CORPORATE GOVERNANCE IN UGANDA: THE ROLE OF BANK FINANCE

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ABSTRACT

Neither the current literature nor empirical studies on corporate governance have paid much attention to corporate governance in Africa. In particular, there has been no attempt to explore the potential for alternative institutions, which may perform the functional role of law in fostering sound corporate governance practices.

This study seeks to examine the role of informal mechanisms of control, specifically bank finance, in shaping and influencing corporate governance in Uganda. It involves both a conceptual review of the literature on corporate governance systems and an empirical component involving 30 public companies and 6 banks in Uganda. Based on my research, I found that company law in Uganda is extremely weak and enforcement inadequate. In addition, the ownership of companies is highly concentrated and companies predominantly raise external finance from banks. Therefore, as in many jurisdictions, banks in Uganda are a part of the corporate governance system. They are able to deter the improper conduct of corporate insiders, ensure compliance with core company law obligations, such as keeping proper books of accounts and audits. However, as opposed to other jurisdictions, such as Germany, where the governance role of banks for a long time has centered on the fact that banks hold significant stock in corporations and as such, are able to exert their influence, banks in Uganda are not permitted to hold stock in non-financial firms. In addition, while the traditional role and influence of banks is gradually declining in Germany, banks are likely to remain at the center of the corporate governance system in Uganda, because of the significance of bank finance compared to other forms of corporate finance.

Scholars have long traced the trajectory of law, finance and governance. Legal centrists, in particular, have advanced the “law matters” theory— that the nature of a legal system, its legal rules and quality of enforcement are fundamental in shaping corporate governance systems. In contrast, there are jurisdictions in which legal rules or formal mechanisms of control have not played a significant governance role; instead, informal mechanisms have performed the functional role of law. As a result, the extent to which

either formal or informal mechanisms of control shape and influence corporate governance varies across jurisdictions. Informal mechanisms are particularly important in circumstances in which legal rules and enforcement institutions are inadequate to support a sound governance system. This research seeks to explore the role and impact of informal mechanisms of control, specifically bank finance, in shaping corporate governance in Uganda.

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INTRODUCTION

"If a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere."[1]

This thesis attempts to explore the role played by informal mechanisms of control, specifically bank finance, in shaping and influencing corporate governance in a developing country—Uganda. Current literature on corporate governance revolves around the formal and informal mechanisms of governance and the debate on convergence of corporate governance systems. The literature largely focuses corporate governance within developed and industrial nations especially the U.S, the U.K, Germany, Canada, Japan and to a less extent Sweden, Italy as well as emerging economies, such as India, China and western Europe. Current debates on corporate governance have not fully brought developing countries, particularly Africa, into the discussion. Some scholars have attempted to deal with corporate governance issues in developing countries, especially on the issue of convergence of corporate governance systems and the implications for developing and emerging economies. [2] However, apart from that, there is hardly any literature or empirical studies on how informal mechanisms of control shape corporate governance in developing economies, hence the contribution of my thesis to this field—with particular focus on bank finance and corporate governance in Uganda.

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[1]Arthur Levitt, former Chairman, US Securities and Exchange Commission in "*Corporate Governance in a Global Arena*."(October 1999),at http://www.sec.gov/news/speech/speecharhive/1999/spch302.htm. (Accessed 20/1/06)

[2] Erik Berglof and Ernst-Ludwig Von Thadden, *The Changing Corporate Governance Paradigm: Implications for Transition and Developing Economies,* Paper presented at the Annual World Bank Conference on Development Economics (June 1999); Charles P. Oman, *Corporate Governance and National Development*, OECD Publication CD/DOC (2001)12; Leora S. Klapper & Inessa Love, *Corporate Governance, Investor Protection and Performance in Emerging Markets*, World Bank Policy Working Paper 2818 (2002).

As corporations increasingly take center stage in almost every aspect of economic activity including trade, investment, employment and production of goods and services, the manner in which they conduct their affairs raises issues of concern to investors, employees, creditors and society. The various parties look to formal (legal) and informal (non-legal) mechanisms to protect their interests. The extent, to which either the formal or informal mechanisms of corporate governance adequately address the concerns of the various parties, depends on the corporate governance system of a particular jurisdiction. Corporate governance systems are either market-based or bank-based. Market-based systems such as the U.S and the U.K typically have dispersed share ownership structures, strong legal rules for minority shareholder protection and adequate enforcement mechanisms. Bank-based systems on the other hand, have concentrated share ownership structures, weak capital markets and the bulk of corporate finance is provided by banks. Germany has for a long time been singled out as a typical bank-based system.

Corporate governance systems vary from one jurisdiction to another, and even within a specific jurisdiction, overlapping features may be found.[3] The corporate governance system of a specific jurisdiction is shaped by various factors, including historical[4], legal[5], social and political factors[6]. Empirical studies particularly identify legal rules and the availability of enforcement institutions as critical factors in shaping a corporate governance system.[7] This is because of the importance of legal mechanisms for investor protection. Such mechanisms include standards on information disclosure, director's duties, shareholder rights and voting procedures. These mechanisms and other market forces, such as the market for corporate control (takeover threats), should deter managers from engaging in conduct that does not maximize value for shareholders. The studies by Rafael La Porta et al., are particularly important. They argue that countries such as the

[3] Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*,at http://ssrn.com/abstract=784744 (stating that the U.S, which is characterized as a market-based system, has some corporations where ownership is concentrated).
[4] Lucian Arye Bebchuck and Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 Stan L. Rev. 127 (1999).
[5] Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. Fin. Econ. 3 (2000).
[6] Mark J. Roe, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT (2003).
[7] Rafael La Porta et al., *supra*, note 5; Rafael La Porta et al., *Law and Finance*, 106 J. Pol. Econ. 1113 (1998).

U.S and the U.K, which have strong legal rules for shareholder protection have market-based corporate governance systems, where the principal source of external financing for corporations is the capital markets.

In contrast, the vast majority of countries have not had corporate governance evolve along the U.S and the U.K trends. Most other countries, such as Germany, Italy, most of continental Europe as well as emerging and developing countries have concentrated share ownership structures. In addition, the formal mechanisms of control (legal rules and enforcement institutions) are usually inadequate to protect the rights of the various stakeholders in a company. Capital markets and the market for corporate control have not played a significant governance role in these jurisdictions. Rather, banks have been instrumental in shaping the corporate governance systems of these countries. Germany is particularly singled out at the country where banks have for a long time been a part of the corporate governance system.[8]

Although formal mechanisms of corporate governance are largely considered superior to the informal mechanisms, the role played by the informal mechanisms cannot be completely ignored, and may sometimes play a more significant role than formal mechanisms, especially where there it a total failure of corporate law. This thesis seeks to explore the governance role of informal mechanisms of control in Uganda, specifically bank finance. It attempts to contribute to existing literature on alternative mechanisms of corporate governance, by exploring the extent to which informal mechanisms of control, in particular, bank finance, shapes and influences corporate governance in Uganda. It is an attempt to displace the "law matters" hypothesis of some scholars who emphasize the importance of law and legal institutions in shaping corporate governance systems.

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[8] Ekkehart Boehmer, *Corporate Governance in Germany: Institutional Background and Empirical Results,* in CORPORATE GOVERNANCE AND ECONOMIC PERFORMANCE, (K. Gugler, ed., 2002); Peter O. Mulbert, *Bank Equity Holdings in Non-Financial Institutions and Corporate Governance: The Case of German Universal Banks*, in, COMPARATIVE CORPORATE GOVERNANCE, 445, (Klaus J. Hopt ed., 1998).

Although Uganda is a common law country, whose legal rules heavily draw on the legal rules of its former colonial master—Britain, the two countries have different corporate governance systems (the U.K is a market-based system, while Uganda is a bank-based system), due to inadequacy of legal rules and enforcement institutions in Uganda. Therefore, the formal mechanisms of corporate governance are inadequate to support a sound corporate governance system in Uganda.

This research entails a conceptual review of the literature on formal and informal mechanisms of corporate governance including the strengths and weaknesses of each. It also entails an empirical component involving a field study of 6 commercial banks and 30 public companies in Uganda. As of December 2005, there were 15 commercial banks in Uganda, 12 of which are foreign owned. The 6 banks that were selected included 2 local banks, 2 small foreign banks and 2 large foreign banks. A development bank was also included for comparative purposes.

As of December 2005, there were about 517 public companies in Uganda. I was able to access records of 173 public companies at the Registrar of Companies, from which I took a random sample selection of 30 companies. I studied the files of the 30 companies and conducted interviews with officers of the companies. The objective of the interviews was to establish to what extent companies in Uganda use bank finance and how banks impact on the internal governance of the companies through monitoring and debt covenants. The interview protocols are in Appendix 1.

Chapter I discusses the general theory of corporate governance including definition of corporate governance, developments in international corporate governance, importance of corporate governance in developed, emerging and developing economies. This chapter also briefly discusses the key aspects of corporate governance, especially standards on issues such as board composition and structure, shareholder rights, transparency and accountability that are contained in various corporate governance codes.

Chapter II discusses the theoretical conceptions of formal and informal governance mechanisms. The formal mechanisms relate to the role of law and enforcement institutions in shaping corporate governance structures. Non-formal mechanisms on the other hand relate to other factors that may play a critical corporate governance role such as corporate finance and are especially important in cases where the formal mechanisms are inadequate.

Chapter III provides background information about companies and corporate governance in Uganda including the structure of ownership of public corporations, corporate governance issues, weaknesses in company law and enforcement mechanisms, the role of codes and other statues.

Chapter IV provides an empirical analysis on bank finance and corporate governance in Uganda. This includes an attempt to establish to what extent corporations in Uganda rely on bank finance, monitoring tools employed by banks and how they impact on corporate governance.

The recommendations and conclusion are contained in chapters V and VI respectively.

I.0 CORPORATE GOVERNANCE THEORY

1.1 Defining Corporate Governance

There is no generally agreed-upon definition of corporate governance; however, there have been several attempts at defining the term. The Organization of Economic Cooperation and Development (OECD) defines corporate governance as a set of relationships between a company's management, its board of directors, its shareholders and other stakeholders.[9] Corporate governance is also defined as the means by which outside investors protect themselves from insiders,[10] or the mechanisms for transmitting signals from products and input markets into corporate behavior.[11] Most definitions center on the manner in which a corporation is governed, directed and controlled.[12] The essence of corporate governance is to address conflicts of interest commonly referred to as "agency costs" that arise out of the separation of ownership and control of companies.

Berle and Means first articulated the agency cost problem, in their book on the modern corporation and property,[13] where they pointed out the problems that arise from the separation of ownership and control of a corporation. They state that the typical structure of the large American publicly traded corporations is the existence of several dispersed shareholders with small holdings and no substantial equity stake with which to exercise control.[14] This in their opinion left too much power in the hands of the managers who would increasingly become unaccountable to the shareholders.[15] Jensen and Meckling subsequently shed further light on the agency cost problem in their article on the theory

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[9] The OECD Principles of Corporate Governance, (2004).
[10] Rafael La Porta et al., *Investor Protection and Corporate Governance*, *supra* note. 5.
[11] Erik Berglof & Ernst Ludwig Von Thaden, *supra* note 2.
[12] See Report of the Cadbury Committee on the Financial Aspects of Corporate Governance (December 1992) UK; Shann Turnbull, *Corporate Governance: Its Scope, Concerns and Theories*, in Corporate Governance Vol.5 No.4; Robert A.G Monks and Nell Minow, CORPORATE GOVERNANCE, (2004); The King Committee Report on Corporate Governance (2002, South Africa), The Capital Markets Authority(Corporate Governance) Guidelines (2001)(Uganda).
[13] Adolf A. Berle Jr., Gardiner C. Means, The Modern Corporation and Property, 1(1982).
[14] Berle and Means, *id* at 47.
[15] Berle and Means, *id* at 67.

of the firm.[16] They state that the relationship between stockholders and managers in a corporation is a principal-agent relationship, and the problems that arise out of the separation of ownership and control are intimately associated with the general problems of such relationships. Such problems include divergent interests between the principal and agent, the costs of monitoring the agent and the costs of inducing the agent to maximize the principal's welfare.

1.2 Key aspects of corporate governance

Corporate governance involves both external and internal mechanisms for reducing agency costs. The internal mechanisms govern the relationships of participants in a corporation, such as controlling shareholders and the minority shareholders. The external mechanisms, on the other hand, govern relationships between insiders and outsiders, such as investors, creditors and society in general. The key aspects of corporate governance relate to mechanisms designed to ensure transparency and accountability of corporate mangers and controllers, the independence of the board of directors from controlling shareholders, fairness and the equitable treatment of shareholders.[17] The providers of capital, both debt and equity, who may not necessarily form part of the management of a corporation risk losing their investment in the absence of adequate measures to protect them. Such measures ensure adequate and timely flow of information, especially financial information relating to the performance of the corporation. In addition, mechanisms to prevent managers and controllers from extracting private benefits of control from the corporation through self-dealing and to prevent majority or controlling shareholders from oppressing minority shareholders must exist. Mechanisms to encourage managers to work in the best interests of stockholders must also be in place. These are usually referred to as "bonding mechanisms," such as executive and board compensation schemes[18].

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[16] Michael C. Jensen & William H. Meckling, *The Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976).
[17] The OECD Principals on Corporate Governance (2004); The King Committee Report on Corporate Governance (2002, South Africa).
[18] Michael C. Jensen and Clifford W. Smith Jr., *Stockholder, Manager and Creditor Interests: Application of Agency Theory* at http://papers.ssrn.com/abstract=173461,6.

