

ADDIS ABABA UNIVERSITY SCHOOL OF GRADUATE STUDIES



LLM Program in Business Law



Master's Thesis on:

Corporate Governance In Ethiopian Share Companies: What Should The Future Look Like?

By: Hussein Ahmed Tura

Advisor: Zekarias Keneaa (LLB, LLM, Associate professor)

A Master's Thesis Submitted to School of Graduate Studies of Addis Ababa University in Partial Fulfillment of the Requirements of Masters of Law (LL.M)

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Acronyms

AACCSA	Addis Ababa Chamber of Commerce and Sectoral Association
APRM	African Peer Review Mechanism
Art.	Article
ASX	Australia's Stock Exchange
BIS	Bank for International Settlement
CEO	Chief Executive Officer
Com. Code	Commercial Code of Ethiopia
EC	European Union
FDRE	Federal Democratic Republic of Ethiopia
GAAP	Generally Accepted Accounting/Auditing Principles
GDP	Growth Domestic Product
GTP	Growth and Transformation Plan
IFRS	International Financial Reporting Standards
IPO	Initial Public Offer
ISA	International Standards on Auditing
LSE	London Stock Exchange
MFI	Micro Financing Institutions
NBE	National Bank of Ethiopia
No.	Number
OECD	Organization for Economic Cooperation and Development
OFAG	Office of the Federal Auditor General
PLC	Private Limited Companies
PPESA	Privatization and Public Enterprises Supervising Agency
Proc	Proclamation
RDCC	Revised Draft Commercial Code
ROSC	Report on the Observance of Standards and Codes
SC	Share companies
SEBI	Securities and Exchange Board of India
SOX	Sarbanes-Oxley Act
WTO	World Trade Organization

ABSTRACT

In publicly held companies which are formed by contribution of capital from thousands of shareholders, ownership usually separates from the control of dispersed shareholders and goes into the hands of few managers or few controlling shareholders. Total separation between ownership and control in turn creates a risk of the managers (agent) working for their own interest at the expense of the shareholders' (principal's), what is known as agency cost. This paper posits that the separation between ownership and control is growing in Ethiopia and accordingly submits some empirical evidence in support of adopting good corporate governance principles and laws in this regard. Based on the available data and literature on corporate governance, the paper attempts to show the deficiency in the Commercial Code and other pertinent Proclamations and Directives in addressing current issues in corporate governance related to board of directors, protection of rights of minority shareholders and issues regarding financial reporting, transparency and audit. The analysis of the relevant laws shows that the overall standard of corporate governance in Ethiopia is disappointing. Accordingly, the paper provides detailed recommendations based on internationally recognized best principles and practices of corporate governance as they are expected to address the specific needs of Ethiopian share companies.

Moreover, the paper argues that good economic and corporate governance are essential pre-requisites for promoting economic growth and reducing poverty and thus urges policy makers in Ethiopia to give heightened attention to reform of corporate governance so as to achieve the same. It also contends that Ethiopia should adopt a mandatory law of corporate governance instead of a market-oriented corporate governance system to protect shareholder interests from the abuses and mismanagement of directors and officers and to protect minority shareholders from the opportunism of controlling shareholders as well as to promote accelerated economic development in the country. The study employs both primary and secondary data.

CHAPTER ONE

GENERAL INTRODUCTION

1.1 Background of the Study

Good corporate governance is an important pillar of market economy as it relates to the investors' confidence both in the companies and in the overall business environment.¹ In addition to their being kept out of trouble, well-governed companies often draw huge investment premiums, get access to cheaper debt, and outperform their objectives.² Good corporate governance requires a strong and balanced board of directors as a supervising body for the executive management of a company. In companies with dispersed ownership, shareholders are usually unable to closely monitor management, its strategies and its performance for lack of information and resources.³ Hence, the role of non-executive directors in one-tier board structures and supervisory directors in two-tier board structures is to fill the gap between the uninformed shareholders as principals and the fully informed executive managers as agents by monitoring the agents more closely.⁴

Policymakers can choose from two competing models of corporate governance. The first is a market-oriented model that relies on voluntary law to protect shareholders. It depends on a host of other formal and informal mechanisms, such as incentive-based compensation and hostile takeovers, to hold managers and directors accountable.⁵ For instance, countries like Great Britain embody this approach, with its so-called "enabling" corporate law that parties can opt out of in determining their governance structures.⁶ The second approach depends on a mandatory model of corporate law in which the state, as opposed to the marketplace, plays a central role in shoring

¹ See Indonesia's Code of Good Corporate Governance, (National Committee on Governance, 2006).

² Ibid

³ Report of High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law In Europe, Brussels, 4 November 2002, p.59

⁴ Ibid

⁵ Troy A. Paredes, Corporate Governance and Economic Development, (Washington University, 2005), p.1

⁶ Ibid

up shareholder protections by fashioning mandatory rules that define shareholder property rights.⁷

In Ethiopia, the number of share companies formed or under the process of formation with thousands of shareholders is increasing. In this prevalent situation, multitudes of complex corporate governance issues are emerging with respect to share companies. For instance, booming of such companies with dispersed shareholders leads to transfer of management of the company from the numerous shareholders into the hands of a few managers. The separation of ownership and control on its turn poses a risk of unfair advantage or exploitation by the managers against dispersed shareholders. Furthermore, in case of concentrated ownership of a huge portion of the corporate capital, control of the company will largely fall into the hands of block-holders, and minority shareholders may face high risk of exploitation.

Although Commercial Code of Ethiopia incorporates provisions pertinent to corporate governance of share companies, such provisions are said to lack comprehensiveness and clarity to address contemporary issues in corporate governance related to board of directors (responsibilities, composition, independence, special board committees (audit, remuneration and nomination committees) and their responsibilities, separation of roles of chairman and CEO, procedure for determining directors remuneration etc.), rights and roles of shareholders as well as financial reporting, transparency and audit. The Revised Draft Commercial Code also does not address these issues as may be expected based on the international experiences. Moreover, the proclamations and the directives governing financial share companies in Ethiopia do not sufficiently address issues in corporate governance despite the fact that the NBE is strictly regulating such companies.

This paper attempts to deal with what the potential problems, 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 share companies. It devotes to analysis of laws pertinent to corporate governance of share companies with specific reference to board of directors, rights of minority shareholders and disclosure and transparency in corporate governance with a view to identifying deficiencies in

⁷ Ibid

the law and indicate the pressing need for reform and attempts to indicate what the future should look like, by assessing the international best principles and practices in the context of Ethiopia.

1.3 Statement of the Problem

The emergence of share companies with many shareholders in Ethiopia raises multiple issues of corporate governance. The ownership separates from the control of shareholders and goes into hands of few managers who have no or little ownership interest over companies. The separation of ownership and control on its turn poses the risk of unfair advantage or exploitation by the managers and/or block holders against dispersed shareholders or minority shareholders. Even if this prevalent situation calls for reform of law in favor of good corporate governance, few relevant studies show that “the overall standard of corporate governance in Ethiopia is disappointing.”⁸ Due to the fact that the Commercial Code is not revised since its adoption in 1960, its pertinent provisions are insufficient to address the current needs of corporate governance in the country. In addition, laws governing financial share companies are also criticized to be incomprehensive and inefficient due to the fact that they are not formulated in light of international best practices to address issues in corporate governance such as board of directors, transparency and disclosure as well as protection of minority shareholders.

Therefore, it is imperative to address the corporate governance related problems in the Commercial Code of Ethiopia and other relevant laws to devise solutions for the future since the number of publicly held companies are increasing in the country.

1.4 Literature Review

As public policy issue, corporate governance was originated in “*The Modern Corporation and Private Property*” the classic work by Adolf Berle and Gardiner Means in 1932.⁹ Berle and Means observed the growing concentration of economic power in the modern corporation and noted the emergence of professional managers having operational control of large corporations but little or no ownership of the of company.¹⁰ In addition, they found the increasing dispersion

⁸ Minga Negash, *Rethinking Corporate Governance in Ethiopia*, (University of the Witwatersrand, 2008), p.2

⁹ Adolf Berle, Jr. and Gardner C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932), p.8

¹⁰ Ibid

of corporate shares among a growing number of persons who, greatly scattered and had relatively small interests, would not be able to exercise control over the company they owned. They stressed that this separation of ownership from control in the modern American corporation created a challenge to the interests of shareholders. Berle and Means viewed the corporate governance as “classical agency problem: how could corporate managers, as agents of shareholders, be encouraged to manage corporate assets in the best interests of their principal.”¹¹

Corporate governance is a subject for which only little is written about in Ethiopia. There are only few researches conducted regarding (the current status of) corporate governance. To name some of them, Minga Negash (2008) has identified seven key areas that indicate the low standard of corporate governance in Ethiopia.

He argues that:¹²

- *“The Commercial Code of 1960 does not provide adequate legislative response to complex governance issues of the day, and the new draft corporate law has not yet been finalized;*
- *Key international conventions, codes and standards are not ratified or adequately incorporated in the Proclamations, the Decrees and Directives lack coherence and foresights, and at times suffer from poor drafting;*
- *Political parties own substantial number of economic institutions that operate in key sectors of the economy; making the funds suffer from high political and agency costs;*
- *Ownership concentration and pyramids create particular problems of agency, and increase the risk of chain bankruptcies and contagion especially when interest rates are liberalized;*
- *Investor and creditor protection laws are inadequate, and as the court system is ineffective local investors substantially rely on traditional dispute resolution mechanisms;*
- *There is no organized share market. Hence, even though many share companies were created in the last decade or so, valuation and price discovery are problematic;*
- *The quality of professional education has become even more problematic in that the increase in the number of tertiary institutions offering degrees and diplomas is not matched by improved quality standards.”*

¹¹ See Salacuse, W. Jeswald, Corporate Governance In The UNECE Region, The Fletcher School of Law and Diplomacy, Tufts University, Medford, Massachusetts, USA. Paper commissioned for the Economic Survey of Europe, 2003 No. 1 by the secretariat of the United Nations Economic Commission for Europe, UN/ECE, Geneva, December 2002, p.9

¹² Minga Negash, supra note 8

However, he left how these and related matters should be addressed for future researches.

Other researchers, like Kefene Gurmu¹³, Mokonnen Shifaraw¹⁴, and Fikadu Petros¹⁵ have tried to touchup on some of corporate governance issues in Ethiopian share companies. Kefene Gurmu discussed the general powers, duties, and liabilities of board of directors. Mokonnin's focus was on the powers, duties and responsibilities of board of directors of Financial Institutions in Ethiopia. Fikadu dealt with rights of minority shareholders under the Ethiopian Commercial Code. He found that the law is insufficient to protect minority shareholders from undue exploitation of controlling shareholders. All of them, however, didn't appreciate problems surrounding core issues in corporate governance related to board of directors such as responsibilities, composition, independence, special board committees (including audit committee, remuneration committee and nomination committee) and their responsibilities, separation of roles of chairman and CEO, etc of the board as well as transparency and disclosure in corporate governance in light of international best principles and practices.

Therefore, this research will be different from those previous related works in addressing the specific problems surrounding corporate governance in Ethiopian share companies and by suggesting possible recommendations for what the future should look like in detail.

1.5 Objective of the Study

The study is sought to achieve the following general and specific objectives.

1.5.1 General objective:

The purpose of this study is to analyze the current state of Ethiopia's corporate governance laws for share companies (both financial and non financial) with a view to identify gaps in these relevant laws in light of international best practices. The study also sought to indicate how these international best practices should be adopted or adapted in Ethiopia. It focuses on share companies for a number of reasons including their importance to the national economy and due

¹³ Kefene Gurmu, Powers and Liabilities of Board of Directors under the Commercial Code of Ethiopia, ([Unpublished] Masers thesis, Faculty of Law, AAU, 2007).

¹⁴ Mokonnen Shifaraw, Rights, Duties And Responsibilities Of Board Of Directors In Financial Sector In Ethiopia: With Special Emphasis On The Banking Sector, (Unpublished, Addis Ababa University Law Library, 2009).

¹⁵ Fekadu Petros, Emerging Separation of Ownership and Control in Ethiopian Share Companies: Legal and Policy Implications, *Mizan Law Review*, Vol. 4 No.1, (March 2010).

to prevalence of separation of ownership and control in such companies which poses agency costs and calls for good corporate governance laws and their enforcement.

1.4.2 Specific objectives:

1. To critically examine the existing laws pertinent to corporate governance of financial and non financial share companies in Ethiopia in light of core corporate governance issues related to board of directors, protection of minority shareholders and disclosure and transparency and identify the deficiencies in pertinent laws to corporate governance including the Commercial Code and its revised draft version, proclamations and directives pertinent to governance of share companies;
2. To provide recommendations on how should corporate governance be reformed in Ethiopia with the view to indicate what the future should look like with specific reference to:
 - Approaches to reform corporate governance in Ethiopia in light of:
 - Shareholder vs. stakeholder models of corporate governance and
 - regulatory vs. non regulatory approaches to corporate governance
 - Development policy considerations for corporate governance in Ethiopia
3. Indicating what the future should look like based on different international best principles and practices on:
 - ✦ board issues such as responsibilities, composition, independence, board committees, remuneration of the board of directors and so on.
 - ✦ Protection of minority shareholders, and
 - ✦ Financial reporting, transparency and audit

1.5 Research Questions

- 1.5.1 Why should corporate governance in Ethiopia be reformed?
- 1.5.2 Do the present pertinent provisions of Commercial Code, Revised Draft Commercial Code, Proclamations and Directives governing financial institutions in Ethiopia adequately address issues in corporate governance of share companies?
- 1.5.3 What are the deficiencies in the relevant laws regarding issues in corporate governance pertinent to board of directors, rights of minority shareholders and transparency and disclosure in corporate governance?

- 1.5.4 What corporate governance in Ethiopia should look like for the future?
- 1.5.5 Which model of corporate governance should (shareholder vs. stakeholders) be adopted to Ethiopia?
- 1.5.6 Which approach of corporate governance (regulatory vs. non regulatory) fits current needs of share companies in Ethiopia?
- 1.5.7 How should board issues, rights of minority shareholders and transparency and disclosure be addressed in the forthcoming revised Commercial Code of Ethiopia?

1.6 Significance of the Study

It is believed that the study will contribute to the effort of revising the Commercial Code of Ethiopia in particular and introducing good corporate governance in the country in general. In addition, the study will be a basis to other researchers to conduct further studies on the issue.

1.7 Methodology of the Study

In conducting this research, both primary and secondary data are employed.

Interviews: face-to-face interviews will be made with different people including well known professionals in relation to company law, members of board of directors, managers, shareholders in different share companies, concerned government officials, researchers in the area and others.

Documents: In addition, primary documentary sources such as the Commercial Code of Ethiopia, relevant Proclamations, Directives of the NBE, Draft Project Document for Development of Corporate Governance in Ethiopia, OECD principles, Basel Committee on Banking Supervision's Principles for Enhancing Good Corporate Governance, Codes of best practices, and other related sources will be employed.

Secondary data: mainly literature existing regarding corporate governance will be employed in addition to primary data.

1.8 Scope and Limitation of the Study

This study is limited to briefly reviewing the current state of Ethiopia's corporate governance laws for publicly traded (share) companies in financial and non financial sectors and tries to indicate what the future should look like based on selected international best practices and

principles. This study does not, however, cover non-publicly held companies such as private limited companies and state-owned enterprises. Yet, it should be noted that the corporate governance principles discussed herein can be applied to these latter groups of business entities.

1.10 Structure of the study

The paper has four chapters. The first chapter deals with General Introduction. The second chapter deals with conceptual framework of corporate governance in general. It tries to find the definition of the term, the genesis of corporate governance, models of corporate governance (shareholder vs. stakeholder), the importance of corporate governance, mandatory vis-à-vis voluntary codes of corporate governance and comparative study of how key issues in corporate are treated in different corporate governance principles and codes.

The third chapter critically examines the emerging status of corporate governance in Ethiopia with a view to show the inadequacy of the existing company laws pertinent to financial and financial share companies in the country. It first dwells on clarification of some preliminary issues such as profile of Ethiopian companies, the emerging separation of ownership and control in the Ethiopian share companies and significance of corporate governance to Ethiopia's economy. Then, it reviews the current legal framework governing share companies in the country. After that the chapter critically and selectively examines provisions pertinent to issues in corporate governance of share companies related to board of directors (its roles and responsibilities, composition and independence and remuneration of board of directors), rights of minority shareholders and transparency and disclosure in corporate governance. Accordingly, it identifies the deficiencies in the current laws pertinent to issues of corporate governance with a view to indicate the urgency of reforming relevant laws. This chapter is believed to be crucial as it reveals the low level of corporate governance and the need to reform it in the context of booming of share companies with numerous shareholders where ownership and control are separated, and the inadequacy of the law to address agency cost involved in such situation.

The last, but not certainly the least, chapter four looks for Ethiopia the ways to reform its corporate governance laws. It presents and analyses different approaches of corporate governance such as which model (shareholder or stakeholder model), mandatory vis-à-vis voluntary codes of corporate governance fits the current needs of Ethiopian share companies, as

well as how should corporate governance treat development policy of the country. Finally it provides recommendations on specific issues of corporate governance pertinent to board of directors, shareholders' role and rights and transparency and disclosure in corporate governance. It also recognizes special nature of financial share companies and provides specific recommendations.

CHAPTER TWO

CORPORATE GOVERNANCE: AN OVERVIEW OF CONCEPTUAL FRAMEWORK

2.1 Definition

The term “corporate governance” does not have a single definition for the reason that different scholars and practitioners define it differently.¹ Economists and social scientists, for instance, tend to define it broadly as “the institutions that influence how business corporations allocate resources and returns” and “the organizations and rules that affect expectations about the exercise of control of resources in firms.”² This definition focuses not only on the formal rules and institutions of corporate governance, but also on the informal practices that evolve in the absence or weakness of formal rules.

Corporate managers, investors, policy makers, and lawyers, on the other hand, tend to employ a narrower definition. For them, corporate governance is the system of rules and institutions that determine the control and direction of the corporation and that define relations among the corporation’s primary participants.³ Accordingly, the United Kingdom’s 1992 Cadbury Report’s often quoted definition is: “Corporate governance is the system by which businesses are directed and controlled.”⁴ The Cadbury report was a forerunner and made a significant contribution to the understanding of the concept. This narrower definition focuses almost exclusively on the internal structure and operation of the corporation’s decision-making processes. It has been this narrower definition that has been central to public policy discussions about corporate governance in most countries.⁵

¹ A. C. Fernando “Corporate Governance: Principles, Policies, and Practices.” (Pearson Education, 2006), p.12

² Jeswald W. Salacuse ‘Corporate Governance in the New Century’ (2004) 25 No.3 The company Lawyer, p.69

³ Ibid

⁴ Report of the Committee on the Financial Aspects of Corporate Governance (Cadbury Report), para. 2.5 available at < www.ecgn.org > Visited on 24 March, 2011.

⁵ see Salacuse, supra note 2

Regarding distinction between corporate governance and corporate management, one scholar has stated the following:

*“Corporate governance is not just corporate management; it is something much broader to include a fair, efficient, and transparent administration to meet certain well defined objectives. It is structuring, operating and controlling a company with a view to achieving long term strategic goals to satisfy shareholders, creditors, employees, customers and suppliers and to comply with the legal and regulatory requirements, apart from meeting environmental and local community needs.”*⁶

Currently, corporate governance refers to all issues related to ownership and control of corporate property, shareholders rights, and management, powers and responsibilities of Board of Directors, disclosure and transparency of corporate information, the protection of interests of stakeholders in addition to that of shareholders, enforcement of rights, etc.⁷ Definitions point to the fact that corporate governance systems depend upon a set of institutions such as laws, regulations, contracts and norms that create self-governing firms as the central element of a competitive market economy.⁸ These institutions ensure that the internal corporate governance procedures adopted by firms are enforced as well as managements are responsible to owners and other stakeholders.

The definition of “corporate governance” is nowhere given under the Ethiopian Company Laws. The term “corporate governance” is mentioned under Article 14(4) of the Banking Business Proclamation No.592/2008, which states that “the National Bank may issue directives on the duties, responsibilities and *good corporate governance of board of directors*.” However, it is not clear as to what constitute “good corporate governance of board of directors” apart from responsibilities and duties of the board of directors. It seems as if it refers to ‘good corporate governance of Banks’. Therefore, for the purpose of this study, it is important to adopt working definition as the above mentioned definitions vary. Thus, corporate governance can be defined as: *a system of rules and institutions that determine the control and direction of a company and that*

⁶ A. C.Fernando “Corporate Governance-The Time for a Matamorphosis”, The Hindu, (9 July 1997): As cited in A. C. Fernando “Corporate Governance: Principles, Policies, and Practices. (Pearson Education, 2006), p.13

⁷ Corporate Governance in Developing Countries: Shortcomings, Challenges and Impact on Credit <[Http://Www.Uncitral.Org/Pdf/English/Congress/Cooper_S_Rev.Pdf](http://www.uncitral.org/Pdf/English/Congress/Cooper_S_Rev.Pdf)> P. 3.(Last visited on 23 April 2010)

⁸ Fernando, supra note 1, p.13

*define relations among the company's primary participants including board of directors, managers, shareholders and other stakeholders.*⁹

This definition tries to combine narrow and broad definitions given on the subject by different writers above. Accordingly, it views corporate governance as a system of rules and institutions which determine the control and direction of a company. It also includes not only shareholders but also stakeholders.

2.2 The Genesis of Corporate Governance

The discussion of problems inherent with the separation of ownership and control goes back at least as far as Adam Smith (1776, p.700), who stated:

*"The directors of such [joint stock] companies, however, being the managers of other people's money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartner frequently watch over their own...Negligence and profusion, therefore, must always prevail, more or less, in the management of such company."*¹⁰

The agency problem was later framed in more detail by Berle and Means (1932), who were concerned with the rising prevalence of large corporations with diffuse ownership that insulated managers from the concerns of shareholders.¹¹ According to them, the dispersed shareholders (principals) have no choice but to hire managers (agents) to manage the company, which has been creating the principal-agent relationship. In effect, an agency problem typically arises from the principal-agent relationship¹² and as such, agents may expropriate the principals' investments. This can occur when the agents have more information and knowledge than the principals¹³ or

⁹ Company primary participants should not be limited to insiders (share holders, managers and board of directors) but also stakeholders such as suppliers of finance, depositors, creditors and the community, the regulators and executive organs such as ministry of trade and industry as well as courts which enforce rights and obligations of such participants.

¹⁰ Adam Smith, The Wealth of Nations, (Cannon Edition Modern Library, New York, 1776), Cited in Stephen C. Alford, *supra* note 6

¹¹ Adolf Berle and Gardiner Means are considered distinguished scholars in the field of corporate governance based on their seminal work on the separation of company ownership. After conducting a study of America's larger companies after the Wall Street crash of 1929, they concluded that the separation of ownership and control is attributable to widely fragmented company ownership. See Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (1932).

¹² Brian R. Cheffins, 'Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies' (2003) 23 *Oxford Journal of Legal Studies* 3, 4

¹³ Yuwa Wei, Comparative Corporate Governance: A Chinese Perspective, (2003), p.43

when information asymmetry between principals and agents exists.¹⁴ Moreover, two circumstances that have been the focus of the principal-agent framework can be identified. Firstly, “moral hazard arises when the agent’s action, or the outcome of the action, is only imperfectly observable to the principal.”¹⁵ For instance, a manager may exercise a low level of effort, waste corporate resources, or take inappropriate risks. Secondly, “Adverse selection can arise when the agent has some private information, prior to entering into relations with the principal. Individuals with poor skills or aptitude will present themselves as having superior ones, people with low motivation will apply for the positions that involve the least supervision, and so forth.”¹⁶ Due to this reason, Berle and Means’ corporate governance study mainly focused on the expropriation of shareholders’ assets by managers due to separation of ownership and control.¹⁷ In a nutshell, the divorce between ownership and control brings about the likely considerable free-rider dilemma between agents and principals.¹⁸

In the 1970s, due to the emergence of a number of important contributions, agency theory and issues of corporate governance became popular research topics. Ross (1973) provided one of the first formalized descriptions of macroeconomic foundations of Agency theory.¹⁹ Alchian and Demsetz (1972) examined contracting issues within a firm, noted the shirking problem that arises from the misaligned interests and discussed many of the issues that have subsequently dominated corporate governance research, including imperfect monitoring, labor market discipline of managers, the market for corporate control and issues of efficient compensation design.²⁰ Jensen and Meckling (1976) provided an often-cited definition of agency relationship, formalized the agency cost concept by detailing its components and analyzed the impact of ownership structure

¹⁴ Joseph Heath and Wayne Norman, 'Stakeholder Theory, Corporate Governance and Public Management: What Can the History of State-Run Enterprises Teach Us in the Post-Enron Era?' (2004) 53 *Journal of Business Ethics* 252-253

¹⁵ Miko Kamal, Corporate Governance and State-owned Enterprises: A Study of Indonesia's Code of Corporate Governance, *Journal of International Commercial Law and Technology*. Vol. 5, Issue 4 (2010), p.207

¹⁶ Ibid

¹⁷ Malla Praveen Bhasa, 'Global Corporate Governance: Debates and Challenges' (2004) 4(2) *Corporate Governance: The International Journal of Business in Society*, p. 7

¹⁸ Heath and Norman, *supra* note 18, p.252

¹⁹ S.A. Ross, The Economic Theory of Agency: the principal's problem. *American Economic Review* 63,134-139

²⁰ A. Alchian and H.Demsetz, production, information costs and economic organization. *American Economic Review* 62,1972,777-795

on these cost components²¹ Their assertion is similar to that of Berle and Means' work as they state that "the aim of all governance mechanisms is to reduce the agency costs that exist due to the separation of ownership and control especially in large public corporations".²² Fama and Jensen²³ similarly suggest that "the problem of corporate governance mainly arises in large organizations such as publicly held and listed corporations whose ownership and controls are typically separated".²⁴ Even though the agency problem typically occurs in a company where shareholders are fragmented includes listed corporations, such a problem may also arise in other types of companies such as small companies, family firms and non-listed companies but the types and the degree of the agency problems would be different.²⁵

Furthermore, La Porta, Lopez-de-Silanes, Shleifer and Vishny confirm the study of Berle and Means, Jensen and Meckling, and Fama and Jensen. By conducting a series of empirical work on investor protection,²⁶ La Porta et al. argue that the nature of corporate governance is absolutely to protect outside investors from the diversion of their assets by insiders.²⁷ While both controlling shareholders and managers are classified as insiders, La Porta et al. classify investors and minority shareholders as outsiders.²⁸ They assert that the diversion of outsiders' money by insiders takes place because of an asymmetric information problem between outsiders and insiders. The asymmetric information problem typically occurs as insiders are the company's majority shareholders and controlling management do not share the company's vital information they have to the outsiders.²⁹ Therefore, La Porta et al. defines corporate governance as "A set of

²¹ Michael C. Jensen and William H. Meckling, 'Theory of the firm: managerial behaviour, agency costs and ownership structure' (1976) 3 *Journal of Financial Economics* 305-360

²² Carol Padgett and Amama Shaukat, 'The UK Code of Corporate Governance: Link between Companies and Firm Performance' (2005) ICMA Centre Discussion Papers in Finance DP2005-17

²³ Eugene F. Fama and Michael C. Jensen, 'Separation of Ownership and Control' (1983) 26 *Journal of Law and Economics* 301-325

²⁴ Jochen Zimmermann, Igor Goncharov and Joerg R. Werner, 'Does Compliance with the German Corporate Governance Code Have an Impact on Stock Valuation? An empirical analysis' (2006) 14 *Corporate Governance International* 434

²⁵ Miko Kamal, supra note 15, p.208

²⁶ Rafael La Porta et al, 'Legal Determinant of External Finance' (1997) 52 *Journal of Finance*; Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'Law and Finance' (1998) 106 *Journal of Political Economy* 1152; Rafael La Porta et al, 'Corporate Ownership around the World' (1999) 54 *Journal of Finance*; Rafael La Porta et al, 'Agency Problem and Dividend Policies around the World' (1999) 55 *Journal of Finance*.

