261

⁴⁹²China Securities Regulatory Commission, **Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies** (Aug. 16, 2001). Available at http://www.csrc.org.cn/cn/search/search_detail.jsp?infoid=1061947864100&type=CMS.STD

Thereafter, the respective listed companies are required to submit their nominations of non-shareholder directors for examination and approval by the CSRC.⁴⁹³ Hence, it is only after the nominees are approved by CSRC that shareholder meetings are held on the appointment of non-shareholder directors.⁴⁹⁴

Of the methods mentioned above, I do believe that the selection and appointment process through independent nomination committee is more advantageous. This is because the selection of non-shareholder directors through independent committee helps to keep the independence as well as the quality of the candidates proposed for directorship in companies.⁴⁹⁵ This system also insulates the nominees from the interference of potential shareholders and rent-seeking managers. It also saves the composition of boards from the influence of block holders and rent-seeking managers.⁴⁹⁶

4.3.2. The Proportion of Non-shareholder Directors on Boards

The proportion of non-shareholder directors on boards also varies from country to country as well as from share company to share company. This is valid and same numbers across countries and boards is not expected, because the corporate governance problems experienced in countries as well as in share companies are varied or have different degrees. So, it depends on the very persistence of the problems experienced in a country or in a firm.⁴⁹⁷ However, boards should be comprised of sufficient number of non-shareholder directors, so that they can perform their functions in an objective, professional, impartial, and dispassionate manner and thereby mitigate the experienced governance problems.⁴⁹⁸ Accordingly, in India, clause 49 (I)(A) of the Equity Listing agreement specifies that “where the chairman is an executive or a promoter or related to a promoter or a senior official, then at least one-half the board should be comprised of non-shareholder directors; in other cases, non-shareholder directors should constitute at least one-third of the board size.”

⁴⁹³ Jiang Yu Wang, *supra* note 305, p.51

⁴⁹⁴Chien-Chung Lin, Independent Directors in China (March 9, 2006), p.2, Accessed at http://www.waseda.jp/law-school/jp/keisei/pdf/action1_17_07.pdf viewed on November 11, 2013

⁴⁹⁵Anil Shivdasani and David Yermack, “CEO Involvement in the Selection of New Board Members: An Empirical Analysis,” *The Journal of Finance*, Vol. 54, No.5 (1999), p.1851

⁴⁹⁶Umakanth Varottil, *supra* note 254, p.25

⁴⁹⁷Donald E. Pease, *supra* note 348, p.34

⁴⁹⁸Umakanth Varottil, *supra* note 254, p.17

In China, the CSRCs “Guidance Opinion on the Establishment of Non-shareholder Director System in Listed Companies” (August, 2001) requires boards of listed companies in China to be constituted at least one third of non-shareholder directors.⁴⁹⁹ In France, the Bouton report made all French listed companies with dispersed capital and without controlling shareholders to compose their boards with half of non-shareholder directors.⁵⁰⁰ In the UK, boards are made to comprise at least half of non-shareholder directors⁵⁰¹ and in the USA, NYSE and NASDAQ make it mandatory that all listed companies to be comprised of majority of non-shareholder directors.⁵⁰² Thus, when we introduce non-shareholder directors, we should fix their proportion on the basis of the type and degree of corporate problems experienced in the country or in the firm.

4.3.3. The Roles and Responsibilities of Non-shareholder Directors

The other subject matter that needs to be considered is what roles and responsibilities should non-shareholder directors assume? Should they carry out roles and responsibilities the same with shareholder directors or should they shoulder different tasks and duties? When we determine the roles and responsibilities of non-shareholder directors, it is necessary to consider “the modern day corporate governance, the board of directors and the inter-relation of non-shareholder directors within this framework in achieving the objectives of any enterprise.”⁵⁰³ Hence, non-shareholder directors may assume diverse forms of tasks and duties in different countries and share companies subject to the corporate governance principles and listing requirements applied and practiced. It may also vary in companies with dispersed ownership and controlled companies. No matter how, non-shareholder directors, as we may learn from the experiences of different countries, share companies and academic literatures, may perform the following roles:

⁴⁹⁹Jie Yuan, “ Formal Convergence or Substantial Divergence?,” *Asian-Pacific Law and Policy Journal*, Vol.9, Issue.1(2007), p.81

⁵⁰⁰Bouton Committee, supra note 290

⁵⁰¹ Derek Higgs, supra note 250

⁵⁰² NYSE, supra note 485

⁵⁰³ S. Gopalakrishnan, role and responsibilities of independent directors (2005), p.861. Accessed at www.icaai.org/resource_file/10500jan05p861-866.pdf visited on November 9, 2013.