Most of the key aspects of corporate governance have been translated into principles on corporate governance and enacted as guidelines in several jurisdictions such as the U.S,[19] U.K,[20] Malaysia,[21] South Africa,[22] Uganda,[23] Kenya,[24] and Tanzania[25] among others. The OECD[26] and the Commonwealth[27] also issued guidelines to provide a benchmark for good corporate governance practices to member countries. In most of the jurisdictions, the guidelines were developed in recognition of the fact that while companies have remained a key profit making vehicle, investors are increasingly getting worried about over concentration of power in the hands of management.[28] Although guidelines are not enforceable, they delineate best practice relating to structures and processes that companies may use in their efforts to achieve an optimal governance framework.[29] In some jurisdictions such as the UK, an attempt has been made to make them enforceable, by requiring listed companies to report on compliance with the code of best practice.[30] Common corporate governance principals provide guidance on matters relating to[31]:

- *The Board of Directors*

Most guidelines recognize the fact that the board of directors is the focal point of corporate governance. The composition and structure of the board, method of appointment, policies on remuneration and self-dealing transactions have a direct bearing on corporate governance. The board's duties include giving strategic direction to the company, ensuring compliance with laws and regulations, overseeing and monitoring management and ensuring that adequate information flow mechanisms exist. Accurate

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[19] The American Law Institute, Principles of Corporate Governance (1994).
[20] See Report of the Cadbury Committee on the Financial Aspects of Corporate Governance (1992).
[21] Malaysian Code on Corporate Governance (2000).
[22] The King Committee Report on Corporate Governance, (2002).
[23] The Capital Markets Authority (Corporate Governance) Guidelines, (2001).
[24] The Capital Markets Authority (Corporate Governance) Guidelines (2002).
[25] Guidelines for Corporate Governance Practices by Public Listed Companies in Tanzania, (2002).
[26] The OECD Principles on Corporate Governance, (2004).
[27] Commonwealth Association for Corporate Governance (CACG) Guidelines, Principles for Corporate Governance in the Commonwealth, November 1999.
[28] The King Committee Report on Corporate Governance (2002, South Africa), para 9.
[29] Malaysian Code on Corporate Governance, March 2000, para 13.
[30] Brian R. Cheffins, *Current Trends in Corporate Governance: Going from London to Milan via Toronto,* 10 Duke J. Comp. & Int'l L. 5, 9 (1999).
[31] Code of Best Practices and Conduct, The King Committee Report on Corporate Governance (2002, South Africa); Best Practices in Corporate Governance, Malaysian Code on Corporate Governance, March 2003; Part 111 and 111-A, American Law Institute Principals of Corporate Governance.

and timely information is crucial to the efficacy of board meetings because that is where directors make key decisions concerning companies that ultimately impact on investors. The board also, must ensure that proper procedures for monitoring the company and its management exist. Therefore, persons appointed to serve on boards are required to act with due care and diligence.

The board should also have procedures to prevent conflicts of interest and self dealing by individual directors. This is usually achieved by adopting a fair balance between executive and non-executive directors. The role of non-executive directors is to ensure fairness, transparency and objectivity. Note; however, that in some cases the role of the non-executive directors may be compromised if there are no adequate information flow mechanisms, if they are misled by insiders, act under the control or influence of a controlling shareholder or if they simply neglect to perform their duty.

- *Shareholders*

With regard to shareholders, most principles of the corporate governance relate to fair and equitable treatment of shareholders. The board of directors must ensure that there are adequate mechanisms to protect and facilitate the exercise of shareholder rights, such as secure methods of ownership registration, transfer of shares, the right to vote including voting by proxy, and the right to share in the profits of the company[32] as well as the right to obtain accurate and timely information about the company.

- *Disclosure and Transparency*

Disclosure and transparency are key corporate governance tools that enable investors to make informed decisions. Most guidelines provide for minimum standards of information flow to the Board as well as outside investors. Availability of accurate and timely information about the company is a key investor protection tool, especially with regard to material information such as financial information, share ownership, and risk factors.

[32] The OECD Principles on Corporate Governance (2004); Commonwealth Association for Corporate Governance (CACG) Guidelines, Principles for Corporate Governance in the Commonwealth ,(November 1999).

1.3 Importance of Corporate Governance

Monks and Minow underscored the importance of corporate governance today stating that "[t]he impotence of corporate governance became dramatically clear in 2002 as a series of corporate meltdowns, frauds, and other catastrophes led to the destruction of billions of dollars of shareholder wealth, the loss of thousands of jobs, the criminal investigation of dozens of executives and record-breaking bankruptcy filings."[33] Although Monks and Minow refer to events in the United States, poor corporate governance practices have caused disastrous consequences in several jurisdictions. For instance, the Asian crisis of 1997-98 was attributed in part attributed to bad corporate governance.[34] Investor concerns in the fast-developing economies, especially China and India, largely relate to corporate governance: and the collapse of commercial banks in Uganda in the 1990's was partly due to poor corporate governance[35].

- *Economic Growth and Globalization*

Economic growth and globalization have led to increased interaction between world economies and, therefore, to renewed focus on corporate governance. Corporations are increasingly engaging in activities that require immense capital. This means that the traditional sources of finance such as personal resources of individuals and banks are either not able or not well-suited to provide the necessary capital. Corporations have had to look elsewhere for finance including capital markets. By providing a mechanism where corporations can raise capital from investors who do not participate in the day-to-day management of corporations, capital markets have engendered the "Berle and Means" corporation where ownership is separated from control. Globalization has enabled corporations to go further than Berle and Means envisaged. Corporations are not only able to operate beyond national boarders, but to raise capital beyond national jurisdictions as well. These activities of corporations, both inside and outside national boundaries, have both spurred economic growth and made corporate governance critical.

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[33] Robert AG Monks, Nell Minow, *supra* note 12 , at 1.
[34] Barry Metzger, *International Financial Institutions, Corporate Governance and the Asian Financial Crisis*, *in* THE ECOLOGY OF CORPORATE GOVERNANCE: THE EAST ASIAN EXPERIENCE (Tom Heller ed., 2004).
[35] Denton Wilde Sapte, Report on Evaluation of the Resolution of UCB Ltd (2002).

- *Investor Confidence*

Until recently, corporate governance was not a major concern in most developed economies because of the strong legal frameworks that ensured adequate measures for the protection of shareholders, adequate disclosure standards as well as the discipline imposed on corporate insiders by the capital markets, labor and products markets as well as the market for corporate control.[36] Following the wave of corporate scandals, especially in the U.S, investor confidence needed to be rebuilt, hence increased focus on corporate governance as well as a shift from market regulation, towards increased government regulation of corporate activity. The Sarbanes Oxley Act,[37] for example, was enacted as a response to corporate failures and aims to improve corporate governance and restore investor confidence.[38] Therefore, managers of corporations are witnessing a new regulatory regime characterized by rigorous corporate governance standards aimed at increasing transparency, accountability and effective board performance.

There have also been increased calls for better corporate governance in emerging economies such as in China and India. These economies are experiencing phenomenal growth and investment. However, investor confidence is still low due to several factors, including inefficient legal rules and the lack of transparency and accountability. Addressing these concerns as well as fostering good corporate governance practices is crucial for sustainable growth and development. In the developing world, processes of economic transformation, such as privatization and measures aimed at increasing foreign direct investment imply that governments must address corporate governance concerns.

As indicated above, corporate governance is crucial to both developed and developing economies.[39] Economic growth and increased interaction of world economies as a result

[36] For a general discussion on the disciplinary role of markets, see Lucian Arye Bebchuck, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 Harv. L. Rev 1820, 1841-1846 (1989).
[37] Pub. Law No.107-204, 15 U.S.C.
[38] For a discussion as to whether the Act achieved its intended objectives see Roberta Romano, The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, at http://ssrn.com/abstract=596101
[39] Charles P. Oman, *supra,* note 2; Erik Berglof & Ernst Ludwig Von Thaden, *supra note* 2; Leora S. Klapper & Inessa Love, *supra* note 2.

of globalization and improvements in technology make corporate governance a global concern. Even within the bounds of a specific economy, it is recognized that corporate governance is critical to investment, growth and sustainable development.[40]

Commenting on the importance of corporate governance in jurisdictions with weak legal rules for the protection of shareholder's rights, Klapper and Love state that good governance matters more to investors in environments in such jurisdictions.[41] They suggest that corporations in countries with poor investor protection rules can use provisions in their charters to improve their governance which in turn may improve their performance and valuation. However, they point out that firm level governance can never be a replacement for country-level weaknesses and firms cannot completely compensate for the absence of strong laws and weak enforcement. This has strong policy implications for legal reform and strengthening enforcement mechanisms, such as judicial institutions.

- *Enhance Company Performance*

Charles P. Oman attempts to link corporate governance to national development. He states that in all countries, institutions of corporate governance serve two functions: to enhance performance and to ensure conformance of corporations.[42] He further states that they facilitate and stimulate the performance of corporations-the principal generators of economic growth and wealth in society--by creating and maintaining a business environment that motivates managers and entrepreneurs to maximize firms' operational efficiency, returns on investment and long-term productivity growth. He further states that corporate governance institutions ensure corporate conformance with investor's and society's interests and expectations by limiting the abuse of power, the siphoning-off of assets, the moral hazard and the significant waste of corporate controlled resources. This is achieved by establishing means to monitor manager's behavior to ensure corporate

[40] Donald, J. Johnston, OECD Secretary General, Foreword to the OECD Principles of Corporate Governance (2004).
[41] Leora S. Klapper and Ineesa Love, *supra* note 2.
[42] Charles P. Oman, *supra* note 2.

accountability and provide cost effective protection of investors' and societies interests *vis-`a-vis* corporate insiders.[43]

- *Sustainable Growth*

Commenting on the importance of corporate governance for developing and transitional economies, Iskander and Chamlou state that a healthy and competitive corporate sector is fundamental for sustained and shared growth.[44] They further state that countries are beginning to appreciate that just as public governance is important in the public sector (including service delivery regulation, tax administration), corporate governance is important in the private sector. Countries also realize that good governance of corporations is a source of competitive advantage and, therefore, critical to economic and social progress. This is not only for purposes of attracting foreign capital, but also to broaden and deepen local capital markets as well by attracting local investors. If local markets are to grow, corporate governance standards must be improved to give investors confidence and to encourage them to provide capital.

Although there is consensus among scholars and policy makers about the importance of corporate governance, weak legal regimes, poor enforcement mechanisms and poor public sector governance pose challenges for the establishment of effective corporate governance systems in developing and emerging economies. Various scholars have dealt with the issues of corporate governance and investor protection in developing and emerging economies as well as the changing corporate governance paradigm and its implications for their economies. Carlin and Mayer, for example, make a case for the role of banks in economies with concentrated ownership structures as providers of finance and major governance actors.[45]

Despite its importance, achieving an optimal governance structure that addresses concerns of all stakeholders in a corporation can be challenging. Corporate governance

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[43] Charles P. Oman,*supra* note. 2,at 13.
[44] Magdi R. Iskander and Nadereh Chamlou, *Corporate Governance: A Framework for Implementation*, World Bank Group, Washington DC (1998).
[45] Wendy Carlin and Collin Mayer, *International Evidence on Corporate Governance: Lessons for Developing Countries*, 2 Revista ABANTE 133 (2000).

structures differ from one jurisdiction to another. Some countries such as the U.S and the U.K have market based corporate governance systems, where capital markets play an important governance role through standards and other disciplinary measures they impose on corporations. Other jurisdictions, such as Germany and Sweden, have bank-based corporate governance systems where banks which are the major providers of finance to corporations play a major governance role. Market-based and bank-based systems have evolved along different paths and their impact on corporate governance differs as discussed in the next chapter.

2.0 CORPORATE GOVERNANCE AND CORPORATE FINANCE THEORY

2.1 The Theory of the Firm

The corporation is the most important vehicle for business organization today; indeed most forms of investment are conducted through corporate entities. Commenting on the centrality of the corporation to economic life, Berle and Means state that "[c]orporations have ceased to be merely legal devices through which the private business transactions of individuals may be carried on…the corporate form has acquired a much larger significance…has in fact become both a method of property tenure and a means of organizing economic life."[46] Therefore corporate governance is as critical today as it was when the corporation was first recognized as a form of business entity separate from its owners.[47] Corporations are increasingly taking center stage in all aspects of economic activity and investment hence making corporate governance more critical.

In order to appreciate the importance of corporate governance, one must first appreciate the importance of the corporate entity and its relevance to business organization. In his article on the nature of the firm, Ronald Coase gave an economic explanation for the existence of business firms as opposed to conducting business on the basis of individual transactions. He stated that a firm is an efficient form of business organization for repetitive transactions, due to lower transaction costs, compared to repetitive market contracting.[48] He hypothesized that as long as the transaction costs of contracting within a firm are low and firm organization provides certainty, repeated business will be more efficiently carried out by firms as opposed to market contracting. Coase's analysis is still relevant today, because as mentioned earlier, in every part of the world, corporations are a major vehicle for investment and wealth creation. It should be noted, however, that despite Coase's analysis and the fact that the corporate entity continues to provide an efficient mechanism for business organization, the corporations, especially publicly held corporations are replete with agency costs (costs that arise out of tensions or conflicts of

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[46] Berle and Means, *supra* note 13, at 1.
[47] Solomon v. A. Salomon & Co. [1897] AC 22.
[48] R.H. Coase, *The Nature of the Firm*. 4 Economica 386 (1937).

interest between the various participants, such as shareholders, managers, employees and stakeholders), which not only harm the firm, but also business and society.[49]

Jensen and Meckling attribute the agency cost problem in corporations to the existence of agency relationships. They define a company as an artificial legal entity that consists of a nexus of contracting relationships that include managers, shareholders, creditors, debtors, employees and other stakeholders.[50] All of these parties have their own interests, the divergence of which is one of the fundamental problems of corporate law. Therefore, the essence of corporate governance is how to reduce the agency cost problem by ensuring there are mechanisms to prevent insiders/controllers from expropriating wealth to themselves at the expense of the debt and equity holders who provide capital but do not manage the firms.

Jensen and Meckling further explain the agency cost problem by analyzing the agency problems of both debt and equity. With regard to equity, they argue that when a manager owns 100 percent of the residual claims in a firm, he will strive to maximize utility because he bears the entire cost of misappropriating the firm's resources. However, when he reduces his stake in the firm, there is less motivation to maximize utility and increased incentive to expropriate the firm's resources for private benefit. The incentive to maximize utility is further reduced as the manager's stake declines.[51] The outside investors who purchase a stake in the firm, on the other hand, will want the manager to maximize utility, hence, the divergence of interests.

While the above problem is typical of agency problems in corporations, some factors may come into play to prevent managers of public corporations from acting contrary to the interests of investors. Legal rules may impose obligations on managers especially with regard to accounting and disclosure requirements, which then deter managers from improper conduct, especially if there are strong enforcement mechanisms. In addition,

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[49] Enron and WorldCom and other recent corporate scandals offer vivid illustrations of the wide-ranging effects of poor corporate governance. The business of the corporations was adversely affected, investors lost their investments, employees lost jobs and market confidence was shattered.
[50] Jensen and Meckling, *supra* note 16, at 10.
[51] Jensen and Meckling, *supra* note 16,at 10.

capital markets, labor markets product markets and the market for corporate control also deter managers from acting contrary to the interests of investors.[52] Corporations with bad managers may not be able to raise sufficient capital from capital markets if outside investors are concerned about internal governance. Labor markets will replace managers who reduce firm value by failing to maximize utility while product markets deter bad managerial behavior through competition. Firms of managers who fail to maximize value cannot produce efficiently. The market for corporate control, on the other hand, deters bad managerial behavior through take over threats. Firms where managers fail to maximize value will have their share prices drop hence making them targets for takeovers. However, it should be noted that none of these deterrence measures is perfect. Markets are imperfect and, in the absence of strong legal rules, their role can be further weakened.