²⁷ Simeon Djankov et al, 'The Law and Economics of Self-dealing' (2008) 88 *Journal of Financial Economics* 430

²⁸ Rafael La Porta et al, 'Investor protection and corporate governance' (2000) 58 *Journal of Financial Economics* 4

²⁹ Ibid

mechanisms through which outside investors protect themselves against expropriation by the insiders.”³⁰

Generally, the agency problems that occur between principal and agents of company necessitated the system of corporate governance. Within the context of the modern corporation age, a company is normally owned by dispersed shareowners through the capital market³¹ who cannot exercise direct control over the company. Besides, there is a major shareholder that often teams up with the company’s management in making policies that are inconsistent with the interests of the dispersed owners. Therefore, codes of corporate governance around the world are specifically designed to fill the gap of unbalanced information between investors and companies,³² to prevent insiders not to divert the outside investors’ money to their own gain. Although corporate governance has focused traditionally on the problem of separation of ownership by shareholders and control by management, it is now accepted that firms should respond to the expectations of more categories of stakeholders. The wide range of corporate governance practices include business ethics, social responsibility, management discipline, corporate strategy, lifecycle development, stakeholder participation in decision making processes and promotion of sustainable economic development.³³

2.3 Models of Corporate Governance

Albeit variation in the terminologies used to describe systems of corporate governance classifications, Scholars generally divide the world’s systems of corporate governance into two categories. While Cheffins employs the outsider/arm’s length and the insider/control-oriented terms,³⁴ Moerland prefers market-oriented systems and network-oriented systems to describe the

³⁰ Ibid

³¹ Simeon Djankov et al, supra note 27

³² Steen Thomsen, 'The Hidden Meaning of Codes: Corporate Governance and Investors Rent Seeking' (2006) 7 *European Business Organization Law Review* 851, 848

³³ Fernando, supra note 1, p.18

³⁴ Cheffins, supra note 12, p.3

two corporate governance systems.³⁵ Furthermore, two models are employed to demonstrate the division: the Anglo-American model and the German-Japanese model.³⁶

2.3.1 The Anglo-American Model

This model is labeled as arm's length because, according to Cheffins, the company's shareholders control their shares at a distance by putting their trust in the company's management to run daily activities.³⁷ It prevails in the common law countries, notably USA and UK, for the reason that most of their large companies are listed in stock markets.³⁸ The shareholders in these countries' companies are scattered than any other else in the world. And this model is viewed as an outsider model for its key focus is on a company's shareholders' value and shareholder-management relations, and positions the market as a supervising tool.³⁹

There are two major theories that can be used to examine the Anglo-American corporate governance model: the principal-agent or finance model and the myopic market model. According to the principal-agent (finance) model, the maximization of shareholders' prosperity is regarded as a social function of the corporations.⁴⁰ The only role of a company in a community in a free market for the company's shareholders is making profits.⁴¹ As a result, the proponents of this theory assert that "other social functions should not hinder the company in realizing its goal, and therefore should be undertaken by other government and charitable organizations."⁴² They believe that the performance of the economic structure at large can be easily improved when corporations are managed properly to maximize the value of its shares.⁴³

³⁵ Pieter W. Moerland, 'Alternative Disciplinary Mechanisms in Different Corporate Systems' (1995) 26 *Journal of Economic Behavior and Organization*, 19

³⁶ Marry O'Sullivan, *Contests for Corporate Control Corporate Governance and Economic Performance in the United States and Germany*, (1978).

³⁷ Cheffins, *supra* note 16

³⁸ Moerland, *supra* note 39

³⁹ Irene Lynch Fanon, 'The European Social Model of Corporate Governance: Prospects for Success in an Enlarged Europe' in Paul Ali and Greg Gregoriou, N (eds), *International Corporate Governance After Sarbanes-Oxley* (2006) 424

⁴⁰ Steve Letza et al, 'Corporate Governance Theorizing: Limits, Critics And Alternatives' (2008) 50 *International Journal of Law and Management* 18

⁴¹ Milton Friedman, 'The Social Responsibility of Business is to Increase its Profits' (1970) *The New York Times Magazine* <<http://www.colorado.edu/studentgroups/libertarians/issues/friedman-soc-resp-business.html>> Visited 24 March 2011

⁴² *Ibid*

⁴³ *Ibid*

Although the myopic market model also supports the maximization of shareholders' wealth as the key company's goal, it criticizes the financial model for its main concern with the short-term interests of a company's performance, such as short-term return on investment, short-term corporate profits, short term management performance, short-term stock market prices, and short-term expenditure.⁴⁴ The proponents of this model believe that the finance model neglects the corporation's long-term value and its competitiveness.⁴⁵ The myopic market model, as an alternative, suggests that shareholders and managers should be encouraged to share long-term performance perspectives while reforming corporate governance by "increasing shareholders' royalty and voice, reducing the ease of shareholders' exit, restricting the takeover process and voting rights for short-term shareholders, encouraging relationship to lock financial institutions into long-term positions and empowering other groups such as employees and suppliers to form long-term relationship with the firm".⁴⁶

To sum up, in the Anglo-American model, the corporation's shares are owned by dispersed shareholders; the maximization of shareholders' value is the corporation's principal objective;⁴⁷ and a well-developed financial market is placed as a firm's supervising instrument.⁴⁸

2.3.2 The Continental-European Model

Japan⁴⁹ and Continental European countries such as Germany⁵⁰ are considered to be representatives of this model.⁵¹ This model is characterized by a close relationship between the

⁴⁴ Steve Letza and Xiuping Sun, 'Philosophical and Paradoxical Issues in Corporate Governance ' (2004) 1 *International Journal of Business Governance & Ethics* 32

⁴⁵ Letza et al, supra note 40, p.19

⁴⁶ Letza and Sun, supra note 44

⁴⁷ Yuan Dujuan, 'Inefficient American Corporate Governance under the Financial Crisis and China's Reflections' (2009) 51 *International Journal Law and Management* 140-141

⁴⁸ Moerland , supra note 35

⁴⁹ The Japanese model is the business network model, which reflects the cultural relationships seen in Japanese Keiretsu network, in which boards tend to be large, predominantly executive and often ritualistic. In this model the financial institution has accrual role in governance. The shareholders and the main bank together appoint board of directors and the president. It has unique characteristics: the president who consults both the supervisory and the executive management is included and the importance of the lending bank is heightened. See Fernando, supra note 1, p.55

⁵⁰ In this model, which is also termed as the two-tier board model, corporate governance is exercised through two boards, in which the upper board supervises the executive board on behalf of stakeholders. This approach is more societal oriented. Despite some differences between the German and Japanese models of corporate governance, there are certain significant features to justify their being bracketed together, including:

- Banks and financial institutions have substantial stakes in the equity capital of companies. In addition, cross holding among groups of firms is common in Japan.

corporation and its capital providers, including shareholders and bankers and other financial institutions. In addition to shareholders, it allows stakeholders to be members of the company's board (a supervisory board) and hence called insider model.⁵² It is originated from Germany company structure termed as Codetermination or *betriebliche Mitbestimmung*, which gives an opportunity to the employees to become members of company's supervisory board.⁵³ In Germany, in a large company, up to half members of supervisory board are elected by the company's employees under the Management Relation Act of 1952 and the Codetermination Act of 1976. Besides, there are three types of codetermination in Germany: Full Parity Codetermination, Quasi-Parity Codetermination and One-Third Codetermination.⁵⁴

The insider model is mainly aimed at counteracting the abuse of executive power in shareholder models.⁵⁵ The Anglo-American model is criticized for the abuse of executive power as it gives greater power to the executive management who can potentially distort their authority for their own interests, at the expense of stockholders and society at large. For instance, exorbitant executive overpayment, in which the executive managements are allowed, set their big salaries in a way that does not reflect the performance of the company is one of the areas susceptible to problem of abuse of power by the executive management, which cannot be resolved though the system introduces institutional restraints on managerial behavior, such as executive directors, audit processes and threats of takeover, according to proponents of the insider model.⁵⁶ They also doubt whether corporate governance reforms such as non-executive directors, shareholder

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- Institutional investors in both countries view themselves long term investors. They play a fairly active role in corporate managements.
 - The disclosure norms are not very stringent, checks on insider trading are not very comprehensive and effective, and the emphasis on liquidity is not high. All these factors lead to the efficiency of the capital market.
 - There is hardly any system of corporate control in these countries; mergers and take-overs are uncommon. See Ibid

⁵¹ Fannon, supra note 39, p.425

⁵² Ibid

⁵³ Gérard Hertig, 'Codetermination as a (Partial) Substitute for Mandatory Disclosure?' (2006) 7 *European Business Organization Law Review* 129

⁵⁴ Jean J. Du Plessis and Otto Sandrock, 'The German System of Supervisory Codetermination by Employees' in Jean du Plessis, J et al (eds), *German Corporate Governance in International and European Context* (2007) 111

⁵⁵ Letza et al, supra note 40

⁵⁶ Ibid

involvement in major decisions and transparency into corporate affairs are in fact appropriate monitoring instruments.⁵⁷

As an alternative, proponents of insider model propose the idea of “managerial freedom with accountability”, which involves letting decision-making management build up the longer term plans of the company, while ensuring the board is strictly responsible to all stakeholders involved in the company.⁵⁸ The corporation is seen to have a responsibility to a large number of individuals and groups, who are also considered stakeholders in addition to the company’s capital providers.⁵⁹ This approach recognizes the existence of non-shareholding company groups, for example employees, suppliers, customers and managers who have a continuing connection with the company.⁶⁰

The major goal of the insider/stakeholder model of corporate governance is to maximize the business’s values at large, unlike the shareholder’s perspective.⁶¹ From the perspective of stakeholder model, therefore, two groups exist: first, the primary stakeholders such as minority shareholders, lenders, consumers, employees, suppliers and managers, and second, the secondary stakeholders, including the local community, the media, the court, the government, special interest groups and the general public.⁶²

In general, the German-Japanese model is characterized by affording an opportunity for company stakeholders other than shareholders to be on the company board. Moreover, this model recognizes and values the involvement of major shareholders and banks as providers of capital and controllers of the corporations.⁶³

⁵⁷ Id, 20

⁵⁸ Ibid

⁵⁹ James P. Hawley and Andrew T. Williams, 'Corporate Governance in the United States: The Rise of Fiduciary Capitalism A Review of the Literature' (1996) <<http://www.lens-library.com/info/papers96/first/firstpart2.htm>> Visited on 21 March 2011

⁶⁰ Letza et al, supra note 40, p.20

⁶¹ Ibid

⁶² Ibid

⁶³ Moerland, supra note 35

It is worth noting that the models are merely intellectual constructs.⁶⁴ They are not mutually exclusive of each other with all their complexity. For one thing, the effort to make management, whether American or European, more responsive to other parties outside of management can only serve as helpful discipline on managers.⁶⁵ The movement towards more independent directors is also a step forward, whether the goal of the corporation is seen as shareholder profit or stakeholder benefits. The effort, now well advanced in Europe, to separate the positions of chairman and CEO, would probably be seen as beneficial by the shareholders of most American corporations. A point of convergence between the bare shareholder model advanced by Americans and the extreme stakeholder model advocated by Europeans, may reside in the notion of "socially responsible corporate governance,"⁶⁶ a concept that seeks to bring together two important themes that really have not been joined thus far: corporate good governance and corporate social responsibility.

2.3.3 Successful Strategies for Developing Countries- One Size Does Not Fit All

Corporate governance was long ignored as a matter of importance for developing countries. It remained virtually invisible in those countries until the East Asian financial crises of 1997-1998 drew attention to the problems of "crony capitalism," and their perceived relationship to poor local corporate governance practices, in several major emerging-market economies.⁶⁷ Yet, as the threat to the global financial markets raised by that crises has receded, efforts significantly to improve corporate governance in the developing world have flagged.⁶⁸ Indeed, even at the height of the international concern for corporate governance in the emerging market economies,⁶⁹ little attention was given to corporate governance in other developing countries, especially the smaller and poorer ones.⁷⁰ It is firmly asserted, to this end, that *"the tendency to ignore the quality of corporate governance in the developing world is a mistake because the institutions of corporate*

⁶⁴ Jeswald W. Salacuse, Corporate Governance In The UNECE Region, The Fletcher School of Law and Diplomacy, Tufts University, Medford, Massachusetts, USA. Paper commissioned for the Economic Survey of Europe, 2003 No. 1 by the secretariat of the United Nations Economic Commission for Europe, UN/ECE, Geneva, December 2002, p.52

⁶⁵ Ibid

⁶⁶ Ibid

⁶⁷ Charles P. Oman, Corporate Governance in Development: The Experiences of Brazil, Chile, India, and South Africa, (OECD Development Centre, Centre for International Private Enterprise, 2003), p.2

⁶⁸ Ibid

⁶⁹ Called "emerging" because of the rapid growth of portfolio equity flows thereto in the early 1990s by large institutional investors based mainly in United States and Great Britain, See Ibid

⁷⁰ Ibid

governance play an essential role in the long-term process of development of a country."⁷¹ Thus, it is argued that "corporate governance should be an important element in developing countries' strategies for growth, financial strength, and productive private sectors."⁷²

On the other hand, the countries in transition economies face problem of corporate governance in paradoxical situation. Their corporate sector consists of "instant corporations" formed as a result of mass privatization, without the simultaneous development of legal and institutional structures necessary to operate in competitive market economy.⁷³ The business environment is without the set of elements needed for making competitive relationships, which provides an advantage to old, large, dominant companies and discourages entrepreneurship and the appearance of new companies.⁷⁴

The question is, therefore, not as to the importance of good corporate governance for developing countries, it is rather, how they should introduce it. Is it possible, after all, to reproduce all at once the institutions of developed market economies in transition economies? Salacuse (2002:54) and Fernando (2006:490) argued that "merely transplanting these institutions is not possible because there are new conditions and many cultural differences. On the other hand, to develop entirely new institutions would be an unpredictable adventure for transition economies."

Salacuse (2002) strongly suggested that developing countries should examine carefully and critically the entire experience of both North America and Western Europe before adopting their laws and institutions. He put that "Rather than leap to a shareholder or stakeholder model or hastily choose a unitary or two-level board structure, each transition state needs to determine the system of corporate governance most appropriate to its own individual needs and circumstances."⁷⁵ In a similar vein, Fernando maintains that: "[they] have to find way to accept the existing institutional portfolio and to make it work in the specific cultural, historical and economic environment as they cannot afford the luxury of searching for third system between socialism and capitalism."⁷⁶

⁷¹ Ibid

⁷² Salacuse, supra note 64, p.54

⁷³ Fernando, supra note 1, p.490

⁷⁴ Ibid

⁷⁵ Ibid

⁷⁶ Ibid

Furthermore, Fernando and Salacuse contend that:

“Organizations and individuals from western developed countries inevitably press for the adoption by transition economies of “best practices” in corporate governance, best practices that have invariably originated in their own home countries. Those best practices were of course the product of specific national experiences and cultures, factors that may make their adoption by a given transition economy inappropriate or at least difficult without significant adaptation.”⁷⁷

Mere transplantation of Western models of corporate governance, according to Fernando, more often than not, fails to instill or improve corporate governance since these models are not designed for local realities and challenges because of which indigenous groups are then faced with task of adapting the international model to local conditions.⁷⁸

Therefore, policy makers in transition economies would do well to remember that to a large extent western corporate governance systems have evolved over time as a response to periodic, specific financial crises in individual countries in evaluating foreign models of corporate governance.⁷⁹ As has been predicted by Salacuse in 2002 in his statement that “... while recognizing that those crises have come and gone, they should also remember that others, leading to still further corporate governance reforms, are probably yet to come”⁸⁰, the 2008 Financial and Economic Crises has cleared doubts surrounding the importance of good corporate governance for every countries around the world irrespective of their level of economic development.

2.4 Why is Corporate Governance Important?

Corporate governance has got heightened importance and concern in government policy circles, academia, and the popular press throughout much of the world due to various reasons, including:

Good corporate governance helps to prevent corporate scandals, fraud, and potential civil and criminal liability of the organization. It is also good business. A good corporate governance image enhances the reputation of the organization and makes it more attractive to customers, investors, suppliers, and in the case of non-profit organizations, contributors.⁸¹

⁷⁷ See Salacuse, supra note 2 64, p.53 and Fernando, supra note 1, p.488

⁷⁸ Fernando, Supra note 1, p.488

⁷⁹ Salacuse, supra note 64, p.53

⁸⁰ Ibid

⁸¹ Frederick D. Lipman and L Keith Lipman, Corporate Governance Best Practices: Strategies for Public, Private, and Not-for-Profit Organizations (2006), p.3

The new century's financial scandals affecting major American firms, such as Enron, WorldCom and Arthur Andersen, and the resulting loss of confidence of the investing public in the stock market led to dramatic declines in share prices and substantial financial losses to millions of individual investors.⁸² Both the public and the experts have identified failed corporate governance as a principal cause of the scandals.⁸³ Even before the recent scandals, significant efforts had been underway since the early 1990s within the OECD,⁸⁴ the European Commission⁸⁵ and individual European countries to understand the economic consequences of corporate governance and to formulate recommendations on appropriate governance structures and practices.

In emerging market economies, experience over the last decade has clearly shown that successful privatizations and the development of lively private sectors depend, to a considerable extent, on the existence of effective systems of corporate governance.⁸⁶ More generally, the ability of countries to attract foreign capital is affected by their systems of corporate governance and the degree to which corporate management is obligated to respect the legal rights of lenders, bondholders, and non-controlling shareholders.⁸⁷ Individual and institutional investors will refrain from providing capital or will demand a higher risk premium for their capital from enterprises in countries without effective systems of corporate governance than from similar enterprises in countries having strong corporate governance standards.⁸⁸ International investment not only provides corporations with expanding sources of capital, but also encourages the continued

⁸² Ibid

⁸³ Ibid

⁸⁴ Organization for Economic Cooperation and Development, OECD Principle of Corporate Governance (endorsed by the Ministers at the OECD Meeting, May 26-27, 1999), Paris, OECD, 1999. Also available at www.oecd.org In the wake of the financial scandals in the United States and the growing international concern over corporate governance, the OECD Council at Ministerial level at its meeting of May 15-16 2002, launched a new initiative to strengthen corporate governance. OECD launched an assessment within the member countries and came up with new corporate governance guidelines in 2004.

⁸⁵ See Weil, Gotshal and Manges LLP, on behalf of the European commission, International Market Directorate General 'comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States (January 2002). Available at http://www.europa.eu.int/comm/internal_market/en/company/news/corp-gov [Accessed on 25 March 2011]

⁸⁶ See Alexander Dyck 'Privatization and Corporate Governance: Principles, Evidence and Future Challenges' (2002) 16 World Bank Observer 59-84; Saul Estrin 'Corporate Governance and Privatization: Lessons from Transition Economies' (2002) 11 *Journal of African Economies* 28; Saul Estrin 'Competition and Corporate Governance in Transition Economies' (2002) 16/1 *Journal of Economic Perspectives* 101-124.

⁸⁷ Ibid

⁸⁸ Salacuse, *supra* note 2, p. 70.

integration of sound corporate governance practices, which may help the corporations to gain the trust of investors, reduce their capital costs and induce more stable financial sources.⁸⁹

Corporate governance is also perceived as important mainly for companies whose shares trade on the stock market.⁹⁰ In developing countries, many people still hesitate the significance of corporate governance for their economies due to the prevalence of small firms that do not have listed shares and of large state-owned and private family-owned companies whose shares are not widely traded locally.⁹¹ However, studies of Brazil, Chile, India, and South Africa show that corporate governance has a role of growing importance to play in helping both to increase the flow of financial capital to firms in developing countries and to enhance those countries' financial development as a whole.⁹² They further show that corporate governance matters for development more than is widely perceived, because it can attribute greatly to achieving sustained productivity growth in developing countries' real economies.⁹³

In general, corporate governance is important for a society because of a number of justifications stated below:⁹⁴

- ✓ It lays down the framework for creating long term trust between companies and the external providers of capital;
- ✓ It improves strategic thinking at the top by inducting independent directors who bring in a wealth of experience and a host of new ideas;
- ✓ It rationalizes the management and monitoring of risks a firm faces globally;
- ✓ It limits the liability of the top management and directors by carefully articulating the decision making process;
- ✓ It ensures the integrity of financial reports; and
- ✓ It helps to provide a degree of confidence that is necessary for the proper funding of the market economy.

⁸⁹ Melinda Vaughn and Lori Verstegen Ryan, 'Corporate Governance in South Africa: a bellwether for the continent?' Corporate Governance: An International Review (September 2006) Vol.14 No.5.

⁹⁰ Ibid

⁹¹ Oman, supra note 71, p.1

⁹² Ibid

⁹³ Ibid

⁹⁴ Fernando, Supra note 1, p.504

2.5 Mandatory vs. Voluntary Codes of Corporate Governance

A number of codes of corporate governance are developed following the importance of good corporate governance for firm performance and investor and minority shareholder protection in many countries around the world. Broadly speaking, these codes can be classified as mandatory and voluntary. The mandatory code of corporate governance emerged with the introduction of the Sabanes-Oxley Act (SOX) of 2002 in USA following the collapse of some huge companies such as Enron, WorldCom and Tyco International in 2002.⁹⁵ This law is considered as a foundation tale for the new era of corporate governance in USA. The law requires all companies that have registered equity or debt securities with the Security and Exchange Commission (SEC) to adhere to it. Therefore, the publicly held companies have to meet all the requirements contained in the SOX - the so-called mandatory model, which means "legally mandated, with penalties imposed on those who fail to comply with the legal rule in question".⁹⁶ This means, this law is binding on every listing company in the country and those who fail to abide by it must face penalties prescribed by this law.

The proponents of the mandatory system of corporate governance claim that it would be a road to culminate the crucial problem of corporation. For instance, Paul Atkins argues that:

*"the world needs a strict corporate governance regime, which is able to eliminate fraud, corruption and other misdeeds and practices; soft law and requiring a company to hire a number of non-executive directors, for instance, would not prevent corporate failures. This is evident from the experience of Enron and WorldCom – though these companies had non-executive directors, they were unable to prevent these companies from falling into bankruptcy."*⁹⁷

On the other hand, some countries like UK and Australia are applying the voluntary model of corporate governance. The Australia Stock Exchange Corporate Governance Council clearly

⁹⁵ In the wake of the disaster on 30 July 2002, the American Congress passed a new law, the Sarbanes-Oxley Act of 2002, which is known as the Public Company Accounting Reform and Investor Protection Act of 2002, which is the most important law reform relating to corporate governance in the US. See Paul S. Atkins, 'The Sarbanes-Oxley Act of 2002: Goals, Content, and Status of Implementation' (2003) <<http://www.sec.gov/news/speech/spch032503psa.htm>> (Visited on 20 March 2011).

⁹⁶ Anita I. Anand, 'Voluntary vs. Mandatory Corporate Governance: Towards and Optimal Regulatory Framework' (2005). Working Paper 566 4

⁹⁷ The crises were created while companies have been applying the voluntary concept of corporate governance. See Atkins, supra note 95.

states that the Australian Principles of Good Corporate Governance and the Best Practice Recommendation contain a voluntary system which requires publicly held companies that might not comply with the Principles to provide sufficient and reasonable arguments as to why they don't.⁹⁸ The Australian system functions on the basic principle of "if not, why not" as opposed to the "one size fits all" approach.⁹⁹ The basic concept of the Australian's code is that the market can come to its own conclusions about the significance of non-compliance based on the circumstances of individual companies.¹⁰⁰

The implementation of the voluntary system in the UK can be observed in paragraph 4 of the preamble of the combined code, which states two points: firstly, listed companies are free to design the form of disclosure statement because the committee does not provide listed companies with a specific form; secondly, there is no requirement for all listed companies to apply the content of the code. Where listed companies do not adhere to the combined code, they must explain it; this is known as the "comply or explain" approach.¹⁰¹ In the UK the philosophy of the "comply or explain" approach is to pay attention to smaller listed companies. This approach takes into account that there are many small listed companies, for which the substance of the code might not be suitable.¹⁰² Therefore, the smaller listed companies are allowed to conduct their business under the other model by giving substantial reasons.¹⁰³ To put it simply, the UK combined code and the Australian model provide for the fact that not all of listed companies need the same model.

The debate on mandatory and voluntary models is in essence not about which would be most suitable to apply to corporations at large. These are two perspectives that aim to deal with the laws that are needed to support the agency problems facing companies with shareholdings that are fragmented. From a practical point of view, the Sarbanes Oxley Act of 2002 is a product of

⁹⁸ ASX Corporate Governance Council, Corporate Governance Principles, Recommendations, (August 2007) <http://www.asx.com.au/supervision/pdf/corp_governance_principles_recommendations_2nd_edition.pdf> visited on 11 April 2011

⁹⁹ Ibid

¹⁰⁰ Ibid

¹⁰¹ The Combined Code on Corporate Governance (July 2003), <<http://www.frc.org.uk/documents/pagemanager/frc/Web%20Optimised%20Combined%20Code%203rd%20proof.pdf>> Visited on 11 April, 2011.

¹⁰² Ibid

¹⁰³ Ibid

the “law matters” thesis, which essentially contends that law is important to protect shareholders, especially minority shareholders, from insider expropriation.¹⁰⁴ The critical goal of the “law matters” thesis is to promote capital markets and economic growth, which can be achieved by upholding shareholders’ property rights.¹⁰⁵ This thesis, therefore, considers minority shareholders as primary players of capital markets.

2.6 Issues in Corporate Governance

Authorities on the subject identify some crucial and critical governance issues to achieve objectives of publicly held companies. Distinguishing the roles of the board and management, composition of the board and related issues, separation of the roles of the CEO and Chairperson, directors’ and executives’ remuneration, protection of shareholder rights and their expectations as well as disclosure and transparency are some of the core issues involved in corporate governance. Under this section, the paper will devote to see how core issues of corporate governance (Board Issues, Rights and Roles of Shareholders and Disclosure and Transparency in corporate governance), are incorporated under the OECD principles and other Codes of Corporate Governance in a comparative method.¹⁰⁶ The codes preferred for this section include: the Combined Code of UK, which is considered to be base for most codes around the world, that of India from developing countries¹⁰⁷ that of Basel Committee on Banking Supervision¹⁰⁸ and so on.

¹⁰⁴ Troy A. Paredes, 'A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law isn't the Answer' (2004) 45 *William and Mary Law Review* 1057

¹⁰⁵ Ibid

¹⁰⁶ The Organization for Economic Cooperation and Development (OECD) was one of the earliest non governmental organizations to work on and spell out principles and practices that should govern corporations in their goal to attain long-term shareholder value. In summary, they include the following aspects of corporate governance: the rights of shareholders; equitable treatment of all stakeholders; the role of stakeholders in corporate governance; disclosure and transparency and the responsibilities of the board. Since issues involved in corporate governance are so many in number and varies according to the model of corporate governance prevailing in different countries, only those which are considered crucial are focused.

¹⁰⁷ The experience of India helps one analyze how this code was accepted; more specifically whether it was transplanted or adapted taking the local circumstances into consideration. Besides, India has best corporate governance laws.

¹⁰⁸ This is particularly relevant for corporate governance of financial share companies in general and banks in particular.

Table 2.1 Comparative Study of Issues in Corporate Governance

Issues	Principles and Codes of Corporate Governance
1. Board Issues	
Responsibility of the Board	OECD Principles¹⁰⁹ The board should fulfill certain key functions, such as (i) reviewing and guiding corporate strategy, risk policy, annual budget and business plans, setting performance objectives, monitoring corporate performance and overseeing major capital expenditures and acquisitions; (ii) selecting, compensating and monitoring key executives; (iii) reviewing key executive and board remuneration; (iv) monitoring and managing potential conflicts of interest of management, board members and shareholders; (v) ensuring the integrity of corporation's accounting and financial reporting systems; (vi) monitoring the effectiveness of the governance practices; and (vii) overseeing the process of disclosure and communications.¹¹⁰ BIS¹¹¹ The board has overall responsibility for the bank, including approving and overseeing the implementation of the bank's strategic objectives, risk strategy, corporate governance and corporate values. The board is also responsible for providing oversight of senior management. LSE Combined Code¹¹² Every company should be headed by an effective board, which is collectively responsible for the success of the company. SEBI¹¹³ The board of directors of a company directs and controls the management of a company. The day-to-day management of the company is the responsibility of the management.

¹⁰⁹ See OECD Principles of Corporate Governance, Edition of 2004.

¹¹⁰ OECD Principle VI.D

¹¹¹ Basel Committee on Banking Supervision, Principles For Enhancing Corporate Governance, Bank for International Settlements' Communications CH-4002 Basel, Switzerland, October 2010, principle 1

¹¹² The Combined Code, supra note, section 1A, Main Principle.

Accountability to Shareholders/ Stakeholders	OECD Principles¹¹⁴ Directors should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.¹¹⁵ In addition, boards are expected to take due regard of, and deal fairly with, other stakeholder interests including those of employees, creditors, customers, suppliers and local communities. Observance of environmental and social standards is relevant in this context.¹¹⁶ LSE Combined Code Not covered. SEBI¹¹⁷ The board is accountable to the shareholders for creating, protecting and enhancing wealth and resources for the company, and reporting to them on the performance in a timely and transparent manner.
Access to Information	OECD Principles¹¹⁸ In order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information. LSE Combined Code¹¹⁹ The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge. SEBI¹²⁰ Management should provide timely, accurate, substantive and material information, including financial matters and exceptions, to the board and board committees.

