

# **Corporate Governance with Special Reference to Sudan**

A Thesis Submitted to the University of Khartoum in Partial  
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## **Dedication**

To my parents, wife and friends  
in recognition of their indefinite support and love.  
To those who have been there for me for a reason or a purpose.

"I conclude then that the necessary and sufficient conditions for knowing that something is the case are first that what one is said to know be true, secondly that one be sure of it, and thirdly that one should have the right to be sure."

**A. J. Ayer** (1910 - 1989)  
British philosopher  
*The Problem of Knowledge*

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## مستخلص

مقدم البحث: عبدالخالق محمد شايب عبدالله.

عنوان البحث: الضبط المؤسسي بالإشارة الى السودان.

ان الإستثمارات في كل انحاء العالم تحتاج لجذب التمويل من المستثمرين حتى تتوسع و تنمو. ان المستثمرين و قبل اتخاذ قرار الإستثمار في اي مشروع ، يريدون التأكد من جدوى المشروع المعني، كما انهم يريدون الإطمئنان على حسن ادارة المشروع و على انه سيظل مربحاً و مشرفاً عليه بصورة جيدة. بغية التأكد من ذلك يطلع المستثمرين على التقرير السنوي المنشور من قبل الشركة و الذي يوضح حسابات المشروع. انهم يتوقعون ان يعكس هذا التقرير صورة حقيقية لموقف الشركة. حيث ان التقرير السنوي يخضع لمراجعة سنويه دقيقة لسجلات و معاملات الشركة من قبل مراجع خارجي مستقل، فهو الذي يشهد بصحة مطابقة الحسابات للمعايير المحاسبية المتعارف عليها. الا انه على الرغم من ان التقرير السنوي قد يعكس صورة - الى حد ما- يمكن ان تكون دقيقه لنشاطات الشركة و وضعها المالي في وقت ما ، تظل هناك حقائق في مشاريع كثيره لم تعكس في التقرير السنوي مما يدعو الى التساؤل عن مدى مصداقية المراجعة (Auditing) ، و هل حفظ التقارير السنوية لوحده يكفي لإقناع المستثمرين بالدخول في اي مشروع في بلد ما ام لا.

هناك عدد من الشركات التي انهارت على الرغم من حقيقة ان التقارير السنوية كان يبدو عليها الدقه و السلامه. هذه الإنهيارات كان لها الأثر السلبي على الكثير من اصحاب المصالح و المساهمين و الذين رأوا استثماراتهم تتلاشى و تنتهي ، هناك ايضاً الموظفين الذين فقدوا و وظائفهم و موردي البضائع و الخدمات للشركات الخاسرة. لماذا حدثت هذه الإنهيارات؟ ماذا يمكن عمله لتجنب حدوث مثل هذه الإنهيارات مرة اخرى؟ كيف يمكن استعادة ثقة المستثمر؟

ان اجابة هذه الأسئلة مرتبطة بالضبط المؤسسي او مايعرف بحوكمة الشركات (Corporate Governance) ، ان افتقاد ضوابط مؤسسيه فعاله يعني امكانيه حدوث هذه الإنهيارات. ان وجود معايير جيده للضبط المؤسسي من شأنها منع اي انهيارات للشركات.

ان هذا البحث مكرس لتسليط الضوء على مفهوم الضبط المؤسسي و خصائصه و على وجه الخصوص كيفية انعكاس ذلك على قانون الشركات وممارساته في السودان.

## **Abstract**

**By:** Abdelkhalig Mohamed Shaib Abdalla

**Title:** Corporate Governance with Special Reference to Sudan

Investments in all over the world need to be able to attract funding from investors in order to expand and grow. Before investors decide to invest their funds in a certain business, they want to be as sure as they can be that the business is financially sound and will continue to be so in the foreseeable future. Investors therefore need to have confidence that the business is being well managed and will continue to be profitable and well observed and supervised. In order to have this assurance, investors look to the published annual report and accounts of the business and to other information releases that the company might make. They expect that the annual report and accounts will reflect a true picture of the company's present position. After all, the annual accounts are subject to an annual audit whereby an independent external auditor examines the business' records and transactions, and certifies that accounts have been prepared in accordance with accepted accounting standards and gives a 'true and fair view' of the business' activities. However, although the annual report may give a reasonably accurate picture of the business' activities and financial position at the point in time, there are many facts of the business that are not effectively reflected in the annual accounts which increasingly raise the question of the auditing credibility and whether keeping well prepared annual accounts is sufficient enough to convince investors to enter into a business in the particular country or not.

There have been a number of high-profile corporate collapses that have arisen despite the fact that the annual accounts seemed fine and accurate. These corporate collapses have had an adverse effect on many stakeholders, shareholders who have seen their financial investment reduced to nothing, employees who have lost their jobs, and in many cases the security of their company pension, which has also evaporated overnight; suppliers of goods or services to the failed companies; and the economic impact on the local and international communities in which the failed companies operated. In essence

corporate collapses affect us all. Why have such collapses occurred? What might be done to prevent such collapses happening again? How can investor confidence be restored?

The answers to these questions are always linked to corporate governance, a lack of effective corporate governance meant that such collapses could occur; good corporate governance can help prevent such collapses happening. The thesis is devoted to the examination of corporate governance and its attributes and in particular how these are reflected in the corporate law and practice in the Sudan.

## Chapter One

### Introduction

Introduction

What is governance?

What is corporate governance?

Governance makes a difference

The value of corporate governance

Why corporate governance of a great importance?

The crisis in investor confidence

What will happen if there is no adoption of good corporate governance measures?

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## **What is governance?**

"Governance" simply means: the process of decision-making and the process by which decisions are implemented (or not implemented). Governance can be used in several contexts such as corporate governance, international governance, national governance, local governance and good governance. All this underscores the importance of governance.<sup>1</sup>

Since governance is the process of decision-making and the process by which decisions are implemented, an analysis of governance focuses on the formal and informal actors involved in decision-making and implementing the decisions made and the formal and informal structures that have been set in place to arrive at and implement the decision.<sup>2</sup>

*Governance* also means to control and regulate; the exercise of influence to maintain good order and adherence to predetermined standards of behavior.<sup>3</sup>

## **What is corporate governance?**

The attribute of corporate governance is poorly defined. Different people have come up with different definitions that basically reflect their special interest in the field. The following definitions reflect the different attributes of the attribute as referred to by professionals and scholars.

1. Corporate governance as defined by Circular No. (9/2005) issued by Central Bank of Sudan, Banking Supervision department Regulations and Circulars, 4th October 2005 " is the set of relations between the management of the institution, its board of directors, its shareholder and other stakeholders who are they concerned with the institution, as it clarify the structure that explain the institution objectives and the means for achieving those objectives and reviewing that they are

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<sup>1</sup> UN Economic and Social Commission for Asia and the Pacific, What is Good Governance? pamphlet, P1

<sup>2</sup> Ibid.

<sup>3</sup> Knell Alex, Corporate Governance — How to Add Value to Your Company, A Practical Implementation Guide, CIMA Publishing, first publish 2006, p 5.

achieved. The proper corporate governance is the one that provide for both the board of directors and the management of the institution the appropriate incentives to approach the objectives which are in the best interests of the institution and facilitate the finding out of an effective supervision process, and eventually helps the institution to utilize its resources efficiently"

2. Organisation for Economic Co-operation and Development (OECD) April 1999 defined corporate governance as "the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance".
3. An article in *Financial Times* [1997] defined corporate governance " as the relationship of a company to its shareholders or, more broadly, as its relationship to society ".
4. "Corporate governance is about promoting corporate fairness, transparency and accountability" J. Wolfensohn, former President of the World Bank.
5. "Some commentators take too narrow a view, and say it (corporate governance) is the fancy term for the way in which directors and auditors handle their responsibilities towards shareholders. Others use the expression as if it were synonymous with shareholder democracy. Corporate governance is a topic recently conceived, as yet ill-defined, and consequently blurred at the edges...corporate governance as a subject, as an objective, or as a regime to be followed for the good of shareholders, employees, customers, bankers and indeed for the reputation and standing of our nation and its economy".<sup>4</sup>

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<sup>4</sup> Maw *et al.* [1994, page 1].

6. "Corporate governance is the process of supervision and control intended to ensure that the company's management acts in accordance with the interests of shareholders."<sup>5</sup>

*Corporate Governance* could also be defined as "the regulating influence applied to the affairs of a company to maintain good order and apply predetermined standards".<sup>6</sup>

Put simply, Corporate Governance is an ethical environment in which all business processes are undertaken.<sup>7</sup>

Referring to the aforesaid definitions and for the purposes of this thesis, it could be argued that the definition proposed by Organisation for Economic Co-operation and Development OECD has illustrated and covered the attribute as it defined corporate governance as "The system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance".<sup>8</sup> J. Wolfensohn, former President of the World Bank is of the view that corporate governance is about "promoting corporate fairness, transparency and accountability". These two definitions have summarized what corporate governance is all about.

### **The value of corporate governance**

Corporate governance helps in reducing the risks, promoting performance, enhancing the opportunities to approach the stock exchange markets,

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<sup>5</sup> (Parkinson, 1994).

<sup>6</sup> What Is Corporate Governance? by John L. Colley ,Wallace Stettinius, Jacqueline L. Doyle, George Logan. P6.

<sup>7</sup> Ibid.

<sup>8</sup> OECD April 1999.

improving the ability to market the products and services, promoting the leadership, and eventually increasing the transparency and the ability for social accountability and responsibility. Moreover, the corporate governance determines the shareholders rights, and defines the board of directors' responsibilities on the basis of a convenient ground for both of them on the basis of mutual benefit, responsibility and confidence

The proper application for the principles of corporate governance ensures not only the strategic tendency for the company, but also the efficient supervision upon the management by the board of directors, and securing the board of directors' responsibility towards the company as well as shareholders.

*Johnston Birchall*, a Professor of Public and Social Policy in the department of Applied Social Science in the university of Stirling, Scotland, UK argues that it is useful to focus on three main issues when considering how organizations are governed.<sup>9</sup>

First, which individuals or groups are provided with membership rights? Membership rights might only be given to one class of people. The shareholder system of corporate governance is probably the most prominent example of this approach within the corporate realm. In these organizations, membership rights are only provided to those who supply financial capital to the firm. Membership rights might alternatively be provided to more than one class of people or groups. In the corporate arena, these bodies are usually said to have a stakeholder system of corporate governance. Alongside shareholders, typical stakeholders include employees, members of the local population, representatives from supplier firms, customers, and local government.<sup>10</sup>

Second, it is valuable to examine the content of the rights provided to members. Two broad sets of rights are of significance here. On the one hand, it is useful to focus on the precise character of the rights members enjoy over

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<sup>9</sup> Mark Bevir *Editor*, *Encyclopedia of Governance*, 2007 by SAGE Publications, Inc, p 165

<sup>10</sup> *Ibid*.

governance. For example, do members only have a right to be consulted about the direction of corporate policy or are they allowed to make decisions alongside managers? On the other hand, it is important to examine the rights over the surplus generated by the organization. Not-for-profit companies do not permit any part of the surplus to be distributed to members. For-profit firms are allowed to distribute the surplus to members, usually in the form of dividend payments.<sup>11</sup>

Third, it is useful to study the modes of representation available to members. Direct representation might be used to represent members' interests. Members might vote directly for a representative on the board of directors. Indirect representation occurs when organizations are used to represent members. For instance, a consumer council might be used to represent the views of customers.<sup>12</sup>

Before looking in detail at the issues involved in corporate governance, it is useful to consider the benefits of good corporate governance to public companies. It could be argued that the same attributes might be applicable in private companies.

The main arguments in favour of having a strong corporate governance regime for listed companies are as follows: <sup>13</sup>

1. Good governance will eliminate the risk of misleading or false financial reporting, and will prevent companies from being dominated by self-serving chief executives or chairmen. By reducing the risks of corporate scandals, investors will be better protected. This should add generally to confidence in the capital markets, and help sustain share prices.
2. Companies that comply with best practice in corporate governance are also more likely to achieve commercial success. Good governance and good leadership and management often go hand in hand.
3. Well-governed companies will often develop a strong reputation and so

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<sup>11</sup> Ibid.

<sup>12</sup> Ibid.

<sup>13</sup> Coyle, Brian Corporate Governance Essentials, ICSA Publishing 2008, P 29-30.

will be less exposed to reputational risk than companies that are not so well governed.

4. Good governance encourages investors to hold shares in companies for the longer term, instead of treating shares as short-term investments to be sold for a quick profit. Companies benefit from having shareholders who have an interest in their longer-term prospects.
5. Perhaps the key issue is whether good corporate governance reduces investment risks to shareholders, or even improves company performance and share values. The main arguments against having a strong corporate governance regime for listed companies focus on costs, benefits and value:
6. It is argued that, for many companies and institutional investors, compliance with a code of corporate governance is a box-ticking exercise. Companies adopt the required procedures and systems, without considering what the potential benefits might be. The only requirement is to comply with the 'rules' and put a tick in a box when this is done. Corporate governance requirements therefore create a time- and resource-consuming bureaucracy, and divert the attention of the board from more important matters.
7. Good corporate governance is likely to reduce the risk of scandals and unexpected corporate failures.
8. The connection between good corporate governance and good financial results (due to good leadership and management) has been claimed by some people, but denied by others.
9. Less regulation and fewer requirements for compliance would reduce the costs of corporate governance. At the moment, the costs far outweigh the benefits. To make matters worse, companies that are obliged to comply with corporate governance regulations or best practice are at a competitive disadvantage to rival companies from countries where corporate governance regulation is much less

stringent.<sup>14</sup>

### **Good governance makes a difference**

The relative effectiveness of corporate governance has a profound effect on how well a business performs. It has been observed that businesses that have prospered and remained prosperous are those that have found ways to govern their affairs effectively. Similarly, with companies that have performed poorly, it is common to track the problems to boards that have not effectively addressed the issues confronting their businesses. The governance model of successful corporation typically includes the following characteristics:<sup>15</sup>

1. An effective board of directors that carries out its responsibilities with integrity and competence.
2. A competent Chief Executive Officer CEO hired by the board and given the authority to run the business.
3. Selection by the CEO of a "good" business (or businesses) in which to operate with the board's advice and consent. This means a business in which the firm can compete effectively and profitably in an industry that is reasonably attractive. It also implies that the company has the skills and recourses necessary for competitive success.
4. A valid business attribute created by the CEO and his or her management team, and, again, with the board's advice and consent. A business attribute encompasses the definition of the customer (s) to be served the goods and/or services to be delivered, and the means or processes by which these goods and services will be delivered. A valid business attribute is one that meets the needs of the customer in a superior and often unique way that will allow the firm to become and/or remain profitable.
5. Appropriate implementation of the business attribute, which normally requires that:
  - a. There are board goals that set the direction for the organization.