Corporate governance and much of corporate law is designed to minimize the divergent interests between the various participants in a corporation, especially the insiders and managers on one hand, and outside investors on the other hand.[53] The extent to which agency costs can be reduced and an optimal corporate governance framework achieved varies among jurisdictions depending on several factors including the nature and strength of legal rules,[54] the efficiency of enforcement mechanisms,[55] political factors,[56] and other factors or variables. In cases in which the law inadequately provides sufficient safeguards and standards, especially with regard to preventing self-dealing, protecting minority shareholders from exploitation and enforcing the disclosure of information, other mechanisms such as debt finance can provide alternative governance tools as discussed below.

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[52] See Lucian Arye Bebchuck, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 Harv. L. Rev 1820, 1841-1846 (1989) (for a detailed discussion on the deterrence role of markets).

[53] William T. Allen & Reinier Kraakman, *Introduction to the Law of Enterprise Organization,* in COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS, Aspen Publishers (2003).

[54] Rafael La Porta et al, *Corporate Ownership Around the World*, 54 J. Fin. 471 (1999).

[55] Leora S. Klapper and Ineesa Love, *supra* note 2, at 5.

[56] Mark J. Roe, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT (2003).

2.2 The Trajectory of Law, Finance and Governance

The nature of external finance that a firm uses will impact on its governance and is in turn dictated by several factors including the extent to which owners are willing to dilute ownership, availability of alternative forms of finance and the underlying legal rules of the jurisdiction in which the firm operates. Legal rules and the strength of enforcement mechanisms are particularly important, because as earlier mentioned they determine whether a particular jurisdiction has a market- or bank-based corporate governance system.

Peter Gourevitch explains the origin of the separation of ownership and control of a firm. He states that entrepreneurs are driven by two motives to sell part of their ownership to the public: the desire to diversify their assets to reduce risk and the need for additional capital.[57] Capital may be raised either using debt or equity, or both. Ideally, the decision is a matter of choice for the corporation; however, the existing legal rules and degree of protection offered to either debt or equity holders, may favor the use of one form over another. Berle and Means also acknowledge the importance of legal rules in this regard. They state that "[t]he law holds management to certain standards of conduct…a separation of ownership from management becomes factually greater or is accomplished by legal devices, it becomes increasingly the only reason why expectations that corporate securities are worth having, can be enforced by shareholders…[w]e are thus led to conclude the strength of the law in this regard is the only enforcible safeguard which a security holder really has."[58]

Each of the two forms of finance has legal, financial and corporate governance implications for the firm. Therefore, the capital structure adopted will entail a careful examination of and balance of the various implications. Rafael La Porta et al.[59] state that both debt and equity securities provide investors with intrinsic rights such as the right to vote, which investors, particularly equity investors, will use to replace management if

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[57] Peter A. Gourevitch, *Mark J. Roe's The Politics of Corporate Governance Regulation: Political Determinants of Corporate Governance: Political Context, Corporate Impact* 112 Yale L.J 1829, 1837 (2003) (Book Review).
[58] Berle and Means, *supra* note 13, at 220.
[59] Rafael La Porta et al., *supra* note 7 .

they act contrary to their interests. Equity investors also have a right to a discretionary dividend and residual interest in the property of the firm. Debt holders on the other hand, although they do not vote, can constrain management's action by demanding higher interest on their debt if they anticipate some risks or may impose obligations on borrower firms through debt covenants. These actions have the potential to constrain management from engaging in conduct tat reduces firm value such as self-dealing and, therefore, promote good corporate governance. Debt holders typically expect a fixed return on their capital in the form of interest, have the right to liquidate the assets of the firm in the event of failure to pay and have no control over the firm, particularly because the lack of a vote.[60]

Apart from the individual choices made by a corporation as regards use of debt or equity, especially on the issue of diluting ownership, the extent to which a firm is able to raise finance will depend on the nature of its market. Theoretically, the world is divided into two corporate governance systems.[61] On the one hand is the Anglo-American market-based system (U.S and U.K) with widely dispersed shareholding, strong securities markets, rigorous disclosure standards, and high market transparency, in which the market for corporate control (takeover threats) is a key disciplinary mechanism. Corporations in these jurisdictions typically have several shareholders, each with a small stake, and no controller or shareholder with a majority stake.

There are also systems of concentrated share ownership structures, such as Germany, Italy, and Japan, characterized by predominant use of bank finance and existence of controlling shareholders. The controlling shareholders may also use their position to closely monitor corporate activity and ensure the maximization of firm value. Alternatively, they may take advantage of weaknesses in legal rules to oppress minority shareholders and extract private benefits of control, such as diverting corporate opportunities to themselves and engaging in self-dealing transactions, thus destroying

[60] Debt holders such as banks can exercise control through debt covenants that may contain restrictions on what management can and cannot do until the loan is repaid. This may be in the form of restrictions on payment of dividends and nature of activities to or not to engage in.
[61] Rafael La Porta et al., Corporate *Ownership Around the World*, 54 J. Fin. 471 (1999).

firm value. Other common characteristics of countries with concentrated ownership structures include high private benefits of control, inadequate disclosure standards, weak securities markets and banks are the major providers of external finance for corporations.

The existence of different share ownership structures is attributed to, among other factors, differences in legal systems. Some empirical studies indicate that common law countries have stronger shareholder protection rules, which favor the development of capital markets and dispersed ownership structures, while civil law systems generally have weaker shareholder protection and consequently have concentrated ownership structures.[62] A study of 49 countries revealed that common law countries generally have strong investor protection laws; French civil law countries are very weak, while German and Scandinavian civil law countries are relatively strong.[63] It also showed that enforcement is crucial to the exercise of rights and cannot be a substitute to strong legal rules. In addition, it was found that among the substitutes for weak laws was the presence of ownership concentrations in jurisdictions with weak legal protection. This has obvious implications for corporate governance. The majority shareholders will tend to expropriate private benefits of control at the expense of minority shareholders and have greater incentive to entrench themselves so as to maintain their position and some of the means used to entrench themselves may in the long run reduce firm value.

The empirical studies done by Rafael La Porta et al, focus on the importance of legal rules and the availability of enforcement mechanisms as critical factors for the development of market-based systems. In their view, the outside investors must be able to rely on law to protect their interests and prevent insiders from expropriating wealth to themselves. They also argue that legal rules and enforcement foster development of capital markets because they protect financiers from expropriation by insiders and raise their willingness to surrender funds in exchange for securities.[64] This is consistent with the fact that jurisdictions with weak legal rules for the protection of investors have

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[62] Rafael La Porta et al., Law *and Finance*, *supra* note 7; Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. Fin. 1131 (1997).
[63] Rafael La Porta et al, *Law and Finance*, *supra* note 7
[64] Rafael La Porta et al, *Legal Determinants of External Finance,52* J. Fin.1131, at 1149 (1997) .

undeveloped capital markets. The major source of external finance for corporations in such jurisdictions is bank finance and therefore debt may play a critical role as a governance tool.

Some scholars have built on the studies done by Rafael La Porta et al., to illustrate how market-based systems shape corporate governance. Brian Cheffins states that in jurisdictions characterized by dispersed share ownership structures, such as the U.S and the U.K,[65] capital markets play an important corporate governance role. Because of the need to raise external finance from capital markets, corporations must address investor concerns. Management and insiders should desist from engaging in practices that reduce shareholder value, if they expect to raise finance from capital markets. Major investor concerns relate to access to information, equal treatment of shareholders, and access to the vote. Therefore, legal rules on voting rights and procedures, access to information and duties of directors are important.[66] The quality of corporate law and other legal rules that protect outside shareholders, as well as institutions for enforcement of those rules, such as courts, are critical in such markets. These factors will lower agency costs and favor the development of market-based systems where capital markets, the major source of external finance for corporations deter bad corporate governance practices. Therefore, the disciplinary role of markets has significant implications for corporate governance. However, one needs to aware that markets are imperfect and their disciplinary role can sometimes be undermined, especially in cases of information asymmetry or weaknesses in the market regulatory system. The recent corporate governance failures in a market-based system, such as the U.S demonstrate the shortcomings of market discipline. The response to the failures, especially through legislative means, such as the enactment of the Sarbanes-Oxley Act may be an indicator of the shortcomings of market systems.

[65] Brian R. Cheffins argues that ''traditionally, corporate governance has been organized much differently in the US and UK than it has in Germany (and elsewhere)…in the U.S and U.K share ownership is widely dispersed…also in both countries banks do not play a significant corporate governance role," *49 Am. J.Comp L. 497 (2001).*

[66] Rafael La Porta et al., *Investor Protection and Corporate Governance*, *supra* note 5.

On the other hand, some scholars believe the law only offers a partial explanation to the variations in corporate governance structures. Ron Gilson, for example, argues that the Rafael La Porta et al. analysis does not explain the existence some firms with concentrated ownerships in countries such as the U.S and the U.K which typically are classified as dispersed ownership systems.[67] In addition, he states that some countries such as Sweden have concentrated ownerships but have strong shareholder protection laws and therefore cannot be placed in the same category as those jurisdictions with weak shareholder protection rules.[68]

In contrast, jurisdictions that are characterized by the existence of controlling shareholders, such as Germany, Italy, and most developing countries, capital markets do not play a major governance role. Although capital markets may exist, they are not the major source of external finance for corporations because of high agency costs and inadequate investor protection laws. Other institutions such as banks often will be the major providers of external finance to corporations and, as such, a part of the corporate governance system. Corporate governance concerns in such jurisdictions relate to the exploitation and oppression of minority shareholders and the destruction of firm value through the extraction of private benefits of control by controlling shareholders or directors.

Some scholars are of the view that although law is essential for good governance, other institutions such as banks can play an equally important governance role.[69] Bank finance is considered to be an alternative governance tool through the use of debt covenants and the monitoring of borrowers. In order to reduce risk of default, lenders will impose conditions on borrower firms, such as proper bookkeeping and accounting, periodic reporting, restricting activities borrower firms can undertake and conditioning dealings with firm assets. These conditions have the potential to deter bad behavior by

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[67] Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, at http://ssrn.com/abstract=784744.
[68] Ronald J. Gilson, *supra* note 67, at 15.
[69] Brian R. Cheffins, *Does Law Matter? The Separation of Ownership and Control in the United Kingdom*, 30 J. Legal Stud 459 (2001).

management and corporate insiders and encourage good corporate governance practices. In addition, since banks lend medium to short term, the need for additional finance and desire to keep the credit line with banks open, will compel corporations to comply with the lender's conditions and this ultimately has a long term impact on the internal governance of the borrower firms. In this respect, debt finance acts as a governance tool.

Triantis and Daniels have examined the various ways in which debt plays a governance role, including the strengths and weakness of each mechanism used by debt finance.[70] They state that debt can act as a check on managerial slack by requiring the borrower companies to supply periodic information that will help the banks police compliance with debt covenants; obtain undertakings from management that they will report non-compliance with debt covenants, and use of threats to exit the lender-borrower relationship when there is a breach or default. In their view, the tools used by debt providers to reduce risk of default, such as periodic monitoring and obligations imposed on the borrower by debt covenants, contribute to improved governance of the borrower and benefit other stakeholders as well.

However, Triantis and Daniels further state that the effectiveness of debt as a governance tool depends on a number of factors, such as how effective the lender monitors the borrower, the gravity of the threat of exit and the inability of the borrower to obtain capital elsewhere.[71] Therefore, to be an effective governance tool, the bank must not only monitor but also be able to act on the information it acquires, for example, by using the exit threat as a catalyst for intervention in the governance of the firm.[72]

The impact of debt finance on governance is more apparent when either the borrower company has defaulted on repayments or the lender has detected managerial slack. In cases in which there has been a default or the lender detects a likelihood of default, a bank will evaluate its options. If it is easier and less risky for the bank to exit from a

[70] George D. Triantis, Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance* 83 Calif.L.Rev. 1073 (1995).
[71] *Id*, at 1084.
[72] *Id*, at 1085.

lender-borrower relationship, it will exercise that option which will have no impact on corporate governance. On the other hand, if the exit option is not realistic for the bank, it may use threats to demand corrective action,[73] thereby impacting on corporate governance. However, it should be noted that the corrective action taken may result in some benefits for the borrower or simply be geared towards securing the lender's position in bankruptcy. The former may impact governance but the latter is unlikely to do so. Whether a lender's intervention is opportunistic or beneficial will depend on the credibility of the threat and the options available to the borrower as well bankruptcy laws that void certain transactions when a borrower approaches bankruptcy.

However, the effectiveness of debt as an alternative governance tool in the absence of strong legal protections has sometimes been overstated. Shleifer and Vishny argue that in order to be effective as a governance tool and to enforce obligations on borrower firms, legal rules and adequate enforcement mechanisms are critical.[74] It should be noted that the legal environment in which banks operate may also enhance or constrain their governance role. In Germany, the powers of the banks *vis-`a-vis* borrower companies are quite significant because banks hold large blocks of shares, sit on boards of directors, play a dominant role in lending, and, therefore, are a part of the German corporate governance system.[75] In the U.K, while banks are not prohibited from holding stock, they have consistently preferred to have arms-length dealings with corporations they finance, hence, a limited governance role[76]. In the U.S, Gilson, states that there is a large number of comparatively small banks that play no governance role at all.[77] In other countries where banks are constrained by legal rules that do not permit them to hold stock, their governance role may be limited. This particular issue will be discussed in greater detail in chapter 4 which addresses the governance role of banks in Uganda.

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[73] Triantis and Daniels, *supra* note70, at 1087.
[74] Robert W. Vishny and Andrei Shleifer, *A Survey of Corporate Governance*, 52 J. Fin. 737, 757 (2000).
[75] Brian R. Cheffins, *The Metamorphosis of the 'German Inc': The Case of Executive Pay, 49 Am. J. Comp. L. 497(2001).*
[76] Brian R. Cheffins, *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom*, 55 Vand. L. Rev 1699, at 1717 (2002).
[77]Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 Am. J. Comp. L. 329, at 342 (2001).

