

ADDIS ABABA UNIVERSITY
COLLEGE OF LAW AND GOVERNANCE STUDIES
SCHOOL OF LAW



ASSESSING CORPORATE GOVERNANCE OF ETHIOPIAN PRIVATE LIMITED COMPANIES: WITH PARTICULAR EMPHASIS ON MAKING BOARD OF DIRECTORS COMPULSORY TO SUCH COMPANIES.

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A THESIS SUBMITTED IN PARTIALFULFILMENT FOR THE REQUIRMENTS OF
MASTERS DEGREE OF BUSINESS LAW /LL.M/

ADDIS ABABA

APRIL 2014

ADDIS ABABA UNIVERSITY
FACULTY OF LAW AND GOVERNANCE
SCHOOL OF GRADUATE STUDIES

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DECLARATION

I, the undersigned, declare that the thesis is my original work and has not been presented for a degree in any other university and that all sources of materials used in the thesis have been duly acknowledged.

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Acknowledgment

First and for most, I would like to praise the almighty God for giving me the second chance and all the strength and hope to accomplish my post graduate studies.

I am very thank full to my advisor Zekarias Keneaa (Associate Professor of Law at Addis Ababa University) for his patience in going through the draft of this paper. His insightful comments were also invaluable assets for the paper. He also scrutinizes the draft paper with his usual verb and diligence. It is really honorable to be under his decision and receive his comments and advice.

I am also indebted to Tilahun Teshome/Professor at Addis Ababa University, faculty of Law/ for his cooperation in conducting interviews and for his graciousness in responding to my questions.

My parents, I have no words to say thank you. Thousands of words do not express the passion what I have to mother and father. I am deeply indebted to my Dad/Alamirew Moges/ and Mom/Lingerish Admasie/ who has struggled over the years for a brighter future and supported me throughout my life and this study. My sister Alamine Alamirew/ pass away since I was grade 7/ I don't fail to remember you forever. Miss you much my sister. Oh God! Bless and Place her soul in your commune.

Abstract

In Ethiopia, Private limited companies have increased in number, size and complexity and they require more complex organizational structures and a more diverse workforce possessing various levels and areas of expertise. In light of internationally recognized best practices and principles of corporate governance and based on the available data and literature, this paper attempts to show the deficiency of the Commercial Code in addressing current issues in corporate governance of private limited companies related to absence board of directors in the governance structure, conditional ordinance of shareholders meeting and auditors appointing, the minimum two person mandatory requirement for the formation of such companies and issues regarding conflict of interest. The sketchy nature of the provisions of the Commercial Code that govern private limited companies and lack of reference to share companies' provisions worsen those problems.

Accordingly, the paper provides crucial recommendations based on internationally recognized principles and practices of corporate governance of private limited companies as they are expected to address the basic governance problems of Ethiopian private limited companies. The writer recommends that it is essential to formulate the contemporary corporate governance rules to the private limited companies in Ethiopia particularly making board of directors compulsory to the governance of such companies. Making private limited companies to have a governance board that should have an appropriate mix of knowledge, skills and experience is very vital to make private limited companies effective and value add to the country's growth.

Acronyms

PLC	private limited company
BoD	board of directors
CEO	Chief Executive Officer
OECD	organization for economic cooperation and development
CC	civil code
Proc	Proclamation
Art	Article
OHADA	Organisation pour l'Harmonisation en Afrique du Droit des Affaires' or Organization for the Harmonization of Business Law in Africa
ASX	Australian Security Exchange
USA	United States of America
ND	No Date
AACCSA	Addis Ababa Chamber of Commerce and Sectoral Association
EU	European Union
NBE	National Bank of Ethiopia
WTO	World Trade Organization
GmbH	Limited Liability Company (Gesellschaft mitbeschränkter Haftung,) of Germany
SOEs	(state-owned enterprises)
Unlisted companies	private limited companies
Listed companies	public/share companies
SARL	/Société à responsabilité limitée/
SA	/Société Anonyme/
SIDA	Swedish International Development Agency

Introduction to the study

The 1960 Commercial Code of Ethiopia /hereinafter the Commercial Code/ incorporates provisions pertinent to the governance of private limited companies. However, such provisions are inadequate to address specific issues in corporate governance related to board of directors, shareholders meeting, auditors and the mandatory requirement of two shareholders for the formation of private limited companies /hereinafter PLCs/. This study examines the law pertinent to the governance of private limited companies in Ethiopia with specific reference to the necessity of board of directors to such companies, shareholders meeting and appointment of auditors' base on the number of shareholders, the issue of conflict of interest and the mandatory requirement of two shareholders for the formation and existence of private limited companies.

To address these problems the study is divided into five chapters. The first chapter is all about the proposal of the study in which it discusses about the background, question, literature review and scope and significance of the study. Chapter two discusses on the corporate governance in general. In this chapter the study addresses the concept of corporation, definition of corporate governance, principles and factors that shape corporate governance, the concept of boards of directors and corporate governance and the role that board of directors' play in company governance.

Chapter three is all about the concept of corporate governance in private limited companies. In this chapter the writer discusses on the nature of private limited company, the rationale behind studying governance of PLCs, what seems corporate governance and role of board of directors of PLCs in common and civil law legal system. Plus to these, for comparative analysis, the writer selects the PLC governance and boards of directors' laws and tradition of UK, Germany, France, China and India.

Chapter four is the main body of study that the writer tries to see and analyses the corporate governance journey of Ethiopia: the governance system and structure of partnership, governance system and structure of share and private limited company. In this chapter the writer tries to address the legal and practical corporate governance problems of private limited company with particular emphasis on the absence of board of directors in the governance of such companies. The last part is all about the conclusion and recommendation. The writer summarises points

discussed in all chapters and puts the possible solutions for the corporate governance problems of private limited companies.

CHAPATE ONE

1.1. BACKGROUND OF THE STUDY

There is no definitive historical treatment of corporate governance; however it has been with us since the use of the corporate form created the possibility of conflict between investors and managers¹. This is for the reason that in governance of corporations the owners and managers are different persons i.e. there is a separation of ownership and control. The history of corporate governance correspondingly extends back at the 16th and 17th centuries.² A series of events (such as high profile scandals, financial crises and/or institutional failures) over the last two decades have placed corporate governance issues as a top concern for the international business community.³ In today's globalized economy, companies and countries with weak corporate governance systems are likely to suffer serious consequences above and beyond financial scandals and crises.⁴ How corporations are governed commonly referred to as corporate governance largely determines the fate of individual companies and entire economies in the age of globalization.⁵

To talk about corporate governance means to reminisce companies which are artificial persons created by law that often have a life beyond that of their members. The best definition of corporate governance is probably the system by which companies are directed and controlled and that definition applies to all companies and not only just to the large corporations with dispersed shareholders. In determining corporate structure, the company's size and activity should be taken into account. A too heavy corporate structure may sometimes prove inefficient and impede the company's development. Thus, corporate governance structure and system of share (public) companies and private limited companies could not be same due to their difference in size and activity what they perform.

¹ Brian R. Cheffins, The History of Corporate Governance, University of Cambridge - Faculty of Law, January 2012, p 1. (available at: <http://ssrn.com/abstract=1975404>)

²Ibid

³CIPE, Instituting Corporate Governance in Developing, Emerging and Transitional Economies, A Handbook, March 2002, pp 1-5. (Available at: <http://www.sourceoecd.org/emergingeconomies/9264035737>)

⁴ Ibid

⁵ Ibid

According to the OECD, improved corporate governance amongst unlisted companies has the potential to significantly boost productivity, growth and job creation.⁶ However, in the past, despite their large numbers and economic importance, the governance of unlisted companies was most of the time neglected area of corporate governance studies and recommendations⁷; or what of corporate governance in the context of private companies, which until relatively recently has received little or no attention from governance experts and policy makers. However, in present-day larger private limited companies are regarded as the backbone of a robust economy, policymakers have become more and more aware that neglecting the governance needs of these firms will stunt productivity, growth and job creation.

In governance of corporations the owners and managers are different persons i.e. there is a clear separation of ownership and control. The most common statutory bodies that are key actors in corporate governance of the company are the shareholders, board of directors, managers and auditors. Among these corporate governance actors the board of directors are the most important and forefront and brain of the company governance. Because when we see the corporate governance practice around the globe, having a board provides oversight, leadership and strategic vision and value to the business than a corporation simply run by a manager.⁸

Stephen Bainbridge⁹ in his article asking why corporate law calls for a board, rather than just a chief executive officer, to be at the apex of the corporation's management. He points to behavioral psychology studies which suggest that groups, such as corporate boards, often produce better decisions than can single individual when it comes to matters of judgment.¹⁰ A board often includes persons with specialized expertise or professionals who can bring valuable outsider perspectives to the table.¹¹ Decision making by groups will generally be preferable to

⁶ Beatrix Dekoster (ed.), Corporate Governance of Non-Listed Companies in Emerging Markets, OECD 2006, p. 93

⁷ Ibid

⁸ The International Finance Corporation(World Bank Group), Who's Running the Company?: A guide to reporting on corporate governance, Washington: 2012, p 15

⁹ Stephen M. Bainbridge, "Why A Board? Group Decision Making In Corporate Governance," Vanderbilt Law Review, vol. 55 No. 1, (2002)

¹⁰ Ibid

¹¹ Ibid

decision making by an individual autocrat when it comes to the sort of critical evaluative judgments boards are asked to make.¹²

In Ethiopia, the modern concept of corporation and principle of corporate governance is new and at its infant stage even if the Commercial Code that governs companies enacted in 1960. The legal framework of the corporate system is principally set out by two basic codes: the 1960s Commercial Code and the Civil Code. Even though, the Commercial Code together with subsequent legislations are there to govern the operation and or performance of companies in Ethiopia, still there are so many gaps and the very updated principles of corporate governance are not included in the code and other subsequent legislations; especially private limited companies.

We can say that better corporate governance atmosphere (or principles and rules) are legislated in companies that operate in the financial sector.¹³ The governance structure and system in financial companies is under strict supervision and control of the National Bank of Ethiopia.¹⁴ The statutory governance bodies, especially the board of directors, in the banking, insurance companies or microfinance institutions are elected according to the criteria put or formulated by the National Bank.¹⁵ Companies that operate in the non financial sector, specially private limited companies governance, law and practice is very weak and the Commercial Code rules are not in line with the modern private limited companies law rules. In Ethiopia, the number of private limited companies formed or under the process of formation is increasing. In this prevalent situation, multitudes of complex corporate governance issues are emerging with respect to private limited companies.

The corporate governance regime of private limited company in Ethiopia has many legal and practical problems such as problem in relation to absence of board of directors, the appointment of auditors and shareholders meeting based up on the numbers of shareholders and the minimum requirement of number of shareholders for the formation of private limited company etc are

¹² Ibid

¹³ Banking Business Proclamation, Proclamation No. 592/2008, Federal Negaret Gazeta No.57 and microfinance Business proclamations, proclamations No. 626/2009 are equipped with better corporate governance rules.

¹⁴ Ibid

¹⁵ Banking Business Proclamation, Proclamation No. 592/2008, Federal Negaret Gazeta No.57, Article 14

some. Above all, the absence of board of directors in the governance of private limited companies in Ethiopia is a big problem the writer has tried to address. The 1960 commercial code with subsequent legislations and the Revised Draft Commercial Code do not address these issues based on the international experiences.

These are the main issues or tricky situations that made the writer to carry out this research on the corporate governance of PLCs in Ethiopia under the title “*Assessing Corporate Governance of Ethiopian private limited companies: with Particular emphasis on making Board of Directors Compulsory to such companies*”. This paper deals with the deficiencies in the existing relevant laws in addressing issues in corporate governance and what type of legal change, if any, needs to be made to address the newly emerging corporate governance issues in the Ethiopian private limited companies. Thus, in this study the writer an attempt is made identify problems and put possible recommendations to the governance problems of private limited companies in Ethiopia.

1.2. STATEMENT OF THE PROBLEM AND RESEARCH QUESTIONS

Companies cannot operate successfully without adequate rules of governance and the institutions that support them, or without the acceptance of a culture of corporate governance among managers, owners and other stakeholders. Corporate governance/CG/ is directly related to financing and investments. For a country in transition CG is doubly important; the scarcity of domestic savings demands that capital be directed towards the most profitable companies, which is possible only if principles of corporate governance are given publicity, transparency and monitoring.

The corporate governance regime in Ethiopian companies as a whole is not fertile or poor when we see it in light of different countries and international corporate governance rules or principles. Private limited companies corporate governance law and practices in Ethiopia is surrounded with many legal and practical problems. The absence of up to date corporate governance principles and law in Ethiopia makes private limited companies poorly operated even if they cover massive part of the country’s economy. Most of Ethiopian private limited companies are importers and/or do not participate in the manufacturing and export industry due to the absence of well acquitted corporate governance law and principles that govern them. Among the many problems the following are some;

- the absence of strategic corporate body/board of directors; /making private limited company to be run by managers than by both managers board of directors/ makes them not to be strategically, flourishing, values add to the country's economic growth like other countries;
- the making of shareholders meeting based up the numbers of shareholders of companies make corporate governance regime in the private limited companies incomplete;
- the making of auditors, one of the statutory corporate body and element of boards of directors of private limited company in other countries, being based up on the number of shareholders of companies;
- the requirement of a minimum of two shareholders for the formation of private limited companies and the dissolution of the company when the number of members fall below two than allowing formation of the company by one man and make board of directors mandatory to the governance of the company like other countries practices. This makes most private limited companies in Ethiopia nominal shareholders and not taking part/participate in their governance of the companies;
- Absence of rules concerning the management of conflict of interest problem in between shareholders and the companies, managers and the companies

In addressing the problems and searching the possible solutions to the legal and practical problems of governance of Ethiopian private limited companies, the writer made an attempt and addresses the following questions all the way through the research;

1. What are the corporate governance characteristics of private limited companies?
2. Why corporation laws around the world, generally call for corporate governance by or under a board of directors?
3. Why is this form of governance employed versus other alternatives? Why aren't corporations run using "direct democracy? Or why not run by "absolute corporate monarchy i.e. allowing management to make all the decisions without oversight"?
4. What are the driving forces for improving corporate governance practices of private limited company in Ethiopia?
5. What is the role of a public policy framework in supporting good corporate governance of private limited companies?

6. Is it a necessity to have board of directors for Ethiopia Private Limited Companies? Or is it a necessity to have board of directors system of governance to Ethiopian Private Limited Companies? Why/why not?
7. Does having board centered mode of governance system a void/ at least minimize the problematic behavior of Ethiopian Private Limited Companies?

1.3. LITERATURE REVIEW

The concept of corporate governance is a new notion in Ethiopia. Even if the company law/ Commercial Code has enacted in 1960, it has acquired little attention from the policy makers, business community and academicians. There is no fertile ground for the formation and operation of companies in Ethiopia due to lack of better or updated legal framework concerning governance of private limited companies in Ethiopia. The Commercial Code, particularly Book II title II of the Code that deals with Private Limited Companies, suffers from legal and practical problem that makes PLCs in Ethiopia less effective and inefficient compared to other countries. In addressing the corporate governance problems in Ethiopia, different researches have been conducted and the writer is going to use some of those works and shows the point with which this study departs from those studies.

Hussein Ahmed Tura¹⁶ addresses the issues related to the separation of supervision and management responsibilities, and on the composition, independence and remuneration of board of directors in share companies. Hussein in his article his article examines Ethiopia's company law with reference to the powers, composition and remuneration of board of directors in light of internationally recognized best practices and principles of corporate governance. He argues that there is a need to distinguish between corporate governance and corporate management in Ethiopian company law and the remuneration of board of directors should emanate from the law not from the shareholders meeting or articles of associations. Hussein in his article also discusses the role, composition and remuneration of boards of directors in share companies not about private limited companies.

¹⁶ Hussein Ahmed Tura, "Overview of Corporate Governance in Ethiopia: The Role, Composition and Remuneration of Boards of Directors in Share Companies", Mizan Law Review, Vol. 6 No.1, (2012)

Getahun Seifu¹⁷ on the other hand, in his article titled Revisiting company law with the advent of Ethiopia commodity exchange (ECX), examines the features of company law and argues a broader understanding of the concept of companies in Ethiopia. Getahun Seifu examined the main features of private limited companies, share companies, public enterprises and the Ethiopian Commodity Exchange) ECX. The 1960 Commercial Code of Ethiopia limits the scope of the law of companies only to private limited companies and share companies, save the partnerships included in the Code. Getahun Seifu argues that the advent of the ECX has challenged the frontiers of the existing legal framework of Ethiopian law of companies i.e. argues that ECX is a unique “hybrid-model” which can neither be categorized as a registered company nor as a public enterprise (statutory company) and explains the need for a wider conception of company law in Ethiopia. Getahun Seifu, however, does not deal in his article with corporate governance issues or the legal and practical problems in the governance of private limited companies.

Nigusie Tadesse¹⁸ in his LLM thesis on the title Major problems associated with private limited companies in Ethiopia: points out the legal and practical problems related with: fully paid up capital, the mandatory legal requirement of the two members in the formation of such company, restrictions of share transfer outside the company, and the limited liability of members who manage a private limited company (piercing the corporate veil issue). In his research, Nigusie does not address the corporate governance problems of PLCs what this study going to address. Conversely, this study has discussed mainly on the introduction of board of directors for the private limited companies of Ethiopia as a compulsory requirement. In this research, the writer addresses different legal and practical corporate governance problems of private limited companies and relates these problems with the absence of board of directors to such companies. In addition to this the writer raises the necessity of having board of directors to Ethiopian private limited companies to avoid such legal and practical governance problems.

1.4. OBJECTIVES OF THE STUDY

¹⁷ Getahun Seifu, “Revisiting company law with the advent of Ethiopia commodity exchange (ECX)”, Mizan Law Review, Vol. 4 No.1, (2010)

¹⁸ Nigusie Tadesse , Major problems associated with private limited companies in Ethiopia, [Unpublished] Masers thesis, Faculty of Law, AAU, (2009)

A private limited company is a company whose registered capital is made up of its members' contributions and members are not liable for the company's obligations. It is a very popular legal form for small and medium-sized businesses in Ethiopia. The establishment of an effective governance framework that defines the company's approach is of equal importance to public and private limited companies. Good governance can also play a crucial role in gaining the respect of key external stakeholders such as actual and potential financiers, employees, customers, and local communities. In Ethiopian business life today, by far the most important corporate forms are the Share Companies and private limited companies. Among the companies those incorporated in Ethiopia, 97% of companies are incorporated as private limited companies and while 3% are organized as share companies.¹⁹ Even if the majority of companies in Ethiopia are private limited companies, the corporate governance legal framework of such companies is suffered from many legal and practical governance problems.

Corporate governance guidelines for private limited companies may need to be encouraged: proper and efficient governance is valuable also for such companies, especially taking into account the economic importance of certain very large private limited companies. Thus, it has a paramount importance to create a superb corporate governance atmosphere for private limited companies since they cover and play significant role in the country's economic development. The objectives of the study *inter alia* are;

- To show the legal and practical corporate governance problems of private limited companies and suggest the possible solutions or recommendations to such problems;
- To show the problems of private limited companies that derive from the absence of board of directors in the governance of such companies and demonstrate the possible benefits that private limited companies could obtain if BoDs are made compulsory instead of making them run only by managers;
- To demonstrate how the lack of auditors for private limited companies for those companies whose members are below twenty affects the corporate governance regime of such companies and recommend the possible solution
- To show the problem of two shareholders mandatory requirement for the formation of PLCs; i.e. to recommend for making the two or more shareholders

¹⁹ Data obtained from Ministry of Trade and Industry, Data Base Department, October 2013

optional requirement to allow a company to be formed or continue even if the number of shareholders reduced below two by making BoD compulsory to such companies

- To show the problems those derive from the making of shareholders meeting base up on the numbers of shareholders to the PLC and show the benefits of making shareholders meeting and to recommend shareholders meeting not only be base of the shareholders;

1.5. SIGNIFICANCE OF THE STUDY

The research shade light on the legal and practical problems in the governance of private limited companies in Ethiopia and then recommends the possible solutions to those problems. The study addresses corporate governance problems in relation with the minimum numbers of shareholders requirement to the formation of PLC, the problem of making shareholders meeting and appointment auditors' base on the numbers of shareholders and the making of private limited companies to be run by managers than directors in light of different countries corporate governance law and experience and international corporate governance principles. The study comes with a very new concept of introducing board of directors to the Ethiopian private limited companies and making BoD as a compulsory corporate governance body to such companies. PLCs are problematic business organization in Ethiopia. In addition to the inadequacy of the provisions of the Commercial Code applicable to such companies in Ethiopia, the governance issue has proven to be of crucial importance over the years. The study is significant in that it will take governance issue in the majority of business organization in the country with emphasis on making BoD compulsory to such companies. It will also have certain contributions for the concerned body such as the academicians' for further research, legislators, lawyers and investors of private limited companies, in creating awareness on the area.

1.6. SCOPE OF THE STUDY

The study is concerned with assessing corporate governance problems of Ethiopian private limited companies particularly the legal and practical problem of the absence of board centred governance in such companies. In doing that, the study deals with the legal and practical governance problems of private limited companies; not include SOEs (state-owned enterprises).

The governance system and structure of partnerships and companies as a whole and similarities and distinctions of governance system and structure of private limited company and Share Company of Ethiopia is also part of the study.

In doing the research, the corporate governance system and structure of private limited companies of some countries have been dealt with the purpose of comparisons. Accordingly, the principles or rules of corporate governance of private limited company incorporated in the OHADA, the law of France, Germany, China, UK and India are made part of the study. The geographical limit of the study is based on the information collected from the Federal Ministry of Trade and Industry, the Addis Ababa chambers of commerce and private limited companies found in Addis Ababa.

1.7. METHODOLOGY OF THE STUDY

The method used in the study of the legal and practical problems in the governance of private limited companies and making compulsory BoD to such companies' in Ethiopia base on the 1960 Commercial Code of Ethiopia both the qualitative and qualitative methods. The study has employed qualitative method in that it devotes on the rationales and or logical arguments for corporate governance essentiality to private limited companies in general and board of directors inevitability in particular. The study is quantitative because it depends on data and information collected from Ministry of Trade and Industry, companies and interviews. Data was collected from primary and secondary sources. Primary data were gathered mainly through interviews, inspection of memorandum and article of associations of private limited companies and company websites. The secondary sources are foreign and domestic legislations, domestic and foreign literatures related with the study.

The corporate governance system and structure of private limited company shows us there is a slight difference between countries in the globe. For the sake of comparative analyses in assessing corporate governance of PLC particularly in making board of directors compulsory, the writer has consulted what seems the corporate governance system and board of director's role and status of private limited company in the common law and civil law countries as a whole and in OHADA uniform act, France, china and India. The writer has selected these countries based on different rationale. The reason that makes the writer opt for to discuss the corporate

governance system and structure of private limited company under the OHADA uniform act is since it is seen as a model in the trade and commercial law harmonization in between African states even if it is observed mainly in the western Africa of former French colony states to create one economic community.²⁰

The rationales that make me prefer to see and discusses the corporate governance system and structure of private limited company in France is that the French law in general and company law particular is the parent or the sources of Ethiopian Commercial law²¹; Company law for that matter. We can say that the Ethiopian Civil Code and Commercial Code are highly influenced by the French Civil and Commercial Codes respectively. Therefore, it is necessary to deal on the French corporate governance structure and directors role of private limited company.

Whereas, the rationale that made me deal with the corporate governance structure and role of board of directors of Chinese is that China is currently building and being owner of the world's huge part of the economy.²² In addition to this, Chinese economy is growing dramatically at the time when most of the world's economy has gone down to negative due to economic depression.²³ Among the causes of the depression absence of good and effective corporate governance scheme was one and in fact the major reason.²⁴ This shows us, even if there are still other factors compared to that of the rest of the world, Chinese corporate governance structure is better at least at this time when world economy is suffering from depression. This made me opt for corporate governance and the role and status of directors in the Chinese's private limited companies. The same justification rams me to deal corporate governance and the role of board of directors of private limited company of India.

²⁰ At present, OHADA has 16 members: Benin, Burkina Faso, Cameroon, the Central African Republic, Chad, the Federal Islamic Republic of the Comoros, Congo, Côte d'Ivoire, Equatorial Guinea, Gabon, Guinea, Guinea-Bissau, Mali, Niger, Senegal and Togo.

²¹ Winship, Peter(Ed), Background Documents of the Ethiopian Commercial Code of 1960, Faculty of Law A.A.U., (1974), p 61-71 , See also PAUL BRITZY, "PRIVATE LAW IN ETHIOPIA", J.A.L., Vol.18 No. 2, (1974), p 150 (Available at: www.abssynialaw.com), Franklin F. Russell, The New Ethiopian Civil Code, Brooklyn Law Review, Commentary, (N.D), P 237. (Available at: www.abssynialaw.com),

²² Stijn Claessens and Burcin Yurtoglu , Corporate Governance and Development-An Update, Washington: world bank, The International Finance Corporation, (2012), p. 18

²³ Ibid

²⁴ David H. Erkens et al, Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide, California: Los Angeles, (2012), p. 19

CHAPTER TWO

CORPORATE GOVERNANCE

2.1. THE CONCEPT OF A CORPORATION

A business enterprise may be owned by one person or a group of persons. When it is owned by one person, it is known as sole proprietorship²⁵. Except this all other forms of business organizations come under the category of group ownership or joint ownership.²⁶ When we behold the development of business, the classical business unit or enterprise is owned and controlled by the same person or persons.²⁷ That is there is no the concept of separate existence of the business enterprise and the person who owns it. This classical business can be either a sole proprietorship or a partnership. Nowadays, these two forms of economic organization no longer play a dominant role in economic transactions. Even though they may be still noteworthy in number, they no longer account for the bulk of economic activities.²⁸ Nowadays, most economic activities are carried out by large corporations that own large percentage of assets.

A business that runs under the exclusive ownership and control of an individual is called sole proprietorship or single person entrepreneurship. Such business start through the initiative of an individual and is run with the capital supplied by the proprietor from his resources or through borrowing. The proprietor manages the business himself, bears all risks alone and gets all profits by the mere fact of his sole proprietorship. He has almost unlimited freedom of action to run his business. It is the simplest and the oldest form of business organization. However, sole proprietorship suffers from limited capital, limited managerial skill, unlimited liability, uncertainty of continuity, inability to avail of specialization and hasty decision.²⁹ The limitations and deficiencies of sole proprietorship and family business in respect of limited financial resources, limited managerial ability and skills concentrated risk and other shortcomings led to

²⁵ Carlton DW & Perl off J.M., Modern Industrial Organisation, USA: (Scott Forssmann & Co. 1990), p.23. See also Berle AA and Means GC, The Modern Corporation and Private Property, New York: MacMillan, (1963), p 300.

²⁶ Ibid

²⁷ Jennifer Reuting, Limited liability companies for Dummies, (Wiley Publishing, 2008), p 200.

²⁸ Carlton DW & Perl off JM, Supra note 23, p 24

²⁹ Ibid

the emergence of partnership as a form of business organization.³⁰ A partnership is an association of two or more persons who carry on business together for the purpose of earning profits.³¹

Until the beginning of the 17th century, the partnership was the dominant form for organizing jointly owned business firms.³² Partnership type of business is where two or more persons who intend to join together make contributions (might be in the form of either cash, in kind or skill) for the purpose of carrying out activities of an economic nature and of participating in the profits and losses arising out thereof³³, if any. Partners bore unlimited personal liability for the contractual obligations of the firm. Business organizations were very small, quasi-governmental institutions chartered by the state or government for a specific purpose.³⁴

The sole proprietorship and partnership forms of organizations have failed to meet the growing needs of modern industry and commerce due to the limitations like limited resources, unlimited liability and fear of discontinuity.³⁵ To get over these limitations, company forms of business organizations came into existence. Now it is the most widely used form of business organization not only in the private sector but also in the public sector or state owned business enterprises³⁶. Company form of organization has proved to be very suitable for large scale enterprises. It is also equally good for undertakings on a small scale business because of easier access to financial resources, limited liability and continued existence.³⁷ The start of the industrialization changed this picture heavily.³⁸ Industrialization was connected with the huge capital demand of new giant firms. The doctrine of limited liability, allowing corporate owners and managers to avoid responsibility for harm and losses caused by the corporation, made this business form even more interesting. The growing industrialization in the 19th century also meant that more citizens left

³⁰ Jonathan Berk and Peter Demarzo, Corporate Finance, (3rd Ed.), (Pearson Education Inc., 2011), p. 37

³¹ International Corporate Governance Network, www.Icgn.Org, (accessed on 8/8/2013)

³² Udo C. Braendle and Alexander N. Kostyuk, Developments in Corporate Governance, (N.D.), P. 3

³³ Mary O'Sullivan, Contests for Corporate Control: Corporate Governance and Economic Performance in the United States and Germany, Oxford: (Oxford University Press, 2000), P. 4 and commercial code of Ethiopia, 1960, Negaret Gazeta, No. 3, article 211

³⁴ Ibid

³⁵ Ibid

³⁶ Cheffins, Brian R., History and the Global Corporate Governance Revolution: The UK Perspective, Business History, (Oct. 200), p. 87.

