

# OVERVIEW OF CORPORATE GOVERNANCE IN ETHIOPIA: THE ROLE, COMPOSITION AND REMUNERATION OF BOARDS OF DIRECTORS IN SHARE COMPANIES

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## Abstract

Good corporate governance is an important pillar of the market economy and it enhances investor confidence. A strong and balanced board of directors is necessary as a supervising body for the executive management of a company with dispersed ownership. The Ethiopian company law does not have adequate legislative provisions on governance issues related to the separation of supervision and management responsibilities, and on the composition, independence and remuneration of board of directors in share companies. Besides, the draft Commercial Code has not yet been finalized. This article critically examines Ethiopia's company law with specific reference to the powers, composition and remuneration of board of directors in light of internationally recognized best practices and principles of corporate governance. It argues that there is a need to distinguish between corporate governance and corporate management in Ethiopian company law, and that the board should be suitably composed of non-executive and truly independent members who should be professionally competent. Furthermore, directors' remuneration should be incentive-oriented based on company and individual best performance, subject to the *caveat* against excessive amounts of remuneration that go beyond the achievement of this purpose.

## Keywords:

Corporate governance, powers of board of directors, composition of board of directors, remuneration of board of directors, share companies, Ethiopia.

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## Acronyms:

BIS	Bank for International Settlement
CEO	Chief Executive Officer

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GTP	Growth and Transformation Plan
LSE	London Stock Exchange
MFI	Micro Financing Institutions
NBE	National Bank of Ethiopia
OECD	Organization for Economic Cooperation and Development
SEBI	Securities and Exchange Board of India

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## Introduction

Good corporate governance enhances the confidence of investors in the companies and positively contributes towards the overall business environment.<sup>1</sup> Well-governed companies often draw huge investment premiums, get access to cheaper debt, and outperform their objectives.<sup>2</sup> Good corporate governance requires competent 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.<sup>3</sup> Hence, the function 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.<sup>4</sup>

The Commercial Code of Ethiopia (hereinafter the Commercial Code) incorporates provisions pertinent to the governance of share companies.<sup>5</sup> However, such provisions are inadequate to address specific issues in corporate governance related to board of directors such as separation of roles of non-executive directors and CEOs, composition and independence of the board as well as director's remuneration. Moreover, proclamations and directives governing financial share companies in Ethiopia do not sufficiently address the aforementioned issues.

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<sup>1</sup> See *Indonesia's Code of Good Corporate Governance*, (National Committee on Governance, 2006), Preamble.

<sup>2</sup> *Ibid.*

<sup>3</sup> See *Report of High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe*, Brussels, (4 Nov. 2002), p.59.

<sup>4</sup> *Ibid.*

<sup>5</sup> 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).

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This Article examines the law pertinent to the governance of share companies in Ethiopia with specific reference to the powers, composition and remuneration of board of directors with a view to identifying deficiencies in the company law and suggests the solutions in light of internationally recognized best principles and practices of corporate governance. It contends that the supervisory powers of the board should be separated from the management responsibilities of the executives of share companies in the relevant laws. It also argues that the composition and independence of directors should be reconsidered. Moreover, it examines the effects of quantum of directors' remuneration on the integrity of share companies, independence of directors and the retention of competent and diligent directors. It further provides some conclusions based on the findings of the study.

## 1. What is Corporate Governance?

Various scholars and practitioners define 'corporate governance' differently.<sup>6</sup> 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."<sup>7</sup> This definition encompasses not only the formal rules and institutions of corporate governance, but also 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 determines the control and direction of the corporation and that defines relations among the corporation's primary participants.<sup>8</sup> The definition used in the United Kingdom's 1992 Cadbury Report is widely cited from this perspective, and it reads: "Corporate governance is the system by which businesses are directed and controlled."<sup>9</sup> This narrower definition focuses almost exclusively on the internal structure and operation of the corporation's decision-making processes, and is central to public policy discussions about corporate governance in most countries.<sup>10</sup>

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<sup>6</sup> See A. C. Fernando (2006), *Corporate Governance: Principles, Policies, and Practices*, (Pearson Education), p.12.

<sup>7</sup> See Jeswald W. Salacuse (2004), "Corporate Governance in the New Century", 25 No.3, *The company Lawyer*, p.69.

<sup>8</sup> *Ibid.*

<sup>9</sup> See *Report of the Committee on the Financial Aspects of Corporate Governance*, (Cadbury Report), para. 2.5 available at <[www.ecgn.org](http://www.ecgn.org)> (Visited on 24 March, 2011).

<sup>10</sup> Salacuse, *supra* note 7.

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It is to be noted that corporate governance differs from corporate management. As Fernando notes:

[c]orporate 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.<sup>11</sup>

Thus, corporate governance refers to all issues related to ownership and control of corporate property, the rights of shareholders and management, powers and responsibilities of the Board of Directors, disclosure and transparency of corporate information, the protection of interests of stakeholders that are not shareholders, enforcement of rights, etc.<sup>12</sup> Corporate governance systems depend upon a set of institutions such as laws, regulations, contract enforcements and norms that create self-governing firms as the central element of a competitive market economy.<sup>13</sup> These institutions ensure that the internal corporate governance procedures adopted by firms are enforced and they render management responsible to owners and other stakeholders.

The definition of ‘corporate governance’ is not provided under the Ethiopian company law. For the purpose of this study, it is thus important to adopt a working definition for corporate governance as a system of rules and institutions that determine the control and direction of a company and that define relations among the company’s primary participants including board of directors, managers, shareholders and other stakeholders.<sup>14</sup> This combines the narrow and broad definitions and it considers corporate governance as a system of rules and institutions which determine the control and direction of a company. It recognizes not only shareholders but also stakeholders that should be involved in the governance of share companies.

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<sup>11</sup> A. C. Fernando (1997), *Corporate Governance -The Time for a Metamorphosis*, The Hindu, (9 July, 1997): As cited in A. C. Fernando, *supra* note 6, p.13.

<sup>12</sup> Fekadu Petros Gebremeskel (2010), “Emerging Separation of Ownership and Control in Ethiopian Share Companies: Legal and Policy Implications”, 4(1) *Mizan Law Rev.* p.4. See also Fekadu Petros Gebremeskel (2004 Ethiopian Calendar), *Ethiopian Company Law*, (Far East Trading Ltd., Addis Ababa, Amharic.), p.118.

<sup>13</sup> Fernando, *supra* note 6, p.13.

<sup>14</sup> 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, 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.

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## 2. Corporate Governance in Ethiopia

There are a number of companies that are being formed by sale of shares to the wider public unlike most share companies in the past which were formed among founders.<sup>15</sup> The emergence of publicly held share companies in Ethiopia gives rise to a multitude of issues on corporate governance.<sup>16</sup> Typically, ownership separates from the control of dispersed shareholders and goes into the hands of few managers, which in turn creates the principal-agent relationship.<sup>17</sup> In such situations, agents (managers) may misappropriate the principals' (shareholders') investments as they have more information and knowledge than the shareholders.<sup>18</sup> Where there exist few block holders in share companies, minority shareholders could be exploited in the hands of such block holders. The agency problems that could occur between dispersed shareholders and managers and/or block holders of share companies in Ethiopia, therefore, necessitate good corporate governance laws and institutions.<sup>19</sup>

### 2.1. An Overview of Related Literature

Some scholarly works have been published recently on company law in general and corporate governance in particular by Ethiopian academics.<sup>20</sup> Minga Negash (2008) observes that the status of corporate governance in Ethiopia is disappointing and notes that “[t]he 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;” and he further states that “[k]ey international conventions, codes and standards are not ratified or adequately incorporated in the Proclamations” and that “the Decrees and

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<sup>15</sup> See for example, *Addis Fortune*, (Addis Ababa), April 28, 2011.