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<sup>14</sup> Ibid.

<sup>15</sup> Ibid at 4.

- b. The interests of the board and management are aligned with those of the shareholders.
- 6. Systems to ensure that the organization's obligations to its major stakeholders---customers, employees, creditors, suppliers and distributors, the community, and owners---are met with integrity and in compliance with applicable laws and regulations.
- 7. Full and timely disclosure of the performance of the business to its owners and to the investment community at large.<sup>16</sup>

A board of directors that fails to guarantee that a sound governance model is in place and well executed and managed, will lead to the collapse of the company. Success cannot be ensured without an effective and honest board of director that takes into consideration the interests of all relevant actors in the surrounding corporate space.

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<sup>16</sup> Ibid.

## Chapter Two:

### Basic Attributes

#### Introduction

#### Corporate Governance Basic Attributes

1. Transparency
  2. Honesty
  3. Openness
  4. Independence
  5. Accountability
  6. Responsibility
  7. Fairness
  8. Reputation
-

## **Corporate Governance Basic Attributes**

The following are the main attributes of corporate governance.

### **1. Openness, Honesty and Transparency**

Openness is an attribute that denotes the basis of how various groups and organizations operate. It is typified by open access to the information or material resources needed for projects. Openness also means the willingness to provide information to individuals and groups about the company, taking into consideration not giving away commercially sensitive information.<sup>17</sup>

Honesty might seem an obvious quality for companies to have, but in the time of manipulation of facts, honest information is not prevalent as it should be.<sup>18</sup>

Transparency allows outsiders to obtain valid and timely information about the activities of government or private organizations. While related to governance ideas such as accountability, openness, and responsiveness, the attribute of transparency originated in the financial world, referring to a corporation's duty to provide accounts of its activities to shareholders, oversight bodies, and the public.<sup>19</sup> Transparency is the ability of an outsider to make a meaningful analysis of the company and its actions. Transparency is about both information, the one that covers the financial position of the company and the non-financial matters. Transparency also refers to clarity in the way that decisions are made or processes are carried out.<sup>20</sup>

### **2. Independence**

Independence refers to the extent to which procedures and structures are in place so as to minimize, or avoid completely, potential conflicts of interest that

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<sup>17</sup> Coyle, Brian Corporate Governance Essentials, ICSA Publishing 2008, P 26

<sup>18</sup> Ibid at 26.

<sup>19</sup> Mark Bevir, Encyclopedia of Governance, SAGE Publications, Inc. 2007, p 988-989.

<sup>20</sup> Coyle, Brian Corporate Governance Essentials, ICSA Publishing 2008, P 26

could arise, such as the domination of a company by an all-powerful chairman-cum-CEO, or a major shareholder.<sup>21</sup>

An auditor may not be independent if the audit firm relies on the company for a large percentage of its annual income. In the countries where there are non-executive directors, the term 'independence' is of particular relevance to the company and its professional advisers. Non-executive directors are considered independent when they can be expected to express their honest and/or professional opinion in the best interests of the company. Independence can be threatened by having a connection to the company or dependence on the goodwill of the company or its management, so that personal interests can distort the individual's opinions.<sup>22</sup>

Independence can also be undermined by familiarity: if an auditor has known the company's management for a long time, he or she may develop personal friendships that blind them to management failings and shortcomings.<sup>23</sup>

Independence is the state that exists when there is no conflict of interests. People are able to act objectively and in the best interest of the company. Examples where independence *no longer applies* illustrate the point best:<sup>24</sup>

1. Auditors developing significant fee-earning non-audit work – they may be reluctant to risk losing the *non-audit work* if they uncover a major problem in the audit and may be compromised.
2. Auditors becoming highly dependent on a single client – they may be reluctant to risk losing the *client* if they uncover a major problem in the audit and may be compromised.
3. Chairman and CEO are the same person – the temptation is to wield power as a CEO and 'rubber stamp' the actions through the Board, emasculating the Board which may be compromised.<sup>25</sup>

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<sup>21</sup> Ibid

<sup>22</sup> Ibid.

<sup>23</sup> Ibid.

<sup>24</sup> Alex Knell, Corporate Governance — How to Add Value to Your Company A Practical Implementation Guide, P 31, 1<sup>st</sup> Ed, Elsevier

As can be seen, the demonstration of independence is a basic necessity in the credibility of any Corporate Governance initiative.

When the auditors relying on the company, this means that, the truth of the exact situation of the company will not be revealed since the auditors will not jeopardize their job by uncovering a gap in the company. Managers of the company will always look after their interests. This makes them reluctant to advise the company not to enter into a suspicious transaction, and their friendly relations resulted from spending years in the service of the company will also make them reluctant and hesitated not to contact the board over any problem that needs a prompt action.

### **3. Accountability**

Individuals who make decisions in a company and take actions on its behalf on specific issues should be accountable for the decisions they make and the actions they take. Shareholders should be able to assess the actions of the board and the committees of the board, and have the opportunity to query them.<sup>26</sup> A problem with accountability is deciding how the directors should be accountable, and in particular over what period of time. In theory, if the objective of a company is to maximize the wealth of its shareholders, this will be achieved by maximizing the financial returns to shareholders through increases in profits, dividends, prospects for profit growth and a rising share price. It might therefore follow that directors should be held accountable to shareholders on the basis of the returns on shareholder capital that the company has achieved.<sup>27</sup>

However, there is no consensus about the period over which returns to shareholders and increases in share value should be measured. Performance can be measured over a short term of one year at a time, or over a long term - five or ten years, or even longer. In practice, it is usual to measure returns over the short term and assess performance in terms of profitability over a

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<sup>25</sup> Ibid.

<sup>26</sup> Coyle, Brian Corporate Governance Essentials, ICSA Publishing 2008, P 27- 28.

<sup>27</sup> Ibid.

twelve-month period. In the short term, however, a company's share price may be affected by factors unrelated to the company's underlying performance, such as excessive optimism or pessimism in the stock markets generally. In the short term, it is also easier to soothe investors with promises for the future, even though current performance is not good. It is only when a company fails consistently to deliver on its promises that investor confidence ebbs.<sup>28</sup>

If company performance were to be judged by the return to shareholders over a twelve month period, the directors would focus on short-term results and short-term movements in the stock market price. Short-termism is easy to criticize, but difficult to disregard if performance targets ignore the long term. They should really be looking after the underlying business of the company and its profitability over the longer term.<sup>29</sup>

In an article by John Kay<sup>30</sup> reflecting on the reasons given by the former finance director of Marconi for the company's financial collapse in 2000, made the following comment:

[A director's] job is to run a business that adds value by means of the services it provides to customers. If he succeeds, it will generate returns to investors in the long term. And this is the only mechanism that can generate returns to investors. The problem is that the equivalence between value added in operations and stock market returns holds in the long run but not the short. Share prices may, for a time, become divorced from the fundamental value of a business. This has been true of most share prices in recent years ... In these conditions, attention to total shareholder returns distracts executives from their real function of managing businesses:

The problem of accountability remains, however. Even if it is accepted that company performance should not be judged by short-term financial results

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<sup>28</sup> Ibid.

<sup>29</sup> Ibid.

<sup>30</sup> The Financial Times, 29 January 2002.

and share price movements, how can the board be made accountable for its contribution to longer-term success? <sup>31</sup>

#### **4. Responsibility**

A manager who is responsible for his or her decisions and actions should be subject to corrective measures. Mismanagement should be penalized. An issue in corporate governance is therefore whether directors should be liable for their performance to stakeholders and their shareholders in particular. For example, should shareholders have the right to re-elect all the board directors each year? <sup>32</sup>

A key issue in corporate governance is to decide who should have responsibility. Executive managers are responsible for the operations of the business, and the ultimate responsibility rests with the CEO. The board also has responsibilities, and it is a principle of good corporate governance that the board should establish a list of matters for which it should take the decisions itself, without delegation to management or the CEO. Similarly, when a board establishes committees with delegated responsibilities (for example, an audit committee and a remuneration committee), the terms of reference and responsibilities of those committees should be clearly established. <sup>33</sup>

With authority comes the responsibility to be accountable to those on whose behalf they act. For example, the Board is given the authority by the company to act on the company's behalf. The Board is, therefore, responsible to the company for its actions. <sup>34</sup>

Responsibility is an important attribute of governance because it requires individuals and institutions to be answerable for their actions both in the public

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<sup>31</sup> Ibid.

<sup>32</sup> Ibid at 28.

<sup>33</sup> Ibid.

<sup>34</sup> Alex Knell, *Corporate Governance — How to Add Value to Your Company A Practical Implementation Guide*, P 31, 1<sup>st</sup> Ed, Elsevier.

domain (to specific political authorities) and in the private domain (to themselves and their families).<sup>35</sup>

Accountability goes hand in hand with responsibility. Any individual or group with authority and responsibilities should be held accountable for their achievements and performance.

## **5. Fairness**

Fairness denotes impartiality and lack of bias together with reasonable and consistent behavior. This is particularly relevant, for example, with respect to minority shareholders and their interests.<sup>36</sup>

Fairness requires that all shareholders should receive equal consideration. Minority shareholders, for example, should be treated in the same way as majority shareholders. This attribute might seem fairly straightforward in the UK, where the rights of minority shareholders are protected to a large extent by company law.<sup>37</sup>

## **6. Reputation and reputational risk**

A company or business, like an individual, will be known widely by its reputation, defined as the character generally ascribed to that entity. A reputation may be good or bad and may be an asset or a hindrance. For any company that has shares traded on a market, a good reputation is a key asset. A strong share price facilitates the raising of extra cash from existing and new members. It also makes the company's shares acceptable as a way of paying for acquisitions, remunerating staff and generally enhancing the way the business is viewed by the financial community. Damage to a company's

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<sup>35</sup> Mark Bevir, *Encyclopedia of Governance*, SAGE Publications, Inc. 2007, p 837

<sup>36</sup> Alex Knell, *Corporate Governance — How to Add Value to Your Company A Practical Implementation Guide*, P 32, 1<sup>st</sup> Ed, Elsevier.

<sup>37</sup> Coyle, Brian *Corporate Governance Essentials*, ICSA Publishing 2008, P 27.

reputation is very quickly reflected by a drop in its share price, reducing all these advantages.<sup>38</sup>

A good reputation needs to be built up over many years and encompasses many facets of business activity. It will reflect the way in which the company is perceived by the markets and in the wider community. Reputation cannot rely solely on a code of ethics, corporate social responsibility, fair treatment of staff, attitudes to customers, community involvement or willingness to obey the spirit as well as the letter of the law. It is, however, influenced by all of these.<sup>39</sup>

Although it takes years to build a good reputation, this can be destroyed overnight by a badly handled catastrophe or bad publicity. Recovery of a damaged reputation takes even more work than is required to acquire the good reputation in the first place. The loss of reputation can even destroy a company completely. The accounting firm Anderson was destroyed by the damage of its involvement in the Enron affair.<sup>40</sup>

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<sup>38</sup> Coyle, Brian Corporate Governance Essentials, ICSA Publishing 2008, P 28

<sup>39</sup> Ibid.

<sup>40</sup> Ibid.

## Chapter Three

### Incorporating corporate governance attributes in companies

Introduction

A code of Ethics

Corporate Codes of Conduct

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## **Introduction:**

In the previous chapter the necessary basic attributes that should be in corporations were discussed. However, it would be essential to see how corporate governance attributes could be incorporated in companies.

## **A code of ethics**

Based on guidelines for moral behavior, a code of ethics can be developed to encourage appropriate behavior. So, guided by a sense of right and wrong (the underlying moral values), a code of ethical conduct can be developed and those to whom it is addressed are expected to abide by it. However, some people will regard such a code as guidelines to the way they behave. Others will regard it as an obstacle to be circumvented and between this and that problems arise.<sup>41</sup>

There are a number of areas a code of ethics should deal with such as.<sup>42</sup>

1. The avoidance of conflicts of interests.
2. Opportunities for personal gain.
3. Confidentiality.
4. Fair dealings with stakeholders.
5. Appropriate use and protection of corporate assets.
6. Legal compliance.
7. Encouragement of Whistle-blowing.

## **Corporate Codes of Conduct**

Corporate codes of conduct (CCC) relate to codified sets of ethical standards to which corporations aim to adhere. They are commonly generated by the corporations themselves. Crucially, they are not directly subject to legal enforcement. In an era acutely aware of the dramatic social and

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<sup>41</sup> Alex Knell, *Corporate Governance — How to Add Value to Your Company A Practical Implementation Guide*, P 27, 1<sup>st</sup> Ed, Elsevier.

<sup>42</sup> *Ibid* at 28.

environmental effect of corporate activity across the world, such codes of conduct have become the focus of considerable attention.<sup>43</sup>

Strictly speaking, there is no fixed consensus on what CCC should cover. Stated objectives generally relate to the particular concerns of the corporation, and authors are likely internal managers and serving consultants (although sometimes in consultation with nongovernmental organizations (NGOs) and the UN's Global Compact). Accordingly, the codes are produced in numerous formats, ranging from detailed best-practice guidelines on social and environmental issues to broad proclamations by the corporation to uphold a range of values (such as the recognition of human rights). A familiar theme is corporate social responsibility (CSR), introduced to promote the idea that corporate activities should, at the very least, avoid disruption to the wider society and preferably generate positive effects. Examples of CSR practices include the preservation of the environment through low pollution and energy-efficient measures, the production of merchandise that is recyclable and biodegradable, and the promotion of uniform treatment of employees across labor markets, thus ensuring acceptable working conditions irrespective of local market standards (such as the refusal of child labor).<sup>44</sup>

Given the formidable power of corporations and the profit motives that shape their priorities, questions remain as to the degree to which they will genuinely prioritize socially responsible behavior and facilitate stakeholder input in corporate governance. The corporate sector's most prominent response to these issues is CCC.<sup>45</sup>

Advocates of CCC argue that it is in the interest not only of society to harness at least some of the inordinate wealth and power that corporations wield and reorient it toward societal benefit, but that it also makes good business sense. Motivated by the primary corporate objectives of minimizing risk and enhancing returns, the corporation seeks to project an attractive public image

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<sup>43</sup> Mark Bevir, *Encyclopedia of Governance*, SAGE Publications, Inc. 2007, p 163-164

<sup>44</sup> *Ibid.*

<sup>45</sup> *Ibid.*

and increase shareholder investment. Codes of conduct that prescribe ethical behavior are deemed to positively influence purchasing decisions and thus boost shareholder profit and secure new investors. They are seen as a way to mainstream ethical concerns into the core of business procedures. However, the efficacy of such codes depends upon their reliability as a gauge for actual corporate behavior and whether stakeholders (such as consumers, governments, advocacy groups, and unions), as well as investing shareholders, can rely on their accuracy.<sup>46</sup>

Central to the credibility of CCC then is comprehensive monitoring, enforcement, and transparency of corporate conduct. The corporate sector has long resisted the call for tighter centralized regulation of its activities, claiming that this would unacceptably reduce competitive capacity and depress financial growth. Instead, there is an increasing trend to produce publicly available CCC and related CSR reports for the inspection of the public and shareholders alike.<sup>47</sup>

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<sup>46</sup> Ibid.