³⁷ Ibid

³⁸ Ibid

the countryside to look for jobs in the cities.³⁹ A wave of immigration created a new class of society which was depended on factory jobs to earn a living.⁴⁰

Between 1895 and 1904, the corporation was transformed from state-controlled organizations to unlimited private organizations with limited responsibility and limited accountability.⁴¹ As share trading became easier, the shareholders as capital providers increasingly relied on the exit option to express their pleasure or displeasure with their managers' decisions.⁴² Thus, considerable authority was granted to management.⁴³ Control via voice shifted to the boards of directors, which in turn were dominated by managers.⁴⁴ In other words, at the end of the 19th century and beginning of the 20th century, control of corporations shifted more and more into the hands of the managers and therefore ownership and control separated.⁴⁵

The term Corporate Governance developed from an analogy between the government of nations or states and the governance of corporations⁴⁶. According to James Wolfensohn (June 1995-may 2005), former president of the World Bank, the governance of corporations is now as imperative in the world economy as the government of countries.⁴⁷ Corporate governance in the academic literature seems to have been first used by Richard Eells (1960) to denote "the structure and functioning of the corporate polity".⁴⁸ Nevertheless, how to manage companies and the query for the best structure to attain an optimal allotment of resources is as old as the history of companies.⁴⁹

The presence of an effective corporate governance system, within an individual company or group and across an economy as a whole, helps to provide a degree of confidence that is

³⁹ J. Corey Pierce, Business start up; Where to Begin & How to Grow, (2004), p. 14. Available at: (<http://www.businessfinance.com/>). Accessed on 12/8/2013

⁴⁰ Ibid

⁴¹ Mary O'Sullivan, supra note 33, P. 5

⁴² Turnbull and Shann, Evolution of Business and the Corporate Structure, Corporate Directors, Australia: University of New England, (1997), p. 11

⁴³ Ibid

⁴⁴ Ibid

⁴⁵ Mary O'Sullivan, supra note 41, P. 1

⁴⁶ Id, P. 6

⁴⁷ Known as the "renaissance Banker"; Pushed through reforms that have made the bank more inclusive, with renewed focus on poverty reduction.

⁴⁸ Mary O'Sullivan, supra note 45

⁴⁹ Ibid

necessary for the proper functioning of a market economy.⁵⁰ In defining a good corporate governance system, the constitutive rudiments are specific assets to invest in company, separation between ownership and control and incentives for controlling agents for the efficient allocation of control.⁵¹ The original need for corporate governance stems from the separation of ownership and control in publicly held companies.⁵² This separation of ownership and control is often referred to as the "principal-agent problem."⁵³ The principals are the investors who supply the capital, while the managers are the agents of the investors who run the company. To achieve these objectives adequate institutional framework composed of company law, securities law, competition law, bankruptcy law, property right regime base up on free market principle and enforcement structure (public and private) are compulsory.⁵⁴

The four defining characteristics of the modern corporation are⁵⁵ separate legal personality, separation of ownership and management, limited liability and transferability of shares. To talk about the concept of corporation and corporate governance one may be obliged to consider the following features or the most essential rudiments.

- ❖ **Separate Legal Personality:** - meaning company is a legal person in its own right; and it is separate from those who own or run it, and has 'limited liability' (unless its owners choose to have unlimited liability).⁵⁶ A company has its own legal personality. Consequently it can be a party to contracts and the subject of rights and liabilities. A company is an incorporated voluntary association of persons in business having joint capital divided into transferable shares of a fixed value, along with the features of limited liability, common seal and perpetual succession. Furthermore, the existence of a corporation may continue for an indefinite period unless and until it is liquidated. Companies are formed to create a legal identity separate from the individuals who make up the membership of the company.

⁵⁰ Ibid

⁵¹ Ibid

⁵² U.S. Chamber Of Commerce, Instituting Corporate Governance in Developing, Emerging and Transitional Economies, Hand Book, (2002), P. 9

⁵³ Ibid

⁵⁴ Ibid

⁵⁵ RC Clark, Corporate Law, (1986), P. 2

⁵⁶ Le Talbot, Critical company law, London: Routledge Cavendish, (2008), p 23

- ❖ **Separation of Management from Ownership:** - There is a formal separation of the company's management (under the board of directors) from the shareholders. The latter are sometimes termed as “the owners” of the company. They share the company's profits. As they are communally unconstrained to sign up and take out directors from the board, they exercise ultimate control over management. Ordinarily, the number of shareholders, who are the owners of the company, is fairly large and hence all of them or most of them cannot participate in the day-to-day management of the company.⁵⁷ The law therefore provides for the board of directors, elected by members (owners) in the general body meeting of the company, to govern the affairs of the company.⁵⁸
 - ❖ **Limited Liability:** The Starting point for this feature is the company's responsibility for its own debts and liabilities. In other words, the shareholders share the company's profits, but they are not responsible for its losses. They are only liable to the company to pay up their share capital and have no further liability.⁵⁹ So limited liability actually shifts the risk of business failure from the company's shareholders to its creditors.⁶⁰ This seems to give the company's owners and managers too much of an incentive to take risks and can lead to an inefficient use of resources even if there are many circumstances in which the directors and shareholders become liable for losses to third parties.
- Limited liability gives the owners of the company (its shareholders) protection if the company fails.⁶¹ This means that if a company is put into liquidation, the people who own the company will only be required to pay what they have already paid or agreed to pay towards settling its debts - usually what they have paid or agreed to pay for their shares. Because debts of company are the debts of the artificial legal person and not of the people running the company or owning shares in it.⁶² Personal property of the shareholders cannot be attached for the recovery of corporate debts. Incorporation gives the privilege of limited liability to its members up to a maximum of their investment or

⁵⁷ Stephen G. Marks, The Separation of Ownership and Control, USA, Boston University School of Law, (1999), p. 3

⁵⁸ Ibid

⁵⁹ John Armour, et al, The Essential Elements of Corporate Law: What Is Corporate Law? John M. Olin Centre for Law, Economics and Business, (2009), p. 12. available at: The Harvard John M. Olin Discussion Paper Series: (http://www.law.harvard.edu/programs/olin_center/)

⁶⁰ Ibid

⁶¹ Ibid

⁶² Ibid

share in the entity or undertaken by them in the event of winding up.⁶³ Nevertheless, this does not mean that shareholders could not be liable at all and the issue of piercing the corporate veil can come into picture.

Liability of the members of a limited liability company is limited to the value of the shares subscribed to or the amount of guarantee given by them.⁶⁴ Members cannot be asked to pay anything more than what is due or unpaid on the shares of the company held by them even though the assets of the company are not sufficient to satisfy fully the claims of creditors of the company in the event of its winding up. However, this does not mean that the members could not be liable in absolute sense. For example, the shareholders might be liable for interest that derives from the nonpayment of the subscribed shares and liability to meet calls.⁶⁵ Thus, by virtue of this characteristic the personal property of a shareholder cannot be attached for the debts of the company if he/she holds a fully paid up share.

- ❖ **Transferability:** A share in a company carries rights against the company to receive dividends and (usually) to vote at shareholders meetings.⁶⁶ A share can be transferred to a new holder and this transfer comprises rights and liabilities. Shares in a public company are usually traded on a stock exchange, facilitating transfer and making shareholding a more flexible kind of investment.⁶⁷ Members of a public limited company are free to transfer the shares held by them to anyone else while the members of private limited company are not free to transfer shares like public or share companies.⁶⁸
- ❖ **Delegated management with a board structure:**

In partnerships type business organization, each partner has an equal say in the management of the partnership.⁶⁹ It would be difficult, if not logically impossible, to find consensus among dispersed individual shareholders on issues concerning the day-to-day affairs of the corporation.

⁶³ Ibid

⁶⁴ Ibid

⁶⁵ Commercial Code of Ethiopia, 1960, , Negaret Gazeta, extra ordinary issue, No. 3, article 342

⁶⁶ John Armour, et al, The essential elements of corporate law: what is corporate law?, New work: (Oxford University Press, 2009), p. 112

⁶⁷ Ibid

⁶⁸ Ibid

⁶⁹ Ibid

In a corporation, shareholders delegate responsibilities to the board of directors and managers. Delegation of responsibility works in the following scheme:⁷⁰

- ✓ The power to determine the company's overall direction is given to the board of directors;
- ✓ The power to control the company's day-to-day operation is given to the managers;
- ✓ In order to allow the company to operate with maximum efficiency, the shareholders give up the right to make decisions on all but the most general issues facing the company;

Corporate law typically vests principal authority over corporate affairs in a board of directors or similar committee organ that is periodically elected, exclusively or primarily, by the firm's shareholders.⁷¹ Business corporations are distinguished by a governance structure in which all but the most fundamental decisions are delegated to a board of directors. Though largely or entirely chosen by the firm's shareholders, the board is formally distinct from them. This separation economizes on the costs of decision-making by avoiding the need to inform the firm's ultimate owners and obtain their consent for all but the most fundamental decisions regarding the firm.⁷² It also permits the board to serve as a mechanism for protecting the interests of minority shareholders and other corporate constituencies.⁷³

2.1.1. DEFINITIONS OF CORPORATE GOVERNANCE

A corporation may accurately be called a company⁷⁴; however, a company should not necessarily be called a corporation⁷⁵, which has distinct characteristics. According to Black's law dictionary a company means a corporation — or, less commonly, an association, partnership or union — that carries on industrial enterprise. However, "corporation" is a wider concept than "company" in which the later can be a type of the former.

⁷⁰ Id, p. 13

⁷¹ Id, p. 14

⁷² Id, p. 15

⁷³ Ibid

⁷⁴ Corporate governance, <https://www.law.upenn.edu/journals/jil/articles/volume2/issue2/>, (Accessed on 23/8/2013)

⁷⁵ Ibid

A decade ago, the term corporate governance was hardly known⁷⁶. However, today, like climate change and other sensitive issues that call for the attention of global society, corporate governance is a staple of everyday business language and capital markets are better for it.⁷⁷ The phrase corporate governance is nowadays a very fashionable phrase. But very often there is a lot of different definition associated with it. Different definitions are related both to the concept of corporations and to the concept of governance. Even though, there are many different definitions of corporate governance they all invariably address the following central theme. “Corporate governance is the framework of laws, rules, and procedures that regulate the interactions and relationships between the providers of capital (owners), the governing body (the board or boards in the two-tier system), seniors managers and other parties that take part to varying degrees in the decision making process and are impacted by the company’s dispositions and business activities.”⁷⁸

Corporate governance is defined as the system by which business corporations are directed and controlled.⁷⁹ Indeed, the corporate governance structure specifies the distribution of rights and responsibilities among different participants in the company, such as the board, managers, shareholders, and other stakeholders, and spells out the rules and procedures for making and monitoring decisions on corporate affairs⁸⁰. By doing this, corporate governance also provides the structure through which the company objectives and strategy are set, and the means of attaining those objectives and monitoring performance. The term Corporate Governance is susceptible to both narrow and broad definitions⁸¹. It therefore, revolves around the debate on “whether management should run the corporation solely in the interests of shareholders (shareholder perspective) or whether it should take account of other constituencies (stakeholder perspective)”⁸².

⁷⁶ Paul L. Davies QC, et al, Principles of Modern Company Law, (8th Edition), London: (Sweet & Maxwell, 2008), p. 97.

⁷⁷ Ibid

⁷⁸ International Corporate Governance Network – www.icgn.org. (retrieve on 12/8/2013)

⁷⁹ Corporate governance definition, www.corpgov.net, (retrieve on 12/8/2013)

⁸⁰ OECD Principles of Corporate Governance, (2nd Edition), 2004, p. 11

⁸¹ International Corporate Governance Network , Supra note 78

⁸² Ibid

Narrowly defined corporate governance concerns the relationships between corporate managers, board of directors and shareholders.⁸³ But it might as well encompass the relationship of the corporation to stakeholders and society. More broadly defined, corporate governance can encompass the permutation of laws, regulations, listing rules and voluntary private sector practices that enable the corporation to attract capital, perform efficiently, generate profit, and meet both, legal obligations and general societal expectations.⁸⁴ Corporate Governance refers to that blend of law, regulation, and appropriate voluntary private sector practices⁸⁵ which enables the corporation to attract financial and human capital, perform efficiently, and thereby perpetuate itself by generating long-term economic value for its shareholders, while respecting the interests of stakeholders and society as a whole.⁸⁶

Corporate governance is, “the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations.”⁸⁷ The OECD⁸⁸ principles define corporate governance as involving “a set of relationships between a company’s management, its board, its shareholders, and other stakeholders”. It encompasses the mechanisms by which companies, and those in control, are held to account. Corporate Governance shows how the objectives of the company are laid down and achieved how risk is observed and appraised, and how performance is optimized.

Different nation’s corporate governance systems articulate the primary objective of the corporation in different ways. Some nations - predominately in Continental Europe and Asia center on the need to satisfy societal expectations.⁸⁹ These are the interests of stakeholders’ such as employees, suppliers, creditors, tax authorities and the communities in which corporations

⁸³ Ibid

⁸⁴ Ibid

⁸⁵ Holly J. Gregory, Comparative Matrix Of Corporate Governance Codes Relevant to the European Union and Its Member States, (2002), P. 1

⁸⁶ Ibid

⁸⁷ Australian Security Exchange Corporate Governance Council, Corporate Governance Principles and Recommendations with 2010 Amendments, (2nd Edition, 2010), P.1. Available at: corp_governance_principles_recommendations_2nd_edition.pdf, (<http://www.asx.com.au/supervision/pdf/>)

⁸⁸ The *OECD Principles of Corporate Governance* were endorsed by OECD Ministers in 1999 and have since become an international benchmark for policy makers, investors, corporations and other stakeholders worldwide. They have advanced the corporate governance agenda and provided specific guidance for legislative and regulatory initiatives in both OECD and non OECD countries.

⁸⁹ Neil Fligstein and Jennifer Choo, Law and Corporate Governance, California: University of California, (2005), P.

operate. Other nations – (typically the Anglo-Saxon) are countries that emphasis on the primacy of ownership and property rights and focus on returning a profit to shareholders over the long term.⁹⁰ The corporate focus is on shareholder value.⁹¹ Under this view, employees, suppliers and other creditors have contractual claims on the company. As owners with property rights, shareholders have a claim to whatever is left after all contractual claimants have been paid.

2.1.2 CORPORATE GOVERNANCE VS. MANAGEMENT

Governance and management are words that hold significance in terms of running an organization in a smooth and efficient manner.⁹² While there are governing bodies and managers both serving inside an organization, their roles and responsibilities should clearly be spelt out. Literally, when we see corporate governance vs. management, there seems to be no difference between the two concepts with both being concerned with controlling an organization for the purpose of running it to achieve the goals that have been set forth.⁹³ In fact, there are many who use the words interchangeably. However, there are subtle differences that will be highlighted throughout this paper. Governance can be said to be representing the owners, or the interest group of people, who represent a firm, company or any institution.⁹⁴ Governance represents the will of these interest groups who manage the company. Governance consists of a governing body, which directs the management on all aspects of a company.⁹⁵ It is the governing body that oversees the overall function of an organization.

The governing body, on the other hand, appoints management personnel, whom are given the power to administer the organization.⁹⁶ Management comes only second to the governing body, and they are bound to strive as per the wishes of the governing body. Governance can be said to set the right policy and procedures for ensuring that things are done in a proper way.⁹⁷ On the contrary, management is all about doing things in the proper way as to the direction of board of

⁹⁰ Id, p.15

⁹¹ Ibid

⁹² <http://managementhelp.org/blogs/boards-of-directors/2010/08/27/the-changing-role-of-boards-and-management-as-companies-grow/#sthash.Ub0VHiLi.dpuf>, (retrieve on 9/1/2013)

⁹³ Ibid

⁹⁴ Ibid

⁹⁵ Ibid

⁹⁶ Ibid

⁹⁷ Ibid

directors most of the time.⁹⁸ The responsibilities between governance and management also differ. The responsibilities of governance include choosing top executives, evaluating their performance, authorizing plans/commitments and evaluating the organization's performance.⁹⁹ On the other hand, management has the responsibility for managing and enhancing the overall performance of the organization.¹⁰⁰ Management has the responsibility to implement the systems of governance. It is the day to day executive organ or body in corporate governance.¹⁰¹

While governance pertains to the vision of an organization and translation of the vision into policy, management is all about making decisions for implementing the policies.¹⁰² In corporate governance, while board of directors form the nucleus of governance, managers and executives form part of the management core.¹⁰³ Governance relates to providing the right direction and leadership. Management relates to managing the operations of an organization. The governing body has only the role to oversee the functioning of the management, and it has no role in management.¹⁰⁴

2.1.2.1 CORPORATE GOVERNANCE

Governance means thinking about strategic issues, rather than the operational day-to-day running of the business.¹⁰⁵ This is especially true when financial expectations from organizations have increased manifold and governing bodies in a company are no longer names on a letterhead and equally responsible for generating profits as are the managers in the company.¹⁰⁶ However, governance is broadly seen as an errand that is concerned with setting goals for an organization, direction to be taken to achieve these goals, and roles and responsibilities of functionaries in the organization. Looking objectively, governance is a term that deals with what an organization is as the word comes from government, and we all know what a government does. What an organization must do and what it should become in the future is primarily the concern of

⁹⁸ Ibid

⁹⁹ Ibid

¹⁰⁰ Ibid

¹⁰¹ Ibid

¹⁰² Difference between Corporate governance and management,
<http://www.differencebetween.net/miscellaneous/difference-between-guidelineandpolicy>, (retrieve on 9/ 1/2013)

¹⁰³ Ibid

¹⁰⁴ Ibid

¹⁰⁵ <http://www.iod.org.nz/FirstBoardsFirstDirectors/FirstBoards.aspx>, ((retrieve on 9/ 1/2013)

¹⁰⁶ Ibid

governance. Governance is ensuring compliance with the rules and regulations and making necessary changes in policies to avoid conflicts inside the organization.

2.1.2.2 CORPORATE MANAGEMENT

Management is a more common term used in organizations these days. It is seen as a task that confines itself to resource allocation and looking after operations of the organization on a day to day basis.¹⁰⁷ The role of management seems to be to look after smooth running of the organization in the direction that has been chosen by the governing body that happens to be the board of directors in most instances these days. Management works at various levels at the same time and represents the face of the company to not just the shareholders but also to the stakeholders. Hiring and firing of employees, bookkeeping, check writing, securing orders, arranging raw material and looking after production are all jobs that make up management.¹⁰⁸ Generally:

1. Governance can be said to be representing the owners, or the interest group of people, who represent a firm, company or any institution. The governing body, on the other hand, appoints management personnel.¹⁰⁹
2. While governance pertains to the vision of an organization, and translation of the vision into policy, management is all about making decisions for implementing the policies.¹¹⁰
3. Management comes only second to the governing body, and they are bound to strive as per the wishes of the governing body.¹¹¹

2.1.2. OWNERSHIP STRUCTURE OF CORPORATIONS

The ownership structure of an economy is an important factor in corporate governance and shapes the agency relationships within the firms.¹¹² Corporate structures depend in part on the structures a country had in earlier times, in particular the structures with which the economy started.¹¹³ The openness of economies, the distribution of wealth within national economies, the

¹⁰⁷ Ibid

¹⁰⁸ Ibid

¹⁰⁹ Ibid

¹¹⁰ Ibid

¹¹¹ Ibid

¹¹² Carsten Barhop, corporate governance, (2012), p. 7.

¹¹³ Pascal Gantenbein and Christophe Volonté, Does Culture Affect Corporate Governance? (2012), p. 4.

distribution of political power within countries and the political system shaped the political economy of corporate governance systems.¹¹⁴ In conducting this research, I have discovered that the starting point of discussion for legal scholars, institutional economists and political scientists, who study corporate governance systems, is that they acknowledge that there exist multiple systems of corporate governance around the world. Scholars have tended to cluster corporate governance models around four paradigms while acknowledging that national and regional characteristics are also apparent; the U.S. model, the German model, government ownership of firms and family owned business model¹¹⁵.

The U.S. model (what has been called the model of “shareholder capitalism”) contains dispersed shareholders who provide the bulk of the financing to large, public firms¹¹⁶. These companies are directed by management teams that are constrained by boards of directors. Workers have few rights and no representation on boards.¹¹⁷ In the U.S., outside directors, private watchdog entities and government authorities play a role in keeping managers in check.¹¹⁸ Incentive compensation for managers, and takeovers and proxy fights also provide competitive market mechanisms designed to align management interests more closely with those of the shareholders.¹¹⁹ The US model dominates across the common law nations.

The German model has large stock shareholders, often comprised of founding families, banks, insurance companies or other financial institutions who own the bulk of the shares.¹²⁰ This closed ownership structure enables large shareholders to internally monitor the day-to-day operation of the firm. Cross-shareholding among insiders is common and information flow is controlled and murky.¹²¹ Stakeholders such as organized labor play a substantially greater role in the governance of corporate firms under the German model.¹²² Norms of shareholder capitalism do not automatically prevail over the claims of other corporate stakeholders in countries that

¹¹⁴ Petri Mäntysaari, Comparative Corporate Governance: Share Holders As A Rule Maker, Berlin: (Springer Berlin, 2 March 2005), p. 389.

¹¹⁵ Neil Fligstein and Jennifer Choo, *Supra* note 91, P. 18

¹¹⁶ *Id.*, p. 15

¹¹⁷ *Ibid*

¹¹⁸ *Ibid*

¹¹⁹ *Id.*, p. 16

¹²⁰ Prof. Dr. Jean J. du Plessis, et al, German Corporate Governance in International and European Context, Berlin: (Springer-Verlag Berlin Heidelberg, 2007), p. 119

¹²¹ *Ibid*

¹²² Neil Fligstein and Jennifer Choo, *supra* note 115, p. 18)

exhibit the concentrated ownership model. The German model dominates across civil law countries.¹²³

A third model is government ownership of firms. Here, large firms and the financial sector are owned and operated by the government. In Many developed and developing societies still there is substantial government ownership of firms.¹²⁴ This is particularly true in sectors like banking, natural resources, utilities, and transportation.¹²⁵ Since employees are government employees, they tend to have careers guided by bureaucratic rules and fixed benefits.

A final model that dominates most of the developing world is the model of family owned business.¹²⁶ Here, owners are managers. Firms are private and equity and debt markets tend to play minor roles in the provision of capital. Workers generally have less power.¹²⁷ We can still classify corporate ownership structure from other perspectives. For example, we can classify into two general types of corporate ownership structures: concentrated and dispersed.¹²⁸ In concentrated ownership structures, ownership and/or control is concentrated in the hands of a small number of individuals, families, managers, directors, holding companies.¹²⁹ Because these individuals or groups often manage, control or strongly influence the way that a company is run, they are called insiders.¹³⁰ Hence, concentrated ownership structures are referred to as insider systems.¹³¹ Most countries, especially those following the civil law system have concentrated ownership structures.¹³²

¹²³ Vitols S., Varieties of corporate governance: comparing Germany and the UK. In Varieties of Capitalism: The Institutional Foundations of Comparative Advantage, new work: (Oxford Univ. Press, 2001), p. 60.

¹²⁴ Ibid, and Wade R. Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization, (Princeton Univ. Press, 1990), p. 81.

(China, India, Ethiopia are the prominent actors of this model)

¹²⁵ Strange S. The Retreat of the State: The Diffusion of Power in the World Economy, New York: (Cambridge Univ. Press, 1996), p. 101.

¹²⁶ Neil Fligstein and Jennifer Choo, Supra note 122, p. 20

¹²⁷ Ibid

¹²⁸ Centre for International Private Enterprise, Supra note 3, p 7.

¹²⁹ Markus Berndt, Global Differences in Corporate Governance Systems: Theory and Implications for Reforms, (2000), p. 25. (available at: http://www.law.harvard.edu/programs/olin_center/)

¹³⁰ Ibid

¹³¹ Gary Herrigel (Ed), A New Wave in the History of Corporate Governance, New work: (Oxford University Press, 2007), p. 5

¹³² Ibid

Insiders exercise control over companies in several ways. A common scenario is where insiders own the majority of the company shares and voting rights.¹³³ Other times, insiders own some shares, but enjoy the majority of the voting rights.¹³⁴ This happens when there are multiple classes of shares and some shares enjoy more voting rights than others.¹³⁵ It also occurs if there are proxy votes and voting trusts.¹³⁶ If a few owners own shares with significant voting rights, they can effectively control a company even though they did not provide the majority of the capital.¹³⁷

Dispersed ownership is the other type of ownership structure. In this scenario, a large number of owners each hold a small number of company shares.¹³⁸ Small shareholders have little incentive to closely monitor a company's activities and tend not to be involved in management decisions or policies.¹³⁹ Hence, they are called outsiders,¹⁴⁰ and dispersed ownership structures are referred to as outsider systems.¹⁴¹ Common law countries such as the UK and the US tend to have dispersed ownership structures.¹⁴²

2.1.3. FACTORS THAT SHAPE CORPORATE GOVERNANCE

Corporate governance does not occur in a vacuum. It reflects the economic, historical, cultural and legal characteristics of a country, its business history and corporate landscape.¹⁴³ It is also shaped by the ownership structures and patterns of that economy and by the financing options available to businesses.¹⁴⁴ Differences in these areas account for some of the notable differences in the governance models found on either side of the Atlantic.¹⁴⁵ The following are some of the underlying factors that shape the corporate governance structure.

¹³³ Ibid

¹³⁴ Ibid

¹³⁵ Markus Berndt, *Supra* note 129, p. 26

¹³⁶ Ibid

¹³⁷ Ibid

¹³⁸ Coffee, J.C., "The rise of dispersed ownership: The roles of law and the state in the separation of ownership and control", *Yale Law Journal*, vol. 111 No.1, (2001), p. 82.

¹³⁹ Gary Herrigel, *Corporate Governance: History Without Historians*, Oxford: (Oxford University Press, 2006), p. 20.

¹⁴⁰ Ibid

¹⁴¹ Coffee, J.C, *supra* note 138

¹⁴² Ibid

¹⁴³ Licht, A. N., et al, "Culture, Law, and Corporate Governance," *International Review of Law and Economics*, vol. 25 No 2, (2005), p. 229

¹⁴⁴ Ibid

¹⁴⁵ Ibid

2.1.3.1 IMPACT OF OWNERSHIP AND CONTROL STRUCTURES AND PATTERNS ON CORPORATE GOVERNANCE

Corporate governance is inextricably linked to the ownership, control structures and patterns prevalent in an economy.¹⁴⁶ Distinguishing between ownership and control and explaining the agency factor, i.e. the owners of the company hire directors/ managers (agents) who control and manage the assets of the company is an intrinsic feature of the corporation and one that is central to any corporate governance model.

2.1.3. 2 INFLUENCE OF THE ECONOMIC MODEL ON CORPORATE GOVERNANCE

The economic model in use is another factor that shapes and influences corporate governance. The relationships and interactions between the economic actors that prevail in an economy shape corporate governance.¹⁴⁷ For example, the US model is often characterized as market oriented with more emphasis on unrestrained competition i.e. the “winner take all” criteria.¹⁴⁸ The government provides the regulatory framework and lets market forces and actors fight it out. While other countries (example German and France and other civil law countries) place greater emphasis on cooperation and consensus between the different economic and market actors.¹⁴⁹ These two models and the many variations that exist in different countries do in turn have insinuations and upshots on the corporate governance model.¹⁵⁰

2.1.3.3 INFLUENCE OF LEGAL SYSTEMS ON CORPORATE GOVERNANCE

¹⁴⁶ Kurt A. Desender, The relationship between the ownership structure and the role of the board, (2009), p. 12. (Available at: http://www.business.illinois.edu/Working_Papers/papers/09-0105.pdf/)

¹⁴⁷ Miguel A. Mendez, Corporate Governance, a US/EU Comparison, Washington: University of Washington, (2004), p. 7.

¹⁴⁸ Ibid and Frydman R, et al, When does privatization work?: the impact of private ownership on corporate performance in the transition economies, (1999), P. 91.

¹⁴⁹ Ibid Lamoreaux N, Rosenthal J., Legal regime and business's organizational choice: a comparison of France and the United States during the mid - nineteenth century, (2004), p. 45.

¹⁵⁰ Ibid

A large majority of states in the common law legal system countries (dispersed ownership structure) stipulates the primacy of the shareholders over other stakeholders.¹⁵¹ In the civil law nations, the law and/or the various governance codes, in the majority of countries stipulate the primacy of the company's interest i.e. the combined interest of the various stakeholders.¹⁵² This is a fundamental difference with broad implications.¹⁵³ The common law reasoning goes somewhat as follows; if directors look out for the long term interest of shareholders they will also be deemed to have taken care of the corporation's other stakeholders¹⁵⁴ while civil law reasoning for the most part stresses on the interest of the company as a separate entity from its shareholders and as a convergence of different interest that must be balanced.¹⁵⁵ Directors are expected to look after the interest of the company.¹⁵⁶ Actually in many civil law legal system countries a shareholder cannot bring legal action against a director only the company can take such action.

2.1.4. IMPORTANCE OF CORPORATE GOVERNANCE

The governance of the corporation is now as important in the world economy as the government of countries.¹⁵⁷ Corporate governance is the new international language of business, and often forms the basis for dialogue between companies, lenders, and investors.¹⁵⁸ It does not matter where a company is located. Corporate governance plays an important role in transforming business and state relations, growth and economic sustainability.¹⁵⁹ However, to play the above role, the principles/values of fairness, transparency, and efficiency should apply/ be observed in the governance of a company.

The lack of transparency in business-state interactions often leads to preferential legal and regulatory treatment, asset stripping, wasting resources, and corruption that undermine the

¹⁵¹ Licht, A. N., et al, supra note 143

¹⁵² Ibid

¹⁵³ Ibid

¹⁵⁴ Mahoney PG, The common law and economic growth, J. Legal Study, (2001), p 25.

¹⁵⁵ Ibid

¹⁵⁶ Ibid

¹⁵⁷ James D. Wolfensohn, A Battle for Corporate Honesty, (1999), p 38.

¹⁵⁸ Ibid

¹⁵⁹ Barnali Choudhury, "Serving Two Masters: Incorporating Social Responsibility into the Corporate Paradigm", University of Pennsylvania, Journal of Business Law Vol. 1, No.3, (2009), p. 648.

competitiveness of national economies while benefiting a few insiders.¹⁶⁰ Corporate governance helps to address these problems and is an effective solution to corporatism, cronyism, and favouritism.¹⁶¹ Corporate governance, as a set of mechanisms that deals with institutional reform and not just company-level changes, suggests that it is one of the integral components of successful development strategies. Corporate governance is growing as one of the more important aspects of business conduct and development. The concept helps to explain proper business management and governance practices and offers recommendations on the best path towards success within any company's business culture.