<sup>16</sup> See Fekadu, *supra* note 12, p.2, See also Tewodros Meheret (2011), *Governance of Share Companies in Ethiopia*, in Seyoum Yohannes eds., “Starting and Building a Business Association in Ethiopia: The Legal and Institutional Dimensions”, *Ethiopian Business Law Series*, Vol. IV, AAU, School of Law, (August 2011), p.53, See also Fekadu, *Ethiopian Company Law*, *supra* note 12, p.119-121, 124-127.

<sup>17</sup> See Fekadu, *supra* note 12. See also Adolf A. Berle and Gardiner C. Means (1932), *The Modern Corporation and Private Property*, p.13.

<sup>18</sup> *Ibid.*

<sup>19</sup> See Fekadu, Emerging Separation of Ownership and Control in Ethiopian Share Companies: Legal and Policy Implications, *supra* note 12, p.29.

<sup>20</sup> See Fekadu, Ethiopian Company Law, *supra* note 12, p.119-121, 124-127, Fekadu, Emerging Separation of Ownership and Control in Ethiopian Share Companies: Legal and Policy Implications, *supra* note 12, p.2, see also Tewodros Meheret, *supra* note 16, p.53.

<sup>20</sup> See Fernando, *supra* note 12, p.12.

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Directives lack coherence and foresights, and at times suffer from poor drafting.”<sup>21</sup>

Fekadu Petros (2010) underlines the growing separation between ownership and control in Ethiopia, and he submits some empirical evidence in this regard.<sup>22</sup> Relying on the data and literature on corporate governance, he shows the deficiency of the Commercial Code in protecting the rights of minority shareholders in the context of publicly held companies. He raises crucial issues such as: “what powers does the board have? Who is it accountable to? How is it organized? What are its standards of liability?” among others.<sup>23</sup> In his book titled ‘Ethiopian Company Law’ (2011), Fekadu further addresses most of the issues in corporate governance related to board of directors.<sup>24</sup>

Tewodros Meheret (2011) discusses the legal regime applicable to governance of share companies in Ethiopia.<sup>25</sup> He explores the theoretical background and legal framework of corporate governance and examines the rules of governance in light of available standards. In particular, he discusses the structural choice, appointment and removal, powers, duties and responsibilities, remuneration, and the working methods and mechanism for controlling the boards of directors. Tewodros states that “a share *company is managed* by its board which is composed of directors appointed by the general meeting of shareholders.”<sup>26</sup>

The study conducted by the Addis Ababa and Ethiopia Chambers of Commerce and Sectoral Associations on corporate governance in Ethiopia suggests the introduction of a voluntary code of corporate governance in the country.<sup>27</sup> It recommends that “corporate governance law reform should

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<sup>21</sup> Minga Negash (2008), *Rethinking Corporate Governance in Ethiopia*, (University of the Witwatersrand), p.2.

<sup>22</sup> See Fekadu, *Emerging Separation of Ownership and Control in Ethiopian Share Companies: Legal and Policy Implications*, *supra* note 12, pp.1-30.

<sup>23</sup> *Ibid*, p.5.

<sup>24</sup> See Fekadu, *Ethiopian Company Law*, *supra* note 12, pp.134-17.,

<sup>25</sup> See Tewodros M., *supra* note 16, p.53-111.

<sup>26</sup> *Ibid*, p.96.

<sup>27</sup> See Dr. Gabor Bruszt and Zekrie Negatu (2009), *Draft Project Document for Development of Corporate Governance in Ethiopia*, AACCSA, (June 2009). 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. It has adopted a voluntary code of corporate governance in 3 June, 2011.

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consider key development policy aspects which match with the country's plans for poverty reduction and wealth creation."<sup>28</sup>

This article takes the themes discussed in the aforementioned works further and makes a distinction between *corporate governance* and *corporate management*, and examines whether the same should be stipulated in the relevant laws with a clear articulation of the powers of non-executive board members. I contend that *corporate governance* is different from *corporate management*; and share companies are *governed by a non-executive board* while *management is the task of the executive of a company*. The article also argues that there is inadequacy in the law on the composition and independence of directors and forwards recommendations.

Prior works have dealt with the importance of the remuneration of directors.<sup>29</sup> This author takes this theme further and argues that companies should pay directors' remuneration even where articles of associations are silent. A procedure helpful for the determination of directors' remuneration will be indicated to resolve the controversies surrounding the quantum of directors' remuneration. This article tries to deal with issues that have not been addressed by making specific reference to the roles, composition and remuneration of board of directors in the governance of share companies in Ethiopia.

## 2.2. Significance of Corporate Governance to Ethiopia's Economy

Corporate governance issues have attracted attention in government policy circles, the academia and the popular press throughout much of the world.<sup>30</sup> Good corporate governance is recognized for:

laying down the framework for creating long term trust between companies and the external providers of capital; improving strategic thinking at the top by inducting independent directors who bring in a wealth of experience and a host of new ideas; rationalizing the management and monitoring of risks a firm faces globally; limiting the liability of the top management and directors by carefully articulating the decision making process; [ensuring] the integrity of financial reports; and helping to provide a degree of confidence that is necessary for the proper funding of the market economy.<sup>31</sup>

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<sup>28</sup> *Ibid*, p.19.

<sup>29</sup> See Fekadu, *supra* note 12, p. 145-149 and Tewodros M., *supra* note 16, p.103-105

<sup>30</sup> Fernando, *supra* note 6, p.504.

<sup>31</sup> *Ibid*.

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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.<sup>32</sup> Both the public and the experts have identified failed corporate governance as a principal cause of the scandals.<sup>33</sup> Even before the scandals, significant efforts were underway since the early 1990s within the OECD,<sup>34</sup> the European Commission<sup>35</sup> and individual European countries to understand the economic consequences of corporate governance and formulate recommendations on appropriate governance structures and practices.

Furthermore, research has found that the current global financial crisis is mostly attributed to failures in corporate governance such as oversights, failure of risk analysis and unfair compensation.<sup>36</sup> It is found that CEOs were more likely to be replaced following large losses if boards have more independent directors and firms were mainly held by institutional investors, but not when firms were controlled by insider blockholders.<sup>37</sup> There was also a high level of director turnover in corporate boards, especially for directors in risk committees.

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<sup>32</sup> *Ibid.*

<sup>33</sup> *Ibid.*

<sup>34</sup> 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](http://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.

<sup>35</sup> 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](http://www.europa.eu.int/comm/internal_market/en/company/news/corp-gov) [Accessed on 25 March 2011].