The ability of the lender to effectively monitor corporations will also depend on the quality of information available, especially financial information relating to the borrower. Therefore, the quality of accounting is critical. In addition, lender monitoring like any form of monitoring, involves costs. The lender will only effectively monitor up to the point at which the marginal cost of monitoring will not exceed the marginal return. Therefore, in cases in which it is too costly for the lender to monitor or the value of the loan does not pose a substantial risk to the lender, the role of debt as a governance tool may be insignificant.

This chapter has illustrated how formal and informal mechanisms of control impact corporate governance. In the next chapters I provide an overview of the corporate governance system in Uganda, the weaknesses in formal mechanisms of control and explore the governance role of bank finance, as an informal mechanism of control.

3.0 CORPORATE GOVERNANCE IN UGANDA

This chapter provides an overview of corporate governance in Uganda including the structure of ownership of public companies, major corporate governance problems, weaknesses in corporate law and its enforcement mechanisms, the role of codes and other statutes in promoting corporate governance. The purpose of this chapter is to illustrate the failure of formal mechanisms (legal rules and legal institutions) of corporate governance in Uganda, particularly company law. I also will show how the failure of formal mechanisms of governance manifests itself in the structure of ownership.

3.1 Company Law and Corporate Governance

In Uganda, companies are incorporated under the Companies Act, Chapter 110 of the Laws of Uganda, a re-enactment of the English 1948 Companies Act. The Act creates a distinction between private limited liability companies and public limited liability companies. Section 3(1) provides that any seven or more persons or, in cases in which the company to be formed will be a private company, any two or more persons associated for any lawful purpose may form an incorporated company by subscribing their names to a memorandum of association. Only a few of the companies incorporated in Uganda are registered as public limited liability companies. Records at the companies' registry at the office of the Registrar General indicate that as of December 2005, there were 517 public limited liability companies out of a total of 78,970 registered companies. The majority of companies in Uganda are private limited liability companies, commonly known as "closely-held" corporations. These are usually owned by family members and their charters typically contain restrictions on the transfer of shares, have a maximum upper ceiling of 50 members, and are prohibited from raising capital through public offerings.[78]

Although there are corporate governance concerns relating to private companies, especially with regard to the treatment of minority shareholders by majority or controlling shareholders, this research focuses on corporate governance in public limited liability companies in Uganda. The rationale for this focus is that the number of public companies in Uganda is growing rapidly, and with the ongoing process of privatization, a

[78] S.29 Companies Act, Cap 110.

number of previously state owned-companies have been converted into public limited liability companies. This is part of a deliberate government policy to encourage local citizens to invest in privatized companies. Since the late 1980's, when the Government of Uganda started the privatization program, about 117 state owned corporations have been privatized, either by selling them to core investors, or to the public, through public flotation on the Uganda Securities Exchange. The policy of encouraging the public to buy shares in privatized companies requires addressing a number of issues that affect investor confidence, including corporate governance. In addition, within Uganda and, more broadly, within the East African region, governments have been making concerted efforts to attract foreign direct investment. The governments recognize that in order to attract foreign direct investment and foreign capital flows, several investor concerns must be addressed, including corporate governance.

Companies incorporated in Uganda are governed by the Memorandum of Association[79] and Articles of Association.[80] The former provides for the manner in which a company is established, including its objectives, capital structure, and physical location, while the latter governs relations between the members of a corporation and provides for matters such as conduct of meetings, quorum, notices for meetings and payment of dividends. When incorporated, companies become legal entities, separate from their members. The authority to conduct the day-to-day business of a company is vested in the board of directors.[81] Unlike closely-held companies, in which the shareholders, especially the controlling shareholders, also typically double as management, in most public companies, there is a clear separation of functions between shareholders and management or directors. The directors are appointed by shareholders at an annual general meeting and are responsible for giving strategic direction of the company, hiring senior management, monitoring the activities of the company, ensuring compliance with laws and regulations and overall management through board decisions and meetings.

[79] S. 4, Companies Act provides that the memorandum of every company should state the name of the company, its registered office and the objects of the company.

[80] S.8, Companies Act provides that every company limited by shares is required to have Articles of Association, which contain regulations of the company. Companies usually adopt the provisions in Table A of the Companies Act as their Articles of Association.

[81] S. 176-204 Companies Act provide for appointment, duties and obligations of directors.

A typical Ugandan public limited liability company has both executive and non-executive directors. Ideally, the primary purpose of non-executive directors is to monitor full time executives and ensure the objectivity and independence of the.[82] However, it should be noted that although the Companies Act makes it a requirement for every company to have directors,[83] it does not prescribe for a particular number of directors to be either executive or non-executive. The Corporate Governance Guidelines recommend appointment of non-executive directors as a matter of good practice, but such a practice is not binding on the companies. Therefore, although other jurisdictions require at least one-third of the board to be composed of non-executive directors, Uganda does not have a legal or regulatory requirement for non-executive board members.

The structure of ownership and control of public companies in Uganda is characterized by the existence of controlling shareholders. As of December 2005, there were 517 public companies in Uganda.[84] A sample selection of these companies indicates that the bulk of them have controlling shareholders as indicated in the table below.

[82] Note that in some circumstances, non-executive members of the board may fail to be objective or to act independently, especially if they act on an uninformed basis or are compromised through transactions with the company or by other means.
[83] S. 176 of the Companies Act requires public companies to have at least two directors and private companies to have at least one director.
[84] Government of Uganda, Register Public Companies. (Accessed 12/21/2005).

Table 1: Sample Selection of Public Companies in Uganda[85]

No.	Name of Company	Controlling Shareholder	Debt	Comment
1	Munno Publications, Ltd.	√	√	Annual Returns not up to date Usual Terms of Debt
2.	Uganda Grain Milling Co. Ltd.	√	√	Directors representing controllers, Transactions with controllers (borrowed from related companies of controllers) Substantial debt Company in receivership
3	Jinja Garage, Ltd.	√	√	Annual Returns not up to date Usual Terms of Debt
4	Bugungu, Ltd.	X	n/a	
5	Steel Corporation of East Africa, Ltd.	√	√	Annual Returns not up to date Usual Terms of Debt
6	Kabulasoke Coffee Factory Ltd	√	√	Annual Returns not up to date Usual Terms of Debt
7	Nile Breweries, Ltd.	√	√	Annual Returns not up to date Usual Terms of Debt
8	Uganda Breweries, Ltd.	√	√	Annual Returns not up to date Usual Terms of Debt
9	Financial Investments, Ltd.	x	n/a	Newly incorporated
10	Uganda Clays, Ltd.	√	√	Annual Returns not up to date Usual Terms of Debt
11	Uganda Telecom, Ltd.	√	√	Annual Returns up to date

[85] I was able to access records of 173 public companies in Uganda. I then conducted a simple random sample selection of 30 companies out of the 173 and studied the files to obtain the information listed in the table.

				Usual Terms of Debt
12	Masaka Investments, Ltd.	√	n/a	
13	Securities and futures dealers, (U) Ltd.	x	n/a	
14	Kampala Public Development Co. Ltd.	x	n/a	
15	Plant Leasing, Ltd.	x	n/a	
16	Property & General Investments, Ltd.	x	n/a	
17	Masaka Farmers & Producers, Ltd.	√	√	Annual Returns not up to date Usual Terms of Debt
18	WRAF (U) Ltd.	x	n/a	
19	Technology Consults	√	n/a	
20	MTN Communications, Ltd.	x	√	Annual Returns up to date Usual Terms of Debt
21	Front Page Finance (U) Ltd.	√	n/a	
22	Isingiro Rural Credit Savings & Credit Ltd.	x	n/a	
23	Kyangyenyi Rural Savings & Credit Ltd.	x	n/a	
24	Kyotera Coffee Growers Ltd.	√	√	Annual Returns not up to date Usual Terms of Debt
25	Kiira Saw Mills Ltd.	√	√	Annual Returns not up to date Usual Terms of Debt
26	Mvule Furniture Mart, Ltd.	√	√	Annual Returns not up to date Usual Terms of Debt
27	Peter & Co. Ltd	√	√	Annual Returns not up to date Usual Terms of Debt
28	DFCU, Ltd.	√	√	Annual Returns up to date

				Usual Terms of Debt
29	New Vision Printing & Publishing CO. Ltd.	√	√	Annual Returns up to date Usual Terms of Debt
30	PAMBA, Ltd.	√	√	Annual Returns not up to date Usual Terms of Debt

Note

x- No controlling shareholder

n/a- No information on file to indicate the use of debt finance

Bank Finance- Evidence of bank finance was obtained from mortgage deeds and debentures on the company files as well as company resolutions to borrow. The majority of borrowing was secured.

Usual terms of debt include:

- Requirement to conduct business in a proper manner
- Requirement to furnish periodical financial information to lender-Management, quarterly and annual audited financial statements
- Requirement to comply with the Companies Act
- Requirement to keep proper books of accounts
- Requirement to keep lender informed of any material changes
- Requirement for prior consent from the lender for particular transactions, such as material change of ownership and additional borrowing
- Requirement to keep pledged assets in good order
- Right of the lender to inspect premises
- Right of the lender to call on loan at any time

From the table above, one is able to establish the following:

- *Presence of Controlling Shareholders*

About 20 of the 30 companies studied have a majority or controlling shareholder. The finding is consistent with prior empirical studies on share ownership structures in countries with weak legal systems.[86] The lack of adequate investor protection laws to regulate issues such as information disclosure, shareholder access to the ballot and enforcement of fiduciary duties, inhibits the use of equity finance. For equity investors, the vote is the most powerful governance tool available to them.[87] In theory, the vote is a tool that can be used to change bad management, effect policy by deciding on important transactions, such as mergers and acquisitions. However, in the absence of strong legal rules to enable and protect the right to vote, the vote is rendered ineffective as a governance tool, such as in cases in which the requirement to hold an annual general meeting can easily be flouted or the disclosure standards are inadequate to enable an informed vote. These hindrances coupled with weak or poor enforcement mechanisms, lack of access to courts and weaknesses in judicial systems such as corruption, engender bad governance that ultimately hurts shareholders.

Records at the registrar of companies indicated that the majority of controlling shareholders are individuals, as opposed to institutions. Only 7 of the 30 companies whose records studied have institutional shareholders as controlling shareholders. These institutional shareholders are either pension funds or foreign parent companies. The controlling shareholders typically have a representative on the board of directors. The other companies had either one individual, or a group of individuals as controlling shareholders. The controllers usually form part of senior management (CEO or Managing Director) and control the board. In two cases, the government was a controlling shareholder.

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[86] Rafael La Porta et al., Corporate *Ownership Around the World*, 54 J. Fin. 471 (1999).
[87] Andrei Shleifer and Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. Fin. 737 ,at 750 (2000).

The problems that arise out of the ownership structure in Uganda vary. Companies with institutions as controlling shareholders do not usually experience governance problems such as self-dealing because the institutions are not normally involved with the day-to-day business of the companies. In some cases the controlling shareholder, especially foreign controllers, have had a positive influence on the companies by, for example, insisting that the companies adopt governance standards and procedures of the controllers' home jurisdiction. Such companies tend to have: a fair balance of executive and non-executive directors, internal control procedures on risk management, audit committees, hold regular shareholders meetings and file periodical returns. The only issue that commonly arises in companies is the divergence of interests between institutional shareholders and individual shareholders. Individual shareholders have frequently accused institutional shareholders of using the majority stake to support management in cases where a dividend is either not declared or a low dividend is paid.

In companies in which individuals are the controlling shareholders, common governance problems include self-dealing, failure to hold annual general meetings, failure to file periodical returns and a lack of shareholder access to information. One case that is worth mentioning is where controlling shareholders used debt to alienate minority shareholders. The controlling shareholders, who were also on the board of directors, allowed the company to obtain credit facilities from a micro-credit lender owned by one of the controllers. The credit institution extended credit facilities to the company well beyond the company's capacity to pay back the debt. When the company defaulted, the lender sought to liquidate it. The minority shareholders sued the directors for breach of fiduciary duty and the case is still in court.

The presence of concentrated ownership structures in Uganda therefore raises concerns about oppression of minority shareholders, self-dealing and destruction of firm value through the extraction of private benefits of control. In circumstances in which legal rules and institutions are inadequate to prevent such conduct, majority shareholders use their position to their benefit and often to the detriment to minority shareholders. Brian Cheffins states that the existence of a concentrated ownership structures has a profound impact on corporate governance; when public companies have controlling shareholders, the position of the minority becomes a primary source of concern and probably deserves a higher priority than managerial accountability.[88] He adds that the danger with controlling shareholders is their ability to exploit weaknesses in the law to destroy firm value through extracting private benefits of control and colluding with management to cheat and oppress minority equity holders.[89]

However, Cheffins, recognizes that the presence of controlling shareholders in public companies is not entirely detrimental--companies with a dominant shareholder are different from companies with dispersed shareholders, with each having a small stake. With a dominant shareholder, managerial accountability is unlikely to pose a serious problem since controlling shareholders are likely to have a large enough financial stake to motivate them to monitor management. In addition, he states that controlling shareholders should be able to influence the removal of ineffective managers. Gilson also explains the circumstances in which controlling shareholders may add value. He states that in jurisdictions with strong legal rules such as Sweden, controlling shareholders are unlikely to destroy firm value by extracting private benefits of control or oppressing minority shareholders.[90] He attributes this to legal and institutional mechanisms that protect minority shareholders and restrain improper conduct of controlling shareholders.

- *Broader use of debt than Equity Finance*

About 18 of the 30 companies studied use bank finance rather equity or other forms of corporate finance. This finding categorizes Uganda as a bank-based market in which banks are a part of the corporate governance system in Uganda. This finding is consistent with earlier empirical studies on law, finance and governance.[91] The implications of bank

[88] Brian R. Cheffins, *Current Trends in Corporate Governance: Going from London to Milan via Toronto,* 10 Duke J. Comp. & Int'l L. 5 (1999).
[89] Brian R. Cheffins, *supra* note 88, at 32.
[90] Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*,at http://ssrn.com/abstract=784744.
[91] Rafael La Porta et al., *Law and Finance*, *supra* note 7 ; Rafael La Porta et al., *Investor Protection and Corporate Governance*, *supra* note 5

finance and its impact on corporate governance in Uganda are discussed in the next chapter.

