Assessment of Problems Facing State Owned Enterprises in Kenya

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Abstract

This paper makes an assessment of problems that face SOE and the factors that have contributed to poor corporate governance in so SOEs in Kenya. This will be discussed in the context of the appointment and removal of the BOD and impact of irregular appointment of directors on the performance of SOES. the problems highlighted include: poor legal framework and indebtedness, politicization of the appointment process, irregular appointment of BOD, lack of diversity and gender mainstreaming in board appointment and stringent economic conditionality's especially 2008,the irregular appointment of BOD contributes to poor performance of SOE s. this is due to the fact that persons appointed to the board fail to act in the best interests of the corporation by engaging in activities detrimental to the corporation. However, the research recognizes that irregular appointment and removal of persons from BOD, is not the only cause of the poor performance of SOEs. Poor legal framework and indebtedness, Politicization of the appointment process, irregular appointment of BOD, Diversity and gender mainstreaming in board appointment, Stringent Economic Conditionality's,

Introduction

This paper gives an assessment of problems that face SOE and the factors that have contributed to poor corporate governance in SOEs in Kenya. This will be discussed in the context of the appointment and removal of the BOD and impact of irregular appointment of directors on the performance of SOEs. The problems highlighted include politicization of the appointment process, corruption, impunity, mismanagement of state corporations' assets and the effect of the donor agencies' conditionality's. The irregular appointment of BOD contributes to poor performance of SOEs.[1] This is due to the fact that persons appointed to the board fail to act in the best interests of the corporation by engaging in activities detrimental to the corporation.[2] However, the research recognizes that irregular appointment and removal of persons from BOD, is not the only cause of the poor performance of SOEs.

Politicization of the appointment process

It is a feature of SOE in Kenya that the appointment of BOD is guided by politics, ethnicity and patronage. That explains why directors are usually perceived to be political aides of prominent politicians, whose appointment is part of the reward system for patronage.[3]In many cases, appointments to the BOD have been made without due regard to the requirements of the SCA and the State Corporations (Performance Contracting) Regulations on appointment of chief executives. The Communications Commission of Kenya CEO (Charles Njoroge) was dismissed through a court order since his appointment had been un-procedural.[4]

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[1]Kiarie Mwaura, 'the Failure of Corporate Governance in State Owned Enterprises and the Need for Restructured Governance in Fully and Partially Privatized Enterprises: The Case of Kenya', (2007) *31Fordham International Law Journal* 34 at 1.

[2] Ibid.

[3]Gakuu Mathenge, 'MPs Plot to Oust Parastatal Chiefs Who Hold Party Posts', *Daily Nation* (Kenya September 19, 2010) at 21.

[4] Paul Ogemba, 'Court Annuls Appointment of CCK Boss,' *Daily Nation*, May 17, 2012: Information Minister, Samuel Pogishio, in 2011 had ignored the Communication Commission of Kenya board's recommendation not to re-appoint Mr. Njoroge.

Proof of political interference in board appointment is also seen when Professor Anyang' Nyongo in one incident disregarded the recommendations of the Kenya Medical Training College board which had recommended for the extension of Dr Timothy Kingondu's term. Instead, he (the Minister) advertised the job, on the strength that position would be filled competitively**.** Similarly, the current Minister for Heritage**,** Mr. Ole Ntimama once rejected the recommendation of the NGO Co-ordination Board to renew the term of Mr. David Isoe as chief executive and instead appointed a former Permanent Secretary Peter ole Nkuraiya to the position. The then tourism Minister, Mr. Najib Balala, appointed his close political adviser, Mr. Kenneth Ombongi, to head the Kenya Utalii College without advertising the position. Irregular appointments have been made because Ministers exceed their powers by not admitting that their duties end at the policy formulation level and forgetting that heads of SOEs have been given their jobs by the statutes creating the SOEs. Depending then on the manner a particular director has been appointed, and especially if one was appointed as a favour, such an appointee is threatened with sacking for failure to strictly adhere to the orders of the line Ministers or someone higher up the rank, which greatly contributes to the poor corporate governance of SOE's. [5]It is, therefore, evident that the Office of the President and the parent ministries wield a lot of influence over the appointment of BOD to SOE's and their Chief Executives.[6] This deprives state corporations of autonomy and eventually contributes to their poor performance.