The preamble to the guidelines (OECD 1999) offered the following theme on the importance of corporate governance:¹⁶² *“The degree to which corporations observe basic principles of good corporate governance is an increasingly important factor for investment decisions. Of particular relevance is the relation between corporate governance practices and the increasingly international character of investment. International flows of capital enable companies to access financing from a much larger pool of investors”*

Corporate governance has a crucial role to play not only in readying companies for privatization, but in preventing the potential market mayhem that can occur when companies are privatized without effective internal controls, reporting mechanisms, and shareholder protections.¹⁶³ Effective corporate governance:

- Promotes the efficient use of resources both within the company and the larger economy.¹⁶⁴ Debt and equity capital should flow to those corporations capable of investing it in the most efficient manner for the production of goods and services most in demand, and with the highest rate of return.¹⁶⁵ In this regard, effective governance helps to protect and grow scarce resources, therefore helping to ensure that societal needs are met. In addition, effective governance could make it more likely that managers who do

¹⁶⁰ Ibid

¹⁶¹ Eric Hontz And Aleksandra Shkolnikov, USAID the Center for International Private Enterprise(CIPE), Corporate Governance, The Intersection of Public and Private Reform, (2009), P. 30.

¹⁶² The OECD Principles of Corporate Governance (Principe's de gouvernement d'entreprise de l'OCDE), 1999)

¹⁶³ David Finegold, et al, “Corporate Boards and Company Performance: review of research in light of recent reforms”, Vol.15 No. 5, (September 2007), p. 870.

¹⁶⁴ Ibid

¹⁶⁵ Ibid

not put scarce resources to efficient use, or who are incompetent or (at the extreme) corrupt, are replaced.¹⁶⁶

- Assists companies (and economies) in attracting lower cost investment capital by improving both domestic and international investor confidence that assets will be used as agreed (whether that investment is in the form of debt or equity).¹⁶⁷
- Assists in making sure that the company is in compliance with the laws, regulations and expectations of society.¹⁶⁸ Effective governance involves the board of directors ensuring legal compliance and making judgments about activities that, while technically lawful in the countries in which the company operates, may raise political, social or public relations concerns.¹⁶⁹

Briefly, corporate governance brings stability to markets, strengthens competitiveness (companies and economies), strengthens institutions, improves risk mitigation, promotes investment, lowers cost of capital, weakens corruption, strengthens lending, promotes reform of state-owned enterprises (promotes successful privatization), builds transparent relationships between business and state and helps to combat poverty.

2.2. PRINCIPLES OF CORPORATE GOVERNANCE

Corporate governance is a dynamic force that keeps evolving. Corporate governance practice evolves in the context of developments of a country, “in the light of the changing circumstances of a company and is customized to meet those circumstances”¹⁷⁰. That is there is no single model of good corporate governance. There is no typical organization and no single readily identifiable model for corporate governance because at different times and stages in a company’s life, some governance structures may be better for the generation of wealth for investors than others.

Principle1 – AGENCY PRINCIPLE

¹⁶⁶ Ibid

¹⁶⁷ Ibid

¹⁶⁸ Ibid

¹⁶⁹ Ibid

¹⁷⁰ Paul L. Davies QC, et al, supra note 76, p. 101

Fundamental to any corporate governance structure is establishing the roles of the board and senior executives.¹⁷¹ The principle dictates all about that corporate governance laws and companies' code of conducts should establish and disclose the respective roles and responsibilities of board and management or set concrete foundations for management and oversight. Agency theory depicts the central role of corporate governance as restraining executives' self-serving inclinations (i.e. their attitude to behave in opportunistic ways)¹⁷². This is done by engendering compliance through activities such as monitoring their conduct, providing incentives that encourage agents to act in the principal's best interests, and if necessary, threatening legal sanctions.

Principle 2 - STRUCTURE THE BOARD TO ADD VALUE

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.¹⁷³ Companies should have a board of an effective composition, size and commitment to adequately discharge its responsibilities and duties with a balance of skills, experience and independence on the board appropriate to the nature and extent of company operations. The board should function reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.¹⁷⁴ structuring the board to add value helps monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.¹⁷⁵ The company's framework should be designed to enable the board to provide strategic guidance for the company and effective oversight of management, clarify the respective roles and responsibilities of board members and senior executives in order to facilitate board and senior executives' accountability to both the company and its shareholders and ensure a balance of authority so that no single individual has unfettered powers.

¹⁷¹ Neil Fligstein and Jennifer Choo, Supra no. 127, P. 5

¹⁷² Daniel Bădulescu and Alina Bădulescu, Theoretical Background of Corporate Governance, (2008), p. 3.

¹⁷³ ASX Corporate Governance Council, supra note 88, p. 16.

¹⁷⁴ Ibid

¹⁷⁵ Ibid

Principle 3 – STAKEHOLDERS APPROACH

There is a crucial need for integrity among those who can influence a company's strategy and financial performance, together with responsible and principled decision-making which takes into account not only legal obligations but also the interests of stakeholders.¹⁷⁶ The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.¹⁷⁷ According to stakeholder theory or principle, companies should design their corporate strategies considering the interest of their stakeholders¹⁷⁸ i.e. groups and individuals who can affect or are affected by the organization's purpose. The 2004 OECD principle recognizes that there are other stakeholders in companies in addition to shareholders. Banks, bondholders and employees for example are important stakeholders in the way in which companies perform and make decisions. The OECD guidelines lay out several general provisions for protecting stakeholder interests.

Principle 4-SAFEGUARD INTEGRITY IN FINANCIAL REPORTING

Presenting a company's financial and nonfinancial position requires processes that maintain, both internally and externally, the integrity of company reporting.¹⁷⁹ Meeting the information needs of a modern investment community is also paramount in terms of accountability and attracting capital.¹⁸⁰

Principle 5- MAKE TIMELY AND BALANCED DISCLOSURE

Provide a timely and balanced picture of all material matters is one of the basic principles in the governance of company. The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.¹⁸¹

¹⁷⁶ Silvia Ayuso and Antonio Argandona, Responsible Corporate Governance: Towards Stakeholder Board of Directors?, University of Navarra, (2007), P. 4

¹⁷⁷ OECD Principles of Corporate Governance, Supra note 89, p. 21

¹⁷⁸ Ibid

¹⁷⁹ ASX Corporate Governance Council, Supra note 175, P. 26

¹⁸⁰ Ibid

¹⁸¹ Id, p. 29 and OECD Principles of Corporate Governance, Supra note 177, p. 22

Principle 6- SHAREHOLDERS APPROACH

The corporate governance framework should protect and facilitate the exercise of shareholders' rights.¹⁸² The rights of company owners, that is, shareholders, need to be clearly recognized and upheld. Observing shareholder rights is necessary for a company to function and grow. All shareholders should have the opportunity to obtain effective redress for violation of their rights, including a mechanism for the resolution of disputes. The Rights of Shareholders includes¹⁸³ a set of rights including secure ownership of their shares, the right to full disclosure of information, voting rights, participation in decisions on sale or modification of corporate assets including mergers and new share issues. The guidelines go on to specify a host of other issues connected to the basic concern of protecting the value of the corporation.¹⁸⁴

Principle 7- RECOGNIZE AND MANAGE RISK

Every business decision has an element of uncertainty and carries a risk that can be managed through effective oversight and internal control.¹⁸⁵ All companies, whatever their specific fields of operations, face a wide variety of external or internal risks. According to their specificities (field of activity, size, international exposure, complexity) they should develop an adequate risk culture and arrangements to manage them effectively.

Principle 8-REMUNERATE FAIRLY AND RESPONSIBLY

Rewards are also needed to attract the skills required to achieve the performance expected by shareholders. The corporate governance constitutions of a company should be designed in ways that ensure fair and responsible/reasonable remuneration and compensation to the managers and board of directors.¹⁸⁶ This system makes the corporate bodies to employ their knowledge, skills and potential to the best interest of shareholders and the company.

2.3. CORPORATE GOVERNANCE AND THE BOARD OF DIRECTORS

¹⁸² Michael H. Lubatkin, et al, Origins of Corporate Governance in the USA, Sweden and France , SAGE Publications, (2005), p. 5 (available at: www.egosnet.org/os/)

¹⁸³ Ibid

¹⁸⁴ Ibid

¹⁸⁵ ASX Corporate Governance Council, Supra note 180, p. 33

¹⁸⁶ Id, p. 36

2.3.1. THE HISTORICAL AND POLITICAL ORIGINS OF THE CORPORATE BOARD OF DIRECTORS

The history of corporate governance arrangements, understood as the constitutive processes shaping the relationship between ownership and management of enterprises, is a relatively new field of inquiry for business historians.¹⁸⁷ The development of corporate boards is consistent with the notion that the use of representatives (representative democracy) arise out of problems with direct governance by groups that have large numbers of members (in other words, the central management rationale).¹⁸⁸

In a literal and narrow manner, to say that a corporation shall be managed by or under the direction of a board of director's doesn't say yet much. After all, someone must manage a corporation. The substance of board model of corporate governance comes from three underlying concepts. These concepts involve the relationship of the directors to the shareholders, the relationship of the directors to each other, and the relationship of the directors to the corporation's executives.¹⁸⁹ The term 'director' was first used generally at the end of the seventeenth century. It was used by the Bank of England and Bank of Scotland.¹⁹⁰

The first underlying concept of the board-centered model of corporate governance is that shareholders elect (normally annually) the directors.¹⁹¹ Under the partnership law default rule, the owners of the firm (the partners), simply by virtue of being owners, manage the partnership. Another extremely common governance model in partnerships, and in other non-corporate forms of business, is for an agreement among the owners to specify who shall be the managers of the business. The traditional limited partnership encompasses this approach as part of its basic governance model. In this model, some owners (general partners) manage and face unlimited liability, while other owners (limited partners) agree to relinquish a role in management in exchange for limited liability.¹⁹² Yet another scheme would be management by a self-

¹⁸⁷ Gary Herrigel, *supra* note 139, P. 2.

¹⁸⁸ Franklin A. Gevurtz, "The European Origins and the Spread of the Corporate Board of Directors", *Stetson Law Review*, (2004), p. 93. Available at: <http://justice.law.stetson.edu/lawrev/abstracts/PDF/33-3Gevurtz.pdf/>

¹⁸⁹ *Id.*, p. 94

¹⁹⁰ Formoy RR, *The Historical Foundations of Company Law*, London: Sweet and Maxwell, (1923), p 21.

¹⁹¹ Franklin A. Gevurtz, "The Historical and Political Origins of the Corporate Board of Directors", *Hofstra Law Review*, vol. Vol. 33 No. 89, (2004), p. 93.

¹⁹² *Ibid*

perpetuating oligarchy of managers. The corporate scheme of periodic elections is obviously different, in theory if not in fact, from contractually designated or self-perpetuating managers. By contrast, the corporation's owners (the shareholders), by virtue of being shareholders, have no right to manage the corporation.¹⁹³ Their right is to elect directors through general meeting, and to vote on matters the directors submit (either under compulsion of statute or voluntarily) for shareholders approval.

The second concept underlying the board-centered model of corporate governance is that a group composed of peers acting together makes the decisions.¹⁹⁴ Again, the significance of this concept becomes clear if one compares it to other governance schemes. Many businesses have one person who single-handedly makes at least the ultimate decisions. As businesses or other organizations grow, group decision-making commonly replaces the solitary decision-maker. By contrast, the corporate board norm is that all directors have equal vote, and majority rule prevails in the event of differences.¹⁹⁵ The longstanding corporate law rule is that directors lack any authority to act as individual directors; rather, the directors only have authority when they act as a group through board meetings.¹⁹⁶

The third concept embedded in the board-centered model of corporate governance is that the board has the ultimate responsibility for selecting and supervising the corporation's senior executives (especially its chief executive officer).¹⁹⁷ Actually, corporation statutes often allow, and a rare corporation's bylaws might provide, for shareholder election of the corporation's president or other senior officers. Nevertheless, the overwhelming practice around the globe is for the board to appoint the chief executive officer and other senior corporate officials.¹⁹⁸

2.3.2. THE RATIONALE FOR THE BOARD-CENTERED MODEL OF CORPORATE GOVERNANCE

The critical question one can winch up here is that, why do companies have boards of directors? Why aren't corporations run using "direct democracy i.e. putting all major corporate decisions to

¹⁹³ Ibid

¹⁹⁴ Id, p. 94

¹⁹⁵ Ibid

¹⁹⁶ Ibid

¹⁹⁷ Id, 95

¹⁹⁸ Ibid

shareholders vote"? Or why aren't corporations run by using "absolute corporate monarchy i.e. allowing managers to make all the decisions without oversight"? Or why not a management team?

Having a board provides oversight, leadership and strategic vision to the business and value is the main priority.¹⁹⁹ Nobel laureate economist Kenneth Arrow's seminal work on organizational decision making identified two basic decision-making structures: "consensus" and "authority." Consensus is utilized where each member of the organization has identical information and interests and will therefore select the course of action preferred by all the other team members.²⁰⁰ In contrast, authority-based decision-making structures arise where team members have different interests and amounts of information.²⁰¹ They are characterized by the existence of a central agency to which all relevant information is transmitted and which is empowered to make decisions binding on the whole.

It is very hard to imagine a modern corporation that could be effectively run using consensus-based decision-making mechanisms.²⁰² At the most basic level, the mechanical difficulties of achieving consensus amongst shareholders impede direct democracy.²⁰³ Even if those collective action problems could be overcome, however, active shareholder participation in corporate decision making still would be precluded by the shareholders' widely divergent interests and distinctly different levels of information. As to the former, while neoclassical economics assumes that shareholders come to the corporation with wealth maximization as their goal, and most presumably do so, once uncertainty is introduced it would be surprising if shareholder opinions did not differ on which course will maximize share value. As to the latter, shareholders lack incentives to gather the information necessary to actively participate in decision making and thus are rationally apathetic.

Consequently, it is hardly surprising that, among companies, corporate governance precisely fits Arrow's model of an authority-based decision-making system.²⁰⁴ Shareholders lack the

¹⁹⁹ why have a board?, <https://www.iod.org.nz/>, (Retrieve on 12/8/2013)

²⁰⁰ Ibid

²⁰¹ Ibid

²⁰² Ricardo Molano-León, *The roles of the board of directors: The unresolved riddle*, (2011), p. 548.

²⁰³ Ibid

²⁰⁴ Franklin A. Gevurtz, *Supra* note 198

information and the incentives necessary to make sound decisions on either operational or policy questions. Under these conditions, Arrow predicts, it is "cheaper and more efficient to transmit all the pieces of information to a central place"²⁰⁵ and to have the central office "make the collective choice and transmit it rather than retransmit all the information on which the decision is based,"²⁰⁶ which is precisely what a board-centred system of corporate governance does.

When we come to the second question (issue), i.e. why not a monarchy? Or why a board than an individual autocrat? In theory, corporate governance has always been board-centred. As the Delaware General Corporation Law, for example, has long put it: the corporation's "business and affairs shall be managed by or under the direction of the board of directors."²⁰⁷ We can see this from the following Cadbury's definition of corporate governance. Cadbury's Report define corporate governance as²⁰⁸ *"Corporate governance is the system by which companies are directed and controlled. The boards of directors are responsible for the governance of their companies. The shareholder's role in governance is to appoint the directors and the auditors to satisfy themselves that an appropriate governance structure is in place."*

The Cadbury's model/definition of corporate governance thus contemplates not a single hierarchy, but rather a multi-member body that typically will act by consensus.²⁰⁹ In practice, however, corporations are de facto run by a CEO, or a team of senior managers, with little or no interference from other stakeholders.²¹⁰ Shareholders are essentially powerless and typically quiescent. Boards of directors are little more than rubber stamps.²¹¹ In recent years, several trends coalesced to encourage more active and effective board oversight than a monarchy. One can notice this from the following;

²⁰⁵ Ibid

²⁰⁶ Ibid

²⁰⁷ Cadbury's report, European corporate governance institute, www.ecgi.org/codes/documents/cadbury, (retrieve on 14/10/2013)

²⁰⁸ Ibid

²⁰⁹ René B. Adams, et al, "Role of the Governance: A Conceptual Corporate in Directors Boards of Survey, and Frame work", *Journal of Economic Literature*, vol.48 No. 1, (2010), p. 58. (Available at: <http://www.aeaweb.org/articles.php?doi=10.1257/jel.48.1.58>)

²¹⁰ Cadbury's report, supra note 208

²¹¹ Lynne L. Dallas, "The Multiple Roles of Corporate Boards of Directors", *San Diego Law Review*, (2003), p. 781.

1. Effective board processes and oversight are essential if board decisions are to receive the deference traditionally accorded to them under the business judgment rule, especially insofar as structural decisions are concerned.²¹²
2. Directors' conduct is constrained by an active market for corporate control, ever-rising rates of activist shareholders.²¹³ As a result, modern boards of directors typically are smaller than their antecedents, meet more often, are more independent from management, own more stock, and have better access to information.²¹⁴
3. The economic advantages associated with board primacy vis-à-vis CEO primacy come into play when we consider the three major functions of the board of directors:²¹⁵ (1) providing an in-house set of specialists and access to a network of outside resources; (2) broad policy making; and (3) monitoring and disciplining top management.

Along with the above reasons, the following can place as a justification for board centred model of corporate governance than other types of governance.

1. GROUP DECISION-MAKING

Stephen Bainbridge in his article²¹⁶ asking why corporate law calls for a board, rather than just a chief executive officer, to be at the apex of the corporation's management. Stephen Bainbridge points to behavioral psychology studies which suggest that groups, such as corporate boards, often produce better decisions than can single individuals when it comes to matters of judgment. The notion that groups might reach better decisions than individuals is hardly new to corporate law scholarship.²¹⁷

Networking is the easiest context in which to make the case for groups, of course. Unlike a single CEO, who often came up through the ranks, specializing in a particular area of the firm's business, a diverse board comprised mainly of outsiders links the firm to a network of other

²¹² Bay singer, et al, 'Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition', Journal of Law, Economics, and Organization, (1985), p. 101.

²¹³ Lynne L. Dallas, *supra* note 211, p. 782

²¹⁴ *Ibid*

²¹⁵ *Ibid*

²¹⁶ Stephen M. Bainbridge, "Why a Board? Group Decision making in Corporate Governance", Vanderbilt Law Review, Vol. 55, No. 1, (2002), p. 12.
(Available at: <http://law.vanderbilt.edu/publications/vanderbilt-law-review/archive/volume-55-number-1-january-2002/index.aspx/>)

²¹⁷ Franklin A. Gevurtz, *Supra* note 206, p. 96

companies who may be useful suppliers or customers.²¹⁸ Likewise, such a board often includes persons with specialized expertise or professionals, such as lawyers or bankers, who can bring valuable outsider perspectives to the table.²¹⁹ Decision making by groups will generally be preferable to decision making by an individual autocrat when it comes to the sort of critical evaluative judgments boards are asked to make.²²⁰ Why, because, group decision making ensures individual overconfidence by providing critical assessment and alternative viewpoints.²²¹

2. REPRESENTATION OF CORPORATE CONSTITUENTS AND MEDIATING CLAIMS TO DISTRIBUTIONS

The other elucidation for the use of corporate boards focuses on the need to mediate the competing claims of those who have an interest in distributions from the corporation.²²² This derives from the rationale that a director /the board/ is expected to be independent and representative of the company and not of the shareholders, especially in the civil law countries.²²³ This sort of rationale asserts that boards exist to mediate claims not just among shareholders, but also between shareholders and other corporate constituencies, such as managers, other employees, creditors, and perhaps even the community at large.²²⁴

3. MONITORING OF MANAGEMENT

This rationale is that boards elected by shareholders exist as a necessary tool to monitor corporate management.²²⁵ Typically, this view starts with the assumption that corporate hierarchy exists to gain the advantage of team production, while minimizing agency costs (shirking and disloyalty) by having higher level agents monitor lower-level agents.²²⁶ The

²¹⁸ Ibid

²¹⁹ Stephen M. Bainbridge, *Supra* note, 216, p. 19

²²⁰ Franklin A. Gevurtz, *supra* note 217, p. 99

²²¹ Ibid

²²² Ricardo Molano-León, *Supra* note 202, p. 550

²²³ Ibid

²²⁴ Franklin A. Gevurtz, *supra* note 220, p. 103

²²⁵ Ricardo Molano-León, *Supra* note 223, p. 549.

And Terence J. Gallagher, *The Activist Board and Corporate Governance*, (2013), p 59. (Available at: Hein Online (<http://heinonline.org>))

²²⁶ Ricardo Molano-León, *Supra* note 225, p. 550

corporate board, elected by the shareholders, provides a solution to the practical difficulty of shareholders monitoring on their own behalf.²²⁷ The assumption is that shareholders, who are too numerous and disengaged to monitor management on their own behalf, will become sufficiently engaged and organized to select vigilant directors to perform the monitoring for the shareholders.²²⁸

4. THE NEED FOR CENTRAL MANAGEMENT

A simple-minded rationale often expressed for the board-centered model of corporate governance is that businesses with numerous owners need “central management.”²²⁹ The basic notion is that it is impractical to have numerous owners especially if they own freely tradable interests constantly meet together to make decisions for the firm.²³⁰ Companies are fashioned to boast a legal identity separate from the individuals who make up the membership of the company.²³¹ A company is the predominant form of legal creature for conducting business in the world today. The Law recognizes a company, as a “legal person²³²” which in its own rights, is capable of owning property, making contracts, conducting litigations and also responsible for doing wrongs. When we look at these matters from practical angle, and at the way in which this artificial person functions; its corporate will is manifested, its decisions taken and its acts performed, we see that a company cannot do anything at all except through the human beings; the business of a company is run and managed by its board of directors.²³³

When companies are floated and public issues are brought, big advertisements are issued giving big names as directors and promoters of the company.²³⁴ These names are the names of successful CEOs, or directors who have achieved success in other fields. Due to these names at the very inception and formation of company, when there is no wealth or property of the company, the share of the company is sold at a premium promising big business and success.²³⁵ Once money is mopped up from the public, in all those cases where the companies were created

²²⁷ Ibid

²²⁸ Ibid

²²⁹ RC Clark, Supra note. 55, P. 16

²³⁰ Stephen M. Bainbridge, Supra note 219, p.106

²³¹ Paul L. Davies, Introduction to Company Law, New York: (Oxford University Press, 2002), p. 112.

²³² Ibid

²³³ Stephen M. Bainbridge, Supra note 230, p.106

²³⁴ Franklin A. Gevurtz, supra note 224

²³⁵ Ibid

only for the purpose of wipe up hard earned money of public or to befool them,²³⁶ it is found that those big names disappear and in almost every litigation those directors who formed part of the core of the company and gave promises that the company would do roaring business quietly disappear from the scene or take plea that they were not responsible for business of the company.²³⁷

Company is a legal personal and BoD acts as its body and mind. BoD is the governing body of a corporation, elected by the shareholders to establish corporate policy, appoint executive officers, and make major business and financial decisions.²³⁸ A Director is a person charged with the conduct and management of the company's activities. The directors (as a body, the "Board of Directors" or the "Board"²³⁹), act as a team, under the authority of a meeting that is properly convened and is duly quartet, without improper exclusion of any of the directors. The Board, then, as a team, conducts and regulates the affairs of the company. The board does all such activities as the company law of a country authorizes it to exercise, unless any law or the constitutional documents of the company requires the exercise of the power, or the doing of any act or thing, to be by the company in general meeting. The supreme authority in the control of a company and its affairs resides by delegation in individual known as directors who are collectively designated the board of directors.²⁴⁰

2.3.3. TYPES OF BOARD OF DIRECTORS AND BOARD SYSTEM

Diversified expertise is considered the key to efficient board work. A variety of professional backgrounds is needed to ensure that the board as a whole understands, for example, the complexities of global markets, the company's financial objectives and the impact of the business on different stakeholders including employees. Accurate assessment of skills and expertise is the single most important factor in selecting board members. Therefore, recruitment policies which identify the precise skills needed by the board could help increase its ability to monitor the company effectively.

²³⁶ Ibid

²³⁷ Ibid

²³⁸ Bryan A. Garner (Editor in Chief), Black's Law Dictionary, 9th Edition, USA: (West Publishing Co., 2004), p. 196.

²³⁹ Stephen G. Marks, The Separation of Ownership and Control, (1999, p. 693.

²⁴⁰ Ibid

There are different types of directors or board of directors. Their difference lies on their means of acquiring the status and power or role that they have played in the governance of companies. Most directors can be classified as inside directors or outside directors. Inside directors are employees or former employees of the firm.²⁴¹ They generally are not thought to be independent of the CEO, since the success of their careers is often tied to the CEO's success. Outside directors are not employees of the firm and usually do not have any business ties to the firm aside from their directorship.²⁴² Outside directors are typically CEOs from other firms or prominent individuals in other fields. The following are some of the types of directors.

Shadow directors: - In addition to those who are formally appointed as directors, any person, other than a professional advisor, with whose instructions the directors of the company normally comply is a shadow director.²⁴³ In other words, where a person who is not a director exerts such an influence over the company's directors that those directors are accustomed to acting in accordance with that person's instructions, that person is a shadow director.²⁴⁴ The significance of being a shadow director is that a shadow director has many of the legal responsibilities of a director.

De facto directors: directors are defined in law according to what they do, rather than their actual job title. Even a person not formally appointed to the board might be deemed a director if his role could be considered equivalent to that of a director, or if he has acted as a director.²⁴⁵ This is known as a de facto director.²⁴⁶ A de facto director is a person who has not been validly appointed or who is disqualified but whom in effect occupies the position of, and acts as if he were, a director. In addition to the legal categories of director as set out above, other terms are used in business to describe company directors.²⁴⁷ In practice company directors are generally categorized as either being executive directors or non-executive directors.²⁴⁸ However, it is

²⁴¹ Deakins, et al, The Role and Influence of External Directors in Small, Entrepreneurial Companies: Some Evidence on VC and Non-Vc Appointed External Directors, (2000), p. 111.

²⁴² Ibid

²⁴³ Ibid

²⁴⁴ Ford, R. H., Outside Directors and the Privately-Owned Firm: Are They Necessary? Entrepreneurship: Theory & Practice, (1988), pp. 49-57.

²⁴⁵ Ibid

²⁴⁶ Ibid

²⁴⁷ Ibid

²⁴⁸ Why every board needs fresh eyes, <http://www.larryputterman.com/#sthash.f7Mpzd16.dpuf>, (accessed on 23/9/2013)

important to note that these are not legal classifications but rather are distinctions drawn under corporate governance best practice.

Executive directors: Executive directors /also called senior-most executives or 'inside directors'²⁴⁹/ directors of the company who are involved in the day to day management of the company. As these individuals are involved in the management of the company they may, in practice, have specific titles within the company, for example, managing director, marketing director, finance director etc. Executive directors perform operational and strategic business functions such as, managing people, looking after assets, hiring and firing and entering into contracts.²⁵⁰

Non-Executive directors: non executive director (also called as experts or respected persons chosen from the wider community, independent directors or outside directors²⁵¹) are not involved in the day to day management of the company and are appointed from outside the company.²⁵² The rationale behind appointing non-executive directors is that, as they are not involved in the day to day management of the company, they can bring an independent voice and perspective to the board.²⁵³ For example, a "scientific advisory board" would be useful in providing technical guidance to a firm whereas a "business advisory board" would be helpful in advising on matters of a financial or marketing nature.

Nominee directors: Normally, banks or other financial institutions give huge loans to companies and in order to protect their interests, they nominate their directors on the board of Companies.²⁵⁴ These directors are called nominee directors and the function of these directors is to safeguard the financial interest of the institution and to ensure that no decision is taken by

²⁴⁹ Thomas Ritchie, Independent Directors: Magic Bullet or Band-Aid?, (2007), p. 7

²⁵⁰ Ibid

²⁵¹ <http://epublications.bond.edu.au/cgej>The International Finance Corporation(World Bank Group), Who's Running the Company?: A guide to reporting on corporate governance, Washington: 2012, p. 17

²⁵² Ibid

²⁵³ Zalecki, Paul H., The Corporate Governance Roles of the Inside and Outside Directors, University of Toledo Law Review, (1993), p. 24

²⁵⁴ Ibid

BoD which goes against the financial institution. Such directors are not considered responsible for the business of the company.²⁵⁵

'BOARD STRUCTURE'

'Board structure' refers to whether a board is a single-tier board or two-tier board, and 'board composition' refers to the make-up of the board in terms of executive and non-executive directors, independent and affiliated directors, and shareholder-elected and employee-elected directors.²⁵⁶ The one-tier board system is the practice of common law countries. A single-tiered board is a single body of directors who sit together in board meetings and pass board resolutions.²⁵⁷ The two-tier board system has originated in German law. A two-tiered board is where there are two separate bodies of directors /supervisory board and a management board/ operating separately but interacting with each other. It was introduced with the intention of enhancing the monitoring of management.²⁵⁸ The supervisory board has the right of appointing and replacing members of the managing board and the obligation of supervising the management of the company.²⁵⁹

2.3.4. THE ROLE OF BOARDS OF DIRECTORS IN CORPORATE GOVERNANCE

2.3.4.1. KEY CORPORATE ACTORS

There are two fundamental elements in the rights, privileges and powers etc. of a shareholder: the power to play a part in the governance of the company, and the right to a share in its profits.²⁶⁰ Closed companies, with few owners, frequently offer good opportunities for shareholders to monitor – and perhaps take active part in the administration of the company's

²⁵⁵ Ibid

²⁵⁶ Professor David F. Larcker, Board of Directors: Structure and consequences Corporate Governance Research Program, Stanford Graduate School of Business, (2011), p. 11

²⁵⁷ Hopt KJ, The German Two-Tier Board (Aufsichtsrat) A German View on Corporate Governance in Hopt KJ and Wymeersch E (ed), Comparative Corporate Governance, Essays and Materials, New York: Walter de Gruyter, (1997), p 6.

²⁵⁸ Ibid

²⁵⁹ Ibid

²⁶⁰ Per Samuelsson, Boards of Limited Companies; Internal Governance Structures, Stockholm Institute for Scandinavian Law, (2009), p. 260

affairs.²⁶¹ Once a company's ownership grows beyond a certain size, relations between shareholders change.²⁶² Practical reasons make it impossible for all of them to be involved in company administration. As a result, shareholders who do not participate actively in the administration of the company are exposed to a risk: the financial gain from their investment may turn out to be less than expected in consequence of the active groups who have secured benefits for themselves at the other shareholders' expense.²⁶³ Here we perceive one of the classic problems with limited companies, and one of the hardest to solve; how can we minimize the unfavorable effects which arise when shareholding is separated from participation in corporate governance?