First, non-shareholder directors have roles towards shareholders and stakeholders. Non-shareholder directors work to serve the interests of shareholders as well as stakeholders.⁵⁰⁴ As we know non-shareholder directors are directors who have not owned any stock in companies and thereby less dependent on the managements and corporations. Thus, they ensure transparency and bring balance towards resolving conflict areas. They have significant role in influencing the decision of boards as well as managements to respect and protect the interests of individuals or group of stakeholders. They closely monitor and oversee the conducts of managers and other fellow directors and prevent them from abusing the assets of firms to enhance shareholders' and stakeholders' interests.⁵⁰⁵ Non-shareholder directors also serve as watchdog of block shareholders on the behalf of minority shareholders.⁵⁰⁶ They ensure the assets of companies to be used for all shareholders alike.⁵⁰⁷

Second, non-shareholder directors are Strategic advisors. Non-shareholder directors may also be a strategic advisor to the managements, fellow directors and block shareholders by sharing their knowledge, experience, skills, perspectives and different information on diverse business matters.⁵⁰⁸ They lesson the perceptions of different customers and clients, assess the market demands, determine the needs and interest of the people, produce products or services satisfying the interests of diverse people, propose plan to reach out in different market places and create strong ties with different cultures, peoples and norms, so that they, through their strategic advising, enhance the value of firms.

Third, non-shareholder directors have roles towards to the board. Non-shareholder directors have, as member of boards, also similar roles as that of other directors (shareholder directors).⁵⁰⁹ However, non-shareholder directors are primarily expected to come up with different cognitive elements such as different views, ideas, skills, information, specialist knowledge and wide

⁵⁰⁴Mervin Messias, Non-executive Directors (Gauteng Law Council) Available at <http://www.gautenglaw.co.za/content/index.cfm?navID=7&itemID=72> Accessed on January 02, 2014

⁵⁰⁵Rob Dixon, Keith Milton and Anne Woodhead, "An investigation into the role and effectiveness and future of non-executive directors," **Journal of General Management**, Vol. 31, No.1(2005) , p. 3

⁵⁰⁶Mervin Messias, supra note 504

⁵⁰⁷ Ibid

⁵⁰⁸Ruth Barratt and Nada Korac-Kakabadse, " Developing Reflexive Corporate Leadership: The Role of the Non-executive Directors," **Corporate Governance** , Vol. 2, No. 3(2002), p. 33

⁵⁰⁹Vinod Kothari, Role and Responsibilities of Independent Directors under the Companies Act. Available at <http://www.scribd.com> ≥

experience to all key decision making, performance and risk evaluation affecting the company.⁵¹⁰

In addition to their roles, non-shareholder directors have also responsibilities similar to shareholder directors.⁵¹¹ Hence, they are required to observe their fiduciary duties of care, diligence, impartiality and acting in good faith.⁵¹² It is also necessary for non-shareholder directors to “prepare themselves thoroughly for meetings; be objective in forming decisions; be open minded; be free and frank expressing their opinion, be committed to decisions of the board, continuously seek information from inside or outside, be informed on laws and regulations and utilize the expertise they possess to the good advantage of the company.”⁵¹³

4.3.4. Remuneration of Non-shareholder Directors

The remuneration of non-shareholder directors also brings varying concerns. It involves diversities on compensation mechanisms, i.e. is it fair, too low or excessive? It is also tough to specify clearly whether the remuneration of non-shareholder directors should resemble the compensation packages of shareholder directors and CEOs. Thus, when we deal with remuneration of non-shareholder directors, these things have to be clearly addressed.

Certainly, non-shareholder directors assume several extra roles and responsibilities in addition to the roles and duties they share with shareholder directors. They work under different environments. They are influenced by their fiduciary duties because if they fail to meet their obligations, they are liable for damages.⁵¹⁴ They are influenced by their own aspiration to create and maintain good reputation because if they fail to secure their good reputation as a monitor, they may not get any external directorship in the market.⁵¹⁵ They do assume huge tasks and monitor the conducts of managers in firms under diverse influences and environments. Non-

⁵¹⁰Nick Gould, The Role of the Non-executive Directors: An Overview (2008), p.2. Available ≤at <http://www.incelaw.com/>≥

⁵¹¹Vinod Kothari, supra note 509

⁵¹²Bernard S. Black, The Principal Fiduciary Duties of Boards of Directors (Presentation at Third Asian Roundtable on Corporate Governance, Singapore, April 4, 2001), pp1-12.