¹¹³ Securities and Exchange Board of India (SEBI): *Report of the Kumar Mangalam Birla Committee on Corporate Governance*, Final Report: India, (March 2000), Section 6.2 Available at <http://www.sebi.gov.in/commreport/corpgov.html> [Last visited on 24 May, 2011]

¹¹⁴ Annotation to OECD Principle VI

¹¹⁵ OECD Principle VI.A

¹¹⁶ Annotation to OECD Principle VI.A and VI.C

¹¹⁷ SEBI, Supra note 118, Section 6.2

¹¹⁸ OECD Principle VI.F

¹¹⁹ The UK Combined Code, Section A.4

¹²⁰ SEBI, Supra note 114, Section 13.2

Election	<i>OECD Principles</i>¹²¹ The board should Ensure a formal and transparent board nomination and election process. <i>LSE Combined Code</i>¹²² There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board. All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance. The board should ensure planned and progressive refreshing of the board <i>SEBI</i> Not covered.
Composition	<i>OECD Principles</i>¹²³ Majority must be independent board members who can contribute sufficiently to the decision-making of the board. <i>LSE Combined Code</i>¹²⁴ The board should include non-executive directors of sufficient calibre and number for their views to carry significant weight in the board's decisions. Non-executive directors should comprise not less than one third of the board. <i>BIS</i>¹²⁵ Board members should be and remain qualified, including through training, for their positions. They should have a clear understanding of their role in corporate governance and be able to exercise sound and objective judgment about the affairs of the bank. <i>SEBI</i>¹²⁶ The board of a company should have an optimum combination of executive and non-executive directors with not less than fifty per cent of the board comprising the non-executive directors. The number of independent directors would depend

¹²¹ OECD Principle VI.D.5

¹²² The Combined Code, section A.5 & A.7

¹²³ Annotation to OECD Principle VI.E

¹²⁴ The Combined Code, Section A.3.1

¹²⁵ BIS, supra note 112, principle 2

¹²⁶ SEBI, Supra note 114, Section 6.3

	on the nature of the chairman of the board. In case of a non-executive chairman, at least one-third of board should comprise of independent directors and in case of an executive chairman, at least half of board should be independent. (Mandatory Recommendation)
Independence	<i>OECD Principles</i>¹²⁷ In order to exercise its duties of monitoring managerial performance, preventing conflicts of interest and balancing competing demands on the corporation, it is essential that the board is able to exercise objective judgment. In the first instance, this will mean independence and objectivity with respect to management with important implications for the composition and structure of the board. Board independence usually requires that a sufficient number of board members will need to be independent of management. Members should be required to disclose any material interests in transactions or matters affecting the corporation. BIS¹²⁸ Independence can be enhanced by including a large enough number of qualified non-executive members on the board who are capable of exercising sound objective judgment. Where a supervisory board or board of auditors is formally separate from a management board, objectivity and independence still needs to be assured by appropriate selection of board members. <i>LSE Combined Code</i>¹²⁹ A majority of non-executive directors should be independent of management and free from any business or other relationship that could interfere with their independent judgment; they should be identified in the annual report. SEBI¹³⁰ Independent non-executive directors have a key role in the entire mosaic of corporate governance. Independence is defined as: “Independent directors are directors who apart from receiving director’s remuneration do not have any other material pecuniary relationship or transactions

¹²⁷ Annotation to OECD Principles VI.E

¹²⁸ BIS, supra note 112, principle 2, section 38

¹²⁹ The Combined Code, section A.3.2

¹³⁰ SEBI, supra note 114, section 6.5

	with the company, its promoters, its management, or its subsidiaries, which in the judgment of the board may affect their independence of judgment.” Further, all pecuniary relationships or transactions of the non-executive directors should be disclosed in the annual report.
Chairman and CEO	<i>OECD Principles</i>¹³¹ In a number of countries with single tier board systems, the objectivity of the board and its independence from management may be strengthened by the separation of the role of chief executive and chairman, or, if these roles are combined, by designating a lead non-executive director to convene or chair sessions of the outside directors. Separation of the two posts may be regarded as good practice, as it can help to achieve an appropriate balance of power, increase accountability and improve the board’s capacity for decision making independent of management. <i>LSE Combined Code</i>¹³² There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company’s business. No one individual should have unfettered powers of decision. <i>SEBI</i>¹³³ Chairman’s role should in principle be different from that of the chief executive, though the same individual may perform both the roles. A non-executive Chairman should be entitled to maintain a Chairman’s office at the company’s expense and also allowed reimbursement of expenses incurred in performance of his duties to enable him to discharge the responsibilities effectively.
Board Committees	
Audit Committee	<i>OECD Principles</i>¹³⁴ Boards should consider assigning a sufficient number of non-executive directors

¹³¹ Annotation to OECD Principle VI.E

¹³² The Combined Code, section A.2

¹³³ SEBI, supra note 114, section 8

¹³⁴ OECD Principle VI.E.1

	capable of exercising independent judgment to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of directors and key executives, and board remuneration. <i>LSE Combined Code</i>¹³⁵ The audit Committee should comprise at least three non-executive directors, a majority of whom should be independent, with written terms of reference that identify their authority and who should be named in the annual report. The audit committee should review the significant financial reporting issues and judgments made in connection with the preparation of the company's financial statements, interim reports, preliminary announcements and related formal statements. BIS¹³⁶ The audit committee of banks should provide oversight of the bank's internal and external auditors, approving their appointment and dismissal, reviewing and approving audit scope and frequency, receiving their reports and ensuring that management is taking appropriate corrective actions in a timely manner. The independence of this committee can be enhanced when it is comprised of external board members who have banking and financial expertise. <i>SEBI</i>¹³⁷ A qualified and independent audit committee should be set up by the board of a company with a view to enhancing the credibility of the financial disclosures of a company and promoting transparency. (Mandatory Recommendation) The audit committee should have minimum three members, all being non-executive directors, with the majority being independent, and with at least one director having financial and accounting knowledge. (Mandatory Recommendation) The Chairman of the committee should be an independent director and should be present at AGM to answer shareholder queries. (Mandatory Recommendation)
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¹³⁵ The Combined Code, Section D.3.1 and D.3.2

¹³⁶ BIS, supra note 112, section 50 & 51

¹³⁷ SEBI, supra note 114, section 9

	The audit committee should meet at least thrice a year. One meeting must be held before finalization of annual accounts and one necessarily every six months. (Mandatory Recommendation) As the Audit Committee acts as the bridge between the board, the statutory auditors and internal auditors, its role should include the following: Oversight of company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible. Recommending the appointment and removal of external auditor, fixation of audit fee and also approval of payment for any other services. Reviewing with the management the annual financial statements before submission to the board, focusing primarily on any changes in accounting policies and practices, major accounting entries based on exercise of judgment by management, qualifications in draft audit report, significant adjustments arising out of audit, the going concern assumptions, compliance with accounting standards, compliance with stock exchange and legal requirements concerning financial statement, any related party transactions of the company of material nature, with promoters or the management, their subsidiaries or relatives etc. that may have potential conflict with the interests of the company at large Reviewing adequacy of internal control systems and functions Reviewing the company's financial and risk management policies. Looking into the reasons for substantial defaults in the payments to depositors, debenture holders, shareholders, and creditors. Reviewing/looking into the matters where there is a suspected fraud or irregularity or a failure of internal control system of material nature and reporting the matter to the board.
Nomination Committee	<i>OECD Principles</i>¹³⁸ Boards may consider establishing nomination committee with a minimum number or to be composed entirely of non-executive members. <i>LSE Combined Code</i>¹³⁹

¹³⁸ OECD Principle VI.E.1 & Annotation to OECD Principle VI.E.1

	A majority of the members of the nomination committee should be non-executive directors and the chairman of the committee should either be the chairman of the board or a non-executive director. The chairman and members of the committee should be identified in the annual report. BIS¹⁴⁰ Nomination committee should be set up for providing assessment of the board effectiveness and directing the process of reviewing and replacing board members.
Remuneration Committee	OECD Principles¹⁴¹ Boards may consider establishing this committee with “a minimum number or be composed entirely of non-executive members.” LSE Combined Code¹⁴² Remuneration committees should be made up exclusively of nonexecutive directors who make recommendations on the company’s framework of executive remuneration and who must operate independently from managerial interference and from any intrusive business relationship; they should be granted full authority to seek counsel from both inside and outside sources. They should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. BIS¹⁴³ A Compensation Committee should be set up for providing oversight of remuneration of senior management and other key personnel and ensuring that compensation is consistent with the bank’s culture, objectives, strategy and control environment. SEBI¹⁴⁴ The board should set up a remuneration committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, the company’s policy on specific remuneration packages for executive directors, including

¹³⁹ The Combined Code (2003), Section A.4.1

¹⁴⁰ BIS, supra note 112, principle 3, section 53.

¹⁴¹ OECD Principle VI.E.1 & Annotation to OECD Principle VI.E.1

¹⁴² The Combined Code, supra note, section B.2.2

¹⁴³ BIS, supra note 112, principle 3, section 53.

¹⁴⁴ SEBI, supra note 114, section 10.1-10.7

	pension rights and any compensation payment. (Non-mandatory Recommendation) The remuneration committee should comprise of at least three directors, all of whom should be non-executive directors, the chairman of the committee being an independent director. (Non-mandatory Recommendation) The Chairman of the remuneration committee should be present at the AGM to answer the shareholder queries. (Non-mandatory Recommendation)
Board Meetings	<i>OECD Principles</i> Not covered. <i>LSE Combined Code</i>¹⁴⁵ The board should meet regularly and have a formal schedule of matters specifically reserved to it for decision. <i>SEBI</i>¹⁴⁶ The board meetings should be held at least four times in a year, with a maximum time gap of four months between any two meetings. The Committee has prepared a list of minimum information to be placed before the board of directors. (Mandatory Recommendation)
Nominee Directors ¹⁴⁷	<i>OECD Principles</i> Not covered. <i>LSE Combined Code</i> Not covered. <i>SEBI</i>¹⁴⁸ The financial or investment institutions should appoint nominees on the boards of companies only on a selective basis where such appointment is pursuant to a right under loan agreements or where such appointment is considered necessary to protect the interest of the institution. When a nominee of the institution is appointed as a director of the company he should have the same responsibility, be

¹⁴⁵ The Combined Code, supra note 106, section B.2.2

¹⁴⁶ SEBI, supra note 114, section 11.2

¹⁴⁷ A nominee director is generally appointed in a company to ensure that the affairs of the company are conducted in a manner dictated by the laws governing companies and to ensure good corporate governance, see Fernando, p.192

¹⁴⁸ SEBI, supra note 118, section 7.3

	subject to the same discipline and be accountable to the shareholders in the same manner as any other director of the company.
Disclosure of Director Biographical Information	<i>OECD Principles</i> Not covered. <i>LSE Combined Code</i>¹⁴⁹ Sufficient biographical data should accompany names of directors submitted for election and re-election by which shareholders may make informed voting decisions. <i>SEBI</i>¹⁵⁰ In case of appointment of a new director or reappointment of a director, shareholders must be provided with a brief resume of the director, his expertise in specific functional areas and names of companies in which he holds directorship and the membership of committees of the board. (Mandatory Recommendation)
Remuneration	
Amount of Remuneration	<i>OECD Principles</i> Not covered. <i>LSE Combined Code</i>¹⁵¹ Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance. <i>SEBI</i>¹⁵² Adequate compensation package should be given to the non-executive independent directors so that these positions become financially remunerative to attract talent. The board of directors should decide the remuneration of non-executive directors. The remuneration packages for executive directors to be determined by the remuneration committee.

¹⁴⁹ The Combined Code, supra note, section A.6.2

¹⁵⁰ SEBI, Supra note 114

¹⁵¹ The Combined Code (2003), Section B.1

¹⁵² SEBI, supra note 114, section 10.1

Procedure for Determining Remuneration	OECD Principles¹⁵³ The board should Align key executive and board remuneration with the longer term interests of the company and its shareholders. LSE Combined Code¹⁵⁴ There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration. SEBI¹⁵⁵ The board of directors should decide the remuneration of nonexecutive directors. (Mandatory Recommendation)
Disclosure of Remuneration	OECD Principles¹⁵⁶ Companies are generally expected to disclose sufficient information on the remuneration of board members and key executives (either individually or in the aggregate) for investors to properly assess the costs and benefits of remuneration plans and the contribution of incentive schemes, such as stock option schemes, to performance. LSE Combined Code¹⁵⁷ The company's annual report should contain a statement of remuneration policy and details of the remuneration of each director. SEBI¹⁵⁸ The disclosures regarding all elements of remuneration package of all the directors, i.e. salary, benefits, bonuses, stock options, pension etc. should be made to the shareholders.

¹⁵³ OECD Principle VI.D.4

¹⁵⁴ The Combined Code (2003), Section B.2

¹⁵⁵ SEBI, supra note 114, section 10.7

¹⁵⁶ Annotation to OECD Principles V.A.4

¹⁵⁷ The Combined Code, supra note, section B.3

¹⁵⁸ SEBI, supra note 114, section 10.8

Shareholder Involvement in Determining Remuneration	OECD Principles¹⁵⁹ Shareholders should be able to make their views known on the remuneration policy for board members and key executives. The equity component of compensation schemes for board members and employees should be subject to shareholder approval. LSE Combined Code¹⁶⁰ Shareholders should approve any long term incentive schemes for executives and either decides compensation of non-executive and remuneration committee members or, if the articles allow, the board should delegate a sub-committee to address this matter, the AGM should be considered a convenient forum for shareholder approval of remuneration policy. Shareholders may be called on to approve the board's remuneration report, and they should approve any new or supplemental long-term incentive. SEBI Not covered.
2. Rights and Roles of Shareholders	
Shareholder Rights and Shareholder Voting	OECD Principles¹⁶¹ The corporate governance framework should protect and facilitate the exercise of shareholders' rights. • Basic shareholder rights should include the right to: 1) secure methods of ownership registration; 2) convey or transfer shares; 3) obtain relevant and material information on the corporation on a timely and regular basis; 4) participate and vote in general shareholder meetings; 5) elect and remove members of the board; and 6) share in the profits of the corporation. • Shareholders should have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as: 1) amendments to the statutes, or articles of incorporation or similar governing documents of the company; 2) the authorization of additional

¹⁵⁹ Annotation to OECD Principles II.C.3

¹⁶⁰ The Combined Code, section B.3.4

¹⁶¹ OECD Principle II (A-C)

	shares; and 3) extraordinary transactions, including the transfer of all or substantially all assets, that in effect result in the sale of the company. • Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings: + Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting. + Shareholders should have the opportunity to ask questions to the board, + including questions relating to the annual external audit, to place items on the agenda of general meetings, and to propose resolutions, subject to reasonable limitations. + Effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members, should be facilitated. + Shareholders should be able to make their views known on the remuneration policy for board members and key executives. The equity component of compensation schemes for board members and employees should be subject to shareholder approval. + Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia. <i>LSE Combined Code</i>¹⁶² Shareholders have a responsibility to make considered use of their votes. Unless a poll is called, all proxy votes should be counted, and after resolutions have been dealt with on a show of hands, the company should indicate the number of proxy votes cast, along with for and against vote, on each resolution. <i>SEBI</i>¹⁶³ A company must have appropriate systems in place, which will enable the shareholders to participate effectively and vote in the shareholders' meetings. The
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¹⁶²The Combined Code, Section C.2.1

¹⁶³ SEBI, supra note 114, section 14.9

	company should also keep the shareholders informed of the rules and voting procedures, which govern the general shareholder meetings.
General Meetings	OECD Principles¹⁶⁴ Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. LSE Combined Code¹⁶⁵ The board should use the AGM to communicate with investors and to encourage their participation. SEBI¹⁶⁶ The AGMs of the company should not be deliberately held at venues or the timing should not be such which makes it difficult for most of the shareholders to attend. The company must also ensure that it is not inconvenient or expensive for shareholders to cast their vote.
3. Financial Reporting, Transparency and Audit	
Financial Reporting	OECD Principles¹⁶⁷ Corporate governance framework should ensure that timely and accurate disclosure is made on all material matters including the financial situation, performance, ownership and governance of the company. LSE Combined Code¹⁶⁸ The board should present a balanced and understandable assessment of the company's position and prospects. SEBI¹⁶⁹ Information like quarterly results and presentations by companies to analysts may be put on the company's web-site or may be sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own web-site.
Disclosure and	OECD Principles¹⁷⁰

¹⁶⁴ OECD principle III

¹⁶⁵ The Combined Code (2003), Section D.2

¹⁶⁶ SEBI, supra note 114, section 14.10

¹⁶⁷ OECD Principle V

¹⁶⁸ The Combined Code, supra note, section D.1

¹⁶⁹ SEBI, supra note 114, section 14.7 and 14.8

Transparency	Disclosure should include, but not be limited to, material information on the financial and operating results of the company; and material foreseeable risk factors. Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed. BIS¹⁷¹ Transparency can reinforce sound corporate governance. Therefore, public disclosure is desirable in the following areas: ✦ Board structure (size, membership, qualifications, and committees) ✦ Senior management structure (responsibilities, reporting lines, qualification and experience) ✦ Basic organizational structure (line of business structure, legal entity structure) ✦ Nature of transactions with affiliates and related parties LSE Combined Code¹⁷² The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors. SEBI¹⁷³ As shareholders have a right to participate in, and be sufficiently informed on decisions concerning fundamental corporate changes, they should not only be provided information as under the Companies Act, but also in respect of other decisions relating to material changes such as take-overs, sale of assets or divisions of the company and changes in capital structure which will lead to change in control or may result in certain shareholders obtaining control disproportionate to the equity ownership.
Accounting	OECD Principles ¹⁷⁴

¹⁷⁰ OECD Principle V.A (1-8)

¹⁷¹ BIS, Supra note 112, sec 6.6

¹⁷² The Combined Code, section D.3

¹⁷³ SEBI, supra note 114, section 14.6

¹⁷⁴ OECD Principle V.B

Standards	Information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure. <i>LSE Combined Code</i>¹⁷⁵ Audit reporting responsibilities go beyond the actual audit and embrace any price-sensitive report or statement made to outside parties; reporting on going concerns should be a requirement and accompanied with supporting assumptions and qualifications.
Internal Control	<i>OECD Principles</i>¹⁷⁶ Insider trading and abusive self-dealing should be prohibited. Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation. <i>LSE Combined Code</i>¹⁷⁷ The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets. BIS¹⁷⁸ In banks there should be strong internal control systems, including internal and external audit functions, risk management functions independent of business lines, and other checks and balances. <i>SEBI</i>¹⁷⁹ Audit Committee of the board to look into these aspects.
Auditor Independence	<i>OECD Principles</i>¹⁸⁰ An annual audit should be conducted by an independent, competent and qualified, auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects. External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.

¹⁷⁵ The Combined Code, section D.1.2 & D.1.3

¹⁷⁶ OECD Principle III.B & C

¹⁷⁷ The Combined Code (2003), Section C.2

¹⁷⁸ BIS, supra note 112, sec 6.6

¹⁷⁹ Ibid, sec 10.7

¹⁸⁰ OECD Principle V.C & D

	BIS¹⁸¹ An important form of oversight in banks should be through independent risk management and audit functions. As the role of auditors is vital to the corporate governance process the importance of the audit process should be communicated throughout the bank. Board should take measures to enhance the independence and statute of auditors. The findings of auditors should be utilized in a timely and effective manner. Head auditor should report to the board and the audit committee in an independent manner. <i>LSE Combined Code¹⁸²</i> Not only should the auditors discharge their duties in total independence from personal interest or managerial interference, they should perform a regular review of their independence, along with their cost effectiveness and objectively.
Stakeholder- Definition and Communication	<i>OECD Principles¹⁸³</i> The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises. The corporate governance framework should permit performance enhancing mechanisms for stakeholder communication. Stakeholders who participate in the corporate governance process should have access to information necessary to fulfill their responsibilities. <i>LSE Combined Code</i> Not covered.

¹⁸¹ BIS, supra note 112, sec 6.3

¹⁸² The Combined Code, section D.3.2

¹⁸³ OECD principle IV

Disclosures related to Management	<i>OECD Principles</i>¹⁸⁴ Managers must disclose any material interests in transactions or matters affecting the corporation. <i>LSE Combined Code</i> Not covered. <i>SEBI</i>¹⁸⁵ The annual reports of the companies should contain Management Discussions and Analysis, including discussions on matters such as industry structure and developments, opportunities and threats, segment-wise or product-wise performance, outlook, risks and concerns, internal control systems and their adequacy. (Mandatory Recommendation) The management must disclose to the board all material, financial and commercial transactions, where they have personal interest that may have a potential conflict with the interests of the company at large. (Mandatory Recommendation)
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¹⁸⁴ OECD Principle III.C

¹⁸⁵ SEBI, supra note 114, section 13.4

CHAPTER THREE

CURRENT STATUS OF CORPORATE GOVERNANCE IN ETHIOPIA

Corporate governance is a new issue for Ethiopia. Even if the history of companies in the country needs independent study, currently Ethiopia has a number of companies formed and being formed by sale of shares to the wider public; unlike in near past where most share companies have been formed among founders.¹ The emergence of publicly held share companies in Ethiopia gives rise to multitude of complex corporate governance issues. Typically, Ownership separates from control of dispersed shareholders and goes into the hands of few managers, which in turn creates the principal-agent relationship. In such situation, agents (managers) may expropriate the principals' (shareholders') investments as they have more information and knowledge than the principals.² On the other hand, in share companies where there exist few block holders, minority shareholders could be exploited in the hands of such block holders. The agency problems that occur or could occur between dispersed shareholders and managers and/or block holders of share companies in Ethiopia, therefore, call for good corporate governance laws and institutions.

The purpose of this chapter is to examine the status of current laws pertinent to corporate governance in Ethiopia in the context of booming share companies. It mainly focuses on issues related to board of directors, rights of minority shareholders as well as disclosure and transparency in corporate governance. The discussion begins by highlighting the profile of Ethiopian companies, their ownership patterns, significance of corporate governance to Ethiopian economy and review of the legal framework governing share companies briefly.

¹Addis Fortune, (Addis Ababa), April 28, 2011, However, this does not mean that no company has been formed among founders and none is being formed.

² See Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (1932).



3.1 PRELIMINARY ISSUES

3.1.1 Profile of Ethiopian Companies

The majority of Ethiopian companies are family or closely owned and small in size of operation.³ Most of them are Private Limited Companies which are considered to be “the best form for a company with only few owners.”⁴ For instance, among the 125 companies formed from 1991-1993, only 6 were share companies while 119 were private limited companies.⁵ By the same token, among 2098 companies formed from 2008-2009, only 38 were share companies while 2060 were Private Limited Companies.⁶ Few years ago, only wealthy people used to set-up well capitalized share companies with five or more members who are often kit or kin with the founders.⁷ The case of entrepreneurs and professional managers launching companies with huge capital base and with nominal contribution from their own pockets was rare.⁸ Establishing companies by raising capital through public equities has been in the boom in the country, especially since mid 2008.⁹

Although there are few share companies ordinarily incorporated under the existing Commercial Code and are unconnected to State Owned Enterprises, endowments and Midrock Groups in the country, the majority of Ethiopia’s largest companies are owned or controlled by state bodies or political parties.¹⁰ Structurally, the endowment companies appear to have some similarity with nominee and proxy companies that were used to be found in some European institutions.¹¹ Such companies account for larger part of the economy than privately owned companies, which can

³ Most of the smallest Ethiopian businesses are not organized as companies but as sole proprietorships, which are also required to register with the state. Those businesses have little or no reason to be companies; for instance, limited liability has little meaning for small scale businesses especially when business is done on personal basis and court lawsuits are virtually unknown or impracticable. See USAID, *Infra* note

⁴ See USAID, *Ethiopian Commercial Law and Institutional Reform and Trade Diagnostic*, (January, 2007), p.19

⁵ Abu Girma (1994), “Problems and Prospects for the Emergence of a Stock Market in Ethiopia,” in Getachew Yoseph and Abdul Hamid Bedri Kello (Eds.), *The Ethiopian Economy: Problems and Prospects of Private Sector Development* (Addis Ababa, *Proceedings of the Third Annual Conference on the Ethiopian Economy*), p.217

⁶ From the Archives of the Trade Registry at the Ministry of Trade of FDRE, March, 2011.

⁷ *Addis Fortune*, (Addis Ababa), April 28, 2011

⁸ *Ibid*

⁹ <http://www.hg.org/article.asp?id=19590>, visited on 9 May 2011.

¹⁰ see Minga Negash, *Rethinking Corporate Governance in Ethiopia*, (2008), p.10

¹¹ *Ibid*

add a political tone in doing business.¹² State-owned companies are not organized under the company law and thus not subject to its rules and protective provisions. The regulation on boards of public enterprises is to be found in proclamation 25/1992 and 277/2002. The boards of public enterprises, excluding those in financial sector, are supervised by the Privatization and Public Enterprises Supervising Agency (PPESA). On the other hand, Public financial enterprises are supervised by the Public Financial Enterprise Agency. PPESA is responsible for the appointment and replacement of board members of all public enterprises under its jurisdiction including the chairman. The *Public Enterprises Proclamation* (25/1992) requires state owned enterprises to keep books of accounts following Generally Accepted Accounting Principles (GAAP). The annual audits of the enterprises are carried out by the Office of Auditor General.¹³

3.1.2 The Emerging Separation of Ownership and Control in the Ethiopian Share Companies

As has been tried to be mentioned above, there has been unprecedented growth in the number of companies under formation through initial public offer of shares (IPOs) presently in Ethiopia.¹⁴ While this has helped the companies to mobilize large amounts of capital from the public, it has also brought about the dispersion of corporate ownership among several thousands of shareholders in each of these companies.¹⁵ Although separation of ownership and control usually comes into effect with the existence of thousands of shareholders in a given company, this may not be true in case where the distribution of shares is relatively even.

¹²USAID, supra note 4, p.20

¹³ See Private Sector Development (PSD) Hub, Draft Project Document for Development of Corporate Governance in Ethiopia, (June 2009), p.16

¹⁴ For instance, currently, about six banks are under formation in the country, while 16 commercial banks including the recently formed Abay Bank are operating in the market. See the list of commercial private Banks Under formation in the 2010-2011, including Debub Global Bank, Enat Bank, Hawassa Bank Zam Zam Bank, Hewan Bank, Tsehay International Bank, Mercato City Bank. available at http://capitalethiopia.com/index.php?option=com_content&view=article&id=14181:three-hundred-million-birr-for-new-bank&catid=12:local-news&Itemid=4 accessed on April 26, 2011

¹⁵ See Fekadu Petros, Emerging Separation of Ownership and Control in Ethiopian Share Companies: Legal and Policy Implications, *Mizan Law Review* Vol. 4 No.1, (March 2010), p.14

Patterns in Some of the Non Financial and Financial Companies

	Combined holdings of highest holders in %	Average holding in %	Combined holdings of directors in %	No of share holders
	5.64	0.564	3.954	177
ewoch	9.0	0.909	6.363	110
	3.89	0.359	7.5	110
	1.138	0.020	0.399	2793
	6.667	0.083	2.583	360
t SC	6.57	0.657	5.921	152
	NA	0.037	NA	2834*
	NA	0.01	NA	6000
	NA	0.008	NA	11, 200
	9.37	0.034	1.659	2, 878**

the Ministry of Trade (2011); USAID (2007), Fekadu (2010); * 2010/1011 AIB's

<http://awashinternationalbank.com/Governance%20home.html> [visited on March 12,

the above table, there is a movement particularly in the financial share
 in other sectors from a closely held company towards more and broad
 Even though what is truly triggering the growth of dispersion of
 two factors are suggested to have constituted the causes for this
 related to the rise of inflation which might have made saving less
 driving investment towards the mid-level and high-level

through initial public offerings currently in Ethiopia in this regard.¹⁷ The second reason seems to be the design of company promoters who put a minimum and maximum amount of shareholding.¹⁸ This in turn must have been propelled by the emergence of professional and eager managers who are confident enough to collect capital from the wider public and make profit.¹⁹

Even though there is no clear policy in relation to non-financial companies, the government policy in relation to the financial share companies engaged in banking business seems to be supporting dispersed share ownership. In this regard, Article 11 (1) of Banking Business Proclamation No.592/2008 prohibits any person other than the FDRE Government from holding more than 5 percent of the shares in a bank. Moreover, while Article 2 (11) defines a shareholder who owns 2 percent or more of the shares as an influential shareholder, the Proclamation refers to fitness criteria to be met by such a person under Article 4 (1). The Proclamation also states that a share transfer that will make a person an influential shareholder be approved by the National Bank (NBE) under Article 10 (1). To implement these provisions, the NBE has issued directives entitled "*Time Limit for Reduction and/or Relinquishing Shareholdings Directive No.SBB /47/ 2010*" that specify the time limit for reduction of Excess Shares. It provides that "within 36 months from the effective date of this directive (i.e., 16th day of August 2010), a person who holds shares in a bank, either on his own or jointly with his spouse or with a person who is below the age of 18 years and related to him by consanguinity to the first degree, in excess of 5% of total subscribed capital of the bank shall reduce such holding to 5% or less and/or is influential shareholder in a bank, must relinquish his share holdings in another bank."²⁰ According to this directive, a person who fails to comply with the provisions of this directive shall be penalized in accordance with article 58 (7) of Proclamation No.592/2008. That is, such a person shall be punished with a fine up to Birr 10, 000 and with an imprisonment up to three years.²¹ Thus, the cumulative readings of these provisions seem to show that the government's policy in relation to financial share companies is towards diffused ownership. Nevertheless, there is no clear policy

¹⁷ According to Access Capital research, in the year 2009, more than a billion Birr share sale was launched by six companies. See, Access Capital SC, (2009). It is not clear whether or not bank deposits dropped by an equivalent amount.

¹⁸ Addis Fortune, (Addis Ababa), April 28, 2011

¹⁹ Ibid

²⁰ Directives No.SBB /47/ 2010, Art.3(1) and (2)

²¹ See Banking Business Proclamation, 2008, Art.58 (7), Proclamation No.592, Fed.Neg.Gaz. 14th year, No.57

regarding non financial share companies because the Commercial Code does not have a provision dealing with such issue.

Even if the policy towards diffused ownership in the financial institutions might be related to the fear of minority shareholder exploitations, this should not be taken as a conclusion that companies with small investors are not important to Ethiopia. Regarding the importance of such companies, one writer has stressed that:

*"If the country needs to create a middle income segment of its population, and if it wants to have big companies that can pool capital from the broader public and compete on global level in post WTO accession, encouraging the public to invest in share companies is an indispensable policy."*²²

Concentrated companies are vital for the country's economic development as they add assets to its overall GDP and create job opportunities to the citizens.²³ Thus, it can be argued that concentrated ownership should not be prohibited for the mere fear of minority shareholders exploitation by block holders. The government should encourage such types of share companies since formation of companies in such manner enables them to pull huge amount of capital from the general public by way of public subscription as may be deemed necessary.²⁴

In general, the emergence of newer companies with dispersed shareholders who have no control over the company is changing the company environment in Ethiopia. In such cases, control over the company is left in the hands of a few managers who in turn may be controlled by block holders. This demonstrates that the law should be reformed in a way that ensure shareholders protection and boost the confidence of investors on share companies. In other words, appropriate laws and institutions that can tackle problems of corporate governance emerging under the new situation of separation between ownership and control in the country are highly necessary and should be introduced without delay.