Impact of irregular appointment of BOD

The impact of politicizing appointments to SOE boards is that politically appointed boards will bow to pressure or interests of those who appointed them to these positions rather than act in their respective SOEs' best interests, so as not to risk losing their jobs.[7]In the case of *Australian Growth Resources Corporation Pty Ltd v. Van Reesema,*[8] it was held that any exercise of improper purpose can be set aside even though the directors may honestly believe that they were acting in the best interest of the firm.This is usually the case even when such political interests will result in mismanagement of the assets of the SOEs. The reason for political influence in appointments of Chief Executives and their boards is that such politicians are in most cases aiming at controlling SOE for political reasons.[9] This leads to poor performance of SOEs, corruption and misappropriation of public funds. In *Re Benham& Co.*[10]the court held that any benefit to the company must of necessity promote the prosperity of the company, benefits procured through corruption by directors' amount to breach of their fiduciary duty. As a consequence, the PIC Committee in its 11th report noted that most appointments to BOD have not measured up to the expected requirements. The effect of this is that SOE cannot maximize their full potential in terms of production, returns and provision of services. This partly explains why SOEs continue to operate under financial constraints occasioned by mismanagement and/or imprudent commercial arrangements. This leaves the government with the challenge of privatizing SOE so as to enhance their viability.[11]

Poor legal framework and indebtedness

Kenya's regulatory framework for the appointment of directors is still based on the common law where no special skills are required.[12]

[5] Symonds KichamuAkivaga, Anti-Corruption Politics in Post-KANU Era, In Ludeki Chweya and John KithomeTuta, '*Control of Corruption in Kenya: Legal Political Dimensions 2001-2004* (Claripress: Nairobi, 2005) at 243.
[6] Consider the 2008 struggle between the Communications Commission of Kenya on who was to be Chairman.
[7] Honourable Kiraitu Murungi submitted to the House once that the parastatal heads who were looting parastatals were not doing it alone and although they have big titles like executive director and managing director, they do not really have much power over the parastatals they head. It is the political godfathers who appoint such parastatal heads who exercise the real power over parastatals. He went on to say that most politically correct but corrupt transactions are usually sanctioned at a very high level.
[8](1988) 13 ACLR 261.
[9] An example can be drawn of the managing director of the Kenya Tea Development Authority, as it was before privatization, whose case was pending in Court for misappropriating about half a million of farmers' money. During investigations, it was discovered that most of the contracts that had been awarded by the Kenya Tea Development Authority were given to companies which had connections with powerful politicians.
[10](1853) 25 Ch. 572.
[11] The Seventeenth PIC report on the Accounts of State Corporations (2010)1 noted that Nzoia and Chemilil Sugar Companies financial performance was wanting and recommended that the government speed up their privatization.
[12]*Re City Equitable Fire Insurance Co. Ltd.* [1925] Ch 407.

Thus, line Ministers in the past took advantage of this fact that there is no statutory provision requiring directors to have expertise and experience in the management of SOE[13] to appoint boards where the appointees lack the necessary skills.[14] When this happens, the performance of SOE goes down. An opinion has been expressed to the effect that directors with nothing to offer in terms of skills and experience should be replaced with well qualified individuals in the boards.[15] This is notwithstanding the fact that they are usually cronies of Ministers and highly placed politicians. This is why re-appointment of some of the directors responsible for the collapse of SOEs to other directorships is a common practice.[16] For instance, despite the public outcry and prosecution that followed the investigation of the former Managing Director (MD) of the Kenya Posts and Telecommunications (KPTC), Mr. Kipng'eno Arap Ng'eny, for masterminding the loss incurred by the corporation, he was retired in 1993 and appointed to head the Kerio Valley Development Authority.[17] According to the 1990/91 Auditor General's Report on the Kenya Posts and Telecommunication, the MD was responsible for a number of fraudulent dealings.[18]This was not in the best interest of the company and according to the holding in the case of *Evans v. Brunner Mond and Company Ltd,*[19]such a director would be liable for a breach of duty.

