CORPORATE GOVERNANCE FOR STATE CORPORATIONS: A CASE FOR THE TWO-TIER BOARD STRUCTURE

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DECLARATION

I, WAWERU CYNTHIA NJERI, do hereby declare that this research is my original work and that to the best of my knowledge and belief, it has not been previously, in its entirety or in part, been submitted to any other university for a degree or diploma. Other works cited or referred to are accordingly acknowledged.

Signed: ....

Date: ....

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

Signed: ....

Mrs. Eunice Kiumi

DEDICATION

I dedicate this undergraduate thesis to God for His grace and continuous presence in my life and to my family for their continuous support in my educational journey.

ACKNOWLEDGEMENTS

I am greatly indebted to my supervisor Mrs. Eunice Kiumi for her support and guidance throughout this entire process. I would also like to thank Dr. Joy Malala for her words of wisdom during the defense of the proposal of this paper which have stayed with me throughout this process.

ABSTRACT

State corporations are essential as they are mandated to provide public goods and services and cater to the general welfare of members of the public. State corporations in Kenya have served different purposes in different industries since their establishment during the colonial period. However, they have been plagued by a number of issues over the years, chief among them, mismanagement. Other issues that have arisen as a result of mismanagement include pilferage, wastage and bureaucracy. This has greatly undermined the achievement of their objectives. This paper seeks to investigate the suitability of applying the two-tier board structure to correct this corporate governance failure.

The paper is anchored by the concept of governance and its important role in the management of a corporation. Corporate governance guidelines, frameworks and mechanisms are implemented to ensure that the management team of a corporation act and administer their duties in the interest of all stakeholders. With this in mind, the paper shall look into the state of state corporations in Kenya and the laws that govern their administration. It shall particularly look into the one-tier board structure, the rationale behind its use, its benefits and the shortcomings and how these shortcomings have undermined the activities of state corporations.

The paper shall discuss the applicability of the two-tier board structure as a remedy to the corporate governance failures that plague state corporations. In order to do so, it shall delve into the application of the two-tier board structure in two jurisdictions; namely Germany and the Netherlands whose economic success can be partly attributed to the nature of their corporation laws. Finally, the paper shall give recommendations that can be tailored to meet the needs of Kenyan state corporations.

CHAPTER ONE: INTRODUCTION

Background

State corporations are corporate entities that are established and governed by legislation in order to provide a good or service to the public.[1] State corporations play a pivotal role in the society. They are an avenue for the government to fulfil its mandate in the provision of services to the public. They ensure that members of public have access to essential services such as transport, health and housing to a name a few. State corporations also prevent monopolization of markets, that is, one dominant entity controlling the market, so as to protect consumers from high prices and poor quality products.[2] These are just a few of the benefits of the establishment of state corporations.

State corporations in Kenya have been through a number of challenges. Perennial losses, debt and misappropriation of funds are some of them. The government has had to bail them out on a number of occasions.[3] All these problems stem from poor management. For any institution to run smoothly, the management team must be well-qualified and committed to the attainment of the institution's objectives. Additionally, the members of these boards serve on many boards which leads to a conflict of interest.[4] Corporate governance guidelines are formulated and implemented to correct and prevent the aforementioned issues. Corporate governance can be described as the processes, policies, customs, laws and institutions that direct corporations in the way they act, administer and control their operations.[5]

At the apex of the management pyramid of a corporation is the board of directors. The formation of a board of directors of state corporations is enshrined in statute.[6] Its role is to make decisions and policy that are aimed at the achievement of the corporation's objectives. Their directive role is fundamental to the corporation. If they discharge their mandate, the corporation prospers and if

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[1] http://www.thefreedictionary.com/parastatals on 30 November, 2016.
[2] Odoyo S, Omwono A and Okinyi O, 'An Analysis of the Role of Internal Audit in Implementing Risk Management-A Study of State Corporations in Kenya' (5) 6 *International Journal of Business and Social Science*, 2014, 171.
[3] Between 1988 and 1999, a total of Kshs 8 billion was injected to 18 state corporations to prevent failure as a result of mismanagement.
[4] Odoyo S et al, 'An Analysis of the Role of Internal Audit in Implementing Risk Management-A Study of State Corporations in Kenya', 170.
[5] Khan H, 'A Literature Review of Corporate Governance', International Conference on E-business, Management and Economics, Singapore, 2011, 1.
[6] Section 6 (1) of the State Corporations Act, Cap 466.

they fail to do so, the corporation fails.[7] Due to the responsibility and power given to them, it is important to have a sound corporate governance framework. A sound corporate governance framework, among other things, looks at the type of board structure that is employed.

The most common board structure is the one-tier board structure. This structure provides for the board to perform two functions-management and supervision. It consists of executive directors such as the chief executive officer and the chief financial officer who are tasked with the daily operations of the corporation and non-executive directors who play a supervisory role, that is, they oversee the operations of the management team. In this structure, as will be discussed, it is difficult to maintain neutrality in the decision-making process.[8] The non-executive directors can easily be influenced by the executive directors and it is often difficult to supervise an entity that one is part of. This and other disadvantages shall be discussed in the dissertation. The two-tier board structure provides for two boards-a management board and a supervisory board. The management board comprises the senior management team such as the chief executive officer and the chief financial officer. The supervisory board comprises independent directors that are charged with overseeing the activities of the management board. The major advantage of this is that there is a clear distinction of roles which promotes accountability and transparency.

This dissertation proposes that a solution to the mismanagement that plagues state corporations would be a change in the board structure, that is, from the one-tier board structure and the two-tier board structure. It shall look into the two-tier board structure using Germany and the Netherlands as countries of best practice. Further, it shall analyse the applicability of the two-tier board structure to Kenya and make recommendations regarding the same.

Statement of the Problem

The current one-tier board structure employed by state corporations is undermining good corporate governance practices resulting in poorly managed institutions.

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[7] Gregory H and Simms M, 'Corporate Governance: What it is and Why It Matters', 9th International Anti-Corruption Conference, October 1999, Durban, South Africa, 3.

[8] Block D and Gerstner A, 'One-Tier Vs Two-Tier Board Structure: A Comparison between the United States and Germany', *Comparative Corporate Governance and Financial Regulation*, Paper 1, 2016, 19.

Justification of Study

It cannot be stressed how important good corporate governance practices are to an institution. As mentioned before, corporate governance can be described as the processes, policies, customs, laws and institutions that direct corporations in the way they act, administer and control their operations.[9] Without an effective and competent management team, an institution cannot fully realise its objectives. The board of directors is at the apex of any corporation. It is charged with making vital business decisions and supervising the work of senior management.[10] Therefore, it is important that a comprehensive corporate governance framework is formulated to prevent abuse of power.

State corporations operate in the same vein as any other corporation with the exception that they are wholly or partially owned by the government. State corporations are important for the socio-economic welfare for a nation as they facilitate the provision of public goods and services among other functions that shall be elaborated in the dissertation. State corporations in Kenya are unable to realise their objectives due to mismanagement. The political nature of the appointment of directors only adds insult to injury. It creates competency issues, conflict of interest among other issues. [11]

This study seeks to look into the possibility of having the two-tier board structure as opposed to the one-tier board structure. To do so, the benefits and the shortcomings of both structures shall be discussed in the dissertation. The two-tier board structure has been adopted in Germany and the Netherlands and has been successful. This study seeks to recreate the same success in Germany and the Netherlands in Kenya.

Research Questions

1. Is the one-tier board structure inadequate for state corporations?
2. Should Kenya shift from one-tier board structure to two-tier board structure?

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[9] Khan H, 'A Literature Review of Corporate Governance', International Conference on E-business, Management and Economics, Singapore, 2011, 1.
[10] Roe J, 'The Institutions of Corporate Governance' John M. Olin Centre for Law, Economics and Business, Harvard Law School, Discussion Paper No. 488, 2004, 9.
[11] Odoyo S, Omwono A and Okinyi O, 'An Analysis of the Role of Internal Audit in Implementing Risk Management-A Study of State Corporations in Kenya', 171.