⁵¹³S. Gopalakrishnan, supra note 503, p.865

⁵¹⁴Price water house Coopers (PWC), Non-executive Directors’: Practices and Fees Trends Report (South Africa, 2013), p.42

⁵¹⁵Rudieger Fahlenbrach, Angie Low and Rene M. Stulz, “The Dark Side of outside Directors: Do they quit when they are most needed?,” Charles A. Dice Center, Working Paper No. 2010-7(2013),p.2.

shareholder directors also like financial incentives.⁵¹⁶ Thus, to recognize their effort and motivate them for more works, there shall be incentives for non-shareholder directors. Accordingly, there are legal and structural mechanisms which provide for incentives for non-shareholder directors to make them think like shareholders about firms.⁵¹⁷

Non-shareholder directors have legitimate authority to determine their remuneration within the limitations provided and subject to the approval of shareholders meetings.⁵¹⁸ Traditionally, non-shareholder directors are awarded with different components of compensation for their service, i.e. they may be paid in the form of cash compensation, stock option award, stock grant and in addition, they often are awarded with pension plan for certain number of years after retirement.⁵¹⁹ Though these are some of the compensation mechanisms secured for non-shareholder directors, it is not wise to pay them too low or too excessive. If their remuneration is too low, they may be discouraged to ensure corporate governance and protect the interests of shareholders, stakeholders and firms. They may be ineffective, passive and may not be able to control and prevent agency related problems. On the other hand, if their remuneration is too excessive, they may be less independent and form ties with the managements as well as corporations. Thus, they may not perform those roles and responsibilities expected from them. Rather, they have to be awarded with fair compensation commensurate with their performance as well as wealth and turnover of companies.⁵²⁰

In recent periods, in some countries, it has been said that the remuneration of non-shareholder directors is too low. For instance, in India, in an interview made with independent directors, it was found out that their payment is insufficient and imbalance to their increased liabilities and other nuisance risks they incur outside their control.⁵²¹ However, a reform measure had been taken as per CII (Confederation of Indian Industry) report which recommended non-shareholder directors to receive adequate sitting fees which have to be calculated on the basis of companies'

⁵¹⁶Tod Perry, "Incentive Compensation for Outside Directors and CEO Turnover", **Journal of Economic Literature**, No.G30 and G34(2000), p.3

⁵¹⁷Ibid, p.4

⁵¹⁸ Stephen Bryan, et al, "Compensation of Outside Directors: An Empirical Analysis of Economic Determinants," **New York University**, Working Paper No. 2451/27453 (2000), p.9

⁵¹⁹Ibid, pp. 9-11

⁵²⁰ King Report III. See also Tom Wixley and Geoff K. Everingham, **What You must Know About Corporate Governance** (Cape Town: Siber Link, 2002), p. 67

⁵²¹Vikramaditya Khanna and Shaun J. Mathew, supra note 429, p.63

net worth and turn over.⁵²² But, the report, to keep non-shareholder directors independent and enable them objectively perform their monitoring activities, prohibited the issuance of stock options or profit linked compensations.⁵²³ Non-shareholder directors in Singapore also feel their remuneration is low.⁵²⁴

Opposing this, there is a group which argues that the remuneration paid to non-shareholder directors is excessive. This group also quarrels that board members are not paid amounts commensurate with their performance; rather, they are inactive, unproductive, and dependent and do not try to prevent agency problems from occurring with sitting management.⁵²⁵

But, there is also a third group which disagrees with the above criticisms and concludes that the compensation paid to non-shareholder directors these days is fair. This group argues that the compensation mechanisms provided are centered on agency cost reduction and are similar to the mechanisms of remuneration paid to CEOs.⁵²⁶ However, they hold that the remuneration of non-shareholder directors is increasing.⁵²⁷

Any ways, now, we are observing that the compensation paid to non-shareholder directors began to be measured in terms of pre-determined standards and elements and hence, non-shareholder directors are entitled to a payment which is determined in terms of a percentile rate of established norms.⁵²⁸ This mechanism is safe and avoids unnecessary controversies on compensation. This would be better if regulators introduce remuneration committee comprising of independent directors.⁵²⁹ This committee sets the remuneration of non-shareholder directors to be fair and in conformity of the financial stability and future performance of companies. It also prevents excessive compensation of directors.