<sup>36</sup> See David Erkens, Mingyi Hung, and Pedro Matos, *Corporate Governance in the Recent Financial Crisis: Evidence from Financial Institutions Worldwide*, (University of Southern California, Marshall School of Business, Los Angeles, July 2009), p.2 This study investigated the role of corporate governance in the current financial crisis using a unique dataset of 306 global financial firms across 31 countries that were at the center of the 2007-2008 credit crisis. It documented that financial firms have experienced substantial CEO turnover during this period. It then examined whether board and ownership governance mechanisms were associated with risk taking in financial institutions.

<sup>37</sup> *Ibid.*

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Firms with more independent boards and institutional ownership experienced larger accounting writedowns during the crisis, and firms with more institutional ownership also had higher default risk before the crisis.<sup>38</sup> Finally, it is found that firms that awarded CEOs more compensation in the form of cash bonuses (instead of equity-based incentives) experienced higher losses.<sup>39</sup>

In developing countries, 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.<sup>40</sup> 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 required to respect the legal rights of lenders, bondholders, and non-controlling shareholders.<sup>41</sup> 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.<sup>42</sup> International investment not only provides corporations with expanding sources of capital, but also encourages the continued 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.<sup>43</sup>

Over the past few years, Ethiopia has experienced a number of encouraging economic gains. In 2010 alone, private banks declared a net profit of Birr 1.4 billion after paying Birr 575.4 million in profit tax.<sup>44</sup> Approximately 5,000 companies representing share companies and private limited companies are registered,<sup>45</sup> and this figure does not include state owned enterprises.<sup>46</sup> During

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<sup>38</sup> *Ibid.*

<sup>39</sup> See CIMA (the Chartered Institute of Management Accountants), *Executive remuneration schemes and their alignment with business sustainability*, Discussion paper (May 2010), p.2.

<sup>40</sup> See Alexander Dyck (2002) 'Privatization and Corporate Governance: Principles, Evidence and Future Challenges,' 16 *World Bank Observer* 59-84; Saul Estrin (2002), 'Corporate Governance and Privatization: Lessons from Transition Economies', 11 *Journal of African Economies* 28; Saul Estrin (2002), 'Competition and Corporate Governance in Transition Economies' 16/1 *Journal of Economic Perspectives* 101-124.

<sup>41</sup> *Ibid.*

<sup>42</sup> Salacuse, *supra* note 7, p.70.

<sup>43</sup> See Melinda Vaughn and Lori Versteegen Ryan (2006), 'Corporate Governance in South Africa: a bellwether for the continent?' *Corporate Governance: An International Review* (September 2006) Vol.14 No.5.

<sup>44</sup> See *Addis Fortune*, (Addis Ababa), January 29, 2011.

<sup>45</sup> See Trade Registry at Ministry of Trade of Federal Democratic Republic of Ethiopia, 2010/2011.

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the month of March 2010, the total number of banks, insurance companies and microfinance institutions (MFIs) stood at 15, 12 and 30, respectively.<sup>47</sup> The total number of bank branches increased from 617 to 673 in March, 2009.<sup>48</sup> Likewise, the number of insurance increased from 190 to 207, and the number of forex bureaux also increased from 302 last year to 331 in the review period.<sup>49</sup>

At present, Ethiopia has launched an ambitious Growth and Transformation Plan (GTP) to double its current GDP by 2015 Eth. Cal.<sup>50</sup> While these figures are promising indicators of the country's economic progress, private and public investment is crucial in the country's economic development objectives. Economic development, which is a key prerequisite for reducing poverty and creating wealth, presupposes the fundamental requirements of effective regulatory framework and good corporate governance.<sup>51</sup>

To this end, corporate governance *inter alia* facilitates access to capital through the banking system and other financial institutions by making company performance visible and reliable.<sup>52</sup> Corporate governance may also lower the costs of capital by reducing the 'risk premium' normally added by creditors to borrowing.<sup>53</sup> Application of good standards to company's affairs improves the control of business transactions and increases efficiency. Ethiopia's developmental and poverty alleviation pursuits require stronger enterprises that can generate and increase employment opportunities, produce goods and services and create profit for the investors. This envisages continuous investment of capital and human resources as well as consumer satisfaction and public confidence in the enterprises.<sup>54</sup> To achieve these objectives, companies must have good and effective system of corporate governance and must also be perceived to be properly managed.

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<sup>46</sup> See *Report on Observance of Standards and Codes (ROSC)- Ethiopia* (Nov. 2007), p.5.

<sup>47</sup> National Bank of Ethiopia, *The Monthly Macroeconomic Indicators for the Month of March*, (2010).

<sup>48</sup> *Ibid.*

<sup>49</sup> *Ibid.*

<sup>50</sup> "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>> last visited on 21 February, 2011.

<sup>51</sup> Dr. G. Bruszt, Zekrie, *supra* note 27, p.11.

<sup>52</sup> Introducing Corporate Governance in Ethiopia, available at <[http://www.ethiopiainvestor.com/index.php?option=com\\_content&task=view&id=164&Itemid](http://www.ethiopiainvestor.com/index.php?option=com_content&task=view&id=164&Itemid)> (Last visited on 1 April, 2011).

<sup>53</sup> *Ibid.*

<sup>54</sup> Justine Tumuheki (2007), "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.

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### 2.3. An Overview of Company Law in Ethiopia

In market economies company law plays a significant role in setting the legal environment for the creation and continuing operation of privately owned businesses.<sup>55</sup> It can encourage new investment and provide investor protection by setting forth clear and objective rules for a company's internal governance. It can also enhance entrepreneurship by making it easy to start up and register a company, and encourage businesses to come out of the underground economy into the publicly registered, taxpaying economy.<sup>56</sup>

Publicly held companies are referred to as “share companies” in Ethiopia's Commercial Code. Even though all companies (including financial institutions) have to adhere to the provisions of the Commercial Code to operate in the country, financial companies have other proclamations and subsidiary directives that require them to comply with additional requirements.<sup>57</sup> Accordingly, share companies engaged in banking have to comply with the Banking Business Proclamation No.592/2008 and the directives and procedures issued by the National Bank of Ethiopia (NBE). 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. Microfinancing Institutions are governed by Proclamation No.626/2009, NBE directives and procedures issued by the NBE. These specific laws apply to financial share companies in addition to the Commercial Code.

The non-financial share companies operating in Ethiopia have to comply with the provisions of the Commercial Code.<sup>58</sup> Pursuant to Article 304 of the Commercial Code, a share company is a company whose capital is fixed in advance and divided into shares and whose liabilities are met only by the assets

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<sup>55</sup> USAID, “Ethiopian Commercial Law and Institutional Reform and Trade Diagnostic”, (January, 2007), p.18.

<sup>56</sup> *Ibid.*

<sup>57</sup> 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 the 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.

<sup>58</sup> See title VI-Companies Limited by Shares, Articles 304-509 of the Code.

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of the company.<sup>59</sup> While the minimum is five, there is no limit as to the maximum number of 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,<sup>60</sup> 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 have been 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. It provides additional rules on the formation and registration of share companies<sup>61</sup> and other business organizations.<sup>62</sup>

In general, share companies are governed by the relevant provisions of the Commercial Code,<sup>63</sup> and by the specific proclamations issued regarding financial share companies, and other general and specific laws that have bearing on the operations of such companies.