3. Will the shift promote good corporate governance for state corporations?

Statement of Objectives

1. Assessing the one-tier board structure within state corporations.
2. Evaluating the possible shift to a two-tier board structure within state corporations.
3. Examining whether or not the shift from the one-tier board structure to the two-tier board structure will improve corporate governance in state corporations.

Literature Review

The analysis of corporate governance and its importance cannot be undervalued. This paper shall outline its evolution, importance and highlight the principles of corporate governance found in the *G20/OECD Principles of Corporate Governance.* This document highlights the seven principles of corporate governance and discusses each principle in detail. These principles shall also be discussed with the *OECD Guidelines on Corporate Governance of State-Owned Enterprises.*

In tandem with the discussion on corporate governance, the dissertation shall look at three theories of corporate governance, namely the agency theory, the stewardship theory and the stakeholder theory. An analysis of the corporate governance theories shall be found in *A Literature Review of Corporate Governance.* It highlights these theories and their influence on corporate governance frameworks. *The Birth of Corporate Governance* shall inform the discussion on the development and importance of corporate governance for the efficient management of a corporation. Corporate governance stemmed from the changes in shareholder voting from a democratic system which protects minority to a plutocratic system which favoured major shareholders.

With regards to the legal framework governing state corporations, the State Corporations Act[12] shall be looked into; particularly provisions on the establishment and appointment of the board of directors. The two forms of board structure shall be compared as highlighted in the article *One-Tier V Two-Tier Board Structure: A Comparison between the United States and Germany.* This

[12] Cap 466.

article shall inform the discussion on the benefits and shortcomings of both board structures allowing for a comprehensive analysis of both structures.

The article *One-Tier V Two-Tier Board Structure: A Comparison between the United States and Germany* shall discuss the two-tier board structure in detail-highlighting its effectiveness in Germany. The German Corporate Governance Code and its origins shall give insight to the effectiveness of the two-tier board structure and its requirements of corporations. The article *The Development of German Corporate Law until 1990: An Historical Reappraisal* shall show the history of the two-tier board structure, highlighting the origin and evolution of the German Corporate Law and the effects of German's preference for the two-tier board structure. The article *Corporate Governance in the Netherlands* discusses the corporate governance framework, that is, among other things the two-tier board structure as employed in the Netherlands.

Taking into account the aforementioned articles and other materials that shall be utilised, the dissertation shall analyse the viability of the two-tier board structure for state corporations in Kenya.

Theoretical Framework

This paper will be anchored by three theories of corporate governance namely; the agency theory, the stewardship theory and the stakeholder theory.

The agency theory focuses on the principal-agent relationship that arises between shareholders and the board of directors. The board of directors is tasked with acting on behalf of the shareholders and must act in their best interests.[13] However, it is argued that human beings are unable to act in favour of the interests of others before their own. The challenge here is to ensure that management is incentivized to act in the best interests of shareholders. Corporate governance mechanisms come in to correct the problems that arise from the principal-agent relationship.[14]

The stewardship theory is the opposite of the agency theory. It argues that the board of directors act in favour of the interests of the shareholders. It states that the management chooses to act for the good of the organisation because not only will the organisation benefit but they will also

[13] Miles J,'The Jossey-Bass Business and Management Reader Series: Management and Organization Theory: A Jossey-Bass Reader (1)', 34.
[14] Miles J,'The Jossey-Bass Business and Management Reader Series: Management and Organization Theory: A Jossey-Bass Reader (1)', 34.

benefit.[15] Management shall maximise the available resources to achieve the objectives of the firm. The profits earned would have a trickle-down effect, in that, the management would benefit from them.

The stakeholder theory focuses on the effect of the management's decisions on other individuals and groups that are affected by the operation of the institution. Stakeholders refer to any individual or group that is affected by the activities of any institution. These includes employees, customers, suppliers and the local community.[16] When management is making decisions, they must consider the interests of the shareholders as well as the interests of these individuals and groups. These groups have a stake in the direction the institution shall take and must be considered.

The different types of theories will inform the subject matter of the paper and promote an understanding of the research being done.

Research Design

The dissertation shall highlight the development and the importance of corporate governance, the institutions affected by corporate governance and how it influences the growth and development of institutions. It shall also discuss the theories of corporate governance that inform the importance of corporate governance.

The dissertation shall then delve into the analysis of the one-tier board structure as a manifestation of corporate governance through discussing the advantages and disadvantages of the structure and its impact on the management of state corporations.

From this juncture, the dissertation shall look into the two-tier board structure by discussing the advantages and disadvantages of the structure and how it can affect the management of state corporations using Germany and the Netherlands as case studies.

Finally, from the comparative analysis, the dissertation will provide a conclusion on whether Kenya should adopt the two-tier board structure to improve corporate governance practices within state corporations.

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[15] Block P and Piersanti, S, 'BK Business: Stewardship: Choosing Service over Self-Interest (2), *Berrett-Koehler Publishers,* 2013, 24.

[16] Freeman R.E., 'A Stakeholder Theory of Modern Corporation, 4.

Research Methodology

Data will be collected from the following sources:

1. Books and journals relating to corporate governance and the two different board structure.
2. Statute and Subsidiary Legislation
3. Statistics showing the financial implications of the two different board structures.

Limitations

The available information is more focused on the management structure of private corporations than state corporations. However, both types of corporations operate in a similar manner therefore this will not be an impediment to the research.

There are few case studies on the application of the two-tier structure to state corporations.

Chapter Breakdown

Chapter 1: Introduction (research proposal)

Chapter 2: Theoretical Framework

Chapter 3: Corporate Governance of State Corporations in Kenya

Chapter 4: The Two-Tier Board Structure in Germany and the Netherlands

Chapter 5: Analysis and Recommendations

CHAPTER TWO: THEORETICAL FRAMEWORK

This section of the paper shall define corporate governance and its elements, look at the evolution of corporate governance, discuss the theories of corporate governance and ultimately how corporate governance relates specifically to state corporations.

What is Corporate Governance?

Scholars have described corporate governance in a number of different ways. Corporate governance broadly describes the processes, customs, policies, laws and institutions that direct the corporations in the way they act, administer and control their operations.[17] It is viewed from different angles; it can be described as ways in which suppliers of finance to corporations assure themselves of getting a return on their investment,[18] or as governance that determines how the firm's top decision makers (senior management) actually administer contracts.[19] It focuses on managing the relationship among the stakeholders including the board of directors and shareholders in order to achieve the goals of the organisation.[20]

Corporate governance has evolved over the years with the evolution of the corporate legal personality. Corporate governance essentially arose from the agency problems that were created by the separation of ownership and control which promotes a dominant management team and powerless shareholders.[21] This was described by Adam Smith in the *Wealth of Nations* where he identified the divergent interest between managers and owners which would cause a problem for the efficient operation of the corporation. He stated that the manager would not protect the owners' interests as diligently as he would protect his own interests.[22] In the mid-nineteenth century, corporate governance practices changed with the changes in shareholder voting from a democratic system which protected minority shareholders to a plutocratic system which favoured majority shareholders.[23] These examples laid the backbone to the development of the concept of corporate

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[17] Khan H, 'A Literature Review of Corporate Governance', International Conference on E-business, Management and Economics, Singapore, 2011, 1.

[18] Shleifer A and Vishny R, 'A Survey of Corporate Governance' 2 (53) *the Journal of Finance*, 1997, 737.

[19] Swan P and Garvey G, 'The Economics of Corporate Governance: Beyond the Marshallian Firm', 1 (2) *Journal of Corporate Finance*, 1994, 139.

[20] Khan H, 'A Literature Review of Corporate Governance', 1.

[21] Wells H, 'The Birth of Corporate Governance', 1252.

[22] Smith A, 'An Inquiry into the Nature and Causes of the Wealth of Nations', Edited by S. M. Soares, *MetaLibri Digital Library,* 2007, 585.