⁵²²Report of the CII Task Force on Corporate Governance, Corporate Governance: Recommendations for Voluntary Adoption(2009) , p.3

⁵²³Ibid

⁵²⁴Wong Meng Meng, “Directors Nomination and Remuneration-Some Thoughts”, (2007), p.5. Accessed at <http://www.icsa.co.za/documents/2010SpeakerPresentations/JacquiBaumgardt.pdf> ≥ viewed on December 01, 2013

⁵²⁵ Stephen Bryan, et al, supra note 518, pp.1-2

⁵²⁶ Ibid, pp.1

⁵²⁷Oppermann, 1997; Schellhardt, 1999; Perry, 1999 Cited in Stephen Bryan, supra note 518, p.1

⁵²⁸Wong Meng Meng, supra note 524, p.4

⁵²⁹Tshepo Mongalo, Corporate Law and Corporate Governance: A Global Picture of Business Undertakings in South Africa (New Africa Education, 2003), P. 225

4.3.5. Liability of Non-shareholder Directors

There are also questions on the liabilities of non-shareholder directors. Thus, we have to closely consider how their liabilities should be determined. Should they be subject to similar liability standards of shareholder directors or to a different system? Should their liabilities go to the extent of the amount of their compensation or go beyond and make them incur out-of-pocket liabilities?

Historically, it is a worldwide norm to make non-shareholder directors to incur near zero personal liability.⁵³⁰ The reason why non-shareholder directors incur small risk of out-of-pocket liability is attributable to different reasons such as:

- ✓ incorporation of different provisions which put procedural barriers to bring suits against non-shareholder directors;
- ✓ establishment various indemnification mechanisms by companies which aim at reimbursing expenses incurred by non-shareholder directors ;
- ✓ recognition of directors and officers liability insurance policies (D&O) and incentives; and
- ✓ establishment of other mechanisms which facilitate settlement of cases that save non-shareholder director from incurring any expenses.⁵³¹

However, there are two arguments on this historical persistence of non-shareholder directors low risk personal liability, i.e. those who argue for or against low level of personal liability. Those who argue for the tough out-of-pocket liability justified that if liability is remote, non-shareholder directors may be slack off and fail to satisfy their roles and responsibilities.⁵³² They could be reckless, passive, ineffective and fail to oversee the managers in a meaningful way.⁵³³ It

⁵³⁰Boris Feldman, "Directorial Liability: Tips for Outside Directors on Minimizing Personal Exposure in Shareholder Lawsuits"(2002), p.1. Available at <http://www.borisfeldman.com/directors.html> ≥. viewed on February 10, 2014

⁵³¹ Bernard Black, Brian Cheffins and Michael Klausner, "Outside Director Liability," **Stanford Law Review**, Vol.58(2006), P. 1062,

⁵³² Lisa M.Fairfax, supra note 418, p.172

⁵³³ Ibid

also allows ineffective and careless non-shareholder directors to settle their liabilities through their personal mechanisms' and continue their directorship on boards which is devastating.⁵³⁴

On the other hand, it has also been suggested that the near-zero personal liability of non-shareholder directors is better and brings many advantages than the toughened one. For that, they suggest the following justifications:

First, non-shareholder directors may not always become attentive watchdogs of managers fearing personal liability.⁵³⁵ They also become efficient and effective in monitoring the conducts of managers due to diverse incentives such as cash compensations, stock options awards, etc.⁵³⁶ So, incentive mechanisms motivate non-shareholder directors to be productive and ensure good corporate performance in contrast to the impacts of personal liability which brings downside risks.

