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CORPORATE GOVERNANCE GUIDEBOOK

SETTING UP A BOARD OF DIRECTORS

What is Corporate Governance

Corporate governance as the name suggests is the framework, method and process that corporations are governed. The assumption has been that corporate governance applies only to entities incorporated as companies under the Companies Act or companies which are listed.

Both assumptions are wrong because corporate governance applies to all entities no matter the size of the entity. Corporate governance's main aim is to provide a means for effective management of the business to enhance longevity and survival of the business. For businesses with a more complex structure, corporate governance is mainly the duty of the board of directors whose role is to ensure that the company is managed and governed for the best interest of shareholders.

Corporate governance can be statutory or voluntary. In Kenya the Companies Act contains aspects of corporate governance while the Capital Markets Corporate Governance Regulations set out a code of governance for listed and licensed companies.

Types of governance structure

There are several governance structures depending on the type of business. The best governance structures are those that separate ownership from management, even if business owners tend to be the managers of the business. The benefit of this separation is to place management of the business under professionals who are skilled in management.

Separation of management and ownership creates an agency relationship between the owners and the managers, whereby the managers in this case the board, acts as agents for the owners. This means they must act in the best interest of the owners. The board of directors have statutory and common law duties to the owners for example they have an obligation to act in the best interest of the company, avoid negligence, and give proper and accurate information, fiduciary duties and a myriad of other duties which can be found in the Companies Act.

I advise businesses of all sizes to have in place a sound management structure where ownership and management is separate.

A sole proprietorship, which is a business with only one owner can set up a governance structure in various ways. The business owner can set up an advisory board comprised of different professionals, to advice the owner in managing his business. The advisory board reports directly to the owner and is usually paid a fee for this advisories service. The advisory board assists the owner in strategic decisions,

A partnership which is a business owned by two or more persons with the purpose of sharing profits and losses could also adopt the model of governance suggested for a sole proprietorship.

How to set up a board of advisors

The first thing is to identify your need for advisors by assessing your strengths and weaknesses. Once you have established the gap in your business then it is important to consider the kind of professional you would want to retain in your board. It is important to not only consider professional skills, but also consider a lot of other factors for example personality type, level of emotional intelligence, gender and age. The global trend calls for a more diversified board. A diversified board allows your business get advice from different perspectives.

Once you have identified the suitable persons and they have agreed to be part of your board it is important to set out their duties and obligations. Other than managing the business, a director can give professional advice where required. The directors have a responsibility to the owner of the business and it is important to set this out clearly. It is important to set out the reward or incentive that a director would have from being part of your advisors. Some of the incentives include sitting allowances, salaries, medical cover, pensions, club membership and many others. In some organizations for example NGOs, directorship can be purely voluntary that is, the director can serve as an advisor with no reward.

It is important to draft the proper documentation describing the above. There must also be proper dispute resolution clauses, usually arbitration clauses which will set out the procedure in which disputes between directors will be managed or a dispute between the director and owner.

If the entity is a company, then the necessary company filings have to be filed.

Keeping the directors in check

Recently, there have been a lot of corporate scandals in the private sector highlighting the need for good governance in corporates.

Shareholders are the owners of any company while directors manage the company. Listed companies usually have more shareholders than smaller companies. In Kenya the smallest sized company is a company with one shareholder. Directors may or may not be shareholders of the company. A company where the shareholders and the directors are the same people, usually has better transparency as information and communication is seamless.

Companies where the shareholders and directors are different require a higher level of governance practise due to the information asymmetry that arises. Directors hold day to day information on company affairs as compared to the shareholders. Therefore there is a higher standard of governance required in such companies. Duties of directors and governance practises are set out in the Companies Act and other related laws for example the Capital Markets Authority governance laws. Such governance practises are mandatory and there are consequences of non-adherence to the mandatory governance rules.

The private sector can participate in the fight against corruption by the use of shareholder activism. Shareholder activism occurs when shareholders of a company exercise their statutory rights as pertains to the affairs of the company. One of the rights to exercise is the right to information allowing shareholders to closely scrutinise company affairs such as contracts and books of account. There are other rights such as the right to vote and the right to inspect.

There are some times when a particular director breaches his statutory obligations and his duties to the shareholders. Shareholders ought to understand that in such cases they have power and authority over the errant director in several ways.

Where for any reason, shareholders opine that the actions of a particular director or even the board is not satisfactory and would want to oust such directors, then the same can be done through an ordinary resolution. The shareholders can pass resolutions stating the reason they would want to remove such a director. The director ought to be given sufficient notice of the decision by shareholders to oust him. The affected director has 21 days in which to put forth his written response. In the event his submissions as to why he should not be ousted fail, then the resolution would stand and the director removed from office. This provision allows shareholders to maintain control over the management affairs of the company. Shareholders may later opt to file a recovery suit the affected director for breach of fiduciary and statutory duty once the removal has taken effect.

The second way shareholders can enforce good governance is through court ordered company inspection. This happens when the shareholders have valid suspicions that all is not well with how the company affairs are managed. At times directors can conspire to mismanage e the company for their own selfish gain. They may give shareholders false information or may engage in high level corruption to the detriment of the company.

In such cases, it is advisable for the company shareholders to apply for an inspection of the company. The court will appoint a professional inspector who will conduct an inspection of the company and this may include forensic inspections and others so as to uncover any incidences of mismanagement. The inspection report filed in court enables the shareholders take further actions against the directors.