### **3. The Role, Composition and Remuneration of Boards of Directors in Share Companies in Ethiopia**

The Board of Directors is a body of elected or appointed members who jointly oversee the activities of a company.<sup>64</sup> It is sometimes simply referred to as “the

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<sup>59</sup> In addition, Article 2(5) of the Banking Business Proclamation (Proclamation No. 592/2008) regards “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.’

<sup>60</sup> Commercial Code of Ethiopia, 1960, Article 513.

<sup>61</sup> See for instance, *Commercial Registration and Business Licensing Proclamation*, Art.12, Proclamation No. 686/2010, which provides the requirements to be complied with for the commercial registration of a share company.

<sup>62</sup> See *Ibid* Art.11, which lists the requirements for the Commercial Registration of a Business Organization Other than a Share Company.

<sup>63</sup> The Commercial Code contains important provisions that have a bearing on corporate governance. Articles 304-509 of the Code 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 processes and voting rights, the right of minority shareholders, auditing and reporting obligations, transparency requirements, the involvement of the Ministry of Trade and Industry and the grounds of liquidation and dissolution of companies.

<sup>64</sup> A. C. Fernando, *supra* note 6, p.12.

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board.” A board’s activities are determined by the powers, duties and responsibilities delegated to it or conferred on it by authority outside itself. “Director” may be defined as “a person having control over the direction, conduct, management or superintendence of the affairs of the company.”<sup>65</sup> The definition of “director” is nowhere given under the Commercial Code of Ethiopia. The term is defined under Article 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 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 considered as a director in the eyes of the law.

### 3.1. The Role of the 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.<sup>66</sup> Thus, the role of the 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.<sup>67</sup>

Pursuant to the Commercial Code, the board of directors is the ultimate ‘managing’ body of a company.<sup>68</sup> It enjoys extensive powers as provided in the Code and under the Memorandum and Articles of Association.<sup>69</sup> In practice, the responsibility of management is given to the CEO (general manager), who in turn may delegate the responsibility to other senior executives.<sup>70</sup> Therefore, the

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<sup>65</sup> *Ibid*, p.189.

<sup>66</sup> See Fekadu, *Ethiopian Company Law*, *supra* note 12, p.134; see also *supra* note 3.

<sup>67</sup> *Ibid*. But we have directors or a board in closed companies as well. It is their only role and this role is not true in closely owned companies.

<sup>68</sup> Article 347(1) of the Commercial Code states that “Only members of a company may manage the company”, While the Draft Commercial Code provides that “A Company shall be managed by a board of directors and not more than one third of the directors may be non shareholders 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.

<sup>69</sup> See Commercial Code, *supra* note 60, Art.363.

<sup>70</sup> 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

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board occupies a key position between the shareholders (owners) and the company's management.<sup>71</sup>

There is a unitary board of directors in share companies in Ethiopia.<sup>72</sup> The law does not distinguish between managerial and supervisory roles of the board. The Commercial Code provides that the board of directors shall appoint a manager and that only members may be appointed as directors.<sup>73</sup> All matters relating to directors in the Code appear under a section that is dedicated to the *management*.<sup>74</sup> Since corporate governance is a broader concept than corporate

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company and the management, while the day-to-day activities are run by the general managers/CEOs.

<sup>71</sup> See Fekadu, *Ethiopian Company Law*, *supra* note 12, p.134, Tewodros M., *supra* note 16, p.85.

<sup>72</sup> The Commercial Code of Ethiopia is silent on the structure of board of directors. The practical survey of share companies supports the existence of only a one-tier board system in the country. See also Tewodros M., *supra* note 16, p.87.

<sup>73</sup> See Commercial Code, Arts 348 (3) & 347 (1).

<sup>74</sup> The draft version of the Code maintains the Title of Book 2 Chapter 4 of the Code which is entitled "Directors, Auditors and Shareholders' Meeting". The Revised Draft Commercial Code, to some extent, tries to remedy the deficiency in Article 363 of the Code which deals with the powers of board of directors by providing for clearer supervisory powers of the board of directors. Accordingly, Article 363 of the Draft Code stipulates 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;
  - 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.

According to these provisions, the 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 the board of directors, which is typically followed in USA. This approach confers specific powers to the general meeting such as the power of altering the statute of the company, appointment and removal of the directors, and conferring all other powers on the board of directors. According to

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management,<sup>75</sup> the law should have treated them differently. There is no provision in the Code that employs the term “company governance” or “corporate governance.” Furthermore, the law does not separate the powers of the board chairman from that of the CEO of a company.

The relevant proclamations and directives governing financial companies in the country do not incorporate provisions dealing with the supervisory functions of the board of directors. Article 14(4)(c) of the Banking Business Proclamation No.592/2008 provides that “[t]he National Bank may issue directives on the duties, responsibilities and good corporate governance of board of directors.” However, the NBE has not yet issued such directives although the “advancement of corporate governance principles in the financial sector is critical to fostering improvement in a business climate.”<sup>76</sup>

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Article 363 (3) of the draft Code, the board is given certain specific powers expressly in addition to those mentioned in a broader sense under sub-article (1) of the same provision. The board has the power to define the objectives of the company and guidelines for its administration, control the management (and, if need be, the general manager), and prepare the financial statements of each fiscal year. This provision is very crucial in determining the supervisory roles of the board of directors. Although the draft Code is meant to fill the deficiencies of the existing Code such as the need for specific reference to the supervisory roles/powers of board of directors, there are still many issues that remain untouched. For instance, issues related to board of directors including: access to information, composition, independence, chairman and CEO, board committees (i.e., audit committee, nomination committee, remuneration committee) are not given due consideration in the Draft Code.

<sup>75</sup> See Fekadu, Ethiopian Company Law, *supra* note 12, p.118.

<sup>76</sup> 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 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 that limitation on stock ownership by a single owner in many countries and hostile takeovers are not adequately used 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

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In an emerging market economy like Ethiopia, the financial sector plays a significant role by channeling its society's savings into investments and providing necessary credits to the private sector.<sup>77</sup> 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.<sup>78</sup> This is true especially in the context of the current global economic crisis.<sup>79</sup> 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 aggravated by insufficient transparency and disclosure.<sup>80</sup> Such asymmetries are capable of undermining stability of the banking system, leading to loss of confidence, possible runs on banks, or a credit crunch which adversely affect the economy and household sectors.<sup>81</sup>

In Ethiopia, it is expected that enhanced corporate governance and transparency in the share companies (particularly financial sector) will positively influence 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.<sup>82</sup> It will also help develop other segments of capital markets such as equity capital markets. An effective system of corporate governance in banks imposes standards of conduct for managers and appropriate procedures for internal controls in order to maximize opportunities for legitimate profits in the best interests of depositors and shareholders.<sup>83</sup> Good corporate governance regulates the relationships between bank shareholders and

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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 57, p.9.

<sup>77</sup> See the Preamble of Banking Business Proclamation No.592/2008.

<sup>78</sup> *Ibid.*

<sup>79</sup> See M. Mustafa et al, *supra* note 57, p.9.

<sup>80</sup> *Ibid.*, p.10.

<sup>81</sup> *Ibid.*

<sup>82</sup> In this case, some 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 in particular. On the other hand, there 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.