- *Failure of Company Law*

In Uganda, the problem of controlling shareholders is exacerbated by a near total failure of company law. The current Companies Act that governs, among other things, the formation, capitalization, management and dissolution of companies is weak and offers little protection to all participants. In addition, the penalties for non-compliance are too minimal to have any deterrent effect. Most public companies do not comply with company law requirements, such as filing periodic returns or holding mandatory annual general meetings. For example the penalty for failure to file an annual return is a default daily fine of 100 Uganda Shillings (approximately $0.05 U.S), failure to hold an annual general meeting as required by section 131 of the Companies Act attracts a default fine of 2,000 Uganda Shillings (about $1.00 U.S). Failure to keep proper books of accounts and audits as required by sections 147-163 attracts a penalty of 12 months imprisonment for the directors or a fine of 10,000 Uganda shillings (about $ 5.00 U.S).

Enforcement is also inadequate partially due to weaknesses in the law and lack of resources to monitor companies and ensure compliance with legal requirements. Records of some of the company files studied indicate practices that have a direct bearing on corporate governance, such as failure to file annual returns, failure to conduct annual general meetings and the oppression of minority shareholders. It is clearly difficult for the registrar of companies to enforce the law, because is it cheaper for companies to default than to comply with the law. For example, section 191 prohibits loans to directors, however, the prohibition is susceptible to a number of loopholes that can be exploited by directors. In addition, Section 210 which aims at preventing self-dealing transactions by requiring directors to disclose interests in contracts has a very minimal penalty of 2,000 Uganda shillings (about $1.00 U.S).

Poor governance of corporations extends to all sectors including those that are regulated such as banks and insurance companies. A report on the sale of Uganda Commercial

Bank (UCBL), which was previously state owned, revealed that the bank was severely mismanaged under the control of the purchasers-Westmont Ltd (51%).[92] The report indicated evidence of substantial related party transaction. For example, almost 35 billion Uganda shillings (about $17 million U.S) was lent to Greenland Bank, a smaller Ugandan Bank together with other companies within the Greenland group. The loans were made without proper security and at levels substantially in excess UCBL's permitted maximum prudential limits. The report further stated that during 1998-99, three other banks--International Credit Bank, Cooperative Bank and Greenland Bank, failed and were closed. The failures of each bank involved insider lending, inadequate credit policies and procedures and weaknesses in corporate governance.

Since 1996, there have been attempts to reform the Companies Act as part of the broader commercial justice reform program that aims at revising commercial and other related laws as well as strengthening institutions, such as the judiciary and the Registrar General's office. The objective of the reform is to align the laws with current business practices and changing patterns of regulation at both the regional and global levels.[93] Significant areas that are the focus of reform include disclosure requirements, protection of minority shareholders and transactions involving directors and controllers.[94] Some of the proposed changes related to corporate governance include new provisions on accounting and record keeping; director's powers, duties, qualifications and responsibilities, shareholder remedies; enhanced penalties for non-compliance, and self-dealing transactions of directors; and protection of minority shareholders.

3.2 Statutory Corporate Governance

Some statutes have incorporated mandatory corporate governance standards for specific sectors, such as banks. The standards are more onerous than the provisions in the Companies Act and corporate governance guidelines and non-compliance attracts regulatory sanctions. The Financial Institutions Act, for example, has more rigorous standards and procedures for the appointment and disqualification of directors, duties and

[92] Denton Wilde Sapte, Report on Evaluation of the Resolution of UCB, Ltd (2002).
[93] Uganda Law Reform Commission, A Study on Company Law, (September 2004) p. 33.
[94] Clare Manuel, Report on the Reform of Company Law in Uganda (1999).

responsibilities of the board, addressing conflicts of interest, conduct of board meetings, audit and asset liability management committees, internal and external auditors, rotation of auditors, duties of external auditors to the financial institution and the central bank, content of audit reports and control over management.[95]

The Act has several provisions intended to foster good governances such as the requirement that board members meet the fitness and properness standards set out in Schedule 3, half of the board of directors must be composed of non-executive directors, a prohibition of cross directorships, fiduciary duties of directors, approval of external auditors and four mandatory rotation for external auditors. In addition, the Act prohibits a single owner from holding a more than 49% stake in a financial institution,[96] requires substantial owners to be subjected to fitness and properness tests,[97] requires approval of substantial allotment or transfer of shares,[98] and, except for some narrow exceptions,[99] prohibits transactions with insiders.[100] However, the Act is of limited application. Section 2(1) provides that the Act applies to financial institutions as defined in Section 3. Section 3 defines a financial institution to mean a company licensed to carry on financial institutions business in Uganda and includes a commercial bank, merchant bank, mortgage bank, post office savings bank, credit institution, building society, acceptance house, discount house and finance house. Therefore, companies not involved in these kinds of business are not required to comply with the Act.

Proposals have also been made to revise Insurance laws in Uganda, and, among other things, incorporate provisions that have a direct bearing on corporate governance. These proposals include setting "fitness and properness" standards for executives and board members, prohibiting cross ownerships and simultaneous directorships between

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[95] Financial Institutions Act No.2, 2004, Part VII.
[96] S. 18, Financial Institutions Act No.2, 2004.
[97] S. 19, Financial Institutions Act No.2, 2004.
[98] S. 20, Financial Institutions Act No.2, 2004.
[99] S.34(1),(4) &(8) permits transactions with insiders if they are at an arms length, fully secured and do not exceed 2.5% of the core capital of the bank. Any director who violates the s.34 ceases to be a fit and proper person (s.34(12)).
[100] S. 34, Financial Institutions Act No.2, 2004.

insurance firms and brokerage firms, mandatory accounting standards, and rotation of auditors.[101]

3.3 Corporate Governance Codes

The Institute of Corporate Governance (ICGU) and Capital Markets Authority (CMA) have separately developed corporate governance guidelines that provide guidance to companies on best practices relating to the conduct of board meetings, accounting and audit, risk management, board composition and treatment of shareholders. The ICGU guidelines have a much broader application. They apply to public and private companies as well as state enterprises. The CMA guidelines, on the other hand, apply to publicly listed companies and issuers of corporate debt in Uganda.[102] The guidelines are similar in several respects and contain common standards for a number of issues, such as:

- Separation of the role of Chairman of the Board and CEO
- At least one-third of the Board should be composed of non-executive board members
- Functions of the Board
- Management of conflicts of interest
- Conducting of annual general meetings
- Accountability and the role of the audit committee
- Shareholder rights

The guidelines draw heavily on international best practice on each of the above issues and, in particular, corporate governance principals in the U.K, Commonwealth, OECD countries and South Africa were very instructive in drawing up the guidelines in Uganda. However, being guidelines, they heavily depend on the good will of corporations to adopt them. They are not enforceable, and although the CMA guidelines require companies to report on compliance with the guidelines in their annual reports, there is little or no evidence to show that apart from the listed companies other companies have adopted them.

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[101] LeBoeuf, Lamb, Green & MacRae (Pty) Ltd, Draft Report on Review of Insurance Laws of Uganda (March 2005).

[102] Capital Markets Authority (Corporate Governance) Guidelines (2001), para 2.

This chapter has provided an overview of the governance framework for companies in Uganda, the ownership structure and the legal environment in which companies operate. The legal rules, particularly the Companies Act and institutions responsible for enforcing it, such as the Registrar of Companies and courts are not in a position to sufficiently protect the rights of the various parties in a company especially minority shareholders. Uganda is currently revising some laws such as the Companies Act and Bankruptcy Act. In addition, within the broader framework of commercial justice reform, efforts are being made to strengthen and build the capacity of institutions, such as the Registrar of Companies and Commercial Courts. However, legal reform process does not take place overnight. Until the law reform process is concluded, formal mechanisms of control will not play a significant governance role in Uganda. In the next chapter, I explore the governance role of informal mechanisms, specifically bank finance.

4.0 BANK FINANCE AND CORPORATE GOVERNANCE IN UGANDA

This chapter illustrates the interrelationship between bank finance and corporate governance in Uganda and attempts to provide empirical evidence of the role of banks in Uganda's corporate governance system. The chapter specifically examines how banks, as the major source of finance for companies in Uganda, monitor companies to whom they lend money, and how the monitoring impacts corporate governance. I will also discuss the limitations to the governance role of banks. I stated at the outset that the objective of this thesis was to explore the extent to which informal mechanism of control, specifically bank finance, shape and influence corporate governance in Uganda. This was based on the premise that formal mechanisms of control--legal rules and the relevant enforcement institutions are inadequate to support a sound system of corporate governance.

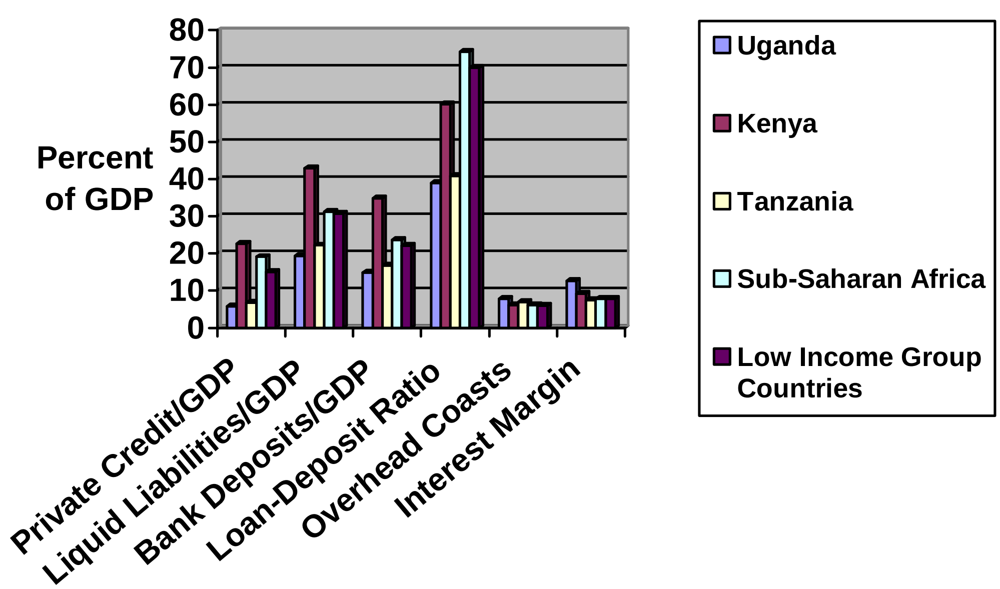
4.1 Bank Finance in Uganda

There are currently 15 commercial banks currently operating in Uganda, 12 of which are foreign owned and 3 are locally owned.[103] Subsidiaries of foreign owned banks comprise of most of the banking sector. Banks dominate the financial services sector and more than half of the assets, deposits and loans of commercial banks are concentrated in the four largest foreign owned commercial banks—Stanbic Bank, Standard Chartered Bank, Barclays Bank and DFCU Bank. Commercial banks are regulated by the Central Bank of Uganda. The primary legislation governing banks is the Financial Institutions Act (2004), which provides for the licensing of commercial banks, the requirements for capital adequacy, credit restrictions, accounting and supervision. The impact of some of the provisions and regulations made under the Act on bank finance and the governance role of banks will be discussed later in the chapter. With the exception of the period in the late 1990's when three commercial banks failed and were closed due to insider lending and other governance-related problems, the banking sector has remained relatively stable and is steadily growing, with a private credit/ GDP ratio of 5.8[104] as of March, 2005. The

[103] Registered Commercial Banks as of December 31, 2004, Appendix 2, Bank of Uganda Annual Supervision Report, 55 (2004).
[104] The World Bank Financial Sector Assessment Report, March, 2005, p.10. Private credit/GDP ratio is defined as the total claims of financial institutions on the domestic private non-financial sector as a share of the GDP.

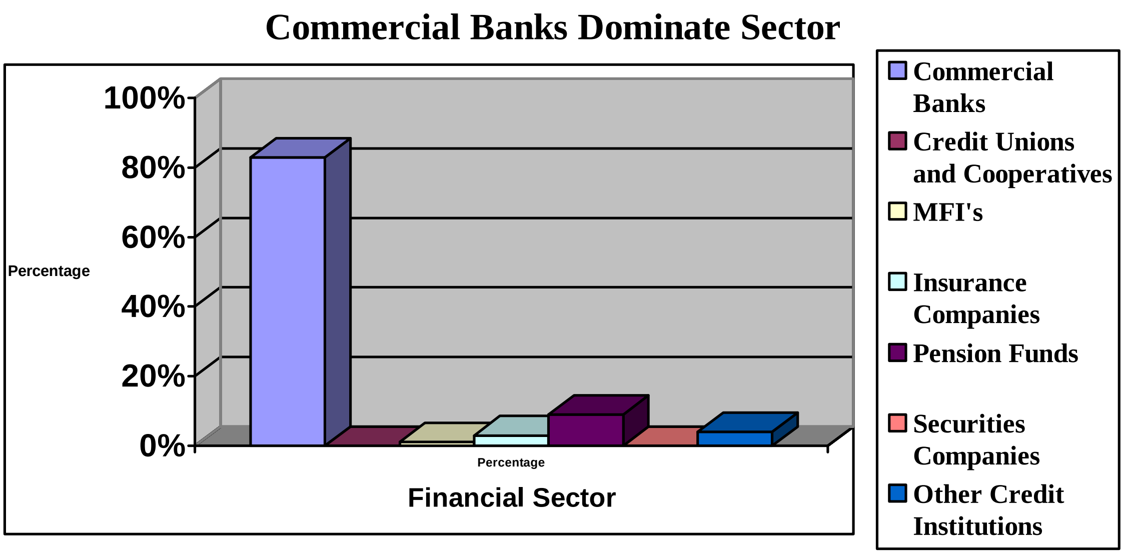
total assets of commercial banks as of December 2004 were 3,315 billion shillings[105] (about $1,657.5 billion USD). Although these figures and generally the level of financial intermediation is low by regional and global standards (see table below), for a country whose GDP as of July, 2005, was at 15,134 billion Uganda shillings[106] (about $7,617 billion USD) and where other forms of finance are almost non- existent, the role of banks is fairly significant.

Financial Intermediation Across Eastern Africa



Source: The World Bank, Financial Sector Assessment Program Update, Aide-Memoire, March 2005. Table 1. Uganda: Financial System, 2003-04 p.10

[105] Commercial Banks Assets and Liabilities, Appendix 1, Table 1, Bank of Uganda Annual Supervision Report, 51 (2004).
[106] Budget Speech for the Financial Year 2005/6, 13, at http://www.finance.go.ug/budgetSpeech05-06.htm (Accessed 2/12/06).