In 1985, the corporation lost nine million Kenya Shillings after making payments to a firm of advocates to wind up the former Kenya External Telecommunications Corporations (KETC). The payment was made despite the fact that KETC was in the process of being merged with KPTC. The winding-up process was rendered a sham when the two companies merged. In another incident in 1990, the corporation had failed to remit to various public authorities statutory deductions from staff salaries amounting to about 170 million Kenya Shillings.[20] Recommendations made by the PIC for the prosecution surcharging or in the alternative barring public officers adversely mentioned for involvement in corrupt practices during their tenure from sitting as board members has never been carried out. Besides serving in high positions in the government,[21] some have been re-appointed to various boards of state corporations. [22] There is no doubt that irregular appointment of BOD has a negative impact on their performance based on the fact that failure to take action against errant directors will contribute to the downfall of a SOE. This arises from the impunity they enjoy, confident that no action can be taken against them. This is against the legal position in *Trevor Price and Another v. Raymond Kelsali,*[23]that directors are not allowed to make secret profits. The Seventeenth PIC Committee Report observed that several state corporations continued to operate under financial constraints occasioned by mismanagement and/or imprudent commercial arrangements.[24] The Committee took evidence from Nzoia and Chemelil sugar companies and noted that their financial performance was wanting due to indebtedness. The Committee also noted that the companies were operating on a going-concern basis and were awaiting approval from the Cabinet for restructuring of their debts and eventual privatization.[25]A recommendation by the Ndegwa Commission's Report[26] that allowed civil servants to double up as merchants, politicians and businessmen contributed to the failure in corporate governance of SOE.

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[13]Kiarie Mwaura, 'Regulation of Directors in Kenya: An Empirical Study', (2002) 13(12) *I.C.C.L.R* 465-479.

[14]A good example was the appointment in 2009 of Najib Balala's personal political adviser, Kenneth Ombongi a history lecturer at Nairobi University, to head the Kenya Utalii College. This was despite the fact that he had little to do with management and knowledge of the hospitality industry to bring any much needed change to the institution. When questioned, Najib Balala, the then Tourism Minister arrogantly stated that he saw nothing amiss with appointing a friend as "such was the practice now in government."

[15]Centre for Corporate Governance and Development op cit note 4 at 27.

[16]Ibid..

[17] Ibid.

[18] Ibid.

[19][1921] Ch. 359.

[20]Kiarie Mwaura, 'Disqualification of Directors in Kenya', (2003) *54 Northern Ireland Legal Quarterly* 118 at 135.

[21] Ibid.

[22] Examples include; Oluoch Kanindo (South Nyanza Sugar Company Limited) and Lawi Kiplagat (Milling Corporation of Kenya Limited) Alfred KiptanuiKeter (Cereals and Produce Board), Harun Lempaka (Mwea Rice Mills Limited), Cyrus Maina (Teachers Service Commission).

[23](1957) EA 752.

[24]Seventeenth Report of the Public Investments Committee on the Accounts of State Corporations (Vol. 1)2010, available at <http://www.parliament.go.ke/index-php?option.com (accessed on 10/2/2012).

[25]Ibid.