To begin with the legal technicalities of the issue, corporate law distributes influence over administration by means of a hierarchic structure of organs. From a principal point of view, the shareholders' general meeting is the superior organ, usually appointing the board of directors.²⁶⁴ The board is a collegiate organ, responsible for the organization of the company and the administration of its affairs.²⁶⁵ The board may, in its turn, appoint a managing director whose job it is to run the company's day-to-day business in accordance with guidelines and directions issued by the board.²⁶⁶ Mainly, there are three groups of people playing important roles in managing and monitoring a corporation.²⁶⁷ An effective governance framework establishes stable and accepted relationships between shareholders, the board, management, and other stakeholders.²⁶⁸ In effect, it defines an agreed distribution of power between the main players involved with the firm. This is an essential prerequisite for the effective operation of an enterprise.

Shareholders are the real company owners because they invest their money. They indirectly control the company by appointing the board of directors as their representatives to supervise the

²⁶¹ Ibid

²⁶² Kiel, et al, "Evaluating Boards and Directors: Corporate Governance": An International Review, vol. 13 No. 5, (2005), pp. 613-631.

²⁶³ Ibid

²⁶⁴ Ibid

²⁶⁵ Renée Adams, et al, The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey, (November 2008), p. 10

²⁶⁶ Ibid

²⁶⁷ Ibid

²⁶⁸ Ibid

company for their best interest.²⁶⁹ Shareholders clutch the ultimate right to decide imperative matters. They also have the right to get returns from their investment in the company. The shareholders own the company and they appoint the directors who in turn appoint the managers.²⁷⁰ When companies raise capital by attracting new investors, these new shareholders will, with the current shareholders, want to make sure that their interests are served by a competent board of directors.²⁷¹

The management team, appointed by the board, implements the policies assigned by the board.²⁷² The last group, the board of directors oversees the company by setting policies, monitoring management performance, and protecting assets of the company.²⁷³ The board is a collegiate organ, responsible for the organization of the company and the administration of its affairs.²⁷⁴ The board may, in its turn, appoint a managing director whose job it is to run the company's day-to-day business in accordance with guidelines and directions issued by the board.

Effective corporate governance requires a clear understanding of the respective roles of the board, management and shareholders, their relationships with each other, and their relationships with others that have an interest in the corporation and its well-being.²⁷⁵ The relationships of the board and management with shareholders should be characterized by transparency and appropriate engagement; their relationships with employees should be characterized by fairness;²⁷⁶ their relationships with the communities in which they operate should be characterized by good citizenship; and their relationships with government should be characterized by a commitment to compliance.²⁷⁷

The board of directors has the important role of overseeing management performance on behalf of shareholders.²⁷⁸ Its primary duties are to select and oversee a well-qualified and ethical chief

²⁶⁹ Ibid

²⁷⁰ Jonathan Berk and Peter Demarzo, *supra* note 29, p. 40

²⁷¹ Ibid

²⁷² Id , p. 41

²⁷³ Id , p. 42

²⁷⁴ Ibid

²⁷⁵ Business Roundtable, Principles of Corporate Governance, USA, (2012), p. 8

²⁷⁶ Ibid

²⁷⁷ Ibid

²⁷⁸ John, K., and L. Senbet, "Corporate Governance and Board Effectiveness", Journal of Banking and Finance vol. 22, (1998), p. 371

executive officer who, with other management, runs the corporation on a daily basis, and to monitor management's performance and adherence to corporate and ethical standards.²⁷⁹ Effective corporate directors are diligent monitors, but not managers, of business operations.²⁸⁰

Management, led by the CEO, is responsible for running the day-today operations of the corporation and properly informing the board of the status of these operations.²⁸¹ Shareholders invest in a corporation by buying its stock/ shares and receive economic benefits in return. Shareholders are not involved in the day-to- day management of corporate operations, but they have the right to elect representatives (directors) to look out for their interests and to receive the information they need to make investment and voting decisions.²⁸² Shareholders also should expect that a corporation will be responsive to issues and concerns that are of widespread and long-term shareholders interest.²⁸³

Effective corporate governance requires a proactive, focused state of mind on the part of directors, the CEO and senior management, all of whom must be committed to business success through the maintenance of the highest standards of responsibility and ethics.²⁸⁴ Although there are a number of legal and regulatory requirements that must be met, good governance is far more than a "check the box" list of minimum board and management policies and duties²⁸⁵. In addition, even the most thoughtful and well-drafted policies and procedures are destined to fail if directors and management are not committed to enforcing them in practice. A successful corporate governance structure for any corporation is a working system for principled goal setting, effective decision making, and appropriate monitoring of compliance and performance.²⁸⁶ Through this vibrant and responsive structure, the board of directors, CEO and senior management can interact effectively and respond quickly and appropriately to changing circumstances, within a framework of solid corporate values, to provide long-term value to shareholders.

²⁷⁹ Ibid

²⁸⁰ Ibid

²⁸¹ Ibid

²⁸² Ibid

²⁸³ Ibid

²⁸⁴ Ibid

²⁸⁵ Fama, E.F., And M.C. Jensen, "The Separation of Ownership and Control", The Journal of Law and Economics, (1983), P 303.

²⁸⁶ Ibid

The separation of ownership and control which is inherent in the modern corporate form of organization causes the agency problem between shareholders (the principals) and management (the agent).²⁸⁷ This is due to the nature of the company i.e. separation of ownership and management or separate legal personality of company and the ownership structure of a company is highly dispersed, and shareholders generally hold more than one kind of security to diversify their risks,²⁸⁸ therefore, no individual shareholder has enough incentives and resources to ensure that management is acting for the shareholders' interest. To control this agency problem, corporate governance "encompasses the set of institutional and market mechanisms that induce self-interested boards and or managers to maximize the value of the residual cash flows of the firm on behalf of its shareholders."²⁸⁹ Among the set of corporate governance mechanisms, the board of directors is often considered the primary internal control mechanism to monitor top management, and protect the shareholder interest.²⁹⁰ Board of directors is a "market-induced institution, the ultimate internal monitor of the set of contracts called a firm, whose most important role is to scrutinize the highest decision makers within the firm".²⁹¹

Earnings management can be seen as a potential agency cost since managers manipulate earnings to mislead shareholders and fulfil their own interests.²⁹² Therefore the board of directors which is in charge of solving the agency conflicts between managers and shareholders should play a role in restraining the level of earnings management. It is generally believed that a more active board is better for shareholders' interest, because directors have to spend more time and energy on the company affairs in an active board.²⁹³

Most organizations are governed by a board of directors. In fact, having a board is one of the legal (or at least by default) requirements for incorporation around the world.²⁹⁴ Many non incorporated entities also have a governing board of some kinds, such as a state university's

²⁸⁷ Ibid

²⁸⁸ Ibid

²⁸⁹ Corporate Library, Board effectiveness ratings: <http://www.thecorporatelibrary.com/Productsand-Services/board-effectiveness-ratings.html>, (2004), (Accessed 27 /9/ 2013).

²⁹⁰ Ibid

²⁹¹ Kiel, et al, Supra notes no. 262, P. 30

²⁹² Fama, E.F., And M.C. Jensen, Supra note 288

²⁹³ Ibid

²⁹⁴ Ibid

board of regents.²⁹⁵ Given the innumerable boards in place today, it is reasonable to ask, why do they exist at all? What do they do? These questions are at the heart of corporate governance. Although a company is a separate legal entity, it can only make decisions and change its business through the persons authorized for that purpose, usually the directors, who in turn are accountable to the members.²⁹⁶ There are many opinions on the role and responsibility of directors/board of directors in a Company. In Private Limited companies or the public companies, the role and responsibility of the directors or the board of directors depend upon the regulations in the articles of the company and the provisions of company law of a country in which the company acquires its legal personality.²⁹⁷

Good corporate governance exists only if a corporation has a perfect, model or ideal board.²⁹⁸ An ideal board is one which works closely with the Chief Executive Officer (the "CEO") of the company to give not only support and direction to him or her, but one which also challenges the CEO to make sure that s/he leads the company in accordance with the company's plans.²⁹⁹ The board should be the pillar which holds the company up.³⁰⁰ The board is responsible for the success or failure of the company. Furthermore, it is the soul and conscience of the enterprise. If the management of a company is not doing its career: that is because the board is not doing its job in the first instance. It is well settled that directors, while exercising their powers, do not act as agents for the majority or even all the members and so the members cannot by a resolution passed by a majority or even unanimously, supersede the directors' power and instruct them how they shall exercise their power i.e. a board serves the company not specific shareholders or groups.³⁰¹

Typically, a director is (or should be) a shareholder in the company. Directors are appointed, i.e. voted into office, by the shareholders of a company at a properly convened meeting of shareholders.³⁰² The number of directors of a company is determined by corporate law and a

²⁹⁵ Ibid

²⁹⁶ John, K., and L. Senbet, Supra note 278, p. 305

²⁹⁷ Ibid

²⁹⁸ Kiel, G. C. et al, Board, director and CEO evaluation, Sydney: (McGraw-Hill, 2005), p. 25

²⁹⁹ Ibid

³⁰⁰ Ibid

³⁰¹ Ibid

³⁰² Daily, C. M. and Dalton, D. R. Board of Directors Leadership and Structure: Control and Performance Implications, Entrepreneurship: Theory and Practice, (1993), pp. 65-81.

special resolution of shareholders, which number can be changed only by a shareholder vote.³⁰³ The role of the board of directors is great as it is the highest authority of any company between shareholders' meetings and managers.³⁰⁴ The board, acting either as a whole or through its committees, is responsible, among other things, for establishing, and helping the company achieve business and organizational objectives through oversight, review and counsel.³⁰⁵

The board of directors is the supreme governing body of the company, except for those matters which by law or as provided by the articles of incorporation must be decided by the general shareholders meeting.³⁰⁶ The effective supervision of all corporate activities is vested in the board. The board exercise its functions in the best interests of the company, in terms of viability and maximizing the long-term value of the company in legitimate interests involved, either of a public or private nature, and in particular taking into account other interest groups of the company: employees, customers, business partners and society in general.³⁰⁷ The board represents the interests of the membership, provides strategic direction expressed in broad policies, offers a clear, future-oriented leadership, outward vision and a broad range of viewpoints.

2.3.4.1. DIFFERENCES BETWEEN DIRECTORS AND MANAGERS

There are many fundamental differences between being a director and a manager. The difference is not simply a trifling matter of getting a new job, title and a bigger office. The differences are copious, substantial and quite onerous. The table below outlines the major differences between directing and managing.

Role	Directors	Managers
Leadership	It is the board of directors who must provide the intrinsic leadership and direction at the top of the organization;	It is the role of managers to carry through the strategy on

³⁰³ Ibid

³⁰⁴ Ibid

³⁰⁵ Ibid

³⁰⁶ Paul L Davies, The Board of Directors: Composition, Structure, Duties and Powers, London: London School of Economics and Political Science, (December 2000),p. 5

³⁰⁷ Ibid

	establish and maintain its vision, mission and values. It is the responsibility of the board of directors to provide central leadership and direction in formulating company strategy.	behalf of the directors.
Decision making	are required to determine the future of the organization, its strategy and structure and protect its assets and reputation and take into account how their decisions relate to stakeholders and the regulatory framework. Directors have control of the company's assets and must determine the future of the organization.	Managers are concerned with implementing the decisions and policies made by the board, or are not responsible for making strategic decisions for the company.
Duties and responsibilities	Directors, not managers, have the ultimate responsibility for the long-term prosperity of the company. Directors are required in law to apply skill and care in exercising their duty to the company and are subject to fiduciary duties. If they are in breach of their duties or act improperly, directors may be made personally liable in both civil and criminal law. On occasion, directors can be held responsible for acts of the company.	Managers have far fewer legal responsibilities.
Relationship with shareholders	Directors are accountable to the shareholders and other stakeholders for the company's performance and can be removed from office by them or the shareholders can pass a special resolution requiring the directors to act in a particular way. Directors act as "fiduciaries" of the shareholders and should act in the best interests of the company (as a separate legal entity).	Managers are usually appointed and dismissed by directors or management and do not have any legal requirement to be held to account.

Source: Chris Pierce, "The Effective Director," London: Kogan Page, 2003 As cited in The International Finance Corporation(World Bank Group), Who's Running the Company?: A guide to reporting on corporate governance, Washington: 2012, 19

CHAPTER THREE

CORPORATE GOVERNANCE AND BOARD OF DIRECTORS IN PRIVATE LIMITED COMPANIES: THE PRACTICES SOME COUNTRIES

3.1. NATURE OF PRIVATE LIMITED COMPANIES

Private limited companies are incorporated businesses – which means they are set up as legal entities in their own right and exist quite separately from their owners. The owners of private limited companies are called shareholders, because they own a part, or a share, of the company. For the reason that a company is a separate legal entity, shareholders owe limited liability for the debts of the business. A private limited company can own property and equipment employ people and borrow money. It also pays corporation tax (an income tax on companies) from the profits of the company as well as the dividends' to be paid to the individual shareholders i.e. economic double taxation.

A private limited company is a very different form of business enterprise from a sole trader or a partnership in that a private limited company is a separate legal entity from its members. This means that a company can raise finance in its own right and any debt which is run up belong to the company and not the owners. Private Limited companies are owned by shareholders who have limited liability under law. What this means is that if a private company runs up huge debts the individual shareholders will not have to sell their private possessions to cover the debts, they will simply lose the money they have invested in the business. Limited liability companies are incorporated businesses that exist quite separately from their owners. Private limited companies are not allowed to sell their shares to the general public. A private company is a separate legal entity formed by persons entering into an agreement called a memorandum of association (Memorandum).

The major difference between a public and private company is in relation to the level and marketability of its share capital.³⁰⁸ Public companies are also subject to a number of statutory

³⁰⁸ Two differences between Private limited and public limited companies, <http://answeryahoo.com/question/index?> (retrieve on 23/10/2013)

requirements which do not apply to private companies.³⁰⁹ Most companies in the business world are private companies limited by shares whose members are known as shareholders.³¹⁰ The Company's constitutional documents comprise the memorandum, its articles of association (Articles) and any resolutions which affect the Articles.³¹¹ PLC is one of the foundations of the world's business community.³¹² Its creation, growth and longevity are critical to the success of the global economy.³¹³ Although facing many of the same day to-day management issues as publicly-owned companies, they must also manage many issues specific to their status.³¹⁴

A private limited company is a legal entity or a type of incorporated firm which (like a public company) offers limited liability to its shareholders but which (unlike a public company) places certain restrictions on its ownership.³¹⁵ These restrictions are spelled out in the firm's articles of association or bylaws and are meant to prevent any hostile takeover attempt. The major restrictions are: /shareholders/ cannot sell or transfer their shares without getting consent of majority shareholders and offering them first to the other stockholders for purchase, shareholders cannot offer their shares or debentures to the general public over a stock exchange and number of shareholders cannot exceed a fixed figure.³¹⁶

There different types of private limited company around the world. We can mention for example, private limited company by share, private limited by guarantee and unlimited private limited company /type of private limited company whose liability is unlimited/.³¹⁷ A private company limited by shares means the members' /shareholders/ liability is limited to the original value of the shares issued but not paid for.³¹⁸ A company is limited by shares when the liabilities of its owners /shareholders/ bear do not exceed the monetary value of the shares they hold.³¹⁹

³⁰⁹ Ibid

³¹⁰ Ibid

³¹¹ Ibid

³¹² Corporate law, <http://tools.wmflabs.org/ftl/cgi-bin/ftl?>, (Retrieve on 27/10.2013)

³¹³ Ibid

³¹⁴ Ibid

³¹⁵ Ibid

³¹⁶ Ibid

³¹⁷ Types of Business - Private Limited Companies, <http://tools.wmflabs.org/ftl/cgi-bin/ftl?> (Retrieve on 27/10/2013)

³¹⁸ Ibid

³¹⁹ Ibid

Companies limited by guarantee are companies formed on the principle of having the liability of its members limited to the respective amounts that the members guarantee to contribute to the property of the company if it is wound up.³²⁰ This type of company does not have a share capital and its members are guarantors rather than shareholders. A private company limited by guarantee means the company members financially back the company up to a specific amount if things go wrong.³²¹ There are no shareholders in a company limited by guarantee instead anyone who joins the company is known as a member.³²² The members are effectively the owners of the company and all members must guarantee to pay a nominal if the company is in debt or on winding up.³²³ Companies limited by guarantee cannot raise finance by issuing/ selling shares and therefore do not have a share capital.³²⁴

3.1.1. GOVERNANCE OF PRIVATE LIMITED COMPANIES

The primary purpose of a corporate governance structure should always be the efficient management of the company.³²⁵ Therefore, in determining such corporate structure, the company's size and activity should be taken into account. A too heavy corporate structure may sometimes prove inefficient and impede the company's development.³²⁶ Thus, corporate governance structure and system of share (public) company and private limited company could not be same due to their difference in size and activity what they perform.³²⁷

Kenneth Arrow's work on organizational decision-making, who identified two basic decision-making mechanisms: "consensus" and "authority."³²⁸ Consensus is utilized where each member of the organization has identical information and interests, which facilitates collective decision-making. In contrast, authority-based decision-making structures arise where team members have different interests and amounts of information. Authority-based structures are characterized by the existence of a central agency to which all relevant information is transmitted and which is empowered to make decisions binding on the whole because collective decision-making is

³²⁰ Ibid

³²¹ Ibid

³²² Ibid

³²³ Ibid

³²⁴ Ibid

³²⁵ Ibid

³²⁶ Ibid

³²⁷ Ibid

³²⁸ Kenneth J. Arrow, the Limits of Organization, (1974), pp. 68-70.

impracticable in such settings.³²⁹ Decision-making systems in small business firms such as private limited companies and other family businesses typically resemble Arrow's consensus model. As firms grow in size /this growth might be in number or capital/, however, consensus-based decision-making systems become impractical since human want and interest is unlimited and divergent. In most countries corporate governance practices show that there are mainly three bodies that play in the governance of private limited companies. These are shareholders /through appointment of directors, conducting general meetings/, board of directors and managers.

One may think that board of directors is reserved for large corporations to oversee shareholders' investments and strategic decisions to be made. The truth is that many small businesses can benefit from having a board of directors. Not all small businesses have the skills they need to operate effectively especially if they've experienced rapid growth. A board of directors can help by adding to and complementing skills and industry expertise that you might not have in-house. A board can also help ensure you have the right processes in place to manage growth, focus your strategy, and prepare to raise capital. Effective and networked boards can also help bring in new talent both at the board and management level—and help with succession planning /an important aspect of running a family business/. More than anything, a board of directors is there to help the company effectiveness.³³⁰ A board can give private limited companies the opportunity to step back from the tangled hairball of day-to-day tactical business operations and focus strategically and objectively on business at large.³³¹

3.1.2. WHY CORPORATE GOVERNANCE MATTERS TO PRIVATE LIMITED COMPANIES

According to the OECD, a corporate governance framework consists of three main elements³³²:

- ✓ A set of relationships between a company's management, its board, its shareholders and other stakeholders.

³²⁹ Id, p. 69

³³⁰ Institute of Directors, Corporate Governance Guidance and Principles for Unlisted Companies in the UK, UK: (2010), p. 11 ((Available at: www.iod.com, (accessed at 21/10/2013))

³³¹ Ibid

³³² OECD Principles of Corporate Governance , Supra note 176

- ✓ A structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined.
- ✓ Proper incentives for the board and management to pursue objectives those are in the interests of the company and its shareholders.

The establishment of an effective governance framework that defines the firm's approach to each of these issues is of equal importance to public and private limited companies.³³³ However, there are a number of reasons why private limited companies should specifically concern themselves with corporate governance. Among these the following are some;

i) Performance and Internal Efficiency

Corporate governance is ultimately concerned with the decision-making processes, procedures, and attitudes that assist the company in achieving its objectives.³³⁴ It is the framework within which decisions are made and power exercised.³³⁵ Consequently, as the firm seeks to improve the professionalism and sustainability of its activities, it needs to give greater thought to issues of governance. This is a particular need if the company wishes to shift away from dependence on the unique contribution of the founding entrepreneur. Although the ability and dynamism of one individual may have been instrumental in establishing the enterprise, this is unlikely to be sustainable in the longer term.³³⁶ As the company grows in size and maturity or outlives the interest or working life of the founder, governance processes must be established to ensure continuity and success beyond the efforts of one person.³³⁷

Undeniably, the development of effective governance processes may lift a significant burden from the founder, facilitate a swift succession and allow access to a wider pool of expertise and know-how.³³⁸ The result may be improved leadership, decision-making and strategic vision. Improved governance may also make it easier to monitor and manage the various risks to which the company is exposed, particularly as it grows in size and complexity.

³³³ Supra note 330, p. 11

³³⁴ Id, p. 10

³³⁵ Ibid

³³⁶ Ibid

³³⁷ Ibid

³³⁸ Ibid

Governance will also become an increasing issue for private limited companies as they develop new sources of finance.³³⁹ Initially, the primary source of funds is likely to be retained earnings or financing from internal networks, e.g. families or associated corporate groups. However, private limited companies may also turn to banks, venture capitalists, and private equity investors in order to finance their expansion and growth. A greater reliance on such external sources of finance will necessitate the implementation of a more explicit governance framework, as external financiers seek assurance that their investments will be well managed.³⁴⁰ In particular, the involvement of additional owners in the company, even if the founder retains a controlling stake, will require governance mechanisms to resolve differences between shareholders with potentially diverging agendas. A governance structure that sustains the confidence of internal and external sources of finance such as shareholders, banks and other creditors will contribute to the long-term success of the firm by securing the commitment of patient capital partners.³⁴¹ The reward to the company of such a governance structure will be more stable financing at lower cost than would otherwise be available.³⁴²

ii) Managing Patient Capital and Illiquidity Risk

Shareholders in private limited companies are typically restricted in terms of their ability to sell their ownership shares or stakes.³⁴³ By definition, the shares of private limited companies are not quoted or traded on public equity markets. Furthermore, company law restricts the sale or marketing of shares in private limited companies to the general public (or even to any persons without a prior connection with the company or its existing shareholders).³⁴⁴ Restrictions on the transfer of shares may also be introduced by the shareholders themselves (e.g. through the company's articles of association or shareholder agreements). As a result, the shareholders of private limited companies may find themselves in the uneasy position of being "captive"³⁴⁵ owners of a company. This lack of liquidity presents shareholders with a significant investment

³³⁹Id, p. 11

³⁴⁰ Ibid

³⁴¹ Ibid

³⁴² Ibid

³⁴³ Id, p. 12

³⁴⁴ Ibid

³⁴⁵ Ibid

risk.³⁴⁶ Investors are forced to commit themselves to the company for the medium to longer term performance of the company. In contrast to the owners of public companies, shareholders private limited company do not have the option of easily selling their shares when they are in disagreement with the company's strategy or if they believe the company's activities become too risky.

An effective corporate governance framework provides a way of mitigating this risk. It provides shareholders in private limited companies with some reassurance that, although there is no easy exit from their ownership stake, their interests will continue to be respected and safeguarded by the board and company management.³⁴⁷ Moreover the governance framework may also induce reflection on a possible exit strategy for those shareholders that feel the necessity to exit the company's share capital partly or completely.³⁴⁸ Consequently, shareholders are more likely to invest in the company in the first place. Furthermore, they will be more comfortable in their role as patient capital partners, and be a source of support for the company over the longer term.

iii) Building Corporate Reputation in Line With Societal Expectations

Private limited companies have to operate within a social context in which there exists growing public scrutiny of corporate behavior. The governance of companies is an issue of increasing interest for outsiders such as the media and civil society.³⁴⁹ Furthermore, the public demand for improved corporate accountability and transparency has grown in the wake of the recent financial crisis.³⁵⁰ Existing corporate governance codes for private limited companies are also raising the profile of corporate governance. In particular, global corporate governance principles (e.g. the OECD) Corporate Governance Code is shaping societal norms of appropriate corporate structures, procedures and behavior. In assessing whether companies are governing themselves appropriately or not public opinion pay much regard to nuance. Indeed, private limited companies may even be viewed with greater suspicion by external observers due to their lower levels of transparency in comparison with publicly held enterprises.³⁵¹

³⁴⁶ Ibid

³⁴⁷ Id, p.13

³⁴⁸ Ibid

³⁴⁹ Ibid

³⁵⁰ Ibid

³⁵¹ Beatrix Dekoster (ed.), supra note 6, p. 10

Good governance can play a crucial role in gaining the respect of key external stakeholders such as actual and potential financiers, employees, customers, and local communities.³⁵² Good governance effectively provides a “license to operate”, since it offers external stakeholders assurance that the company is being run in an appropriate and responsible manner, with due regard for the interests of “non-insiders”.³⁵³ When company behavior does not fulfill the expectations of society, the company may suffer significant consequences.³⁵⁴ Even if the firm is not breaking any formal laws, it may be operationally affected by the negative perception of employees and consumers.³⁵⁵ The implementation of a robust governance framework is the main means by which such significant reputational risks can be mitigated.

The corporate governance system and structure of private limited company shows as there is a slight difference between countries in the globe. For the sake of comparative analyses in assessing corporate governance of PLCs in Ethiopia particularly in making board of directors compulsory, the writer discuss what seems the corporate governance system and board of director’s role and status of private limited company in the common law and civil law countries as a whole and in OHADA uniform act, France, china and India.

3.2. CORPORATE GOVERNANCE AND BOARD OF DIRECTORS OF PRIVATE LIMITED COMPANIES IN COMMON LAW VS. CIVIL LAW LEGAL SYSTEM

In most of common law countries, private limited company and companies limited by guarantee may be registered with only one member.³⁵⁶ The shareholders, as owners of the company, are entitled to delegate management to the directors.³⁵⁷ English law takes a shareholder-centered view of the companies, as demonstrated for example, in the UK Corporate Governance Code which sets out principles of corporate governance in the interests of shareholders. Directors are seen as stewards of the shareholders.³⁵⁸ Private limited Companies are formed by shareholders and managed by directors for the benefit of shareholders and this purpose is achieved through

³⁵² Ibid

³⁵³ Ibid

³⁵⁴ Ibid

³⁵⁵ Ibid

³⁵⁶ supra note 350, p 6

³⁵⁷ Ibid

³⁵⁸ Ibid

fiduciary obligations and a duty of care and skill, with remedies available for a breach.³⁵⁹ One of the basic principles of corporate governance of private limited companies in UK is to have directors.³⁶⁰ Every company should strive to establish an effective board, which is collectively responsible for the long-term success of the company, including the definition of the corporate strategy.³⁶¹

One of the main shareholder rights is to nominate the directors and define the powers the board of directors is entrusted with. As such, the shareholders ultimately define the overall contours of the governance framework. According to the 2006 UK company law, the board of directors is envisaged as the primary decision-making body of the company. It is collectively responsible for all aspects of the company's activities. Notwithstanding the possibility for shareholders to limit the power of the board, its broad responsibilities are to establish and maintain the company's vision, mission, and values, to establish its structure, strategy, and risk profile, to delegate authority to management, and to monitor and evaluate its implementation of policies, strategies, and operational plans and to be responsible to shareholders and other stakeholders.³⁶²

Section 154 of the 2006 Companies Act requires that every public company to have at least two directors whilst every private company should have at least one director (although the Secretary has to be a different person).³⁶³ In a public company, if there is only one director, this director cannot act except to appoint a sufficient number of directors, which is prescribed in the Model Articles for Public Companies.³⁶⁴ The shareholders, as owners of the company, are entitled to delegate management to the directors. Even courts do not seek, and are not entitled (other than in certain limited exceptions) to overturn the exercise of this delegated power by the directors³⁶⁵. The shareholders are able to vote out directors on a majority vote at a meeting called on special notice.³⁶⁶ Any exercise of this right cannot be expressly curtailed by private agreement or in the Articles. It is not a statutory requirement that a director own shares in the company but a

³⁵⁹ Ibid

³⁶⁰ Ibid

³⁶¹ Ibid

³⁶² Ibid

³⁶³ Company act 2006, section 82

³⁶⁴ Statutory Instrument 2008/329, article 11

³⁶⁵ Institute of Directors, Supra note 301, p 8

³⁶⁶ Supra note 302, section 303

requirement can,³⁶⁷ however, be inserted in the Articles of Association. Any appointment of a director at a vote of members in general meeting shall be voted on, on an individual basis.³⁶⁸

Under the UK 2006 Company act every company is required to appoint an auditor or auditors³⁶⁹ and auditors must be appointed at a general meeting of members. However, it is possible for a private company to elect not to appoint auditors annually³⁷⁰. The auditors are also entitled to receive notice of and attend general meetings and be heard at any meetings where matters relevant to them as auditors are to be discussed.³⁷¹

In Germany, mainly there are two commonly known companies, namely, the Limited Liability Company (Gesellschaft Mit Beschränkter Haftung or GMBH) and the Stock Corporation (Aktiengesellschaft or AG).³⁷² In Germany, there are four different ways to appoint a director in private limited companies: the articles of association may provide for the appointment of the directors³⁷³, in case the articles of association do not provide for the appointment of the directors and the company does not have a supervisory board, the directors are appointed by the members,³⁷⁴ the articles of associations may provide that a different body has authority to appoint the directors³⁷⁵. This body does not have to be constituted by members of the company.³⁷⁶ Even authorities, creditors, parent companies or other third parties may be granted such a competence.³⁷⁷ The supervisory board in private Limited Companies is optional.³⁷⁸

When we see the corporate governance system of private limited companies in the common law and civil law legal system, there is no uniformity on the governance system and structure of PLCs. However, the majority of the common and civil law countries regulate private limited companies to have directors. For example, Czech Republic, England, Estonia, France, Ireland,

³⁶⁷ Ibid, section 287(3)

³⁶⁸ Ibid, section 287(3)

³⁶⁹ Ibid, section 384

³⁷⁰ Ibid, section 386

³⁷¹ Ibid, section 390

³⁷² The Reform of German Private Limited Company: Is the GmbH Ready for 21st Century? <http://www-germanlawjournal.com/article.php/> (retrieve on 22 10/2013).