²² Fekadu, supra note 15, p.27

²³ Interview with Abdishu Hussein, Vice chairperson of Board of directors of Wogagen Bank SC, 24 May 2011, Interview with Ato Diriba Megersa, Public Relation Officer of Awash International Bank SC, 26 April, 2011, Interview with Mr. Hailu W/Gabriel, Executive Assistant/ Board Secretary at Wogagen Bank SC, 9 May, 2011

²⁴ Ibid

3.1.3 Significance of Corporate Governance to Ethiopia's Economy

Over the past few years, Ethiopia has experienced a number of encouraging economic gains. For instance, in 2010 alone, Private Banks declared a net profit of 1.4 billion Birr after paying 575.4 million Birr in profit tax.²⁵ Besides, approximately 5000 companies representing share companies and private limited companies are registered with Ethiopia's Central Commercial Register of the Ministry of Trade²⁶ and the country is also a home for state owned enterprises and non-governmental organizations (NGOs).²⁷ During the month of March 2010, the Composition of the Financial Sector, i.e., the total number of Banks, Insurance Companies and Microfinance Institutions (MFIs) stood at 15, 12 and 30, respectively.²⁸ The total number of bank branches increased to 673 from 617 in March, 2009.²⁹ Similarly the number of insurance branches was up to 207 from 190, the number of forex bureaus also jumped from 302 last year to 331 in the review period.³⁰

Moreover, currently following the 2010 election, the country has launched an ambitious "Growth and Transformation Plan (GTP)", to double its current GDP by 2015.³¹ While these figures are promising indicators of the country's economic progress, private and public investment is a key to meet the country's economic development objectives. Economic development, on the other hand, is a key prerequisite for reducing poverty and creating wealth. Whereas the main carrier of such development and growth is the entire business community, observance of law, rules and good corporate governance is a fundamental requirement for sustained growth.³²

²⁵ *Addis Fortune*, (Addis Ababa), January 29, 2011.

²⁶ See Trade Registry at Ministry of Trade of FDRE, 2010/2011

²⁷ Report on Observance of Standards and Codes (ROSC)- Ethiopia (Nov. 2007), p.5

²⁸ National Bank of Ethiopia, the Monthly Macroeconomic Indicators for the Month of March, 2010.

²⁹ Ibid

³⁰ Ibid

³¹ Ethiopia Approves Five-Year Growth Plan That Targets Farming: available at <http://www.ethiopian-news.com/ethiopia-approves-five-year-growth-plan-that-targets-farming> visited on 21 February, 2011.

³² Dr. Gabor Bruszt, Zekrie Negatu, draft project document for development of corporate Governance in Ethiopia, AACCSA, (June 2009), p. 11

Needless to state, Corporate Governance 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.³³ Corporate governance may also lower the costs of capital by reducing the “risk premium” normally added by creditors to borrowing.³⁴ 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 in Ethiopia.

Therefore, to reduce poverty and sustain a stable society, Ethiopia should have stronger enterprises that can generate and increase employment opportunities, produce goods and services and create revenue for the investors. To strengthen companies, whether private or state owned; small, medium or large; there must be continuous investment of capital and human resources as well as consumer satisfaction and public confidence in the enterprises.³⁵ To achieve these objectives, companies must have good and effective system of corporate governance and must also be perceived to be properly managed. Thus, good corporate governance is crucial not only for developed countries, but also to the developing countries like Ethiopia.

3.2 The Legal Framework Governing Share Companies in Ethiopia

In market economies, whether in developed or developing countries, company law plays a significant role, particularly in setting the legal environment for the creation and continuing operation of privately owned businesses.³⁶ The function of good company law is more decisive in transition-economy countries like Ethiopia as it lays the ground for economic development and growth. For instance, it can encourage new investment and provide investor protection by setting forth clear and objective rules for a company’s ongoing internal governance; it can encourage entrepreneurship by making it easy to start up and register a company; and it can also encourage

³³ Introducing Corporate Governance in Ethiopia, available at http://www.ethiopiainvestor.com/index.php?option=com_content&task=view&id=1164&Itemid, visited on 1 April, 2011.

³⁴ Ibid

³⁵ Justine Tumuheki, Towards Good Corporate Governance: An Analysis of Corporate Governance Reforms in Uganda, School for Advanced Legal Studies – Faculty of Law University of Cape Town, (September 2007), p.22

³⁶ USAID, Ethiopian Commercial Law and Institutional Reform and Trade Diagnostic, (January, 2007), p.18

businesses to come out of the underground economy into the publicly registered, taxpaying economy.³⁷

The current laws governing share companies in Ethiopia are found scattered under different laws, although the Commercial Code is the basic one. While non-financial share companies are governed by the Code and other relevant laws such as Proclamation No.686/2010, financial companies are required to adhere to other additional relevant laws besides the Commercial Code.

Broadly speaking publicly held companies can be classified as financial and non-financial companies. Such companies are referred to as “share companies” in the parlance of Ethiopia’s Commercial Code. Even though all companies (including financial companies) have to adhere to the provisions of the Commercial Code to operate in the country, financial companies have different proclamations and subsidiary directives that require them to comply with additional requirements owing to their nature of operation and their importance for the overall economy of the country.³⁸ Accordingly, share companies engaged in banking businesses have to comply with the Banking Business Proclamation No.592/2008, directives and procedures of the NBE. Furthermore, insurance companies are required to comply with the Licensing and Supervision of Insurance Business Proclamation No.86/1994 and directives and procedures of the NBE. By the same token, Microfinancing Institutions are governed by Proclamation No.626/2009, directives as well as procedures of the NBE. It is to be noted that the financial share companies are required to comply with the Commercial Code in addition to the aforementioned specific laws.

The remaining non-financial share companies operating in Ethiopia have to comply with the provisions of the Commercial Code so as to legally operate in the country (See title VI- Companies Limited by Shares, Articles 304-509 of the Code). Pursuant to Article 304 of the Commercial Code, Share Company is a company whose capital is fixed in advance and divided

³⁷ Ibid

³⁸ There are researchers who believe that there exist important distinctions between the governance of financial and non financial companies (see Macey and O’hara, 2003). They argue that the financial institutions are distinguished from other institutions mainly because of their importance in overall stability of a country (Trayler, 2007). For this reason, most governments regulate their country’s financial sector strictly. Such researchers argue for separate study of corporate governance of financial institutions. See Muhamet Mustafa et al, Improving Corporate Governance and Transparency in Banks and Insurance Companies in Kosova, Center for International Private Enterprise (CIPE), Washington D.C.,(April 2009), p.9

into shares and whose liabilities are met only by the assets of the company.³⁹ While the minimum is five, there is no limit as to the maximum number of the persons who may be members of a share company. Compared to private limited companies, which are prohibited from undertaking banking, insurance and any other financial business activities,⁴⁰ there is no limit as to the kind of business activity that Share Companies may engage in. It is worth noting that certain provisions of the Commercial Code, as applied to share companies and other forms of business organizations are amended on a case by case basis. A case in point is the Commercial Registration and Business Licensing Proclamation No.67/1997, which has been amended several times and recently replaced by the new Commercial Registration and Business Licensing Proclamation No.686/2010 to catch up with the changing circumstances and interests. It provides additional rules on the formation and registration of share companies⁴¹ and other business organizations.⁴²

In general, share companies are governed by the relevant provisions of the Commercial Code, specific proclamations issued regarding financial share companies, and other general and specific laws that have bearing on the operations of such companies.

In the next section, the legal regime governing the current corporate governance in Ethiopia, which will be limited to financial and non financial share companies, including the Commercial Code and other subsequent relevant laws, regulations and directives pertinent to the governance of financial institutions will be covered. Besides, with the aim of examining the reform of corporate governance in the country, the relevant provisions of the Draft Revised Commercial Code and the comments given by “The Fourteen National Experts” on the relevant draft provisions of the Code will be included.

³⁹ In addition, Article 2(5) of Proclamation No. 592/2008, Banking Business Proclamation, defines “company” ‘as a share company as defined under the Commercial Code of Ethiopia, in which the capital is wholly owned by Ethiopian nationals and organizations wholly owned by Ethiopian nationals and registered under the laws of, and having its head office in, Ethiopia.’

⁴⁰ Commercial Code of Ethiopia, 1960, Art.513, Proclamation No166, Neg.Gaz. Extraordinary Issue No.3 of 1960

⁴¹ See for instance, Commercial Registration And Business Licensing Proclamation, 2010, Art.12, Proclamation No. 686, Fed.Neg.Gaz. 16th Year, No. 42 which provides the requirements to be complied with for the Commercial Registration of a Share Company:

⁴² See Ibid Art.11, which lists the requirements for the Commercial Registration of a Business Organization Other than a Share Company.

3.3 CORPORATE GOVERNANCE OF SHARE COMPANIES IN ETHIOPIA: ISSUES AND ANALYSIS OF RELEVANT PROVISIONS

The Commercial Code contains important provisions that have bearing on corporate governance. The pertinent provisions of the Code (Art. 304- 509) deal with the legal requirements of establishing a share company, the management aspects, the board of directors and its mandates, the auditors, the right of share holders, and the general assembly, the different types of meetings, voting process and voting rights, the right of minority shareholders, auditing and reporting obligations, transparency requirements, the involvement of ministry of trade and industry and grounds of liquidation and dissolution.⁴³ For instance, in share companies, dealings between the company and a director that involve conflict of interest must receive prior approval by the board of directors (Art. 356); the company may not make loans to a director (Art. 357); directors are personally liable to the company for failure to carry out their duties that include a duty of due care and diligence (Art.364) and the company may sue a misbehaving director up on approval of shareholders representing 20% of the capital (Art.365).

According to the Commercial Code, “management of the company” is carried on by the shareholders’ meeting, board of directors and general manager(s).⁴⁴ The Code does not, however, employ the term “corporate governance,” which also encompasses the concept of ‘management’ but much broader than the concept of “corporate management.”⁴⁵ This is one of the facts which support the argument that the existing provisions of the Code lack comprehensiveness and clarity due to the fact that they were not updated since 1960. Although recently revision process of the Code has been started and the first working draft is developed by the committee entrusted with this work in 2006 under the auspices of the FDRE Ministry of Justice, after the “Fourteen

⁴³ Note that the Commercial code has been under Revision by a committee organized by the Ministry of Justice for reform and improvement although the work is stopped for some time. There is also a working draft at the ministry of Justice legal draft department, which was set to be final in 2006. In July 2008, A Team Of Fourteen National Experts Prepared Recommendations and Position Paper of the Business Community on the Revision of the Commercial Code of Ethiopia under the auspices of AACCSA with financial support from SIDA. However, the revision work is stopped after 2008.

⁴⁴ See Art. 347- 509 of the Commercial Code, supra note 40, although both the Code and its draft amendment do not incorporate the term ‘company governance’, chapter 4 of book two of the Code which entitled “board of directors, auditors and general meeting” is directly relevant to management and governance aspects of share companies.

⁴⁵ A. C. Fernando “Corporate Governance: Principles, Policies, and Practices.” (Pearson Education, 2006), p.13

National Experts” submitted their recommendations on the draft revised provisions of the Code in 2008, the work did not continue.

Under this section, therefore, the provisions of the Commercial Code together with the draft version of the Code will be analyzed with specific reference to some corporate governance issues, which are believed to be central in the subject matter. The paper argues that the issue of corporate governance should be given due consideration in the process of revising the Commercial Code of Ethiopia. It tries to show the inadequacy of the current provisions of the company laws pertinent to issues of corporate governance of share companies (financial and non-financial) in addressing the timely needs and their compliance with international practices.

3.3.1 BOARD OF DIRECTORS

A director may be defined as “a person having control over the direction, conduct, management or superintendence of the affairs of the company.”⁴⁶ The definition of directors is not given by the Code. Rather, the term, director is defined under Art.2 (6) of the Banking Business Proclamation No.592/2008 as “any member of the board of directors of a bank, by whatever title he may be referred to.” In this definition, the important factor to determine whether a person is a director or not is to refer to the nature of the office and its duties. It does not matter by what title s/he is referred to. If s/he is the member of the board and performs the functions of a directorship, s/he would be termed as a director in the eyes of the law.

According to Art.347 of the Code, a company shall have not less than three or more than twelve directors who shall form a board of directors and may be appointed based on the memorandum of association for only three years but are eligible for re-election unless otherwise provided in the memorandum or articles of association.⁴⁷ However, members of boards of directors of private Banks serve for a maximum of two terms only (a total of six years).⁴⁸ Directives No.SBB/39/2006 prohibit a board member of a bank not to serve, at the same time, as a board member of any other financial institution; while Chairperson of board of directors of a bank must

⁴⁶ Id, p.189

⁴⁷ Com. Code, supra note 40, Art 350(1)

⁴⁸ Directives No.SBB/39/2006

not be chief executive officer of the same bank.⁴⁹ These directives also state that a director shall not serve on a board of a bank for more than six consecutive years; however, he/she may be re-elected after a lapse of six years.⁵⁰ It allows re-election exceptionally for only one more term if the shareholders of a bank wish to maintain continuity in the board and re-elect some of the existing board members. The number of board members so re-elected shall, however, be limited to a maximum of one-third (1/3) of the outgoing board members.⁵¹ At the end of each term, there will be another board election where at least one third of previous board members must be re-elected for the sake of sustainability of the operation of the board and the institution.⁵² Once directors are appointed by majority shareholders vote for a single term at Annual General Meetings, the board in turn shall elect a chairman from among its members and it shall appoint a general manager/president of the company,⁵³ who carries out the day-to-day management activities with the assistance from the vice presidents and department managers with high academic qualification and long years of professional and sectoral experience.⁵⁴

⁴⁹ Id, Art.5.1.4 (i-ii)

⁵⁰ Id, Art.5.1.5 (i)

⁵¹ Directives No.SBB/39/2006 Art.5.1.4 (i) and Art.5.1.5 (i) has been challenged to be against the superior law (i.e., Commercial Code) in the dispute between United Insurance SC, Eyesuswork Zafu, Workeshet Bekele, major shareholders and directors of the company, and National Bank of Ethiopia (NBE). Eyesuswork was managing director of United Insurance since its establishment in 1994 and was also a director of United Bank, its sister company in which the insurance company holds a significant share. He had to give up his place on the board of the insurance firm he manages, and continued as chairman of the board of directors of the bank. Both Eyesuswork and Workeshet, together with the insurance firm, sought legal recourse by filing their complaints at the First Instance Court in July 2007. They challenged the legitimacy of the directive arguing that it held no power against the Commercial Code that imposes no such limitations. The First Instance Court ruled that although the NBE has power to issue directives, its directives should be within the bounds of the laws it delegates, while it must refrain from issuing directives which may contradict other laws. The court held Arts 5.1.4 and 5.1.5 of the directives were illegitimate, in which it subsequently suspended their enforcement. Similarly, the Federal High court upheld the ruling of the first instance court while the Cassation Bench of the Federal Supreme Court reversed the decisions of the lower courts by arguing that there is no provision in the Code limiting the regulator from restricting term limits and imposing other requirements on the appointment of senior managers, and the executive branch could be delegated to issue laws for purposes of expediency.

SEE ADDIS FORTUNE, EDITION OF 21 FEBRUARY 2011: DIRECTIVES OVERRIDE COMMERCIAL CODE, RULES SUPREME COURT.

⁵² This is supported by the bylaws of many institutions

⁵³ Commercial code, supra note 40, Art.348

⁵⁴ The CEO and the top management are accountable to the board and are required to submit periodic reports of their stewardship to the board. see Martha Kibru, Corporate Governance in the Ethiopian Financial Sector, (Unpublished, AAU, FBE Library, 2008), p.63

Regarding Appointment of Directors and Officers, Proc. No.592/2008 provides that a director shall be a person with honesty, integrity, diligence and good reputation to the satisfaction of the National Bank.⁵⁵ It also states that appointment of any director, chief executive officer or senior executive officer of a bank at the time of licensing or at any other time may not be valid unless written approval is granted by the National Bank.⁵⁶ Moreover, the term of office of outgoing directors of a bank may not terminate until written approval for the incoming directors is granted by the National Bank.⁵⁷ Accordingly, the NBE is strictly regulating the appointment of directors to board membership of Banks. For instance, the NBE has banned Board Chairman of Zemen Bank SC. and other members of board directors, from their positions despite the fact that they had been elected at the Annual Second General Meeting and second Extraordinary Meeting of Shareholders in October 2010.⁵⁸

3.3.1.1 The Role of Boards of Directors

In companies with dispersed ownership, shareholders are usually unable to closely monitor management, its strategies and its performance for lack of information and resources.⁵⁹ Thus, the role of board of directors is to fill this gap between the uninformed shareholders as principals and the fully informed executive managers as agents by monitoring the agents more closely.⁶⁰

Pursuant to the Commercial Code, the board of directors is the ultimate “managing” body of a company.⁶¹ It enjoys extensive powers as provided under the Code and a share company’s Memorandum and Articles of Association.⁶² In practice, the responsibility for managing the business is delegated to the CEO (general manager), who in turn delegates the responsibility to

⁵⁵ Banking Business Proclamation No.592/2008, *supra* note 21, Art.14 (1)

⁵⁶ *Id.*, Art.14 (2)

⁵⁷ *Id.*, Art.14 (3)

⁵⁸ The NBE refused to ratify Zemen’s latest elections for the board of directors after it received complaints from shareholders dating back to September 2010. See *Addis Fortune*, (Addis Ababa), March 20, 2011.

⁵⁹ Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law In Europe, Brussels, (4 November 2002), P.59

⁶⁰ *Ibid*

⁶¹ Art 347(1) of the Com. Code states that “only members of a company may manage the company”, While the Draft Commercial Code (DCC hereinafter) provides that “A Company shall be managed by a board of directors and not more than one third of the directors may be non share holders of the company.” But it is not clear why the legislator tries to exclude external directors from governing companies in which they are not shareholders. It seems as if people are driven by envy.

⁶² Com. Code, *supra* note 40, Art.363

other senior executives.⁶³ Therefore, the board occupies a key position between the shareholders (owners) and the company's management (day-to-day managers of the company's resources).

A closer look at of the Commercial Code shows that there is only one-tier, management board of directors in the parlance of current corporate governance in Ethiopia.⁶⁴ There is no distinction between managerial and supervisory roles of the board in relation to governance of share companies under the Code. The Code provides that the board of directors shall appoint a manager and it also provides that only members may be appointed as directors to manage a company (Arts 348(3) & 347(1)). All matters relating to directors in the Commercial Code appear under a section that is dedicated to the management. The draft version of the Code also maintained the Title of Book 2 Chapter 4 of the Code which says "Directors, Auditors and Shareholders' Meeting" as it is.⁶⁵

The Revised Draft Commercial Code, to some extent, seems to remedy the deficiency in Art.363 of the Code which deals with the powers of board of directors by providing for clearer supervisory powers of board of directors. Accordingly, Art.363 of the Draft Code stipulates the powers of board of directors as follows:

- (1) The board of directors shall have the widest powers to decide in all circumstances on behalf of the company.*
- (2) It shall exercise its powers within the limits of the objects of the company and subject to those expressly conferred by the Law to meetings of shareholders.*
- (3) The board of directors shall in particular:*
 - (a) Define the objectives of the company and guidelines for its administration;*

⁶³ See for instance, the Articles of Association of Financial Institutions such as Awash International Bank and Awash Insurance Company, Bunna International Bank, Wogagen Bank ... as well as non financial share companies such as Cheha Business SC, Ehil Beranda Ehil Negadewoch SC, Sky Bus SC, Yeshera Tera Birhan Limat SC, which indicate that the role of the board is to direct and supervise the company and the management, while the day-to-day activities are run by the general managers/CEOs.

⁶⁴ The Commercial code of Ethiopia is silent on the structure of board of directors. However, the tone of the Code tells one that it is recognizing the unitary board of directors. The practical survey of Share companies also support for the existence of only one-tier board system in the Ethiopian share companies.

⁶⁵ Taking this deficiency into the consideration, "A Team of Fourteen National Experts, Recommendations and Position Paper of the Business Community on the Revision of the Commercial Code of Ethiopia" commented that "The title of Chapter 4 which reads "Directors, Auditors and Shareholders' Meetings "should be changed to "Company Governance". See the Report which was provided as of July 2008.

(b) Control, on the permanent basis, the management of the chairman and, if need be, the general manager;

(c) Prepare the financial statements each fiscal year.

(4) The provisions of Articles of Association or the decisions of the general meeting restricting the powers of the board of directors shall not be demurrable to third parties.

As can be understood from these draft provisions, board of directors is given wider powers to decide in all circumstances on behalf of the company. The only restriction imposed on the powers of board of directors is to act within the limits of the object of the company and subject to those expressly conferred by the law to Meetings of Shareholders. Accordingly, it tends to follow the liberal approach of conferring powers to the general meeting of shareholders and board of directors, which is typically followed in USA.⁶⁶ This approach confers specific powers to general meeting such as the power of altering statute of the company, appointment and removal of the directors, and conferring all other powers on the board of directors.⁶⁷ In a similar vein, according to Art.363 (3) of draft provision, the board is given certain specific powers expressly in addition to those mentioned in a broader sense under sub-article (1) of the same article. Accordingly, the board has (a) power to define the objectives of the company⁶⁸ and guidelines for its administration; control, on the permanent basis, the management of the chairman and, if need be, the general manager; as well as prepare the financial statements of each fiscal year.⁶⁹ This provision is very crucial in determining the supervisory roles of the board of directors, which are deemed essential in the conduct of its duties.

⁶⁶ There are two approaches of conferring powers to the general meeting of shareholders and board of directors. They are the "liberal and restrictive" approaches. The liberal approach which is typically followed by USA Legal System is to confer specific power to general meeting such as the power of altering statute of the company, appointment and removal of the directors, and conferring all other powers to the board of directors. The restrictive approach on the other hand is to confer the power to the board of directors and general meeting by specifying in the memorandum or articles of association. According to this approach board of directors has limited power. This approach is adopted by the continental law legal system. For example, French company law, which is one of the models of Continental European Legal System, and which is also the model of Commercial Code of Ethiopia, confers the powers specifically to the board of directors. See Kefene Gurm, Powers and Liabilities of Board of Directors under the Commercial Code of Ethiopia, Unpublished Masters Thesis, Faculty of Law AAU, 2007, p.50.

⁶⁷ Ibid

⁶⁸ This doesn't seem to be correct because the objectives have already been defined in the memo and articles of association and the board would be endeavoring towards achieving them.

⁶⁹ The Draft Com. Code Art.363 (3 (a-c))

Although the draft Code tries to fill the deficiencies of the existing Code with specific reference to the supervisory roles/powers of board of directors, at least to some extent, there are still many issues that remain untouched. For instance, issues related to board of directors such as: access to information, composition, independence, chairman and CEO, board committees (i.e., audit committee, nomination committee, remuneration committee), rights of minority shareholders, financial reporting, transparency and audit (disclosure and transparency, accounting standards, internal control, auditor independence, stakeholder - definition and communication as well as disclosures related to management) are not given due consideration in the draft Code.

The relevant proclamations and directives governing financial share companies in Ethiopia also do not have provisions dealing with the supervisory functions of board of directors. Although Article 14(4) (c) of the Banking Business Proclamation No.592/2008 provides that “*The National Bank may issue directives on the duties, responsibilities and good corporate governance of board of directors (banks),*” the NBE has not issued directives that provide for ‘duties, responsibilities and good corporate governance of banks.’ The relevant Directives of the NBE that should be noted here are Directives No.SBB/39/2006 on Approval of Directors and CEO and “Limits on Board Remuneration and Number of Employees Who Sit on Bank Board Directives No.SBB/49/2011.” Nevertheless, these directives do not provide for the duties and responsibilities of directors of banks, rather, they deal with composition of board of directors (indirectly) and amount of remuneration. Thus, the content of these two directives of the NBE will be discussed under the coming sub-sections devoted to the composition and remuneration of directors respectively.

Taking the special nature of the financial share companies into consideration, it can be argued that good corporate governance practices should be introduced promptly. Regarding the importance of good corporate governance of financial institutions, researchers have firmly noted that “advancement of corporate governance principles in the financial sector is critical to fostering improvement in a business climate.”⁷⁰ In an emerging market economy like Ethiopia,

⁷⁰ In discussing the special characteristics of banks and other financial institutions that intensify the corporate governance problem, Caprio and Levine (2002) identify three features of banks that make them different from other firms. First, banks are more opaque, a characteristic that intensifies the agency problem. Opacity in banking makes it (i) more difficult for equity and debt holders to monitor managers, (ii) easier for managers and large

the financial sector plays a significant role by channeling its society's savings into investments and providing necessary credits to the private sector.⁷¹ Moreover, the stability and sustained growth of an economy is closely linked to the stability of the financial sector (especially the banking system) and any shock to the latter is capable of creating serious instability in the former.⁷² This is especially true when it comes to the current global economic crisis.⁷³ The financial sector suffers from particular information asymmetries (e.g. between bank managers and bank depositors, between risk taking managers and the bank's board, between managers and shareholders, and between banks and regulators), which may be emphasized by insufficient transparency and disclosure.⁷⁴ Such asymmetries are capable of undermining stability of the banking system, leading to a loss of confidence, possible runs on banks, or a credit crunch adversely affecting the economy's enterprises and household sectors under a weak system of corporate governance.⁷⁵

In Ethiopia, it is expected that enhanced corporate governance and transparency in the financial sector will influence positively the sector's development and also plays a significant role in reducing the informal economy through better channeling of money circulation and other financial transactions.⁷⁶ In addition, it will help develop other segments of capital markets such as

investors to exploit the benefits of control, rather than maximizing value, (iii) unlikely for potential outside bidders to generate an effective takeover threat, and (iv) more likely that a more monopolistic sector will ensue, lessening the impact of corporate governance mechanisms through competition. Second, banks are heavily regulated and this, more often than not, imposes a natural hindrance to corporate governance mechanisms. Measures that include deposit insurance, regulatory restrictions on concentration of ownership, entry, takeover, bank activities etc., all have adverse effects on mechanisms designed to control the management by shareholders. Levine (2003) argues limitation of stock ownership by a single owner in many countries and hostile takeovers are diminished as corporate governance mechanisms, because of lack of regulation and the opaqueness of banks. Third, as Caprio and Levine (2002) suggest, government ownership makes corporate governance of the banking industry very different from that of other industries. State ownership of banks is common in many countries, presenting a problem for corporate governance since it creates a situation of conflict of interest between the state as a monitoring authority and as a regulatory authority. State ownership also means that the managing of the bank is handed to bureaucrats who are unlikely to maximize firm value, but rather cater to the interests of specific groups. See also Muhamet Mustafa et al, *supra* note 38, p.9

⁷¹ See Banking Business Proclamation No.592/2008, *supra* note 21, preamble

⁷² *Ibid*

⁷³ M. Mustafa et al, *supra* note 38, p.9

⁷⁴ *Ibid*, p.10

⁷⁵ *Ibid*

⁷⁶ In this case, most managers, directors, employees, shareholders of different share companies as well as accountants and lawyers believe that the strict regulation of Banks in Ethiopia is good step towards protecting the interests of the stakeholders in general and shareholders as well as the integrity of the institutions particular. On the other hand, there

equity capital markets.⁷⁷ Besides, an effective system of corporate governance in banks will impose both standards of conduct for managers and appropriate procedures for internal controls in order to maximize opportunities for legitimate profits subject to the best interests of depositors and shareholders.⁷⁸ Good corporate governance regulates the relationships between bank shareholders and depositors, and bank boards and management, prevents abuses of power and self-serving conduct, as well as imprudent and high risk behavior of bank managers, and resolves conflicts between private interests and official duties.⁷⁹

Therefore, as the corporate governance of the financial sector has important implications for the stability of the whole economy; the NBE should issue directives dealing with *duties, responsibilities of board of directors and good corporate governance of banks* in particular and financial share companies in general. The issuance of such directives will play an important role in easing the regulatory tasks of the NBE and in turn enables it to maintain healthy financial industry in general and safeguard the interests of the stakeholders in particular.

As far as the practice is concerned, share companies are governed by board of directors. All share companies have board of directors, which is accountable to the Shareholders' Meetings. The Boards of directors also appoint the President who is anchor of companies' day-to-day management.⁸⁰ However, since there is no requirement of the law that clearly delimits the managing responsibilities of directors from that of directing and supervising a company, it is difficult to conclude that the roles of the board of directors are limited only to supervising the management even in practice.

some individuals who argue that such external regulation inhibits the proper functions of such companies and internal mechanism of good corporate governance should be given due consideration.

⁷⁷ Interview with Dr. Professor Fissehatsion Mengistu, 11 May, 2011

⁷⁸ Ibid

⁷⁹ Ibid

⁸⁰ See for instance, the Articles of Association of Financial Institutions such as Awash International Bank and Awash Insurance Company, Bunna International Bank, Wogagen Bank ... as well as non Financial share companies such as Cheha Business SC, Ehil Beranda Ehil Negadewoch SC, Papyrus School SC, Sky Bus SC, Crstal Tannery SC, Yeshera Tera Birhan Limat SC etc which indicate that the role of the board is to direct and supervise the company and the management while day to day activities are run by the general managers.