Second, reputation also motivates non-shareholder directors to work effectively.⁵³⁷ Non-shareholder directors are outside directors and hence, unless they perform effectively, they might not get directorship in any other external firms. So, to secure their reputation, non-shareholder directors efficiently monitor the conducts of managers; prevent shirking or sharking of the assets of firms;⁵³⁸ and issue an opposing or dissenting opinion.⁵³⁹

Third, if non-shareholder directors are made to incur tough out-of-pocket liability, they will not get interesting upside benefits; rather, they incur a wider scope of personal liability. So, they will be forced to incur downside risks and thereby adopt extensive precautions and bureaucratic procedures which in turn affect the performance of boards and interests of shareholders.⁵⁴⁰

⁵³⁴ Bernard Black, Brain Cheffins and Michael Klausner, "Outside Director Liability: A Policy Analysis," **Journal of Institutional and Theoretical Economics**(2006),p.10

⁵³⁵ Lisa M. Fairfax, supra note 418, p.172

⁵³⁶ Scott(1983), cited in Bernard Black, Brain Cheffins and Michael Klausner, supra note 534, p.10

⁵³⁷ Fama and Jensen (1983) cited in Mohamed Belkhir, supra note 347, p.6

⁵³⁸ Jeffrey N. Gordon, supra note 252, p.1488

⁵³⁹ Karen Lin, et al, "Exit as Voice: The Unintended Consequence of Independent Director Resignations in an Emerging Economy"(April 2, 2011), p≤ 18. Accessed at <http://areas.kenan-flagler.unc.edu/Accounting/Documents/2011%20GIA%20Conference/Exit%20as%20Voice.pdf> ≥ visited on November 11, 2013

⁵⁴⁰ Bernard Black, Brain Cheffins and Michael Klausner, supra note 534, p.12

Fourth, increased out-of-pocket liability also discourages other professional non-shareholder directors to assume directorship in firms.⁵⁴¹ An increment of personal liability has an impact on the supply of qualified, expertise and professional non-shareholder directors. This situation particularly affects those wealthy individuals because they, in many cases, became wealthy as result of efforts of qualified and business expertise of non-shareholder directors.⁵⁴² Moreover, it also badly affects the performance of boards and corporate governance.

Therefore, the near zero personal liability for non-shareholder directors seems a sensible policy. This is because the potential benefits of near zero personal liability outweigh the benefits of increased out-of-pocket liability. Moreover, the costs incurred in changing the present near zero personal liability may not be balanced with the benefits to be received, because increased out-of-pocket liability discourages qualified nominees from serving on boards, causes counterproductive, and forces non-shareholder directors to adopt extensive precautions and bureaucratic procedures.⁵⁴³

In the US, the corporate law specifies that non-shareholder directors owe duty of care and loyalty to their firms.⁵⁴⁴ US security law also specifies that non-shareholder directors are liable for misstated information in public offering of securities.⁵⁴⁵ Moreover, non-shareholder directors are liable under different legal regimes.⁵⁴⁶ In the US, different from other countries, the system is more designed to serve litigation against directors. Further, litigants pay their own legal expense whether win or lose; derivative and class action suits are permitted;⁵⁴⁷ and attorneys are seen as entrepreneurs who seek out legal violations and suitable clients rather than waiting passively for prospective litigants to come to them.⁵⁴⁸ Accordingly, there are many suits brought against non-

⁵⁴¹Robert W. Hamilton, "Reliance and Liability Standards for Outside Directors," **Wake Forest Law Review**, Vol.24, No.1 (1989), P.28

⁵⁴² Bernard Black, Brian Cheffins and Michael Klausner, supra note 534, p.12

⁵⁴³ Ibid, p.1

⁵⁴⁴ David I. Michaels, "No Fraud? No. Problem: Outside Director Liability for Shelf Offerings Under Section 11 of the Securities Act of 1933," **Review of Banking and Financial Law**, Vol. 28(2009), pp.370-371

⁵⁴⁵ Securities Act of 1933 of US, Section. 11

⁵⁴⁶ William A. Knepper, and Dan A. Bailey, Liability of Corporate Officers and Directors, volume 1 (6th ed., 1998) cited in Brian R. Cheffins, Bernard S. Black and Michael Klausner, "Outsider Directors, Liability Risk and Corporate Governance: A Comparative Analysis," **ECGI – Law**, Working Paper No. 48 (2005), p.7

⁵⁴⁷ Kevin M. LaCroix, "Outside Director Liability: Increased Risks and Practical Considerations," (2006), p.3

⁵⁴⁸ Coffee (1986) cited in Brian R. Cheffins, Bernard S. Black and Michael Klausner, "Liability Risk for Outside Directors; A Cross-Border Analysis," **European Financial Management**, Vol.11, No.2 (2005), p.156

shareholder directors every year, but none of these cases brought tough out-of-pocket liability for non-shareholder directors.⁵⁴⁹ In the period between 1991 and 2003, it is only in two cases that non-shareholder directors incurred out-of-pocket liability.⁵⁵⁰ The reason why non-shareholder directors did not incur increased out-of-pocket liability is due to procedural barriers, indemnification systems and directors and officers (D&O) insurance plans.⁵⁵¹