<sup>83</sup> *Ibid.*

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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.<sup>84</sup>

As far as the practice is concerned, share companies are governed by board of directors. All share companies have a board of directors, which is accountable to the shareholders' meetings. The boards of directors also appoint the president who is the anchor of day-to-day management.<sup>85</sup> However, since there is no requirement of the law that clearly distinguishes the management responsibilities of executive directors from that of directing and supervising a company, it is difficult to conclude that the roles of directors are limited only to supervising the management.

As noted earlier, the concept of corporate governance is much broader than that of the corporate management.<sup>86</sup> The existing literature also supports that the primary role of board of directors, particularly in companies where there is only a unitary board structure, is to direct and superintend the management on behalf of shareholders/stakeholders, and in effect, mitigate agency costs.<sup>87</sup> Furthermore, most principles and codes of corporate governance around the world clearly provide for the supervisory and controlling roles of the board. According to the OECD Principles of Corporate Governance, the board should fulfill certain key functions, such as:<sup>88</sup>

- 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 ... accounting and financial reporting systems; monitoring the effectiveness of the governance practices; and
- overseeing the process of disclosure and communications.

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<sup>84</sup> *Ibid.*

<sup>85</sup> 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.

<sup>86</sup> Fernando, *supra* note 6, p.33.

<sup>87</sup> *Ibid.*

<sup>88</sup> See OECD Principles of Corporate Governance, (2004), principle VI.D.

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Similarly, the Bank for International Settlement (BIS) provides that:

[t]he 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.<sup>89</sup>

The UK Combined Code also stipulates that “[e]very company should be headed by an effective board, which is collectively responsible for the success of the company”.<sup>90</sup> Likewise, pursuant to Securities and Exchange Board of India (SEBI), “[t]he 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.”<sup>91</sup>

When one examines the provisions of the Commercial Code and other relevant laws of Ethiopia in light of these principles of corporate governance, they are far from being adequate. The law should thus delineate the supervisory and management roles of the board of share companies in light of international corporate governance principles and best practices. The Commercial Code does not provide for separation of the roles of the CEO and board chairperson. But, a board chairperson’s role should be different from that of the chief executive officer.<sup>92</sup> Separation of the two posts may be regarded as good practice, and can help to achieve an appropriate balance of power, increase accountability and improve the board’s capacity for decision-making which is independent of management.<sup>93</sup> A non-executive chairperson should be entitled to maintain an office at the company’s expense and also be allowed reimbursement of expenses

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<sup>89</sup> Basel Committee on Banking Supervision, *Principles for Enhancing Corporate Governance*, (Bank for International Settlement (BIS), Oct. 2010), available at <<http://www.bis.org/pub/bcbs/68.pdf>> Last visited on 24 May, 2012].

<sup>90</sup> London Stock Exchange (LSE): Committee on Corporate Governance, Hampel: *The Combined Code*, Section 1A, Main Principle, (London, July 2003). <<http://www.frc.org.uk/documents/pagemanager/frc/Web%20Optimised%20Combined%20Code%203rd%20proof.pdf>> Visited on 11 April, 2012.

<sup>91</sup> 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, 2012.

<sup>92</sup> *Ibid*, section 8.

<sup>93</sup> Annotation to OECD Principles, principle VI.E.

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incurred in the course of the performance of duties and the discharge of responsibilities.<sup>94</sup>

## **3.2. Composition and Independence of the Boards of Directors**

### **3.2.1 Composition**

The composition of board of directors refers to the number and type of directors that participate in the work of the board.<sup>95</sup> 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 they are together with other team members collectively known as ‘management’ of the company.<sup>96</sup> A company may also have part time non-executive directors who have nothing to do 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.<sup>97</sup> Fama and Jensen suggest 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.<sup>98</sup> They argued that “if the CEO was able to dominate the board, separation of these functions would be difficult” to the disadvantage of shareholders and that “outside directors are able to separate these functions and exercise sound decision control.”<sup>99</sup>

The Commercial Code and other relevant laws do not require share companies to have independent non-executive directors. The law does not define the independence of board of directors. In fact, the Code provides that “the general manager may not be a director.”<sup>100</sup> However, there is a discrepancy between the English and the Amharic versions of this provision. While the English version excludes a CEO or general manager from simultaneously assuming the functions of the board and management responsibilities, the Amharic version uses the words ‘አስተዳዳሪዎ ላይሆን ይችላል’ and this cannot be construed as a mandatory provision which excludes the director from appointment as director.<sup>101</sup> As the Amharic version is the authoritative version

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<sup>94</sup> SEBI, *supra* note 91, sec 8.

<sup>95</sup> Fernando, *supra* note 6, p.23.

<sup>96</sup> *Ibid*, p. 189.

<sup>97</sup> *Ibid*.

<sup>98</sup> E. F. Fama and M. C. Jensen (1983), “Separation of Ownership and Control,” *Journal of Law and Economics*, 26, 301-325.

<sup>99</sup> *Ibid*.

<sup>100</sup> See the Commercial Code, Art. 348(4).

<sup>101</sup> Compare the English and the Amharic versions of Article 348 (4) of the Commercial Code.

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in case of contradiction between the two, most non-financial share companies appoint the general manager to be a board member.

With regard to financial companies (particularly banks), however, Proclamation No.592/2008<sup>102</sup> and NBE Directives prohibit general manager/s or CEOs from concurrently holding the positions of CEO and membership in the board of directors.<sup>103</sup> The new NBE Directives (i.e., No.SBB/49/2011) specifically prohibit any (permanent or contractual) employee of the banks, to serve as a member in the board of directors of any bank.<sup>104</sup> The directives target at avoiding conflict of interest, and applying appropriate chain of command, and checks and balances.<sup>105</sup> It has been further argued that “senior employees who have a seat on the board of banks will control the financial sector and force other members of the board to implement their interest in the industry.”<sup>106</sup> According to the NBE, allowing senior officials of a bank to sit on its board is a dubious practice that undermines the fundamental principle of checks and balances.<sup>107</sup> Hence, these provisions are believed to be significant 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. Such prohibition can indeed help ensure the independence of the board from the influence of the management.<sup>108</sup>

The Commercial Code stipulates that “only members of a company may manage a company.”<sup>109</sup> This provision seems to exclude external directors from engaging in the governance of share companies to which they are not shareholders. This provision is outdated. In the first place, external directors are recommended by different corporate governance committees<sup>110</sup> to independently direct the company and supervise the management in the interest of the shareholders. Secondly, directors should be elected for their professional talents

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<sup>102</sup> 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.”

<sup>103</sup> “Limits on Board Remuneration and Number of Employees Who Sit on Bank Board Directives No.SBB/49/2011”, NBE.

<sup>104</sup> 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.

<sup>105</sup> See *Capital*, (Addis Ababa), February 26, 2011.

<sup>106</sup> Interview with Mr. Solomon Desta, Director of Bank Supervision for NBE, April 26, 2011

<sup>107</sup> See *Capital*, (Addis Ababa), February 26, 2011.

<sup>108</sup> The legality of the National Bank Directives (No SBB/49/2011) is also being challenged by many critics. They say it is ultra virus.

<sup>109</sup> Commercial Code, *supra* note 60, Art. 347(1).

<sup>110</sup> See Recommendations of Cadbury Committee on Corporate governance, 1992, *The UK Combined Code*, (2000).