Source: The World Bank, Financial Sector Assessment Program Update, Aide-Memoire, March 2005. Figure1. Uganda: Financial System, 2003-04 p.12

Manufacturing, agriculture, trade and commerce are the leading sectors of commercial bank credit.[107] Macro-economic instability and high non-performing loans have previously constrained banking activity. However, steady economic growth, relative macro-economic stability and improved asset quality of the banks, have enabled the banking sector to increasingly take center stage as the main avenue for financial intermediation.

[107] Sectoral Distribution of Commercial Banks' Credit, Appendix 2, Table 3, Bank of Uganda Annual Supervision Report, 53 (2004).

Table 2: Registered Commercial Banks as of December 31, 2004[108]

No.	Name of Bank	Ownership	Controlling Shareholder	Asset Size (000)
1.	Dfcu Bank	Foreign	Yes	UGX 204,670,853
2.	Nile Bank Ltd	Foreign	Yes	UGX 153,000,000
3.	Allied Bank International	Foreign	Yes	UGX 55,069,000
4.	Centenary Rural Development Bank	Local	No	UGX 145,629,855 (2003)
5.	National Bank of Commerce	Foreign	N/A	N/A
6.	Orient Bank Ltd	Local	YES	UGX 96,082,818
7.	Barclays Bank (U) Ltd	Foreign	Wholly owned by Barclays PLC	N/A
8.	Bank of Baroda (U) Ltd	Foreign	YES	N/A
9.	Stanbic Bank	Foreign	YES	UGX 917,418,556

[108]Bank of Uganda, The Annual Supervision Report Issue No.6 December 2004 p. 55; http://www.dfcugroup.com/dfcu/dfcu_report04.pdf;http://www.alliedbank.co.ug/ABI%20 2004.pdf;http://www.centenarybank.co.ug/financials/financials_files/balsheet.htm; http://www.orient-bank.com/financial_reports.htm;http://www.trafbank.com/ balancesheet.htm (accessed 3/15/2006).

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10.	Standard Chartered Bank	Foreign	YES	UGX, 782,338,333
11.	Tropical Bank	Foreign	YES	UGX 36,385,148,000
12.	Crane Bank	Local	YES	USD 100,000,000
13.	Cairo Bank	Foreign	N/A	N/A
14.	Diamond Trust Bank	Foreign	N/A	N/A
15.	Citi Bank	Foreign	N/A	N/A

4.2 Banks and Corporate Finance in Uganda

Banks play an important corporate finance role in Uganda. About 18 of the 30 companies studied (see Table 1 in Chapter 2) use bank finance. This fact was established from records, such as mortgage deeds, debenture deeds and board resolutions on file at the Registrar of Companies. In addition, officials of five other companies revealed during interviews that they borrow from banks. This evidence leads to the logical conclusion that banks in Uganda play an important corporate finance role. This can be attributed to several factors, including the fact that other forms of corporate finance, such as equity finance and venture capital, are almost non-existent; macro-economic instability makes other forms of corporate finance unviable, the lack of awareness about other forms of finance, such as use of commercial paper, bonds and private placements and the fact that banks have less rigorous requirements for loan approvals.

The credit facilities that commercial banks specifically offer to companies include:

- Commercial Loans--The facility is usually offered to companies engaged in trading. The period of the facility is usually 1-2 years, interest rates range between 16%-18%. Collateral is required.

- Overdraft facilities--This is a working capital facility. It is usually a one-year rolling facility. It may be secured or unsecured, depending on the borrower. Interest rates range between 13%-18.5%. Interest rates vary depending on the base rate and the risk associated with the borrower.

- Medium-Term Loans- These are on average, for periods of 2-3 years. They are used primarily for capital expenditure, such as asset acquisitions. Collateral is usually required. Interest rates range between 15.5%-18%.

Other facilities include trade finance, invoice finance, guarantee limits and donor fund-based facilities. Each of the facilities has different approval and monitoring requirements; therefore, depending on which facility a company uses, the nature and degree of monitoring employed by a bank will differ. For example, an overdraft facility will have different approval and monitoring requirements from a medium-term capital expenditure loan. Companies will typically have either one facility or several facilities concurrently with one or more banks. Whenever a company has multiple facilities with the same bank, it will be subject to different approval and monitoring requirements for each of the facilities. For the purposes of the discussion below on bank finance and governance, I will treat the different facilities generically as loans to companies and only mention a specific facility when necessary.

4.3 Bank Finance and Corporate Governance in Uganda

In 4.2 above, I illustrated the fact that bank finance is a major source of capital for corporations in Uganda. This is primarily because other forms of corporate finance are undeveloped and the fact that bank finance requires less rigorous procedures. I will now link bank finance to corporate governance by demonstrating the various ways in which bank finance impacts corporate governance in Uganda. This discussion will focus on describing the interface between banks and companies in Uganda, prior to obtaining finance, during and after the period of the loan and the resultant impact on corporate governance at each stage.

4.3.1 Eligibility Criteria for Loans

Banks typically have lending requirements or appraisal criteria to determine whether to advance money to a borrower. These criteria include the track record of the borrower, business of the borrower, particulars of the directors and major shareholders and the financial history of the company. The track record, financial history and particulars of directors and major shareholders, including any material adverse information relating to their duties, were among the factors considered to be crucial in the appraisal process. Most banks prefer to lend to companies that have been in existence for a year or more, preferably without a history of financial distress, whose directors and major shareholders are in good standing (such as no adverse information relating to their activities as shareholders or directors). The banks recognize that most corporations have controlling shareholders who exercise influence on them; hence, their identity is crucial.

Therefore, the eligibility criteria for loans, has a disciplining effect on directors and controlling shareholders of companies in Uganda. Companies that anticipate the use of bank finance will ensure that they have a clean track record and that their directors/ majority shareholders are in good standing; otherwise, they face the consequences of difficulty in obtaining finance or, alternatively, obtaining it at a high cost. Most banks have rating criteria that ranges from 1-12, 12 being the score for a very high risk borrower. Therefore, the corporate governance role of banks starts at the initial stages of corporate finance. Ideally, the conduct of directors and controlling shareholders and their duties towards the company and its shareholders should be the realm of corporate law and fiduciary duties enforced by courts.

The appraisal process also involves the evaluation of a company's prior transactions with its directors and controlling shareholders. Banks often insist on companies subordinating claims relating to substantial transactions with their directors /controlling shareholders. This is an important check on self-dealing transactions with directors or controlling shareholders. In Chapter 3, I mentioned the fact that share ownership in Uganda is highly concentrated. Some of the problems associated with concentrated ownerships are the oppression of minority shareholders, the extraction of private benefits of control through transactions with the companies and the diversion of corporate opportunities to themselves. The Companies Act attempts to regulate transactions with directors, but the legal provisions are susceptible to many loopholes. In jurisdictions where the legal rules are inadequate to ensure that company transactions with directors/insiders are properly disclosed and fair to the company, directors and controlling shareholders will often expropriate value to themselves at the expense of the company and minority shareholders. The intervention of bank finance, although not primarily aimed at prohibiting such transactions, acts as a check on the actions of directors and controlling shareholders.

4.3.2 Debt Covenants

The sample standard form loan agreements that I reviewed contained provisions that impact corporate governance, especially on accountability and financial disclosure. Standard financial covenants include an obligation to operate a proper and efficient accounting system that complies with international financial reporting standards and the requirement to submit periodical financial statements to the lender. The Company's Act contains provisions on accounts and auditing for corporations (s.147-163); however, there is no prescribed accounting standard, and the penalty for non-compliance with the accounting and audit requirements of 10,000 Uganda shillings (about $5 USD), is very minimal. As a result, it is not surprising that many companies do not comply with these requirements. In contrast, the provisions on accounting, audit and disclosure of financial information in the debt covenants are much more onerous insofar as they require borrower corporations to submit quarterly, semi-annual and annual accounts, provide for a standard of accounting (GAAP or IFRS) and the appointment of auditors. For large corporations or if a lending transaction involves substantial amounts of money, the banks generally insist on accounts being audited by international accounting firms--the big four (KPMG, PWC, Ernst &Young and Delloitte & Touche). In other cases, the accounts are usually required to be audited by an auditor approved by the Institute of Public Accountants of Uganda (ICPAU).

The non-financial covenants include a requirement to conduct business in a proper manner, to inform the lender of any material changes in business or ownership of the company and to comply with the requirements of the Companies Act. Some of the covenant terms, such as the requirement to conduct business in a proper manner and to comply with the Companies Act, appear to be too broad or too general. Although these two provisions were found in all the standard agreements I reviewed, and it was not easy to establish the exact nature of obligation that the lender was imposing on the borrower, none of the bank officials interviewed, could explain the exact nature of the obligation. My interpretation was that they were general clauses that may be invoked when a borrower's breach is not covered by any specific clause in the contract. Some interviewees thought that the requirement to comply with the Companies Act required filing periodic returns, obtaining the necessary board resolutions and other such related matters, although they indicated that this was only material when it related specifically to the borrowing transaction.

Some of the covenant terms, such as the requirement to keep proper books of accounts, are obligations ordinarily imposed on companies by the Companies Act, but which as I mentioned earlier, companies do not regularly comply with. By requiring borrower companies to keep proper books of accounts, conduct periodic audits and submit financial statements to the lender periodically, banks are able to enforce compliance with the Companies Act. Banks consider the obligation on accounts and audit a material condition, which is used as a monitoring tool as indicated below. Non-compliance is considered to be a trigger for close monitoring of the defaulting company and may lead to either suspension or termination or function as grounds for denying additional financing in the future.

In cases in which the borrower corporation is engaged in business that is subject to regulatory supervision, including the environment or health and safety, debt covenants usually contain a requirement that the borrower company obtain prior approvals from the regulator, and comply with regulatory standards. The concern here is that non-compliance with regulatory standards may have adverse consequences for the borrower and, as a result, ultimately the lender. In this case, the lenders monitoring role extends to ascertaining compliance with regulatory requirements.

The loan agreements also typically contain restrictive covenants, which seek to control the activities of borrower corporations, such as restrictions on additional borrowing, the disposal of assets. Other conditions include the requirement for prior approvals from the bank for transactions (such as those that may involve a substantial change in the business of the corporation or a substantial change in ownership) and restrictions on director remuneration as well as on the payment of dividends. Most of the bank officials I interviewed revealed that the restrictions on director remuneration and the payment of dividends tend to be invoked when the company is in financial distress.

4.3.3 Monitoring

There are various mechanisms used by banks to monitor the companies that they lend money to, including:

(i) *Periodic Review of Financial Information*--As indicated earlier, borrower corporations have an obligation to submit periodic financial information to lenders. The loan agreements typically require companies to submit quarterly management accounts, semi-annual and annual financial statements. The primary purpose of the financial information is to enable the lender to monitor cash flow and repayments. The failure to submit financial statements is a default that may trigger closer monitoring of the borrower or other intervention by the lender, such as suspension, restructuring or recalling the facility. The threat of recalling a facility as well as the desire to maintain a good relationship with a bank force companies to comply with the financial reporting obligations. To ensure the integrity and accuracy of the financial information submitted by companies, banks often cross check the information in the financial statements against other reports, such as statements of stock and receivables, debtors' lists and bank statements. Requiring the borrower to submit periodic financial information and verifying the information to ensure it was accurate was done by all the six banks. However, the larger banks such as Stanbic Bank and Standard Chartered Bank, which typically lend to the large well established companies, indicated that some large companies have well established financial reporting systems. In such cases it was not necessary to verify the information submitted.

(ii) *Inspections*—All the officials of the six banks I interviewed have a practice of assigning a relationship manager to each borrower company, who periodically checks for compliance with debt covenants, monitors repayments and conducts scheduled onsite inspections. Information gathered from the inspections is used to verify the submissions made by the borrower and to note any "red flags" that may indicate problems and require lender intervention. In cases in which the company is in financial distress, the inspections are conducted more frequently, subjecting the company to strict or closer scrutiny. In addition, the lender will exert pressure upon the borrower corporation's management with a view to obtaining corrective action, such as instituting proper accounting practices and hiring professional management. Such corrective actions are usually demanded by the lender as conditions for either restructuring or maintaining the loan facility, when the borrower is experiencing financial distress. The corrective measures and undertakings given by companies to lenders, following intervention will usually lead to improved governance.

(iii) *Account Monitoring*--Obtaining accurate reports and financial statements regarding the status of the borrower company is a key concern of banks. Banks usually insist that companies use external auditors of international repute, or alternatively, they demand that companies select external auditors from the bank's list of approved auditors. All the six banks had a list of approved auditors, who are usually members of the Institute of Certified Public Accountants of Uganda. Although the auditor requirement does not entirely eliminate the risk that companies may submit inaccurate financial information to banks, the risk is minimized. One bank official commented that he was aware that companies prepare different financial statements for tax purposes and for loan approvals; therefore, other means have to be used to verify the accuracy of the information. One such method involves establishing a banking relationship with the borrower companies, through which loan funds are disbursed and cash flows monitored.

(iv) *Market Information*--This is a key monitoring tool used by banks. The relationship managers attached to companies are required to report any material market or public information about the companies that has been obtained through media reports or other formal and informal mechanisms. Such information might include reports on regulatory sanctions, improper business practices, improper conduct of directors and controlling shareholders and material litigation concerning a company. The companies are aware that such information may have adverse consequences for them, including the denial of future loans.

(v) *Partial Release of Loan Funds*—The release of borrowed funds in installment payments is also an important tool to prevent management from misappropriating resources to the detriment of the company and the lender. This technique is often used when substantial loan amounts are involved and when the bank has some reservations about the integrity of management. This is particularly true if management has previously failed to account for funds disbursed, or the company is in financial distress, and the bank provides additional finance as a rescue measure. Furthermore, the partial release of loan funds acts as a constraint on management because the need for additional finance will deter them from engaging in improper conduct. In addition to installment releases, some banks indicated that if they had concerns about the credibility of management, or if they needed to restructure a credit facility because the account was not performing well, they might insist on paying the company's suppliers, contractors or creditors directly.

(vi) *Representation on the Board of Directors*--Commercial banks typically do not appoint representatives to the boards of companies that they lend money to. There was one case in which one of the banks indicated that they would sometimes require a representative to be appointed to the board of directors of a borrower company. However, this strategy was limited to cases in which the borrower company was engaged in a medium-long term (over 5 years) investment project, and funding was needed for successive periods over the entire project period. On average, banks lend short term (up to 12 months) or medium term (between 2-3 years).