In countries such as Australia, Britain, Canada, France, Germany and Japan, the liability of non-shareholder directors arise from three instances, i.e. from the duties non-shareholder directors owe to companies; the rights of shareholders to bring suit against directors ;and severe financial distresses.⁵⁵² In these countries, non-shareholder directors are subject to civil liabilities, criminal sanctions and administrative penalties specified under their company law and diverse legal regimes.⁵⁵³ Moreover, non-shareholder directors receive a less protection for out-of-pocket liability than in the US and the only layers of protection designed are indemnification and D&O insurance plans.⁵⁵⁴ However, there are systems which discourage suit against non-shareholder directors.⁵⁵⁵ But, still the risk of non-shareholder directors is not near zero personal liability. In each country, non-shareholder directors are made to pay “damages or a related financial penalty, or could have been in this position with a minor adjustment of the facts”.⁵⁵⁶ Thus, in these countries the risk of out of pocket liability is small but not absent.⁵⁵⁷

⁵⁴⁹ Brian R. Cheffins and Bernard S. Black, “Outside Director Liability Across Countries,” **Texas Law Review**, Vol.84 (2006), p.1387. See also Roger W. Wells, “Corporations – Outside Directors’ Liability for Breach of Fiduciary Duty to Investigate- Doyle v. Union Insurance Co., 202 Neb.559, 277 N. W. 2d 36(1979),” **Creighton Law Review**, Vol. 13, No. 1(1979)

⁵⁵⁰ Brian R. Cheffins, Bernard S. Black and Michael Klausner, supra note 546, p.9

⁵⁵¹ Jiangyu Zhu, “Liability of Outside Directors and Corporate Governance-A Comparative Study,” **Perspectives**, Vol. 3, No.2, pp. 7-9

⁵⁵² Brian R. Cheffins, Bernard S. Black and Michael Klausner, supra note 548, p.164

⁵⁵³ Ibid

⁵⁵⁴ Brian R. Cheffins, Bernard S. Black and Michael Klausner, supra note 546, p.18

⁵⁵⁵ Bernard S. Black, Brian R. Cheffins, and Michael Klausner , “Shareholder Suits and Outside Director Liability: The Case of Korea,” **Journal of Korean Law**, Vol.10, No.2 (2011), pp.336-342

⁵⁵⁶ Brian R. Cheffins, Bernard S. Black and Michael Klausner, supra note 546, p.22

⁵⁵⁷ Bernard S. Black, Brian R. Cheffins, and Michael Klausner , supra note 555, pp.336-342

Chapter Five

5. Conclusion and Recommendations

5.1. Conclusion

Human beings do have individual taste, demand and interest on objects so far as they exist on the globe. For that, they engage in different undertakings. Of these activities, business is the basic one. A business is an institution organized and operated to provide goods and services to the society in financial, commercial or industry aspects with the objectives of earning profits, benefits, advantages or livelihoods. It is “an incorporeal movable consisting of all movable property brought together and organized for the purpose of carrying out any of the commercial activities specified in Art.5 of Commercial Code.”

Share Companies are one aspects of businesses in which human beings engage to earn profits, benefits, advantages or livelihoods. According to Article 304 (1) of the Commercial Code, share companies are companies whose capital are fixed in advance and divided into shares and whose liabilities are met only by their assets. Though share companies are owned by shareholders, their management is, due to lack of information, resources and dispersed ownership, given to other bodies, i.e. directors, managers and other officers. The managements of companies, generally named as corporate governance, have the responsibility to run companies in the interests of both shareholders and stakeholders.

However, the collapse of Enron Corp, World Com Inc, Global Crossing Ltd, and other big firms and the financial crisis experienced since 2008 press countries on the globe to look at corporate governance seriously and take reformative measures on the composition of their boards. These reformative measures have been taken by governments, stock exchange markets and shareholders with their own motivation and target at introducing non-shareholder directors (professional and qualified independent, non-executive and stakeholder directors) in the governance of firms hoping they would enhance the capacity of boards to monitor the conducts of managers or block holders to protect the interests of shareholders or minority shareholders respectively. These reformative activities are supported by diverse theories, research works, scholars and even by the public hoping that they would enhance corporate governance and

companies' performance. However, there are also scholars and empirical works that challenge the introduction of non-shareholder directors in the governance of firms.