[26]The committee was a commission of inquiry on public service structure and remuneration. The commission was constituted January 15, 1970 by the former president H.E. Jomo Kenyatta to investigate the organization and structure of the public

The effect of which was to encourage conflict of interest where directors traded with the organizations they headed. As such, a situation has arisen where appointments to boards of SOEs and chief executive positions of SOEs, of persons who double up as political party officials, trustees, branch and National Executive Committee officials. Such directors are forced to spend time shuttling between their offices and political functions.[27] This paper argues that due to the political nature of their work in their various positions, such appointees are thinly spread and cannot be effective as board members. They also lack the requisite diligence required by virtue of holding a multiplicity of positions.[28] This leads to the SOEs they are in charge of performing poorly. SOE could benefit from best practices encapsulated by the Capital Markets Act, Guidelines on Corporate Governance Practices by Public listed Companies in Kenya.[29] The Act recommends that all listed companies when making appointments to their boards should only consider persons of good calibre, credibility and who have the necessary skills and expertise to exercise independent judgment on issues that are necessary to promote a company's objectives and performance in its area of business. This can be interpreted to infer that, appointing authorities follow this particular guidelines so that a director's duty of care and skill can be met and ensure accountability in subsequent dealings. This is due to the fact that a director is obliged to do as much as could be expected from someone as incompetent and foolish as he happens to be.[30]This means that a director is required to exhibit a degree of skill and care that may be reasonably expected from a person of his knowledge and experience.[31] Therefore, when appointing authorities entrust persons who do not meet the qualifications for positions to the board, the appointees cannot be held liable for honest mistakes of judgment even when the SOEs they head incur heavy losses and are faced with collapse.

Diversity and gender mainstreaming in board appointment

Diversity can be viewed as a focus on the influence of different cultures, educational levels, ages, gender, regional backgrounds, sexual orientation and ethnicity on quality, product development and other core business issues.[32] The Guidelines on Workplace Diversity booklet[33] defines diversity to include gender, age, language, ethnicity, cultural background, sexual orientation, socioeconomic background, personality, religious beliefs, family responsibilities and cognitive style. Workplace diversity, therefore, involves recognizing the value of individual differences and managing them in the workplace. It also involves how people' perceptions affect their interactions. Diversity is relevant to board composition because it has the capacity to influence work relations by offering greater perspectives on business issues and opportunities as well as a wider range of ideas and solutions.

The lack of diversity in board composition is a major problem affecting the performance of our SOEs.
This confirms the underlying criteria of appointment based on ethnicity and political patronage, with a bias towards men.[34] The absence of diversity will have a negative impact, on the performance of the SOE to which they are so appointed.[35]

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services and to recommend reforms whichever desirable. It published its report in May 1971(Report of the Commission of Inquiry - Service Structure and Remuneration Commission).

[27] Ben Turok, 'Control in the Parastatal Sector of Zambia', (September, 1981) 19(3) *The Journal of Modern African Studies* at 422.

[28] Past examples of such parastatal heads and board members who held other positions include; Former Nominated MP, Julia Ojiambo(Chairperson, Kenya Plant Health Inspectorate Service Board and chair of the Labour Party of Kenya, Jimmy Angwenyi, PNU vice chairman and Kenya Electricity Distribution Company Director, Philip Okundi, CCK Chairman and chairman of the ODM election board, Paul Sang, Nyayo Tea Zone board chairman and Bureti Kanu branch chairman). This is as at 2010.

[29] Gazette Notice No. 3362 of 2002, Guideline 3.1.3 at 484.

[30] Mackenzie, 'A Company Director's Obligations of Care and Skill', (1982) *Journal of Biblical Literature 460* at *475*-476.

[31] This test contains an objective element because the director could be held liable for failing on a particular occasion to live up to the standard of which he or she is in face capable of reaching, but the stronger element in the proposition is the subjective one meaning that directors can never be required to achieve a standard higher than that which he or she is personally capable of reaching.

[32] Thomas, R Roosevelt, *Beyond Race and Gender: Unleashing the Power of Your Total Work Force by Managing Diversity*, (AMACOM: New York, 1991) at 15.