The other isolated case was one in which the bank seconded senior management to a borrower company as one of the conditions for granting the facility. The credit facility was not an ordinary credit facility but rather a credit rescue facility. The company was heavily indebted to several banks, unable to meet its liabilities, and some banks were considering foreclosure and liquidation. The company was able to obtain additional financing from the new lender, to clear its prior obligations. In addition, the new lender imposed several obligations on the company, including seconding senior management to the company.

Another exception was with a development bank--the East African Development Bank (EADB), which undertakes equity investments in selected local corporations whose business has a developmental impact, but with a clear exit strategy, preferably through an initial public offering (IPO). The EADB also appoints representatives to boards of most of the companies it lends money to, with or without acquiring an equity interest, as a means of monitoring management as well as a monitoring tool due to the exposure associated with the projects they finance.

In contrast, note that in jurisdictions, such as Germany, board representation is a key monitoring tool used by banks. German banks, besides lending, are substantial holders of stock of the corporations, thereby obtaining board representation by virtue of their position. Therefore, banks in Germany have three mechanisms through which they can obtain information about the corporations for monitoring purposes--as shareholders, by board representation and through banking operations.[109] Although each of these three mechanisms has limitations,[110] the three combined give German banks better leverage over companies than banks in Uganda, which have only one source of information--banking operations.

In Uganda, the Financial Institutions Act prohibits banks from holding stock in other companies.[111] This is a major point of departure from the German corporate governance system. In addition, banks are also prohibited from lending to a single borrower in excess of 25% of their core capital.[112] Therefore, one could argue that even if banks are not permitted to hold stock, they should be able to appoint a representative to the board if they have lent substantial amounts of money, the extent to which they can lend or be exposed to a particular borrower is limited by statute.

It should also be noted that while the governance role of banks in Germany is increasingly becoming less important, due to decreasing traditional loan financing,[113] in Uganda banks still play an important corporate finance role. In addition, the information advantages enjoyed by banks in Uganda in an

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[109] Peter O. Mulbert, *Bank Equity Holdings in Non-Financial Institutions and Corporate Governance: The Case of German Universal Banks*, in COMPARATIVE CORPORATE GOVERNANCE, 445, at 451 (Klaus J. Hopt ed, 1998).

[110] See Mulbert,*supra* note 109, at 451-453 (where he argues that share ownership and board representation are not as strong information sources for banks as banking operations. He further states that developments in information disclosure standards have reduced banks' leverage and the corporate governance role of banks has been greatly reduced by decreasing traditional loan contracting).

[111] S. 39, Financial Institutions Act, 2004.

[112] S. 31, Financial Institutions Act, 2004. Note, however, that banks that are subsidiaries of foreign banks are able to lend in excess of this amount through syndicated arrangements or whenever the facility is guaranteed by the parent company.

[113] Peter O. Mulbert, supra note109, at 454.

environment of imperfect information make bank finance an important governance tool.

The above monitoring mechanisms employed by banks, although primarily designed to reduce the risk of default and employed without any particular attention being paid to specific corporate governance issues, such as the relations between minority and controlling shareholders, duties and responsibilities of directors to shareholders and other corporate governance concerns, have an indirect impact on corporate governance. Commenting on the governance role of banks, Daniels and Triantis state that when bank lenders provide the bulk of the financing to firms, they enjoy significant monitoring advantages over other stakeholders and can use their governance levers to play the principal role in controlling managerial slack.[114]

4.3.3.1 Incentives for Banks to Monitor Borrower Companies

As indicated in 4.3.1 above, the governance role begins at the very initial corporate finance stages, when a company approaches a bank for financing. However, the governance role of banks is more pronounced during the actual period of the loan, when banks actively monitor borrowers. I have already discussed the impact of various monitoring mechanisms employed by banks on corporate governance. Below, I give the incentives banks have to engage in monitoring.

- *Problems of contract enforcement.*

Generally, banks are of the opinion that the enforcement of covenants in courts in the event of a breach by the borrower is a slow and uncertain process. They prefer to use strict appraisal processes and active monitoring to minimize incidences of default, which would require resorting to the courts to recover funds from the borrower. Whenever the loan is secured, the mortgage and debenture deeds usually have a clause that allows the lender to foreclose without going to court. Court action is considered to be a last resort mechanism. In addition, in cases in which a borrower is either likely to default, actually defaulted or breached covenant terms, alternative intervention mechanisms to try to

[114] Triantis and Daniels, *supra* note70,at 1082.

rescue the lender, are explored. Such alternative mechanisms include restructuring the facility, suspending interest and working with the lender to employ stricter internal controls. The rationale for this was to avoid court action, minimize damage to the reputation of the bank, as well as to minimize risks to the bank if the borrower becomes bankrupt.

- *Central Bank Regulations*

The Central Bank regulations on accounting and provisioning for non-performing assets also indirectly enhance the governance role of banks. For example, the Central Bank's regulations on credit classification and provisioning require banks to classify credit facilities as either normal risk, watch, substandard, doubtful or loss.[115] This classification has an impact on the size of a bank's non-performing assets and, therefore, its profits. *Normal* risk refers to the fact that the borrower is in good financial condition and repayments are being made as scheduled. The *watch* category is the case in which the borrower's credit facility is up to date, but evidence suggests that certain factors could affect the borrower's ability to service the account or impair collateral in the future. The *substandard* category means that there is evidence to suggest inadequate cash flow and financial information. *Doubtful* accounts are those for which collection of the debt is highly questionable, or improbable, whereas the *loss* category refers to accounts for which collection is not practical and a write off is deemed appropriate.

In addition to the above classifications, banks are required to provision for facilities at 20% if the borrower has not paid interest within a 90-day period, at 50% if the borrower has not paid within 180 days and at 100% if the borrower has not paid within 365 days. These requirements are quite stringent and affect the profitability of the banks. Therefore, in order to minimize cases of provisioning, the banks not only impose stringent repayment schedules on borrowers, but also constantly monitor borrowers to ensure that their accounts are performing well. It is assumed that the pressure from banks and enhanced monitoring will preclude management and controllers of borrower corporations from slacking. Some of the officials of the companies interviewed expressed concern that

[115] The Financial Institutions (Credit Classification and Provisioning) Regulations, r.10 and 11.

the Central Bank regulations made it difficult for them to borrow or, alternatively, made it expensive for them to borrow. They pointed out that banks were more vigilant in monitoring the activities the borrower and demanding accountability.

- *Reduced importance of collateral.*

The study also extended to establishing whether the impact of bank finance varies with secured or unsecured lending. This was based on the assumption that where lending is secured, banks are likely to be engaged in less monitoring because of the security provided by collateral in the event of a default. The interviews with bank officials revealed that apart from the large multinational corporations and other large local public companies which satisfy the 1-4 rating criteria used in evaluating loan applications, and can borrow without security, all other borrowers are required to provide security. However, collateral security is heavily discounted. On average, collateral was discounted by 55% and although this puts a burden on lenders to find substantial collateral, it indicates that banks do not attach much importance to collateral. They are instead concerned with the cash flows of the borrower and the borrower's state as a going concern. They also indicated that realizing security was considered to be a last resort measure. The reliance on cash flows as opposed to collateral, implies that banks are forced to actively monitor borrowers.

Nevertheless, it should be noted that the monitoring mechanisms banks employ vary as well as their effectiveness and ultimately their impact on corporate governance, depending on a number of factors. Corporations that are able to obtain financing from elsewhere, such as subsidiaries of foreign corporations that are able to borrow cheaply from their parent companies, will have their corporate governance shaped by other forces, such as group practices, parent company directives or legislation of the home state of the parent company.

It should also be noted that the effect of a bank's intervention in cases in which a borrower is in financial crisis have varying corporate governance implications. For example, the borrower may make demands that drive the company further into insolvency, or demand corrective action that in the long run benefits the borrower, the lender and other stakeholders. Triantis and Daniels state that the extent to which a borrower's intervention may be opportunistic depends on the lender's leverage over the borrower and the strength of bankruptcy laws to void credit preferences.[116]

The governance role of banks is also likely to be minimal for large corporations. Some of the officials of the large corporations I interviewed stated that due to the current economic conditions in Uganda, bank financing was very expensive. As a result, they try to minimize their borrowing to capital expenditure and overdraft facilities for short-term working capital. The reinvestment of profits was the preferred form of financing. On the other hand, the banks also employ less rigorous standards for certain categories of corporations. Corporations such as Shell, Total, Celtel and other multinationals were considered to be financially sound and normally have a rating of between 1-4, which means they were eligible to obtain facilities without providing security and with less scrutiny and monitoring. Some interviewees stated that such multinationals usually have proper accounting and financial disclosure practices. In addition, such corporations as well as some large public corporations incorporations incorporated in Uganda, such as Nile Breweries, Ltd., Uganda Breweries, Ltd., Uganda Clays, Ltd., Kinyara Sugar Works, were considered to have financing needs in excess of the capacity of some small banks. In this case, the governance role of smaller banks is limited to corporations that they are able to finance. In contrast, the larger banks that are able to finance large corporations also often find themselves in situations in which they have to compete among themselves to offer facilities to such corporations. Some companies stated that if they needed to finance a large project, they would invite various banks to tender and select the bank with the best offer in terms of interest rates and repayment obligations. In such cases, the banks are unlikely to have any meaningful governance impact on these corporations.

My study also extended to investigating whether there are differences in monitoring mechanisms employed by foreign and local banks and whether they have differing incentives to monitor. I found that the monitoring mechanisms used are similar across all

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[116] Triantis and Daniels, *supra* note 70,at 1097.

banks. There were similarities in credit policies, appraisal mechanisms, follow-up and monitoring, verification of information and constraints. Variations occur on a case-by-case basis.

Therefore, it is clear from the above discussion that there is an established link between bank finance and corporate governance. The extent to which bank finance is a part of the corporate governance system of a particular jurisdiction depends on several factors, including the relative importance of bank financing, compared to alternative sources of financing, the leverage that the bank has over the borrower and the availability of information to enable the bank to monitor borrowers. In addition, the legal rules of a particular jurisdiction may weaken or enhance the governance role of banks.

5.0 THE FUTURE OF CORPORATE GOVERNANCE IN UGANDA

As indicated in Chapter 3, the ownership structure of companies in Uganda is highly concentrated and as opposed to some jurisdictions in which controlling shareholders are usually institutions, in Uganda, the majority of controlling shareholders are individuals. In addition, the corporate governance system is embedded in an environment of inadequate legal rules and weak enforcement. There are obvious difficulties with the enforcement of core company law obligations and basic corporate governance standards, such as the requirement for companies to hold an annual general meeting, file periodic returns and to maintain proper books of accounts and audits. In contrast, banks as lenders have engendered practices among borrower companies that not only lead to compliance with some aspects of core company law, but also to corporate governance standards broadly. Banks subject self-dealing transactions to greater scrutiny, enquire into the conduct of corporate managers and demand for compliance with the Company's Act requirements on matters such as audits and financial reporting. Therefore, the corporate finance role of banks involves a governance role.

It is clear that as long as other forms of corporate finance remain undeveloped in Uganda, banks will continue to serve an important corporate finance role. This is what distinguishes the potential for the governance role of banks in Uganda from banks in other jurisdictions. In Germany, for example, the traditional role of banks is gradually declining with increased use of alternative forms of corporate finance. However, the extent to which the corporate finance role of banks in Uganda will be translated into a more meaningful governance role remains unclear. For banks to be able to significantly shape and influence corporate governance in Uganda, a number of issues that currently constrain their governance role need to be addressed, including:

- *Access to and Quality of Information*

The governance role of banks arises from their monitoring role as lenders. However, for banks to perform a meaningful governance role, they must have access to information about the companies that they monitor. Banks cannot effectively monitor companies that they lend money to in the absence of timely and accurate information, especially financial information regarding the borrower's status. In the course of the interviews for this research, bank officials revealed that obtaining accurate financial information was a challenge. Although several measures have been adopted to verify the information that they receive, there are still concerns about the quality of the information as well as the administrative and financial burdens associated with verifying the accuracy of the information. Triantis and Daniels recognize the importance of the availability of information to enable the lender to take appropriate action.[117] In addition, it has been recognized that in jurisdictions such as Germany, banks have for a long time been able to play a major corporate governance role because of the information advantages that they for a long time had over other stakeholders.[118] Therefore, it is important that the nature of accounting and financial disclosure standards for companies in Uganda be addressed.

- *Broader Financial Intermediation by Banks*

Given the small size of the capital markets,[119] the inability of many companies to raise capital through capital markets, the time it takes to build a vibrant securities market, banks will continue to play a vital corporate finance role in Uganda and, therefore, be an important part of the corporate governance system. In addition, other factors such as unstable macro-economic conditions do not permit other forms of corporate finance. However, it is necessary to make the governance role of banks more meaningful. Although the statistics indicate a growing trend in the lending activity of banks,[120] financial intermediation by banks is still relatively low, and access to commercial credit is still a big challenge for most companies. There is need for a specific policy to encourage banks to lend more and, therefore, to have greater impact on corporate finance and governance. The current regulatory framework for banks in Uganda was enacted after a series of bank failures and focuses on the soundness and liquidity of banks, but constrains the ability of banks to lend. As long as the lending role of banks is constrained

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[117] Triantis and Daniels, *supra* note 70,at 1084.
[118] Peter O. Mulbert, *supra* note 109, at 451.
[119] Market Capitalization as of 4/11/2006, was $2,039.8 million U.S. http://www.use.or.ug/documents/USE_MARKET_REPORTApr_11-2006.pdf (accessed 5/2/2006)
[120] The Bank of Uganda Annual Supervision Report (2004), indicates that the total sectoral distribution of Commercial Bank credit grew from 525 billion Uganda Shillings in 2004 to 977 billion Uganda Shillings in 2004.

by regulatory measures and other factors, their corporate finance and governance role will be limited.

The corporate finance and governance role of banks is also likely to be greatly enhanced by macro-economic improvements. High interest rates and unstable inflation increase the cost of borrowing and discourage companies from borrowing from banks hence limiting the role of banks. Unfavorable macro-economic conditions are some of the factors that have previously led to high numbers of non-performing loans that discouraged banks from commercial lending. Most banks preferred, instead, to invest in government securities and real estate. In addition, unfavorable macro-economic conditions make debt expensive for companies due to high interest rates and, therefore, constrain borrowing. All of these conditions make it difficult for companies to access bank financing, hence limiting the corporate finance and corporate governance role of banks.