These days, the idea of non-shareholder directors became a worldwide interest and adopted in different jurisdictions. Some countries are also preparing themselves to integrate the system with their domestic regime. Thus, there are different experiences and practices on the emergence of non-shareholder directors on the globe.

Accordingly, USA took the pioneer in adopting non-shareholder director system just following the collapse of its giant firms such as Enron, World Com and others as a solution to the manager-shareholders agency problem experienced in the country. For that matter, USA enacted Sarbanes-Oxley Act, NYSE and NASDAQ which require all listed companies to be composed of majority of non-shareholder directors. Following the US, the UK also integrated non-shareholder directors system which is almost similar to that of the US as result of the similarity of corporate problems experienced in their companies. In the UK, the base for this system was laid by Cadbury Committee Report. Later on, the Higgs report suggested at least half of the members of boards be consisted of non-shareholder directors and this has also been reflected in the current version of the UK Combined Code of 2008. The idea of non-shareholder directors also spreads out across countries of the globe such as France, China, South Africa and Francophone West African Countries (OHADA). However, consequent to these reformative measures, different studies were conducted in the above mentioned countries on the relationships between non-shareholder directors and firms performances. The research works conducted reveal two opposite results, i.e. some findings showed that non-shareholder directors are vital to enhance good corporate governance and firms' financial performances whereas other studies found negative relationships between non-shareholder directors and firms' financial performances. The only exception is South Africa where all researches showed that there are significant positive relationships between non-shareholder directors and firms' performances.

In Ethiopia, non-shareholder director is not recognized. The Commercial Code and other relevant laws prohibit boards of share companies from composing non-shareholder directors. On the top of that the Commercial Code does not specify competitive qualifications needs to be satisfied to assume directorship. Thus, incompetent shareholders may assume directorship in Ethiopian share companies.

This paper, having considered these and other corporate governance problems, dealt on merits and demerits of introducing qualified and professional non-shareholder directors in the governance of Ethiopian share companies. So, it, considering different theories, research works, suggestions of scholars, best international practices and the domestic situation, determined that introducing non-shareholder directors in the governance of Ethiopian share companies brings more advantages. For instance, introducing non-shareholder directors in the governance would:

- ✓ enable boards to look at stakeholders concerns as a governance mechanism;
- ✓ vital for the survival of companies;
- ✓ enhance the quality of boards and the performance of companies;
- ✓ help boards to get the business experience, working knowledge of strategic decision making and internal firm operations, alternative view points and information on how similar issues and concerns are dealt with in other companies from each non-shareholder director; and
- ✓ increase boards human capital such as expertise, experience, knowledge, reputation and skills and relational capital like links to strategically relevant enterprises, etc

The paper also determined that non-shareholder directors system may have some counterproductive effects. So, non-shareholder directors:

- ✓ may not be suitable to solve matters that necessitate verifiable or correct answer;
- ✓ affect boards' cohesiveness;
- ✓ consume more time on firms issues;
- ✓ subject boards to multiple principals;
- ✓ bring multitask problems;
- ✓ undermine the right to private property of shareholders;
- ✓ face lack of information; etc.

In Ethiopia, although there are challenges, there are plenty of factors which facilitate the inclusion of non-shareholder directors in the domestic regime. For instance,

- ✓ the government has adopted free market economic policy since 1991;
- ✓ more share companies with dispersed ownership are being formed in which agency problem and other corporate governance issues are indeed inevitable;

- ✓ our economy is emerging and developing in fastest rate;
- ✓ our firms began to invest in some foreign countries;
- ✓ the government actively working in inviting investors; there are multiple corporate governance problems need quick and efficient responses; the commercial code is under revision; etc.

However, the writer of this thesis has a strong belief on the appropriateness of introducing non-shareholder directors in the governance of Ethiopian share companies because of the following reasons:

- ✓ It brings numerous advantages to companies, shareholders, stakeholders, society and the country.
- ✓ There are a number of determinants suitable to introduce non-shareholder directors systems in the domestic regime.
- ✓ The demerits and challenges that may be faced can be easily over come and made suitable to the domestic environment.