³⁷³ Gesetz betreffend die Gesellschaften mit beschränkter Haftung (Limited Liability Company Act), section 6(3), sentence 2, 6(4) Gesellschaft mit beschränkter Haftung (GmbHG)

³⁷⁴ Ibid, sections 6(3), sentence 2, 46 no. 5 GmbHG

³⁷⁵ Ibid, section 45(2) GmbHG

³⁷⁶ Carsten Gerner et al, *Infra* note 403 p 328

³⁷⁷ Ibid

³⁷⁸ *Supra* note 375, Section 52

Wales, Norway and Switzerland, Germany, Australia, Finland etc make private limited companies to have directors/board of directors.³⁷⁹

3.3. CORPORATE GOVERNANCE AND BOARD OF DIRECTORS OF PRIVATE LIMITED COMPANIES IN OHADA

What Is OHADA? - OHADA is a regional organization that is created by a treaty signed in Port-Louis (Mauritius) by 14 Governments from French-speaking African States.³⁸⁰ The acronym 'OHADA' stands for 'Organisation pour l'Harmonisation en Afrique du Droit des Affaires' (Organization for the Harmonization of Business Law in Africa, occasionally referred to in English as 'OHBLA'). The OHADA Uniform Acts provide an overall legal framework which is in general based on civil law and has to a certain extent borrowed from modern French business law.³⁸¹ Eight Uniform Acts have now entered into force. These are general commercial law, commercial companies and economic interest groups, securities, simplified recovery procedures and enforcement measures, collective insolvency proceedings, arbitration, accounting law and carriage of goods by road.³⁸²

The OHADA legislation relating to commercial companies takes much of its inspiration from modern French company law³⁸³ and is much better suited than the old law to contemporary commercial practices. The Uniform Commercial Act, defines a commercial company as a contract between two or more persons who agree to make cash or other contributions to an activity for the purpose of sharing the resulting profits or savings and to contribute towards losses.³⁸⁴ The Uniform Act has created various types of companies with either limited liability or unlimited liability.³⁸⁵ There are two types of Limited Liability Company: the SA/ Société Anonyme/ and the SARL/Société à responsabilité limitée/. In both types of companies, the liability of each shareholder for the debts of the company is limited to the amount of his shareholding.

³⁷⁹ Frank Dornseifer(Ed), Corporate business forms in Europe ,A compendium of public and private limited company in Europe, European law publisher, Munchen: (Stämpfli Publishers Ltd. Berne, 2005), pp. 11-169

³⁸⁰ Boris Martor, et al, Business law in Africa, OHADA and the harmonization process, (second edition, 2007), p. 1

³⁸¹ Ibid, p 16

³⁸² Id, p 59

³⁸³ Id, page 74

³⁸⁴ OHADA, The commercial uniform act of 1998, article 4

³⁸⁵ Ibid, article 5

3.3.1. GOVERNANCE STRUCTURE OF PRIVATE LIMITED COMPANIES UNDER THE OHADA

The Uniform Act provides for two alternative methods of management for an SA/ Société Anonyme/, one of which must be chosen in the articles of association;³⁸⁶ a sole managing director acting as chief executive officer, assisted if required by one or more deputy managing directors or a board of directors. In fact, therefore, there is a choice between a board of directors and a managing director only where the company has either two or three shareholders. When an SA/ Société Anonyme/ has more than three shareholders, it cannot be managed by a sole managing director but must have a board of directors.³⁸⁷ On the other hand, if an SA/ Société Anonyme/ is wholly owned by a single shareholder, it cannot have a board of directors but must have a managing director.³⁸⁸

The OHADA Uniform Act, even if it is translated from the French company law, it has provisions that are not familiar with the French corporate governance principle and even to the majority of countries what the writer has consulted in doing this research. The OHADA Uniform Act dictates public company /SA/Société Anonyme/ is required to have board of directors if it has more than three shareholders. The minimum shareholder requirement of a public company in majority of the countries is five / seven and above. Plus to this the SA/Société Anonyme/ corporate governance as to the OHADA Uniform Act provides company to be run by a managing director where the company has either two or three shareholders. It seems that the uniform act determines the necessity of board of directors of SA be base up on the number of shareholders.

Under French law, a public limited company (Société Anonyme: SA) is a company whose (minimum) capital is divided into shares (actions) and is formed by shareholders who only bear any losses up to the amount of their contributions.³⁸⁹ A SA must have at least seven shareholders. A SA is generally managed by a board of directors (“*conseil d’administration*” or

³⁸⁶ Ibid, Article 414

³⁸⁷ Ibid ,Article 494

³⁸⁸ Ibid, Article 417

³⁸⁹ French corporate law and finance, Infra note 393

“*directoire*”). However, both the SAS and the SARL may be formed with only one shareholder.³⁹⁰

Under the OHADA uniform act, SARL/*Société à responsabilité limitée*/ is the other type of commercial company in which the shareholders are liable for the company’s debts only up to the amount of their respective contributions. SARLs/*Société à responsabilité limitée*/ are dealt with in Articles 309–384 of the Uniform Act. Shareholders may conduct collective decision or general and ordinary meetings. Collective decisions are generally taken at general meetings. Collective decisions are required for the approval of the annual accounts, appointment of managers, appointment of auditors’ and Amendments to the articles of association

The corporate governance structure of SARL/*Société à responsabilité limitée*/ devolves on shareholders meeting and managers. An SARL/*Société à responsabilité limitée*/ is managed by one or more managers.³⁹¹ A manager must be an individual, and may be either a shareholder or a non-shareholder. He is appointed in the articles of association or, during the life of the company, by the majority of the shareholders holding more than one-half of the registered capital.³⁹² As to relations with the shareholders are concerned, managers may perform any acts of management in the interests of the company unless the articles of association restrict their powers. However, the French company law makes private limited companies to be governed by directors instead of managers. Therefore, the OHADA uniform act seems modify the French corporate governance practice of private limited companies i.e. to run by board of directors than managers.

3.4. CORPORATE GOVERNANCE AND BOARD OF DIRECTORS OF PRIVATE LIMITED COMPANIES OF FRANCE

3.4.1. INCORPORATION CONDITIONS OF PRIVATE LIMITED COMPANIES

There are three main types of companies with limited liability in France. Commercial companies are ordinarily incorporated in France under the form of French SA ("*Société Anonyme*" or Share Company), a French SAS ("*Société par actions Simplifiée*") which is a flexible form of Share

³⁹⁰ Ibid

³⁹¹ supra note 388, Article 323

³⁹² Ibid ,Article 323

Company or a French SARL ("*Société à responsabilité limitée*" or private limited company)).³⁹³ The Société par actions simplifiée (SAS) is very similar to the SA but operates under simplified rules. The choice of SA or SARL generally depends on how big the business in France is expected to be. When incorporating a French company, its legal form (i.e. SAS, SARL or SA) is determined, by taking into consideration, *inter alia*: the amount of share capital of the company, the number of shareholders of the company and means of financing.³⁹⁴

A SARL must have at least one director ("*gérant*").³⁹⁵ Two directors ("*co-gérants*"), each of whom will have the right to represent the company, may also be appointed.³⁹⁶ A SARL may also be managed by a panel of directors ("*collège de gérants*").³⁹⁷ The registration of a SARL is made by the commercial court having jurisdiction over the company's registered office. To register a SARL proof of absence of criminal record of the directors is one of the mandatory preconditions. Depending on the company form, the functions of the company directors may be supervised and controlled by a supervisory board or other corporate bodies having similar functions. The exercise, by the directors, of their duties is ultimately controlled by the shareholders, who have the authority to revoke the directors and are called upon to resolve on certain material decisions /such as, approval of financial statements, sale of material assets /"*fonds de commerce*"/, share capital increases and reductions./³⁹⁸

While certain French company forms, such as SAS, allow for great flexibility in determining the rights and obligations of the shareholders in the bylaws, other company forms /such as SARL or SA/ are regulated by more stringent provisions of French law, which are mandatory and may not be excluded from the bylaws. Most commercial companies are incorporated in the form of a French SAS or SARL. A SARL is a company normally formed of at least two shareholders,³⁹⁹ created for a commercial purpose. However, a SARL may be created by, and may continue to exist with, only one shareholder. A SARL with only one shareholder is known as an enterprise

³⁹³ French corporate law and finance, www.frenchbusinesslaw.com, (Retrieve on 21/9/2013)

³⁹⁴ Ibid

³⁹⁵ Ibid and Julie Cannesan (Ed.), *infra* note 405, p 15

³⁹⁶ Ibid

³⁹⁷ Ibid

³⁹⁸ Ibid

³⁹⁹ Ibid

unipersonnelle à responsabilité limitée (EURL).⁴⁰⁰ A EURL is considered to be a special type of SARL and is subject to the regulations applied to SARL unless specifically indicated otherwise by the law.⁴⁰¹

3.4.2. CORPORATE GOVERNANCE STRUCTURE OF SARL

A corporate governance structure is the mechanism put in place to determine the distribution of management and control powers and duties within a company. While the day-to-day management of a company always vests with its directors (President, CEO, director general), the exercise of their powers and duties should be subject to control. Such control may be exercised by a supervisory board, whose members are generally appointed by the shareholders, or directly by such shareholders, who will be called to resolve upon certain important decisions to be taken by the directors. The primary purpose of a corporate governance structure should always be the efficient management of the company. Therefore, in determining such corporate structure, the company's size and activity should be taken into account. A too heavy corporate structure may sometimes prove inefficient and obstruct the company's development. French law has provided two methods of organizing a corporation (*société Anonyme*), one with a board of directors and the other with a management board and supervisory board.⁴⁰² The corporate governance structure of French SARL as follows.

3.4.2. 1. COMPANY DIRECTORS

In France, even though the regulation of the company's organization and operation may differ depending on whether the company is a public or private limited company and its shares are admitted to trading on a regulated market, the rules concerning directors' duties and liability apply to both private and public companies with only minor adjustments.⁴⁰³ Under French corporate governance practice, a SARL must have at least one director ("*gérant*"). Two directors

⁴⁰⁰ Ibid

⁴⁰¹ Ibid

⁴⁰² Ibid

⁴⁰³ Carsten Gerner et al, *Study On Directors' Duties and Liability*, Prepared for The European Commission DG Market, London: (Department of Law, The London School of Economics and Political Science), (No date), p 294 and Frank Dornseifer(Ed), *supra* note 387, p 292.

("co-gérants"), each of whom will have the right to represent the company, may also be appointed. A SARL may also be managed by a panel of directors ("collège de gérants").⁴⁰⁴

The directors are in charge of the governance of the company and are generally the only persons authorized to act on the company's behalf.⁴⁰⁵ "The board of directors sets the direction for company operations and oversees the implementation of strategy; it may deal with all issues relevant to the satisfactory running of the company and deliberates and decides upon all matters related thereto."⁴⁰⁶ "[The Board] defines the company's strategy, appoints the corporate officers responsible for managing the company and implementing this strategy, oversees management and ensures the quality of information provided to shareholders and to financial markets through the financial statements or at the time of very important operations."⁴⁰⁷

3.4.2. 2. AUDITORS

In France, all companies have to publish their statutory financial statements, their consolidated financial statements and their management report.⁴⁰⁸ The statements have to be publicly available after each annual general shareholder's meeting.⁴⁰⁹ The accounts have to be available to anybody who requires them and who asks for them at a specific "desk" of the commercial court.⁴¹⁰ Whether a company has to have an external auditor depends on the legal form of the enterprise and its size. Enterprises with the legal form SA (*Société Anonyme*), SCA (*Société en Commandite par Actions*) and SAS (*Société par Actions Simplifiée*) must have a statutory auditor, regardless of their size.⁴¹¹ Enterprises with the legal form SARL (*Société à Responsabilité Limitée*) only need a statutory audit if their numbers (during the two preceding years) are higher than a total balance sheet of 1.55 million Euros, a turnover of 3.1 million Euros, and 50 people.⁴¹² All these enterprise forms can be private or public companies. A SARL must

⁴⁰⁴ Ibid

⁴⁰⁵ Julie Cannesan (Ed.), Doing Business in France : setting up Business in France successfully, 2012 Edition, (Updated October 2012), p. 15 available at : (www.investinfrance.org)

⁴⁰⁶ Article L 225-35 of the French Commercial Code

⁴⁰⁷ Julie Cannesan (Ed.), Supra note 405

⁴⁰⁸ Ibid

⁴⁰⁹ Ibid

⁴¹⁰ Ibid

⁴¹¹ Ibid

⁴¹² French corporate law and finance , Supra note 402

appoint an auditor if it exceeds, at the close of a financial year, two of the three following thresholds: €1.550.000 of total assets, €3.100.000 of turnover, 50 employees.⁴¹³

3.4.2. 3. OVERSIGHT COMMITTEES

Larger corporations may implement, in addition to a board, various controlling or oversight committees to assist the directors of the company and/or the board in the exercise of their duties.⁴¹⁴ Such committees may be a committee on compensation, an audit committee, a scientific committee.⁴¹⁵

3.4.2. 4. SHAREHOLDERS MEETING

The shareholders of a company generally exercise the ultimate control over its management by appointing and dismissing the company directors and board members. In addition, they alone are authorized to resolve on certain material decisions, such as, issuance of securities, approval of annual financial statements, and dissolution of the company.⁴¹⁶ The exercise, by the directors, of their duties is ultimately controlled by the shareholders, who have the authority to remove the directors and are called upon to resolve on certain material decisions (such as, approval of financial statements, sale of material assets (*“fonds de commerce”*), share capital increases and reductions, etc.).⁴¹⁷ The most important decisions can only be taken by the shareholders by way of general meeting.⁴¹⁸ However, the Articles may specify that, with the exception of the decisions approving annual accounts, all or certain decisions may be taken by consultation by exchange of letters of the members or may result from the consent of all the members expressed in a deed. Each share entitles the holder to one vote at meetings.⁴¹⁹

3.5. CORPORATE GOVERNANCE AND BOARD OF DIRECTORS OF PRIVATE LIMITED COMPANIES CHINA

3.5.1. INCORPORATION OF PRIVATE LIMITED COMPANY IN CHINA

⁴¹³ Ibid

⁴¹⁴ Ibid

⁴¹⁵ Julie Cannesan (Ed.), *Supra* note 407

⁴¹⁶ Ibid

⁴¹⁷ Ibid

⁴¹⁸ Ibid

⁴¹⁹ Ibid

Chinese company law and Chinese civil law generally resembles the approach to law of continental European legal systems, i.e. to codify legal norms and not acknowledging case law as a source of law.⁴²⁰ The law that govern the corporate governance of company in china is the 2005 company law. The company law dictates the rationale behind the enactment as “is enacted for the purposes of regulating the organization and operation of companies, protecting the legitimate rights and interests of companies, shareholders and creditors, maintaining the socialist economic order, and promoting the development of the socialist market economy.”⁴²¹

A limited liability company established according to this Law shall include the words "limited liability company" or "limited company" in its name.⁴²² A limited liability company shall be established by no more than 50 shareholders that make capital contributions.⁴²³ A private limited company in china can be run by a single individual (single person company) and the state (wholly state-owned limited liability companies). The limited liability company shares many features with the joint stock companies. The main difference to the joint stock companies is that the limited liability companies must not be incorporated by more than 50 shareholders contributing to the capital. There are also some restrictions as to the transfer of shares of a limited liability company⁴²⁴ but these provisions are not mandatory as they can be amended by the articles of association.⁴²⁵

3.5.2. GOVERNANCE OF PRIVATE LIMITED COMPANIES IN CHINA

3.5.2.4. THE BOARDS

The Company Law of the People’s Republic of China prescribes for a two tier board not only in joint stock companies but also for limited liability companies. The legal structures of the joint stock companies has three mandatory organs; the board of directors, the supervisory board and the general meeting. Besides these organs of a joint stock companies the Company Law provides

⁴²⁰ LIU Junhai/Knut Benjamin Pibler, Corporate Governance of Business Organizations in the People’s Republic of China, (2010), p. 4

⁴²¹ Company Law of the People's Republic of China, 2005, Article 1

⁴²² Ibid, Art. 4

⁴²³ Ibid, article24

⁴²⁴ Ibid, Art. 72

⁴²⁵ Ibid, Art. 72 Para 4

for a mandatory manager.⁴²⁶ The limited liability company is also composed of three mandatory organs: a board of directors, a supervisory board and a board of shareholders (or general meeting).⁴²⁷

One difference between the limited liability company and the joint stock companies is that the “manager” is not mandatory for the limited liability company.⁴²⁸ There are special provisions in the company law on one-person limited liability company and wholly state-owned limited liability company. One-person limited liability companies are not required to establish a board of shareholders.⁴²⁹ In a wholly state-owned limited liability companies which have not established a board of shareholders the state-owned asset supervision and administration authorities exercise the duties and powers of the board of shareholders.⁴³⁰

The board of directors’ of limited liability companies must generally comprise 3 to 13 members⁴³¹ whereas joint stock limited company shall set up a board of directors, which shall be composed of 5-19 persons.⁴³² However, limited liability companies with relatively fewer shareholders or of a relatively smaller scale may appoint an executive director instead of establishing a board of directors.⁴³³ An executive director may hold the post of the company manager concurrently.⁴³⁴ The board of directors of a limited liability company incorporated by two or more State-owned enterprises or two or more other State-owned investment entities must comprise employees’ representatives.⁴³⁵ A solely state-owned company shall establish a board of directors⁴³⁶ and the board of directors of other limited liability companies may comprise employees’ representatives.⁴³⁷

⁴²⁶ Ibid, Art. 114

⁴²⁷ Ibid

⁴²⁸ Ibid, Art. 50

⁴²⁹ Ibid, Art. 58 to 64

⁴³⁰ Ibid, Art. 67 clause 1

⁴³¹ Ibid, Art. 45 Para 1

⁴³² Ibid, Art.109

⁴³³ Ibid, Art. 51 Para 1 clause 1

⁴³⁴ Ibid, Art. 51 Para 1 clause 2

⁴³⁵ Ibid, Art. 45 Para 2 clause 1

⁴³⁶ Ibid, Art. 68

⁴³⁷ Ibid

A limited liability company may set up a board of supervisors, which shall be composed of at least 3 persons.⁴³⁸ For a limited liability company in which there is a relatively small number of shareholders or which is relatively small in scale, it may have 1 or 2 supervisors and does not have to establish a board of supervisors.⁴³⁹ The boards of supervisors include shareholders representatives and representatives of the employees' of the company. The supervisors may attend the meetings of the board of directors as non-voting attendees, and may raise questions or suggestions about the matters to be decided by the board of directors.⁴⁴⁰

3.5.2.2. AUDITORS

All companies are required to prepare financial accounting reports at the end of each accounting year, which shall be audited by an accounting firm.⁴⁴¹ According to Article 165 Company Law (2005) preparation of financial accounting reports must comply with the provisions of the laws and administrative regulations and the rules of the finance authorities of the State Council. It is unclear, however, whether this provision requires a mandatory auditing by external auditors.⁴⁴² The task of the auditors is to examine the financial accounting reports and to issue an audit report. In this, the auditors have to verify whether the financial accounting reports were compiled in accordance with the applicable accounting standards, whether the report reflects the financial situation, the business results and the cash flow of the audited company in all material aspects.⁴⁴³ The Chinese company law prefers company finance to be audited by an accounting firm than to appoint internal auditor⁴⁴⁴ like other countries such as French and India and even Ethiopia /even if it is conditional/.

3.5.2.3. THE SHAREHOLDERS MEETING

The shareholders of a company shall be entitled to enjoy the capital proceeds, participate in making important decisions choose managers and enjoy other rights.⁴⁴⁵ The shareholders'

⁴³⁸ Ibid, article 52

⁴³⁹ Ibid

⁴⁴⁰ Ibid, article 55

⁴⁴¹ Ibid, Art. 165 and 63

⁴⁴² Ibid

⁴⁴³ Ibid

⁴⁴⁴ Ibid

⁴⁴⁵ Ibid, article 4

meeting of a limited liability company is composed of all the shareholders.⁴⁴⁶ The shareholders' meetings shall be convened by the board of directors and presided over by the chairman of the board of directors. Shareholders may needed and pass resolution at a shareholders' meeting on revising the articles of association, increasing or reducing the registered capital, merger, split-up, dissolution or change of the company form.⁴⁴⁷

The china company law contains special law on general meeting of shareholders. Different writers on company law of china, prefers to use the word “board of shareholders than shareholders meetings” in private limited company governance which has equivalent status with shareholders meeting of private limited company in other countries.⁴⁴⁸ The shareholders general meeting of joint stock limited company and of limited liability companies is the “organ of highest authority.”⁴⁴⁹ The shareholders' meetings shall be classified into regular meetings and interim meetings.⁴⁵⁰ The regular meetings shall be timely held in accordance with the articles of association.

3.6. CORPORATE GOVERNANCE AND BOARD OF DIRECTORS OF PRIVATE LIMITED COMPANIES IN INDIA

3.6.2. INCORPORATION OF PRIVATE LIMITED COMPANIES IN INDIA

A company in India can pursuant to the Companies Act of 1956 legally organize itself as private company or a public company.⁴⁵¹ Whether the company is private or public, it can be organized with limited liability (by shares or by guarantee) or with unlimited liability.⁴⁵² In case of a public company, it can choose either to list its shares on a recognized Indian stock exchange or to be an unlisted public company.⁴⁵³ A private limited company is a voluntary association of not less than two and not more than fifty members, whose liability is limited, the transfer of whose shares is

⁴⁴⁶ Ibid

⁴⁴⁷ Ibid, article 44

⁴⁴⁸ LIU Junhai/Knut Benjamin Pibler, Supra note 382

⁴⁴⁹ Supra note 447, Art. 37 and 99

⁴⁵⁰ Ibid, Art. 40

⁴⁵¹ Indian company act, 1956, Part II, Section 3(1), Gazette of India, Extraordinary Act No.1

⁴⁵² Ibid

⁴⁵³ Ibid

limited to its members and who is not allowed to invite the general public to subscribe to its shares or debentures.⁴⁵⁴

Private limited companies cannot raise money from public whether as capital or as loan.⁴⁵⁵ A private company can be incorporated by a minimum of two (2) members whereas the maximum number of members of a private company cannot exceed fifty (50).⁴⁵⁶ ‘One person company’ has been recognized under the 2013 company act. In a private company, the directors can refuse to register the transfer of shares at their absolute discretion.⁴⁵⁷ The CG structure of PLCs in India looks as follows;

3.6.2. COMPANY DIRECTORS

As per the Indian Companies Act of 1956 every PLC incorporated in India is required to have at least two directors on board⁴⁵⁸. The shareholders own the company but they do not manage the affairs of the company.⁴⁵⁹ It is the directors who run the company as per the provisions of memorandum and articles of association.⁴⁶⁰ Shareholders decide who will be the director by passing a resolution in the AGM.⁴⁶¹ A private company is required to have at least two directors while a public company should have a minimum of three directors.⁴⁶² This shows us that there is a clear separation of ownership and control in the Indian private limited company. Thus, a person who has been validly appointed or elected to the board of directors of the company and on whose behalf the relevant form has been filed with the concerned authorities is considered to occupy the position of a director, irrespective of any title that may have been agreed to between the company and such person. Section 2 (13) of the 1956 Indian Companies Act, defines director as any person, occupying the position of a director, by whatever name called. At times articles of

⁴⁵⁴ Ibid

⁴⁵⁵ Id, section 2A –subsection 2(iii)

⁴⁵⁶ Ibid

⁴⁵⁷ Ibid

⁴⁵⁸ Section 2 (13) of the 1956 Indian Companies Act

⁴⁵⁹ Ibid

⁴⁶⁰ Ibid

⁴⁶¹ Ibid

⁴⁶² Ibid

association may provide guidelines for appointing a director but generally it is shareholders who decide that who will be able to run the business on their behalf successfully.⁴⁶³

The board, then, as a team, conducts and regulates the affairs of the company.⁴⁶⁴ The 1956 Company Act empowers the board to do all such activities as the company is authorized to exercise, unless any law or the constitutional documents of the company requires the exercise of the power, or the doing of any act or thing, to be by the company in general meeting.⁴⁶⁵ Indian law does not prescribe any qualifications for being appointed as a director. However it does lay down certain restrictions on the appointment of the directors. Persons who are unsound mind and an undischarged insolvent cannot be appointed as directors of a private limited company.⁴⁶⁶

In Indian CG practice, a director plays a dual role⁴⁶⁷, as an agent of the company; and as a person with a fiduciary duty to the company, while discharging his duties. A director rarely has powers to discharge his duties as an individual director. It is the board that has the power and authority to carry on the activities of the company and to meet the business objectives of the company as a team.⁴⁶⁸ Directors have the power to run the company. Since With power comes the responsibility, they need to ensure that company fulfils all its obligations under the law as well as ensure that the decisions they make are in the best interest of the company.⁴⁶⁹ Unlike the 1956 Act, the 2013 Act prescribes specific duties for directors which, amongst others, requires a director to exercise his duties with due and reasonable care, skill and diligence and not be involved in a situation to have any direct/indirect conflict of interest with the interest of the company. Further, directors are now required to “act in good faith in order to promote the objects of the company for the benefits of its members as a whole, and in the best interests of the company, its employees, shareholders, community and for protection of environment.”⁴⁷⁰

3.6.3. AUDITORS

⁴⁶³ Ibid

⁴⁶⁴ Ibid

⁴⁶⁵ Ibid

⁴⁶⁶ Corporate law in India, (<http://www.Private Limited Company in India/>), (retrieve on 27/7/2013)

⁴⁶⁷ Ibid

⁴⁶⁸ Ibid

⁴⁶⁹ Ibid

⁴⁷⁰ Indian company act, 2013, Clause 166

Every company shall, at each annual general meeting, appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting⁴⁷¹ and shall, within seven days of the appointment, give intimation thereof to every auditor so appointed. Provided that before any appointment or re-appointment of auditor or auditors is made by any company at any annual general meeting, a written certificate shall be obtained by the company from the auditor or auditors proposed to be so appointed.⁴⁷² Where at an annual general meeting no auditors are appointed or re-appointed, the central government may appoint a person to fill the vacancy.⁴⁷³ All notices of, and other communications relating to, any general meeting of a company which any member of the company is entitled to have sent to him shall also be forwarded to the auditor of the company⁴⁷⁴; and the auditor shall be entitled to attend any general meeting and to be heard at any general meeting which he attends on any part of the business which concerns him as auditor.⁴⁷⁵

3.6.3. SHAREHOLDERS MEETING

The 1956 Companies Act contains several provisions regarding meetings. For a meeting, there must be at least 2 persons attending the meeting.⁴⁷⁶ One member cannot constitute a company meeting even if he holds proxies for other members. Kinds of company meetings in a company can be shareholders meeting, board of directors meeting and other meetings.⁴⁷⁷ Meetings of members are meetings where the members / shareholders of the company meet and discuss various matters.⁴⁷⁸ Member's meetings are of the following types:-

Annual General Meeting: Must be held by every type of company, public or private, limited by shares or by guarantee, with or without share capital or unlimited company, once a year.⁴⁷⁹ However, a company may hold its first annual general meeting within 18 months from the date of its incorporation.⁴⁸⁰ In such a case, it need not hold any annual general meeting in the year of

⁴⁷¹ Supra note 465, Section 224 (1)

⁴⁷² Ibid, paragraph 2

⁴⁷³ Ibid

⁴⁷⁴ Ibid

⁴⁷⁵ Ibid

⁴⁷⁶ Ibid

⁴⁷⁷ Ibid

⁴⁷⁸ Ibid

⁴⁷⁹ Ibid, section 165 (1)

⁴⁸⁰ Ibid, section 166 (1), paragraph one

its incorporation as well as in the following year only.⁴⁸¹ In the case there is any difficulty in holding any annual general meeting (except the first annual meeting), the registrar may, for any special reasons shown, grant an extension of time for holding the meeting by a period not exceeding 3 months;⁴⁸² provided the application for the purpose is made before the due date of the annual general meeting. Companies having share capital should also state in the notice that a member is entitled to attend and vote at the meeting and is also entitled to appoint proxies in his absence.⁴⁸³ A proxy need not be a member of that company.⁴⁸⁴ In case of default in holding an annual general meeting any member of the company may apply to the company law board.⁴⁸⁵ The company law board may call, or direct the calling of the meeting, and give such ancillary or consequential directions as it may consider expedient in relation to the calling, holding and conducting of the meeting.⁴⁸⁶ At every AGM, matters to be discussed and decided can be either as ordinary business or special business.⁴⁸⁷ Matters constitute ordinary business at an AGM are consideration of annual accounts, director's report and the auditor's report, declaration of dividend, appointment of directors in the place of those retiring and appointment of and the fixing of the remuneration of the statutory auditors.⁴⁸⁸

Extraordinary General Meeting: Every general meeting (i.e. meeting of members of the company) other than the statutory meeting and the annual general meeting or any adjournment thereof, is an extraordinary general meeting.⁴⁸⁹ Such meeting is usually called by the board of directors for some urgent business which cannot wait to be decided till the next AGM.⁴⁹⁰ Every business transacted at such a meeting is special business.⁴⁹¹ An explanatory statement of the special business must also accompany the notice calling the meeting. The notice should also give the nature and extent of the interest of the directors or manager in the special business, as also the extent of the shareholding interest in the company of every such person. The articles of

⁴⁸¹ Ibid

⁴⁸² Ibid

⁴⁸³ Ibid, section 176 (1)

⁴⁸⁴ Ibid

⁴⁸⁵ Ibid, section 167 (1)

⁴⁸⁶ Ibid

⁴⁸⁷ Ibid

⁴⁸⁸ Ibid

⁴⁸⁹ Ibid, section 173 (1)(a)

⁴⁹⁰ Ibid, section 169 (1)

⁴⁹¹ Ibid, section 173 (2)

association of a company may contain provisions for convening an extraordinary general meeting.⁴⁹²

Class Meeting: Class meetings are meetings which are held by holders of a particular class of shares⁴⁹³, e.g., preference shareholders. Such meetings are normally called when it is proposed to vary the rights of that particular class of shares.⁴⁹⁴ At such meetings, these members discuss the pros and cons of the proposal and vote accordingly.⁴⁹⁵ Class meetings are held to pass resolution which will bind only the members of the class concerned, and only members of that class can attend and vote.⁴⁹⁶ All provisions pertaining to calling of a general meeting and its conduct apply to class meetings in like manner as they apply with respect to general meetings of the company.⁴⁹⁷

⁴⁹² Ibid

⁴⁹³ Ibid, section 394

⁴⁹⁴ Ibid

⁴⁹⁵ Ibid

⁴⁹⁶ Ibid

⁴⁹⁷ Ibid

CHAPTER FOUR

CORPORATE GOVERNANCE IN ETHIOPIA

4.1. ETHIOPIA'S CORPORATE GOVERNANCE JOURNEY

4.1.1. 1960-1974 SEPARATION OF GOVERNANCE AND ENTERPRISE

Ethiopia, with a population of about 80 million is the second most populous country in Africa. It is the only country in Africa that has never been colonized. The country started modern governance and administration system after the end of Zemene Mesafint, especially with the coming into power of emperor Minilik II. The last emperor, emperor H/selassie I, who came into power after the death emperor Minilik II, was forcefully abdicated by a public uprising in 1974. From the 1974-1991, the country was ruled by the military dictatorship of the Derg. The present government is controlled by a group that took power from the military regime after a long civil war.