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rather than their positions as shareholders. Such stipulation unduly disregards the advantages of involving talented professionals in the operation of companies regardless of their membership in them. This issue is not given due consideration in the Revised Draft Commercial Code as it limits external directors not to exceed one third (1/3) of board of directors.<sup>111</sup>

The Code does not prescribe formal qualifications for directors of companies other than financial institutions, as a result of which even incompetent persons can become members of boards of directors. Apparently, 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. Some training on board practices should also be provided to the elected members at the cost of the company towards which an Institute of Directors may be set up.<sup>112</sup>

Directives No. SBB/39/2006 issued by NBE deal with the appointment and selection criteria for membership in the board of directors of banks. The Directives set selection criteria such as education, employment, propriety, age, financial soundness and etc.<sup>113</sup> 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 a recognized higher learning institution; and the remaining board members should, at least, complete general secondary school.<sup>114</sup> Moreover, 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.<sup>115</sup> Furthermore, the Directives provide that a board member shall be a person with honesty, integrity, diligence and reputation to the satisfaction of the NBE.<sup>116</sup>

The directives stipulate 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 sequestered, 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

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<sup>111</sup> See Draft Commercial Code, Art.347 (1).

<sup>112</sup> 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>> Last visited on February 23, 2012.

<sup>113</sup> See Directives No.SBB/39/2006, Article 5, NBE.

<sup>114</sup> *Ibid*, Article 5.1.1.

<sup>115</sup> *Ibid*, Article 5.1.2.

<sup>116</sup> *Ibid*, Article 5.1.3.

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bank.<sup>117</sup> Pursuant to the directives, a member of the board of a bank shall be at least 30 years old.<sup>118</sup>

Article 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 competence prescribed by the NBE and their appointment shall be approved by the NBE. Moreover, Directives No.MFI/3/1996 state the criteria for the selection of officers and directors, and for licensing and supervision of micro-financing institutions. It provides that the members of boards of directors should at least complete high school education with the ability to read and grasp reports. Members of the board of directors should also preferably have adequate managerial experience in business and/or similar organizations.

It can be concluded that the board should be comprised 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.<sup>119</sup>

### 3.2.2 Independence

Nowadays, the importance of the independence of directors is subject of discourse among corporate circles and academics.<sup>120</sup> 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 OECD Principles of Corporate Governance provides that “[b]oard 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.”<sup>121</sup> 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.”<sup>122</sup> Similarly, SEBI states that:

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<sup>117</sup> *Ibid*, Article 5.1.6 (i-ii).

<sup>118</sup> *Ibid*, Article 5.2.

<sup>119</sup> See Advisory Group On Corporate Governance In India, *Corporate Governance In India: Current Status, & Recommendations*, *supra* note 112.

<sup>120</sup> Fernando, *supra* note 6, p. 205.

<sup>121</sup> Annotation to OECD principles V.E. p.43.

<sup>122</sup> See London Stock Exchange (LSE): “Committee on corporate Governance”, Hampel: *The Combined Code*, (London, 2000), sec A.3.2.

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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.<sup>123</sup>

Despite the fact that most members of board of directors of share companies in Ethiopia are part-time directors,<sup>124</sup> the law does not explicitly stipulate how their independence from the influence of the management could be ensured. Hence, a provision dealing with independence of board of directors should be introduced into the Ethiopian company law.

### 3.3. Directors' Remuneration

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 remuneration of board of directors should be seen in light of their constructive roles and responsibilities.<sup>125</sup> On the other hand, critics argue against the hefty fees directors receive for attending meetings, millions of dollars paid as severance payments, huge payouts as bonus, and other benefits.<sup>126</sup> The main criticism is that:

[e]xecutives and directors are not properly controlled in their virtual self awards of stock options 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.<sup>127</sup>

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 companies.

The Commercial Code deals with the remuneration of directors under Article 353. Accordingly, "a director may receive a fixed annual remuneration, the amount of which shall be determined by a general meeting and charged against general expenses."<sup>128</sup> The Code also provides that "the articles of associations

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<sup>123</sup> SEBI, *supra* note 91, sec. 6.5.

<sup>124</sup> The survey made in some financial and non financial share companies reveal this fact

<sup>125</sup> Fernando, *supra* note 6, p.104.

<sup>126</sup> *Ibid.*

<sup>127</sup> *Ibid*, p.207.

<sup>128</sup> Commercial Code, Article 353 (1).

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may provide that the directors may receive a specified share in the net profits of a financial year”.<sup>129</sup> 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.<sup>130</sup>

Nevertheless, the remuneration of board of directors, in Ethiopia, is one of the most contentious issues particularly in financial companies. The first controversy is related to the issue whether remuneration is mandatory on the basis of the Commercial Code even if it is not provided in a company’s articles of association. The second issue, and probably the most debatable, is connected with the amount of remuneration set by the law (i.e., 5%-10% share of annual net profit) and its application to the financial share companies which is considered excessive and causing conflict of interests among shareholders according to the survey conducted by the NBE in 2011.

### **3.3.1. Directors’ Remuneration: are companies obliged to pay it in all cases?**

It has been argued that a director should not be entitled “to any remuneration for the services he performs since he is not an employee of the company merely by reason of holding office.”<sup>131</sup> McCardie J, in *Moriarty v Regent’s Garage & Co*, state that “[n]ot only is a director not a servant of the company, but he is not, *prima facie*, entitled to any remuneration for his service.”<sup>132</sup> According to this view, a director is entitled to remuneration only if he/she shows some contract or agreement to be inferred from the articles of association.<sup>133</sup> Moreover, in *Re George Newman & Co Ltd*,<sup>134</sup> Lindley LJ states: “Directors have no right to be paid for their services, and cannot pay themselves or each other, or make presents to themselves out of the company’s assets, unless authorised so to do by the instrument which regulates the company or by the shareholders at a properly convened meeting.”<sup>135</sup>

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<sup>129</sup> *Ibid*, Art.353 (2).

<sup>130</sup> *Ibid*.

<sup>131</sup> Simon Goulding, *Company Law*, (Cavendish Publishing Limited ,Second ed. 1999), p.249.

<sup>132</sup> *Ibid*.

<sup>133</sup> *Ibid*, citing: *Moriarty v Regent’s Garage & Co* [1921] 1 KB 423, p 446.

<sup>134</sup> *Ibid*, citing: [1895] 1 Ch 674.

<sup>135</sup> *Ibid*, citing: *Re George Newman & Co Ltd* [1895] 1 Ch 674, p 686.

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In Ethiopia, the question as to whether directors are entitled to remuneration as of right is debatable. Article 353 of the Code provides that:

- (1) Directors may receive a fixed annual remuneration, the amount of which shall be determined by a general meeting and charged against general expenses.
- (2) The articles of association may provide that the directors may receive a specified share in the net profits of a financial year...