In the second chapter of this Thesis, it has been noted that the concept of corporate governance is much broader than the concept of corporate management.⁸¹ The existing literature on the role of the board also supports that the primary role of board of directors, particularly in companies where there is only unitary board structure, is to direct and superintend the management on behalf of shareholders/stakeholders with purposes of mitigating agency costs.⁸² Furthermore, most principles and codes of corporate governance clearly provide for the supervisory and controlling roles of the board. For instance, according to the OECD Principles of Corporate Governance, the board should fulfill certain key functions, such as:

“reviewing and guiding corporate strategy, risk policy, annual budget and business plans setting performance objectives, monitoring corporate performance and overseeing major capital expenditures and acquisitions; selecting, compensating and monitoring key executives; reviewing key executive and board remuneration; monitoring and managing potential conflicts of interest of management, board members and shareholders; ensuring the integrity of corporation's accounting and financial reporting systems; monitoring the effectiveness of the governance practices; and overseeing the process of disclosure and communications.”⁸³

Similarly, Bank for International settlement (BIS) provides that:

“Bank boards should establish strategic objectives and set corporate values that will direct the ongoing activities of the bank. The board should ensure that senior management implements policies that prohibit activities and relationships that diminish the quality of corporate governance, such as conflicts of interest, self-dealing and preferential dealings with related parties. Board should set and enforce clear lines of responsibility and accountability throughout the organization. Keeping in view their oversight role board of directors should feel empowered to recommend sound practices, provide dispassionate advice, and avoid conflict of interests.”⁸⁴

The UK Combined Code also stipulates:

⁸¹ Fernando, Supra note 42, p.33

⁸² Ibid

⁸³ OECD Principles of Corporate Governance, (2004), principle VI.D

⁸⁴ Basel Committee on Banking Supervision, Principles for Enhancing Corporate Governance , Bank for International Settlement (BIS), (October 2010)

*Every company should be headed by an effective board, which is collectively responsible for the success of the company.*⁸⁵

Likewise, pursuant to SEBI:

*The board of directors of a company directs and controls the management of a company. The day-to-day management of the company is the responsibility of the management.*⁸⁶

When one tries to examine the provisions of the Commercial Code and the Revised Draft Commercial Code as well as other relevant laws of the country in light of these principles and best practices of corporate governance, they are far from being clear and comprehensive. These facts, therefore, support the argument that there is a pressing need to overhaul the laws in light of international best corporate governance principles and practices in Ethiopia.

3.3.1.2 Composition and Independence of Board of Directors

The composition of board of directors refers to the number of directors of different kinds that participate in the work of the board.⁸⁷ A company may have managing or whole time directors who are in charge of the day-to-day conduct of the affairs of a company and are together with other team members collectively known as “management” of the company.⁸⁸ A company may also have part time non-executive directors who do not have anything to do with the day to day management of the company. They may attend board meetings and meetings of committees of the board in which they are members.⁸⁹ Fama and Jensen (1983) suggested that effective company boards would be composed largely of outside independent directors; and that effective boards have to separate the functions of management and control.⁹⁰ If the CEO was able to dominate the board, separation of these functions would be difficult, and shareholders would

⁸⁵ London Stock Exchange (LSE): Committee on corporate Governance, Hampel: The Combined Code, SECTION 1A, Main Principle, (London, July 2003)

⁸⁶ Securities and Exchange Board of India (SEBI): *Report of the Kumar Mangalam Birla Committee on Corporate Governance*, Final Report: India, (2000).

⁸⁷ Fernando, *Supra* note 45, p.23

⁸⁸ *Id.*, p.189

⁸⁹ *Ibid*

⁹⁰ E. F. Fama and M. C. Jensen (1983a), “Separation of Ownership and Control,” *Journal of Law and Economics*, 26, 301-325.

suffer as a result. They contended that outside directors are able to separate these functions and exercise sound decision control.⁹¹

In Ethiopia, general manager/s or CEOs are prohibited by the Commercial Code,⁹² Proclamation No.592/2008⁹³ and NBE directive⁹⁴ to hold the position of a board of directors and the CEO simultaneously. The New NBE directives (No.SBB/49/2011) particularly prohibit any employee of the banks, permanent or contractual, not to serve as a member in the board of directors of any bank.⁹⁵ The directive is said to be introduced to avoid conflict of interest, and apply appropriate chain of command and checks and balances.⁹⁶ In this case, it has been argued that “senior employees who have a seat on the board of banks will control the financial sector and force the other members of board of directors to implement their interest in the industry.”⁹⁷ In addition, as can be inferred from the preamble of the directive, it was necessitated by the need to separate the board and executive function of the banks and for proper checks and balances of the business without any interference from senior employees. Before the issuance of the directive, many banks, including state owned ones, allow their senior officials to sit on the board;⁹⁸ a dubious practice that undermined the fundamental principle of checks and balances that should be in place.⁹⁹ The National Bank contends that “the presence of the president on the board affects the proper checks and balances required from him/her and the board.”¹⁰⁰ Hence, these provisions are so important in regulating the conflict of interests that arise in the company which can adversely affect the stakeholders of banks in general and shareholders in particular. Besides, they can help ensure the independence of the board from influence of the management to some extent.

⁹¹ Ibid

⁹² Art. 348 (4) of the Com. Code provides that “the general manager may not be a director.”

⁹³ Article 15(3) of Banking Business proclamation provides that “... chief executive officer of a financial institution may not, at the same time, serve as a director of a bank.”

⁹⁴ “Limits on Board Remuneration and Number of Employees Who Sit on Bank Board Directives No.SBB/49/2011”

⁹⁵ Accordingly, the NBE has rejected two of the nominees from the list proposed by AIB for board membership position; see Addis Fortune, Edition of January 29, 2011.

⁹⁶ Capital, (Addis Ababa), February 26, 2011

⁹⁷ Interview with Mr. Solomon Desta, Director of Bank Supervision for NBE, done in his Office on April 26, 2011

⁹⁸ Capital, (Addis Ababa), February 26, 2011

⁹⁹ Ibid

¹⁰⁰ Interview with Mr. Solomon Desta, Director of Bank Supervision for NBE, done in his Office on April 26, 2011,

In relation to the external or outside directors, the Commercial Code stipulates that “only members of a company may manage a company.”¹⁰¹ This provision seems to prohibit external directors or non-shareholders not to engage in the management or governance of share companies where they have no shareholding. Nevertheless, this provision is considered to be outdated for several reasons. To mention few, firstly, external directors are recommended by different corporate governance committees¹⁰² to independently direct the company and supervise the management in the interest of the shareholders. Secondly, directors should be elected for their professional and other talents than the mere fact of shareholding criteria. Thirdly, such stipulation seems to disregard the advantages of involving talented professionals in the operation of businesses regardless of their membership in a company. Even those days, it was not clear why the legislator tried to close the possibility of engaging external directors in the governance of share companies. Since final decision on who should run a company is of the shareholders, the legislator shouldn't have closed such an opportunity. Still, this issue is not given due consideration even in the Revised Draft Commercial Code as it also limits the possibility of external directors not to exceed 1/3 of board of directors.¹⁰³

As far as financial share companies engaged in Banking Business are concerned, the NBE has issued Directives No.SBB/39/2006 on the appointment of Banks' Board of Directors and Selection Criteria. The directives set selection criteria such as education, employment, propriety, age, financial soundness and etc.¹⁰⁴ According to these Directives, at least seventy five percent of a bank's board members shall hold a minimum of first degree or equivalent from recognized higher learning institution; and the remaining board members should, at a minimum complete general secondary school.¹⁰⁵ Besides, members of Board of Directors must have adequate managerial experience, preferably in banking business, and/or should take adequate training in banking business management after holding a seat on the board.¹⁰⁶ Furthermore, the directives provide that a board member shall be a person with honesty, integrity, diligence and reputation to

¹⁰¹ Com. Code, supra note 40, Art. 347(1)

¹⁰² see Recommendations of Cadbury on Corporate governance, 1992, The UK Combined Code, (2000).

¹⁰³ See Draft Com. Code, Art.347 (1)

¹⁰⁴ Directive No.SBB/39/2006, Art.5

¹⁰⁵ Id, Art.5.1.1

¹⁰⁶ Id, Art.5.1.2

the satisfaction of the Bank.¹⁰⁷ Regarding Financial Soundness, the directive stipulates that a director may not sit on the board of a bank if he /she or a business entity in which he/she served or is serving as director or chief executive officer: has filed for bankruptcy, has been adjudged bankrupt, had assets sequestrated, or had been involved in court proceedings relating to any default on credit (bank or otherwise) repayments or tax payment; carries non-performing loans as defined in the Bank's relevant directives from any bank.¹⁰⁸ Pursuant to the directives, a member of the board of a bank shall be at least 30 years old.¹⁰⁹

In a similar vein, Art.11 (1) of proclamation No.626/2009, which governs Micro-finance Institutions (MFIs), provides that the directors and the chief executive officer of MFI shall meet the qualification of competency prescribed by the NBE and their appointment shall be approved by the NBE. Moreover, Directives No.MFI/3/1996 provides for criteria for selection of officers and directors for licensing and supervision of the business of micro-financing institutions. Accordingly, it provides that the Board of Directors should complete high school education with ability to read and grasp reports. In addition, members of the Board of Directors must preferably have adequate managerial experience in business and/or similar organizations.

Although requirements provided in the aforementioned laws are important to have some qualified directors in boards of financial institutions, it seems doubtful whether these provisions are sufficient to involve talented and qualified individuals to direct companies in the modern complex business environment.

Nowadays, the issue of the need for, role of, and **importance of independence of directors** is one of the highly debated and discussed issues in the corporate circles and among academicians.¹¹⁰ An independent director is defined as a "non-executive director who is free from any business or other relationship which could materially interfere with the exercise of his

¹⁰⁷ Id, Art.5.1.3

¹⁰⁸ Id, Art.5.1.6 (i-ii)

¹⁰⁹ Id, Art.5.2

¹¹⁰ Fernando, Supra note 45, p.205

independent judgment.”¹¹¹ Recent literature on corporate governance is replete with recommendations of various committees on the desirability of having non-executive, independent directors on the boards of companies to promote better corporate governance practices. For instance, the Cadbury Report identifies two areas where non-executive directors can make an important contribution in the governance process as a result of their independence from executive responsibility: reviewing the performance of executive management and taking the lead where potential conflicts of interest arise.¹¹² Similarly, the OECD Principles of corporate governance provides that “Board independence usually requires that a sufficient number of board members be employed by the company and not be closely related to the company or its management through significant economic, family or other ties.”¹¹³ Likewise, the LSE Combined Code states “A majority of non-executive directors should be independent of management and free from any business or other relationship that could interfere with their independent judgment; they should be identified in the annual report.”¹¹⁴ Likewise, SEBI stipulates that: “Independent directors are directors who apart from receiving director’s remuneration do not have any other material pecuniary relationship or transactions with the company, its promoters, its management, or its subsidiaries, which in the judgment of the board may affect their independence of judgment. Further, all pecuniary relationships or transactions of the non-executive directors should be disclosed in the annual report.”¹¹⁵

Despite most members of board of directors of share companies are part time directors,¹¹⁶ the law does not explicitly stipulate how their independence should be ensured from the influence of the management and on how to avoid conflict of interests within a company. Particularly, there is no provision that defines the relationship that would render the board members not to be independent in the Code and proclamations pertinent to financial share companies.

¹¹¹ Ibid

¹¹² Report of the Committee on the Financial Aspects of Corporate Governance: The Code of Best Practice (Cadbury Code - 1 December 1992)

¹¹³ Annotation to OEDC principles V.E.p.43

¹¹⁴ London Stock Exchange (LSE): Committee on corporate Governance, Hampel: The Combined Code, (London, 2000), sec A.3.2

¹¹⁵ Securities and Exchange Board of India (SEBI): Report of the Kumar Mangalam Birla Committee on Corporate Governance, Final Report: India, (March 2000), sec. 6.5

¹¹⁶ The survey made in some financial and non financial share companies reveal this fact

3.3.1.3 Directors' Remuneration

The directors' remuneration is still unsettled issue and in the wake of several corporate failures, excessive and disproportionately large payments to directors have almost become an outrage.¹¹⁷ There are divergent views on remuneration of directors. Some experts on the subject are of the view that directors are generally underpaid for their work and the onerous responsibilities they shoulder. They argue that:

*Constructive boards are responsible for untold millions going to the bottom-line. The value of a single idea of strategic succession planning, of risk avoidance, and the value one mistake prevented is incalculable.*¹¹⁸

The proponents of this view argue that remuneration of board of directors should be seen with their constructive responsibilities and the role they play in avoiding risks and strategic planning, than the mere amount of remuneration paid to them.

On the other hand, critics argue about the hefty fees directors receive for attending meetings, millions of dollars paid as severance payments, huge payouts as bonus, and other benefits.¹¹⁹ The main criticism is that:

*"Executives and directors are not properly controlled in their virtual self awards of stock options on one hand and directors' remuneration linked to share performance through share options has resulted in encouraging a focus on short term growth with destructive long term consequences, on the other."*¹²⁰

As can be gathered from this assertion, the excessive practices of directors' remuneration may encourage risk taking for short term benefits. Such practices can in turn undermine the health of share companies unless and otherwise controlled properly.

The Ethiopian Commercial Code deals with the remuneration of the directors under Art.353. Accordingly, the director may receive a fixed annual remuneration, the amount of which shall be

¹¹⁷ Fernando, Supra note 45, p.104

¹¹⁸ Ibid

¹¹⁹ Ibid

¹²⁰ Id, p.207

determined by a general meeting and charged against general expenses. The code also provides that “the articles of associations may provide that the directors may receive a specified share in the net profits of a financial year (Art 353(2)). Furthermore, the amount of share in the profits may not exceed 10%, which is calculated after the deduction of: amounts allocated to reserve provided by law (legal reserve) or the article of association (statutory reserve); the statutory dividend, where provided in the articles of association or where not provided, a sum representing 5% of the paid up value of shares which have not been redeemed; amounts allocated to reserve established by resolution of general meeting (discretionary reserves); and amounts carried forward(Art.353 (3(1-4))).

Remuneration of board of directors, in Ethiopia, is one of the most contentious and sensitive issues. There are three main areas of controversy in relation to the remuneration to be paid for directors of share companies. The first controversy is related with the issue whether remuneration is claimed as a matter of right or is a privilege. The second controversy surrounding remuneration of board of directors in Ethiopia is connected with what constitutes “statutory dividend” under Art.353 (4(b)) of the Code and “to whom it is reserved.” Of course, Art. 353(4) (b) has two aspects remaining unclear and controversial: (i) *statutory dividend* and (ii) *a sum representing 5% of the paid up value of shares which have not been redeemed*. The term “*statutory dividend*” in Article 353 (4) (b) is defined nowhere in the Commercial Code and it is difficult to understand the meaning of the term. The third issue and probably the most currently debatable is tied with the amount of remuneration provided by the law (i.e., 5%-10% share of annual net profit) and its application in the financial share companies which is found to be excessive by the National Bank of Ethiopia (NBE) and causing conflict of interests among shareholders and its implication on the overall well being of the institutions (i.e., banks).

(A) Directors’ Remuneration: Right or Privilege?

The first controversy surrounding the issue of remuneration of directors in Ethiopia emanates from the term “may” in Art. 353 (1) of the Code, which raises question as to whether directors of financial and non financial share companies in Ethiopia are entitled to remuneration as of “right” or whether it merely constitutes a “privilege” which is paid or unpaid on the mere wish of

shareholders. As regards this issue, it can be argued that since the term “may” is permissive auxiliary and the law requires the amount of remuneration to be fixed by the general meeting of shareholders, directors have no right to claim its payment as of right. Thus, if one may succeed in claiming remuneration as of right, it has to be only in a case where it is provided in Articles of Association in accordance with Art.353 (2). This goes with the principle of “autonomy of will” in the provisions of contract law that is interpreted in light of Art.1731 (1) of the Civil Code that “the provisions of a contract lawfully formed shall be binding on the parties as though they were law.” Hence, since what may be contained in the Articles of Associations of share companies concerning remuneration of directors constitutes a contract between and among the company, its agents and third parties, directors may avail themselves of the enforcement of the rights to remuneration accordingly. In other words, it may be a difficult task for them to convince the court, when it is not provided in the articles of association, on the basis of the wording of the Commercial Code provision [i.e., Art.353 (1)].

On the other hand, it can fairly be argued that directors have a right to payment of remuneration even where it is not provided under the articles of associations. This is because; there are heavy liabilities that go with the position of directorship. Under the Ethiopian legal system, the law provides that directors are liable to the company and third party creditors of the company.¹²¹ In other words, there is a possibility of piercing of corporate veil, in which agents and/or representatives of a company may be personally responsible for the claims of creditors when the assets of the company become insufficient to meet its liability.¹²²

Besides, remuneration of directors of share companies is an incentive to directors to pursue the interest of shareholders.¹²³ It plays great role in aligning the interest of shareholders with that of directors. Let alone non-payment, the reduced amount of remuneration affects the independence of directors from the influence of executives of the company for which they are there to

¹²¹ Com. Code, supra note 40, Art.364, 365, 366 and 367, Proclamation No. 592/2008, supra note 21, Art.58 provides that board of directors shall be punished with a fine from Birr 50,000 to Birr 100,000 and with a rigorous imprisonment from 10 to 15 years.

¹²² See Com. Code, supra note 40, Art.366

¹²³ Interview with Ato Diriba Megersa, Public Relation Officer of Awash International Bank SC, 26 April, 2011, Interview with Mr. Hailu W/Gabriel, Executive Assistant/ Board Secretary at Wogagen Bank SC, 9 May, 2011

control.¹²⁴ In a nutshell, effective remuneration of board of directors should be seen broadly from perspectives of nature of the work itself. It is the directors who make decisions on core financial and strategic plans and general direction of a company. In other words, it is the board of directors who formulate general strategies, appoint general manager and management team and superintend them, who approve credits involving millions of Birr in case of financial companies and who are responsible if things go wrong. They are believed to be the watchdogs to safeguard the interest of shareholders and of the company. In its simplest facet, the responsibility of board of directors by itself involves costs that need to be remunerated in the form of compensation. Thus, the argument which tends to purport that directors have no right to avail themselves of remuneration as of right does not seem well established. After all, the question to be answered by those who may contend that directors' remuneration is merely a privilege given to them by shareholders would be that "why should directors assume onerous work of board of directors in profit-making share companies in the absence of pecuniary benefits?" The heavy liabilities that directors assume and the agency cost involved in the nature of transactions they carryout necessitate payment of remuneration as of right to directors of a company.¹²⁵ Therefore, the word "may" employed under Art.353 (1) of the Com. Code must be broadly interpreted in light of the nature of the responsibility assumed by directors and its impacts on the healthy operation of business of share companies. Otherwise, the interpretation that directors' remuneration is a mere privilege can discourage talented individuals from assuming board of directors' position and also can lead directors to shirk against the interests of the stakeholders in general and shareholders in particular, which in turn can affect the health of companies at the end of the day.

(B) Statutory Dividend

The second controversy surrounding the remuneration of directors in Ethiopia is related to ambiguity of the term "*statutory dividend*" and "*a sum representing 5% of the paid up value of shares which have not been redeemed*" in the Commercial Code. In the Code, Art 353(4) (b) provides that the amount of share in the net profit may not exceed 10% and that this share is calculated after deduction of "... *the statutory dividend*, where provided in the articles of

¹²⁴ Ibid

¹²⁵ Ibid, the author also supports this argument for similar reasons

association, or where not provided, *a sum representing 5% of the paid up value of shares which have not been redeemed*” [Art.353 (4) (b)]. What is not clear in this provision is the question what constitutes “*statutory dividend*” and *to whose interest it is reserved*? Zekarias Keneaa argues that there is a clue in the Code that would be of help to relate the term “statutory dividend” in Art.353 (4) (b) to terms envisaged in Art.337 and 457 as “statutory interest” or “fixed” or “interim interest.”¹²⁶ He asserted that this is discernable from the provisions of Art.337 (2) that runs: “These shares do not confer any right to that part of the dividend representing the statutory interest.” It may, therefore, be argued that the term “statutory dividend” in Article 353(4) (b) is the same with “statutory interest” “fixed interest” or “interim interest.”

Furthermore, it would be difficult to argue that the term “statutory dividend” in Article 353(4) (b) of the Commercial Code represents the share allocated to founders in the Statutes of formation in accordance with the provisions of Article 310 of the Commercial Code.¹²⁷ The latter, whenever is fixed, in the Statutes of formation, has nothing to do with “statutory dividend.” First of all, “statutory dividend” is distributed by way of interest and not, as such, as profit. Moreover, it may only be paid in the interim, i.e., during the period of preparatory/construction works and for a specified period stated in the Articles of association pending the beginning of the normal business of a company [Art. 457 (2)].

Peter Winship, on the other hand, indicated that Art.353 was taken from the Germany’s experience in which he stated:

“Remuneration of directors must be limited if one wishes to avoid inequitable payments. This article contains severe provisions... It finishes with an important provision for the protection of minorities, in which appears, following the example of German law, the desire to maintain a certain proportion between the remuneration of directors and that of the company’s other personnel (employees, workers). It follows that the tremendous problem of the participation of the personnel in the profits of the enterprise can be attached to this

¹²⁶ Zekarias Keneaa, Some Reflections on Statutory Dividend, 2011?

¹²⁷ Ibid

provision and the whole problem can be discussed at the same time unless one thinks that under present circumstances the discussion would be premature.”¹²⁸

As can be understood from this assertion, Art.353 of the Code was introduced following the example of German law, with a desire to maintain certain proportion between the remuneration of directors and that of the company's other personnel (employees, workers). Germany, with its system of codetermination granting employees a formal role in corporate governance, is often cited as the prime example of the “stakeholder model.”¹²⁹ However, there is no clue in Article 353 and other provisions of the Code that employees are entitled to profit sharing in Ethiopian companies. On the other hand, Art.353 (4) (b) is not clear due to absence of its definition and to whose interest it is reserved. When one tries to read this provision in light of this background commentary on Art.353, it seems as if “statutory dividend” is set to maintain the interest of employees since other sub-provisions of this article are clear enough and do not give such an implication. In contrast, most of members of board of directors and executive officers of share companies as well as well known intellectuals in Ethiopia believe that “Employees do not have any legitimate right to participate in profit sharing scheme of share companies particularly on the annual net profits and may receive only certain amount of bonuses on the sole will of board of directors.”¹³⁰ Due to its vagueness and belief of stakeholders, Art.353 (4) (b) has remained inapplicable since 1960 when the Code was introduced in the country. The controversy surrounding this issue is still going on. It is not certain whether this provision will be made clear and applied even in the future. There is no clue as to what constitutes “statutory dividend” in the Code except the commentary of Winship. The draft version of the Commercial Code also maintained this provision without any modification to it.

¹²⁸ See Peter Winship, Background Documents of the Ethiopian Commercial Code of 1960, (Addis Ababa, Faculty of Law, Haile Sellassie I University, (1974)), p.16

¹²⁹ Jeswald W. Salacuse, Corporate Governance In The UNECE Region, Paper Commissioned for The Economic Survey of Europe, 2003 No. 1 By The Secretariat Of The United Nations Economic Commission For Europe, UN/ECE, Geneva, December 2002, p.54

¹³⁰ Interview with Ato Diriba Megersa, Public Relation Officer of Awash International Bank, 26 April, 2011, Interview with Mr. Hailu W/Gabriel, Executive Assistant/ Board Secretary at Wogagen Bank Share Company, 9 May, 2011, Interview with Mr. Worku Lemma, vice president of Oromia International Bank (OIB), April 23, 2011, Interview with Abdishu Hussein, Vice chairperson of the Wogagen SC, 24 May 2011, Interview with Dr. Professor Fissehatsion Menghistu, 11 May, 2011

Such ambiguity in the provisions of law seems to stem from the transplantation of laws from other countries without adapting them to the local reality of the country. It has been discussed that the objectives of companies and key actors in publicly held companies differ in civil law and common law legal systems. In Germany and other European civil law countries, the main objective of the company is to maximize interest of stakeholders including employees, suppliers, depositors and the community at large unlike the shareholder model of corporate governance followed in the common law countries such as USA and UK, which targets the protection of the interest of the shareholders of publicly held companies alone.¹³¹ Such variation in the experience of countries basically emanates from their cultural and philosophical underpinnings in doing business and the concept of profit sharing that could be extended to role of employees of publicly held corporations.¹³²

As has been mentioned above, Winship indicated that the provision dealing with remuneration of directors in the Commercial Code (i.e., Art.353) was adopted following the experience of Germany, where employees of a company have the right to be represented in the board of directors.¹³³ The interest of the employees can be represented in an organization by variety of ways, including through: trade unions, Codetermination:-employee participation on board of directors, profit sharing, equity-sharing and team production solution.¹³⁴ The concept of profit sharing with employees in order to protect their interests in an organization became much more widely used in Europe in the 1990s.¹³⁵ The majority of profit-sharing schemes are broad-based. That is, all or more employees were included in the scheme of profit sharing rather than just executives only.¹³⁶ Profit-sharing motivates the individual worker to put in his best as his efforts are directly related to the profits of the organization, in which he gets a share.¹³⁷ The objective of

¹³¹ Salacuse, supra note 127, p.23

¹³² Ibid

¹³³ See Fernando, supra note 45, p.162

¹³⁴ Ibid

¹³⁵ Ibid

¹³⁶ Ibid

¹³⁷ Ibid

such profit-sharing is to encourage employees' involvement in the company and improve their motivation and distribution of wealth among all the factors of production.¹³⁸

Even though the background of this provision tends to address employees' rights to participate in the profit sharing of a share company in Ethiopia, it is not clearly provided whether Art.353 (4) (b) is reserved to achieve this purpose. There is also a great doubt that "statutory dividend" or "a sum representing 5% of the paid up value of shares which have not been redeemed" might be reserved for such purpose merely because of its vagueness. In this situation, many questions may come to ones mind such as "do we have a culture of profit sharing to employees/workers in business organizations/companies? How do we perceive the role of employees in the success or failure of publicly held companies? If one answers this question affirmatively, then what is bad in allowing employees to participate on the annual profit sharing of companies? And if this provision (i.e., Art.353 (4) (b)) cannot be applicable in the Ethiopian context, why should it be retained in the forthcoming Revised Commercial Code? More importantly, can the ambiguity and inapplicability of this provision reflect problems related to adoption of foreign laws without considering the local social, economical, political and cultural situations? Which type of corporate governance model, i.e., shareholder model of common law or stakeholder model of civil law countries fits Ethiopia's corporate reality? These and other questions are the matters left for further research and to discover the real meaning of "*statutory dividend*" and "*a sum representing 5% of the paid up value of shares which have not been redeemed*" in Art.353 (4) (b) of the Code.

(C) Quantum of Directors' Remuneration, an Unsettled Issue?

In the third place, there is a controversy regarding the amount of directors' remuneration, especially, in relation to financial share companies in Ethiopia. As has been stated under Art.353 (4) of the Code, the amount of remuneration of directors ranges from 5% - 10% of the annual net profit of companies subject to deductions provided under sub-articles of the same provision [Art.353(4)(a-d)]. When this provision is put into practice, especially the remuneration of banks' directors, as banks remunerate their board members with generous pay packages, the NBE has

¹³⁸ Ibid

found such pay packages as being huge amount of money.¹³⁹ For example, in 2010 alone, Private Banks declared a net profit of 1.4 billion Birr after paying 575.4 million Birr in profit tax and the directors of 11 private banks took home a total of 37.3 million Birr in allowances and profit sharing in the 2009/2010 fiscal year.¹⁴⁰ Among them, Awash International Bank held the leading position by spending out 9.3 million Birr on its directors, followed by Nib International Bank which awarded its board of directors' 7.5 million Birr.¹⁴¹ According to the survey conducted by the NBE, the highest paid director pocketed one million Birr per annum, whereas the lowest paid one took home 102, 000 Birr.¹⁴²

Disputes among shareholders to secure a seat on the board have become prevalent due to this magnanimous remuneration scheme for directors in the private banks which attracted the NBE, the regulator, into their internal affairs as they fail to work pursuant to their articles of association and promote good corporate governance practices.¹⁴³ In relation to the matter, the NBE has issued Directives No.SBB/49/2011 on January 6, 2011 in accordance with the power given to it by Art.14 (4) (e) of the Banking Business Proclamation No.592/2008, which authorizes it to issue directives on the maximum remuneration of director of a bank, to address such disputes and create industry peace and good corporate governance among financial institutions.¹⁴⁴ The directives limit individual private bank directors' remuneration to 50,000 Birr in one operating year, and a monthly allowance of 2,000 Birr. Banks are also prohibited from paying directors any benefits, in cash or in kind, additional to the set annual amount. The failure to implement the directives could earn a non-complying bank a penalty of 10,000 birr and make it liable for criminal and civil suits.¹⁴⁵

These directives have been the bone of contention among different people including members of boards of directors of different banks and officials of the NBE due to reasons discussed hereunder in the form of merits and demerits of the directives.

¹³⁹ Addis Fortune, (Addis Ababa), January 29, 2011

¹⁴⁰ Ibid

¹⁴¹ Ibid

¹⁴² Capital, (Addis Ababa), February 26, 2011 and see Survey conducted by the National Bank on Remuneration of Board of directors of private banks in January, 2011.

¹⁴³ Interview with Mr. Solomon Desta, Director of Bank Supervision for NBE, April 26, 2011

¹⁴⁴ See Directives No.SBB/49/2011, Preamble

¹⁴⁵ See Proclamation No.592/2008, supra note 21, Art.58

i. Merits

In the first place, there are people who argue that the directives have significant importance as it will create industry peace and good corporate governance in the private commercial Banks.¹⁴⁶ In a similar vein, the preamble of the Directives provides that “sound corporate governance is vital for the health of individual banks and the banking sector as a whole” while “excessive remuneration recently being paid by banks to directors have become a threat to the health of the banking system”.¹⁴⁷ It is also argued that “The amount paid to directors before issuance of the directives was excessive which has been creating a corporate governance crisis and conflicts among shareholders to obtain seats on the boards of directors.”¹⁴⁸ It has been also argued that, “it will stop the unnecessary fighting to get onto the board.”¹⁴⁹ It has been maintained that the NBE, as the regulator of financial institutions, is responsible for setting guidelines on the remuneration scheme of board of directors in light of good corporate governance practices in all stakeholders’ best interest.¹⁵⁰

Secondly, it has been contended that limiting the payment of directors would attract only those individuals interested in the work and not those seeking a position for the benefits.¹⁵¹ But the question here is ‘why would directors be willing to work in the absence of benefits in profit making organizations at all and why would seeking legitimate benefits be regarded as wrongful act in this regard?’