The role of the private sector in the Ethiopian economic development has evolved with change in the governing systems of the aforementioned governments. The economic environment in these government systems may be classified into three different types: mixed economy, command economy and free market economy.⁴⁹⁸ The first phase covers the period before 1974 revolution. The period is characterized as a feudo-capitalist system in which land ownership was used as sources of income. This period marks the beginning of modernization of the country and private sector participation in the economic development.

During the last five years of the imperial era the ratio of public and private sector participation in the economic development of the country was 41:59 respectively.⁴⁹⁹ That is 41 percent of the economic activity was run by the public sector while 59 percent of the economic activity had run by the private sector. The then government issued several proclamations to encourage private

⁴⁹⁸ Mulu Gebreeyesus, Industrial Policy and Development in Ethiopia: Evolution and Current Performance, Helsinki, Finland, 2013,

⁴⁹⁹ Alemayehu Geda and Befekadu Degefe , Explaining African Economic Growth Performance: The Case Of Ethiopia, Prepared as a component of the AERC Collaborative Research Project, Explaining Africa's Growth Performance, _African Economic Research Consortium, Kenya: Nairobi, May 2005, p 6

(domestic and foreign) investment in the economy development of the country.⁵⁰⁰ The legal framework of the corporate system is principally set out by two basic codes: the 1960 Commercial Code and the Civil Code of the empire. Of course corporate law is also affected by a number of special legal rules, such as the Act on Trade Licenses, consumer protection law etc.

4.1.2. 1974-1991 DOMINANCE OF STATE-OWNED ENTERPRISES

The second phase started in 1974 with the declaration of centrally planned economy i.e. command economy. The socialist oriented military government's first order on the economic system of the country was to nationalize all of the industries and assume ownership and control of all economic activities.⁵⁰¹ The private sector was marginalized and the market oriented economic system ceased to exist.⁵⁰² After 1974 there was collectivism under a planned economy, single type of ownership, with no separation between management and ownership.⁵⁰³

The SOEs (state-owned enterprises) were directly run by the government. As to what to produce, how much to produce and how to produce, this was all decided by orders issued by government agencies.⁵⁰⁴ The characteristics of enterprise governance were as follows: single type of ownership, with no separation between management and ownership; the direct involvement of several government departments, acting as owners in the operation process, such as in production decision-making; appointment, removal, employment and salary of staff; finance and funds; etc.⁵⁰⁵ The factory director's control over the enterprise was limited to organizing the production process under the limitation of certain kinds of resources, and enterprises lacked both flexibility in the market (weak competitiveness in the market) and self-determination (weak incentives).⁵⁰⁶

4.1.3. 1991 ONWARD: CAPITALISM AND PRIVATIZATION

⁵⁰⁰ Ibid

⁵⁰¹ Government Ownership and Control of the Means of Production Proclamation No.26/1975, 1975, NEGARIT GAZETA, 34th Year, No. 22

⁵⁰² Alemayehu Geda and Befekadu Degefe, supra note 499, p 19

⁵⁰³ Hailegabriel G. Feyissa, European Influence On Ethiopian Antitrust Regime: A Comparative And Functional Analysis Of Some Problems, Mizan Law Review, Vol. 3 No. 2, September 2009, p 271

⁵⁰⁴ Alemayehu Geda, *The Political Economy of Economic Growth in Africa, 1960-2000*, Cambridge University Press, 2007, p 7

⁵⁰⁵ Ibid

⁵⁰⁶ Minga Negash, "Corporate governance and ownership structure: The case of Ethiopia", University of the Witwatersrand, Ethiopian e-Journals, Vol.5, No 1, 2008, p. 7.

The third phase has started since 1991 and it still continues. By this time the economic and political landscape around the world was changed.⁵⁰⁷ With the breakdown of the communism camp and the emergence of global economy, all nations around the globe had moving towards a market based economy.⁵⁰⁸ It had become clear that the market oriented economy fared better than the economic system that guided by the socialist ideology.⁵⁰⁹ Market-based economic systems (dominated by voluntary private sector activity) have replaced command and control-based economic systems in the vast majority of nations.⁵¹⁰

A more formalized corporate law in Ethiopia has a tradition starting from the 1960 Commercial Code. Following the fall of the communist regime in 1991, the relevant business law has been substantially reworked and changed, following democratic principles and supporting the spirit of free enterprise. In this process of transformation, Ethiopian law returned to its original roots, which were severed after the communistic coup in 1974.

At the late decades of 20th, Governments of the world were relinquishing to the private sector of their ownership interests in firms. This is most apparent in the countries that have emerged from the former socialist states/ Soviet bloc, but it is also happening (although less dramatically) in Ethiopia. In Ethiopia, the new government tries transforms the economy from the centrally planned economic system to a market oriented system. The government's main emphasis was the liberalization of both the market and liberalization and commercialization of all state owned enterprises. As a result the government enacts investment proclamations so as to stimulate the private sector participation in the economic system of the country. Even if the government takes different measures, still there are many problems in the Ethiopia private business environment starting from the absence of a separate corporate governance law to the monopolization of the business in environment by few companies or individuals and disgusting government or party owned companies' governance system and structure.

The Ethiopian economy is at a stage of transformation. Reforms during the last couple of decades brought market economy, privatisation of state owned enterprises and openings in the

⁵⁰⁷ Qian, Y. , "Enterprise reform in China: agency problems and political control, *Economics of Transition*," Vol. 4, No. 2 (2007), p. 427

⁵⁰⁸ Ibid

⁵⁰⁹ Ibid

⁵¹⁰ Ibid

financial system. Developments of the latest few years indicate a new phase of economic progress. There is a noticeable increase of exports. Investments and joint ventures with foreign investors are making progress. There is an emerging trend in the financial system from the purely collateral based lending to performance based financing of businesses. Over the past couple of years, investors are seen raising capital from the public through offers of shares in new business ventures. All these indicate the emergence of new types of relations between and among businesses, investors, suppliers, and customers.

These new trends and changes in the Ethiopian economy and business environment would need to be followed up by major changes in the way of conducting business in the country. Good corporate governance in its broad sense will be essential. Without it, necessary new relations between businesses, investors, financiers and foreign customers would not take place and economic development will be slower.

Corporate Governance as a conceptual framework for appropriate management and control of a company which includes rules for relations between owners, boards, management and not least the stakeholders such as employees, suppliers, customers and the public at large would benefit Ethiopian business in several ways. It would facilitate access to capital through the banking system and other financial institutions by making company performance visible and reliable. Through increased transparency and better conduct of businesses, application of good standards to company's affairs improves the control of the business transactions and increases efficiency. In other words: good corporate governance leads to good business.

Introduction and development of Corporate Governance in Ethiopian company law is therefore a necessary and also revolutionary change in the ownership philosophies, management and operations of Ethiopian companies. Introducing the concept of good corporate governance is vital for the continuity and sustainability of the private companies that support economic growth in Ethiopia. It would help to dissolve financial and market access blockages but at the same time place far reaching requirements for revision of business practices by companies aiming at growth and prosperity for their owners and stakeholders. Currently, the Addis Ababa and Ethiopia Chambers of Commerce and Sectoral Associations, in consultation with the Government of Ethiopia, and through support from the Swedish International Development Agency (SIDA),

launched an ambitious private sector led initiative to institutionalize corporate governance in Ethiopia. The Project aims to create awareness and motivate application of the principles of good Corporate Governance among Ethiopian businesses.

4.2. GOVERNANCE OF PARTNERSHIP TYPE BUSINESS ORGANIZATIONS

What the phrase “business organizations” brings to mind is usually an entity concerned with marketing and collecting payments for products and services which they have offered. “Business is a voluntary contract between two or more competent persons to place their money, labour and skill or some or all of them, in lawful commerce or business, with the understanding that there shall be a proportional sharing of the profits and losses between them.”⁵¹¹

A Business organization is any associations arising out of a partnership agreement.⁵¹² The 1960 Commercial Code of the Empire defines the phrase as “Partnership agreement is a contract whereby two or more persons who intend to join together and to cooperate undertake to bring together contributions for the purpose of carrying out activities of an economic nature and of participating in the profits and losses arising out thereof if any.”⁵¹³ A partnership is a business organization in which at least two persons carry on business activity under a common commercial name and bear joint and several liabilities for the obligations (debts) of the partnership with all their property.⁵¹⁴ Business organizations, from a legal point of view, are undertakings with more than one member, having assets separate from the personal assets of the members and a formal scheme of management, which may or may not comprise members of the organization.

Ethiopian law recognizes six different kinds of business entities. These are ordinary Partnership, general partnerships, limited partnerships, share companies, private limited companies, and joint ventures.⁵¹⁵ Therefore, in Ethiopia business can be carried out in one of the above six different kinds of business forms. But for the sake of construing governance of business organization we

⁵¹¹ Henry Campbell Black, Black’s Law Dictionary, (6th Ed.). London: (West Publishing Co. St. Paul, 1991), P. 1120

⁵¹² Commercial code of Ethiopia, 1960, article 211, Negaret Gazeta, No. 3, article 210

⁵¹³ Ibid, article 211

⁵¹⁴ Ibid

⁵¹⁵ Ibid,, article 212

can categorize into two; partnership and company type business organization.⁵¹⁶ In general, legal forms for corporations in the Ethiopia may be distinguished between those, which are limited by shares and those made up of individual partners.

Companies with a capital ground are based on a firmly stated registered capital. The typical representatives of this form of companies are the public (share) company and the private limited liability company which are divided into a certain number of shares. The businesses with a personal ground depend on the individuals, which are firmly connected with the existence of the entity. The respective corporate forms are the general partnership and the limited partnership.

Partnership type of business organization is the collection of individuals whereas company is an aggregate or collection of shares or capital. As a result, capital importance is legal personality of the company. Thus, the company may own property, make contracts, and sue and be sued by its name. Also, it is entirely distinct from its members. The company has perpetual succession since the concept of incorporation is there in case of company. As a result, death or insolvency of a shareholder does not affect its existence. Thus, in a partnership, paramount importance is personality of the individual partner. I.e. incapacity, death, or serious disagreement between partners may result in dissolution of the partnership firm.⁵¹⁷ Therefore, the life of existence of the partnership firm comes to an end when a partner dies or becomes insolvent unless contrary agreement is there. Hence, the life of existence of the partnership firm is generally considered as contingent upon the personality of partners.

Since partnership type of business organization is the collection of individual partners, each partner is considered as agent of the other⁵¹⁸ and of the business organization. I.e. they are jointly and severally liable for the acts of each other and the liability of each partner to third parties is unlimited,⁵¹⁹ (if the assets of the partnership could not cover the claim of creditors)⁵²⁰ although they are liable to contribute to each other's liability and entitled to claim to an indemnity from the partner at fault.⁵²¹ In partnership type of business organization the system

⁵¹⁶ Ibid., Article 10 and 212

⁵¹⁷ Ibid., article 258 (1) and 260

⁵¹⁸ Ibid, Article 241

⁵¹⁹ Ibid, Article 255 sub-articles 2 and 3

⁵²⁰ Ibid, Article 255 sub-article 1 and 2

⁵²¹ Ibid, Article 243 sub-articles 2 and 241 sub article 3

and structure of governance lay on to the partners as a whole i.e. collective decision of partners and managers.⁵²²

4. 2.1.GENERAL MEETING (COLLECTIVE DECISION) OF PARTNERS

In partnership type of business organization the system and structure of governance lay on to the partners as a whole i.e. collective decision of partners and managers. All partners shall have a right to act as managers, unless the partnership agreement or decision of the partnership has appointed one or more of the partners or a third party as a manager.⁵²³ From this we can see that partnership may be managed by one or more managers. The managers may also be partners or outsiders, who may be named in the partnership agreement or appointed at subsequent meetings. What's more, if a partnership agreement is silent as to the persons managing the partnership, and if there is no subsequent appointment, all the partners are considered as managers.⁵²⁴

Despite the fact that different provisions govern management of ordinary partnership, general and limited partnerships, there is no conceptual difference between the Articles 236, 275, 287 and 300; all partners have the status of managers unless otherwise provided. Concerning the governance of joint venture, even if it has its own unique features that makes it different from other partnership type of business organization, where no manager is appointed, all the partners shall have the status of managers and every partner can deal with third parties in as it is clearly dictated under article 275(2) and article 276 (5) of the Commercial Code of the empire. As to article 287, governance of general partnership, the partnership shall be run by one or more managers who may or may not be partners. However, where no manager is appointed, each partner shall be considered as a manager.

In a limited partnership, however, only the general partners or persons who are not partners may be appointed as managers. In this regard, Art.300 of the Code states that: *"The general partners in a limited partnership shall have the same rights and obligations as partners in a general partnership and only they may be appointed as managers"*. This comes from the rational that limited partnership is a firm in which one or more partners are liable for the partnership's

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⁵²³ Ibid,, Article 236,

⁵²⁴ Ibid, Article 287 (2)

obligations up to the amount of his unpaid contribution (limited partner) and one or more partners are liable for the partnership's debts with their entire property (general partner) if the partnership's asset unable to cover the claim of creditors.

The limited partnership is a combined form of a commercial partnership and a private limited liability company. It is typical for such firm that one or more partners secure the obligations of the partnership by all their personal assets (so-called general partners) and one or more of the partners secure the obligations of the partnership up to the amount of its non-paid investment contribution (so-called limited partners).⁵²⁵ Other issues concerning the company are decided both by the general and limited partners by majority of votes, unless stipulated otherwise in the partnership agreement.

Limited partners of a limited partnership cannot be appointed as managers of the firm since, at least in principle, only general partners of a limited partnership may be appointed as managers. Nevertheless, if limited partners, by whatever *raison d'être*,⁵²⁶ represent the limited partnership, they may be jointly and severally held liable as general partners for all effects of the representation they have acted upon. The limited partner is only liable to the extent of his contribution i.e. not personally liable for the debt of the firm not unlike shareholders of companies. The limited partnership firm could create a good opportunity for a business man who has unable to take part in company membership by whatever reason since it allows limited liability or liability to the extent of the partner's contribution. Article 301 of the 1960 Commercial Code declares Limited partners may not act as managers even under a power of attorney. A limited partner who contravenes this rule shall be fully jointly and severally liable for any liabilities arising out of his activities like the general partners. Where appropriate, he may be declared jointly and severally liable in respect of some or all the firm's undertakings. General meeting or collective decision of the partners is required for:

1. Variation of the partnership agreement of the partnership
2. Variation of particular provisions or clause of the partnership agreement

⁵²⁵ Article 296

⁵²⁶ However, as we see from article 301(4) A limited partner shall not be deemed to act as manager when he/she : consult with other partners, deals with the firm, investigates managerial acts, gives advice and counsel to the firm and gives permission to do acts outside the manager's powers.

3. For the appointment of attorney or for the carrying out of any act which goes beyond the partnership practice.

Consent of majority of the partners is required to pass a decision of varying the partnership agreement as a whole or particular provision of the partnership agreement. When we say majority of partners the law presumes majority of individual partners to the partnership unless the partners agree in the partnership agreement that majority mean majority in the holding of the partnership.

4.2.2. MANAGERS

Under the partnership law default rule, the owners of the firm /the partners/, simply by virtue of being owners, manage the partnership. The partners are presumed as managers of the partnership unless otherwise provided in law and agreements of the partners. Another extremely common governance model in partnerships, and in other non-corporate forms of business, is for an agreement among the owners to specify who shall be the managers of the business. The traditional limited partnership encompasses this approach as part of its basic governance model. In this model, some owners /general partners/ manage and face unlimited liability, while other owners /limited partners/ agree to relinquish a role in management in exchange for limited liability.

In a partnership type business relation ownership and management is in the same hands. All partners being owners are entitled to participate in management. Every partner has an implied authority to bind the firm by his act. However, partners may agree to delegate daily management responsibilities to management committee made up of one or more of the partners or to third party non member managers.⁵²⁷ All partners shall have a right to act as managers, unless the partnership agreement or decision of the partnership has appointed one or more of the partners or a third party as a manager pursuant to Articles 236, 275, 287 , 297(3) and 300 of the Ethiopian Commercial Code. From these provisions, one can observe that partnership may be managed by one or more managers. The managers may also be partners or outsiders, who may be named in

⁵²⁷Supra note 526, article 236 and 237

the partnership agreement or appointed at subsequent meetings.⁵²⁸ Partnership managers may act for and bind the firm.⁵²⁹

4.3. GOVERNANCE SYSTEM AND STRUCTURE OF COMPANY IN ETHIOPIA

One of the key reasons for forming a corporation is the limited liability protection provided to its owners. Because a corporation is considered a separate legal entity, the shareholders have limited liability for the corporation's debts. The personal assets of shareholders are not at risk for satisfying corporate debts or liabilities except the justification that cause for piercing the corporate veils. Corporations have a set management structure. The owners of a corporation are shareholders, who elect a board of directors, which then elects the officers. The board of directors is responsible for managing and exercising the rights and responsibilities of the company. The board sets corporate policy and the strategy for the corporation, and elects officers - usually a CEO, vice president and secretary /unless the shareholders meeting elect/⁵³⁰ - to follow the policies set by the board, and manage the corporation on a day-to-day basis. In a small corporation, the line between the shareholders and officers tends to blur because the same people may be serving in all capacities.

In Ethiopian small businesses, most of the times are family businesses, even if incorporated in the form of private limited company the manager and officers and shareholders might be same persons. This makes the concept of corporate governance of private limited company /separation of ownership and control/ questionable because the share holders and the managers are one and the same persons. A company under Ethiopian law may be described as a capital based company with a certain registered capital, which is divided into a certain number of shares. The basic guiding principles of a company Ethiopia are the following:

- The obligation of the company to have a certain registered capital;
- The obligation of the shareholders to make a contribution to the registered capital of the company;

⁵²⁸ Ibid

⁵²⁹ Ibid, Art 289(1)

⁵³⁰ Ibid, Article 348(1)

- The participation in the management of the company by the shareholders solely through certain bodies of the company;
- Directors of a share company must be members, or shareholders, of the company/Article 347/;
- No liability of the shareholders for the obligations of the company unless they act as a director of the company;
- Any loss of the company is basically not allocated among the shareholders

The governance system and structure of Share Companies in Ethiopia is characterized by a strict division between the enterprise part of the company and the capital part of the company. This principle is reflected in the basic structure of the company, which consists of three statutory bodies; General meeting of shareholders, board of directors and managers. The enterprise of the company is managed by the board of directors,⁵³¹ which represents the company vis-à-vis third parties. In contrast, the influence of the shareholders in the governance of the company, who represent the capital part of the company, is limited to their participation in the meeting of the shareholders.⁵³² The activities of the third statutory body of the company, managers, run the company on daily basis as to the strategic plan of directors, are overseen by the board of directors.⁵³³

Both, rights and obligations of the shareholders of a public company, mainly in relation to the governance of the company, under Ethiopian law are rather limited compared to those of the shareholders in a company with limited liability i.e. PLCs or even more significant compared to the partners in a commercial partnership. Share company shareholders only participate in the capital part of the company. The enterprise part of the company is managed by the board of directors. Consequently, the influence of the shareholders on the operation of the company is basically limited to their participation in the shareholders meeting of the company.

As a general rule, the right of the shareholders to participate in the management of the company and their corresponding right to information on the company is limited to their right to participate in the general meeting. Each shareholder is entitled to vote and to make proposals and

⁵³¹ Ibid, Article 347 and 362

⁵³² Ibid, Article 388

⁵³³ Ibid, Article 348(3) and (4)

counter proposals at the general meeting and to require information and explanations regarding the management and business activities of the company.

The general meeting of the shareholders is the supreme body of a company. All major decisions, which affect the rights of the shareholders and the company, are to be taken in the general meeting. The right of the shareholder to attend the general meeting is one of the most important rights of the shareholder. The shareholder may attend the general meeting in person or provide someone with a power of proxy to do so in his name.⁵³⁴ There are annual general meetings and extraordinary general meetings of the company.⁵³⁵ The annual general meeting has to take place at least once a year as often and in such time as stated in the articles of association of the company.

In any case, the annual general meeting must take place at least six months after the end of the accounting year of the company.⁵³⁶ The general meeting must be summoned by the board of directors of the company. The corporate governance law and regulation of Share Company in Ethiopia might be differing as to the company objective. Meaning if a certain share company is incorporated in Ethiopia with the objective of carry out banking, insurance and microfinance business there is great regulation and supervision from the government-commercial bank of Ethiopia.

4.4. GOVERNANCE SYSTEM AND STRUCTURE OF PRIVATE LIMITED COMPANIES

Private limited liability Companies under Ethiopian law may be described as capital based companies with a certain registered capital⁵³⁷, which is made up of the contributions of the shareholders. A limited liability company is a company whose registered capital is made up of its members' contributions and whose members are not liable for the company's obligations beyond the extent of their contribution and it is a very popular legal form for small and medium-sized businesses in Ethiopia. In Ethiopia there is one type of company i.e. company limited by shares. A company limited by shares in Ethiopia can be either a public/Share Company or a

⁵³⁴ Ibid, Articles 398 and 402

⁵³⁵ Ibid, Articles 388, 417 and 426

⁵³⁶ Ibid, Articles 417 and 418

⁵³⁷ Ibid, Article 512

private limited company. There are many differences in the corporate governance of private limited and share/public companies in Ethiopia. The following are some of the basic governance differences;

1. Formation:

For the formation of Share Companies all capital must be subscribed and 25% of the cash shares must be paid-up before registration while Private Limited Company is registered when the memorandum of association shows statements that the capital fully paid.⁵³⁸ A minimum of two and five shareholders is mandatory for the formation of private limited and Share Company in Ethiopia respectively.⁵³⁹ Founders are mandatory for the formation of public companies in Ethiopia since there is a subscription of shares/even if not always/ to the general public but not for PLC.

2. Board of directors:

One great advantage of company form of organization is the separation of ownership and control. The overall performance of a company and the profitability of the business are highly affected by the corporate governance bodies. To achieve the targeted rates of growth and expansion of a company, competent and professional governance bodies /mainly board of directors and managers/ of the company is much important as the accessibility of adequate finance. The governance of the company can be left to a group of professionals (boards of directors and managers) who, with their competence, specialized knowledge or skills, qualifications of training, can bring better corporate performance and success. Governance of the public company is carried on by the shareholders' meeting, board of directors and general managers. However, in Ethiopia, private limited companies' lack the corporate body i.e. board of directors. A private limited company is managed by one or more managers while Share Company is managed by one or more managers and directors whose minimum number shall be three. Unlike a share company, a private limited company does not have a board of directors or managers chosen by the board. A private limited company is managed by its shareholders or some of them, like a partnership.

⁵³⁸ Ibid, articles 312 and 517(g)

⁵³⁹ Ibid, articles, 307(1) and 510(2)

3. Shareholders meeting:

Governance of the companies is carried on by the shareholders' meeting and board of directors' auditors and managers. The corporate governance principles and tradition around the world tells us that shareholders meeting is one of the main governance body in governance of a company. Shareholders' meetings may be general or special based on the issue or agenda that the shareholders are going to discuss. In Ethiopian private limited company shareholders meeting is based on the numbers of shareholders to the company. The Commercial Code under article 525 and 532 dictates that shareholders' meeting is not necessary when the shareholders are below twenty and resolutions or decisions can be made by managers except change of nationality and modification of articles of association of the company. However, at this point what we have to bear in mind is that the Commercial Code does not clearly require it for shareholders' meeting to change nationality of the company and modification articles of association rather majority consent is necessary and this can be made by managers as we can notice it from article 533 of the 1960 commercial code. More over even if the Commercial Code makes shareholders meeting as one governing body when members are above twenty, the type of meeting /either general or special meeting/ is not clearly set.

4. Appointment of auditors:

Corporate governance is the process on which organizations are managed and controlled. It recognizes the inherent conflict in objectives between owner/shareholders and managers and thus establishes institutions, policies, and procedures to protect shareholders' interests. Auditing is one of the four cornerstones of corporate governance bodies (shareholders, managers board of directors and auditors), and the auditing function of auditors has an important role in assisting the governing organ to monitor the effectiveness of its governance. Auditors are appointed by shareholders and are entrusted with the internal control of the company. By helping the governing organ in this way, audit becomes an essential element of the corporate governance process. The 1960 Commercial Code of Ethiopia makes auditors one of the mandatory statutory governance bodies in the corporate governance structure and system of Share Companies. However, when we come to private limited companies, the Commercial Code puts auditors one of the mandatory governance body when the number of shareholders is not below twenty. When

the number of shareholders that form the private limited company is more than twenty the company is obliged to have or appoint at least three auditors/ article 538/1// .

5. Liability

Shareholders of a share company confront unlimited liability only in their role as directors simply because directors must be shareholders. Shareholders of a private limited may have unlimited liability in their capacity as shareholders. Article 519 deals with the consequences of a contribution in kind to a private limited company. Unlike the elaborate procedures set forth in Article 315 for determining the value of a contribution in kind to a share company, Article 519 requires the members of a private limited company to determine the method of valuation and the value of the contribution. Article 519(3) imposes joint and several liability to third persons for the valuation fixed in accordance with the method determined by the shareholders. Article 519(4) imposes joint and several liability upon all members for any overvaluation of the contribution, even if they were unaware of the overvaluation.

Another situation the law governing private limited companies creates unlimited liability to private limited companies shareholders is article 531. This provision makes with the shareholder-managers liability when the private limited company is in bankruptcy proceedings and the assets are insufficient to pay the creditors. The bankruptcy court may order the managers or the shareholders or some of them to pay all or part of the debts of the private limited company(Article 531(1)). Sub-article (1) permits a bankruptcy court to order members, as well as managers, to pay the company's debts while Sub-article (2) says that such an order may not be entered against members who have not acted as managers, nor where the managers and members show that they have acted with due care and diligence. The extent to which a shareholder who is not a manager may escape from unlimited liability is not clear. Because the first clause of Article 531(2) says that an order to pay the company's debts will not be made in respect of members who did not act as managers. Whereas the second clause says that such an order will not be made against members who show that they acted with due care and diligence. However the difficult question that creates vagueness here is “Why are members mentioned at all in either sub-article of Article 531 if only managers may be required to pay?” Generally, in Ethiopia, members of private limited company don’t enjoy the privilege of limited liability when we compare it with those who form a share company.

In Ethiopian business life today, by far the most important corporate forms are Share Companies and private limited companies. In Ethiopia 97% of companies are organized as private limited companies and while 3% are organized as share companies.⁵⁴⁰ There are certain unique features of Ethiopian PLCs that make it different from public/share companies and other countries private limited companies. The basic characteristics of Ethiopian private limited companies are the following:

- the obligation of the company to have a certain registered capital and the obligation of the shareholders to make a contribution to the registered capital of the company;
- the participation in the management of the company by the shareholders is not performed solely through certain bodies of the company/shareholders meetings/, often the shareholders themselves manage the company;
- The shareholders are more vulnerable for liability than shareholders of share company to company debts.
- The minimum obligatory numbers of shareholders to PLCs is two if less, the fate of the company is dissolution
- The company is not obliged to observe some of the principles of corporate governance like share companies .i.e. no board of directors
- The company is not obliged to have auditor and conduct shareholders meeting unless the number of share holders is not greater than twenty.

In order to have a proper understanding of how corporate governance works in Ethiopian private limited companies, it is essential to become familiar with the institutional framework. There are many actors that play an important role in shaping companies' behaviours in Ethiopia. They can be roughly divided into two main groups: those operating inside the company, and those operating outside the company. The outer circle/outside actors are composed of regulators, mainly Ministry of Trade, Ethiopian Investment Agency, the Legal System, the Judicial System, Competition or Market, the Auditing System (external auditors). These external actors have a

⁵⁴⁰ As to the data of the ministry of trade up to July 13/ 2013, there are 22,878 PLC and 464 share companies. One private limited company has found registered many times with different business objective. For example ADAGO MIDROC TRADING PLC has registered 84 times, ORLANDO MAROLI FAMILY PLC 40 times, ADDIS ABABA HILLTON P L C 82 times, GUNA TRADING HOUSE PLC 34 times, IN OUT BUSINESS EXCHANGE P L C 36 times, GREEN LAND PLC 34 times, G K A ENTERPRISE PLC 44 times etc ...of different business objective.

significant impact on a company's corporate governance, but they mainly influence through regulations, codes of conducts, certification of financial reports, legal enforcement, etc. Besides these institutional pillars, there are other agents that may also affect corporate governance of PLCs, for example, consumers, suppliers, employees, media, etc... respective of the business objective of the private limited company. Although statutory bodies⁵⁴¹ constitute an important internal mechanism for holding management accountable for the use of company assets, effective corporate governance of PLC is dependent on the market for corporate control, company law, accounting, and auditing standards, bankruptcy laws, and judicial enforcement.