<sup>47</sup> Ibid.

## Chapter Four

### Corporate Governance in Sudan

Introduction

#### **Corporate governance under the Sudanese Companies Act 1925**

Corporate governance in the other Sudanese relevant acts

Central Bank of Sudan circulars

Khartoum Stock Exchange Market Act 1994

#### **Corporate Governance under English law:**

##### **Duties of director under English Companies Act 2006**

The duties of directors to their company

Common law duties and statutory duties of directors

Fiduciary duties of directors

Tests for breach of fiduciary duty

Case Example (1)

Case Example (2)

A director's duty of skill and care

Case Example (1)

Case Example (2)

##### **General duties of directors: English Companies Act 2006**

- Duty to act within their powers;
- Duty to promote the success of the company;
- Duty to exercise independent judgment;
- Duty to exercise reasonable care, skill and diligence;
- Duty to avoid conflicts of interest;
- Duty not to accept benefits from third parties;
- Duty to declare any interest in a proposed transaction or arrangement.

Consequences of a breach of the general duties

Shareholders' powers

Shareholders' rights

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## **Introduction:**

Different definitions and views concerning corporate governance have been discussed in the previous chapters. Most importantly, as it will be seen in chapter five that the absence of the corporate governance attributes and values would in most of the time lead to the collapse of corporations.

It should be noted that the development and understanding of the value of corporate governance in the UK, USA and European countries is highly advanced and developed, which make it very important to compare the global development of corporate governance with the relevant Sudanese Acts, attempting to bridge the gap or even to comprehend the significance of adoption of corporate governance measures in our corporate legislations.

Examining the Corporate Governance in Sudan, and then going through the English law would be helpful to compare it with the Sudanese relevant Acts that have tackled the topic to some extent.

## **Corporate governance under the Sudanese Companies Act 1925**

Before the Sudanese Companies Act 1925 there was no necessity for an Act covering the aspects of companies in Sudan since the economic transactions were of a plain nature and the commercial growth itself hasn't called for this. Sudan at that time was governed by the condominium rule. The only law is the Civil Justice Ordinance 1900 which stipulated in section 4:

“in cases not provided for by section 3<sup>48</sup> or by any other law for the time being in force the court shall act according to equity, justice and good

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<sup>48</sup> Section 3 laid down the principle that if in any suit in a civil court any question arose pertaining to succession, inheritance, wills, legacies, gifts, marriage, divorce, family relations or wakf the rule of decision should be (a) any custom applicable to the parties concerned, which was not contrary to justice, equity or good conscience, and which had not been abolished by law or invalidated by a competent authority;(b) Sharia law, where the parties were Moslems, unless it had been modified by custom.

conscience”.

The companies' activities prospered and expanded which required an enactment of the Companies Act 1925. This Act has been derived from the rules of the English Companies Act 1908 and the English judicial precedents. The Sudanese courts referred to the rules of English common law practices.

Although Sudan has been influenced by the English companies rules, but still the steps of the Companies Act froze on the 1925. No progress towards the new changes and developments that took place around the world in the financial and commercial sectors was observed. Sudanese courts could refer to the English precedents in its application to the duties of directors, derivatives actions and shareholders rights where there is no contradiction with the Sharia Laws.

Moreover, the Companies Act 1925 is considered a procedural Act with no protective measures for the shareholders rights. Above all, there are no duties of directors as provided for under the English Companies Act 2006. This urgently raises the question of the necessity of coming up with a comprehensive provisions in the Companies Act 1925 that define clearly the directors duties towards the company, although there is section 71 in table A of the said Act that explain the directors powers and duties, but still the Act remains silent with regard to the directors duties as provided for in English Companies Act 2006. This Act would encounter difficulties in comparison with the huge progress in both commercial and financial sectors, but even the English law is considered a regulating Act, the only difference is that judges in England have exercised their discretionary powers to apply common law principles on the cases. Therefore, company law has crystallized in England as a result of the accumulation of the judicial precedents.

Sudanese courts in the absence of a precise definition of the director's duties, are guided by the common law principles in this regard. The courts

are also guided by the English judicial precedents respecting the directors' duties.

One of the Sudanese cases that have quoted different English precedents while discussing minority protection and whether the rule of Foss v Harbottle<sup>49</sup> apply or not is the Sudanese Investment Bank & Sudanese Construction Ltd. Co. SLJ 1977 p 531<sup>50</sup>. In this case it was held that "the shareholder right is partially derived from the existing contract between the individual shareholder and the company, as they are also derived from the common law principles. The shareholder has the right to express his views in the meetings, propose amendments in meetings procedures, to transfer his shares and any other right provided for under Sudanese Companies Act 1925". In addition to that, the case has established that the shareholder always has the right to sue the company for any damages that have occurred to him/her as a shareholder.

Another Sudanese case that has discussed the regulation of the general meeting and whether the notice to such meeting should specify the purpose or not is Rinbo Company Ltd. & Mustafa Abdelhamid Abo El Ez.<sup>51</sup> In this case it was held that the notice of a special resolution or of an extraordinary resolution must specify the intention to propose the resolution as a special resolution or an extraordinary resolution as the case might be. It was held that one of the exceptions to the rule in Foss v Harbottle was referred to in the English case Baillie V. Oriental Telegraph Co. Ltd (1915) 1 ch. 503 and thus, this precedent gives the right to any shareholder to bring a suit against the company to prevent it from proceeding in any special resolution without taking the required correct procedures regarding the notice as provided for in section 74 (1) which read as follows:

"A resolution shall be an extraordinary resolution when it has been passed

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<sup>49</sup> 1843 67 ER 189, (1843) 2Hare 461.

<sup>50</sup> SLJ 1977 p 53.

<sup>51</sup> SLJ 1984 p 188

by a majority of not less than three-fourths of such members entitled to vote as are present in person or by proxy (where proxies are allowed) at a general meeting of which notice specifying the intention to propose the resolution as an extraordinary resolution has been duly given"

On the basis of this the shareholder has the interest and right to sue the company based on this precedent.

However, as far as Sudan is concerned, one would argue that reliance on derivative actions<sup>52</sup> to protect minority shareholders and creditors against unfair prejudice might be effective, but still this is difficult in a country like Sudan, particularly in light of the following factors where:<sup>53</sup>

- a. Illiteracy is above 70 percent;<sup>54</sup>
- b. Most of shareholders lack the sophistication and awareness to realize their legal rights; as their main role could not exceed approving resolutions already prepared on their behalf.
- c. The culture of litigation is very poor among Sudanese as they still thought of this as a shameful way to handle disputes.
- d. Court costs and lawyers fees are high;
- e. There are very substantial court delays;
- f. Judges are ill-trained to deal with complex financial matters and thus the prospects of a fair outcome are low; Most importantly, the judges lack the command in English which affect their ability to refer to foreign references and precedents while perusing disputes of an international nature.
- g. There is an absence of a strong and well-developed public opinion as regards company matters;
- h. There is no specialized financial press or press that has the ability to investigate serious matters of fraud or oppressive

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<sup>52</sup> Derivative actions and unfair prejudice will be analyzed later as consequences for the breach of the directors' general duties.

<sup>53</sup> Dr. Abdalla Idris Mohamed, Article on the Use of the Corporate Form of Business Organization in the Sudan, Sudan Law Journal 1980.

<sup>54</sup> This percentage in eighties, but the percentage might be quite different now.

conduct.

It is worth noting that the Companies Act 1925 has covered aspects where keeping Statements, books and accounts are obligatory. Furthermore, the Act has provided for investigation and inspection to be conducted by the Registrar of Companies. These things are necessary for the corporate governance as it promotes transparency and accountability in the company. The following sections will reflect this:

**Statements, books and accounts:**

Section 123 of the Companies Act 1925 provides as follows:

1. Every company shall keep proper books of accounts in which shall be entered full, true and complete accounts of the affairs and transactions of the company.
2. If a company makes default in complying with the requirements of subsection (1), it shall be liable to a fine not exceeding LS. 100, and every officer of the company who knowingly and willfully authorizes or permits the default shall be liable to the like penalty.

In Section 124, the Companies Act 1925 provided for the annual balance sheet as follows:

1. Every company shall, once at least in every year and at intervals of not more than fifteen months cause the accounts of the company to be balanced and a balance sheet to be prepared.
2. The balance sheet shall be audited by the auditor of the company as hereinafter provided, and the auditor's report shall be attached thereto, or there shall be inserted at the foot thereof a reference to the report, and the report shall be read before the company in general meeting and shall be open to inspection by any member of the company.
3. Every company other than a private company shall send a copy of such balance sheet so audited to the registered address of every member of the company at least seven days before the meeting at

which it is to be laid before the members of the company, and shall deposit a copy at the registered office of the company for the inspection of the members of the company during a period of at least seven days before that meeting.

4. If a company makes default in complying with the requirements of this section, it shall be liable to a fine not exceeding LS. 100, and every officer of the company who knowingly and willfully authorizes or permits the default shall be liable to the like penalty.

it is worth noting that the balance sheet shall contain a summary of the property and assets and of the capital and liabilities of the company giving such particulars as will disclose the general nature of those liabilities and assets and how the value of the fixed assets has been arrived at.<sup>55</sup>

According to section 127 of the Companies Act 1925, copy of balance sheet and auditor's report to be forwarded to the registrar as follows:

1. After the balance sheet has been laid before the company at the general meeting, a copy thereof signed by the manager or secretary of the company shall be filed with the registrar at the same time as the copy of the annual list of members and summary prepared in accordance with the requirements of section 28.
2. If the general meeting before which a balance sheet is laid does not adopt the balance sheet, a statement of that fact and of the reasons therefore shall be annexed to the balance sheet and to the copy thereof required to be filed with the registrar.
3. This section shall not apply to a private company.
4. If a company makes default in complying with the requirements of this section, the company and every officer of the company who knowingly and willfully authorizes or permits the default shall be liable to the like penalty as is provided by section 28 for a default in complying with the provisions of that section.

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<sup>55</sup> Section (125) (1) of the Sudanese Companies Act 1925.

However, any member of a company shall be entitled to be furnished with copies of the balance sheet and the auditor's report.<sup>56</sup>

### **Investigation by the registrar:**

The Companies Act 1925 in section 130 stipulated for the investigation by the registrar. This makes the companies accountable before the registrar. The section has invested the registrar to call for information or explanation as follows:

Section 130:

1. Where the registrar, on perusal of any document which a company is required to submit to him under the provisions of this Act, is of opinion that any information is necessary in order that such document may afford full particulars of the matter to which it purports to relate, he may, by a written order call on the company submitting the document to furnish in writing such information or explanation within such time as he may specify in his order.
2. On the receipt of an order under sub-section (1), it shall be the duty of all persons who are or have been officers of the company to furnish such information or explanation to the best of their power
3. If any such person refuses or neglects to furnish any such information or explanation, he shall be liable to a fine not exceeding LS. 5 in respect of each offence.
4. This section applies to companies incorporated outside the Sudan carrying on business within the Sudan.

### **Inspection and Audit:**

The Companies Act 1925 in section 131 stipulated for the investigation of company's affairs on application of members as follows:

1. The registrar may, on the application either of not less than one

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<sup>56</sup> Section (128) of the Sudanese Companies Act 1925.

hundred members or of holding not less than one-tenth of the shares issued, appoint one or more competent inspectors to investigate the affairs of a company and to report thereon in such manner as the registrar may direct.

2. The application shall be supported by such evidence as the registrar may require for purpose of showing that the applicants have good reason for requiring the investigation.

The main purpose of this inspection is to make sure that the company's affairs were managed correctly and that the company's financial information is accurate and true.

The Act also provided in section 132 for the investigation of company's affairs in other cases:

#### Section 132

Without prejudice to his powers under section 131, the registrar-

- a) shall appoint one or more competent inspectors to investigate the affairs of a company and to report thereon in such manner as the registrar may direct if-
  - i. the company by special resolution, or
  - ii. the Court by order, declares that its affairs ought to be investigated by an inspector appointed by the registrar and,
- b) may do so-
  - i. if the information or explanation required to be submitted to him under section 130 is not furnished within the specified time or if after receipt of such information or explanation the registrar is of the opinion that the document referred to in that section discloses an unsatisfactory state of affairs or that it does not disclose a full and fair statement of the matter to which it purports to relate or,
  - ii. if it appears to him,-

1. that the business of the company is being or has been conducted with intent to defraud creditors or members or any other person or otherwise for a fraudulent or unlawful purpose or in a manner oppressive to any part of its members or that it was formed for any fraudulent or unlawful purpose; or
2. that persons concerned with its formation or the management of its affairs have in connection therewith been guilty of fraud, misfeasance or other misconduct towards it or towards its members; or
3. that its members have not been given all the information with respect to its affairs which they might reasonably expect.

Section 134 of the Companies Act 1925 provided that "the inspector may and, if so directed by the registrar, shall furnish interim reports to the registrar and at the conclusion of the investigation, shall make a final report to the registrar".

Most importantly, section 135 provided that if from any report made under section 134, it appears to the registrar that-

- a) any person has, in relation to the company, been guilty of an offence for which he is criminally liable, the registrar may prosecute such person for the offence;
- b) proceeding ought in the public interest to be taken by any company referred to in a report, for the recovery of damages in respect of any fraud, misfeasance or other misconduct in connection with the promotion or formation of that company or the management of its affairs or for the recovery of any property of the company which has been misapplied or wrongfully retained, he may himself take such proceeding in the name of and on behalf of the company, and the company shall bear any costs or expenses incurred by it in or in connection with such proceeding.

It is plain that the Companies Act 1925 has embodied provisions could be

referred to as standards of corporate governance. But, still it is essential to review the Companies Act 1925, to embody therein provisions determining and defining the director's duties rather than relying only on the common law and English judicial precedents.

### **General meetings in Sudanese Companies Act 1925**

The statutory general meeting of the company shall be held within the period of six months and the directors of the company before the meeting is held shall forward a report to every member of the company and to every other person entitled to receive it. This report should contain the total number of shares allotted, the total amount of cash received by the company in respect of all the shares allotted, an abstract of the receipts of the company, the names, addresses of the company's officers, directors, managers...etc and finally the particulars of any contract <sup>57</sup>. The statutory meeting is held only once.