¹⁴⁶ Interview with Mr. Solomon Desta, Director of Bank Supervision for NBE, April 26, 2011, Interview with Mr. Worku Lemma, vice president of Oromia International Bank (OIB), April 23, 2011, Interview with Mr. Abdishu Hussien Vice chairperson of board of directors of Wogagen Bank SC, 12 May, 2011, Interview with Dr. Professor Fissehatsion Menghistu, Instructor at Addis Ababa University Law School, 11 May, 2011

¹⁴⁷ See preamble of “Limits on Board Remuneration and Number of Employees Who Sit on Bank Board Directives No.SBB/49/2011”

¹⁴⁸ The NBE asserted that it has received many requests from shareholders and those who did not get seats on a bank's board to intervene, before the issuance of the Directives. Interview with Mr. Solomon Desta, Director of Bank Supervision for NBE, done in his office on April 26, 2011,

¹⁴⁹ Interview with Mr. Worku Lemma, vice president of Oromia International Bank (OIB), April 23, 2011

¹⁵⁰ Interview with Mr. Solomon Desta, Director of Bank Supervision for NBE, April 26, 2011

¹⁵¹ Ibid

Thirdly, some argue that it promotes long term profits and interests of companies by discouraging high risk taking for the short-term gains.¹⁵² Similarly, it has been asserted that it will discourage those individuals who participate in the board rooms to pursue only short term benefits rather than long term stability of the institutions.¹⁵³

ii. Demerits

Despite the foregoing arguments, the Directives have been criticized for a number of reasons. In the first place, the fixed pay scheme proposed by the Directives does not take into account the size of the banks, the experience and responsibility of each director, or the complexity of the operations they are engaged in.¹⁵⁴

In the second place, the Directives were said to have removed the right of shareholders to reward those they trust to sit in the boardroom and make risky decisions.¹⁵⁵ Although banks in particular and financial institutions in general are highly important for the over all economy of a country and should be regulated strictly to avoid scandals related to them, it should equally be taken into consideration that private banks are profit oriented institutions and individuals involved in their governance also deserve some sort of incentives which are proportionate to their contribution.¹⁵⁶

Thirdly, it is said that “the new pay package is too draconian and would push talented individuals out of the governance of banking sector.”¹⁵⁷ “Even though the importance of regulating banks in the current situation is unquestionable and while the directive is a move in the right direction, the new remuneration scheme, set at a maximum of 50,000 Birr for the board of directors has been

¹⁵² Interview with Mr. Solomon Desta, Director of Bank Supervision for NBE, April 26, 2011, Interview with Mr. Worku Lemma, vice president of Oromia International Bank (OIB), April 23, 2011, Interview with Mr. Abdishu Hussien Vice chair person of Wagagen Bank’s Board of directors, 12 May, 2011, Yohannes Aseffa, Chief Party at the WTO Plus Project, USAID, February 2, 2011.

¹⁵³ Interview with Mr. Solomon Desta, Director of Bank Supervision for NBE, April 26, 2011 and Interview with Mr. Worku Lemma, vice president of Oromia International Bank (OIB), April 23, 2011, Interview with Dr. Professor Fissehatsion Menghistu, 11 May 2011.

¹⁵⁴ Interview with Mr. Worku Lemma, vice president of Oromia International Bank (OIB), April 23, 2011, Interview with Ato Diriba Megersa, Public Relation Officer of Awash International Bank, 26 April, 2011, Interview with Mr. Hailu W/Gabriel, Executive Assistant/ Board Secretary at Wogagen Bank Share Company, 9 May, 2011

¹⁵⁵ Ibid

¹⁵⁶ Interview with Ato Diriba Megersa, Public Relation Officer of Awash International Bank, 26 April, 2011, Interview with Mr. Hailu W/Gabriel, Executive Assistant/ Board Secretary at Wogagen Bank SC, 9 May, 2011, Interview with Dr. Professor Fissehatsion Menghistu, 11 May 2011.

¹⁵⁷ Addis Fortune, (Addis Ababa), May 1, 2011

set too low” according to a banker in the top management of a private bank who requested anonymity as it is a sensitive case. This was also shared by eight directors of boards of private banks who wished their name to be withheld to protect their banks, who argued that “the amount of remuneration set does not take into consideration the workload, which involves meetings and committee work, as well as the risk involved in being a director.” They also contend that “the content of the directives in relation to the amount of remuneration of the directors would discourage many people as it is mainly those with many years of experience in the banking sector that are sought after.” Four of them honestly unveiled that they would not want to take the workload for the next term of election and risk of a 15-year penalty if things go wrong.¹⁵⁸ These directors believe that the NBE has no genuine power to decide on such issue in such manner, in which it has limited the rights of shareholders to reward the individuals whom they trust to protect their interests. Even if, as a regulator, it is given the power to issue directives, the NBE should have been cautious to pass such a draconian decision. For instance, it should have consulted the experiences of other countries and other possible options for better regulation instead of intervening unnecessarily into the private businesses where its undue intervention can itself inhibit the normal operation of the banking industry.¹⁵⁹

In the fourth place, the low remuneration might also open the door for corruption in the Banking industry as directors are the top governing body of banks and decide on key financial and credit issues.¹⁶⁰ Corruption on its way affects the healthy operation of the institutions and their importance to the overall national economy.

iii. The Middle Way?

Generally speaking, the issuance of the directives can be considered as an action towards a right direction by the NBE. Given the economic significance of banks and the opaque nature of the sector, the rewards of directors must be in line with the interest of all stakeholders. This is why

¹⁵⁸ The liability of board of the directors is provided under Art.364 of Commercial Code and Art.58 of Proclamation No 592/2008 in particular.

¹⁵⁹ Interview with Ato Diriba Megersa, Public Relation Officer of Awash International Bank, 26 April, 2011, Interview with Mr. Hailu W/Gabriel, Executive Assistant/ Board Secretary at Wogagen Bank SC, 9 May, 2011, Interview with Dr. Professor Fissehatsion Menghistu, 11 May 2011.

¹⁶⁰ Ibid

Proclamation No.591/2008 authorizes the NBE “to foster a healthy financial system and to undertake such other related activities as are conducive to rapid economic development of Ethiopia.”¹⁶¹ To achieve these purposes, the NBE is further empowered to license and supervise banks, insurance companies and other financial institutions; and to create favorable conditions for the expansion of banking, insurance and other financial services for the achievement of these objectives in accordance with relevant laws.¹⁶² Furthermore, the Banking Business Proclamation No.592/2008 empowers the NBE to issue directives on the maximum remuneration of directors.¹⁶³ However, the question here is: how should the NBE issue such directive? Would its empowerment to issue directives on the maximum remuneration of directors entail that it can do whatever it thinks fit? As there is no guideline on how the NBE exercises its powers, legally speaking, it is difficult to say that the NBE has no discretion to decide whatever it thinks right in this regard.

Nevertheless, there is strong belief that remuneration of directors of banks in Ethiopia should be in line with the international best practices. It is argued that “Instead of setting monetary figures on the directors’ pay, the regulator should have required banks to set up a remuneration committee independent of the board to prepare a remuneration policy.”¹⁶⁴ This is supported by experiences of countries which adopted good corporate governance in relation to financial institutions. For instance, regarding the governance framework for determining remuneration of directors of financial institutions, the G20 leaders, at their Pittsburgh submit on 24-25 September 2009, endorsed that:

There is a pressing need for remuneration and governance principles in financial institutions to be based on a globally consistent framework aimed at ‘aligning

¹⁶¹ See Proclamation No.591/2008, supra note 21, Art.4

¹⁶² Id, Art.5 (7, 8) & Art.14, The National Bank shall license and regulate banks, insurance companies and other financial institutions in accordance with the relevant laws of Ethiopia.

¹⁶³ Id, Art.14 (4) (e)

¹⁶⁴ Addis Fortune, (Addis Ababa), January 29, 2011

*compensation with long-term value création, not excessive risk taking, rather than national initiatives.*¹⁶⁵

It has been stressed that “a board remuneration committee should be an integral part of an institution’s governance structure and should be competent and independent and should be able to demonstrate that compensation decisions are aligned with the institutions financial stability and future performance.”¹⁶⁶ Therefore, it can be argued that the NBE should have considered the need to incorporate internationally accepted practices in relation to setting the amount of remuneration. Although none of the relevant laws require the establishment of remuneration committee in financial as well as non financial share companies in Ethiopia, the international practice calls for introduction of such requirement under the Ethiopian company laws.¹⁶⁷

As far as the structure of remuneration is concerned, much criticism has been directed at financial institutions’ seeming failure to operate remuneration structures that take into account of the long term impact of a single year’s bonus decisions.¹⁶⁸ To this extent, the G20 leaders criticized excessive risk taking and accepted the implementation of standards seeking to achieve global adherence to the principles for sound remuneration, issued on 2 April 2009 so as to ensure a level playing field for all market participants. The principles prescribe the following:¹⁶⁹

- Effective alignment of compensation with prudent risk taking, including global standards on pay structure which provide for deferral, effective claw back and varied compensation (cash and equity), to ensure compensation practices are aligned with long term value creation and financial stability;

¹⁶⁵ Freshfields Bruckhaus Deringer LLP, Remuneration and Corporate Governance in Financial Institutions, Oct. 2009, available at www.freshfields.com [Visited on April 26, 2011]

¹⁶⁶ Ibid, p.5

¹⁶⁷ The UK Combined Code stipulates that Remuneration committee should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors.

¹⁶⁸ Deringer, supra note 163

¹⁶⁹ Ibid

- Effective governance of compensation, including corporate governance reforms to ensure appropriate board oversight of compensation and risk, including greater independence and accountability of board compensation committees; and
- Effective supervisory oversight and engagement by stakeholders, including greater disclosure and transparency of the level and structure of the remuneration for those whose actions have a material impact on risk taking.

Besides, Ryan, Jr. and Wiggins (2004) adopted a bargaining framework to empirically examine the relations between director compensation and board-of-director independence. Their evidence showed that independent directors have a bargaining advantage over the CEO that results in compensation more closely aligned with shareholders' objectives.¹⁷⁰

To sum up, the amount of remuneration to be paid to the directors of banks in accordance with the Directives No.SBB/49/2011 is too low to align the interests of directors with those of the stakeholders, risks and liabilities involved there and the impact of ineffective compensation on the independence of the board from the management. In this regard one scholar has argued strongly that:

*"Compensation to directors and senior executives should reflect their performance and are in relation to their responsibilities and risks involved in carrying out their functions. One of the reasons in favor of this "pay-for-performance" concept of executive remuneration is that if executive compensation is directly related to an increase in share price, the benefits executives receive would be proportional to those of all shareholders. This would encourage executives to make decisions which will maximize shareholder wealth."*¹⁷¹

Therefore, the NBE should reconsider the Directives in light of best global experiences and adapt them to the local needs. There is no doubt that excessive compensation practices undermine the health of the financial institutions, particularly, by encouraging excessive risk taking and raising conflicts over the position. Thus, it has to take a middle way to properly address all problems surrounding this issue. Rather than setting the maximum figure, i.e., 50, 000 birr to be annual

¹⁷⁰ H.E. Ryan, and R. A. Wiggins, "Who is in Whose Pocket? Director Compensation, Board Independence, and Barriers to Effective Monitoring," *Journal of Financial Economics*, (2004), 73(3), 497-524,

¹⁷¹ Fernando, Supra note 45, p.207

remuneration of directors of banks, it should have reduce the percentage below 5%, the minimum amount in the Commercial Code, so as to make it performance based. For instance, 2% of annual profit of banks would be good amount than 50, 000 Birr, which may differ from bank to bank on their total performance. In addition, the NBE has to see to it the possibility of regulating the problem by requiring the banks to establish independent remuneration committee to reduce its degree of direct involvement in all issues of the institutions under its supervision.¹⁷² The other related point worth mentioning here is that conflicts of interests mostly arise in relation to the selection/election of members of board of directors. Hence, the NBE should focus on this issue as part of its task of regulation so as to make the process more transparent and impartial. To this end, the regulator may see to it to require the financial institutions to establish independent nomination committee which will undertake this task or it may involve in the process with clear guidelines on preconditions to be fulfilled by the nominees/selectees and thereby ensuring shareholders' active participation in the process.

3.3.2 Roles and Rights of Shareholders in Corporate Governance

The very structure of share ownership may facilitate or complicate the task of controlling managerial behavior. In European corporations, where large shareholders exist with seats on the board, managers cannot easily control the machinery of corporate governance in their own interests.¹⁷³ In such a case, it is possible to control managers by the nomination of outside directors or dominating the internal auditing process, than in corporations such as those in the United States, where shareholdings are widely dispersed and directors do not have considerable shareholdings in the corporation and may have social or financial relations to management.¹⁷⁴ One of the purposes of effective corporate governance is to protect minority shareholders from abuse, whether from managers with little ownership interest or controlling shareholders who dominate management. It is argued by some scholars that the concentrated ownership of share in

¹⁷² For example, the UK's combined code provides that the remuneration committee will be responsible for working out remuneration package "to attract, retain and motivate executives of the quality required."

¹⁷³ Salacuse, *supra* note 127, p.46

¹⁷⁴ *Ibid*

many countries serves to protect poor investor which is provided by those countries to shareowners.¹⁷⁵

With respect to the legal rights of shareholders, in both the United States and Europe, direct participation of shareholders in corporate governance is limited to electing directors or members of the supervisory board and, approving certain items that require shareholder approval.¹⁷⁶ In addition, there are legal rights accorded to shareholders to act against corporate officers and directors.¹⁷⁷ Corporate governance advocates are increasingly pressing corporations to grant shareholders the right to approve a variety of fundamental issues affecting the corporation, including stock option plans, and to have easy access to the proxy process.¹⁷⁸

Some studies have concluded that the common law legal tradition affords stronger legal protection to minority shareholders than does the civil law.¹⁷⁹ For instance, in the Anglo-American system of corporate governance, the regulation of self-dealing by officers and directors is more stringent than it is in the European continent.¹⁸⁰ Moreover, the American system allows shareholders to sue directors and officers for injuries that they have sustained either directly by corporate action or derivatively, on behalf of the corporation, for injuries done to the corporation because of wrongful actions by its officers or directors unlike continental law countries.¹⁸¹ Taking note of this important experience as background, now we will proceed to look into the Ethiopian reality.

In Ethiopia, the direct participation of shareholders in corporate governance is also limited to electing or removing board of directors and auditors and deciding the amount of their remuneration as well as approving certain items that require shareholders' approval through

¹⁷⁵ Id, P.47

¹⁷⁶ Ibid

¹⁷⁷ Ibid

¹⁷⁸ Ibid

¹⁷⁹ Id, p.49

¹⁸⁰ Ibid.

¹⁸¹ Ibid

Shareholders' Meetings.¹⁸² Shareholders have rights not to be deprived of the rights inherent in the membership without their consent [Art.389 (1)]. These rights include the rights, which under the law or memorandum or articles of association, do not depend upon decisions of the general meeting or board of directors or which are connected with the right to take part in meetings, such as the right to be a member, to vote, to challenge a decision of the company or to receive dividends and a share in a winding up [Art. 389(2)]. In addition, shareholders are entitled to be given relevant information in advance of any meeting in order to enable them to take fully informed decisions [Art. 406]. Before any annual shareholders' meeting, shareholders are entitled to inspect the company's balance sheet, profit and loss accounts, reports of directors and auditors in the three preceding financial years, minutes and attendance sheets of these meetings and so on. Now let's examine the rights of minority shareholders under the Commercial Code and other relevant laws.

3.3.2.1 Rights of Minority Shareholders

Some of minority rights protections are provided under the Commercial Code of Ethiopia. For instance, Voting by proxy is provided under Articles 398(1) and 402 but no voting by mail is allowed. The minimum percentage required for shareholders to call general meetings is 10% of the capital under Article 391(2). Likewise, the pre-emptive right of shareholders to buy newly issued shares in proportion to their shareholding is explicitly provided under Article 345(4) and 470(1). Similarly, the OECD Principles provides for such requirement on minority rights as reflected in the Annotations.¹⁸³

There are two alternative mechanisms of minority rights protection: cumulative voting and minority representation in the board of directors. Cumulative voting relates to voting during board elections in which the votes of the contending groups will be multiplied by the number of board seats and calculated for the contenders' nominees in accordance to the proportion of each

¹⁸² The meetings of shareholders are classified into general and special. General meetings are meetings which consist of shareholders of all classes. General meetings are in turn classified into ordinary and extra ordinary general meetings. Ordinary General Meeting is held once every year to discuss financial and administrative affairs of the company. Extra ordinary general meeting is a meeting of the shareholders to consider a particular matter specially amendment of the statutes. Special Meeting is a meeting that consisting of shareholder's of particular class to transact business affecting their interest only. See Art 390, Arts 423-435, Arts 426-428 of the Commercial Code

¹⁸³ Annotations to OECD Principles, p.42

group's summed up votes and believed to avoid a majority-take-all outcome.¹⁸⁴ The means envisaged under Article 352 does not seem to ensure proportional minority shareholder representation. Article 352 of the Code which provides for proportional representation in boards reads:

Where there are several groups of shareholders with a different legal status, the articles of association shall provide for each group to elect at least one representative on the board of directors.

The message of this Article is vague. Particularly, it is not clear with what it means by legal status and whether the law is referring to the class of shareholders under Articles 335, 336 and 337 of the Code. In other words, it seems to require a situation where shareholders are divided into several groups with each shareholder having some internal relationship by which to identify with its group and vote in concert. Nevertheless, this cannot be expected in share companies with numerous shareholders that are counted in thousands although it may be easier to realize in a closely held company.

The **derivative suit mechanism**, i.e., the right to initiate suits against directors or third parties on behalf of the company is not provided for in the Commercial Code. However, it appears that the drafter of the provisions (Professor. Escarra) had initially drafted the provisions in article 364-367 with the aim of providing for derivative suit mechanisms. This seems evident from his exposé des motifs in which he states:

*"These very important provisions regulate the liability of directors and the procedure for enforcing this liability by individual or class action. These articles [...] represent a sufficiently simple and precise statement of one of the most complex problems in company law, i.e., the action which can be brought by each shareholder in the case where the fault of the directors has prejudiced the company's property as well as his own property."*¹⁸⁵

¹⁸⁴ Fekadu, supra note 15, p.19

¹⁸⁵ Winship, supra note 126, p.64. It is more probable that, the original rules Prof. Escarra drafted were later changed either by prof. Jauferet who replaced him upon his sudden death without completing the drafting, or by the Codification Commission.

If the remedy is to be sought from the directors themselves, as directors act on behalf of the company, it would be difficult to enforce claims on behalf of the company.¹⁸⁶ In this case, directors may decline the legitimate claims of a company against third parties due to collusion with outside business partners or in return for some illicit considerations.¹⁸⁷ Consequently, the right to take action on behalf of the company should pass to individual shareholders¹⁸⁸ subject to defined conditions in order to prevent abuse of rights wherever any shareholder deems that the company should be taking legal proceedings against directors or some third party, but neither the board nor the general meeting does so. On the other hand, the OECD Principles incorporate this element under Principle number III.A.2, which reads as:

*"Experience has shown that an important determinant of the degree to which shareholder rights are protected is whether effective methods exist to obtain redress for grievances at a reasonable cost and without excessive delay. The confidence of minority investors is enhanced when the legal system provides mechanisms for minority shareholders to bring lawsuits when they have reasonable grounds to believe that their rights have been violated."*¹⁸⁹

The derivative suit mechanism is provided under the Draft Commercial Code. Accordingly, actions for damages suffered by the company as a result of a tort committed by directors in the performance of their duties shall be instituted in the interest of the company by the board of directors.¹⁹⁰ One or more shareholders may institute action in the interest of the company after serving a formal notice to the board of directors to which they fail to react within a time limit of thirty days. The applicants would have the ability to sue for damages for injury suffered by the company. In the event of a verdict in favor of the Company's claim, damages shall be awarded to the company.¹⁹¹ Thus, the draft Commercial Code is believed to fill the deficiency of the existing Code regarding derivative suit mechanism.

¹⁸⁶ Tom Hadden, Company Law and Capitalism, 2nd Ed. (London: Weidenfeld and Nicholson (1977)), p.277

¹⁸⁷ Ibid

¹⁸⁸ Ibid

¹⁸⁹ Annotations to OECD Principles, p. 41

¹⁹⁰ Draft Com. Code, Art.365 (1).

¹⁹¹ Ibid, Art.365 (2)

Moreover, Art.416 (2-5) of the Com. Code provides for the right of a shareholder to challenge decisions of the General Meeting. In addition, when fundamental changes are made to the objects or nature of the company or the transfer of the head office abroad, minority shareholders are accorded the right to withdraw from the company under Article 463 of the Code. What's more, the "one share one vote" right is provided for in the Com. Code by Articles 345 (3) and 407 (2).

By and large, although the Commercial Code incorporates the aforementioned rights that are believed to minimize minority shareholders' exploitation by managers or block holders, it lacks in other rights such as the right to proxy voting by mail; the derivative suit mechanism, Cumulative voting or proportional representation of minorities on board of directors since Art.352 of the Code is too vague to be applicable. The requirement under Art.401 which obliges shareholders to deposit their shares prior to Shareholders' Meeting also reduces the minority rights protection. Hence, it can be concluded that the law is insufficient in shareholder protection due to the fact that the rights lacking under the Code are the most important ones which can minimize minority shareholder exploitation by managers or block holders. Moreover, the absence of stock markets affects the exit rights of minority shareholders.

3.3.3 Disclosure and Transparency in Corporate Governance

The OECD fifth principle on transparency and disclosure states the following:

*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.*¹⁹²

It has been argued that the lack of transparency arising from inadequate disclosure allowed significant problems to build up in the financial and corporate sectors. For instance, when the financial condition is deteriorated in East Asian countries, the inability of investors and creditors to determine sound financial institutions and corporations due to the lack of transparency resulted in investors being reluctant to hold shares while creditors became reluctant to overturn maturing

¹⁹² OECD Principles of Corporate Governance, (2004), Principle V

short-term debts for fear of an imminent loss.¹⁹³ It was believed that this contributed significantly to the erosion of investor confidence and in part exacerbated the crisis.¹⁹⁴

In relation to the disclosure and transparency requirements, Book 1, Title 3, Chapter 1 of the Commercial Code contains the basic rules relating to accounts record keeping. Under article 63(1), all persons and business organizations carrying on a trade must keep, according to the generally accepted accounting principles, such books and accounts as are required in accordance with business practice and usage, having regard to the nature and importance of the trade carried on. Petty traders' may be exempted from keeping accounts. Article 63(1) is intended to be the basic legal requirement for record keeping by regulated persons. The requirement may be supplemented by other, more detailed requirements applying to particular forms of enterprise, but the basic legal requirement applies to all.

The Code goes on to say that any trader shall keep a book of account where he shall make a daily record of his daily dealings and must, once a month reconcile the proceeds of such dealings[Art.66(2)]. Traders must also prepare, at the end of each financial year, an assets and liabilities account and a profit and loss account [Art. 67(2)]. All books and accounting documents must be preserved for at least ten years [Art.69]. There are no additional rules on accounting record-keeping for joint ventures, partnerships or companies (though there are more detailed requirements concerning the format of company accounts).

Furthermore, in Book 2, title 6, chapter 6 the Code makes the directors of companies responsible for the preparation of financial statements, including consolidated financial statements for group of companies and for ensuring that an audit of the financial statements is conducted regularly.¹⁹⁵ Besides, Article 362 of the Code requires board of directors to keep accounts and books; submit the accounts of the auditors and an annual report of the company's operations including a financial statement to the meetings. Moreover, in book 2, chapter 4, section 2 of the Code deals with duties and responsibilities of Auditors under Articles 368- 387. Specifically, it provides for

¹⁹³ Pik Kun Liew, The (Perceived) Roles of Corporate Governance Reform in Malaysia: The Views of Corporate Practitioners, (University of Essex, WP No. 06-02, April 2006), p.5

¹⁹⁴ Ibid

¹⁹⁵ Com. Code, *supra* note 40, Art.446 and 451

the appointment of auditors (Art.368-371), duties of auditors (Art.374-377), powers of auditors (Art.378-379) and liability of auditors (Art.380). As it is provided under Art.374, auditors have the following duties:

- ⌚ audit the books and securities of the company;
- ⌚ verify the correctness and accuracy of the inventories, balance sheets and profit and loss accounts;
- ⌚ certify that the report of the Board of Directors reflects the correct state of the company's affairs; and
- ⌚ carryout such special duties as may be assigned to them.

The auditors are civilly liable to the company and third parties for any fault in the exercise of their duties which occasioned loss (Art. 380(1)). In addition, an auditor who knowingly gives or confirms an untrue report concerning the position of a company or fails to inform the public prosecutor is criminally liable (Art. 3380(2)).

Nevertheless, the provisions for both preparation and audit of financial statements require improvement. In provisions for preparing financial statements, there is no requirement to comply with accounting standards, and the financial statements required to be produced are only balance sheet and profit and loss account.¹⁹⁶ In provisions for audit, there is no requirement to comply with auditing standards, no specified qualification of auditors,¹⁹⁷ and no audit requirement for private limited companies with 20 or less shareholders. Nonetheless, there are two convincing points calling for audits of all private limited companies. In the first place, the limited liability status granted to a company is meant to be accompanied by a mechanism of assuring the credibility of the financial affairs of the company and such mechanism can only be provided through audit.¹⁹⁸ Secondly, there may be private limited companies which, even though they have less than 20 members, are large enough to be public interest entities. Another area which needs to be reviewed in the Commercial Code is the issuance of shares to the public. Share companies are

¹⁹⁶ In comparison, IFRS require income statement, balance sheet, cash flow statement, and statement of changes in equity or statement of recognized gains and losses.

¹⁹⁷ Qualification would be provided by defining auditors as those holding a practicing license issued in accordance with the country's legislation governing accountancy.

¹⁹⁸ ROSC, supra note 27, P.6

allowed to issue shares to the public, but there is no regulation for the issuance of these shares.¹⁹⁹ Regulating public issue of shares protects the public interest by enabling the detection and rectification of frauds, errors, and omissions before the information goes public.²⁰⁰ Preferably, regulation requirements would include an audit report on the financial information to be included in the prospectus and registration, and approval of the prospectus, with a regulator, before release to the public.²⁰¹

The banking industry is one of the financial sectors which face relatively strict oversight from its regulator, the NBE. The Banking Business proclamation No.592/2008 deals with financial records and external audit inspection under part six, in which it has put additional disclosure requirements on Banks. Accordingly, Article 23 (1) of the Proclamation provides that the NBE may direct banks to prepare financial statements in accordance with the *international financial statements standards*, whether their designation changes or they are replaced, from time to time. The problem in this provision is that '*International Financial Statements Standards*' is not defined, and there are no accountings standards set or adopted in the country. It further states that all banks must keep records as are necessary to: exhibit clearly and correctly the state of its affairs; explain its transactions and financial position; and enable the NBE to determine whether the bank had complied with these requirements (Art.23 (a-c)). For Each type of transactions, all banks must register and keep documents. Article 24 of the Proclamation deals with appointment of external auditors in all banks and that should be approved by the NBE. Pursuant to Article 26 (1) of the Proclamation, the duties of external auditor include to report its audit findings and conclusions, carried out on the basis of international auditing standards, to the shareholders of the bank and the National Bank.

Moreover, Proclamation No.592/2008 deals with disclosure of information and inspection of Banks. Art.28 (1) of the Proclamation provides that "*Every bank shall, within a time period to be determined by the NBE, send to the NBE duly signed financial statements and other reports as prescribed by it.*" Besides, it stipulates in Sub-Art.2 that *every bank shall exhibit at every place of*

¹⁹⁹ Ibid

²⁰⁰ Ibid

²⁰¹ Ibid

*its business, including its branches, in a conspicuous place throughout the year, a copy of the last audited balance sheet and profit and loss account in respect of all of its operations; cause such balance sheet and profit and loss account, together with the notes thereto, to be published in a newspaper of wide circulation. The exhibition and publishing of financial statements must occur within two weeks after the annual shareholders' meeting.*²⁰²

By the same token, Art.15 of Microfinancing Business Proclamation No.626 /2009 provides for the “*Financial Records and Disclosure of Information*”. Accordingly, any Microfinancing Institution must: a) prepare its financial statements in accordance with *acceptable accounting standards*; b) keep such records as are necessary to exhibit clearly and correctly the state of its affairs and to explain its transactions and financial position and to enable the NBE to determine whether the micro financing institution had complied with the provisions of this Proclamation and directives issued by the NBE; and c) register and keep documents for each type of transaction in accordance with directives of the NBE.²⁰³ In addition, any Microfinancing Institution shall: within a time period to be determined by the NBE, submit to it duly signed financial statements and mother reports as prescribed by it; and exhibit at all branches, in a conspicuous place throughout the year, a copy of the last audited balance sheet and profit and loss statement.²⁰⁴ Furthermore, any micro-financing institution shall, where it appears likely that: it cannot meet its obligations to its depositors or other creditors; or it may have to suspend payments to depositors or other creditors; forthwith notify the NBE of the full facts of the situation and also provide such other information as the NBE may request.²⁰⁵

The Microfinancing Business Proclamation provides for the *Appointment of External Auditors* in Art.12 that *every micro-financing institution have to appoint an external auditor* satisfactory to the NBE. Where it is without an external auditor, it must immediately notify such fact to the NBE.²⁰⁶ The duty of an external auditor of a micro financing institution shall be *to report his audit findings and conclusions, carried out on the basis of “accepted auditing standards”, to the*

²⁰² Proclamation No.592/2008, supra note 21, Art.28(3)

²⁰³ Micro-Financing Business Proclamation, 2009, Art.15(1), Proclamation No.626, Fed.Neg.Gaz. 15th Year No.33

²⁰⁴ Ibid Art.15(2)

²⁰⁵ Ibid, Art.15(3)

²⁰⁶ Ibid, Art.12(1)

shareholders of the institution and the NBE. The external auditor shall also be required to submit the management letter to the NBE.²⁰⁷ Nevertheless, “*accepted auditing standards*” is not defined in the Proclamation.