Statistics indicate that until 2002, investment in treasury bills dominated commercial banks asset portfolios. However, the asset structure of commercial banks began to change after 2002, with gradual decline of investments in treasury bills and increase in advances. In addition, the non-performing loans have also significantly dropped from Uganda shillings 61.0 billion as at the end of 2003 to 21.4 billion as at the end of 2004.[121] If this trend continues, financial intermediation by banks will likely increase as well as their governance role.

- *Eliminate Legal Barriers to the Governance Role of Banks*

There is need for proactive measures that promote or enhance the governance role of banks, such as lifting the restrictions on banks owning shares in non-financial firms. This measure may further direct the governance role of banks towards the German model. I am aware that the German banks corporate governance role is gradually diminishing due to several factors, including the gradual decline in traditional bank financing. However, the situation in Uganda is different, because banks still play a major corporate finance role. It is also true that in some jurisdictions, such as the U.K., where banks are not

[121] The Bank of Uganda Annual Supervision Report, 13-16 (2004)

prohibited from holding stock in non-financial firms, corporate governance has not evolved along the German lines. However, until the prohibition is lifted in Uganda, it is difficult to say what the impact would be. For example, some banks had equity interests in companies that they had previously lent to, which they had to relinquish when the new law (the Financial Institutions Act) was enacted. Other financial institutions which are not governed by the new legislation, such as development banks, have substantial holdings in and exercise significant influence over the companies they lend money to.

- *The Importance of Legal Reform*

Informal mechanisms of control, such as bank finance, can be supported and enhanced by legal rules producing a result in which both formal and informal mechanisms compliment each other. The discussion on the corporate governance role of banks focuses on informal control mechanisms in corporate governance, as opposed to formal mechanisms. The extent, to which either the formal or informal mechanisms are instrumental in shaping the corporate governance system of a particular jurisdiction, will depend on their strength as well as other factors as discussed in chapter two. Although some scholars such as Rafael La Porta et al.,[122] tend to emphasize the importance of formal mechanisms, it is important to acknowledge that neither mechanism operates in isolation. Therefore, the role of the informal control mechanisms in Uganda, in particular, bank finance, would be significantly enhanced by legal reform and the strengthening of institutions on which they rely, such as courts, the registrar of companies and streamlining accounting standards.

Legal rules not only supplement informal mechanisms of control, but also prevent informal players from acting selfishly or in a manner that only serves their interests, such as when a lender detects that a borrower is likely to default and takes measures to secure its priority in the event of bankruptcy. Bankruptcy laws on voiding creditor preferences may prevent a lender from taking such action.

[122] Rafael La Porta et al., Corporate *Ownership Around the World*, 54 J. Fin. 471 (1999); Rafael La Porta et al., *Law and Finance*, *supra* note 7; Rafael La Porta et al., *Investor Protection and Corporate Governance*, *supra* note 5, at 18.

- *The need to strengthen Enforcement Institutions*

Legal rules alone are insufficient to achieve any desired objective if they cannot be enforced.[123] The various ways in which banks can intervene in the affairs of a company that they lend money to are usually provided for in the debt covenants, such as the option to recall a facility at any time (threat of exit). Other terms are in the form of undertakings and warranties that the borrower gives to the lender. These measures will have a powerful deterrent effect and, therefore, constrain improper conduct, if the lenders are able to invoke them or enforce them. As a result, enforcement is an important component of the governance role of banks. Several scholars recognize the importance of enforcement for both formal and informal governance mechanisms. Rafael La Porta et al., state that the effectiveness of formal control mechanisms depends on the ability to enforce them.[124] Shleifer and Vishy further argue that the effectiveness of informal mechanisms of governance, such as the role of creditors, depends on the rights they have and that banks in Germany and Japan play a dominant role because they operate in a favorable legal environment.[125]

It is not clear whether such legal reform can easily be achieved. Political and the vested interests of some stakeholders can severely constrain legal reform processes.[126] In Uganda, some laws such as the Financial Institutions Act, which fundamentally changed the way in which financial institutions are regulated, have been revised without much controversy, whereas the revision of other laws, such as the Land Act and Domestic Relations Bill, has been delayed due to disagreements and political pressure from various stakeholders.

- *The need to address the position of Controlling Shareholders*

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[123] Andrei Shleifer and Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. Fin. 737, at 753 (1997).
[124] *Investor Protection and Corporate Governance*, *supra* note 5, at 20.
[125] Shleifer and Vishny, *supra* note 123, at 757.
[126] Rafael La Porta et al., *Investor Protection and Corporate Governance*, *supra* note 5, at 18.

There is also a need to address the position of controlling shareholders. Controlling shareholders exist in all jurisdictions, including those markets in which share ownership is characterized as being widely dispersed. Some scholars recognize that controlling shareholders can be valuable,[127] especially when they use their position to monitor management and exercise voice. In this context, Gilson and Gordon argue that it is justifiable for controlling shareholders to extract private benefits of control as compensation for the monitoring costs they incur and that minority shareholders would agree to this strategy, as long as the benefits of having a controlling shareholder do not exceed the value of the private benefits of control that they enjoy.[128] One can also infer from the loan appraisal criteria and debt covenants that controlling shareholders in Uganda have a positive role. Their identity of substantial owners/directors is critical during the loan appraisal process. In addition, most debt covenants contain restrictions on any material change in ownership over the duration of the loan.

However, the challenge is to balance the benefit of having controlling shareholders *vis-à-vis* the problems associated with them. Such a balance can only be achieved by formal mechanisms, specifically, fiduciary duties that impose obligations on controlling shareholders similar to the duties imposed on directors, such as the strict standard of review that courts in the US subject to self-dealing transactions--the intrinsic fairness test. Gilson and Gordon state that courts in the U.S. subject transactions involving controllers who have the potential to transfer large amounts of value from the company to intense judicial scrutiny.[129] In the *Sinclair Oil Corp. v. Levien*[130] case, for example, the minority shareholders of Sinclair Venezuelan Oil Company (a subsidiary of Sinclair Oil Corporation) claimed that the dividend policy favored the controlling shareholder. Although the court found that there was no breach of fiduciary to the minority shareholders because dividends were not paid to the controlling parent company to the

[127] Brian R. Cheffins, *supra* note 69, at 32; Ronald J. Gilson, *supra* note 90.
[128] Ronald J. Gilson and Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U Penn L. Rev. 785, at 786 (2003).
[129] Gilson and Gordon, *supra* note 128, at 791.
[130] 280 A.2d 717(De.1971).

exclusion of the minority shareholders. However, the court stated that an intrinsic fairness test was applicable to a self-dealing dividend declaration by a dominated board.

Therefore, unlike Germany, where the governance role of banks is gradually diminishing, and German corporations embracing other forms of corporate finance and steadily breaking ties with banks,[131] in Uganda, bank finance is still an important source of corporate finance. However, the governance role of banks can only be made more meaningful by addressing the obstacles faced by banks as indicated above.

[131] DaimlerChrysler's appointment of Hilmer Kopper as its new chairman has been widely regarded as a symbolic move that breaks ties between Daimler and the Deutsche Bank. See "Daimler's New Chairman Marks Break with Past," Financial Times 3/8/2006.

6.0 CONCLUSION

This study was based on the hypothesis that although legal rules and legal institutions play a critical role in shaping corporate governance systems, alternative mechanisms of control do exist and can perform the functional role of law. This is especially true in cases in which legal rules and legal institutions cannot be relied upon to foster good governance, either because they are unable to offer the requisite protection or enforcement institutions are weak, or both.

The objective of this thesis has been to examine the role played by informal mechanisms of control, specifically bank finance, in shaping the corporate governance system of Uganda. The current literature on corporate governance is part of the broader spectrum of law and economics that looks at the interplay between law, governance and finance. Legal centrists, in particular, have advanced the "law matters" theory— the nature of a legal system, its legal rules and quality of enforcement are fundamental in shaping corporate governance systems. Consequently, jurisdictions with strong legal rules and adequate mechanisms for the enforcement of legal rights, such as the U.K and the U.S. have corporate governance systems characterized by dispersed share-ownership structures. Such legal systems have vibrant capital markets, which together with the market for corporate control have been instrumental in shaping their corporate governance systems.

In contrast, the vast number of jurisdictions have not had share ownership structures that have evolved in accordance with the U.K and the U.S structures, in which ownership is dispersed. Corporations in several other jurisdictions such as Germany, Italy and Canada have concentrated share-ownership structures. This phenomenon is attributed to weak legal rules for the protection of minority shareholders and inadequate mechanisms for the enforcement of legal rights. There are exceptions, such as Sweden, where share ownership is concentrated, but the legal rules and enforcement mechanisms are adequate to protect minority shareholders.[132] Nevertheless, in cases in which legal rules and enforcement are inadequate, informal mechanisms of control have played an important

[132] See Ronald J. Gilson, *supra* note 3.

governance role. The jurisdiction particularly singled out is Germany, where banks have been at the heart of the German corporate governance system for a long time.

The literature on the role and effectiveness of formal and informal mechanisms of control in corporate governance has focused on corporate governance systems in developed countries, and to some extent, emerging economies, such as China, India and Western Europe. There is very limited literature on corporate governance in developing countries, particularly Africa. A few scholars have addressed the question of current developments in corporate governance—specifically the debate on the convergence of corporate governance systems and the implications for developing and emerging economies.[133] In addition, there is hardly any discussion of, or empirical studies on the role of informal mechanisms of corporate governance in Africa, hence, the contribution of my thesis to this debate—with a focus on bank finance and corporate governance in Uganda.

The law governing companies in Uganda is primarily concerned with core company law matters, such as the formation of companies, the characterization of companies—private/ public, shareholder rights and duties of directors. Corporate finance introduces a much broader perspective--when companies seek external finance, mechanisms must be provided to ensure that the interests of the providers of external finance are not only protected, but balanced *vis-à-vis* the interests of the various parties in a corporation. This is the essence of corporate governance.

As indicated in Chapter 3, public companies in Uganda predominantly have controlling shareholders. The existence of controlling shareholders raises concerns relating to self-dealing and the oppression of minority shareholders. These problems are further exacerbated by the fact that the legal rules are inadequate to offer substantial protection to minority shareholders and their enforcement is equally weak. However, banks as the major source of external finance for companies in Uganda have engendered some degree

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[133] Erik Berglof and Ernst-Ludwig Von Thadden, *supra* note2; Leora S. Klapper and Innessa Love, *supra* note 2; Charles P. Oman, *supra* note 2.

of compliance with corporate governance standards. The governance role of banks is discussed in Chapter 4.

The extent to which informal mechanisms of control impact corporate governance varies depending on a number of factors, including how they function, the availability and strength of support mechanisms and institutions and how they interface with the law. Support mechanisms include access to information and the quality of accounting. The governance role of banks, in particular, depends upon the quality of information available to banks as lenders. In cases in which such information is not readily available, and accounting standards are inadequate, the role of banks may be undermined. In addition, legal rules may enhance or constrain the role of informal mechanisms, for example the governance role of banks in Uganda differs from banks in Germany, because unlike Germany, banks in Uganda are not permitted to hold stock in non-financial firms.

Therefore, the governance role of banks in Uganda is not likely to evolve in accordance with the German model. The fundamental difference between the two countries lies in the fact that banks in Germany have for a long time been substantial stockholders in non-financial firms. This ownership stake enables them to acquire board representation. As lenders, stock holders and with board representation, they have been able to play a significant governance role. In contrast, the governance role of banks in Uganda is only partial—limited to the lending relationship that they have with the companies. Therefore, banks in Uganda cannot be expected to be concerned with the broader corporate governance issues, such as the nature and the quality of information disclosed to shareholders, shareholder rights and other corporate governance issues that have no impact on lending transactions.

In addition**,** the extent to which banks will remain a part of the corporate governance system in Uganda, especially in the long run, remains to be tested empirically. It depends on several factors, particularly the continued reliance on bank finance as a major source of corporate governance for companies in Uganda. The interface between bank finance and companies in Uganda is likely to continue and become more significant as long as other forms of corporate finance are undeveloped and banks remain the main avenue for financial intermediation. As companies increasingly seek external capital from banks, it will be necessary for further studies to establish how the governance role of banks evolves and whether current constraints faced by banks can be eliminated.

APPENDIX 1: INTERVIEW PROTOCOLS

PROTOCOL FOR INTERVIEWS WITH BANK OFFICIALS

Background Information on Interviewee

1. Date:

2. Name: 3.Bank:

4. Job Title:

5. What are your primary responsibilities?

6. How long have you held this job?

Questions Relating to Lending

1. What percentage of the Bank's activities constitutes lending?

2. What is the Bank's policy regarding lending to companies?

3. What type of loans does the bank offer to companies?

4. How do you determine which companies to lend money to (lending criteria)?

5. How do you monitor companies that you lend money to?

6. Does the degree or nature of monitoring vary with the following and if so how?

(a) Size of the loan

(b) Size, nature and identity if the borrower

(c) Nature of the loan (secured v unsecured)

(d) Business of the borrower

(e) Late payment, defaults etc

(f) Any other factors?

7. Any problems encountered in monitoring or enforcing obligations you impose on borrower companies?

8. On which institutions do you rely to enforce your obligations?

9. How efficient are those institutions?

10. Do you think the monitoring mechanisms you employ have a long term impact on the management of the companies?

11. How do the Central Bank Regulations impact on your activities?

12. To what extent are your operations guided by the foreign parent company?

13. Any constraints faced?

14. Any other comments?

PROTOCOL FOR INTERVIEWS WITH COMPANY OFFICIALS

Background Information on Interviewee

1. Date: 2. Name

3. Name of Company: 4. Job Title:

5. What are your primary responsibilities?

6. How long have you held this job?

7.What is the share ownership distribution of this company?

8. What is the size of the company (assets)?

Questions Relating to the Role of Banks

15. Does this company borrow from Banks to finance its operations?

16. What percentage of the company's capital structure is debt?

17. How do you determine which Bank to borrow from?

18. What monitoring mechanisms do banks employ to ensure you do not default on payments?

19. What obligations do banks impose on the company when it borrows?

20. Are the obligations stringent?

21. How do banks ensure that your company complies with the obligations imposed?

22. Do the monitoring mechanisms used by banks vary with the following and if so how?

(g) Size of the loan

(h) Size, nature and identity if the borrower

(i) Nature of the loan (secured v unsecured)

(j) Any other factors?

23. Do you think the obligations imposed by banks as well the their monitoring mechanisms have a long term impact on your company?

24. Have you ever defaulted or been late on repayment and if yes, how did the bank respond?

25. Do the banks actively monitor through out the period of the loan or when you are late on payments/ default?

26. Does this company periodically file returns with the companies registry?

27. Any other comments

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