A general meeting shall be held once at least in every year at such time (not being more than fifteen months after the holding of the last proceeding general meeting) and place as may be prescribed by the company in general meeting or, in default, at such time in month following that in which the anniversary of the company's incorporation occurs, and at such place the directors shall appoint. In default of a general meeting being so held, a general meeting shall be held in the month next following and may be called by any two members in the same manner as nearly as possible as that in which meeting are called by the directors.<sup>58</sup>

The directors may whenever they think fit call an extraordinary general meeting on the requisition of shareholders as provided by section (71) of the Companies' Act 1925. No business shall be transacted at any general meeting unless a quorum of members is present at the time when the meeting proceeds to business, three members personally present shall be

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<sup>57</sup> The Sudanese Companies Act 1925, s 70 (1,2,3)

<sup>58</sup> Sudanese companies Act 1925, the first schedule, table A, s 46

a quorum unless otherwise agreed by the members of the company. Notice for the meeting must be served at least fourteen days before the day appointed for the meeting.<sup>59</sup>

The main purpose of the annual meetings is to ensure that members have a timely opportunity to hold the directors to account. They can further review the financial books and annual reports to make sure that it reflects an accurate and true image of what is taking place in the company's affairs.

### **Vote of members in Sudanese Companies Act 1925.**

The Act has defined two ways for voting, show of hands or a poll. On a show of hands every member present either in person or by a proxy shall have one vote. On a poll every member either personally or by proxy shall have one vote for each share of which he is the holder. In the case of joint holders, the vote of the senior who tenders a vote shall be accepted to the exclusion of the votes of the other joint holders, and for this purpose seniority shall be determined by the order in which the names stand in the registrar of members.<sup>60</sup>

### **Powers and duties of the directors in Companies Act 1925**

The business of the company shall be managed by the directors who may pay all expenses in getting up and registering the company and may exercise all such powers of the company as are not by the Companies Act 1925, or any statutory modification thereof for the time being in force. The directors have the power to appoint one or more of their body to the office of managing director or manager.<sup>61</sup>

The directors shall duly comply with the provisions of the companies Act 1925, or any statutory modification thereof for the time being in force and particular with provisions in regard to the registration of the particulars of

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<sup>59</sup> Sudanese companies Act 1925, the first schedule, table A, s 48,24,51

<sup>60</sup> Sudanese companies Act 1925, the first schedule, table A, s 60,61,64

<sup>61</sup> Sudanese companies Act 1925, the first schedule, table A, s 71,72

mortgage and charges affecting the property of the company or created by it or to keeping a register of the directors and to sending to the registrar an annual list of members and a summary of particulars relating thereto and notice of any consideration or increase of the register and annual list of members and a summary of the particulars relating thereto and notice of any consideration and increase of the share capital and conversion of shares into stock and copy of the register of directors and notifications of changes therein.<sup>62</sup>

The directors also have to cause minutes to be made in books provided for the purpose;

- a) Of all appointments of officers made by the directors.
- b) Of the names of the directors present at each meeting of the directors and of any committee of the directors.
- c) Of all resolutions and proceedings at all meeting of the company and of the directors and of committees of directors.<sup>63</sup>

As explained earlier, the common law duties of directors as provided for in the English Companies Act 2006 could be referred to in the interpretation of these duties and powers. The 1925 Act has disqualified the directors if he is concerned or participated in the profits of any contract with the company, provided that no director shall vacate his office by reason of being a member of any company which has entered into contract with or done any work for the company of which he is a director; but a director shall not vote in respect of any such contract or work, and if he does so, his vote shall not be counted.<sup>64</sup>

### **Corporate governance in Khartoum Stock Exchange Market Act 1994**

One of the relevant Acts that must adopt effective standards for corporate

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<sup>62</sup> Sudanese companies Act 1925, the first schedule, table A, s 74

<sup>63</sup> Sudanese companies Act 1925, the first schedule, table A, s 75

<sup>64</sup> Sudanese companies Act 1925, the first schedule, table A, s 67 (e).

governance is Khartoum Stock Exchange Market Act 1994. A number of countries adopted corporate governance codes in their stock market as it is provided for under Organisation for Economic Co-operation and Development OECD Principles of Corporate Governance.<sup>65</sup> This entails the establishment of a certain code to govern the stock markets in Sudan.

It could be useful to examine the purposes of the establishment of Khartoum Stock Exchange Market Act 1994 as provided for under section (9) as follows:

The stock Exchange shall have the following purposes:-

- a) The regulation and supervision of the issue and dealings in securities, for buying and selling.
- b) The encouragement of savings, the development of investment awareness amongst citizen and the preparation of the conducive atmosphere for the utilization of these saving in securities in a way that benefits the national economy.
- c) The widening and enhancement of the base of private ownership for the productive assets in the national economy and the transfer of public ownership of the state's capital assets to the wider national categories.
- d) The development and promotion of the primary market securities through the regulation and control of such issues, the determination of the terms condition thereof, the setting of the prerequisite for the prospectus when rendering securities for public subscription.
- e) The development and promotion of investment in securities and the

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<sup>65</sup>Organisation for Economic Co-operation and Development OECD Principles of Corporate Governance were endorsed by OECD Ministers in 1999 and have since become an international benchmark for policy makers, investors, corporations and other stakeholders worldwide. They have advanced the corporate governance agenda and provided specific guidance for legislative and regulatory initiatives in both OECD and non OECD countries. The Financial Stability Forum has designated the Principles as one of the 12 key standards for sound financial systems. The Principles also provide the basis for an extensive program of cooperation between OECD and non-OECD countries and underpin the corporate governance component of World Bank/IMF Reports on the Observance of Standards and Codes (ROSC).

preparation of the conducive investment

- f) The provision of all the factors that may assist in the facilitation of the liquidity of the invested money in securities, in a way that may serve the wishes of the investors.
- g) The establishment and consolidation of the bases of the appropriate and fair dealings amongst the investor's categories and the guarantee of fair chances for dealers in securities, in protection of the junior and small investors.
- h) The collection of information, statements, data, and statistics and their provision for all investors and those interested in the same.
- i) The study of the legislation related to the stock exchange and suggesting their amendment in a way that suits the development in the stock exchange.
- j) The suggestion of the way of coordination of the financial and monetary policies the movement of capital and supervision of the policies related to the development of the medium and long-term financing sources in Sudan, in a way that accomplish financial and economic stability and then achieving the aims of economic development.
- k) The endeavor to exchange experiences by contacting the international regional and Arab stock exchange, with a view to joining them.
- l) The establishment of a unified body for the regulation of the transfer of the ownership of securities and their depositing, the follow-up of the share-holders affairs and the management, supervision and control of the stock exchange central building.
- m) The establishment of the professional rules of ethics, the self control and disciplines amongst brokers and those operating in the field of securities.
- n) The qualifying of the employers of the brokers in the way that suits the new development that may occur in the securities industry, with the aim of raising their academic and scientific qualifications.

It could be seen that one of the purposes of the Market is section 9 (m) which is to establish the professional rules of ethics, the self control and disciplines amongst brokers and those operating in the field of securities. It could be understood from this section that the issuance of code of conduct or a corporate governance code is of the great relevance to the market work.

However, the Act also provided for the function and the powers of the board in section 18 of the said Act. Section 18 (1) (a) authorizes the board to:

"conduct studies about the stock exchange in the shadow of the current political financial and economic conditions and the presentation of the recommendation to the relevant government bodies on all matters that may assist in the development of the stock exchange and the protection of money of the savors".

Having such clause in the Act would enable the establishment of the required standards and measures for observing the transactions inside the market. Above all, it helps not only in filling the legislature gap in the Companies Act 1925 but also by introducing the necessary studies and researches for furthering the performance of the market towards the listed companies. Moreover, it requires coordination among different relevant financial institutions to agree upon a mechanism on how to adopt an effective corporate governance code or rules.

All this is theoretically right, but practically it requires the Khartoum Stock Exchange Market Act 1994 relevant provisions to be activated. Thus, it would be easy then to evaluate and assess the development of these provisions by tracing the expected outcome of the application of these clauses.

Furthermore, the Act should ensure transparency, integrity, and justice as well as the development of the investment awareness.

In other Stock markets, for example, listing financial reports is essential. Publications and explanatory regulations are issued from time to time to organize the transactions inside the market.

However, it could be helpful to examine carefully the developments in other stock markets particularly in United Arab Emirates as a fast growing market that has attracted funds and investments from all over the world. Markets in this country have advanced and developed efficient systems of securities listing and leverage of the transactions' levels in the capital markets to be complied with the best practices and standards internationally recognized.

In Dubai, they have launched Hawkamah or corporate governance, the Institute for Corporate Governance that constitutes a groundbreaking development for institution building, corporate sector reform, good governance, financial market development, investment and growth in the region. Hawkamah was created for the region, by the region, and of the region to advance corporate governance reform.

Another country in the Middle East is the Kingdom of Saudi Arabia. Saudi Arabia is considered the second country in the Gulf Cooperation Council GCC, after the Sultanate of Oman, to adopt corporate governance regulations (the "Code of Corporate Governance") for its public companies.

The Code generally requires Saudi public companies to comply with the following:

- a) Disclosures in the directors annual report: directors must make the following key disclosures in their annual reports to shareholders:
  - i. whether their companies have complied with the Code of Corporate Governance, and if not, to explain why they have not complied (i.e. comply or explain);
  - ii. composition of the board of directors and balance between executive and non-executive (including independent) directors;

- iii. brief description of the committees formed by the board of directors, such as audit committees and nomination & remuneration committees, and their composition;
  - iv. details of compensation and remuneration paid to the chairman, board members and the highest-paid five executives (and the chief executive officer and chief financial officer if they are not amongst the highest-paid five executives); and
  - v. the report should also include any punishment, penalty or restriction imposed on the company by the CMA, any supervisory or judicial body.
- b) Board composition: Saudi public companies should re-consider the composition of their board rooms so that a balance is maintained between executive and non-executive directors.
- c) Audit Committee: Saudi public companies will also need to set up audit committees comprising at least 3 non-executive directors (one of whom must come from a financial background). The audit committee will be responsible, among other things, for establishing robust internal controls, dealings with external auditors and devising appropriate accounting policies.

Therefore, establishment of corporate governance code is essential in Sudan in light of the current potentialities for the investment and economic growth. Also, a detailed regulations and standards to cover and organize the listed companies' transactions are highly important. Upgrading the Khartoum Stock Market would be useful for the companies, investors and public as this could help to promote transparency, accountability, fairness and justice, the things which are necessary for the prosperity of business in Sudan. The only way to attract business, investors and cash is by reforming, restructuring and tailoring a market whereby interests of all parties are observed. This could be achieved by corporate governance.

### **Central Bank of Sudan circulars**

As referred to in the first chapter in page 2, the Central bank of Sudan has

issued in 2005 a circular on corporate governance addressed to all financial institutions working in Sudan. This circular has defined the corporate governance as: <sup>66</sup>

"the set of relations between the management of the institution, its board of directors, its shareholder and other stakeholders who concerned with the institution, as it clarify the structure that explain the institution objectives and the means for achieving those objectives and reviewing that they are achieved. The proper corporate governance is the one that provide for both the board of directors and the management of the institution the appropriate incentives to approach the objectives which are in the best interests of the institution and facilitate the finding out of an effective supervision process, and eventually helps the institution to utilize its resources efficiently"

In addition, the circular has listed the objectives of good corporate governance as follows:

1. To set objectives, plans and policies to approach the appropriate economic proceeds for the owners of the institution.
2. To operate day-to-day works according to a specified and appropriate programs and procedures.
3. To comply with the proper conducts and efficient and safe practices with high commitment towards supervisory regulations and by-laws.
4. To protect the interests and rights of the depositors.
5. To protect the interests and rights of investment accounts holders by setting proper investment strategy.

Moreover, the circular stated among other things, the elements of corporate governance and the proposed roles of the board of directors

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<sup>66</sup> Circular No. (9/2005) issued Central Bank of Sudan, Banking Supervision department Regulations and Circulars, 4th October 2005.

and their duties. Most importantly, the circular has called for independency and knowledge to be exercised inside the board.

The circular also has urged the board of directors to draft code of conduct to be circulated in all levels of management inside the bank where reforming, transparency, independency, accountability and responsibility to be part of the proposed code.

Thus, the only corporate governance guidelines in Sudan are referred to only in one of the circulars issued by the Central Bank of Sudan. However, this may raise the question of the scope and effectiveness of this circular in the absence of corporate governance provisions in the Companies Act 1925 or in the Khartoum Stock Exchange Market.

### **Corporate Governance under English law:**

After reviewing what could be implied as corporate governance standards in the Sudanese Acts, it's the time to examine now the English Companies' Act 2006, which adopted and codified the duties of directors for the first time, after they have been driven from the general law for many years. English companies' Act 2006 codified also a number of duties other than the fiduciary duty and duty of care.

Viewing the development of corporate governance in English law will facilitate the comparison with the Sudanese relevant Acts.

Examining of the English Companies Act 2006 will show us clearly that the fiduciary duty of director and duty of care are both derived from the common law. The director's duties have been codified for the first time in the said Act which will help to view the developments that have occurred concerning the directors duties over the years in the English Companies Act 2006. Most importantly, the shareholders powers and rights in the general meetings, derivative actions...etc are all part of the good corporate governance.

## **Duties of director under English Companies Act 2006:**

### **The duties of directors to their company**

The directors act as agents of their company. They have certain duties, which are related and linked to the company itself, but not to its shareholders, its employees or any person external to the company (e.g. general public). Although a company is a legal person in law and has its own legal entity which is separate from its members, but it is not human. The relationship between directors and the company is by its very nature impersonal, which may raise the question of what 'duty' means.<sup>67</sup>

The attribute of duty is not easy to understand, and it will be helpful to make comparison with the duties owed by other individuals or groups.<sup>68</sup>

Examples of individuals owing a duty to something which is not having life are not common, although personnel in the military have a duty to their country. It is more unusual to show loyalty to something not alive rather than to have a duty. For example, we might be expected to show loyalty to our country, although we might voluntarily show loyalty to our sports team, friends or work colleagues. Arguably, solicitors have a duty to their profession to act ethically, although the solicitors' practice rules in the UK specify that solicitors owe a duty of care to their clients. The same is applied in Sudan. Similarly, doctors have a duty to act ethically, but their duty is to their patients, Duty is mainly owed to individuals or a group of people. This is why the directors duty should be extended to be owed by them to their shareholders and possibly to the company's employees, but this is not the issue. Accountability and responsibility should not be confused with duty.<sup>69</sup>

- Directors have a responsibility to use their powers in ways that seem best for the company and its shareholders.