On the other hand, Auditors for insurance companies are not subjected to any additional requirements other than the provisions of the Commercial Code. The Proclamation for Licensing and Supervision of Insurance Businesses No.86/1994 states that the balance sheet, profit and loss account and revenue account of every insurer shall be audited annually by an auditor; and the auditors for insurance companies shall have powers, functions, and duties; and be subject to liabilities and penalties under the Commercial Code.²⁰⁸ There are no other regulations for auditors of insurance companies. Furthermore, there is no accounting and auditing standards set in Ethiopia.²⁰⁹ For accounting standards, there is no law or regulation that has set or requires accounting standards in preparation of financial statements. Some laws require generally accepted accounting principles (GAAP) to be applied or Accepted Accounting and Auditing Standards (AAS).²¹⁰ However, in all cases, GAAP and AAS are not defined. Even though OFAG (Office of the Federal Auditor General), in 2003, directed all auditors to conduct audits in compliance with ISA (International Standards on Auditing), for auditing standards, the directive met resistance from auditors on the argument that it is impossible to apply ISA in the absence of accounting standards, as a result of which the directive was subsequently withdrawn.²¹¹ There are no set penalties for noncompliance with the requirements on accounting and financial reporting. In the Commercial Code, there are no penalties for noncompliance with provisions for keeping accounting records, preparing financial statements, or filing and publication of the financial statements. Similarly, the laws and directives

²⁰⁷ Ibid Art.13(1)

²⁰⁸ Licensing and Supervision of Insurance Business Proclamation, 1994, Art.18 Proclamation No.86 Ne.Gaz, No.46

²⁰⁹ Ethiopia – Accounting and Auditing ROSC, supra note 27, p.6

²¹⁰ For instance, Public Enterprises Proclamation 25/1992, Art.27 requires state-owned enterprises to keep books of accounts following generally accepted accounting principles (GAAP), and proclamation No.626/2009, Art.12 requires micro financing institutions to keep books of accounts following Accepted Accounting Standards.

²¹¹ Ethiopia – Accounting and Auditing ROSC, supra note 27

of insurance companies and state-owned enterprises have no penalties for noncompliance with accounting and other annual financial reporting requirements.²¹²

3.4 Deficiencies of the Existing Legal framework

Although the Commercial Code and other relevant laws provide for the formal structure of corporate governance, they do not address issues in governance of share companies sufficiently. Some of the main deficiencies discovered during the analysis of relevant provisions of the Code and other laws with respect to basic issues in corporate governance are summarized below:

3.4.1 Board of Directors' Issues:

- The Code does not specify the structure of the board to be either unitary or dual;
- Although non-executive directors play a significant role in providing independent and objective guidance and direction of management and company, the Code and other relevant laws do not require companies to have independent non-executive directors and do not distinguish the roles of the board from that of the management. Similarly, the draft version of the Code does not provide for the non-executive and independent directors. Besides, it does not define independence of board of directors.
- The Code does not prescribe any formal qualifications for directors of companies as a result of which even incompetent and mediocre persons can become member of boards of directors;
- It does not provide for separation of the roles of the CEO and board Chairperson;
- The Code and other relevant laws do not require companies to have different board committees. Although many committees on corporate governance have recommended in one voice the appointment of special committees for nomination, remuneration and auditing,²¹³ the existing legal framework, the draft Commercial Code as well as the recommendations given by the group of "Fourteen National Experts" on the draft version

²¹² Id, p.13

²¹³ Fernando, supra note 45, p.24

of the Code do not raise the issue of importance of such committees in the context of Ethiopian share companies.

- The existing legal framework does not clearly address issues related to directors' remuneration such as transparency, pay for performance and process for determination. Furthermore, the Code and its draft version do not define what constitutes "statutory dividend" as well as "a sum representing 5% of the paid up value of shares which have not been redeemed" and to whom should it be paid. In addition, the amount of remuneration of bank's board of directors set by Directives No.SBB/49/2011 is criticized for not consulting global best experiences and its failure to align the interests of directors with those of the stakeholders, and for not taking into account risks and liabilities involved there and the impact of ineffective compensation on the independence of the board from the management.

3.4.2 Protection of Minority Shareholders

In relation to the Rights of Shareholders, the Code lacks in rights such as:

- the right to proxy voting by mail;
- the derivative suit mechanism;
- cumulative voting or proportional representation of minorities on board of directors since Art.352 is too vague to be applicable in the context of diffused share ownership.
- The requirement under Art.401 of the Code which obliges shareholders to deposit their shares prior to Shareholders' Meeting also reduces minority rights protection.
- strong exit rights and voice rights due to the absence of institutions such as stock markets, which play disciplinary roles against misbehaving management and/or block holders.
- Hence, it can be concluded that the law is insufficient in shareholder protection due to the fact that the protections lacking under the Code are the most important ones that can lessen minority shareholder exploitation by managers and/or block holders.

3.4.3 Disclosure and Transparency:

- In provisions for preparation of financial statements of the Code, there is no requirement to comply with accounting standards, and the financial statements required to be produced are only balance sheet and profit and loss accounts.
- In the provisions relating to audit, there is no requirement to comply with auditing standards, no specified qualification of auditors, and no audit requirement for private limited companies with 20 or less shareholders;
- There is no accounting and auditing standards set in Ethiopia. For accounting standards, there is no law or regulation that has set accounting standards in preparation of financial statements. Even in the laws that require accounting standards in preparation of financial statements, such as *accepted accounting principles (GAAP)* in Proclamation No.25/1992, '*International Financial Statements Standards*' in Proclamation No.592/2008, and '*Accepted Accounting and Auditing Standards*' in proclamation No.626/2009, there is no definition as to what constitutes such standards in these laws.
- There are no set penalties for noncompliance with the requirements on accounting and financial reporting in the Commercial Code. In the Code, there are no penalties for noncompliance with provisions for keeping accounting records, preparing financial statements, or filing and publication of the financial statements.
- Enforcement mechanisms of financial reporting requirements are weak because of lack of capacity in regulatory institutions and the absence of penalties in some laws.

CHAPTER FOUR

REFORMING CORPORATE GOVERNANCE IN ETHIOPIA: WHAT SHOULD THE FUTURE LOOK LIKE?

4.1 Conclusions

Nowadays, good corporate governance becomes an essential precondition for promoting economic growth and reducing poverty. Particularly, good corporate governance is critical to boost investors' confidence, expand the private sector, and stimulate economic growth.¹ On the other hand, in many developing countries, especially in Africa, heightened recognition of lost opportunities to mobilize financial resources on domestic and international capital markets through good corporate governance excited the interest of African Heads of States including Ethiopia, which inspired them to include corporate governance as one of the four thematic areas subject to review under the African Peer Review Mechanism (the APRM).²

As a public policy issue, corporate governance was originated in the classic work by Adolf Berle and Gardiner Means entitled "*The Modern Corporation and Private Property*" in 1932.³ Berle and Means pointed to the increasing dispersion of corporate shares among a growing number of persons, who, because they were numerous, widely scattered and had relatively small interests were not able to exercise control over the company they owned.⁴ According to their view, the total separation between ownership and control creates agency cost, i.e., a risk of the agent (managers) working for their own interest at the expense of the principal's (shareholders).⁵

¹ Seward Montgomery Cooper, "Corporate Governance In Developing Countries: Shortcomings, Challenges & Impact on Credit", *Modern Law for Global Commerce*, (9-12 July 2007), p.1

² The APRM is a unique mechanism under which 26 African leaders, including Ethiopia, have agreed to submit their respective countries and themselves to review introspectively by their compatriots and review Africa-wide by their peers in selected areas of governance. The selected areas are (i) political governance and democracy, (ii) economic governance and management, (iii) socio-economic development, and (iv) corporate governance. See Ibid

³ See Adolf Berle, Jr. and Gardner C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932).

⁴ Ibid

⁵ Ibid

Western countries have been addressing agency problems prevalent in modern publicly held companies through different mechanisms. While continental European countries devised dual board structure in companies where minority shareholders and other stakeholders could be represented in the supervisory board, common law countries, notably UK and USA on the other hand, have been addressing the problem by requiring sufficient disclosure on the affairs of companies and by infusing independent outside directors in unitary board of directors who have little or no conflict of interests with the management to alleviate agency cost problem by superintending the managers and block holders in the best interests of shareholders and the company.⁶ Furthermore, these countries (UK and USA) empowered minority shareholders to initiate derivative suits against a felonious board of directors or its members.⁷ Besides, the existence of stock market serves as a disciplining instrument not only through its regulatory role, but also indirectly by facilitating exit for minority shareholders from underperforming or oppressing companies.⁸ In addition, in economically advanced countries market disciplines corporate managers through mechanisms such as hostile takeovers for corporate control.

In Ethiopia, due to the current booming of share companies with thousands of shareholders, ownership is being separated from control of dispersed shareholders and seems to have gone or has gone into the hands of few managers. Given this prevalent situation, there is a need to be cautious that shareholders may be subjected to exploitation in the hands of corporate managers or block-holders.⁹ To address such a fear, appropriate laws and institutions are necessary.

However, the legal framework pertinent to corporate governance, including provisions of Commercial Code as well as other relevant laws, is found to be inadequate to protect the interest of shareholders from undue exploitation of managers and/or block holders in the context of modern share companies. Besides, a closer look at of the pertinent provisions of the Revised Draft Commercial Code shows that the revision process didn't address critical issues in corporate governance. For instance, issues related to board of directors such as: responsibilities of directors as distinguished from that of the management, access to information, election criteria,

⁶ Jeswald W. Salacuse, *Corporate Governance in the UNECE Region*, Paper commissioned for the Economic Survey of Europe, 2003 No. 1 by the secretariat of the United Nations Economic Commission for Europe, UN/ECE, Geneva, (December 2002), p.48

⁷ Rafael La Porta et. al., "Law and Finance," (2000), *Journal of Political Economy* 106, 1113-1142, p.24

⁸ Ibid

⁹ Berle and Means, Supra note 3

composition, independence, separation of roles of chairman and CEO, board committees (e.g., audit committee, nomination committee, and remuneration committee) are not well considered. Besides, the law under review is insufficient in shareholder protection due to the fact that the protections lacking under the Code are the most important ones that can minimize minority shareholder exploitation by managers and/or block-holders. In this regard, the Code and other relevant laws lacks in rights such as: the right to proxy voting by mail; the derivative suit mechanism; cumulative voting or proportional representation of minorities on board of directors since Art.352 of the Code is too vague to be applicable in the context of dispersed shareholders. In addition, the requirement under Art.401 of the Code which obliges shareholders to deposit their shares prior to shareholders' meeting reduces minority rights protection. As far as issues regarding financial reporting, transparency and audit are concerned, there is no requirement for compliance with accounting and auditing standards both in the Commercial Code and other laws for financial share companies. Some laws require compliance with generally accepted accounting principles and generally accepted auditing standards, but these terms are not defined.

These facts, therefore, expose the urgency of carefully and promptly re-designing the law with a view to protecting shareholders' interests and thereby create a favorable condition for the flow of capital by boosting the confidence of investors. To address the existing and potential problems, the government is expected to introduce appropriate laws and institutions, for instance, as is recommended in the coming sections.

As far as share companies engaged in financial services are concerned, even though the strict regulatory situation under Proclamation 592/2008 and Directives of the NBE within which financial companies operate brings their managers and block holders under a strict control of the NBE, that does not seem to be sufficient to address all issues in corporate governance. It is true that financial regulation is just one aspect of corporate governance. But it does not give adequate answer to issues such as problems that minority investors may face in share companies. As can be evidenced from Articles 12-17 of Proc No.592/2008 and NBE Directives, the objective of the NBE is mainly protection of depositors, the maintenance of a sound monetary system and maintaining a healthy financial industry than specific issues in corporate governance. This is why the NBE is given power to dismiss or suspend the board of directors or take other stiff measures like limiting remuneration of directors below the amount set in the Commercial Code without the

request of shareholders of such companies. Accordingly, the conclusions and recommendations in this thesis as regards core issues in corporate governance related to board of directors, protection of minority shareholders and disclosure and transparency should also be applicable for financial share companies.

In the coming sections, the paper tries to address questions such as how corporate governance laws and institutions should be introduced; what type of principles and practices should be adopted and which approach of corporate governance (i.e., non-regulatory or regulatory) would better achieve the purposes of protecting the interests of shareholders in particular and stakeholders in general, in the Ethiopian context.

4.2 Recommendations

4.2.1 Development Policy Considerations for Corporate Governance in Ethiopia

In Ethiopia, the corporate governance reform should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities. Moreover, corporate governance law reform should consider key development policy aspects which match with the country's plans for poverty reduction and wealth creation.¹⁰ In other words, the corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets.¹¹ Hence, the need to adopt best corporate governance principles and practices should also target the creation of vibrant share companies that would undertake corporate social responsibilities and would act as active and integrated partners in the national development objectives of the country. Moreover, in preserving a company's sustainability, Board of Directors should be able to ensure the fulfillment of the company's

¹⁰ Dr. Gabor Bruszt and Zekrie Negatu, Draft Project Document for Development of Corporate Governance in Ethiopia, AACCSA, (June 2009), p.19 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.

¹¹ OECD Principles of Corporate Governance, (2004), principle I.A

social responsibility. To achieve these objectives, Board of Directors should have a clear and focused written planning in meeting the company's social responsibility.¹²

4.2.2 Approaches to Reform Corporate Governance in Ethiopia

4.2.2.1 Shareholder vs. Stakeholder Models of Corporate Governance

Ethiopia should carefully and critically examine the entire experience of both the North America and the Western Europe with a view to look for principles to be adapted to its local needs. Rather than leap to a shareholder or stakeholder model or hastily choosing a unitary or two-level board structure, the country needs to determine the system of corporate governance most appropriate to her own individual needs and circumstances. Organizations and individuals from western developed countries inevitably press for the adoption by transition economies of "best practices" in corporate governance, best practices that have invariably originated in their own home countries.¹³ Those best practices are of course the product of specific national experiences and cultures, factors that may make their adoption by a given transition economy like Ethiopia would make inappropriate or at least difficult without significant adaptation. In evaluating foreign models of corporate governance, policy makers in Ethiopia have to remember that to a large extent, western corporate governance systems have evolved through time and as a response to periodic, specific financial crisis in individual countries.¹⁴

The best approach believed to fit the reality of Ethiopia is, therefore, to selectively adapt/adopt the best experiences from both Anglo American and European Civil Law systems of corporate governance. This is true because of two reasons. In the first place, nowadays, different corporate governance systems are converging to a greater extent.¹⁵ It is noted that a point of convergence between the bare shareholder model advanced by Americans and the extreme stakeholder model advocated by Europeans, may reside in the notion of "*socially responsible corporate governance*," which look for possibility of combining '*corporate good governance*' and '*corporate social responsibility*'.¹⁶ In the second place, some scholars have determinedly advised the transition economies like Ethiopia that:

¹² See for instance, Indonesia's Code of Good Corporate Governance, National Committee on Governance, (2006)

¹³ Salacuse, *supra* note 6, p.52

¹⁴ Ibid

¹⁵ Ibid

¹⁶ Ibid

*Merely transplanting laws and institutions is difficult for the reason that there are new conditions and many cultural differences in one hand and to develop entirely new institutions would be an unpredictable adventure for transition economies, on the other.*¹⁷

Therefore, Ethiopia should carefully adapt experiences of both models of corporate governance to her local circumstances rather than waste its time and resources to develop entirely new institutions of corporate governance. This would inevitably lead to combine the concepts of “good corporate governance” and “corporate social responsibility.” Doing so will not be a difficult task as the Commercial Code of Ethiopia is eclectic from its very beginning. To this end, in the *Exposé des Motifs* of the Commercial Code of Ethiopia, professor Escarra explains the selection of best foreign laws while he was drafting the share company’s part of the Code:

*“[T]he goal to attain is to encourage one day investment of Ethiopian savings in large broad based enterprises [...] This is why, without taking into account the so called preference to be given to this or that model in the Continental or the Anglo American legal system, I had always in mind the interest of Ethiopia and I have selected the solutions which I believe to be the best no matter where they come from, on condition that they may be applied to Ethiopian conditions, if not immediately, at least within a reasonable time.”*¹⁸

As can be inferred from this assertion, Professor Escarra has selected rules which he believes to be best to satisfy the interest of Ethiopia without taking account of the preference to different models in the Continental or the Anglo American legal system. By the same token, the approach to be followed in the process of reforming corporate governance of share companies in Ethiopia should be similar to the one followed by Professor Escarra. As long as the principles of corporate governance adapted in the country entail the desired change, it does not matter where they come from. In this manner, both the existing systems of corporate governance can be strengthened and new mechanisms can be introduced.

4.2.2.2 Voluntary vs. Mandatory Approaches to Corporate Governance

There are two basic approaches to assure managerial devotion to the interests of a company and its shareholders, which are classified as mandatory and voluntary approaches. The mandatory approach relies upon formal rules and institutions backed by the coercive power of the state’s

¹⁷ Id, p. 54 and A. C. Fernando “Corporate Governance: Principles, Policies, and Practices.” (Pearson Education, 2006), p.490

¹⁸ Peter Winship, Commercial Code of Ethiopia (1960) Book II. Expose Des Motifs. (Addis Ababa, HSIU, Faculty of Law, 1970), p.5

legal system.¹⁹ On the other hand, the voluntary approach emphasizes the market mechanism and contractual arrangements such as incentive compensation schemes involving stock and stock options, and efficient capital markets, as means for inducing desired management behavior.²⁰ Although both approaches are needed to achieve optimal systems of corporate governance, an important question for policy makers is what the appropriate balance is.²¹ The voluntary approach had many advocates and even seemed to be in the dominance until the recent financial scandals and their negative impact on securities markets.²²

The Draft Project Document for Corporate Governance in Ethiopia has suggested for adoption of voluntary National Code of Corporate Governance with which companies will be expected to “comply or Explain” i.e., prove and report full compliance with the National Code or explain deviation from it.²³ The project document does not, however, provide a justification why this model is preferred in the context of Ethiopia. The Voluntary Code of Corporate Governance for Ethiopia is adopted in June 3, 2011 under the auspices of Addis Ababa Chamber of Commerce and Sectoral Association (AACCSA). The adoption of the Code, without doubt, can be taken as a good step in the right direction as it introduces standards of good corporate governance in Ethiopia in a detailed and comprehensive manner. It can be a point of reference to companies which are ready to adopt and apply the principles and practices contained in the Code voluntarily. The Code has adapted best principles and practices regarding composition, independence, board committees and other various issues in corporate governance.

Nevertheless, this writer contends that voluntary approach of corporate governance cannot be an appropriate mechanism to control corporate frauds that could occur in the context of booming share companies in Ethiopia. This is not without reason(s). First of all, voluntary code of corporate governance has been adopted in countries where market plays a strong disciplinary role for companies that fail to apply good corporate governance principles voluntarily. For instance, the basic concept of the Australia’s voluntary code is that the market can come to its

¹⁹ Salacuse, supra note 6, p.14

²⁰ Ralph K Winter, “State Law, Shareholder Protection, and the Theory of the Corporation,” *Journal of Legal Studies* 6, 251 (1977); Michael C. Jensen and William H. Meckling, “The Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,” *Journal of Financial Economics* 3, 305 (1976); Henry G. Manne, “Mergers and the Market for Corporate Control,” *Journal of Political Economy* 73, 110 (1965). [As cited in Ibid]

²¹ Salacuse, Supra note 6, p.14

²² Ibid

²³ G. Bruszt and Zekrie N., supra note 10.

own conclusions about the significance of non-compliance based on the circumstances of individual companies.²⁴

In Ethiopia, the disciplinary role of the market is insignificant as the number and sizes of companies are very small. There is also weak culture of competition in the country amongst business community in general and companies in particular. Furthermore, Ethiopian companies do not seem to apply good principles and best practices of corporate governance voluntarily. For instance, share companies engaged in banking business, which are facing strict regulation from the NBE, are not free from frauds as evidenced by their former top executives being criminally prosecuted.²⁵ This shows that the country couldn't control frauds in share companies even where there is a clear mandatory law, let alone a soft law. Therefore, both weak market and conduct of Ethiopia's companies point to the difficulty of applying voluntary laws and ensuring good corporate governance through such laws in the country.

Furthermore, the experience of other countries which have adopted voluntary codes of corporate governance earlier supports the argument that voluntary codes cannot prevent companies from misbehaving and going bankrupt. For example, in the USA, huge companies such as Enron, WorldCom and Tyco International were collapsed in 2002 while they were applying the voluntary system of corporate governance.²⁶ As a result, the American Congress had to adopt a mandatory code of corporate governance that culminated in the Sarbanes-Oxley Act of 2002, which is known as the Public Company Accounting Reform and Investor Protection Act of 2002.²⁷ Accordingly, publicly held companies must meet all requirements contained in the Act,

²⁴ ASX Corporate Governance Council, Corporate Governance Principles Recommendations, (August 2007) <http://www.asx.com.au/supervision/pdf/corp_governance_principles_recommendations_2nd_edition.pdf> Visited on 11 April 2011

²⁵ For instance, on May 6, 2011 witnesses testified against Awash International Bank's Leikun Brehanu, former president, and nine other former employees who had been brought up on charges of mishandling letters of credit and approving a little over 6.1 million dollars in credit outside of the bank's foreign currency procedures. See Addis fortune, volume 12 No.575, May 8, 2011

²⁶ Paul S. Atkins, 'The Sarbanes-Oxley Act of 2002: Goals, Content, and Status of Implementation' (2003) <<http://www.sec.gov/news/speech/spch032503psa.htm>> at 20 March 2011. This is considered as a foundation tale for the new era of corporate governance.

²⁷ Larry E. Ribstein, 'Market vs. Regulatory to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002' (2002) 28(1) *Journal of Company Law* 3

which prescribes formal rules and institutions backed by penalties imposed on companies that fail to comply with the legal rule in the Act.²⁸

The proponents of this system argue that:

*"The world needs a strict corporate governance regime, which is able to eliminate fraud, corruption and other misdeeds and practices; soft law and requiring a company to hire a number of non-executive directors, for instance, would not prevent corporate failures as evidenced from the experience of Enron and WorldCom, though these companies had non-executive directors; they were unable to prevent these companies from falling into bankruptcy."*²⁹

From a practical point of view, the Sarbanes Oxley Act of 2002 is a product of the "law matters" thesis, which essentially contends that law is important to protect shareholders, especially minority shareholders, from insider expropriation.³⁰ The critical goal of the "law matters" thesis is to promote capital markets and economic growth, which can be achieved by upholding shareholders' property rights.³¹

By the same token, there is no convincing reason and circumstance to adopt the voluntary code of corporate governance, which is proved to be failed mechanism even in countries where market plays crucial disciplinary roles. Therefore, the appropriate approach of corporate governance to be adopted in Ethiopia should be the mandatory approach. In other words, the government has to adopt principles and practices of good corporate governance in a mandatory legislation which binds all companies and appropriate penalties should be imposed on those that fail to comply with the rules in the law. Let me conclude this part by borrowing the words of Paredes (2005) in which he stated:

*If the goal is to protect shareholder interests from the abuses and mismanagement of directors and officers, and similarly to protect minority shareholders from the opportunism of controlling shareholders, developing countries generally should turn to a mandatory model of corporate law instead of a market-oriented corporate governance system.*³²

²⁸ Anita I. Anand, 'Voluntary vs. Mandatory Corporate Governance: Towards and Optimal Regulatory Framework' (2005) press Legal Series. Working Paper 5664

²⁹ Atkins, *supra* note 26

³⁰ Troy A. Paredes, 'A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law isn't the Answer' (2004) 45 *William and Marry Law Review* 1057

³¹ *Ibid*

³² Troy A. Paredes, Corporate Governance and Economic Development, (Washington University, 2005), p.1

The other related issue here is whether it is necessary to overhaul the Commercial Code with the view to incorporate best principles and practices of good corporate governance, carefully and selectively in the forthcoming Revised Commercial Code or enact independent corporate governance legislation. In this respect, it is possible to follow either of the two approaches since it is feasible to realize the expected objectives alike if similar principles and rules are to be adopted likely in either Commercial Code or independent corporate governance legislation. As the Commercial Code is under the process of revision currently, it seems cost efficient to incorporate such principles together with appropriate penalties to be imposed on companies that fail to comply with the law in the forthcoming Revised Commercial Code.

Moreover, the following important factors should be considered in the process of reforming corporate governance laws in Ethiopia. Firstly, it should take into consideration the possibility of capital market development in the country with a future stock exchange and a broader category of corporate financial instruments; and secondly it should realize that such law is a dynamic concept which need to change and develop in tandem with changes in the Ethiopian business environment and in accordance with experiences and evaluations of its practice.³³

Therefore, provisions pertinent to corporate governance in the Commercial Code must be overhauled and must include the best principles and practices together with appropriate penalties for the failure to comply. With a view to indicate what the content of the law regarding core issues in corporate governance should look like, the following recommendations are suggested. It will be tried to selectively adopt/adapt principles and practices of good corporate governance from different documents and literatures such as OECD principles, BIS-Principles for Enhancing Corporate Governance, Codes of corporate best practices such as UK Combined Code as well as Recommendations of different Committees such as SEBI. However, the writer doesn't want to claim that these recommendations are the only options. As there are rich experiences and documents in relation to the subject matter, the legislator may conduct further research and adopt/adapt rules from other sources and experiences as it thinks fit for Ethiopia.

³³ See also B. Gabor and Zekrie N., Supra note 10

4.2.3 Recommendations on Specific Issues in Corporate Governance

4.2.3.1 Board of Directors

Board of directors' reform should be at the heart of corporate governance in the Ethiopian company law particularly in relation to the following issues.

A. Structure

It has been suggested that as both unitary and dual board structures have their own specific advantages and disadvantages, they might be appropriate in particular circumstances and that good corporate governance structures can be created in both board systems.³⁴ However, it is advisable to adopt one of the two systems in the forthcoming Revised Commercial Code. For example, if we choose two-tier board structure, which is common in the continental law legal systems such as Germany,³⁵ it is possible to divide the board of directors into executive and supervisory and then assign independent directors in the supervisory board to efficiently supervise executive directors. Such supervisory board would be distinct from the executive board. What the two-tiered system does is to separate the managerial and supervisory functions, usually combined within the unitary board system, into two distinct organs. The existence of a separate supervisory board serves to increase the independence of non-executive directors and to give them extra power in acting as a supervisory body over corporate managers.³⁶ In the dispersed ownership model this seems to work much better if it is associated with the cumulative voting system.³⁷ In order to prevent the influence of managers or block-holders in the selection of directors, cumulative voting should be used to allow minorities to put their representatives in the supervisory board.

B. Responsibility of the Board

As in the OECD Principles³⁸, the responsibility of the board should be clearly defined to include the following key functions:

³⁴ Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, Brussels, (4 November 2002), p.60

³⁵ Salacuse, *supra* note 6, p.37

³⁶ *Ibid*, p.38

³⁷ See for instance the practice in Germany and Japan, in Yoshimichi Hiraide (1998), *The Structure of Company Management and Shareholder Control in Japan*, in Barry A.K. Rider, et al, (editors), *Commercial Law in a Global Context: Some Perspectives in Anglo-Japanese Law* (Kluwer Law International, London), p.153.

³⁸ OECD principles, *supra* note 11, principle VI.D

- reviewing and guiding corporate strategy, risk policy, annual budget and business plans, setting performance objectives, monitoring corporate performance and overseeing major capital expenditures and acquisitions;
- selecting, compensating and monitoring key executives;
- reviewing key executive and board remuneration;
- monitoring and managing potential conflicts of interest of management, board members and shareholders;
- ensuring the integrity of corporation's accounting and financial reporting systems;
- monitoring the effectiveness of the governance practices; and
- overseeing the process of disclosure and communications.

Therefore, the powers of board of directors under Art.363 of the Commercial Code should be reformulated taking the above listed points into consideration.

C. Accountability to Shareholders/ Stakeholders

The board should be accountable to the shareholders of the company, but not necessarily to the stakeholders' context.³⁹ The company should, however, respect its contractual obligations to stakeholders, such as, employees, creditors, suppliers, customers, environmental impact of the operations of the company, etc.⁴⁰

D. Access to Information

In order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information.⁴¹ Management should provide timely, accurate, substantive and material information, including financial matters and exceptions, to the board and board committees.⁴² The board meeting should be conducted properly with clearly laid down agenda for discussion, which should be circulated well in advance and supported by substantive information. The minutes of the board meeting should be circulated well in advance of the next board meeting.⁴³

³⁹ Annotation to OECD Principles, supra note 11, principle VI.A and VI.C and SEBI, infra note 42, Sec 6.2

⁴⁰ Ibid

⁴¹ OECD principles, supra note 11, principle VI.F

⁴² Securities and Exchange Board of India (SEBI): *Report of the Kumar Mangalam Birla Committee on Corporate Governance*, Final Report: India, (March 2000), sec 13.2 Available at <http://www.sebi.gov.in/commreport/corpgov.html> [Last visited on 24 May, 2011].