However, when we introduce non-shareholder directors in the governance of Ethiopian share companies, there are subjects need to be addressed in light of international best practices. Accordingly, foreign best experiences show that: First, the selection and appointment process of non-shareholder directors is made through independent nomination committee. This keeps the independence and quality of candidates supposed for directorship in companies. Second, the proportion of non-shareholder directors on boards is fixed on the basis of the type and degree of corporate problems experienced in a country or in a firm. Fourth, remuneration is determined through remuneration committee composed of independent directors. This serves the remuneration of non-shareholder directors to be fair and in conformity with the financial stability and future performance of companies. It also prevents excessive compensation of directors. Finally, non-shareholder directors, historically, are subjected to near zero personal liability and this seems a sensible policy. Increased out-of-pocket liability discourages qualified nominees from serving boards, causes counterproductive and forces non-shareholder directors to adopt extensive precautions and bureaucratic procedures.

5.2. Recommendations

International experiences show that there is an increasing move towards including non-shareholder directors in the governance of share companies. However, Ethiopia did not introduce non-shareholder directors and joined the system so far. The writer of this thesis, after cognizance of the current corporate governance problems and determines the advantages and disadvantages of non-shareholder directors, concluded that non-shareholder directors should be introduced in the country. But, this does not mean that non-shareholder directors produce complete solutions to the corporate problems saw in Ethiopian share companies and are guarantee to the future. Rather, they can reduce the problems in a considerable manner and relax the tension. But, this needs the attention and co-operation of different bodies such as the government of Ethiopia, share companies and non-shareholder directors themselves. For that, the writer would like to recommend the followings.

I. Recommendations to the government

- ❖ The government should revise its company law in conformity with the real situations of the country, international standards and best practices. Particularly Art 347(1) of the Commercial Code and Art 5 of NBE directive No.SBB/49/2011 shall be amended.
- ❖ The government should start a program on corporate governance, *inter alia* , provide training, education and workshop on corporate governance, non-shareholder directors and their merits, demerits, remuneration and liability, etc. to diverse target groups such as:
 - ✓ company directors(shareholder and non-shareholder directors);
 - ✓ officers;
 - ✓ shareholders;
 - ✓ potential investors (domestic or foreign);
 - ✓ financial and non-financial institutions;
 - ✓ judges; and
 - ✓ professional such as lawyers, accountants, etc
- ❖ The government as well as share companies should establish appropriate legal and structural frameworks which ensure efficient compensation system to non-shareholder directors. There should be a pre-determined standards and elements, so that non-shareholder directors are entitled to a remuneration determined on the basis of a percentile rate of established norm.

This would be better if regulators introduce remuneration committee composed of independent directors.

- ❖ The government should ensure non-shareholder directors to incur near zero personal liability through different mechanisms. This may be through:
 - ✓ adopting laws which set procedural barriers to bring suits;
 - ✓ establishing indemnification mechanisms by companies;
 - ✓ applying different incentive mechanisms;
 - ✓ establishing other mechanisms that do not force non-shareholder directors to pay to settle cases, etc
- ❖ The government should adopt a law which saves non-shareholder directors from being accountable to multiple principals, i.e., to both shareholders and stakeholders. Non-shareholder directors should be made accountable to shareholders and not to stakeholders because they receive their legitimate authority from the investors.
- ❖ The government as well as share companies should set pre requisite standards such as integrity, probity and high ethical standards to non-shareholder directors.
- ❖ The government as well as share companies should devise mechanisms which keep the independence of non-shareholder directors, i.e. reducing directors' length of service, increasing board diversity or giving added consideration to social ties in the definition of independent directors, etc.

II. Recommendations to share companies

- ❖ Share companies should appoint equal proportion of professional, experienced and skilled non-shareholder directors (who are relevant to pass complete decisions on concrete and complex problem), and issue relevant non-shareholder directors (who are capable of determining correct answers to problems).
- ❖ Share companies should establish mechanisms which ensure both shareholder and non-shareholder directors to work together with co-operation and maintain boards' cohesiveness by bringing tasks that are involving, attractive or intrinsically interesting and involve performance goals.

- ❖ Share companies should establish mechanisms which facilitate as well as oblige non-shareholder directors to be attentive, familiar with companies and their organizations and be informed.

III. Recommendations to non-shareholder directors

- ❖ Non-shareholder directors should develop elaborated mechanisms for obtaining feedbacks, greater attention to signals suggesting failure and greater willingness to change boards' decision in the face of negative feedbacks.

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