[23] Wells H, 'The Birth of Corporate Governance' 4 (33) *Seattle University Law Review*, 2010, 1251.

governance. Therefore, corporate governance allows for a balance between what directors do and what shareholders desire through the creation of mechanisms that incentivize directors to act on behalf of shareholders and shareholders are well informed about their activities.[24]

The concept of separation and control evolved with the idea of the corporation. With the growth of large, complex industries, large scale organisations in the manufacturing sector attempted to unite many small firms so as to dominate their respective industries.[25] These large organisations were met with a lot of hostility by the general public for a number of reasons such as small retailers being oppressed by dominating firms. In addition to this, the growing number of shareholders and the broadening market for their securities also played a role in the evolution of corporate governance which is a result of the mergers and acquisition that took place. The mergers brought about new owners who had to be issued shares which led to widening the market for securities and increasing the number of shareholders. This led to the emergence of minority shareholders who had little influence on the managers of the corporation which means that their interests-the managers and minority shareholders- would not be aligned.[26]

The groundbreaking work of Adolf Berle Jr and Gardiner Means[27] was based on this historical events. Their work is considered a culmination of thoughts and ideas from other scholars such as Adam Smith. Berle and Means argued that an increase in the number of small shareholders usurped the influence the shareholders had over the corporations. Management's interest were not necessarily aligned with those of the shareholders.[28] They argued that a small group of individuals at the helm of large organisations had the power to build and destroy, generate wealth but control the distribution of that wealth without concern for the shareholders and stakeholders.[29]

It is from this historical background that countries have adopted corporate governance guidelines. The Organisation for Economic Cooperation and Development (OECD) released seven principles to guide the enforcement of good corporate governance practices. They include ensuring the basis for an effective corporate governance framework, the rights and equitable treatment of

[24] Sale H, 'Delaware's Good Faith' 2 (89) *Cornell Law Review*, 2004, 460.
[25] Wells H, 'The Birth of Corporate Governance', 1255.
[26] Wells H, 'The Birth of Corporate Governance', 1255.
[27] Berle A and Means G, 'The Modern Corporation and Private Property', *Transaction Publishers,* 1932.
[28] Mizruchi M, 'Berle and Means Revisited: The Governance and Power of Large U.S. Corporations', *University of Michigan,* 2004, 2.
[29] Mizruchi M, 'Berle and Means Revisited: The Governance and Power of Large U.S. Corporations', 2.

shareholders and key ownership functions, institutional investors, stock markets and other intermediaries, the role of stakeholders in corporate governance, disclosure and transparency and the responsibilities of the board.[30] These principles serve as a guide to countries as they formulate and implement corporate governance mechanisms.

Importance of Corporate Governance

Corporate governance impacts four different aspects of the operations of a corporation. First, effective corporate governance affects the allocation of the corporation's resources. Corporations are able to invest its resources in the most efficient manner in order to produce the highest number of products and the highest rate of return. It helps in the growth of assets and the creation of new assets.[31] Second, effective corporate governance mechanisms attract low-cost capital because both domestic and international investors have confidence because the funds shall be invested in projects as agreed. They are also assured of getting a return on their investment.[32]

Third, effective corporate governance mechanisms promote compliance with societal expectations. This includes complying with the relevant laws and regulations, protecting the environment in which they operate among others. The corporations are citizens of the areas in which they operate and must act as such; with regard to the local community.[33] Fourth, effective corporate governance mechanisms lead to overall positive performance of the corporation. Efficient use of resources and the promotion of oversight and accountability are a major part of a corporation's productivity.[34]

There are a number of macroeconomic factors such as political stability that affect the performance of a corporation, therefore, it cannot be concluded that corporate governance wholly affects its performance but it cannot also be denied that it plays an important role.

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[30] Organisation for Economic Cooperation and Development 'G20/OECD Principles of Corporate Governance', 2015.
[31] Gregory H and Simms M, 'Corporate Governance: What it is and Why It Matters', 9th International Anti-Corruption Conference, October 1999, Durban, South Africa, 3.
[32] Gregory H and Simms M, 'Corporate Governance: What it is and Why It Matters', 4.
[33] Gregory H and Simms M, 'Corporate Governance: What it is and Why It Matters', 4.
[34] Gregory H and Simms M, 'Corporate Governance: What it is and Why It Matters', 4.

Theories of Corporate Governance

There are several theories of corporate governance that have been formulated since the inception of the concept of corporate governance. However, this paper shall look into the three major theories namely: the agency theory, the stewardship theory and the stakeholder theory.

Agency Theory

The agency theory focuses on the principal-agent relationship and the uncertainties that arise from it. The uncertainty is created by information asymmetry. There are two models of asymmetrical information; the hidden action model and the hidden information model. In the hidden action model, the principal observes the outcome of the actions rather than observing the actions taken by the agent. In the hidden information model, the principal observes the agent's action but is unaware of the vital information required to perform those actions.[35] Managers of a firm can lead the firm to taking actions that may not maximize profit accumulation or minimize operating costs which would end up benefitting them and not the shareholders[36], this is known as moral hazard. In most cases, the divergence of interests between the principal and agent is due to lack of corporate governance mechanisms for efficient control and approval of management's actions.[37] There are a number of ways to help minimize the agency problem. First, board independence. An independent board shall be able to monitor managerial behavior. Second, market for corporate control. An active merger and acquisitions market keeps managers on their toes as they know that they are not safe from termination. Third, agent equity ownership. Managers have a stake in the firm thus their actions will always be in favour of advancing the interests of shareholders.[38] Other measures include firms awarding managers according to their performance through bonuses and promotions to ensure that they use their knowledge and expertise to promote the maximization of profits.[39] The actions that attempt to induce the agent to act in the best interests of the shareholders result in agency costs. The agency costs can be defined as the sum of monitoring expenditure by the principal to limit the deviant activities of the agent, bonding expenditure by the agent which will

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[35]Miles J,'The Jossey-Bass Business and Management Reader Series: Management and Organization Theory: A Jossey-Bass Reader (1)', 34.

[36] Yusoff W and Alhaji I, 'Insight of Corporate Governance Theories' 1 (1) *Journal of Business and Management*, 53.

[37] Darweesh M, 'Correlations between Corporate Governance, Financial Performance and Market Value', Published, Walden University, Washington, 2015. 24.

[38] Miles J,'The Jossey-Bass Business and Management Reader Series: Management and Organization Theory: A Jossey-Bass Reader (1)', 35.

[39] Yusoff W and Alhaji I, 'Insight of Corporate Governance Theories', 54

guarantee that certain actions of the agent will not harm the principal or to ensure that the principal will be compensated in the event that the harm occurs.[40] This theory, as aforementioned, provides the basis of the concept of corporate governance.

Stewardship Theory

The stewardship theory is the opposite of the agency theory; by opposing the fact that management is always working for its own interest, not that of the organisation.[41] The stewardship theory comprises of a number of elements. First, there is a balance of power. Management chooses to act for the good of the organisation. Second, management is committed to the larger community, that is, it is not only concerned with the shareholders but also the stakeholders of the firm. Third, management undertakes its responsibilities and creates a culture in which it can thrive in. Fourth, there is balanced and equitable distribution of rewards. The success, in the form of money and privilege, of the firm is to be shared among the management staff.[42]

The stewardship theory assumes that managers will act in the best interests of the owners.[43] Stewards of the organisation place value on a collectivist approach rather than an individualistic approach which means that the steward will focus on maximizing his utilities to achieve the objectives of the firm. Stewards protect and maximize shareholder wealth through firm performance.[44]

Proponents of the stewardship theory assume that the duty of management is maximizing company performance and market value; thereby creating more benefits for steward and principal.[45] Under this theory, the owners empower management with information, equipment and power assuming that the best interests of the firm are achieved.[46]

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[40] Yusoff W and Alhaji I, 'Insight of Corporate Governance Theories', 54.
[41] Block P and Piersanti, S, 'BK Business: Stewardship: Choosing Service over Self-Interest (2), *Berrett-Koehler Publishers,* 2013, 24.
[42] Block P and Piersanti, S, 'BK Business: Stewardship: Choosing Service over Self-Interest (2), 25.
[43] Yusoff W and Alhaji I, 'Insight of Corporate Governance Theories', 57.
[44] Yusoff W and Alhaji I, 'Insight of Corporate Governance Theories', 57.
[45] Darweesh M, 'Correlations between Corporate Governance, Financial Performance and Market Value', 28.
[46] Darweesh M, 'Correlations between Corporate Governance, Financial Performance and Market Value', 28.