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<sup>67</sup> Coyle, Brian, Corporate Governance Essentials, ICSA publishing, p 44.

<sup>68</sup> Ibid at 45.

<sup>69</sup> Ibid.

- They should be accountable to the owners of the company, the shareholders, for the ways in which they have exercised their powers and/or the performance of the company.
- They have duties to the company.<sup>70</sup>

The one, who is guilty of a breach of duty, should be subject to a process calling him or her to account. An established disciplinary procedure should be existed, for example in a court or before a judicial panel, with a recognized bundle of punishments for misconduct. With companies, however, disciplinary mechanisms are difficult to apply in practice, except in extreme cases of misconduct. Where measures are taken, they are likely to be initiated by shareholders seeking legal remedies on behalf of the company; sometimes on the basis of the derivatives actions.<sup>71</sup>

### **Common law duties and statutory duties of directors**

Companies have many duties and obligations in law, but in the past the directors themselves did not. However, they could be personally liable in some circumstances. For example, directors could be liable to a fine for a failure to take minutes of the meetings or to deliver a copy of the company's report and accounts to the registrar of companies.<sup>72</sup> Professor Gower said that it is often stated that directors are trustee and that the nature of their duties can be explained on this basis.<sup>73</sup>

Until the introduction of the provisions of the English Companies Act 2006, the main duties of directors were duties in common law - a fiduciary duty and duty of skill and care to the company. This duty is to the company, not its shareholders. The Companies Act 2006 has now enacted for the first time the common law duties of directors into statute law.<sup>74</sup>

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<sup>70</sup> Ibid.

<sup>71</sup> Ibid.

<sup>72</sup> Coyle, Brian, Corporate Governance Essentials, ICSA publishing, p 45.

<sup>73</sup> Gower and Davies: Principles of Modern Company Law, sixth ed, Sweet & Maxwell, p 598.

<sup>74</sup> Coyle, Brian, Corporate Governance Essentials, ICSA publishing, p 45.

It is therefore useful to begin by looking at the nature of the common law duties and what they mean.

### **Fiduciary duties of directors**

In UK law, directors have a fiduciary duty to their company. 'Fiduciary' means given in trust and the attribute of trustee (as established in US and UK law) is applicable. This is because the directors hold a position of trust as they make contracts on behalf of the company and also control company's property. Since this is similar to being a trustee of the company, a director has fiduciary duties. However, these are duties to the company, not to its shareholders as we mentioned earlier.<sup>75</sup> The main duties of directors are 1) to exercise their powers for the purpose for which they were conferred and bona fide for the benefit of the company as a whole. 2) not to put themselves in a position in which their duties to the company and their personal interests may conflict.<sup>76</sup> 3) that they must not fetter their discretion as to how they shall act.<sup>77</sup>

If a director were to act in a breach of his or her fiduciary duties, legal action could be brought against him or her by the company. In such a situation, the 'company' might be represented by a majority of the board of directors or a majority of the shareholders or a single controlling shareholder.<sup>78</sup>

Presumably, an accusation of breach of fiduciary duty would focus on a particular action or series of actions by the director concerned. If the court were to find a director in breach of his or her fiduciary duties, it might order him or her to compensate the company for any loss it has suffered and account to the company for any personal profit made.<sup>79</sup> This will happen in a case that the director of the company entered into a transaction and made a secret profit out of transaction.

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<sup>75</sup> Ibid at 46.

<sup>76</sup> Cain's Company Law, p 370.

<sup>77</sup> Gower and Davies: Principles of Modern Company Law, sixth ed, Sweet & Maxwell, p 601.

<sup>78</sup> Coyle, Brian, Corporate Governance Essentials, ICSA publishing, p 46.

<sup>79</sup> Ibid at 46.

## Tests for breach of fiduciary duty

There are three key tests of whether a director is in breach of his or her fiduciary duties carrying out a transaction or series of transactions:<sup>80</sup>

1. The transaction should be reasonably incidental to the business of the company. If it is not related to the business of the company in any way, it would be a breach of fiduciary duty. For example, the CEO of a building construction company might decide to trade in diamonds and lose large amounts of money in these diamond trading transactions. In such a case the act of the CEO is considered ultra vires and that the directors exceeded his or her powers in acting on behalf of the company.
2. The transaction carried out should have been bona fide (i.e. in good faith), with honesty and sincerity. If it is not, it would be a breach of a fiduciary duty.
3. The transaction should also have been made for the benefit of the company, and not for the personal benefit of the director. Directors have a fiduciary duty to avoid a conflict of interest between themselves personally and the company, and must not obtain any personal benefit or profit from a transaction without the consent of the company. In other words, it would be a breach of fiduciary duty for a director to make a secret profit from a transaction by the company in which he or she has a personal interest.<sup>81</sup>

Suppose, for example, that a company wishes to buy some land and has identified a property for which it would be prepared to pay a large sum of money. The CEO might secretly set up a private company to buy the property, and then sell this on to the company of which he or she is CEO, making a large profit in the process. The actions of the CEO would be a breach of fiduciary duty, because the actions would not have been bona fide, and the

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<sup>80</sup> Ibid at 46.

<sup>81</sup> Ibid at 46.

CEO would have made a secret profit at the expense of the company.<sup>82</sup> The land might be also belonging to the director which will make him or her in a conflict of interest if this fact has not been declared to the company.

### **Case Example (1)**

#### **Development Consultants Ltd v Cooley [1972]<sup>83</sup>**

An example of breach of fiduciary duty arose in the case of Industrial Development Consultants Ltd v Cooley [1972]. Cooley, a highly regarded architect, was the managing director of a firm of consultants. The firm advised clients on construction projects in the gas industry. A potential client was planning a new construction project, but had made it clear that it would not use the consultancy services of the firm. Cooley was aware, however, that although the client had objections to using his firm, it might award the work to him personally. He therefore told the board of his company that he was seriously ill and persuaded the directors to release him from his contract of employment. Having been released from his contract of employment, he then succeeded in negotiating a contract with the client to provide his personal consultancy service. His former company found out and took him to court, claiming that he was in breach of his fiduciary duty and must account for his profits. The court agreed, even though the company would not have been awarded the work, and ordered Cooley to account to the company for the profits he had made from the work.

### **Case Example (2)**

#### **Bairstow and others v Queen's Moat Houses plc [2001]<sup>84</sup>**

Queen's Moat Houses plc (QMH) paid dividends to its shareholders on the basis of its accounts in 1990 and 1991. However, the dividend payments exceeded the company's distributable reserves, and so were in breach of ss. 263 and 264 of the

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<sup>82</sup> Ibid at 46.

<sup>83</sup> Industrial Development Consultants v. Cooley [1972] 1 WLR 443.

<sup>84</sup> [2001] 2 BCLC 531.

Companies Act 1985, which make it unlawful for dividends to be paid except out of profits available for that purpose. The directors did not benefit from the dividend payments themselves.

It was claimed that the 1991 accounts were misleading, because they included some: unlawful transactions, adopted some inappropriate accounting treatments and involved significant non-disclosure of information.

QMH brought an action seeking repayment of the unlawful dividends from the directors, claiming that they were in breach of their duties by authorizing the dividend payments when they should have known that there were insufficient distributable reserves.

The directors argued that the breach was only technical, because there were sufficient distributable reserves within the group even if not within QMH itself, so no loss was suffered. They also asked the court to use discretionary powers available under s. 727 of the Companies Act 1985 to relieve them from liability, on the grounds that they had acted honestly and reasonably.

The judgment had three main aspects, and the court ruled as follows:

- A reasonably diligent director should know that dividends cannot be paid from capital, and so should know that any dividend paid on the basis of accounts showing insufficient distributable reserves would be unlawful. Any director not aware of this would be in breach of his or her duty of skill and care.
- The 1990 accounts. The directors had placed too much reliance on their auditors, and had overlooked their responsibilities to ensure that the distributable reserves were sufficient. However, they had acted honestly and reasonably; therefore the court relieved them of liability (under s. 727 of the Companies Act 1985).
- The 1991 accounts. The directors had knowledge that the 1991 accounts did not give a true and fair view. Dividends paid on the basis of inaccurate

accounts are unlawful, because the distributable profits cannot be properly established. The authorization of the dividend payments by the directors, on the basis of accounts they knew to be misleading, amounted to a breach of trust and fiduciary duty, because it was not in the best interests of the company. The conduct of the directors was not honest; therefore they were not entitled to relief under S5. 727 and were liable to repay the dividends (of £.26.7 million).

### **A director's duty of skill and care**

In addition to having a fiduciary duty, directors have also been subject to a common law duty of skill and care to the company. While carrying out his or her duties a director should not act negligently in the performance of the duties, and if any losses occurred to the company he or she could be personally liable as a consequence of such negligence.

The standard of skill and care expected of a director is the higher of the skill that he or she has or the skill that would objectively be expected of a director of the particular company. In the case *Re D'Jan of London* {1993}<sup>85</sup>, the judge ruled that the common law duty of care was the equivalent to the statutory test applied by the Insolvency Act 1986, s. 214. This statutory test refers to what would be expected of: ' a reasonable diligent person having both:

- the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same function as are carried out by that director in relation to the company, and
- the general knowledge, skill and experience that the director has.'

A director is expected to show the technical skills that would reasonably be expected from someone of his or her experience and expertise. If the finance director of a scientific research company is a qualified accountant, he or she

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<sup>85</sup> 1 BCLC 561 is a leading English company law case, concerning a director's duty of care and skill, whose main precedent is now codified under s 174 of the Companies Act 2006. The case was decided under the older Companies Act 1985.

would not be expected to possess the technical skills of scientist, but would be expected to possess some technical skill as an accountant.

The duty of skill and care does not extend to spending time in the company. A director should attend board meetings when it's possible to do so, but is not always required to be concerned with the affairs of the company. The duties of a director are of intermittent nature and might arise from time to time only, such as when the board meets. If a director holds an executive position in the company, a different situation arises, because he or she is an employee of the company with a contract of service. This contract might call for full-time attendance at the company or on its business. However, this requirement arises out of his or her job as a manager, not out of his or her position as a director.<sup>86</sup>

In Re City Equitable Fire Insurance Co [1925] Ch 407 it was held that a director is not bound to give a continuous attention to the affairs of the company since his duties of intermittent nature to be performed at periodical boards meetings.<sup>87</sup> Unless there are particular grounds for suspecting dishonesty or incompetence, a director is entitled to leave the routine conduct of the company's affairs to the management. If the management appears honest, the directors may rely on the information they provide. It is not part of their duty of skill and care to question whether the information is reliable, or whether important information is being withheld.

However, a more modern approach has since developed, and in Dorchester Finance Co v Stebbing [1989] BCLC 498<sup>88</sup> the court held that the rule in Equitable Fire related only to skill, and not to diligence. With respect to diligence, what was required was:

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<sup>86</sup> Coyle, Brian, Corporate Governance Essentials, ICSA publishing, p 49.

<sup>87</sup> The level of care and skill which has to be demonstrated by a director has been framed largely with reference to the non-executive director. In Re City Equitable Fire Insurance Co [1925] Ch 407, it was expressed in purely subjective terms, where the court held that: "a director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of *his* knowledge and experience."

<sup>88</sup> This case will be discussed deeply as an example to the English companies law developments over the years.

"such care as an ordinary man might be expected to take on his own behalf."

More recently, it has been suggested that both the tests of skill and diligence should be assessed objectively and subjectively; in the United Kingdom the statutory provisions relating to directors' duties in the new Companies Act 2006 have been codified on this basis.

A board of directors might make a decision that appears ill-judged or careless. However, UK courts are generally reluctant to condemn business decisions made the board that appear, in hindsight, to show errors of judgment. Directors can exercise reasonable skill and care, but still make bad decisions.<sup>89</sup>

For a legal action against a director to succeed a company would have to prove that serious negligence had occurred. It would not be enough to demonstrate that a loss could have been avoided if the director had been a bit more careful.<sup>90</sup>

### **CASE EXAMPLE (1)**

#### **Finance Co. Ltd v Stebbing**<sup>91</sup>

In the case of *Dorchester Finance Co. Ltd v Stebbing* {1989} BCLC 498, a company brought an action against its three directors for alleged negligence and misappropriation of the company's property. The company (Dorchester Finance) was in the money-lending business and it had three directors. S, Hand P. Only S was involved full time with the company; Hand P were non-executives who made only rare appearances. There were no board meetings. S and P were qualified accountants and H, although not an accountant had considerable accountancy experience. S arranged for the company to make some loans to persons with whom he appears to have had dealings. In the loan-making process he had persuaded P and H to sign blank cheques that were subsequently used to make the loans. The loans

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<sup>89</sup> Coyle, Brian, *Corporate Governance Essentials*, ICSA publishing, p 49.

<sup>90</sup> *Ibid.*

<sup>91</sup> [1989] BCLC 498.

did not comply with the Moneylenders Acts and they were inadequately secured. When the loans turned out to be irrecoverable, the company brought its action against the directors.

It was held that all three directors were liable to damages. S, as an executive director, was held to be grossly negligent. P and H, as non-executives, were held to have failed to show the necessary level of skill and care in performing their duties as non-executives, even though it was accepted that they had acted in good faith at all times.

## **CASE EXAMPLE (2)**

### **Re D'Jan of London [1993]<sup>92</sup>**

An insurance broker completed an insurance proposal form with an incorrect answer, but a director of the company applying for the insurance signed the form. The company premises burned down, and the insurance company, on discovering the mistake on the proposal form, repudiated all liability under the policy. The company went into insolvent liquidation. The liquidator brought an action against the director who had signed the proposal form, alleging a failure to exercise reasonable care to the company. The court found that although it would be unreasonable to expect a director to read every word of every document that he signed, in this case the form consisted of a few simple questions that the director was the best person to answer. The director was therefore guilty of a breach of duty of care, although, in this case, the director was exonerated on other grounds.

## **General duties of directors: English Companies Act 2006**

The duties of directors in common law and equity to their company have now been introduced into statute law by the Companies Act 2006, (ss. 171-7). These consist of a duty to:

- act within their powers;

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<sup>92</sup> [1994] 1 BCLC 561.

- promote the success of the company;
- exercise independent judgment;
- exercise reasonable care, skill and diligence;
- avoid conflicts of interest;
- not accept benefits from third parties;
- declare any interest in a proposed transaction or arrangement.

It is worth remembering that these duties (as in common law) apply to non-executive directors as well as to executive directors. Above all, it should be noted that these duties have been codified for the first time in the English law.