The first issue that captures attention is whether Article 353(1) is a mandatory provision which entitles directors to remuneration.<sup>136</sup> It is difficult to effect payment of remuneration as of right on the basis of Article 353(1) unless it is provided by an express provision in the articles of association or the same is decided by the shareholders.<sup>137</sup> That is, Article 353(1) of the Commercial Code is not a mandatory provision as regards the payment but it provides for the determination of ‘the amount’ of remuneration to be decided by a general meeting.<sup>138</sup> Determination of the ‘amount’ is a secondary issue which comes after the issue of entitlement or payment is settled. Accordingly, remuneration is due only if it is stipulated in the articles of association. The Amharic version of Article 353(1) of the Commercial Code also uses the words ‘(አስተዳዳሪዎች መቀበል ይችላሉ)’ which means ‘may receive’ and not ‘(አስተዳዳሪዎች ይቀበላሉ)’ which could have meant ‘shall receive’.

There will be no basis, contractual or legal, to effect payment where the articles of association is silent about remuneration although it appears that board members should be compensated as their service cannot be free.<sup>139</sup> Even if share companies are not obliged to pay directors’ remuneration in all cases, the articles of association will usually provide for the payment of directors and provide for how the amount is to be calculated.

On the other hand, it can be argued that company directors should be entitled to remuneration even where it is not provided in the articles of association because of the nature of the work they assume, particularly, the heavy liabilities attached to the position of directorship.<sup>140</sup> Remuneration is an incentive for directors for their services in the interest of shareholders. The board of directors

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<sup>136</sup> One may upon first impression think that Article 353(1) entitles directors to remuneration as of right.

<sup>137</sup> See Tewodros, *supra* note 16, p.103 see also Denis Keenan, *Smith and Keenan’s Company Law*, (London, Pearson Education Limited, 2002), p.300-301.

<sup>138</sup> The Amharic version provides that directors may receive remuneration where it is determined by the shareholders.

<sup>139</sup> See Tewodros, *supra* note 16, p.103-104.

<sup>140</sup> Fekadu, *Ethiopian Company Law*, *supra* note 12, p.146, See Commercial Code, *supra* note 60, Articles 366-367.

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formulates general business objectives, appoints and superintends the general manager and management team, approves credits involving huge amounts in case of financial companies and is also responsible if things go wrong at the end of the day.<sup>141</sup> Directors are also the watchdogs of shareholders and of the company. Moreover, the responsibility of board of directors involves cost that needs to be compensated. Therefore, there is no reason why directors would assume the responsibilities in profit-making companies without remuneration, and there is no justification for the law to deny a right to remuneration while it imposes burdensome liabilities on board members. It is the contention of this writer that Article 353 of the Code should be made a mandatory provision that obliges share companies to pay director's remuneration where the articles of association remain silent.

### **3.3.2. Quantum of Directors' Remuneration: An Unsettled Issue?**

There is controversy regarding the amount of directors' remuneration, especially, in relation to financial share companies in Ethiopia. According to Article 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)]. The NBE has found such payments in banks as being huge amounts of money as they remunerate their board members with generous pay packages.<sup>142</sup> 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 received a total of 37.3 million Birr in allowances and profit sharing in the 2009/2010 fiscal year.<sup>143</sup> Among them, Awash International Bank held the leading position by spending 9.3 million Birr on its directors, followed by Nib International Bank which awarded its board of directors 7.5 million Birr.<sup>144</sup> According to the survey conducted by the NBE, the highest paid director pocketed one million Birr per annum, whereas the lowest paid was 102,000.00 Birr.<sup>145</sup>

The NBE further observed that competition among shareholders to secure a seat on the board was prevalent due to this huge remuneration scheme for directors in the private banks.<sup>146</sup> In order to regulate this problem, NBE has issued Directives No.SBB/49/2011 on January 6, 2011 in accordance with

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<sup>141</sup> See *Ibid*, p.149; Tewodros M., *supra* note 16, pp.104-105; See also Commercial Code, Articles 364-367.

<sup>142</sup> See *Addis Fortune*, (Addis Ababa), January 29, 2011.

<sup>143</sup> *Ibid*.

<sup>144</sup> *Ibid*.

<sup>145</sup> See *Capital*, (Addis Ababa), 29 February 2011.

<sup>146</sup> See Survey conducted by the National Bank on Remuneration of Board of directors of private banks in January, 2011.

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Article 14(4) (e) of the Banking Business Proclamation No.592/2008 which authorizes it to issue directives on the maximum remuneration of a director of a bank, to address disputes and create industry peace and good corporate governance among financial institutions.<sup>147</sup> The directives limit the remuneration of individual private bank directors to Birr 50,000.00 (Fifty Thousand) in one operating year, and a monthly allowance of Birr 2,000.00 (Two Thousand). Banks are also prohibited from paying directors any benefits, in cash or in kind, in addition 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.<sup>148</sup>

The Directives have indeed entailed debate among different persons including members of boards of directors of private banks and officials of the NBE. There is an argument that the directives will have positive contribution towards the creation of industry peace and good corporate governance in the commercial banks.<sup>149</sup> It is stated 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”.<sup>150</sup> It is also suggested that “[t]he amount paid to directors before issuance of the directives was excessive and was creating a corporate governance crisis and conflicts among shareholders to obtain seats on the boards of directors.”<sup>151</sup> It has also been maintained that “the NBE, as the regulator of financial institutions, is responsible for setting guidelines on the remuneration of board of directors in light of good corporate governance practices in the best interest of all stakeholders”.<sup>152</sup> Furthermore, it is hoped that the Directives can promote long term profits and interests of companies by discouraging high risk taking for the short-term gains.

On the other hand, the Directives have been criticized for a number of reasons. Firstly, it is contended that the fixed pay scheme proposed by the Directives does not take into account the size of the banks, the experience and

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<sup>147</sup> See Directives No.SBB/49/2011, Preamble, NBE.

<sup>148</sup> See Proclamation No.592/2008, Article 58.

<sup>149</sup> Interview with Mr. Solomon Desta, Director of Bank Supervision for NBE, April 26, 2011, Interview with Dr. Fissehatsion Menghistu, Part time Professor at Addis Ababa University Law School, LL.M program, 11 May, 2011.

<sup>150</sup> See the preamble of “Limits on Board Remuneration and Number of Employees Who Sit on Bank Board Directives No.SBB/49/2011”, NBE.

<sup>151</sup> 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, April 26, 2011.

<sup>152</sup> *Ibid.*

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responsibility of each director, or the complexity of the operations they are engaged in.<sup>153</sup> In the second place, the Directives are said to have removed the right of shareholders to reward those they trust to sit in the boardroom and make decisions on their behalf.<sup>154</sup> According to this view, although banks in particular and financial institutions in general are highly important for the overall economy of the country thereby deserving regulation to avoid scandals, it should equally be taken into account that private banks are profit oriented institutions and individuals involved in their governance also deserve incentives which are proportionate to their contribution.<sup>155</sup>

Thirdly, it is argued that “the new pay package is too draconian and would push talented individuals out of the governance of the banking sector.”<sup>156</sup> A banker in the top management of a private bank who requested anonymity admits “the importance of regulating banks in the current situation” but underlines that “while the directives is a move towards the right direction, the new remuneration scheme, set at a maximum of fifty thousand Birr for the board of directors has been set too low”. This was also shared by eight members of board of directors of private banks who wished their name to be withheld. They 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 argued that “the content of the directives in relation to the amount of directors’ remuneration would discourage many people as it is mainly those with many years of experience in the banking sector that are sought after.” Six of them stated that they would not want to take the workload for the next term of election and risk of a 15-year imprisonment if things go wrong. In the fourth place, the low remuneration might also open the door for corruption in the banking industry as the board of directors is the top governing body that decides on key financial and credit issues.