State corporations act in the interests of the public. Therefore, their activities can be viewed through the lens of the stewardship theory, that is, the boards of directors are aware that their work is also to their benefit as they are members of the public.

Stakeholder Theory

A stakeholder can be defined as any individual or group who can or is affected by the realization of the company's objectives.[47] This theory suggest that managers have a network of relationships that they must serve. Stakeholders include suppliers, employees, customers, business partners and the local community. Each of these groups should not be treated as a means to an end but must participate in determining the future direction of the firm in which they have a stake.[48] The law that governs the operations initially advocated for managers to actively pursue the interests of the shareholders. However, the law has evolved to constrain the pursuit of the shareholder interests at the expense of other claimants on the company. Therefore, the stakeholders such as suppliers, employees, customers and the local community must be considered when management is making decisions and implementing strategies towards the growth of the company.[49] The change in law can be seen in the enactment of statutes that protect the rights of consumers, the rights of employees, the rights of the local community among others. Why should stakeholders be considered? Employees have their livelihood at stake. Employees are to work and follow instructions of management and in return they expect salaries, benefits and security. Essentially, they are used as a means to an end, which means that they are a very important group that must be considered. Without them, the company cannot achieve its objectives.[50] Suppliers are the source of the raw materials of the product being sold by the corporation. Their materials affect the quality of the final product. On the other hand, the company is a customer of the supplier hence the co-dependence. The company must maintain a positive relationship with the supplier so that in a time of need the supplier can assist the company and vice versa.[51]

Customers purchase the products of the company in exchange for the enjoyment of these products. Customers provide revenue for the company which is reinvested to improve products or develop

[47] Freeman R.E., 'A Stakeholder Theory of Modern Corporation, *Ethical Theory and Business,* 2004*,* 2.
[48] Freeman R.E., 'A Stakeholder Theory of Modern Corporation, 4.
[49] Freeman R.E., 'A Stakeholder Theory of Modern Corporation, 4.
[50] Donaldson T and Preston L, 'The Stakeholder Theory of Corporation: Concepts, Evidence and Implications', *Academy of Management*, 1 (20), 1995, 67.
[51] Donaldson T and Preston L, 'The Stakeholder Theory of Corporation: Concepts, Evidence and Implications', 68.

new products. The company must consider the interests of the customers as it depends on them for their revenue.[52] The local community must also be considered because it grants the company the space in which it operates. In return, the company employs its members, increasing the standards of living through building dispensaries and schools and make other social contributions. One way it must be considered is through proper disposal of waste and safe methods of production.[53]

State corporations are corporate entities of a special nature due to the fact they are established through statute and operated by the government. It is for this reason the Organisation for Economic and Development formulated guidelines on corporate governance of state corporations. They were formulated as a response to the specific governance challenges that affect state corporations. These challenges include politically motivated ownership interference leading to unclear lines of responsibility, lack of accountability, lack of proper oversight due to passive or distant ownership by the state and other myriads of problems.[54] These guidelines relate to the rationale for state ownership, that is, the objectives that justify state ownership, state's role as an owner, the legal and regulatory framework that governs state owned enterprises, equitable treatment of shareholders and other investors, stakeholder relations and responsible business, disclosure and transparency and the responsibilities of the boards of state owned enterprises.[55]

Of the three theories discussed, the agency theory, that is, the principal-agent problem resonates with the problems associated with the mismanagement that plagues state corporations. The stewardship theory and stakeholder theory are the ideal models that state corporations should emulate. The above discussion shall inform the discussion and analysis of corporate governance of state corporations in Kenya in the next chapter.

[52] Donaldson T and Preston L, 'The Stakeholder Theory of Corporation: Concepts, Evidence and Implications', 68.
[53] Donaldson T and Preston L, 'The Stakeholder Theory of Corporation: Concepts, Evidence and Implications', 69.
[54] Organisation of Economic Cooperation and Development, 'OECD Guidelines on Corporate Governance of State-Owned Enterprises', 2015, 12.
[55] Organisation of Economic Cooperation and Development, 'OECD Guidelines on Corporate Governance of State-Owned Enterprises', 2015.

CHAPTER THREE: CORPORATE GOVERNANCE OF STATE CORPORATIONS IN KENYA.

Background

State corporations are created to serve in varied industries in a country. They can be classified into four categories. First, utilities. These are monopolies that have little or no competition from the private sector, for example, the provision of water. Second, regulatory parastatal. They are charged with regulating specific sectors or sub-sector of the economy, for example, the Competition Authority of Kenya. Third, commercial or industrial parastatal. They engage in active competition with the private sector. Fourth, development finance parastatal. These provide funding to industrial and commercial ventures.[56] Most of the state corporations that have suffered corporate governance failures are commercial or industrial corporations.

Many state corporations in Kenya have failed to discharge their mandate due to mismanagement and other corporate ills. The poor performance of state corporations has been attributed to mismanagement, bureaucracy, wastage, pilferage, incompetence and irresponsibility by directors. This has led to poor and inconsistent services and poor quality products.[57]

The directors of the National Social Security Fund used their role to award themselves with bonuses and other rewards which led to a loss of three billion Kenyan shilling between 1996 and 1998. This was revealed by the Parliamentary Public Investment Committee in 2001.[58]

The Numerical Machining Complex previously known as the Nyayo Motor Corporation was great opportunity for the country to mass-produce these motor vehicles. The benefits that would have arisen from the implementation of this corporations would have been immense; employment, reduction of dependence on imports and increase in the country's income through the sale of the

[56] Mwaura K, 'The Failure of Corporate Governance in State Owned Enterprises and the Need for Restructured Governance in Fully and Partially Privatized Enterprises: The Case of Kenya', 31 (1) *Fordham International Law Journal*, 2007, 46.
[57] Koech P, Namusonge G and Mugambi F, 'Board Characteristics as a Determinant of Effectiveness of Corporate Governance in State Corporation in Kenya', 5 (4) *International Journal of Business and Commerce,* 2016, 41.
[58] Koech P, Namusonge G and Mugambi F, 'Board Characteristics as a Determinant of Effectiveness of Corporate Governance in State Corporation in Kenya', 38.

motor vehicles, to name a few. There was a lack of effective translation of the vision into tangible outputs.[59]

The Agricultural Finance Corporation (AFC) was tasked to give loans to farmers at low interest rates, 5% p.a. to be precise. Due to mismanagement, at the end of the 1990s, it was unable to give loans and it was unable to recover loans given to the farmers resulting in a portfolio of non-performing loans that increase year after year until the government injected with capital to keep it afloat.[60]

The Kenya Meat Commission (KMC) collapsed due to mismanagement in the 1990s and was only revived in 2006 by the government injecting it with Kshs 500 million.[61] In 2003, the government came to the aid of Kenya Power and Lighting Company by converting loans to the corporation into non-cumulative shares[62] which means that creditors as the preferential shareholders would recover their money where the company has made a profit; in the event it runs into a loss, it shall skip the dividend in that year.[63]

The Kenya Railways had gone through so many financial and operational problems, despite the fact that it is a monopoly in its sector. The government engage a private company, the Rift Valley Railways Company, to correct the operational issues.[64] Between 1988 and 1999, a total of Kshs 8 billion was injected to 18 state corporations to prevent failure as a result of mismanagement.[65]