### **Duty to act within powers**

A director must act within his or her powers in accordance with the company's constitution, and should only exercise these powers for the purpose for which they were conferred. <sup>93</sup> The company is liable for any obligation to the third party in the case that the director acts outside his or her powers to make a contractual agreement with a third party, provided that the third party has acted in bona fide. <sup>94</sup>

### **Duty to promote the success of the company**

One of the most significant and remarkable changes in the Act is in relation to section 172. In the past directors were obliged to act in good faith and in the interests of the company. Section 172 (1) of the Act now requires a director of a company to “act in a way that he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to :<sup>95</sup>

- the likely long-term consequences of any decision;
- the interests of the company's employees;

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<sup>93</sup> Section 171 Companies Act 2006.

<sup>94</sup> Coyle, Brian, Corporate Governance Essentials, ICSA publishing, p 52.

<sup>95</sup> Hemingway, Lindsey & Morrison, David . Companies Act 2006 Note on directors’ duties, Rooks Rider.

- the need to foster the company's relationships with its customers, suppliers and others;
- the impact of the company's operations on the community and the environment;
- the desirability of the company maintaining its reputation for high standards of business conduct; and
- the need to act fairly between members of the company.<sup>96</sup>

Despite the fact that the act does not create a duty of directors to any stakeholders other than the shareholders (members), but it requires directors to give consideration to interests of other stakeholders in reaching their decisions. The Act specifically mentions employees, customers, suppliers and the community. It therefore appears to promote a form of enlightened shareholder approach to corporate governance which is a good point. This indicates clearly that the umbrella of corporate governance could be stretched to cover the stakeholders as well as the shareholders.<sup>97</sup>

It has been suggested by Coyle, Brian that "this aspect of directors' duties has given rise to some concerns that directors will need to create a 'paper trail' to provide evidence if required in a court of law to show that they have given due consideration to the interests of other stakeholders in their decision making, although the government has denied that this is intended by the Act".<sup>98</sup>

It has also been suggested that this statutory duty may be fulfilled for quoted companies by the legal requirement to include a narrative business review in the annual report and accounts, which should discuss the company's policies, and their effectiveness, with regard to employees, the environment and social and community issues.<sup>99</sup>

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<sup>96</sup> Section 172 (1) Companies Act 2006.

<sup>97</sup> Coyle, Brian, Corporate Governance Essentials, ICSA publishing, p 53.

<sup>98</sup> Ibid.

<sup>99</sup> Ibid.

### **Duty to exercise independent judgment**

A director must exercise independent judgment. However, this requirement does not prevent a director from acting in a way authorized by the company's constitution <sup>100</sup> (for example, accepting resolutions passed by the shareholders in general meeting) or from acting in accordance with an agreement already entered into by the company that prevents the director from using discretion. The requirement for independent judgment does not prevent a director from taking advice and acting on it. <sup>101</sup>

### **Duty to exercise reasonable care, skill and diligence**

This is similar to the common law duty of care. A director of a company must exercise reasonable care, skill and diligence. <sup>102</sup> This means the care, skill and diligence that would be exercised by a reasonably diligent person with the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and the general knowledge, skill and experience that the director has. <sup>103</sup>

### **Duty to avoid conflicts of interest**

A director of a company must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company. <sup>104</sup> This applies in particular to the exploitation of any property, information or opportunity (and it is immaterial whether the company could take advantage of the property, information or opportunity). <sup>105</sup> It is worth noting that even when a director ceases to be a director of a company he is still subject to the duty to avoid conflicts of interest regarding the exploitation of any property, information or

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<sup>100</sup> Section 173 Companies Act 2006.

<sup>101</sup> Coyle, Brian, Corporate Governance Essentials, ICSA publishing, p 53.

<sup>102</sup> Section 174 (1) Companies Act 2006.

<sup>103</sup> Section 174 (2) Companies Act 2006.

<sup>104</sup> Section 175 (1) Companies Act 2006.

<sup>105</sup> Section 175 (2) Companies Act 2006.

opportunity of which he became aware while a director of the company.<sup>106</sup>

However, this duty is not breached if the director declares the interest to the board of directors and the interest is authorized by the rest of the board.<sup>107</sup>

In the commercial world, it is inevitable that many directors will have a potential conflict of interest, whether direct or indirect, with their company. For example, a company might be planning to trade with another company in which one of its directors is a shareholder. In such a situation, the director concerned is required to declare his or her interest in the proposed contract to the other directors and must not make a secret profit.<sup>108</sup>

A director or a connected person might have a material interest in a transaction undertaken by the company. For example, the company might award a contract to a firm of building contractors to rebuild or develop a property owned by the company, and the director or his/her spouse might own the building company.<sup>109</sup>

A director might also have a direct or indirect interest in a contract (or proposed contract) with the company. For example, the director might be a member of another organisation with which the company is planning to sign a business contract. Such a contract is not illegal, although the company can choose to rescind it should it wish to do so.<sup>110</sup>

If a director has an interest in a contract with the company and has failed to disclose it, and has received a payment under the contract, he or she will be regarded as holding the money in the capacity of constructive trustee for the company and so is bound to repay the money.

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<sup>106</sup> Hemingway, Lindsey & Morrison, David. Companies Act 2006 Note on directors' duties, Rooks Rider.

<sup>107</sup> Coyle, Brian, Corporate Governance Essentials, ICSA publishing, p 53.

<sup>108</sup> Ibid.

<sup>109</sup> Ibid at 54.

<sup>110</sup> Ibid at 54.

The 2006 Act recognizes three situations in which an actual or potential conflict of interest may arise:

1. A conflict of interest may arise in a situation where the company is not a party to an arrangement or transaction, but where the director might be able to gain personally from 'the exploitation of any property, information or opportunity'. For example, a director might pursue an opportunity for his or her personal benefit that the company might have pursued itself.
2. A conflict of interest may arise in connection with a proposed transaction or arrangement to which the company will be a party. If a director has a direct or indirect personal interest in any such transaction or arrangement, he or she must disclose this interest to the board before it is entered into by the company. An example would be a proposal to acquire a target company in which a director owns shares. ' (Note: the Table A Articles of Association provide that when a director has disclosed an interest in a contract with the company, he or she cannot count towards the quorum of the board that makes a decision about the contract. In practice, the director might be asked to leave the meeting whilst the matter is being discussed.) .
3. A conflict of interest arises in relation to existing transactions or arrangements in which the company is already a party. It can be a criminal offence for a director not to make or update a declaration of interest in an arrangement or transaction to which the company is a party.

### **Duty not to accept benefits from third parties**

A director of a company must not accept a benefit from a third party conferred by reason of his being a director, or his doing (or not doing) anything as director.<sup>111</sup> This duty is not infringed if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest.<sup>112</sup> In

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<sup>111</sup> Section 176 (1) Companies Act 2006.

<sup>112</sup> Section 176 (4) Companies Act 2006.

practice many listed companies already have strict internal policies on accepting gifts and corporate hospitality, especially from other companies that are tendering or about to tender for business with the company. An internal policy might include a requirement for a director to obtain clearance from another director before accepting any such benefits.<sup>113</sup>

### **Duty to declare interests in proposed transactions with the company**

This duty is linked to the duty relating to conflicts of interest. A director must declare the nature and extent of his or her interest to the other directors, who may then authorize it.<sup>114</sup>

### **Consequences of a breach of the general duties**

A director owes his or her duties to the company, and if the director is in breach of those duties only the company can bring a legal claim against the director. -In practice, this has usually meant that the rest of the board of directors might bring an action against a fellow director in the name of the company.<sup>115</sup>

The 2006 Act states that the consequences of a breach of a director's general duties are the same as if the corresponding common law rule or equitable principle applied, but it does not set out in detail what these consequences should be.<sup>116</sup>

In addition, the Act introduces a procedure whereby individual members of the company can bring a legal action for a derivative claim against a director. A derivative action may be brought in respect of 'an actual or proposed act or mission involving negligence, default, breach of duty or breach of trust by a director of the company'. A shareholder would have to bring the action against a director in the name of the company, and if the action were successful the

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<sup>113</sup> Coyle, Brian, Corporate Governance Essentials, ICSA publishing, p 54.

<sup>114</sup> Section 177 (1) Companies Act 2006.

<sup>115</sup> Coyle, Brian, Corporate Governance Essentials, ICSA publishing, p 55.

<sup>116</sup> Ibid.

company and not the individual shareholder would benefit.<sup>117</sup>

The procedures for bringing a derivative action are set out in ss. 260-9 of the Act. They include safeguards designed to prevent individual shareholders from bringing actions that are not reasonable on the basis of the prima facie evidence. Even so, there is a possibility that in future legal actions against directors will be brought by shareholders under the derivatives claims procedure for breach of their general duties.<sup>118</sup>

### **Unfair prejudice**

It's of a vital importance to discuss the attribute of unfair prejudice since we are addressing the measures that should be taken in case of a breach of the general duties of the directors.

Unfair prejudice in United Kingdom company law is a statutory form of action that may be brought by aggrieved shareholders against their company. Under the Companies Act 2006, the relevant provision is s.994, the identical successor to s.459 Companies Act 1985. Unfair prejudice actions have generated an enormous body of cases, many of which are called "Re A Company", with only a six digit number and report citation to distinguish them. They have become a substitute for the more restrictive conditions on a "derivative action", as an exception to the rule in *Foss v Harbottle*.<sup>119</sup> Though not restricted in such a way, unfair prejudice claims are primarily brought in smaller, non public companies. This is the text from the Act.

### **s. 994 Petition by company member**

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<sup>117</sup> Ibid.

<sup>118</sup> Ibid.

<sup>119</sup> *Foss v Harbottle* (1843) 2 Hare 461, 67 ER 189 is a famous decision English precedent on corporate law. In any action in which a wrong is alleged to have been done to a company, the proper claimant is the company itself. This is known as "the rule in *Foss v Harbottle*", and the several important exceptions that have been developed are often described as "exceptions to the rule in *Foss v Harbottle*". Amongst these is the 'derivative action', which allows a minority shareholder to bring a claim on behalf of the company. This applies in situations of 'wrongdoer control' and is, in reality, the only true exception to the rule. The rule in *Foss v Harbottle* is best seen as the starting point for minority shareholder remedies.

- 1) A member of a company may apply to the court by petition for an order under this Part on the ground—
  - a) that the company's affairs are being or have been conducted in a manner that is unfairly prejudicial to the interests of members generally or of some part of its members (including at least himself), or
  - b) that an actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.
- 2) The provisions of this Part apply to a person who is not a member of a company but to whom shares in the company have been transferred or transmitted by operation of law as they apply to a member of a company.
- 3) In this section, and so far as applicable for the purposes of this section in the other provisions of this Part, "company" means—
  - a) a company within the meaning of this Act, or
  - b) a company that is not such a company but is a statutory water company within the meaning of the Statutory Water Companies Act 1991 (c.58).

In *Re Saul D Harrison plc*<sup>120</sup>, Hoffmann LJ remarked, it has been held that:

"'Unfairly prejudicial' is deliberately imprecise language which was chosen by Parliament because its earlier attempt in s. 210 of the Companies Act 1948 to provide a similar remedy had been too restrictively construed. The earlier section had used the word 'oppressive', which the House of Lords in *Scottish Co-operative Wholesale Society v. Meyer* [1959] AC 324 said meant 'burdensome, harsh and wrongful'. This gave rise to some uncertainty as to whether 'wrongful' required actual illegality or invasion of legal rights. The Jenkins Committee on Company Law, which reported in 1962, thought that it should not. To make this clear, it recommended the use of the term 'unfairly prejudicial', which Parliament somewhat tardily adopted in s. 75 of the

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<sup>120</sup> *Re Saul D Harrison & Sons plc* [1995] 1 BCLC 14.

Companies Act 1980. This section is reproduced (with minor amendment) in the present s. 459 of the Companies Act 1985."

### **Derivative Action:**

One of the measures that could be referred to when a breach of the general duties of the directors occurred is the derivative actions.

'Derivative actions' are claims brought by individual shareholders, acting on behalf of a company, against the company's directors. They are brought in respect of wrongs committed against the company that, for whatever reason, the company is not willing to pursue in its own right.<sup>121</sup>

At present, the circumstances in which such actions may be brought are very limited, due to the general rule (known as the rule in *Foss v Harbottle*) that the proper person to bring them is the company itself. Specifically, the English Companies Act 2006 in Part 11 provided that a derivative action may only be brought where the wrong complained of:

- amounts to a fraud on the minority and the wrongdoers are in control of the company;
- cannot be ratified by ordinary resolution; or
- is outside the company's objects and so cannot be ratified in any event.

Moreover, part 11 of the said Act provided that broadens the circumstances in which derivative actions may be brought, extending to actions in respect of any 'actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company'. In particular, the procedure will apply to derivative actions for alleged breaches of any of the new statutory duties of directors in Chapter 2 of Part 10 of the Act, including the duty to exercise reasonable care, skill and diligence.

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<sup>121</sup> Report by Freshfields Bruckhaus Deringer on Corporate Social Responsibility, September 2007

However, despite this general expansion of the circumstances in which derivative actions may be brought, it could be argued that the derivative actions procedure does not change the general rule that the only plaintiff is the company itself and that without the court consent the no derivative action could be brought.

### **Shareholders' powers**

Shareholders' powers are fairly restricted in UK law, although there is some debate as to how extensive these powers are. In the context of corporate governance, shareholders' powers relate to the actions that shareholders can take to make decisions for the company, or to affect decisions taken by the directors with which they disagree.<sup>122</sup>

The most significant powers of the shareholders relate to their voting powers in general meeting, although the matters on which they can make decisions are clearly delineated. These include electing or re-electing directors, appointing or reappointing the external auditors, decisions on authorized share capital and approving or reducing the proposed final dividend.<sup>123</sup>

Shareholders powers in Sudanese Companies Act 1925 also relate to their voting powers in the general meeting. They have also powers of sanctioning a dividend, the consideration of the accounts, balance-sheets, and the ordinary report of the directors and auditors, the election directors and other officers in the place of those retiring by rotation, and the fixing of the remuneration of the auditors.<sup>124</sup>

Shareholder powers in company law include the following:

- Under the Companies Act 2006, s. 188 a provision in a director's service contract is void if it guarantees that the term of the director's employment

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<sup>122</sup> Coyle, Brian, Corporate Governance Essentials, ICSA publishing, p 58.

<sup>123</sup> Ibid.

<sup>124</sup> Sudanese companies Act 1925, the first schedule, table A, s 50

will be more than two years, unless the provision has been approved by ordinary' resolution of the members. Shareholders also have the right to approve loans, quasi-loans and credit transactions to directors.<sup>125</sup>

Nothing governs this matter in the Sudanese Companies Act 1925. Nevertheless, on the requisition of not less than the one-tenth of the issued share capital company upon which all calls or other sums then due have been paid, forthwith proceed to call an extraordinary general meeting<sup>126</sup>. Therefore, election of directors and credit transactions to the directors and other major things could possibly be discussed in an extraordinary meeting called upon by the shareholders.