[33] Part of a series titled "*Working Together*" issued by the Public Service and Merit Protection Commission of Australia following the passage of the Public Service Commission Act 1999.

[34] Samuel Siringi, 'Ministers Disregard Rules Over Key Jobs', *Daily Nation* (Kenya May 19, 2009) at 4.

Diversity cannot be discussed without reference to gender, a close scrutiny of SOE in Kenya shows that board composition is mainly homogenous besides showing signs of patriarchy. This means that women or female representatives in boards of SOEs are few and not well represented. This in effect illustrates the fact that on the issue of appointments, little attention is placed on gender diversity. Mijntje Luckerath – Rovers argues that a homogenous board is more likely to operate as a group and may experience the symptoms of group think, be they conscious or sub-conscious and this could bring about certain three risks namely: excessive self- esteem, the creation of tunnel vision and a strong pressure within the group to come to an agreement.[36] To illustrate this point, the collapse of Enron, was attributed to mismanagement at the board level, absence of diversity and approval of conflicted transactions and at the same time opting for risky disclosure practices. The company had only one female board member which contradicts the theory that better decisions are made by boards that have some diversity to allow consensus building.[37]

Supplementing the Private Sector

One of the reasons for the poor performance of SOEs is that some of their objectives, as set out by the Kenyan government, are to foster private sector activity rather than their own growth.[38]As such, this often results in a conflict of objectives and which is regarded as a source of inefficiency. The need to assist the private sector partly undermines the efficiency and solvency of SOEs, since the need to have high profits is rarely on the agenda SOEs.[39] Although SOEs are not solely driven by profits maximization the way private companies do, they have additional functions of fostering public, social and national interests. In so doing, SOEs are not measured by profitability, which explains why they are regarded by neo-classical law and economic theorists as the main cause of their inefficiency as it deprives them the incentives to increase gains, cut costs and operate efficiently.[40]

Donor Agencies Stringent Economic Conditionality's

The problem that SOEs face is with regard to the stringent conditionality's imposed by the IMF World Bank. The IMF for example has the following guidelines that states are required to comply with before being given grants:[41] adoption of policies of fiscal and budgetary austerity, exchange rate devaluation in essence, "getting the prices right", stimulating investment instead of consumption, massive privatization of industries in major utilities, blanket application of the free market policy which means a unilateral cancellation of all tariff restrictions by the country on the receiving ends of the loans, cuts on public expenditure, prioritizing external debt service and import liberalization.[42] The World Bank (WB) and the International Monetary Fund (IMF) are the leading donor agencies. The function of IMF is to provide support to countries facing acute imbalance between their external payments and receipts. The World Bank on the other hand is dedicated purely to poverty reduction and improving the living standards of people. However, the common goal of these two institutions is the promotion of economic growth and reduction of unemployment. State Corporations get funding from these agencies through the government in the form of guaranteed loans.

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[35] Consider the case of Tourism Minister Najib Balala appointing his personal political adviser, Dr. Ombongi, in 2009 to head the Kenya Utalii College. Dr. Ombongi was a History lecturer at the University of Nairobi and critics argued that he had little knowledge to do with management and expertise in the hospitality department to bring change to the ailing institution.

[36]Luckerath – Rovers,Mijntje, 'A Comparison of Gender Diversity In the Corporate Governance Codes of France, Germany, Spain, The Netherlands and The United Kingdom', (April6, 2010) available at SSRN://http:/ssrn-com/abstract =1585280 (accessed on 12/2/2012).

[37] James S. Fishkin, *The Voice of the People: Public Opinion and Democracy* (New Haven: Yale University Press, 1995) at 166 – 81.

[38]Kiarie Mwaura, 'The Failure of Corporate Governance in State Owned Enterprises and the Need for Restructured Governance in Fully and Partially Privatized Enterprises: The Case of Kenya', (2007) *31Fordham International Law Journal* 34 at 6.