The government through privatisation has attempted to resolve the issues that plague state corporations. Privatisation is the transfer of partial or full ownership of a state corporation to private players.[66] Private sector players have the skill, expertise and efficiency to produce better

[59] Koech P, Namusonge G and Mugambi F, 'Board Characteristics as a Determinant of Effectiveness of Corporate Governance in State Corporation in Kenya', 41.
[60] Odoyo S et al, 'An Analysis of the Role of Internal Audit in Implementing Risk Management- A Study of State Corporations in Kenya', 171.
[61] 'KMC-A History Littered with Crippling Debt' http://www.propertykenya.com/news/007170-kmc---a-history-littered-with-crippling-debts, 2006, on 6 December, 2016.
[62] Odoyo S et al, 'An Analysis of the Role of Internal Audit in Implementing Risk Management- A Study of State Corporations in Kenya', 171.
[63] https://efinancemanagement.com/sources-of-finance/types-of-preference-shares on 6 December, 2016.
[64] Odoyo S et al, 'An Analysis of the Role of Internal Audit in Implementing Risk Management- A Study of State Corporations in Kenya', 171.
[65] Odoyo S et al, 'An Analysis of the Role of Internal Audit in Implementing Risk Management- A Study of State Corporations in Kenya', 171.
[66] Starr P, 'The Meaning of Privatization', 6, *Yale Law and Policy Review*, 1988, 6-41.

quality of goods and services as compared to state corporations. However, this has not been able to solve the underlying issues facing state corporations.[67]

From the above examples, it is clear that corporate governance failures are to blame for the failures of the aforementioned state corporations and other state corporations. This chapter of the paper shall take you through the establishment of a state corporation and its function, the laws that regulate state corporations, the management structure and an analysis of its benefits and drawbacks and the efforts to reform malpractices and their shortcomings.

The State Corporations Act

A state corporation is a legal entity that is wholly or partially owned by the government.[68] It is synonymous with parastatal, public corporations and state-owned enterprises. They are created through incorporation, specific legislation or executive order. They are created to provide essential goods and services to the public that cannot be adequately provided for by the private sector due to their capital-intensive nature. These services include provision of electricity, construction and maintenance of transport and communication networks, provision of housing and the provision health services, manufacturing and agricultural trade.[69] In addition, they are established to reduce foreign dominance in the market. They are also established to increase government revenue to finance development, capital expenditure and current expenditure.[70]

In Kenya, state corporations are subject to the State Corporations Act (hereinafter the Act) which provides for the establishment of state corporations, the control and regulation of state corporations and connected purposes. State corporations established under an Act of Parliament or any other written law is also subject to this Act.[71]

[67] In the article, 'Enhancement of Corporate Governance through Privatisation' published by the Privatisation Commission, Kenya, the author outlines three shortcomings of privatisation as a method of improving corporate governance within state corporations; retention of directors who more often than not lacked the expertise, the abuse of power by the authority prior to handing over and the the major lack of independence of the directors.
[68] http://www.thefreedictionary.com/parastatals on 2 December, 2016.
[69] Odoyo S et al, 'An Analysis of the Role of Internal Audit in Implementing Risk Management- A Study of State Corporations in Kenya', 170.
[70] Aharoni Y, 'State-owned enterprises: An Agent without a Principal, Public Enterprise in Less Developed Countries,' *Cambridge University Press,* 1982, 67-76.
[71] Section 2 of the *State Corporations Act,* Cap 466.

The Act empowers the President to establish a state corporation to perform a specific purpose[72] and assign ministerial responsibility for any state corporation and matters relating thereto.[73] Unless the written law under which a state corporation is established or the articles of association of a state corporation otherwise require, state corporations shall be managed by a board of directors that will consist of a chairman appointed by the President who shall be **non-executive** unless the President otherwise directs; the chief executive, the Permanent Secretary of the parent Ministry; the Permanent Secretary to the Treasury, the Attorney-General or his representative and not more that eleven other members not being employees of the state corporation, of whom not more than three shall be public officers, appointed by the Minister.[74] It also provides for the establishment of the State Corporations Advisory Committee.[75] Its mandate is of a supervisory nature. Its functions include to review and investigate the affairs of state corporations and make such recommendations to the President as it may deem necessary,[76] advise the President on the establishment, reorganization or dissolution of state corporations,[77] advise on the appointment, removal or transfer of officers and staff of state corporations,[78] examine any management or consultancy agreement made or proposed to be made by a state corporation with any other party or person and advise accordingly[79] and examine proposals by state corporations to acquire interests in any business or to enter into joint ventures with other bodies or expand the scope of the activities and advise accordingly.[80]

The Act grants the president power to make the appointments and determine the composition of the board of directors, particularly those that are established under this Act. Further, the political nature of appointments means that the boards of directors are composed of directors who are mainly ex-civil servants with little or no private business experience and act in the interests of their appointers instead of those of the corporation.[81] The appointment criteria relates more to political influence rather than technical expertise which has led to the poor management experienced in

[72] Section 3(1) of the *State Corporations Act,* Cap 466.
[73] Section 4 of the *State Corporations Act*, Cap 466.
[74] Section 6 (1) of the *State Corporations Act*, Cap 466.
[75] Section 26 of the *State Corporation Act*, Cap 466.
[76]Section 27 (1) (a) of the *State Corporation Act,* Cap 466.
[77] Section 27 (1) (b) of the *State Corporation Act,* Cap 466.
[78] Section 27 (1) (c) of the *State Corporation Act*, Cap 466.
[79] Section 27 (1) (d) of the *State Corporation Act,* Cap 466.
[80] Section 27 (1) (e) of the *State Corporation Act,* Cap 466.
[81] Koech P, Namusonge G and Mugambi F, 'Board Characteristics as a Determinant of Effectiveness of Corporate Governance in State Corporation in Kenya', 42.

state corporations.[82] In addition, the Act does not prescribe the criteria that the President or the Minister should use when making the appointments of these officials making it a highly subjective process.

The One-Tier Board Structure

The board of directors assigned to state corporations consists of management officers as well oversight officers. This is referred to as the one-tier board structure. This is where the board of directors comprises the executive team and the non-executive team. The executive team is charged with daily operations and management of the corporation. They include the chief executive officer and, in some cases, other executive directors. The non-executive team is charged with overseeing the executive team and making key decisions that will influence the management of the corporation. The one-tier board structure has been adopted and widely used in Anglo-Saxon countries, that is, the United Kingdom and the United States of America.[83] Kenya has adopted the one-tier board structure for both its private and public institutions due to its history as a British colony.

The one tier board structure has a number of advantages that must be considered. First, there is efficient flow of information. By having the chief executive officer and the independent monitors on the same board, it promotes individual relationships, a better understanding of the business and the independent monitors can exercise their supervisory function in management decision-making.[84] Second, the one tier board structure promotes faster decision making. There is no need for separate approval for tasks to be done. In addition, formal board meetings can occur regularly allowing for more active decision making.[85] Third, a better understanding of the business and its strategies. The combination of the management and supervisory board maximises on the expertise

[82] Koech P, Namusonge G and Mugambi F, 'Board Characteristics as a Determinant of Effectiveness of Corporate Governance in State Corporation in Kenya', 42.
[83] Block D and Gerstner A, 'One-Tier Vs Two-Tier Board Structure: A Comparison between the United States and Germany', *Comparative Corporate Governance and Financial Regulation*, Paper 1, 2016, 19.
[84] Block D and Gerstner A, 'One-Tier Vs Two-Tier Board Structure: A Comparison between the United States and Germany', 19.
[85] Block D and Gerstner A, 'One-Tier Vs Two-Tier Board Structure: A Comparison between the United States and Germany', 19.

of members of both, allowing for not only the understanding of the complexities of the business but also challenging the strategies in place resulting in better decision making.[86]

The one-tier board structure has its disadvantages which may have contributed to the scandals associated with state corporations. First, the dual task of managing and monitoring-a board member may find it difficult to remain neutral because there are personal relationships among board members.[87]This conflict of interest has a profound impact on the structural organisation of the organisation of the company and subsequent strategies that are to be employed in the running of the company's activities.[88] Second, the existence of a serial director. If the non-executive director is an executive director on another board, they may be lax in their monitoring because they would like the same treatment on their own board.[89] Third, board of directors are synonymous with 'boys clubs'. The personal relationships that develop in those situations that undermine the independence of the independent directors.[90] With respect to the state corporations in Kenya, this is further enhanced by the political nature of the appointments. The directors act to benefit the appointers and not to advance the interests of all stakeholders.