The inner circle/internal actors consists of the shareholders' general meeting/conditional/, board of directors (not existing in Ethiopian private limited company governance structure), auditors/conditional/ and management. In countries that we have seen above /France, China and India/ all four i.e. board of directors, shareholders, auditors and managers are engaged in the operation/governance of the company and are directly responsible for company governance.

4.4.1. SHAREHOLDERS' GENERAL MEETING

Needless to say, the importance of meetings cannot be under-emphasized in case of private limited companies. Even if for the formation of company capital play paramount importance, it is an association of persons. Various matters have to be discussed and decided upon the view of the majority. The shareholder meeting is the supreme organ of the company. It has an exceptional significance since a) shareholder rights are exercised in shareholder meetings /i.e. fundamental decisions /measures must be decided at the shareholder meeting/, and b) managers are bound by decisions of shareholders' meetings. A catalogue of fundamental decisions /measures reserved for the shareholder meeting is formulated cattery starting from article 511 of the Commercial Code. In Ethiopia the necessity of conducting shareholders meeting, even if not clearly put by the commercial code as either general or special meeting, is conditioned up on the number of shareholders of the private limited company.

⁵⁴¹ Shareholders meeting and auditors (when the number of share holders are not below twenty), board of directors (not a statutory corporate body in Ethiopian PLC) some PLC's make board of directors to play a role in the governance of the company.

The proper functioning of any company, large or small, requires that the members of the company come together from time to time to discuss matters of common interest and to take decisions by common consent or by a majority as may be possible.⁵⁴² The corporate governance principles and tradition around the world tells us that shareholders meeting is one of the main governance body in governance of a company.⁵⁴³ Shareholders meeting can be general or special meeting base on the issues or agendas that the shareholders going to discuss.

In Ethiopian private limited company shareholders meeting seems to be base on the numbers of shareholders to the company. The Commercial Code under article 525 and 532 dictates that shareholders' meeting is not necessary when the shareholders are below twenty and resolutions or decisions may be passed by managers except change of nationality and modification of articles of association of the company. However, at this point what we have to bear in mind is that the Commercial code does not clearly put it shareholders meeting is mandatory to change nationality of the company and modification articles of association rather majority consent is necessary and this can be made by managers as we can notice it from article 533 of the 1960 Commercial Code.

Share holders meeting in the Ethiopian private limited companies governance is set as a mandatory statutory body only when the number of shareholders is more than twenty.⁵⁴⁴ In other cases shareholders' meeting is not mandatory as we can see it from article 533 of the Commercial Cod. The commercial code under article 533 states that “*Where the holding of a meeting is not required by the law or by the articles of association, the managers shall send to each member the text of resolutions or decisions to be taken and ask for the members' written vote thereon*”. This would encourage Ethiopian private limited companies owners to continue with their kiosk mentality thinking in the business tradition that highly affect the business environment in Ethiopia. The Ethiopian society as a whole and business community in the same fashion has a tradition of eating together while working and doing business is almost such a common occurrence. The business tradition of Ethiopians is not doing in cooperation or association rather individuality prevails.

⁵⁴² Renée Adams, et al, Supra note 265

⁵⁴³ Ibid

⁵⁴⁴ Supra note 539, Article 525 (2) and 532

4.4.2. MANAGERS

Contrary to other countries⁵⁴⁵, corporate governance system and structure, the Ethiopian private limited company is typically characterized by two bodies of governance. The business activities of the company are managed by managers⁵⁴⁶ who represent the company in front of third parties. The shareholders perform their rights in the shareholders' meeting⁵⁴⁷ of the company mainly shareholders are not below twenty. In Ethiopia, private limited companies are made to run by a manager/ managers; board of directors is not recognized as one of a corporate governance body. Managers, other than members, may be appointed by the members or by the memorandum or articles of association.⁵⁴⁸ This provision of the Commercial Code seems controversial because the article seems to send message that shareholders of the private limited company are considered as managers of the company by default like partnership type business organizations.

The Commercial Code stipulates concerning the manner of appointment of members of the company as a manager. From article 527 (1) of the Commercial Code we can infer that shareholders of the private limited company can be appointed as a manger in the memorandum of association. The practice of appointment of managers of private limited companies in Ethiopia shows us that there is no non member manager and that all the appointed managers are shareholder managers appointed in the memorandum of association. The Commercial Code gives full power to the managers of private limited companies within the limits of the objects of the company. Provisions in the articles of association restricting the powers of the managers could have binding effect only as between members and managers. The restricting of the powers of the managers in the articles of association may not bind third parties, even if properly published. The managers are fully and personally liable to third parties for any breach of their duties under Commercial Code or the articles of association and or when the company is at bankruptcy.⁵⁴⁹

⁵⁴⁵ France, India, china, Czech Republic, etc... all allows and make board of directors mandatory in the governance structure of private limited company

⁵⁴⁶ Supra note 476, Article 525(1) and 528

⁵⁴⁷ Ibid, Article 525(2) and 532

⁵⁴⁸ Ibid, Article 526

⁵⁴⁹ Ibid, articles 530 and 531

4.5. LEGAL AND PRACTICAL PROBLEMS IN THE GOVERNANCE OF PLC

4.5.1. NUMBER OF SHAREHOLDERS

In general, legal forms for corporations in Ethiopia may be distinguished between those, which are limited by shares and those made up of individual partners. The corporations with a personal ground depend on the individuals, which are firmly connected with the existence of the business organization. Companies with a capital ground are based on a firmly stated registered capital. The typical representatives of this form of companies are the public (share) company and the limited liability company. Even if capital has a paramount importance in the formation of a company, members or the personality of share holders play a significance role in the formation and operation of company.

Due to this fact, company laws of different countries try to determine the minimum and maximum number of shareholders. Especially these countries put the minimum number of shareholders as astringent precondition for the formation and operation of a company. For the formation and operation of a private limited company the minimum number of shareholders in most countries is two. However the reduction of the number of members below two does not cause for the dissolution of the company. Rather it changes its form and name and becomes a single member or one man company.⁵⁵⁰

For example a limited liability company in Czech Republic may be founded by a single shareholder, either a natural person or a legal entity.⁵⁵¹ However, a private limited company with a sole shareholder cannot be a single founder or single shareholder of another limited liability company.⁵⁵² Further, one person may become a single shareholder of a maximum of three Private limited companies. To make the corporate governance regime more efficient and effective the Czech Republic corporate law makes private limited company to be governed by three statutory bodies.⁵⁵³ In Czech Republic, a private limited company is typically characterized by three bodies. The business activities of the company are managed by the managing

⁵⁵⁰ For example France, Chinese, Indian, Germany, Czech Republic etc company laws make PLC to exist as a single member company when the members reduce below two

⁵⁵¹ Frank Dornseifer (Ed.), supra note 360, p. 39

⁵⁵² Ibid

⁵⁵³ Ibid

director(s), who represents the company with third parties.⁵⁵⁴ The shareholders perform their rights in the shareholders' meeting of the company and the control authorization pertains to the supervisory board.⁵⁵⁵ In contrast to the joint stock company the establishment of the supervisory board is not mandatory.⁵⁵⁶

As we see in chapter three, under French corporate governance law and practice, SARL is a required to be formed by at least two shareholders, created for a commercial purpose. However, a SARL may be created by, and may continue to exist with, only one shareholder.⁵⁵⁷ A SARL with only one shareholder is known as an enterprise unipersonnelle a `responsabilite ´ limite ´e (EURL).⁵⁵⁸ A EURL is considered to be a special type of SARL and is subject to the regulations applied to SARL unless specifically indicated otherwise by the law. What are required to have is directors to run the company and the reduction of shareholders below two does not cause for the dissolution of the company.⁵⁵⁹

Under the Chinese 2005 company law, the law puts the maximum number of share holders and does not determine the minimum requirement. A limited liability company established according to 2005 company law shall include the words "limited liability company" or "limited company" in its name.⁵⁶⁰ A limited liability company can be established by no more than 50 shareholders that make capital contributions.⁵⁶¹ A private limited company in china can be run by a single individual (single person company) and the state (wholly state-owned limited liability companies).⁵⁶² That is the reduction of the members of the private limited company below two does not cause for the dissolution of the company.

What is put as a mandatory requirement for the formation of private limited company in China is to have statutory corporate body for governance of the company. The legal structures of the joint stock companies has three mandatory organs; the board of directors, the supervisory board and

⁵⁵⁴ Ibid

⁵⁵⁵ Ibid

⁵⁵⁶ Ibid

⁵⁵⁷ I'd, p 197

⁵⁵⁸ Ibid

⁵⁵⁹ Ibid

⁵⁶⁰ Supra note 450, Art. 72

⁵⁶¹ Ibid

⁵⁶² Ibid

the general meeting.⁵⁶³ The private limited liability company is also composed of three mandatory organs: a board of directors, a supervisory board and a board of shareholders (or general meeting).⁵⁶⁴ In the private limited liability company the “manager” is not mandatory for the limited liability company like joint stock company and One-person limited liability companies are not required to establish a board of shareholders (general meeting).⁵⁶⁵

Whereas, As to the 1956 company act of India, private limited company is a voluntary association of not less than two and not more than fifty members, whose liability is limited, the transfer of whose shares is limited to its members and who is not allowed to invite the general public to subscribe to its shares or debentures.⁵⁶⁶ A private company can be incorporated by a minimum of two (2) members whereas the maximum number of members of a private company cannot exceed fifty (50).⁵⁶⁷ In the Indian company act the reduction of shareholders below two does not be a good cause for the dissolution of private limited company rather it recognizes one person company.⁵⁶⁸ ‘One person company’ has been recognized under the 2013 company act.⁵⁶⁹

The Commercial Code Ethiopia requires a minimum of two and a maximum of fifty shareholders to the formation and operation of private limited company. Contrary to other countries corporate law, the ultimate fate of the private limited company if the shareholders reduced below two is dissolution of the company. This makes the business society in Ethiopia to search for other means/room to escape from this mandatory requirement. In collecting data from the ministry of trade, I have consult 300(three hundred) private limited companies’ data from the registration documents.⁵⁷⁰ Among these 90% are family base businesses with only two shareholders.⁵⁷¹

What is worse here is that the share of one of the shareholders (most are wives and children) are nominal shareholders. In the shares of the shareholders I have found that the ratio of 99 to1, 99 to3, 3998 to 2, 990 to 10, etc....of shares.⁵⁷² Nominal shareholders are surprisingly minors and

⁵⁶³ Ibid, Art. 114

⁵⁶⁴ Ibid

⁵⁶⁵ Ibid

⁵⁶⁶ Supra note 454

⁵⁶⁷ Supra note 455

⁵⁶⁸ Supra note 456

⁵⁶⁹ Indian company act, 2013, Clause 166

⁵⁷⁰ Ministry of Trade, supra note 19, Business Registration documents of 2001, 20003, 2004, and 2005.

⁵⁷¹ Ibid

⁵⁷² data from the registration documents of 2003, registration no. 1243, 3477, 2314 and 1064 respectively

the block shareholders are parents.⁵⁷³ So one can ask the sources/shares for the capital of these minors; most probably the parents are the sources for the capital/shares of the minors. They make this so as to pass the stringent requirement of a minimum of two shareholders for the formation of private limited company. The corporate governance practice of other countries show us that a private limited company could be formed by one member/shareholder, however what is required to have is the mandatory statutory bodies for the governance of the company i.e. directors, auditors, shareholders' meetings and managers. Therefore, this is a big legal and practical problem in the corporate governance of private limited companies which encourages the kiosk mentality thinking of Ethiopian business community.

4.5.2. MANAGERS VS. DIRECTORS

One of the defining characteristics of modern corporations is that the separate legal personality/existence of company from its founders/owners. Where company has its own legal personality implies that it can be the subject of rights and liabilities. There is a formal separation of the company's management from the shareholders. The primary purpose of a corporate governance structure should always be the efficient management of the company. Since a company is a separate legal entity, it can only make decisions and change its business through the persons authorized for that purpose who in turn are accountable to the members'.⁵⁷⁴

Distinguishing between ownership and control and explaining the agency factor, i.e. the owners of the company hire directors/ managers (agents) who control and manage the assets of the company is an intrinsic feature of the company and one that is central to any corporate governance model.⁵⁷⁵ The key actors in corporate governance are shareholders, board of directors' managers and auditors. These corporate governance bodies have their own fundamental significance in the governance of a company in which one cannot substitute the role of the other.⁵⁷⁶ Or it is difficult to make the role played by one governance body to be run by other body since they have their own specific and natural role as to their establishment since they

⁵⁷³ Ibid

⁵⁷⁴ Supra note 233

⁵⁷⁵ Supra note 146

⁵⁷⁶ Chris Pierce, *The Effective Director*, London: Kogan Page, 2003 As cited in The International Finance Corporation(World Bank Group), Who's Running the Company?: A guide to reporting on corporate governance, Washington: (2012), p 19

have their own natural function. For example managers cannot perform the roles of a directors or share holders at the same legal status. This is the distinct behaviour of a company.

One points what we have to recall here is that the difference between directors and managers of corporate governance and corporate management. There are many fundamental differences between being a director and a manager as we see in the previous chapters. It is the board of directors who must provide the intrinsic leadership and direction at the top of the organization; establish and maintain its vision, mission and values.⁵⁷⁷ In corporate governance principle and practices, it is the responsibility of the board of directors to provide central leadership and direction in formulating company strategy whereas managers carry through the strategy on behalf of the directors. Directors, not managers, have the ultimate responsibility for the long-term prosperity of the company while managers are not responsible for making strategic decisions for the company and hence are only concerned with implementing the decisions made by the board of directors.⁵⁷⁸

By giving due recognition of this fact different countries company law make private limited company to be run by a certain statutory body. Most of the countries around the world make private limited company to run by directors/board of directors.⁵⁷⁹ The countries what we have seen above (French, India and china) make their private limited company to be run by directors than managers. Under French corporate governance practice, a SARL must have at least one director ("*gérant*"). Two directors /"*co-gérants*", and a panel of directors /"*collège de gérants*" / each of whom will have the right to represent the company may also be appointed.⁵⁸⁰

The Company Law of the People's Republic of China prescribes for a two tier board not only in joint stock companies but also for limited liability companies. The limited liability company is also composed of three mandatory organs: a board of directors, a supervisory board and a board of shareholders (or general meeting). One difference between the limited liability company and the joint stock companies is that the "manager" is not mandatory for the limited liability company. The board of directors of limited liability companies must generally comprise 3 to 13

⁵⁷⁷ Ibid

⁵⁷⁸ Ibid

⁵⁷⁹ Supra note 545

⁵⁸⁰ Supra note 397

members whereas joint stock limited company shall set up a board of directors, which shall be composed of 5-19 persons.

However, as to the Company Law of the People's Republic of China, limited liability companies with relatively fewer shareholders or of a relatively smaller scale may appoint an executive director instead of establishing a board of directors.⁵⁸¹ An executive director may hold the post of the company manager concurrently. A limited liability company may set up a board of supervisors, which shall be composed of at least 3 persons.⁵⁸² For a limited liability company in which there is a relatively small number of shareholders or which is relatively small in scale, it may have 1 or 2 supervisors and does not have to establish a board of supervisors.⁵⁸³

Under the Indian company law, the shareholders own the Company but they do not manage the affairs of the Company. As per the Indian Companies Act of 1956 every Private Limited Company incorporated in India is required to have at least two directors on board.⁵⁸⁴ A private company is required to have at least two directors while a public company should have a minimum of three directors. This shows us that there is a clear separation of ownership and control in the Indian private limited company. It is the directors who run the Company as per the provisions of Memorandum and Articles of Association. Shareholders decide who will be the director by passing a resolution in the Annual General Meeting.⁵⁸⁵

Contrary to other countries corporate governance tradition, the Ethiopian company law dictates private limited company to be run only by managers than recognizing managers and directors as a statutory governance bodies. Unlike a share company, a private limited company does not have a board of directors or managers chosen by the board. A private limited company is managed by its shareholders or some of them, like a partnership. The 1960 Commercial Code of Ethiopia under Article 525(1) stipulates that “*a private limited company shall be managed by one or more managers*”. Moreover, article 526 says that *Managers, other than members, may be appointed by the members or by the memorandum or articles of association for such period as is considered desirable*. These tell us that *shareholders of a private limited*

⁵⁸¹ Supra note 433

⁵⁸² Supra note 434

⁵⁸³ Supra note 439

⁵⁸⁴ Supra note 462

⁵⁸⁵ Supra note 461

company are by default consider as managers of the company like partnership type of businesses that partners are considered as managers by default by the mere fact of being a partner to the partnership. This is one of the basic nature or characteristics of private limited company in Ethiopia.

In private limited companies/small business, it is important to recognize that the company is not an extension of the personal property of the owner.⁵⁸⁶ The process of incorporation involves two processes of separation in relation to ownership. One is that the corporation itself is separate from its investors. The other process is the separation of the right of ownership itself. In the classic sense, the right of ownership is an absolute right which consists of a bundle of rights including residual claimant rights, the right of disposition, the right of control, the right to interest.⁵⁸⁷ This means that the owner of the property has a complete and absolute right over the property. While shareholders have the residual claimant rights over the property, the right of disposing and using property is exercised by the salaried manager(s).⁵⁸⁸ In fact, in a corporation, the bundle of rights attaching to ownership is separately owned and exercised by different people as participants including shareholders, managerial staff, employees, creditors and in some cases, government institutions.⁵⁸⁹ Hence, it is appropriate to say that a corporation is a coalition of different groups with different interests.⁵⁹⁰ This is the essential difference between the internal structure of the corporation and of the classic enterprises. Thus having effective governance framework that defines the roles, responsibilities and an agreed distribution of power amongst shareholders, the board, management and other stakeholders is necessary to the Ethiopian PLCs.

However, this does not mean that the shareholders/owners of the company do not involve in the management of the company. Shareholders could be participating in the governance of the company either in director's status, manager's status or shareholder status. Nevertheless what we have to bear in mind is that the shareholders participate in the governance of the company not

⁵⁸⁶ Berle AA and Means GC, The Modern Corporation and Private Property, New York: MacMillan, (1963), p 311.

⁵⁸⁷ Ibid

⁵⁸⁸ Ibid

⁵⁸⁹ Id, p 8-9

⁵⁹⁰ Rosser M, Microeconomics: The Firm and the Market Economy, London: MacMillan Education, (1988), p 118.

only as an owner status rather as a director or manager who run the company by taking the interest of the company and stakeholders as a central or focal point of governance.

When we see Share Companies and private limited companies there is a possibility that both of them could be formed with same numbers of shareholders and same capital amount. For example, both may have ten or twenty members/shareholders with five million registered capitals. However, as to the 1960 Commercial Code the share company is obliged to be run by directors and managers whereas the private limited company runs by managers. I raise this by taking under consideration that being a director/board of directors and manger/team of managers has different legal and practical status. At this juncture, one can ask “what the rationale behind this distinction is” as far as both have same positive and negative externality respective of the business objective of the company. Thus it is a big governance lacuna for the private limited company in Ethiopia that requires deliberation from the business community, the government.

4.5.3. SHAREHOLDERS MEETING

Mainly, there are four groups of corporate actors playing important roles in managing and monitoring a corporation; shareholders, the board, managers and auditors. Effective corporate governance requires a clear understanding of the respective roles of the board, managers and shareholders, their relationships with each other, and their relationships with others that have an interest in the corporation and its well-being.⁵⁹¹ Shareholders are the real company owners because they invest their money. The modern development of corporate governance is a movement from the shareholders’ meeting to the board of directors, as a result of the division of ownership and control.⁵⁹² One of the fundamental elements in the rights, privileges and powers of a shareholder is the power to play a part in the governance of the company.⁵⁹³ They indirectly control the company by appointing the board of directors as their representatives to supervise the company for their best interest. Shareholders clutch the ultimate right to decide imperative matters.

⁵⁹¹ Business Roundtable , Supra note 275

⁵⁹² Dine J, ‘Private Property and Corporate Governance Part II: Content of Directors’ Duties and Remedies’ in Fiona Macmillan Patfield (ed), Perspectives on Company Law: (1995), p 117

⁵⁹³ Per Samuelsson, Supra note 260

The shareholders' meeting is the supreme body of any company. All major decisions that affect the rights of the shareholders and the company are to be taken in the shareholders' meeting. The shareholders' meeting of a limited liability company may be composed of all the shareholders. Meetings of members are meetings where the members / shareholders of the company meet and discuss various matters. As mentioned earlier, all decisions, which may have a substantial impact on the structure of the company or the framework of its business, are to be taken by the shareholders' meeting. Kinds of Company meetings in a company can be shareholders meeting, board of directors meeting and other meetings.

Shareholders meeting are most of the time annual general meeting and extraordinary general meeting. Under the Indian corporate governance law, every type of company, public or private, limited by shares or by guarantee, with or without share capital or unlimited company, are obliged to conduct shareholders' meeting once a year.⁵⁹⁴ Every company must in each year hold an annual general meeting. Not more than 15 months must elapse between two annual general meetings.⁵⁹⁵ As to the 1956 company act of India, Every general meeting (i.e. meeting of members of the company) other than the statutory meeting and the annual general meeting or any adjournment thereof, is an extraordinary general meeting. Such meeting is usually called by the board of directors for some urgent business which cannot wait to be decided till the next AGM.⁵⁹⁶

In Chinese Company law, shareholders' meetings are classified into regular meetings and interim meetings. The regular meetings shall be timely held in accordance with the articles of association but it must be annually.⁵⁹⁷ The shareholders' meetings shall be convened by the board of directors and presided over by the chairman of the board of directors.⁵⁹⁸ Shareholders may needed and pass resolution at a shareholders' meeting on revising the articles of association, increasing or reducing the registered capital, merger, split-up, dissolution or change of the company form.⁵⁹⁹

⁵⁹⁴ Supra note 479

⁵⁹⁵ Ibid

⁵⁹⁶ Supra note 49

⁵⁹⁷ Supra note 450

⁵⁹⁸ Supra note 446

⁵⁹⁹ Ibid

Under the French Company law the shareholders of a company generally exercise the ultimate control over its management by appointing and dismissing the company directors. The exercise, by the directors, of their duties is ultimately controlled by the shareholders, who have the authority to revoke the directors and are called upon to resolve on certain material decisions (such as, approval of financial statements, sale of material assets */fonds de commerce/*, share capital increases and reductions, etc.).⁶⁰⁰ The most important decisions can only be taken by the shareholders by way of general meeting.

When we come to the Ethiopian corporate governance law and practices it is difficult to say shareholders' meeting is considered as one of the formal body in the governance of private limited companies. As it is clearly stipulated under article 525 and 532 the 1960 Commercial Code private limited companies are governed by a manager or managers and the shareholders general meeting is required by the law when the number of shareholders is more than twenty. This shows us that shareholders' meeting is conditional body of corporate governance. Where the number of shareholders in a private limited company is not more than twenty the members to the company are not obliged to conduct shareholders meeting even if certain decisions require the consent or vote of majority of the members such as the dismissal of managers, change of nationality of the company and amendment to the articles of association of the company. As we see from scattered provisions of the Commercial Code these decisions do not require to be made at the shareholders general meeting. It can be done or taken without shareholders meeting, (article 532 of the commercial code), when the managers send to each member the text of resolutions or decisions to be taken and ask for the members written vote thereon.

One question what we can raise here is that what is the rationale of making share holders meeting participation in the governance of the private limited company base up on number of shareholders. Does the corporate governance law regulate the members of the company, the capital of the company or the company? We can raise the above example that when the number of shareholders and registered capital of Share Company and private limited company is the same. At this case the share company is obliged to conduct shareholders meeting or make shareholders meeting as one of mandatory statutory body in the governance of the company

⁶⁰⁰ Supra note 402

while shareholders meeting is not put as a statutory body in the governance of private limited company when the number of shareholders is not more than twenty.

One might raise here another question that “what is the need of shareholders meeting in case that the manager and owner of in most private limited companies of Ethiopia is one and same person since most private limited companies are family businesses”. However, Share Company may be here establish with family base that the managers, board members and shareholders are same individuals but at the same time the company law and corporate governance tradition in Ethiopia make such company to be governed by managers, auditors, board of directors and shareholders’ meeting. The rationale behind such corporate principle and tradition is that company is a separate legal person from its founders or owners and company contain the interests of not only insiders but also outsiders. The brain of company is these statutory governance bodies in which the company runs by these statutory bodies acting in their respective capacity i.e. either as a manager, director or shareholder.⁶⁰¹

As far as the ultimate purpose or aim of corporate governance principles is to give an assurance or guarantee for the members, stakeholders (creditors, employees, customers etc...) of the long term existence or operation of the company, making all statutory bodies i.e. shareholders, directors, managers and auditors to be functional is not a choice rather it is a necessity. Especially in a country like Ethiopia, private limited companies play a substantial role in the country’s economy, making the principles of corporate governance to be functional is not a luxury rather is a necessity/compulsory.

5. AUDITORS

We say corporate governance is the process on which organizations are managed and controlled. Corporate governance recognizes the inherent conflicts in objectives between owner shareholders and managers; and thus establishes institutions, policies, and procedures to protect shareholders’ interests. Auditing is one of the four cornerstones of corporate governance (shareholders, managers board of directors and auditors), and the auditing function of auditors has an important role in assisting the governing organ to monitor the effectiveness of its

⁶⁰¹ Stephen M. Bainbridge, *supra* not 233

governance.⁶⁰² By helping the governing organ in this way, audit becomes an essential element of the corporate governance process. As internal auditors are part of the internal control system, one of their significant roles is to give assurance on the risk management systems objectively to the management of the organization.⁶⁰³ Internal audit's/or audit committees/ relationship with board of directors is considered to be of fundamental importance to achieve sound corporate governance.⁶⁰⁴

Under the Indian company act every company is obliged, at each annual general meeting; to appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting.⁶⁰⁵ The company act obliges all companies to have auditors is not base up on either the number of shareholders or capital and income or profit of the companies rather as far as the private limited companies have already incorporated are required to appoint auditors.⁶⁰⁶ Where at the AGM the shareholders fail to appoint or re-appoint auditors, the Central Government may appoint a person to fill the vacancy.⁶⁰⁷ The auditors have same right of getting any information as shareholders any member of the company is entitled to have.⁶⁰⁸ That is all notices of, and other communications relating to, any general meeting of a company which any member of the company is entitled to have sent to him shall also be forwarded to the auditor of the company; and the auditor shall be entitled to attend any general meeting and to be heard at any general meeting which he attends on any part of the business which concerns him as auditor.

In France, whether a company has to have an auditor depends on the legal form of the enterprise and its size. Enterprises with the legal form SA (*Société Anonyme*), SCA (*Société en Commandite par Actions*) and SAS (*Société par Actions Simplifiée*) must have a statutory auditor, regardless of their size.⁶⁰⁹ In France a SARL must appoint an auditor if it exceeds, at the

⁶⁰² Lawrence B., et al, Sawyer's Internal Auditing: The Practice of Modern Internal Auditing, Altamonte Springs, FL: Institute of Internal Auditors, Vol. 5, No 1 (2013), p 49

⁶⁰³ Ibid

⁶⁰⁴ For details see the website of the Institute of Internal Auditors at: <http://www.iaa.org.uk/en/KnowledgeCentre/ResourceLibrary/corporate-governance.cfm>

⁶⁰⁵ Supra note 471

⁶⁰⁶ Ibid

⁶⁰⁷ Supra note 473

⁶⁰⁸ Ibid

⁶⁰⁹ Frank Dornseifer(Ed), supra note 379, p 201 and French Commercial law, Art. L. 225-218

close of a financial year, two of the three following thresholds: €1.550.000 of total assets, €3.100.000 of turnover, 50 employees.⁶¹⁰

Under the China corporate governance law, all companies are required to prepare financial accounting reports at the end of each accounting year, which shall be audited by an accounting firm.⁶¹¹ The China Company law devise companies to be audited by an auditing firm.⁶¹² The Chinese company law prefers company finance to be audited by an accounting firm than to appoint internal auditor like other countries such as French and India and even Ethiopia (when the number of shareholders is more than 20).

When we come to the Ethiopian Commercial Code, private limited companies in are not obliged to have auditors unless the numbers of shareholders is more than twenty/article 525/. In Ethiopia, even if many of the large firms are incorporated as private limited companies they are not legally required to publish their financial statements. As clearly stipulated under article 538 of the Commercial Code, where a private limited company consists of more than twenty members, not less than three auditors shall be appointed in the memorandum of association. Auditors may be re-elected at such periods and under such conditions as may be provided in the articles of association. Auditors may be dismissed as provided in the articles of association.

The recognition of auditors as a corporate governance body base up on the number of shareholders makes Ethiopian private limited companies odd from other countries corporate governance law and practice. In companies, we are auditing not the members rather the capital or asset of the company. If so, it is not clear why having auditors is base on the number of shareholders of private limited companies in Ethiopia. A private limited company may run a huge capital for that matter may be greater than Share Company even if the number of shareholders is less than twenty. Or there might be a situation in which the number of shareholders and capital of a share company and private limited company be the same. Nevertheless, the company law makes share companies to have auditors while private limited companies are not obliged to have. Thus, it is illogical to make private limited companies to have auditors base on the number of shareholders. It seems that making private limited company to

⁶¹⁰ Ibid , p 219

⁶¹¹ Supra note 441

⁶¹² Ibid

have auditor base on the numbers of share holders is that such companies are considered as family business in Ethiopia and so as to make a private limited company not to govern by a board since auditors are taken as one of the committees of board of directors in the corporate governance principle. That is to avoid bureaucratic governance system of private limited companies/family business. However, this is not the fact in today's PLCs business in Ethiopia.

5.4.1. CONFLICT OF INTEREST

Conflict of interest (or agency problem) between shareholders and managers are arising from the separation of ownership and control. There can also be conflicts of interests between controlling shareholders and minority shareholders. Even though, this is a feature of publicly owned corporations where share ownership is dispersed among a large number of shareholders who do not directly manage the companies, it also happens in closely held/ private limited companies because the very cause for the rising of conflict of interest is separation of ownership and control or separate legal existence/personality of companies from its creators/owners. The primary reason for corporate governance is the separation of ownership and control and the agency problem it engenders.