[39] James S. Fishkin, *The Voice of the People: Public Opinion and Democracy* (New Haven: Yale University Press, 1995) at 166 – 81..

[40] Ravi Ramamurti, 'Performance Evaluation of State-Owned Enterprises in Theory and Practice,' (1987) 33 (7) *Management Science* 876 at 883.

[41]Ahmed Swapan Mahmud, 'International Financial Institutions (IFIs)–The Major Barrier to Change in the Aid System,'available at http://www.realityofaid.org/userfiles/roareports/roareport_205559c731.pdf (accessed on 12/2/2012).

[42] B Drum, 'Privatization in Africa', (1993) 28 (1) *Columbia Journal of World Business* 144 at 150.

The criticism levied against these conditionality's is that, too many conditions are imposed on debtor countries in a time frame that is not always realistic. This is in addition to, the questionable assumption these conditions are based. Much more importantly, the agencies impose conditionality's that do not conform to Kenya's political and economic conditions thus resulting into higher probability of failure and deviations.[43]

Conclusion

This chapter has given an overview of the factors that have contributed to poor corporate governance of SOEs in Kenya. This has not only led to their poor performance but in some instances, total collapse of the said institutions.[44] They include: a weak legal framework, corruption, politicisation of the appointment process, poor or weak oversight institutions and the involvement of the donor community in imposing structural adjustment programmes and cutbacks on balance of payment disbursements. SOE in Kenya have performed poorly because of a weak regulatory framework that gave the executive (the President) discretionary powers in among other things creating SOE, appointing the chairmen and the BOD. These powers extended to exempting some SOE from the Exchequer and Audit Act. The effect of this law is that it led to the President and line Ministries appointing political cronies, retired civil servants who were unqualified to sit on the BOD. As a consequence the appointees had one objective to satisfy those who appointed them which encouraged corruption, impunity and poor corporate governance. This was however made worse by a judiciary (appointed by the President) that failed to prosecute those accused of corruption, abuse of office and malpractices in SOE thus encouraging impunity.

Poor oversight has equally contributed immensely to poor performance and corporate governance of SOEs. The principle oversight institutions to SOEs include the Office of the President, the Ministry of Finance, Controller and Auditor General and Parliament. The Office of the President cannot provide oversight to SOE since as the creating and appointing agency; this would amount to a conflict of interest. The Ministry of Finance's oversight role involves supervising all SOE and as a consequence it is represented on the board of all SOEs. The Ministry suffers the same disability as the Office of the President largely because the minister is appointed by the President. Thus he cannot discharge his mandate different from that assigned by the Office of the President. Parliament generally plays an oversight role by acting as a check on the exercise of executive powers.

The Parliamentary Investment Committee (PIC) could play an important role oversight role but however, it is largely partisan notwithstanding all its reports are normally ignored. It is regrettable that poor corporate governance coincided with Structural Adjustment Programmes (SAP) which brought about donor conditional ties to bear on further balance of payments disbursements. SOE suffered disproportionately because they depended on state grants to survive. As a result, SOEs were required to be answerable to more than one principle, i.e. the government and the donor community led by the International Monetary Fund (IMF) and the World Bank (WB). This divided attention further led to not only poor performance but corporate governance as well. This is coupled by the fact that SOE have mixed objectives of profit maximization/public interest, there poor corporate governance is therefore not an accident. Chapter three explores current legal framework governing the appointment and removal of boards of members, factors that influence the appointment of persons to boards of SOEs as well as gaps and weaknesses in the legal and regulatory framework.

[43] Migai Akech, *Privatization and Democracy in East Africa: The Promise of Administrative Law* (E.A.E.P:Nairobi, 2009) at 27.

[44] Collapse of the Uchumi Supermarkets Limited was attributed to a dysfunctional board.