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[86] Block D and Gerstner A, 'One-Tier Vs Two-Tier Board Structure: A Comparison between the United States and Germany', 19.

[87] Spisto M, 'Unitary Board or Two-Tiered Board for the New South Africa.' (1) 2, *International Review of Business Research Papers*, 2005, 86.

[88] Macey J, 'Corporate Governance: Promises Kept, Promises Broken' *Princeton University Press*, 2008, 55.

[89] Block D and Gerstner A, 'One-Tier Vs Two-Tier Board Structure: A Comparison between the United States and Germany', 19.

[90] Block D and Gerstner A, 'One-Tier Vs Two-Tier Board Structure: A Comparison between the United States and Germany', 20.

CHAPTER FOUR: THE TWO-TIER BOARD STRUCTURE IN GERMANY AND NETHERLANDS

This chapter shall delve into the two-tier board structure, using Germany and Netherlands, as case studies, the rationale, functions and the shortcomings of the structure.

GERMANY

Since the inception of German corporate law, the two-tier board structure has been used. The two-tier board structure consists of two boards- the management board and the supervisory board. The objective behind the two-tier board structure is to separate the act of managing from the act of supervision.

The German Corporation law is a unique system that developed from a mixture of political, economic and cultural factors. In the early industrialisation period, there two principal developments that arose in this period. The emergence and expansion of the limited liability share company (*Aktiengesellschaft* or AG) with its accompanying form of managerial control and the increasing cooperation and integration between and among firms that led to cross-shareholding, communities of interest and corporate groups. [91]

The creation and incorporation of the limited liability company led to the separation of ownership from control. Small unincorporated firms were unable to compete with the large firms that had adopted this form of incorporation. Despite the fact that there was a separation of ownership from control, majority shareholder retained primary control of firms while the management team considered important but had limited authority. The use of the corporate form and management run corporations led to cooperation and concentration among firms in the form of trade and production cartels.[92] There are two aspects of the German Corporation Law that must be considered when discussing it: the theory of path dependency and codetermination.

The theory of path dependence posits that an economy's ownership structure depends on the pattern of ownership structures that the economy had at earlier points in time.[93] This theory can be viewed from two perspectives: structure-driven path independence which concerns the direct effect

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[91] Fohlin C, 'The History of Corporate Ownership and Control in Germany' *University of Chicago Press*, 2005, 225.
[92] Fohlin C, 'The History of Corporate Ownership and Control in Germany', 226.
[93] Block D and Gerstner A, 'One-Tier Vs Two-Tier Board Structure: A Comparison between the United States and Germany', 27.

of initial ownership structures on subsequent ownership structures and rule-driven path dependence which concerns the effect of initial ownership structures have in subsequent structures through their effect on the legal rules governing corporations.[94] During the inception of the modern corporation, the one-tier or two-tier board structure was not mandatory. The management board was seen as an officer of the shareholders while (if implemented) the supervisory board was merely a shareholder committee. As the social views changed, there was need for a supervisory body to ensure managers cater to the interests of shareholders and stakeholders alike. Thus, the introduction of a mandatory two-tier system for limited companies. German Corporation law has since maintained the two-tier system.

One aspect of the path dependency theory that has persisted over the years is Germany's system of labour co-determination. Co-determination promotes participation of employees in not only regulating the working conditions but also in economic planning and decision. The goal of co-determination is the promotion of trust, cooperation and harmony.[95] Co-determination has a number of objectives. First, it promotes democracy in the economy by ensuring resolution of conflicts is through dialogue. Second, it contributes to the improvement of employee's living and working conditions which results in social development. Third, the employer (the corporation) is mandated to consider not only the interests of the shareholders but also those of the employees.[96]

Historical Development of Corporate Ownership and Control in Germany

Germany has been a unified state since 1870. Prior to this, the French Code de Commerce of 1807 was identified as general corporate law which allowed for incorporation with limited liability. Other comparative law precedents were also used as the basis of the first German corporate laws of the early to mid-nineteenth century.[97] German traders relied on forms of business that evolved from Roman precedents such as the *societas* and *commendas* which were personal in the nature of their obligations. Family partnerships were used to create major trading houses on the basis of renewable short-term contracts.[98] At the end of the fifteenth century, the first German corporate

[94] Bebchuk L and Roe M, 'A Theory of Path Dependence in Corporate Governance and Ownership' Columbia Law School: The Centre for Law and Economic Studies, Working Paper No. 131, 1.
[95] Page R, 'Co-determination in Germany-A Beginner's Guide', *Hans Bockler Stiftung*, Arbeltspapier 33, 2009, 11.
[96] Page R, 'Co-determination in Germany-A Beginner's Guide', *Hans Bockler Stiftung*, Arbeltspapier 33, 2009, 12.
[97] Muchlinski P, 'The Development of German Corporate Law until 1990: A Historical Reappraisal' 2 (14) *German Law Journal,* 2013, 341.
[98] Muchlinski P, 'The Development of German Corporate Law until 1990: A Historical Reappraisal', 341.

entities appeared in the mining and metals industry. They were characterised by capital divided into shares and the differentiation of company assets from those of the shareholders.[99]

This period was also characterised by the system of the state corporation -the concession system. It was justified by the need for the state control in order to protect small shareholders and the wider public interest to control private economic power that would lead to monopolization. Industrialisation, particularly, the development of railways pushed for free incorporation. Railway companies still had to obtain a concession from the government but they were also governed by the Law on Railway Companies (*Gesetz uber Eisenbahnunternehmungen*) of 1838. In 1843, the first general corporate law for Prussia (*Preussiche Aktiengesetz*) was enacted. It included limited liability for joint stock companies and excluded partnerships. The 1843 law provided for the disclosure of the size of the initial capital, the method of accounting employed and the nature of voting rights for shareholders. The corporate statute had to be assented by the government which would be granted if the aim of the corporation was of public interest. [100]

In the period between 1870 and 1897, the unification of Germany and the economic need for easy access to the corporate form of limited liability called for a unified German corporate law. It should be noted that it was believed then that competition would be enhanced if freedom of incorporation was availed because it would allow for more business associations to be formed.[101] During this period, the laws contained formalities and restrictions on company formation such as prohibition on dealing in its own shares by the company and prohibition on the company's board members, both supervisory and management, entering into transactions with the company unless a two-thirds majority of the general meeting approved. It is important to note that during this period, the law gave legal force to the two-tier board structure.[102]

In the period between 1897 and 1945, the conceptual changes that occurred were influenced by the two World Wars, the political turmoil of early post World War I, the rise of the new corporatist and state socialist thinking about the relationship between business and society and the Nazi era.[103] In this era, Walter Rathenau wrote on the changes that the German corporate law had to make.

[99] Muchlinski P, 'The Development of German Corporate Law until 1990: A Historical Reappraisal', 342.
[100] Muchlinski P, 'The Development of German Corporate Law until 1990: A Historical Reappraisal', 342.
[101] Muchlinski P, 'The Development of German Corporate Law until 1990: A Historical Reappraisal', 343.
[102] Muchlinski P, 'The Development of German Corporate Law until 1990: A Historical Reappraisal', 350.
[103] Muchlinski P, 'The Development of German Corporate Law until 1990: A Historical Reappraisal', 365.