⁴³ Ibid

E. Election

Independent and non-executive directors should be appointed on the board based on the recommendations of a nomination committee comprising of the independent directors of the board. The nomination committee should adopt clear and transparent criteria for selection of independent board members. The criteria for choosing non-executive directors should be disclosed in the Annual Report.⁴⁴ Hence, Art.350 of the Com. Code should be reconsidered accordingly.

F. Composition

The board should have core group of excellent, professionally qualified non-executive directors who understand their dual role of appreciating the issues put forward by management, and of honestly discharging their fiduciary responsibilities towards the company's shareholders as well as creditors. The board should be suitably composed of non-executive and truly independent members, who should be professionally competent. It is important to have high proportion of non-executive independent directors.⁴⁵ Hence, Art.347 of the Com. Code should be revised in this manner.

G. Independence

In order to exercise its duties of monitoring managerial performance, preventing conflicts of interest and balancing competing demands on the company, it is essential that the board is able to exercise objective judgment.⁴⁶ A majority of non-executive directors should be independent of management and free from any business or other relationship that could interfere with their independent judgment.⁴⁷ Independence of directors should be defined as: "Independent directors are directors who apart from receiving director's remuneration do not have any other material pecuniary relationship or transactions with the company, its promoters, its management, or its subsidiaries, which in the judgment of the board may affect their independence of judgment."

⁴⁴ OECD principles, supra note 11, principle VI.D.5 and The Combined Code, sec A.5 & A.7

⁴⁵ Advisory Group On Corporate Governance In India, Corporate Governance In India: Current Status, & Recommendations, Annexure – I, available at <http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/20024.pdf> visited on February 23, 2011

⁴⁶ Annotation to OECD Principles, supra note 38, part VI.E

⁴⁷ The Combined Code, section A.3.2

Moreover, all pecuniary relationships or transactions of the non-executive directors should be disclosed in the annual report.⁴⁸

Hence, a provision dealing with independence of board of directors should be included in the forthcoming Revised Com. Code as is stated above.

H. Orientation & Training

Only experts, such as those having financial, technical or legal knowledge or specialization in the area of operations of the company, should be appointed to the board. However, some training on board practices should be imparted to the elected members at the cost of the company. For this purpose, an Institute of Directors may be set up.⁴⁹

I. Chairman and CEO

Chairman's role should be different from that of the chief executive officer.⁵⁰ Separation of the two posts may be regarded as good practice, as it can help to achieve an appropriate balance of power, increase accountability and improve the board's capacity for decision making independent of management.⁵¹ A non-executive Chairman should be entitled to maintain a Chairman's office at the company's expense and also be allowed reimbursement of expenses incurred in performance of his duties to enable him to discharge the responsibilities effectively.⁵²

J. Board Committees

The following special board committees should be required to be established and undertake the following activities, in the forthcoming Commercial Code.

i. Audit Committee

All types of companies need to ensure that audit committee of the board is established and functions effectively and independently. The audit committee of share companies should provide oversight of the company's internal and external auditors, approving their appointment and dismissal, reviewing and approving audit scope and frequency, receiving their reports and ensuring that management is taking appropriate corrective actions in a timely manner.⁵³ The

⁴⁸ SEBI, supra note 42, section 6.5

⁴⁹ Advisory Group On Corporate Governance in India, supra note 45

⁵⁰ SEBI, supra note 42, section 8

⁵¹ Annotation to OECD Principles, supra note 11, principle VI.E

⁵² SEBI, supra note 42, sec 8

⁵³ Basel Committee on Banking Supervision, Principles for Enhancing Corporate Governance, Bank for International Settlements Communications CH-4002 Basel, Switzerland, October 2010, para. 50 & 51

audit committee should have minimum of three members, all being non-executive directors, with the majority being independent, and with at least one director having financial and accounting knowledge.⁵⁴

As Audit Committee acts as the bridge between the board, the external auditors and internal auditors, its role should include the following:⁵⁵

- ✓ Oversight of company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.
- ✓ Recommending the appointment and removal of external auditor, fixation of audit fee and also approval of payment for any other services.
- ✓ Reviewing with the management the annual financial statements before submission to the board, focusing primarily on any changes in accounting policies and practices, major accounting entries based on exercise of judgment by management, qualifications in draft audit report, significant adjustments arising out of audit, the going concern assumptions, compliance with accounting standards, compliance with stock exchange and legal requirements concerning financial statement, any related party transactions of the company of material nature, with promoters or the management, their subsidiaries or relatives etc. that may have potential conflict with the interests of the company at large.
- ✓ Reviewing adequacy of internal control systems and functions;
- ✓ Reviewing the company's financial and risk management policies;
- ✓ Looking into the reasons for substantial defaults in the payments to depositors, debenture holders, shareholders, and creditors; and
- ✓ Reviewing/looking into the matters where there is a suspected fraud or irregularity or a failure of internal control system of material nature and reporting the matter to the board.

ii. Nomination Committee

Boards of share companies should set up nomination committees consisting of at least three independent board members. The nomination committee should have the responsibility of proposing new nominees for the board and assessing directors on an ongoing basis. Such a review should be conducted on an annual basis so that boards are operated by persons with the appropriate skills and experience.⁵⁶

iii. Remuneration Committee

The boards should be required to form remuneration committees. Remuneration committee should be made up exclusively of nonexecutive independent directors who make

⁵⁴ SEBI, supra note 42, sec 9

⁵⁵ Ibid

⁵⁶ See the Combined Code and BIS, supra note 42; Advisory Group on CG in India, supra note 45

recommendations on the company's framework of remuneration for the full time directors and senior employees of the company.⁵⁷ The committee should operate independently from managerial interference and from any intrusive business relationship; they should be granted full authority to seek counsel from both inside and outside sources.⁵⁸

K. Board Meetings

The board should meet regularly and have a formal schedule of matters specifically reserved to it for decision.⁵⁹ The board meetings should be held at least four times in a year, with a maximum time gap of four months between any two meetings.⁶⁰

L. Liability

In the Commercial Code, there is a possibility of piercing corporate veil in which directors and other officers of company will be civilly liable to the claims of third party creditors; especially where the asset of the company becomes insufficient to satisfy its liabilities.⁶¹ This provision tends to make directors liable even where they are not at fault due to mere fact of insufficiency of company's assets to meet its liabilities. However, the liability of non-executive directors should be limited. They should not be held responsible for matters that are not disclosed to the board by the executive directors or by the management. The main responsibility and liability thereof in respect of all statutory compliances should solely rest with the CEO/general manager.⁶² Therefore, Art.366 of the Code should be amended in such a way that directors shall be liable to a company's creditors only where they have acted beyond the scope of their power and have committed an act which is not likely to relate to the performance of their duties.

M. Disclosure of Director Biographical Information

The necessary biographical details of directors should be provided in the Annual Report. The details should also contain pecuniary and/or family relationships, if any, of the directors with the company and its management. All such details should be given to the shareholders when a new director is being elected by them at the general meeting of shareholders.⁶³

⁵⁷ The Combined Code (2000), section B.2.2

⁵⁸ Ibid

⁵⁹ Ibid

⁶⁰ SEBI, supra note 42, sec 11.2

⁶¹ Com. Code of Ethiopia, 1960, Art.366

⁶² Advisory Group On CG In India, supra note 45

⁶³ Ibid

N. Remuneration

Although the Commercial Code provides for directors remuneration under Art.353, there are controversies surrounding its application partly due to the vagueness of the provisions and strict regulation of the NBE, in which it has limited the maximum amount of remuneration to be paid to directors of bank's to 50, 000 birr per annum by the regulation it has issued recently. This has been criticized for being too low amount which does not take into account several factors such as the workload, which involves meetings and committee work, and the risk involved in being a director and international standards into consideration. Therefore, the following issues regarding remuneration of directors should be taken notice of.

a) Amount of Remuneration

Directors' remuneration should be incentive-oriented for company and individual best director performance and be so designed as to align directors' interests with those of shareholders; but a company should avoid paying excessive amount which goes beyond the achievement of this purpose.⁶⁴ The remuneration packages for executive directors should be determined by the remuneration committee.⁶⁵

b) Procedure for Determining Remuneration

The remuneration committee should follow a clearly laid down and transparent procedure for determining remuneration of the board. The remuneration committee should take care to position the company among others in the industry so as not to overpay directors when no proportionate improvement in performance may be possible. Criteria such as performance and the company's position among companies in the same or similar industry should factor into the determination of all incentive schemes.⁶⁶

c) Disclosure of Remuneration

The remuneration packages of all directors should be disclosed in the annual report. The disclosures regarding all elements of remuneration package of all the directors, i.e. salary, benefits, bonuses, stock options, pension etc. should be made to the shareholders.⁶⁷

⁶⁴ The Combined Code (2003), Section B.1

⁶⁵ SEBI, supra note 42

⁶⁶ The Combined Code (2003), Section B.2

⁶⁷ SEBI, supra note 42, section 10.8

d) Shareholder Involvement in Determining Remuneration

Shareholders should have the final say in approving remuneration of the full-time as well as the non-executive directors. The remuneration packages of senior employees holding key executive posts should be approved by the board and full details thereof should be disclosed to the shareholders.⁶⁸

4.2.3.2 Protection of Minority Shareholders' Rights

Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress.⁶⁹ Even though the presence of a controlling shareholder can reduce the agency problem by closer monitoring of management, weaknesses in the legal and regulatory framework may lead to the abuse of other shareholders in the company.⁷⁰

To tackle the governance problems in the context of separation between ownership and control in Ethiopian share companies, the voice and exit rights of shareholders should be strengthened. Concerning the *voice rights*, introduction of a derivative suit mechanism seems to be relevant. Nonetheless, sufficient conditions should be provided to prevent abuse of the right because derivative suits are susceptible to exploitation.⁷¹ There should be a better regime of disclosure of corporate information both as a mechanism of shareholder empowerment and as a good corporate governance practice. As far as the *exit right* is concerned, it should be easily available through two methods. In the first place, the oppressed minority exit right under Article 463 should be strengthened. Secondly, *principle of mandatory bid* should be introduced. To this end, there is a pressing need to introduce stock markets. Because, there can be no meaningful right of exit without organized stock markets. With no doubt, this is the most basic question that the growth of dispersed ownership in Ethiopia is posing. Furthermore, the absence of a stock market at present may create share illiquidity⁷² as a result of which, in the long run, the public may be discouraged from buying shares thereby affecting the availability of capital for companies.

⁶⁸ Annotation to OECD Principles, supra note 11, principle II.C.3

⁶⁹ OECD principles, supra note 11, principle II.2

⁷⁰ Annotations to OECD principles, principle II.2

⁷¹ Fekadu Petros, Emerging Separation of Ownership and Control in Ethiopian Share Companies: Legal and Policy Implications, Mizan Law Review Vol. 4 No.1, (March 2010), p.29

⁷² Ibid

The other means of assuring exit rights of shareholders in takeover situations is what is known as mandatory bid rule introduced in England⁷³ and transplanted to many parts of the world including EC and Brazil.⁷⁴ According to this rule, a shareholder who acquires control over a company is obliged to buy shares of minorities at the same price he paid for control.⁷⁵ This in effect means that minority shareholders are not only guaranteed the right to exit the company when control is transferred from one to the other; they also get a right to share from the control premium.⁷⁶

In addition, proxy voting by mail and the requirement of depositing shares during board meetings should be eased up as much as possible. These changes may be easily introduced. In the case of dispersed ownership, cumulative voting or minority representation in the board may not be effective unless it is carefully devised. As the problem will not be intra-shareholder struggle, cumulative voting may not be an adequate solution. Rather, employing independent board members has been found effective in other legal systems.⁷⁷

4.2.3.3 Financial Reporting, Transparency and Audit

a. Financial Reporting

The boards of all types of companies should ensure the integrity and consistency of their reports and they should meet the financial reporting standards. In addition to presenting information, which is already being presented as part of the annual accounts, they should also report certain key financial ratios, which reflect the health of (a) company.⁷⁸

b. Disclosure and Transparency

Disclosure should include, but not be limited to, material information on the financial and operating results of the company; and material foreseeable risk factors. Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.⁷⁹

⁷³ Ibid

⁷⁴ Ibid

⁷⁵ See Annotations to OECD principles, supra note 11, principle II.2

⁷⁶ Ibid

⁷⁷ See for instance the practice in Germany and Japan, in Yoshimichi Hiraide (1998), *The Structure of Company Management and Shareholder Control in Japan*, in Barry A.K. Rider, *et al*, (editors), *Commercial Law in a Global Context: Some Perspectives in Anglo-Japanese Law* (Kluwer Law International, London), p.153

⁷⁸ See OECD Principle V, The Combined Code, section D.1 and SEBI, supra note 42, section 14.7 and 14.8

⁷⁹ OECD Principles, supra note 11, principle V.A (1-8)

c. Accounting Standards

Information should be prepared, audited and disclosed in accordance with high standards of accounting, financial and non-financial disclosures, and audit.⁸⁰ Thus, the Code under revision should require the companies to prepare financial statements in compliance with accounting standards.

d. Internal Control

An annual review of the effectiveness of the company's internal controls over financial, operational and compliance matters should be conducted and reported to shareholders.⁸¹

e. Auditor Independence

Not only should the auditors discharge their duties in total independence from personal interest or managerial interference, they should perform a regular review of their independence, along with their cost effectiveness and objectively.⁸² As the role of auditors is vital to the corporate governance process, the importance of the audit process should be communicated throughout the company. The Board should take measures to enhance the independence and statute of auditors. The findings of auditors should be utilized in a timely and effective manner. The head of the audit firm should report to the board or the audit committee in an independent manner.⁸³

f. Stakeholder - Definition and Communication

The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active co-operation between companies and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises.⁸⁴ The bank's board, in principle, shouldn't have obligation to stakeholders. However, depositors being the major stakeholders in banks, whose interests may not always be recognized, sound corporate governance should consider their interests and ensure that individual banks are conducting their business in such a way as not to harm interests of depositors.⁸⁵

⁸⁰ OECD Principles, supra note 11, part V.B

⁸¹ The Combined Code (2003), Section C.2

⁸² The Combined Code (2000), section D.3.2

⁸³ BIS, supra note 53, sec 6.3

⁸⁴ OECD Principles, supra note 11, principle III.C

⁸⁵ Advisory Group On CG In India, supra note 45

g. Disclosures related to Management

Managers must disclose any material interests in transactions or matters affecting the company.⁸⁶

Besides, regarding disclosure and transparency, the overall framework should:

- bring requirements for accounting and auditing up-to-date with good international practices;
- enhance mechanisms for enforcement of financial reporting requirements;
- enhance the oversight of audit and assurance services.

Revised Commercial Code should include the following:

- ✓ Require the companies to prepare financial statements in compliance with accounting standards.⁸⁷
- ✓ Require auditors to provide audit services in accordance with the requirements of auditing standards and other related pronouncements.
- ✓ Set appropriate penalties for failure to comply with all accounting, auditing, and financial reporting requirements.
- ✓ Require statutory audit for all limited liability companies, whether they are share companies or private limited companies.⁸⁸
- ✓ Provide regulation for issuance of shares to the public i.e., establish a legal requirement of an audit report on the financial information contained in the prospectus; and registration, and approval of the prospectus, with a regulator, before release to the public.

Moreover, it is imperative to:

- ✓ revise other relevant laws and regulations in light of internationally accepted principles and practices;
- ✓ Enact a financial reporting law.⁸⁹
- ✓ Set accounting standards;

⁸⁶ OECD Principles, supra note 11, principle III.C

⁸⁷ In all cases in these policy recommendations, the accounting and auditing standards should be defined as those promulgated by the country's authority responsible for setting accounting and auditing standards. In this case the National Accountants and Auditors Board (when established) would issue the accounting and auditing standards and update them in line with changes in internationally accepted standards. See ROSC Ethiopia, supra note 27, p.16

⁸⁸ Some of the largest private sector corporate entities in the country are private limited companies and are not required to have statutory audit of annual financial statements. See Id, p.17

⁸⁹ Market sophistication, with increased financial risks and resultant need for enhanced regulation, has necessitated dedicated institutions supported by a dedicated law for regulation of accountancy. Examples of this law include Mauritius's Financial Reporting Act (2004), South Africa's Auditing Profession Act (2005), Kenya's Accountants Act (1977), Nigeria's draft Financial Reporting Council Act, and Botswana's Financial Reporting Act. See Ibid

- ✓ Mandate International Standards on Auditing (ISA) for all auditors;
- ✓ Enhance the capacity of all regulators to enable them to effectively discharge their responsibilities and to handle International Financial Reporting Standards (IFRS) related issues in the regulation.

4.2.4 Additional Conclusions and Recommendations

In addition to the recommendations suggested so far, In Book II, the title of chapter 4 of Commercial Code which states “*Directors, Auditors and Shareholders’ Meetings*” should be replaced by “*Company Governance*” because the lists in the title can be best embraced by the latter term. The composition and role of supervisory or non-executive board should be provided under the title “company governance” separately from the title “management.” “Statutory dividend” has remained vague in the Commercial Code and rendered inapplicable because of absence of its definition. Thus, it should be defined in the forthcoming Commercial Code. Furthermore, the Committee vested with the task of revising Commercial Code of Ethiopia should be requested to finalize its work by reconsidering critical issues in corporate governance as has been indicated in this paper.

FINANCIAL INSTITUTIONS

Considering the special importance of financial institutions for the functioning of the country’s economy and quality of life of its citizens, the National Bank should continue to strictly regulate financial institutions in general and banks in particular. However, corporate governance in financial institutions should be based on the international standards since more regulation may inhibit the normal operation of financial institutions. The NBE should consider internationally recognized best principles and practices of corporate governance before issuing directives. For instance, the amount of remuneration to be paid to the directors of banks in accordance with Directives No.SBB/49/2011 is too draconian to align the interests of directors with that of the shareholders and stakeholders, risks and liabilities involved there and the impact of ineffective compensation on the independence of the board of directors from the management. Therefore, the NBE should reconsider the Directives in light of best globally accepted principles and practices. Within the legal framework, special attention should be given to advanced experiences

in corporate governance of financial institutions and Bank for International Settlements (BIS) Principles for Enhancing Corporate Governance in banks which are provided by the Basel Committee on Banking Supervision and OECD principles of corporate governance in this area.

In particular, the following recommendations should be taken into consideration to improve corporate governance of financial institutions in Ethiopia.

- i. regulate the composition of boards of directors more effectively in order to ensure the presence of independent directors; Board members should be and remain qualified, including through training, for their positions. They should have a clear understanding of their role in corporate governance and be able to exercise sound and objective judgment about the affairs of the bank.⁹⁰
- ii. ensure that conflicts of interest both at board and at operational level are dealt with appropriately;
- iii. stipulate the role of stakeholders more clearly and take steps to ensure the involvement of the main stakeholders: i.e. depositors, borrowers, those insured, the community, and employees;
- iv. explore the possibility of promulgating a Law on Deposit Insurance, following current experiences in other countries in the light of the global financial crisis.
- v. More specifically:
 - Banks and other financial institutions should formally adopt and implement OECD Principles of Corporate Governance as well as Voluntary Code of Corporate Governance for Ethiopia Adopted on June 1, 2011, within their policies and procedures, and report on their compliance in their annual reports.
 - Banks and insurance companies should develop corporate governance policies for the appointment of independent board members, establish and maintain better relations with their stakeholders in accordance with existing legal provisions.
 - Banks and insurance companies should develop training programmes for their managerial personnel, as well as for board members, aiming at improving and advancing their corporate governance practices in light of OECD Principles of Corporate Governance.

⁹⁰ BIS, *supra* note 53, principle 2

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- Articles and Memorandum of Associations, Bunna International Bank,
- Articles and Memorandum of Associations, Cheha Business SC,
- Articles and Memorandum of Associations, Ehil Beranda Ehil Negadewoch SC,
- Articles and Memorandum of Associations, Sky Bus SC

Appendix A

ADDIS ABABA UNIVERSITY SCHOOL OF LAW

LLM Program in Business Law

Study of Corporate Governance in Ethiopian share companies

Interview Questions, February 2011

1. What factors, do you think, call for the introduction of good corporate governance in the current Ethiopia? Do you think the booming of share companies in Ethiopia be supported by legal reform? Whose interest should be given priority? A. shareholders/ stakeholders (general) B. outsiders of corporate governance (minority shareholders and investors)

2. Do you think corporate governance principles should be well incorporated in the forthcoming revised commercial code? Would you please cite some corporate governance issues that should be get concern and priority? For instance, board issues (roles of the board, composition of the board and its independence from the management, having different committees such as audit committee, remuneration committee and nomination committee, etc.), rights and roles of shareholders (voting rights-e.g. Proxy voting by mail, derivative suit mechanism, exit rights and role of introducing stock markets in Ethiopia in this regard) and improving disclosure and transparency in corporate governance?

3. Which model of corporate governance (Anglo-American/shareholder model or Continental European model/stakeholder model or mixture of the two) fits the current needs and realities in our country? Should Ethiopia adopt or adapt principles of good corporate governance? Why? Why not?

How?

4. Should Ethiopia enact mandatory code of corporate governance like that of Oxley Act of 2001 of the USA or should it adopt the voluntary code of corporate governance such as Combined Code of UK? Why?

4.1 Is it enough to leave the work of introducing corporate governance in Ethiopia for the private actors such as AACCSA's initiative? What should the role of the government be in this regard? For instance, should the government adopt code of corporate governance from its own initiative? Why? Why not?

5. What do you think are the merits and demerits of strictly regulating financial institutions in Ethiopia? Are regulation and corporate governance similar? How should the two go together? _____

5.1 How do you understand the controversies surrounding remuneration of board of directors in Ethiopia in general and directives that limit the annual compensation to be paid to the directors of banks to 50,000 birr recently in particular?

5.2 Would you please list some of the merits and demerits of the directives?
Merits _____

Demerits _____

5.3 Do you think it should be revised? Why? Why not? _____

6. What do you think corporate governance in Ethiopia should look like for the future? _____

What do you advice me in relation to this study? Please tell me just what is/ was in your mind regarding the need for good corporate governance in Ethiopia.

Thank you for taking your precious time to answer these questions patiently.

Appendix B

Questionnaire

Date _____

Name and type of institution _____

I. Introduction

- 1.1 For how long has the company been in operation? _____
- 1.2 Ownership type: fully state owned ☐ privately owned ☐ Owned partly by the government ☐
- 1.3 Total amount of paid up capital _____
- 1.4 Total number of shareholders _____
- 1.5 Ownership pattern: concentrated ☐ Diffused ☐
- 1.6 Main range of services offered by the company _____

II. Management and Board of Directors

- 2.1 What is the total number of the board of directors? [_____]
- 2.2 How are board members nominated?
- a) Shareholders nominate ☐
 - b) Board nomination committee nominate ☐
 - c) Management nominate ☐
 - d) Block holders nominate ☐
- 2.3 Are there preset criteria for nomination? _____ if yes, specify, _____
- 2.4 How is the board appointed?
- 1) By the vote of majority shareholders ☐
 - 2) By the vote of all shareholders ☐
 - 3) By the old board when a new one is coming into office ☐
 - 4) A head hunt by the chairman ☐
 - 5) Other process [please specify] _____
- 2.5 What is the maximum election term for members of the board? _____
- 2.6 What is the composition of the board? Executive (full time directors) ☐ Non-executive (part time directors) ☐ Both ☐
- 2.7 List the main powers and responsibilities of the board _____
- 2.8 Does the law, regulation, directives or articles of association require the election of independent directors to the board? Yes ☐ No ☐
- 2.9 Does the definition of "independence" exclude persons who are:
- a) Related to management (by blood or marriage) Yes ☐ No ☐
 - b) Related to influential shareholders Yes ☐ No ☐
 - c) Employees of affiliated companies Yes ☐ No ☐
 - d) Representatives of companies having significant dealings with the company in question Yes ☐ No ☐
- 2.10 Does the law or Articles of Association require the separation of chairman and CEO? Yes ☐ No ☐

- 2.11 Specify the prescribed board structure: unitary ☐ Dual ☐
 2.12 How frequently does the board meet (per year)? _____
 2.13 Are there any special committees in the board? [Please specify] _____

- 2.14 Is there any induction program in place for new board members? Yes ☐ No ☐
 2.15 How are deliberations communicated to shareholders and other stakeholders? _____

2.16 Does the board assess the performance and effectiveness of the following stakeholders?
 How?

	Yes; how frequently	No
The board itself		
Individual members		
CEO		
Others (specify)		

2.17 Are reports made from these assessments? (_____)

2.18 At what level are the reports discussed?

- | | Yes | No |
|---------------------------------|--------------------------|--------------------------|
| ▪ Board meeting: | ☐ | ☐ |
| ▪ Annual General Meeting: | ☐ | ☐ |
| ▪ Special meeting: | ☐ | ☐ |
| ▪ Others (please specify) _____ | | |

III. What are some of the company's social responsibility? (Corporate Social responsibility)

IV. Disclosure and Transparency

4.1 Does the law or bylaws of the company provide for consolidated financial reporting?

Yes ☐ No ☐

4.2 Are companies required to disclose non-financial information on:

- a. Corporate governance structure and practice Yes ☐ No ☐
 b. Education and professional experience of directors and key executives Yes ☐ No ☐
 c. Remuneration of directors and key executives Yes ☐ No ☐

4.3 Are companies required to have their financial statements externally audited?

Yes ☐ No ☐

4.4 How and by whom external auditors appointed? _____

4.5 To whom the external auditors report? _____

4.6 Who monitors and evaluates the implementation of the company's strategies, policies, plans and management performance?

- i. The Board Yes ☐ No ☐
 ii. The chief executive officer Yes ☐ No ☐
 iii. Shareholders Yes ☐ No ☐
 iv. Others (please specify) _____

4.7 Is there any measure in place to ensure that the company complies with all relevant laws, regulations, directives, governance practices, accounting and auditing standards? _____

4.8 Who enforces these measures? _____

- | | | |
|------------------|------------------------------|-----------------------------|
| a) The board | Yes ☐ | No ☐ |
| b) The CEO | Yes ☐ | No ☐ |
| c) The regulator | Yes ☐ | No ☐ |
| d) Shareholders | Yes ☐ | No ☐ |

V. Shareholders and Stakeholders Rights and Information

5.1 To what extent do the shareholders ensure that the board is held accountable for the effective running of the company so as to achieve its objectives? _____

5.2 Do the shareholders have the power to change the composition of the board that does not perform the expectations or in accordance with the mandate of the company?
Yes ☐ No ☐

5.3 How does the company communicate with its shareholders and stakeholders? _____

5.4 To what extent is the company accountable to its shareholders? _____

5.5 What accounting g procedures are there in place to effect this? _____

5.6 What are the rights of employees regarding _____

- | | |
|--|-------|
| a) Information on company | _____ |
| b) Collective bargaining participation in the board of directors | _____ |
| c) Consultation | _____ |

5.7 Can employees participate in the company's profits by _____

- Share ownership Yes ☐ No ☐
- Share options Yes ☐ No ☐
- Profit sharing schemes Yes ☐ No ☐

5.8 Are there multiple classes of shares where some shares enjoy more voting rights than others?
Yes ☐ No ☐

5.9 What periodic information are the companies required to provide? _____

- | | | |
|-----------------------------------|------------------------------|-----------------------------|
| a. Annual reports | Yes ☐ | No ☐ |
| b. Unaudited semiannual reports | Yes ☐ | No ☐ |
| c. Quarterly financial statements | Yes ☐ | No ☐ |
| d. Others (please specify) | _____ | |

5.10 What information must be contained in the company's annual report? _____

- | | | |
|--|------------------------------|-----------------------------|
| a) General information on the company | Yes ☐ | No ☐ |
| b) Audited annual accounts | Yes ☐ | No ☐ |
| c) Directors reports on past and future operations | Yes ☐ | No ☐ |
| d) Financial status of the company | Yes ☐ | No ☐ |
| e) Consolidated financial reports | Yes ☐ | No ☐ |
| f) Information on corporate governance | Yes ☐ | No ☐ |

5.11 Do shareholders have the right to vote on:

- | | | |
|---------------------------------------|------------------------------|-----------------------------|
| ± Appointment of removal of directors | Yes ☐ | No ☐ |
| ± Appointment and removal of auditors | Yes ☐ | No ☐ |
| ± Issuing shares | Yes ☐ | No ☐ |

- ⌞ Dividend policy Yes ☐ No ☐
- ⌞ Amendments to company Articles or Memorandum Yes ☐ No ☐
- ⌞ Remuneration of board of directors Yes ☐ No ☐
- ⌞ Major corporate transactions (acquisitions, disposals, mergers, takeovers) Yes ☐
No ☐
- ⌞ Change to company business or objectives Yes ☐ No ☐

5.12 What kinds of voting rights may shares have? _____

Declaration

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

Declared by:

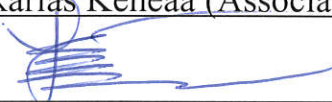
Name: Hussein Ahmed

Signature: 

Date: June 10, 2011

Confirmed by Advisor:

Name: Zekarias Keneaa (Associate professor)

Signature: 

Date: June 10, 2011

Place and date of submission

Addis Ababa University

June, 2011