The manifestations of agency problems or conflict of interest are excess managerial compensation, excess managerial perks, empire building, pet projects (free cash flow problem), slacking, misuse of corporate resources etc⁶¹³. The issue of conflict of interest is clearly addressed in the Commercial Code on the part that deals on share companies. Mainly article 355, 356 and 409 of the commercial code dictates about the restriction of private trade for directors with rival or competing companies directly or indirectly, restriction of dealing between a company and its directors and restriction of the right of vote of a member when a conflict of interest arise between the company and the member/shareholder.

In the Ethiopian private limited companies, the problem of conflict of interest or agency problem mainly arises when the shareholders appoint non member manager. The Commercial Code under article 526 allows private limited companies shareholders to appoint non-member managers. *The commercial code under article 526, "Managers, other than members, may be appointed by the*

⁶¹³ Reinier R. Kraakman, et al, The Anatomy of Corporate Law: A Comparative and Functional Approach, New York: (Oxford University Press, 2004), p 21

members or by the memorandum or articles of association for such period as is considered desirable.” During this time the problem of conflict of interest may arise. The code does not put a mechanism about how to solve conflict of interest between shareholders/members and the private limited company, managers vs. shareholders, managers vs. the company and managers vs. other stakeholders except ordering managers to perform their duties within the limits of the objects of the company with due care and diligence.⁶¹⁴ Except these, there is no legal provision in the commercial code dealing on private limited company about the issue of conflict of interest unless one can consult other laws by following principles interpretation of law. This is a big legal and practical corporate governance problem of Ethiopian PLCs.

3.6. THE NECESSITY OF HAVING BOARD OF DIRECTORS TO ETHIOPIA PRIVATE LIMITED COMPANIES

Corporate governance is often, and wrongly, regarded as the exclusive domain of large corporations with shares that are traded in stock exchanges or public subscription.⁶¹⁵ Perhaps this is because the data of those corporations are public and available for scrutiny by investors, academics and other stakeholders. However, the need for better governance is even more important for smaller/ private limited companies/family businesses. Share companies are as visible as the tip of an iceberg, but below the waterline we find a much larger number of companies, mostly family-controlled/private limited companies in Ethiopia. In Ethiopia, about 463 companies are share companies whereas above 22,000 companies are private limited companies. Corporate governance has through these days received considerable attention, but most of the attention has been given to boards and governance in share companies. However, most companies are small and medium sized, have concentrated ownership and in most cases they can also be characterized as PLCs businesses.

Distinguishing between ownership and control and explaining the agency factor, i.e. the owners of the company hire directors/ managers (agents) who control and manage the assets of the company is an intrinsic feature of the company and one that is central to any corporate governance model. The key actors in corporate governance are shareholders, board of directors,

⁶¹⁴ Commercial Code of Ethiopia, Supra note 481, Article 528(1) and 531(2)

⁶¹⁵ Fianna Jesover, Beatrix Dekoster (Ed.), Corporate Governance of Non-Listed Companies in Emerging Markets, (OECD Publishing, 2006), p. 12

managers and auditors. These corporate governance bodies have their own fundamental significance in the governance of a company in which one cannot substitute the role of the other. It is difficult to make the role played by one governance body to be run by other body since they have their own specific and natural role as to their establishment. For example managers cannot perform the roles of a directors or share holders at the same legal status. This is the distinct behaviour of a company.

One point we have to recall here is that the difference between directors and managers of corporate governance and corporate management. There are many fundamental differences between being a director and a manager. It is the board of directors who must provide the intrinsic leadership and direction at the top of the organization; establish and maintain its vision, mission and values.⁶¹⁶ In corporate governance principle and practices, it is the responsibility of the board of directors to provide central leadership and direction in formulating company strategy whereas managers carry through the strategy on behalf of the directors.⁶¹⁷ Directors, not managers, have the ultimate responsibility for the long-term prosperity of the company while managers are not responsible for making strategic decisions for the company and hence are only concerned with implementing the decisions made by the board of directors.⁶¹⁸ By giving due recognition of this fact, different countries company law make private limited company to be run by a certain statutory body. Most of the countries around the world make private limited company to run by directors/board of directors.⁶¹⁹

Contrary to other countries corporate governance tradition, the Ethiopian company law dictates private limited company to be run by managers than directors. The 1960 Commercial Code of the empire under Article 525(1) stipulates that “*a private limited company shall be managed by one or more managers*”. Plus to this article 526 says that *Managers, other than members, may be appointed by the members or by the memorandum or articles of association for such period as is considered desirable*. These tell us that *shareholders of a private limited company are by default* considered as managers of the company like partnership type of businesses that partners

⁶¹⁶ Huse, M., Board-Management Relations in Small Firms: The Paradox of Simultaneous Independence and Interdependence, Small Business Economics, (1994), p. 55

⁶¹⁷ Ibid

⁶¹⁸ Ibid

⁶¹⁹ Supra note 477

are considered as managers by default/ by the mere fact of being a partner to the partnership. This is one of the basic nature or characteristics of private limited company in Ethiopia.

An effective governance framework defines roles, responsibilities and an agreed distribution of power amongst shareholders, the board, management and other stakeholders. Especially in private limited companies/small business, it is important to recognize that the company is not an extension of the personal property of the owner. However, this does not mean that the shareholders/owners of the company do not involve in the management of the company. Shareholders could participate in the governance of the company either in director's status, manager's status or shareholder status. But what we have to bear in mind is that the shareholders participate in the corporate governance of the company not as an owner status rather as a director or manager who run the company by taking the interest of the company and stakeholders as a central or focal point of governance.

The data from the ministry of trade tells us almost all of the private limited companies are run or managed by a single manager even not by team of managers. The manager in most private limited company is the husband/father of the wife and children respectively. This makes private limited company more complex and difficult to differentiate separation of ownership and control in Ethiopia. Corporate governance goes beyond the protection of shareholders.⁶²⁰ Corporate governance of private limited companies should also aim to protect the interest of other stakeholders, such as employees, suppliers and creditors and the society as a whole.⁶²¹

In Ethiopia, most private limited companies are owned and controlled by two individuals or by a family. In many cases, owners continue to play a significant direct role in management. Good governance in this context is not a question of protecting the interests of absentee shareholders. Rather, it is concerned with establishing a framework of company processes and attitudes that add value to the business and help ensure its long-term continuity and success. In many private limited companies, the distinction between the members of the governance tripod of board, management, and shareholders may often unclear. An owner-manager may fulfil all or several of

⁶²⁰ Fianna Jesover, Beatrix Dekoster (Ed.), *supra* note 615

⁶²¹ *Ibid*

these roles. Nonetheless, it is important to be acquainted with the unique role that the board plays in the leadership of the company. It has overall responsibility for the company's activities.

The purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company. In Ethiopia, Private limited companies have increased in number, size and complexity and they require more complex organizational structures and a more diverse workforce possessing various levels and areas of expertise.⁶²² Private limited companies are of particular importance in country like Ethiopia with less developed capital markets. Therefore, it is necessary to put a comprehensive legal framework concerning the governance of private limited companies and making private limited company to be run by board is not a choice rather it is a necessity. Good corporate governance for private limited companies is not only concerned primarily with having a board of directors and the relationship between a company's board of directors and the company's shareholders (as with public/ share companies) rather it is more about establishing a framework of company processes and attitudes that will add value to the business and the national economy, help build its reputation and ensure its long-term continuity and success.⁶²³

Good governance can play a crucial role in gaining the respect of key external stakeholders such as actual and potential financiers, employees, customers, and local communities.⁶²⁴ Good governance effectively provides a license to operate, since it offers external stakeholders assurance that the company is being run in an appropriate and responsible manner, with due regard for the interests of non-insiders.⁶²⁵ Even if the private limited company is not breaking any formal laws, it may be operationally affected by the negative perception of employees, consumers and other stakeholders.⁶²⁶ The implementation of a robust governance framework is the main means by which such significant reputational risks can be mitigated.

The fact that international companies, attracted by the promise of fast-growing emerging and transition markets, are increasingly pursuing growth in these markets, makes improved

⁶²² Ibid

⁶²³ Corbetta, G. and Tomaselli, S., "Boards of Directors in Italian Family Business", Family Business Review, vol. 9 No. 4, 1996, p. 403.

⁶²⁴ Beatrix Dekoster (ed.), Supra note 6, p. 8

⁶²⁵ Ibid

⁶²⁶ Ibid

corporate governance of non-listed/private limited companies a priority.⁶²⁷ A corporate governance framework must allow companies to ideally match their legal status with their organizational needs, giving them the opportunity to grow and develop in the context of a highly competitive business environment.⁶²⁸ Thus, to achieve these, implementing a full-bodied governance framework; having board of directors than managers is at the stage of necessity than a choice to Ethiopian private limited companies.

Today these companies, even if cover majority of the country's business enterprise (companies), (97%), the majority are not that much at the status of value adding to the economic development of the country. Because they are participating or conducting a business of importing; not manufacturing and/or exporting and in the history of development of mankind there is no country that developed based on import based economy. At this time, having Export lead or based economy and competing in the international trade is the fashion of economic development of the globe. To achieve these, making private limited companies to be run by strategic and professional leaders than an individual manager is very significant in the market economy. The strategic and professional leaders as to the principle of corporate governance are boards of directors not managers.

Board of directors play a significant role in the governance of PLC mainly adding value for shareholders' interest,(as there is often no ready market for shares in private/ and shareholders are therefore committed to staying with the company for the medium to long term, which increases their dependence on good governance),⁶²⁹ balancing the interests of founder families in family companies with the success of the company and Promoting the long-term success of the company and attracting external investment.

One may think that a board of directors is reserved for large corporations with shareholder investments to oversee and strategic decisions to be made. The truth is that many small

⁶²⁷ Fianna Jesover, Beatrix Dekoster (Ed.), Supra not 622

⁶²⁸ Nick Wilson, Family Business Survival and the Role of Boards, Leeds University Business School, (March 2013), p. 13

⁶²⁹ Castaldi, R. and Wortman, M. S. J., "Boards of Directors in Small Corporations: An Untapped Resource", American Journal of Small Business, vol. 9 No.2, (1984), p. 10.

businesses can benefit from a board of directors.⁶³⁰ Not all small businesses have the skills they need to operate effectively especially if they've experienced rapid growth. A board of directors can help by adding to and complementing skills and industry expertise that you might not have in-house. A board can also help ensure you have the right processes in place to manage growth, focus your strategy, and prepare to raise capital. Therefore, it is important to formulate the most modern corporate governance rules for the private limited companies in Ethiopia particularly making BoD compulsory to the governance of such companies. Making private limited companies to have a governance board that should have an appropriate mix of skills and experience without being too large ,which may render it difficult to manage and therefore less effective, is very vital to make PLC effective and value add to the country's growth.

Currently around the globe, since private limited companies are regarded as the backbone of a robust economy, policymakers have become more and more aware that neglecting the governance needs of these companies will stunt productivity, growth and job creation.⁶³¹ The rapid pace of technological change and the decreasing international barriers to trade have not only created new strategic and organizational opportunities for companies, but have also made them more vulnerable to risks.⁶³² Hence, in order to help private limited companies fully exploit the new opportunities and adjust more easily to immediate uncertainty, policymakers should endeavour to devise the most efficient corporate governance framework as part of their long-term strategy to foster investment, innovation and entrepreneurship. Although corporate governance reforms in Ethiopia is generally badly chosen for private limited company, a shift in focus from share companies/primarily financial share companies/ to private limited companies is arguably important in Ethiopia's emerging and transition economy, where most of the firms are PLCs and ownership and control are typically not completely severed. Thus to make private limited companies in Ethiopia to run by board of directors is a cream of the crop thinking of what the present and future business environment seems.

Moreover, the presence of board of directors is very important to avoid the problem of conflict of interest or agency problem. The manifestations of agency problems or conflict of interest are

⁶³⁰ Jeroen Van den Heuvel, Board Roles in Small and Medium-Sized Family Businesses: Performance and Importance, Belgium: Limburg University (changed to Hasselt University), (2005), p. 4

⁶³¹ Fianna Jesover, Beatrix Dekoster (Ed.), supra note 621

⁶³² Ibid

excess managerial compensation, excess managerial perks, empire building, pet projects (free cash flow problem), slacking, and misuse of corporate resources. Even if, conflict of interest is a feature of publicly owned companies, where share ownership is dispersed among a large number of shareholders who do not directly manage the company, it also happens in private limited companies. Because, the very cause for conflict of interest is separation of ownership and control (separate legal existence/personality of companies from its creators/owners). The agency problem in the governance of private limited companies mainly arises when the shareholders appoint external or a non shareholder manager. So based on the corporate governance principles, the conflict of interest or agency problem avoid by having a board of directors for the governance of the company. Therefore, having board directors (or making private limited companies to run by a governance board) to the private limited companies could avoid the problem of conflict of interest.

In conducting the study I have conducted an interview with different individuals. In the interview, what I have taken from Tilahun Teshome⁶³³, he agrees with the compulsoriness of board of directors to private limited companies but conditioned up on certain qualifications. What Professor Tilahun Teshome has said is that a governance board of directors be mandatory to private limited companies however it be base on either the capital threshold of the company, the type of the business what the PLCs operate or base on the number of shareholders to the company. He says that practically most private limited companies have advisory board. Professor Tilahun Teshome says the board of directors be a governance board not be an executive board and to do that the whole legal framework have to be changed.

On top of this, the corporate governance practices of Ethiopian private limited companies tell us that as there are certain companies which are governed by board of directors. In collecting data for the study I have found the following companies run by a governing board. For example, the MIDROC Ethiopia company website tells us that as there are certain groups of MIDROC company group that could be governed by board of directors. All of the MIDROC companies, which plus to the website the data from the ministry of trade shows that total about 84 are private limited companies.

⁶³³ Tilahun Teshome, professor at Addis Ababa University, Faculty of law, (conducted on December 13/2013 E.C)

The website states that⁶³⁴ *“The MIDROC Ethiopia Investment Group is organized with various modalities of management. One set of companies are organized under MIDROC Ethiopia Technology Group, Chief Executive Officer. The other set of companies are organized as totally independent entities, some having Boards of Directors, where as a group have a Consultative Body represented by the Top Management of each of these companies. The Head Office of the MIDROC Ethiopia Investment Group serves also as the secretariat of this Consultative Body....”*

Andnet international plc is another private limited company that runs with a governance board of directors. The board of directors of Andnet international private limited company consists of five members. As I have found from the data and interview what I have conducted from documents and the company manager the main role of the governance board is supervision of the day to day activities of the company manager, designing strategic plans of the company, approve the finance of the company and etc.

Different private limited companies in Ethiopia have advisory boards. This comes from the very problem of Ethiopian investors; having the money but not the knowledge about how to run and utilize it. They have the money but not the knowledge. Most of the owners of Ethiopian business entities do not have the appropriate knowledge about how to run their business professionally. That is why they are obliged to have advisory boards. When company behaviour does not fulfil the expectations of society, the company may suffer significant consequences. Even if the firm is not breaking any formal laws, it may be operationally affected by the negative perception of employees and consumers. The implementation of a robust governance framework is the main means by which such significant reputational risks can be mitigated. One can perceive here is that these companies are even become elite minded than the policy makers about the importance or role of board of directors in the governance of private limited companies. It is a wakeup call for the Ethiopian policy makers about the necessity of having/ making compulsory board of directors in the governance of private limited company. Thus it is necessary to formulate a rule that could encourage shareholders (the business community) of private limited companies to make companies run by board of directors than only a manager or team of managers for the long term success of companies and development of the country's economy.

⁶³⁴ <http://www.midroc-ethiopia.com.et/index.html>, (retrieve on 21/10/2013)

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

5.1. CONCLUSION

The 1960 Commercial Code of Ethiopia incorporates provisions pertinent to the governance of private limited companies. However, such provisions are inadequate/ too little to address specific issues in corporate governance related to board of directors, shareholders meeting, auditors and the mandatory requirement of two shareholders for the formation of private limited companies. This study has examined the law pertinent to the governance of private limited companies in Ethiopia with specific reference to the necessity of board of directors to such companies, shareholders meeting and appointment of auditors' base on the number of shareholders, the issue of conflict of interest and the mandatory requirement of two shareholders for the formation and existence of private limited companies.

In conducting the study the writer has discovered the following corporate governance tribulations of private limited companies. The first corporate governance problem is the absence of board of directors in the governance of PLCs. Contrary to other countries corporate governance tradition, the Ethiopian company law makes private limited companies to be run by managers than directors. The 1960 Commercial Code of Ethiopia under Article 525(1) stipulates private limited companies shall be managed by one or more managers. Company laws of different countries make private limited companies to be run by a certain statutory bodies. Most of the countries around the world make private limited company to run by board/board of directors. Because it is the board of directors who provide the intrinsic leadership and direction at the top of the organization; establish and maintain its vision, mission and values whereas managers carry through the strategy on behalf of the directors.

The other point that takes my attention is the two person minimum requirement for the formation of private limited companies. Even if capital has a paramount importance in the formation of a company, members or the personality of shareholders play a significance role in the formation and operation of company. That is why company laws of different countries tries to determine

the minimum and maximum number of shareholders for the formation and operation of private limited company. For the formation and operation of private limited companies the minimum number of shareholders in most countries is two. However, the reduction of the number of members below two does not cause for the dissolution of the company. Rather it changes its form and name and becomes a single member or one man company. What they put as a compulsory element is that the single member company must have board of directors.

In Ethiopia, contrary to other countries corporate law, the ultimate fate of the private limited companies, if the shareholders reduced below two, is dissolution of the company. This makes the business society in Ethiopia to search for other means/room to escape from this mandatory requirement. Among the private limited companies 90% are family base businesses with only two shareholders in which one of the shareholders are nominal shareholders. Whereas the corporate governance practice of other countries show us that a private limited company could formed by one member/shareholder, however what is required is to have is the mandatory statutory bodies for the governance of the company i.e. directors, auditors, shareholders meeting and managers. Therefore, this is a big legal and practical problem in the corporate governance of private limited companies which encourages the kiosk mentality of Ethiopian business community.

The additional tribulation in the governance of private limited companies is the making of the other governing body (shareholders meeting) base on the number of shareholders of the company. Contrary to the corporate governance law and tradition of other countries, the Ethiopian Commercial Code makes shareholders meeting conditional (conditional corporate governance body) i.e. no shareholders meeting is necessary unless the members to the company are not more than twenty. In the Ethiopian corporate governance law and practices it is difficult to say shareholders' meeting is considered as one of the formal body in the governance of private limited companies. So this again makes one to raise the question “does the corporate governance law regulate the members of the company, the capital of the company or the company”?

The last problem that the writer has discovered in the study is the hitch in relation to conflict of interest. The Commercial Code put clearly the possible solutions of conflict of interest that could arise in share companies. However, the code failed to put the possible mechanisms of how to

solve conflict of interest that could arise between the managers vs. shareholders, managers vs. the company, managers vs. other stakeholders and shareholders/members and the company. Generally, several factors enabled a marked increase in the necessity of improving corporate governance of private limited companies. These factors include notably: globalization, technology, population and free market. Given that these factors are likely to persist in offering progressively greater potential for the negative impact of corporate activity on societies, economies, environment, etc., it is sensible to increasingly calling for substantially improved visibility and controls in Corporate Governance of PLCs in Ethiopia. Accordingly in the recommendation part, the writer would like to put the possible solutions/recommendations for these problems.

5.2. RECOMMENDATIONS

In Ethiopia, private limited companies cover 97% of the country's company type business and play significant role in the country's economy. However, the provisions of the 1960 Commercial Code governing PLCs are incomplete and sketchy. Private limited companies experience many legal and practical corporate governance problems. Among these, the absence of board of directors in the governance of PLCs, the making of auditors and shareholders meeting governance bodies' based on the number of shareholders of the company, the absence of means to resolve conflicts of interest and the two person minimum legal requirement for the formation of private limited companies are the main corporate governance problems of PLCs in Ethiopia. The sketchy nature of the provisions of the Commercial Code that govern PLCs and lack of reference to share companies' provisions worsen those problems. These problems make Ethiopian private limited companies, when we see it in light of private limited companies of other countries, not to be effective and not contribute what it had to be. Private limited companies to run with two foot and competitive in the global market the above problems shall be renovated/modernize and the writer would like to recommend the following so as to create a healthy corporate governance environment for PLCs in Ethiopia.

RECOMMENDATIONS ONE

To begin with, the gigantic corporate governance problem of Ethiopian PLCs is the absence of board of directors. Ethiopian company law/ Commercial Code prefer PLCs to run by managers only than inclusive of board of directors, managers, auditors and shareholders. Thus the writer recommends governance board of directors to be compulsory to such companies for the reason that;

Firstly, the key actors in corporate governance are shareholders, board of directors' managers and auditors. These corporate governance bodies have their own fundamental significance in the governance of a company in which one cannot substitute the role of the other. Or it is difficult to make the role played by one governance body to be replaced by another body since they have their own specific and natural role as to their establishment. For example managers cannot perform the roles of directors or shareholders in the same legal status. This is the distinct behaviour of a company. However, in private limited companies, the distinction between the members of the governance tripod of board, management, and shareholders might be unclear since the members are small in number. An owner-manager may fulfil all or several of these roles. Nonetheless, it is important to recognize the unique role that the board plays in the leadership of the company. It has overall responsibility for the companies' activities. At an early stage of a company's development, it is appropriate to operate many aspects of the board's activities in a relatively informal and non- bureaucratic manner.

Secondly, one great advantage of company form of business organization is the separation of ownership and control. Attributable to this, the governance of the company can be left to a group of professionals /boards of directors and managers/ who, with their competence, specialized knowledge or skills, qualifications of training, can bring better corporate performance and success. An effective governance framework defines roles, responsibilities and an agreed distribution of power amongst shareholders, the board, management and other stakeholders. Especially in private limited companies/small business, it is important to recognize that the company is not an extension of the personal property of the owner. The overall performance of a company and the profitability of the business are highly affected by the corporate governance bodies. To achieve the targeted rates of growth and expansion of a company, competent and

professional governance bodies of the company is as much important as the accessibility of adequate finance.

Thirdly, corporate governance goes beyond the protection of shareholders. Corporate governance of private limited companies should also aim to protect the interest of other stakeholders, such as employees, suppliers and creditors and the society as a whole. In Ethiopia, most private limited companies are owned and controlled by two individuals or by a family i.e. owners continue to play a significant direct role in management. In this context, good governance is not mainly a question of protecting the interests of absentee shareholders. Rather, it is concerned with establishing a framework of company processes and attitudes that add value to the business and help to ensure its long-term continuity and success. Thus it is important to be acquainted with the unique role that the board plays in the leadership of the company.

Fourthly, in Ethiopia, Private limited companies have increased in size and complexity and they require more complex organizational structures and a more diverse workforce possessing various levels and areas of expertise. Private limited companies are of particular importance in country (Ethiopia) with less developed capital markets. Therefore, it is necessary to put a clear legal framework concerning the governance of private limited companies and making private limited company to be run by board is not a choice rather it is a necessity.

Fifthly, the fact that international companies, attracted by the promise of fast-growing emerging and transition markets, are increasingly pursuing growth in these markets, makes improved corporate governance of private limited companies a priority. A corporate governance framework must allow companies to ideally match their legal status with their organizational needs, giving them the opportunity to grow and develop in the context of a highly competitive business environment. Hence, in order to help private limited companies fully exploit the new opportunities and adjust more easily to immediate uncertainty, Ethiopian policymakers should endeavour to devise the most efficient corporate governance framework as part of their long-term strategy to foster investment, innovation and entrepreneurship. Thus, to achieve these, implementing a full-bodied governance framework; having board of directors than only managers is at the stage of necessity than a choice to Ethiopian private limited companies.

Plus to this, in Ethiopia, the majority of the private limited companies are participating or conducting a business of importing; not manufacturing and/or exporting. In the history of development of mankind there is no country that develop base on import base economy. At the present time, having export lead or base economy and competing in the international trade is the fashion of economic development of the globe. To achieve these, making private limited companies to be run by strategic and professional leaders than an individual manager is very significant in the market economy. The strategic and professional leaders as to the principle of corporate governance are boards of directors not managers. Thus making PLCs to run by a governing board is at the tip of necessity.

Sixthly, the corporate governance practices of Ethiopian private limited companies tell us that as there are certain companies which are governed by board of directors. These companies are even become elite minded than the policy makers about the importance or role of board of directors in the governance of private limited companies. It is a wakeup call for the Ethiopian policy makers about the necessity of having/ making compulsory board of directors in the governance of private limited company. Thus it is necessary to formulate a rule that could encourage shareholders (the business community) of private limited companies to make companies run by board of directors than only a manager or team of managers for the long term success of companies and development of the country's economy. Different private limited companies in Ethiopia have advisory boards. This comes from the very problem of Ethiopian investors; having the money but not the knowledge about how to run and utilize it. Most of the owners of Ethiopian business entities do not have the appropriate knowledge about how to run their business professionally. That is why they are obliged to have advisory boards.

Seventhly, conflict of interests (or Agency problem) between shareholders and managers are arising from the separation of ownership and control. Even if, conflict of interest is a feature of publicly owned companies, where share ownership is dispersed among a large number of shareholders who do not directly manage the company, it also happens in private limited companies. Because, the very cause for the rising of conflict of interest is separation of ownership and control (separate legal existence/personality of companies from its creators/owners).

In the Ethiopian private limited companies, the problem of conflict of interest or agency problem mainly arises when the shareholders appoint non member managers. During this time, the problem of conflict of interest may arise up. The Commercial Code does not put mechanisms about how to solve conflict of interest between the managers vs. shareholders, managers vs. the company and managers vs. other stakeholders except ordering managers to perform their duties within the limits of the objects of the company with due care and diligence under article 528 and 531. The Commercial Code does say nothing about a conflict of interest between shareholders/members and the private limited company while the Code clearly addresses such issue in case of share companies. The presence of board of directors is very important to avoid the problem of conflict of interest or agency problem. Base on the corporate governance principle, the conflict of interest or agency problem is avoided by having a board of directors for the governance of the company. Therefore, having board of directors (or making private limited companies to run by a governance board) to the private limited companies could avoid the problem of conflict of interests.

Therefore, it is important to formulate the contemporary corporate governance rules to the private limited companies in Ethiopia particularly making BoD compulsory to the governance of such companies. Making private limited companies to have a governance board that should have an appropriate mix of skills and experience without being too large ,which may render it difficult to manage and therefore less effective, is very vital to make PLCs effective and value add to the country's growth. For that matter, at an early stage of a company's development, it may be appropriate to make PLCs to have a board of directors in a relatively informal and non-bureaucratic manner. However, when the private limited companies become more complex and large the legislative organ or any other concerned body shall make them to run by a governance board. The complexity and largeness of the private limited companies can be calculated either base on the capital threshold, numbers of employees or the type of activity that the companies operate.

RECOMMENDATIONS TWO

The other corporate governance dilemma of private limited companies in Ethiopia is the making of shareholders meeting base on the number of shareholders of the company. Stand on the

principle of corporate governance all major decisions that affect the rights of the shareholders and the company are to be taken in the shareholders' meeting. However, Shareholders meeting is mandatory to the Ethiopian PLCs is only when the members are more than twenty. Shareholders' meeting is the supreme body of any company. So this makes one to raise the question "does the corporate governance law regulate the members of the company or the company"? Thus the writer would like to recommend the policy maker or the legislative organ to adopt the efficient and/or modernized corporate governance principle concerning the governance of PLCs and make shareholders meeting not base on the number of shareholders to the company.

RECOMMENDATIONS THREE

The third point that the writer would like to recommend is the problems of making auditors base on the number of shareholders to the company. In company auditing, we are auditing not the members rather the capital or asset of the company. So this again makes one to raise the question "does the corporate governance law regulate the members of the company, the capital/assets of the company"? Private limited companies may run a huge capital for that matter may be greater than Share Companies even if the number of shareholders is less than twenty. If so it is unreasonable to make the requirement of having auditors base on the number of shareholders of private limited companies in Ethiopia. Thus since auditors are one of the governing organs of companies (since auditors are taken as one of the committees of board of directors in the corporate governance principle), it is necessary to make Ethiopian private limited companies to have auditors not base on number of shareholders and but better to use other additional criterion such as the capital of the companies.

RECOMMENDATIONS FOUR

The other corporate governance pickle is the problems in relation with two person minimum requirement for the formation and existence of the private limited companies. Contrary to other countries corporate governance law and tradition, the Ethiopian Commercial Code likes to make private limited companies to dissolve when the shareholders become below two. Other countries make private limited companies to exist even if the shareholders reduced below two (single

member company) but make board of directors as a compulsory statutory governance body. Thus, in Ethiopia, rather than making private limited companies to dissolve (when the shareholders become below two) it is very important to allow one man/single member company by making board of directors as a compulsory statutory governance body.

RECOMMENDATIONS FIVE

The last point that this study would like to recommend is the crevice of the Commercial Code in relation with conflict of interest of PLCs. The Code does not put a mechanism about how to solve conflict of interest between the managers vs. shareholders, managers vs. the company and managers vs. other stakeholders except ordering managers to perform their duties within the limits of the objects of the company with due care and diligence under article 528 and 531. The Commercial Code does say nothing about a conflict of interest between shareholders/members and the private limited companies while the Code clearly addresses such issue in case of share companies. Therefore, it is critical to formulate a law that clearly addresses the problem of conflict of interest that ensues in private limited companies.

To sum up, the concerned bodies have to draft a well equipped law that separate functions of ownership, control and management and develop the skills and knowledge of founders/owners so they can become responsible owners, as they can assume various roles as an owner, director, manager or an employee. In Ethiopian context, given that private limited companies make a major contribution to Ethiopian economic growth and employment, the significance of corporate governance for such companies should no longer go unrecognized. A classy law have to be endorsed in order to address the distinct lack of modern and full-fledged corporate governance principles, which apply to private limited companies/account for the majority of businesses in Ethiopia/ and to assist such companies design effective corporate governance frameworks based on practical, pragmatic principles of good governance. Thus, it is at the stage of necessity to adopt the most modern corporate governance principles that create fertile ground to the Ethiopian private limited companies so as to make them more fruitful and play a significant role in the country's development.

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