- Under the Companies Act 2006, s. 994 a shareholder can petition the court for an order on the grounds that the company's affairs are being conducted in a way that is unfairly prejudicial to some or all of its members. The court may then issue an order, for example to regulate the company's affairs or to prevent the company from doing something.

In the Sudanese Companies Act 1925 if it appears to the court in the course of a winding up by or subject to the supervision of the court that any past or present director, manager, officer or member of the company has been guilty of any offence in relation to the foe which he is criminally responsible, the court may, on the application of any person interested in the winding up, or of its own motion, direct the official liquidator or the liquidator, as the case may be, to prosecute for the offence, and may order the costs and expenses to be paid out of the assets of the company<sup>127</sup>. The same case applied in the voluntary winding up.

This means that shareholders in the ordinary course of the company's business cannot sue the company for damages occurred to them, and they can only rely on the normal litigation measures. It could be possible to for the shareholders to call for an extraordinary meeting to revoke the

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<sup>125</sup> The Companies Act 2006, s. 188.

<sup>126</sup> The Sudanese Companies Act 1925, s 71 (1)

<sup>127</sup> Sudanese companies Act 1925, s 228 (1)

directors' wrongdoing behavior.

- Under the Companies Act 2006, s. 303 shareholders representing at least 10 per cent of the voting shares can call an extraordinary general meeting of the company.<sup>128</sup>

Under Sudanese Companies Act 1925, shareholders holding not less than the one-tenth of the issued shares can call for an extraordinary general meeting as provided for in s 71 (1) of the Act.

- Under the Companies Act 2006, s. 338 shareholders representing at least 5 per cent of the voting shares of a public company can arrange for a resolution to be put to the annual general meeting. The company then has a duty to give notice of the resolution to all the other members.<sup>129</sup> Also members of a private company with the requisite percentage of voting rights may require the company to circulate a resolution which they propose.<sup>130</sup>

The Sudanese Companies Act 1925 did not provide for this. Members' right to have their resolutions proposed should be adopted in the Sudanese Companies Act.

### **Shareholders' rights**

Shareholders also have rights. For example, they have a right to receive a copy of the company's annual report and accounts, and the right to attend and vote at general meetings of the company. The rights of shareholders relate mainly to the issues on which they may vote in general meetings of the company.<sup>131</sup>

Company law requires some proposals to be approved by the shareholders voting in a general meeting and specifies the size of majority

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<sup>128</sup> The Companies Act 2006, s. 994.

<sup>129</sup> The Companies Act 2006, s. 338

<sup>130</sup> The Companies Act 2006, ss. 288(3) (b) and 292 to 295.

<sup>131</sup> Coyle, Brian, Corporate Governance Essentials, ICSA publishing, p 59.

needed for a resolution to be passed. In the UK, most shareholders' voting requires a simple majority (an ordinary resolution) or a 75 per cent majority vote (a special resolution).<sup>132</sup> This is also the case in Sudanese Companies Act 1925.

Under Companies Act 2006, private companies are not required to hold annual meetings at all. On the contrary, public companies are required to hold annual general meetings linked to the reporting cycle<sup>133</sup>.

In the past, it has been common for shareholders to 'rubber stamp' <sup>134</sup> proposals by the directors at general meetings and to support the directors, with very few questions asked. Most general meetings of a company are attended by very few shareholders and most shareholders vote by proxy. With a proxy vote, the shareholder authorizes another person to voting the general meeting on his or her behalf, normally having indicated how the proxy should vote (for or against each resolution). Institutional investors with large shareholdings in a company might simply indicate how they want to vote on each resolution (normally in favor) and appoint the chairman of the board to cast the votes on their behalf.<sup>135</sup>

Some investors believe that shareholders should use their voting rights more actively, voting against proposed resolutions where appropriate. 'Activist' shareholder groups might try to encourage shareholders to vote against the re-election of directors at the annual general meeting to show their disapproval of certain policies of the board.<sup>136</sup>

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<sup>132</sup> Ibid.

<sup>133</sup> Mayson, French 7 Ryan on Company Law, 26<sup>th</sup> edition 2009-2010, published by Oxford University press, p 383.

<sup>134</sup> Rubber stamp means the routine authorization of an action without any questions.

<sup>135</sup> Coyle, Brian, Corporate Governance Essentials, ICSA publishing, p 59.

<sup>136</sup> Ibid at 59.

## Chapter Five: The consequences of the lack of corporate governance

### **Introduction:**

What will happen if there is lack of good corporate governance measures? It is vital in the absence of good measures for corporate governance and on the light of corporate failures and collapses that occurred years ago; despite the companies seeming healthy. It is helpful in this chapter to review a few examples from recent years, each of which has sent shock waves through stock markets around the world.

### **Barings Bank:**

The downfall in 1995 of one of England's oldest established banks was brought about by the actions of one man, Nick Leeson. Nick Leeson was a clever, if unconventional, trader with a gift for sensing the way that stock markets prices would move in the Far Eastern markets. In 1993, he was based in Singapore and made more than £10 million, about 10 per cent of Barings' total profit that year. He was highly thought of at that time.

However, his run of good luck was not to last and, where a severe earthquake in Japan affected the stock market adversely, he incurred huge losses of Barings' money. He requested more funds from Barings' head office in London, which were sent to him but unfortunately he suffered further losses. The losses were so great, £850 million which led to the collapse and was eventually bought for £1 by ING, the Dutch banking and insurance group.

Barings Bank has been criticized for its lack of effective internal controls at that time, which left Nick Leeson able to cover up the losses that he was making for a quite a number of months. The case also illustrates the importance of having effective supervision, by experienced staff with a good understanding of the processes and procedures of staff who are able to expose the company to such financial disaster. The collapse of Barings Bank

sent ripples through financial markets across the world as the importance of effective internal controls and appropriate monitoring was reinforced.<sup>137</sup>

### **Enron:**

Enron was ranked in the USA's Fortune top ten list of companies based on its turnover in 2000, its published accounts for the year ended 31 December 2000 reflects a seemingly healthy profit of \$979 million and there was nothing obvious to alert shareholders to the impending disaster that was going to unfold over the next year or so, making Enron the largest bankruptcy in US history.

Enron's difficulties related to its activities in the energy market and the setting up of a series of 'special purpose entities' (SPEs). Enron used the SPEs to conceal large losses from the market by giving the appearance that key exposures were hedged (covered) by third parties. However, the SPEs were really nothing more than an extension of Enron itself and so Enron's risks were not covered. Some of the SPEs were used to transfer funds to some of Enron's directors. In October 2001, Enron declared a non-recurring loss of \$1 billion and also had to disclose a \$1.2 billion write-off against shareholders' funds. Later in October, Enron disclosed another accounting problem, which reduced its value by over \$0.5 billion. It looked as though a takeover might be on the cards from a rival, Dynegy, but in November, announcements by Enron of further debts led to the takeover bid falling through, and in December 2001, filed for bankruptcy.

In retrospect, it seems that the directors were not questioned closely enough about the use of the SPEs and their accounting treatment. What has become clear is that there was some concern among Enron's auditors – Andersen - about the SPEs, and Enron's activities. Unfortunately, Andersen failed to question the directors hard enough and Andersen's own fate was sealed when some of its employees shredded paperwork relating to Enron,

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<sup>137</sup> Chrstine A. Mallin, Corporate Governance, Oxford, 2<sup>nd</sup> Edition, p 1-2.

thus obliterating vital evidence and contributing to the demise of Andersen, which has itself been taken over by various rivals.

The Enron case highlighted the overriding need for integrity in business; for the directors to act with integrity and honesty, and for the external audit firm to be able to ask searching questions of the directors without holding back for fear of offending a lucrative client. This latter situation is exacerbated when auditors receive large fees for non-audit services that may well exceed the audit fee itself, thus endangering the independence of the auditors. Enron also highlights the need for independent non-executive directors who are experienced enough to be able to ask searching questions in board and committee meetings to try to ensure that the business is operated appropriately.<sup>138</sup>

### **How Enron Was Discovered?**

This quick survey has shown that a variety of professionals failed to perform as, in theory, they should have. Conceivably, this failure could be explained by the fact that Enron was a brilliantly conceived, perfectly orchestrated fraud. But it was not. Kurt Eichenwald's account of Enron's collapse bears a simple title that says it all: 'Conspiracy of Fools.'<sup>139</sup>

Despite a soaring bull market<sup>140</sup>, hero worship by an infatuated media, conflicted stock analysts, and fraudulent financial reporting, Enron's problems were detected by those whose self-interest led them to study Enron's activities more diligently than others. Ironically, the 'hero' who discovered Enron's fraud was not a 'gatekeeper' with high reputational capital or significant exposure to liability. Instead, it was a much more unlikely champion of the public interest: the short sellers. Motivated by self-interest and the expectation of high profits, they deduced that Enron had to be a house of cards and slowly spread this

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<sup>138</sup> Ibid at 2-3.

<sup>139</sup> See Eichenwald, n 6 above.

<sup>140</sup> A bull market means the financial market of a group of securities in which prices are rising or are expected to rise. The term "bull market" is most often used to refer to the stock market, but can be applied to anything that is traded, such as bonds, currencies and commodities. The opposite of bull market is the bear market.

message to others.<sup>141</sup>

Jim Chanos, a professional trader who ran Kynikos Associates, a firm that specialized in short-selling<sup>142</sup>, deserves the historical credit for being the first to recognize Enron's hopelessly exposed position. Analyzing Enron's public financial statements, he decided that the company was a 'hedge fund'<sup>143</sup> in disguise.<sup>144</sup> More importantly, he determined that it was earning only a very poor return for a high-risk hedge fund—a 7 percent return on capital.<sup>145</sup> This return could not justify, he realized, Enron's then valuation of six times book value. Add to this picture the hint of fraud and self-dealing created by Enron's voluminous related party transactions, and the stock seemed to him ripe for a fall.

Chanos began to expose Enron in November of 2000. Yet, in January 2001, Enron management began to predict publicly that its success at bandwidth trading would add an additional \$35 to Enron's then stock price of \$90—in effect, a prediction of a \$125 market price. In February 2001, Chanos spoke at a national short sellers' conference—known then as 'Bears in Hibernation'—and made Enron one of his two leading picks for a fall. While Chanos sought to educate and convert securities analysts to his position, his real success came when he was able to convince Bethany McLean, a Fortune reporter, that Enron's financial statements raised a host of unanswered questions.

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<sup>141</sup> John C. Coffee Jr. *Gatekeepers: The professions and corporate governance*, p 35

<sup>142</sup> Short selling means profiting from an anticipated drop in the price of a commodity, financial instrument, or security by (1) borrowing and selling it now, or by (2) selling a firm promise (futures contract) to deliver it on a later date at the current (or a specified) price. In either case, the seller counts on buying the item at a cheaper price to return (with a fee) or deliver it. A short seller is a 'bear.' Also called selling short.

<sup>143</sup> Hedge fund is an aggressively managed portfolio of investments that uses advanced investment strategies such as leveraged, long, short and derivative positions in both domestic and international markets with the goal of generating high returns (either in an absolute sense or over a specified market benchmark).

Legally, hedge funds are most often set up as private investment partnerships that are open to a limited number of investors and require a very large initial minimum investment. Investments in hedge funds are illiquid as they often require investors keep their money in the fund for at least one year.

<sup>144</sup> Jonathan Laing, 'The Bear that Roared: How short-seller Jim Chanos helped expose Enron,' *Barron's*, January 28, 2002 at 18.

<sup>145</sup> *Ibid.*

Gradually, Enron's price began to fall, and that decline accelerated when Enron's then CEO Jeff Skilling mysteriously resigned without warning in August 2001. Still, at no point was Chanos aware of the full scope of Enron's fraud, including its extraordinary off-balance sheet liabilities.<sup>146</sup>

Was Chanos simply lucky? The growing evidence is to the contrary. Short sellers appear to have been highly successful at predicting accounting restatements. Researchers have concluded that short sellers can often see through accounting manipulations and profit extensively from this skill.<sup>147</sup>

If they can, why couldn't Arthur Andersen do the same? The critical point here is that Enron's problems were discoverable. Yet, they were not discovered by any of the firm's gatekeepers. Only those whose self-interest led them to search harder-first, the short sellers and, later, Dynegy-discovered the truth. If the truth was discoverable and if, across the board, the professional gatekeepers did not find it, the problems with gatekeepers seem serious.<sup>148</sup>

## **The WorldCom**

Even more than Enron, WorldCom was a skyrocket that soared and then plunged. Whereas Enron was a long-established and indeed dominant natural gas pipeline that sought to shape itself into a trading company, WorldCom started from scratch. Founded -on a shoestring-<sup>149</sup> in 1983 as a discount long-distance service provider (then known as LDDS-'Long Distance Discount Service'), it grew rapidly through a series of mergers, culminating in its 1998

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<sup>146</sup> The fullest statement of Chanos's investigation of Enron and its dubious financial statements is contained in his testimony before the House Committee on Energy and Commerce. See 'Lessons Learned from Enron's Collapse: Auditing the Accounting Industry,' Hearings Before the Committee on Energy and Commerce, House of Representatives, 107th Congress, 2nd Session, Serial No. 107-83 (February 6, 2002) at 71-75.

<sup>147</sup> See Jap Efendi, Michael R. Kinney and Edward P. Swanson, 'Can Short Sellers Predict Accounting Restatements?,' AAA 2005 FARS Meeting Paper, <http://ssrn.com/abstract=591361> (2005). These authors used a sample of 565 firms with restatement disclosures, matched them with a control group of firms not announcing a restatement, and compared the level of the short interest. They concluded that the shorts were able to predict and profit from their anticipation of a restatement. See also, Hemang Desai, Srinivasan Krishnamurthy, Kumar Venkataraman, 'Do Short Sellers Target firms 'With Poor Earnings Quality?':

<sup>148</sup> John C. Coffee Jr. Gatekeepers: The professions and corporate governance ,p 36

<sup>149</sup> If you do something in a shoestring, you do it with a small amount of money.

\$40 billion merger with MCI Communications Corp. Much of the key to WorldCom's success was its apparent efficiency, which baffled its major rivals, AT&T and Sprint. Somehow WorldCom consistently reported a lower ratio of certain key expenses, known as 'line costs', to its overall revenues than did any of its competitors.<sup>150</sup> 'Line costs' are essentially transmission costs paid to other service providers for the use or the right to use their lines. Line costs were WorldCom's largest single expense and accounted for roughly half of its expenses. They were sufficiently material to be reported on a separate line of its financial statements.<sup>151</sup> This apparent efficiency impressed Wall Street and kept WorldCom's stock price high, allowing it to acquire seemingly less efficient rivals in a rapidly consolidating industry.