One of the major arguments that he brought forth was that large corporations belong to the wider community which means that it should not work with the just their interests in mind, but the greater social interest.[104] This period was marked by the rising power of unaccountable management.

The post World War II period was concerned with the reconstruction of Germany after its destruction during World War II. The state encouraged the development of free markets and the development of small and medium sized enterprises. Large enterprises play an important role in society, therefore, it is regulated by corporate law to balance between managerial control and protect minority interests which led to the re-introduction of co-determination laws and reform of the 1937 *Aktiengesetz* law. The co-determination laws allow employee representatives to sit on the supervisory board. This further enhanced the board's ability to supervise the management board.[105]

German Corporation Law

Today, German corporations are governed by the Stock Corporation Act, supplemented by other statutes such as the Codetermination Acts and the German Code of Corporate Governance. The Stock Corporation Act provides for the mandatory two-tier board structure in limited companies. The German Code for Corporate Governance acts as a guide to enhance management standards and improve the relationship between the management board and supervisory board. It is imperative to note that there is a prohibition of members of one board to have a seat in the other board.

The management board (*Vorstand*) comprises the executives of the corporation. They are charged with daily operations of the corporation. They manage the workforce, manage accounts and ensure that the corporations are implemented in an efficient and timely manner.[106] The members of the management board are appointed by the supervisory board. The size of the board depends on the company's size and the applicability of codetermination rules and statutes.

The supervisory board (*Aufsichtsrat*) comprises shareholder representatives and employee representatives. The shareholder representatives are elected at a general meeting. The employee representation depends on the size of the corporation and the codetermination rules and statutes.

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[104] Muchlinski P, 'The Development of German Corporate Law until 1990: A Historical Reappraisal', 366.
[105] Muchlinski P, 'The Development of German Corporate Law until 1990: A Historical Reappraisal', 373.
[106] Block D and Gerstner A, 'One-Tier Vs Two-Tier Board Structure: A Comparison between the United States and Germany', *Comparative Corporate Governance and Financial Regulation,* Paper 1, 2016, 23.

The supervisory board is charged with overseeing the management board. Other duties involve appointing members of the management board, call shareholder meetings, evaluate annual financial statements and provide a written report of the result of the audit for the shareholders meeting and represent the company in its dealings with members of the management board.[107] The supervisory board also has powers that gives them a degree of control over the management board, for example, the management board can only perform certain actions such as insider lending with the consent of the supervisory board.

NETHERLANDS

In the Netherlands, the formal structure of corporations is guided by Book 2 of the Civil Code- *Burgerlijk Wetboek.* The Dutch corporate governance structure provides for the management board and the supervisory board. It applies to both private and public corporations.[108] It only differs from Germany in its implementation.

Historical Development of Dutch Corporate Law

The history of Dutch corporate law steps from the first limited liability joint-stock company, Vereenigde Oostindische Compagnie (VOC) in 1602. The company's objective was to send out a merchant ships to the East Indies. During this time, companies were formed to advance a public interest and were generally controlled by the government. Dutch companies, almost at from the beginning were faced with a number of corporate governance issues such as inadequate financial disclosure to shareholders and lack of a clear payout policy.[109]

Around 1720, the legal form of a limited company or *naamloze venootschap (*NV*)* was borrowed from the English company law. The setting up of companies was no longer limited to advancing public interest but rather the primary objective was private profit. The companies that were formed during this period were reputable due to the prevailing stock market bubble. The consequent

[107] Block D and Gerstner A, 'One-Tier Vs Two-Tier Board Structure: A Comparison between the United States and Germany', 22.
[108] Maassen G, 'An International Comparison of Corporate Governance Models: A Study on the Formal Independence and Convergence of One-Tier and Two-Tier Corporate Boards of Directors in the United States of America, the United Kingdom and the Netherlands' Published, Rotterdam School of Management, Rotterdam, 144.
[109] Jong A and Roell A, 'Financing and Control in the Netherlands: A Historical Perspective' *University of Chicago Press*, 2005, 468.

collapse of company profits and share prices led to a slowdown in the creation of new limited companies. There was a ninety-year hiatus from 1779.[110]

After the French occupation in the nineteenth century, Dutch civil law was codified in line with French Law. The Wetboek van Koophandel (commercial code) of 1838 provided guidelines for public limited companies. From the onset, this law failed to address a number of concerns such as the personal liability of founders, issuers, management and directors, shareholders' obligation with regard to paying in their capital and weak corporate governance safeguards in protecting investors; particularly the inadequacies in monitoring by the board of directors.[111]

From 1871, legislative proposals were submitted, discussions were held and new comprehensive flexible law was enacted in 1928.[112] The new regime was characterised by four principles namely; preventive government monitoring, transparency of the international organisation and division of power, protection of capital against excessive payouts to shareholders and strengthened liability of founders, management and directors.[113]

Between 1970 and 1971, company was revised with two major repercussions. First, the revision was influenced by the European Economic Community's First Directive on Company Law of 1968. There was a need to create a new separate type of limited company *besloten venootschap* (BV) or closed company. Majority of the smaller companies converted from NV to BV due to the lower level of financial disclosure that was required.[114] Second, the revision provided an avenue for employees to increase their influence in company activities. The centralised collective bargaining adopted after World War II contributed to a period of wage restrain which had a positive impact on economic growth. Therefore, employee representation in decisions relating to job security was considered suitable.[115]

[110] Jong A and Roell A, 'Financing and Control in the Netherlands: A Historical Perspective', 470.
[111] Vliet L, 'The Netherlands-New Developments in Dutch Company Law: The 'Flexible' Close Corporation' 7 (1) *Journal of Civil Law Studies*, 2014, 274.
[112] Vliet L, 'The Netherlands-New Developments in Dutch Company Law: The 'Flexible' Close Corporation', 275.
[113] Jong A and Roell A, 'Financing and Control in the Netherlands: A Historical Perspective', 471.
[114] Jong A and Roell A, 'Financing and Control in the Netherlands: A Historical Perspective', 472.
[115] Jong A and Roell A, 'Financing and Control in the Netherlands: A Historical Perspective', 473.

Dutch Corporation Law

Today, Dutch corporation law is governed by Book 2 of the Dutch Civil Code-*Burgerlijk Wetboek* which contains the Companies Act, a Corporate Governance Code issued by the Tabaksblat Committee in 2003 and case law of the Enterprise Chamber of the Amsterdam Court of Appeal.[116] The Dutch apply the rule through four different legal regimes that cater to the size and activities of corporations. These regimes include the common regime (*Gewoon Model*) which governs small and medium-sized corporations, the structure regime (*Structuurmodel*) which applies to corporations that related to the number of employees and the amount of subscribed capital, the mitigated structure regime (*Verzwakt Structuurmodel*) and the exempted regime (*Vrijgesteld Model*) which applies to multinationals and foreign-owned subsidiaries.[117]

The two-tier board structure mainly applies to corporations within the structure regime. The works council have the right to nominate candidates for one-third of the supervisory board ensuring employee representation on the board. The Corporate Governance Code posits that supervisory board acts in the best interest of not only the shareholders but also the stakeholders.[118] The overarching duty of the supervisor board is to supervise the management which is manifested in a number ways namely; corporate strategy on the risks inherent to the business activities, the design and effectiveness of the internal risk management and control systems, financial reporting process, compliance with primary an secondary legislation and the achievement of the company's objectives.[119] As is the case in Germany, the management board is responsible for the daily operations of the corporation and is mandated to report to the supervisory board.[120]

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[116] Bekkum J, Hijink S and Winter J, 'Corporate Governance in the Netherlands' 14 (3) *Electronic Journal of Comparative Law*, 2010, 1.
[117] Maassen G, 'An International Comparison of Corporate Governance Models: A Study on the Formal Independence and Convergence of One-Tier and Two-Tier Corporate Boards of Directors in the United States of America, the United Kingdom and the Netherlands',146.
[118] Article 140 of *Book 2 of the Dutch Civil Code*.
[119] Article 140 of *Book 2 of the Dutch Civil Code*.
[120] Bezemer P, Peji S, de Kruijs L and Maassen G, 'How the Two-Tier Boards can be more effective', 14 (1) *Corporate Governance: The International Journal of Business in Society,* 2014, 17.