Given the economic significance of banks, the rewards of directors must be in line with the interest of all stakeholders. This is why 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

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<sup>153</sup> 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.

<sup>154</sup> *Ibid.*

<sup>155</sup> 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. Fissehatsion Menghistu, 11 May 2011.

<sup>156</sup> See *Addis Fortune*, (Addis Ababa), May 1, 2011.

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development of Ethiopia.”<sup>157</sup> Furthermore, the Banking Business Proclamation empowers the NBE to issue directives on the maximum remuneration of directors.<sup>158</sup> However, the question here is whether NBE’s power to issue directives on the maximum remuneration of directors enables it to do whatever it considers appropriate. Legally speaking, as there are no guidelines on how the NBE exercises its powers, it would be difficult to say that the NBE has no discretion to decide whatever it thinks right in this regard.

Nevertheless, remuneration of directors in Ethiopia should be in line with international best practices. It is argued that “[i]nstead 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.”<sup>159</sup> This is supported by the experience of countries with good practices in the corporate governance of financial institutions. For instance, the G20 summit held at Pittsburgh on 24-25 September 2009 underlined the “pressing need for remuneration and governance principles in financial institutions” which should be “based on a globally consistent framework aimed at ‘aligning compensation with long-term value creation, not excessive risk taking’”.<sup>160</sup> Furthermore, it has been stressed that “a board remuneration committee should be an integral part of an institution’s governance structure and should be competent, independent and be able to demonstrate that compensation decisions are aligned with the institutions’ financial stability and future performance.”<sup>161</sup>

It can be argued that the NBE should have considered the internationally accepted practices while setting the amount of remuneration. Although none of the relevant laws require the establishment of remuneration committee in financial as well as non financial companies in Ethiopia, the international practice indicates the significance of introducing such requirement into the country’s company laws.<sup>162</sup>

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<sup>157</sup> See Proclamation No. 591/2008, Article 4: 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.

<sup>158</sup> *Ibid*, Article 14 (4) (e).

<sup>159</sup> See *Addis Fortune*, (Addis Ababa), January 29, 2011.

<sup>160</sup> See F. B. Deringer LLP, *Remuneration and Corporate Governance in Financial Institutions*, Oct. 2009, available at <[www.freshfields.com](http://www.freshfields.com)> . Visited on 26 April, 2012.

<sup>161</sup> *Ibid*, p.5.

<sup>162</sup> For instance, the UK Combined Code stipulates that Remuneration committee should establish a formal and transparent procedure for developing policy on

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As far as the structure of remuneration is concerned, much criticism has been directed at the alleged failure of financial institutions' to operate remuneration structures that take into account the long term impact of a single year's bonus decisions.<sup>163</sup> G20 leaders have criticized excessive risk taking and commended the implementation of standards that seek 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:<sup>164</sup>

- 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;
- 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.

Ryan and Wiggins adopt a bargaining framework to empirically examine the relations between director compensation and the independence of board of directors. Their findings show that independent directors have bargaining advantage over the CEO that results in compensation more closely aligned with shareholders' objectives.<sup>165</sup>

To sum up, the amount of the directors' remuneration set by the Directives No.SBB/49/2011 is too low to align the interests of directors with that of the stakeholders, risks and liabilities involved, and the impact of ineffective compensation on the independence of the board.

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executive remuneration and for fixing the remuneration packages of individual directors.

<sup>163</sup> Deringer, *supra* note 160.

<sup>164</sup> *Ibid.*

<sup>165</sup> H.E. Ryan, and R. A. Wiggins (2004), "Who is in Whose Pocket? Director Compensation, Board Independence, and Barriers to Effective Monitoring", *Journal of Financial Economics*, 73(3), 497-524.

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## Concluding Remarks

The preceding sections show that the legal framework governing company governance in Ethiopia does not sufficiently address issues related to the roles, composition and remuneration of boards of directors in share companies. The relevant provisions of law among others do not also delineate between corporate management and corporate governance. The governance powers of non-executive directors are not clearly provided separately from the management duties of company executives. Moreover, there is no legal provision that expressly articulates the need for the independence of directors. The procedure in which the remuneration of directors in banks is determined has also become a bone of contention.

As discussed earlier, the concept of corporate governance is much broader than the concept of corporate management. 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 a unitary board structure, is to direct and superintend the management on behalf of shareholders/stakeholders with purposes of mitigating agency costs. Furthermore, most principles and codes of corporate governance around the world clearly provide for the supervisory roles of the board. Thus, the law should expressly indicate the supervisory and the management functions of the board, and also provide for the separation of the roles of the CEO and board chairperson. 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.<sup>166</sup>

The board should have a core group of excellent, professionally qualified non-executive directors who understand their dual role of appreciating the issues put forward by management and honestly discharging their fiduciary responsibilities towards the company's shareholders as well as creditors. 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.<sup>167</sup> With regard to competence of board members, the law is expected to prescribe the qualifications for directors of companies other than financial institutions on top of which some training on board practices can be offered to elected members at the cost of the company.

Even though the law provides for the remuneration of directors, there are some controversies surrounding its application. The law does not expressly oblige companies to pay directors' remuneration unless it is provided in the

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<sup>166</sup> See for instance, Annotation to OECD Principles, principle VI.E.

<sup>167</sup> See for instance, The UK Combined Code, section A.3.2.

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articles of association or decided by shareholders' meeting. Since the law imposes heavy liabilities on directors, there should apparently be a corresponding financial benefit. Therefore, remuneration to directors should be recognized and must emanate from a mandatory provision of the law. With regard to the quantum of remuneration for directors in companies engaged in banking business, the NBE has fixed the maximum amount to fifty thousand Birr per year. This measure neglects factors such as the workload, which involves meetings and committee work, and the risk involved in being a director.

The other extreme of excessive remuneration systems can also hurt a company's long-term strategy by encouraging undue focus on short-term gains. For instance, executive incentive schemes that encouraged excessive risk taking are part of a wider problem that contributed to the global financial and economic crisis in 2008.<sup>168</sup> There is thus the need to strike the appropriate balance between the pitfalls of exaggerated payment packages *versus* inadequate thresholds of remuneration to directors. The remuneration should be incentive-oriented based on company and individual best director performance and meanwhile be designed so as to align directors' interests with those of shareholders subject to the precaution against excessive payments.<sup>169</sup> To this end, the remuneration packages for executive directors should be determined by the remuneration committee which should follow clearly laid down and transparent procedures. Criteria such as performance and the company's position among its competitors in the same or similar industry can indeed be considered in the determination of all incentive schemes.

Finally, the Committee entrusted with the task of revising the Commercial Code is expected to address issues in corporate governance of share companies in light of internationally recognized best principles and practices. In this regard, special attention ought to be given to advanced experiences in corporate governance of public companies and OECD principles of corporate governance. Reference should also be made to principles for enhancing corporate governance in banks that are set by the Basel Committee on Banking Supervision. —■

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<sup>168</sup> *Supra* note 39.

<sup>169</sup> See for instance, *UK Combined Code* (2003), Section B.1.

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