Advantages and Disadvantages of the Two-Tier Board Structure

In light of the above discussion on the two jurisdictions, this section shall look into the benefits and the shortcomings of the two-tier board structure.

The major advantage of the two-tier board structure is the efficient monitoring through separation. This structure stems from that it is difficult to be part of the management team as well as the supervisory team.[121] The roles of both boards are clearly outlined and the express prohibition of members of one board having a seat on the other board prevents any conflict of any interest that may arise. In addition to this, the separation acts as a deterrent to fraud and other irregularities.

Moreover, this board structure not only focuses on the interests of shareholders but also that of stakeholders. The supervisory board is comprised of shareholder representatives and employee representatives. This creates harmony in the work environment as well as ensuring that the corporation makes decisions that not only improve the bottom-line but also the working conditions and the standard of living of its employees.

The independence from management has been done through the creation of supervisory board; one cannot monitor his actions. In addition, any conflict of interest that may arise is dealt with immediately. Management cannot influence the supervisory board. Employee representatives may exert influence due to their connection to management but this can be reduced through the inclusion of an adequate number of independent members. Doing so compensates for any situation where the employee representatives may exert their influence on board decisions.

One of the major disadvantages of two-tier board structure is information asymmetry. The lack of information about the business, due to minimal contact with the daily operations of the business, may hinder the supervisory board from discharging its mandate.[122] Where the supervisory board depends sorely on the information presented by the management board, the information received may not be objective as management may prepare reports that are geared to furthering their own agenda. The lack of information and the lack of the correct and objective information reduces their ability to efficiently monitor and evaluate executive actions. However, this is mitigated by the fact

[121] Block D and Gerstner A, 'One-Tier Vs Two-Tier Board Structure: A Comparison between the United States and Germany', 31.
[122] Block D and Gerstner A, 'One-Tier Vs Two-Tier Board Structure: A Comparison between the United States and Germany', 32.

that the supervisory board has a right to inspect all documentation of the company.[123] Other methods of mitigation can be through formulating rules to which data to collect and in which form the management board shall deliver comprehensive information. Additionally, joint meetings between the two boards should be held so that the supervisory board is always be aware of the activities of the management board.[124]

In addition, in practice, members of the supervisory board are pre-selected by the management board, and are formally elected at the general meeting which reduces the independence of the supervisory board. The members also exercise their mandate in a reactionary manner, that is, they evaluate the actions of the management board after they have already taken measures to implement the goals of the corporation.

Another disadvantage is operational challenges may hinder monitoring. These are challenges that persist with the implementing board practices such as rules on flow of information. It also involves the ability to ask critical questions and solve interpersonal conflicts.[125] Regular meetings between the two boards will help in resolving the operational challenges.

It is clear that with the discussion on Germany and the Netherlands, the adoption of the two-tier board structure could be applied to state corporations. These two countries have vibrant economies that have been directly influenced by the growth and development of industry and business activities.[126] The growth and development of the industry and other business activities is a result, among other factors, of the structure of the corporation that have provided a conducive environment for the growth of its corporations. The next chapter shall provide recommendations for the adoption of the two-tier structure for state corporations in Kenya.

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[123] Hopt K, 'The German Law of and Experience with the Supervisory Board' European Corporate Governance Institute, ECGI Working Paper Series in Law, Working Paper No 305/2016, 12.
[124] Hopt K, 'The German Law of and Experience with the Supervisory Board', 12.
[125] Block D and Gerstner A, 'One-Tier Vs Two-Tier Board Structure: A Comparison between the United States and Germany', 33.
[126] Germany is the fifth largest economy in the world in Purchasing Power Parity (PPP) terms and is a leading exporter of machinery, vehicles, chemicals and household equipment. Netherlands is the sixth largest economy in the euro-zone and is noted for its stable industrial relations, moderate unemployment and inflation and a sizable trade surplus. http://www.indexmundi.com/factbook/compare/germany.netherlands/economy on 9 January, 2016.

CHAPTER FIVE: ANALYSIS AND RECOMMENDATIONS

Corporate governance is an important aspect of the success of a corporation. Without proper management and leadership at the helm of the corporation, it is doomed to fail. Consequently, a proper corporate governance framework must be adopted. A proper corporate governance framework comprises several elements, chief among them is the board structure and the responsibilities of the board of directors which has been the running theme of this paper.

The previous chapters have extensively discussed the one-tier board and the two-tier board structures. They have looked at the rationale behind each structure and the benefits and shortcomings of both structures. The one-tier board structure is less costly and provides for quicker decision-making but with that the neutrality of non-executive directors is put in question due to the development of personal relationships formed within the board. The shortcomings of this structure has plagued state corporations in Kenya. The political affiliations have led to the appointment of incompetent directors who put their interests before the interests of the state corporations and their stakeholders. The two-tier board structure provides clarity in separation of duties and responsibilities. The management board is charged with the daily activities of the corporation while the supervisory board is charged with overseeing the activities of the management board. This brings about the efficiency required to run a corporation. On the other hand, this division tends to delay decision-making which subsequently leads to loss of opportunities that could have benefited the corporation. Summarily, these are the major characteristics of both structures that must be considered before this paper can make its recommendations.

The one-tier board structure in Kenya with regards to state corporations has not been successful. The various scandals that have been mentioned were as a result of mismanagement and the weak enforcement of corporate governance mechanisms. State corporations have failed as a result of lack of neutrality shown by non-executive directors. The State Corporations Act has provided for the State Corporations Advisory Committee to oversee the operations of state corporations. As a way in which it can fulfil its mandate is the adoption of the two-tier board structure. The separation between the management team and the supervisory team shall provide a clarity in duties and responsibilities that has not been experienced before. This will ensure that the operations of state corporations will not be hindered and can serve members of the public efficiently and effectively.

The two-tier board structure has worked in Germany and in its Dutch counterpart as evidenced by their booming economies, which among other factors, has been influenced by this board structure.

The adoption of a new system will be met with some resistance, especially by the old guard, and it may be costly change but the long-term benefits shall surpass the hurdles that need to be overcome to get the system up and running. The new system can be adopted in gradual steps with the mechanisms and institutions provided by law.

First, in order to ensure that the shortcomings of the two-tier board structure do not plague state corporations in Kenya, there must be clear guidelines set out by the State Advisory Committee, on the relationship between the two boards. These guidelines shall include the remuneration of members-which will control the costs associated with having two boards-and limiting time for decision making so as to reduce bureaucracy.

Second, in a bid to make the transition gradual, a supervisory committee within the state corporation can be implemented before providing for a fully fledged board as a permanent solution so as to reduce the bureaucracy associated with having two boards.

Third, this system should be implemented as a pilot program in three state corporations to determine the feasibility of the new system before making it mandatory for all state corporations. In addition, this will assist in making clearer guidelines for the implementation of the new system and make it easier for other state corporations to adopt the new system.

Fourth, a biannual review is done to determine the success of the implementation and to make note of any improvements, or lack thereof, that have been associated with the change in board structure.

Fifth, in terms of appointment of directors, to reduce the political nature of their appointments, the State Corporations Advisory Committee can be mandated to nominate the Chairman and other officials to the board to enhance the diversity among members and improve neutrality of the directors.

Conclusively, the change in system is not guaranteed. It may be plagued by the shortcomings that are plagued by the two-tier structure and any safeguard against them may not work. The new system could be rejected by stakeholders. On the other hand, continuing in the destructive path of the mismanagement of state corporations is not the better option. The adoption of the new system

could be the solution that revolutionises the management of state corporations in Kenya. State corporations can fulfil their mandate of serving the public and earn tidy profits in the same vein because of the adoption of a framework that promotes good corporate governance practices.

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