While impressive, WorldCom's low ratio of line costs to revenues was largely illusory. Ultimately, the key fraud in WorldCom involved the decision of Scott Sullivan, WorldCom's chief financial officer, to cease expensing line costs and instead capitalize them-in order to keep the ratio of line costs to revenues low.

When WorldCom reported its discovery in June of 2002 that line costs payments had been improperly capitalized, it acknowledged that but for the capitalization of over \$3.8 billion in such costs in 2001 and the first quarter of 2002, it would have reported a loss for such periods.<sup>152</sup> Within a month, it was forced into bankruptcy.

The capitalization of line costs was not the first or the only irregularity in WorldCom's financial statements relating to recognition of expenses. In fact, when a full restatement of WorldCom's financial statements was completed in 2004, some \$76 billion in adjustments were recognized, which reduced WorldCom's net equity from approximately \$50 billion to approximately minus \$20 billion.<sup>153</sup> The point then is that the WorldCom fraud was not a one-shot

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<sup>150</sup> WorldCom's ratio of line costs to revenues was 43%, whereas AT&T's equivalent ratio appears to have been 46.8% and Sprint's was 53.8%. See *In re WorldCom Securities Litig.*, 2004 US. Dist. LEXIS 25155 at \*137 n 47.

<sup>151</sup> These facts are summarized in *In re WorldCom Securities Litig.*, 2004 US. Dist. Lexis 25155 (S.D.N.Y. Dec. 15,2004) at \*19 to \*20.

<sup>152</sup> *Ibid.* at \*6.

<sup>153</sup> *Ibid.*

transaction engaged in by a reckless chief financial officer. Rather, as the federal court hearing the private securities litigation concerning WorldCom.

Before capitalizing the line costs in 2001, WorldCom had engaged in other strategies to reduce the apparent magnitude of its line costs.<sup>154</sup>

This is important because if the fraud at WorldCom had been limited to a single occasion, it would be hard to fault WorldCom's gatekeepers, and all the blame would fall on its chief financial officer and his staff. But, in fact, as this court further found, WorldCom had cheated earlier; releasing 'reserves or accruals that had been set aside to cover anticipated costs, and used them to offset line costs.'<sup>155</sup>

In short, in a rapidly consolidating industry, WorldCom was able to acquire rival long-distance service providers, rather than be acquired by them, because it manipulated its reporting of expenses to give it the image of greater efficiency and thereby inflate its stock price.<sup>156</sup>

Why was WorldCom so willing to take these risks and use an accounting treatment that was not even colorably defensible? Here, it is necessary to introduce WorldCom's chief executive, and controlling person, Bernhard Ebbers. Ebbers became WorldCom's chief executive virtually at its outset in 1985 and as a result owned a significant percentage of the company's stock. A true believer in WorldCom, he never diversified his portfolio by selling significant amounts of his WorldCom stock. Rather, most of his wealth remained in WorldCom, and his personal net worth rose and fell with WorldCom's stock price. However, Ebbers did invest heavily in a variety of other private and illiquid enterprises. He did so by pledging all his WorldCom stock to secure loans that he used to acquire private businesses and fund their operations. Most of the loans to Ebbers were made by affiliates of

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<sup>154</sup> Ibid. at \*21.

<sup>155</sup> Ibid.

<sup>156</sup> John C. Coffee Jr. Gatekeepers: The professions and corporate governance ,p 38.

Citicorp and Bank of America, each of whom were also major underwriters.<sup>157</sup>

As a result, when WorldCom's stock price began to fall in 2000, Ebbers faced a personal crisis. Because his WorldCom stock was pledged to secure loans to him, and because the value of this collateral had just shrunk, Ebbers received a margin call from Bank of America in the Fall of 2000. Having no additional shares to pledge, he would be forced to sell his World Com stock in significant quantities, which in turn would drive World Com's price down even further-unless he could obtain financing elsewhere. He solved his predicament (at least temporarily) by convincing the WorldCom board of directors to extend him a \$50 million loan in September 2000. The board's decision has been widely criticized as irresponsible, but the board evidently felt that equivalent sales by Ebbers would cause WorldCom's stock price to crater.<sup>158</sup>

In a sense, they were right. When Ebbers was faced with additional margin calls later in 2000, and when the WorldCom board refused to extend further loans to him, he sold some three million WorldCom shares, and WorldCom's stock price dropped 8 percent on the disclosure of his sales.<sup>159</sup> Following this decline and additional margin calls on Ebbers, the WorldCom board was induced to make additional loans and guarantees to Ebbers, which by May 2001 had reach a grand total of \$250 million.<sup>160</sup>

Thus, throughout 2000 and 2001, Ebbers simply could not afford to have WorldCom fail to make its predicted earnings or to lower substantially its earnings forecasts for fear that its stock price would decline and trigger additional margin calls. Nor could he sell much WorldCom stock, as the market would perceive that to be a bail-out and would drop the price faster than he could unload his stock. His position was desperate.<sup>161</sup>

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<sup>157</sup> Ibid at 38.

<sup>158</sup> Ibid.

<sup>159</sup> These facts are summarized in "In re WorldCom Securities Litig", 2004 US. Dist. Lexis 25155 (S.D.N.Y. Dec. 15,2004) at \*17.

<sup>160</sup> Ibid. at \*18.

<sup>161</sup> Ibid at 39.

Small wonder then that WorldCom's financial reporting was manipulated. But if the motive for fraud was clear, the question again arises: where were the gatekeepers? After all, far more than Enron, WorldCom was widely recognized to be a high risk client. Its meteoric rise from obscurity through merger after merger fits exactly the profile of a company whose financial statements may conceal more than they reveal. Arthur Andersen, recognizing this, internally assigned WorldCom its highest risk rating.<sup>162</sup>

### **How Was the WorldCom Fraud Discovered?**

The answer is simple, but surprising: the company's internal auditors detected the fraud. World Com's capitalization of line costs began in April 2001 and continued through the first quarter of 2002.<sup>163</sup> In May 2002, when WorldCom's internal audit team began its 2002 audit of capital expenditures, it was confused by a new term 'prepaid capacity' that WorldCom managers used to explain the differences between two sets of schedules. The internal auditors had never previously heard this term, which referred to the capital account to which line costs were being transferred. In response, one member of the team-Eugene Morris-used a new software tool to determine how this 'prepaid capacity' account had been created and 'was able to uncover the transfer of line costs to capital accounts in a matter of hours.'<sup>164</sup> In fact, this discovery must have surprised senior management because the internal audit team had not been given access to the corporation's general ledger (precisely to prevent such detection). Thus, the software tool proved critical. But .Morse testified that those having access to the WorldCom general ledger 'could also have uncovered the fraud.'<sup>165</sup> The bottom line then is that internal auditors quickly discovered what the outside auditors (who did have access to the general ledger) could not find for over a year. Interestingly, this story parallels

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<sup>162</sup> Andersen's audit team gave WorldCom its highest risk rating, recognizing that 'there was a "significant" risk of misstatements in the WorldCom financial statements ....' See *In re WorldCom Sec. Litig.*, 2005 U.S. Dist. Lexis 710, (S.D.N.Y. January 18,2005).

<sup>163</sup> The capitalization of line costs began on April 20, 2001 when some \$771 million was transferred from an expense account to a capital account. Days later, the first due diligence conference call was held on April 30. at 642.

<sup>164</sup> Ibid.

<sup>165</sup> Ibid. at 642 n 15

a similar incident at Enron where the internal audit team uncovered unauthorized oil trading, which ultimately cost Enron millions in losses, only to see their investigation handed over to Andersen, which whitewashed the events in question.<sup>166</sup>

In fairness, there is no evidence that Andersen knew of the fraudulent capitalization. Nor is there any hard evidence that any other gatekeeper (even Mr. Grubman) was willfully blind, but there is evidence that the gatekeepers did not investigate as closely as they might have, had they been better motivated. In particular, it is revealing that Scott Sullivan, WorldCom's CFO, was confident that he could deceive his outside auditors, but yet backed away from a proposed merger with Verizon, because he feared that Verizon would conduct serious due diligence efforts that would discover his accounting irregularities.<sup>167</sup> Collectively, the gatekeepers at both Enron and World Com missed clues that more motivated actors-short sellers, Dynergy, and possibly Verizon-were able (or would have been able) to find. Their failings involved sins of omission, not commission. When a clear violation was placed before them, they did respond (for example, Andersen did require a restatement at Enron when it was shown that the '3 percent rule' governing special purpose entities had been violated). Yet, even though Andersen could accurately predict how a fraud would most likely occur at WorldCom,<sup>168</sup> it did not see fit to confirm its own hypothesis by inquiring further.

In short, to the extent that Enron and WorldCom are representative, the gatekeepers in these cases appear to have worn blinders. Although not active participants in fraud, they were indifferent watchdogs who conducted largely perfunctory investigations.

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<sup>166</sup> See text and notes at nn 19 to 20 above.

<sup>167</sup> Scott Sullivan has recently testified at the criminal trial of Bernhard Ebbers that he advised Ebbers to call off merger talks with Verizon 'because if they proceeded further, World Com would have to show Verizon financial documents that could have revealed illegal accounting changes.' See Ken Belson, 'Key Witness On WorldCom Tells Jury He Broke Law,' *New York Times*, February 18, 2005 at C-3.

<sup>168</sup> See text and notes at n 102 to 105 above.

## **Royal Ahold:**

Royal Ahold is a Dutch retail group with international interests, and is the third largest food retailer in the world. The financial scandal surrounding it unfolded during 2003 and was referred to as "Europe's Enron". In February 2003, Royal Ahold announced that it had overstated the earnings of US subsidiary by \$500 million. Royal Ahold's chief executive officer and chief financial officer resigned immediately.

There were a few warning signs at Royal Ahold before the further problems became apparent in 2003, the chief executive officer was dominant and had a long service agreement, directors remuneration was spiraling upwards, its management had a poor reputation for their relations with investors, in 2001 Royal Ahold introduced a voting system for voting on board members which meant that it was effectively impossible for shareholders to oppose the board's nomination. These were all signs of a company in which the directors may have been acting in a way that detrimental to the shareholders. Royal Ahold is now trying to rebuild its reputation and restore the trust of its investors. To that end, it has made sweeping changes to its corporate governance including the appointment of new independent board members and whistle-blower's program.<sup>169</sup>

## **Parmalat**

Parmalat, an Italian company specializing in long-life milk, was founded by Calisto Tanzi. It seemed to be a marvelous success story although, as it expanded by acquiring more companies, its debt increased and, in late 2003, Parmalat had difficulty making a bond payment despite the fact that it was supposed to have a large cash reserve. After various investigations had been carried out, it transpired that the large cash reserves were non-existent and Parmalat went into administration. With debts estimated at £10bn, Parmalat has also earned itself the name of 'Europe's Enron'.

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<sup>169</sup> Ibid at 3.

Calisto Tanzi was a central figure in one of Europe's largest fraud trials started during 2005. He was accused of providing false accounting information and misleading the Italian stock-market regulator.<sup>170</sup>

## **HIH**

HIH was one of Australia's largest insurers and became one of its biggest corporate collapses with debts of over \$A5bn. It went into liquidation early in 2001 as a result of having sold insurance too cheaply, combined with not having put enough aside to meet its future commitments. The situation was made worse by the fact that, during the 1990s, it had expanded by acquiring other insurance businesses for which it over-paid. The Australian government has had to underwrite many of the failed policies, an expensive exercise.

HIH highlights the complexities of the insurance business and what can happen when there is a lack of due diligence. Various board members have been brought to court on charges including giving information with the intention of deceiving other board members and the company's auditor.<sup>171</sup>

## **China Aviation Oil**

China Aviation Oil (Singapore) is the subsidiary of a Chinese state-owned holding company, China Aviation Oil Holding Company. In late 2004, it suffered near-collapse after losing some \$US550 million on speculative oil derivatives trading. In Singapore, this seemed to echo the case of almost a decade earlier when Nick Leeson's trading had similarly caused tremendous losses to Barings Bank. This time, it was the Chief Executive Officer CEO, Chen Jiulin, who was criticized for carrying on with these trades even though losses had crystallized on some of them. Chen Jiulin was arrested and investigations into suspected violations of securities laws are under way.<sup>172</sup>

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<sup>170</sup> Ibid.

<sup>171</sup> Ibid at 3-4.

<sup>172</sup> Ibid at 4.

The six examples above of high-profile corporate collapses and scandals in the UK, USA, Europe, Australia, and Singapore have had, and continue to have, international implications, and would seem to illustrate a number of shortcomings in the way that the companies were run and managed.

1. Barings appears to highlight the lack of effective internal controls and the folly of trusting one employee without adequate supervision and understanding of his activities. But the main reasons for the fall of Barings and the Leeson affair can be summarized as:
  - On the part of Nick Leeson: unethical behavior, trading unlawfully.
  - On the part of Barings' senior management: lack of segregation of Nick Leeson's duties; lack of supervision: failure to conduct further investigation (audits not thorough enough and evident inefficiencies on the part of the auditor)
2. Enron appears to highlight a basic need to ensure, as far as possible, that directors are people of integrity and act honestly, that external auditors must be able to ask searching questions unfettered by the need to consider the potential loss of large audit/accounting fees, and the contribution that might be made by independent directors on boards and committees who question intelligently and insightfully.
3. Royal Ahold appears to highlight what may happen if the involvement of investors is suppressed a corporate structure that had empowered a dominant chief executive officer, that had enabled the directors to have overgenerous remuneration packages, and that ultimately led to Ahold's demise when income was found to be overstated.
4. Parmalat appears to highlight some of the weaknesses that may exist in family owned firms where members of the family take a dominant role across the board structure as a whole. In Parmalat's case, the board lacked independence as of the thirteen directors, only three were independent. This had a knock-on effect on the composition of the various board committees where independent directors were a minority

rather than a majority. There was also a lack of timely disclosure of information.

5. HIH appears to highlight some of the dangers inherent in the insurance business and the complexities of the risks involved. A risk management system appropriate to the organization, together with relevant disclosure of the risks involved and how they are managed, is clearly of fundamental importance. Directors have a key role to play in ensuring that such a system is in place and that the board as a whole is kept informed of the process, as should be the shareholders via the annual report disclosures.
6. China Aviation Oil appears to highlight that some Chinese state-owned subsidiaries, including those operating outside China, may have a poor level of corporate governance. CEOs may be all-powerful and able to take decisions that are not in the best interests of the company and its shareholders. Limited disclosure may exacerbate the situation.

This brings us back to our original questions about corporate governance failures such as those mentioned above. Why have such collapses occurred? What might be done to prevent such collapses happening again? How can investor confidence be restored? The answers to these questions are all linked to corporate governance.<sup>173</sup>

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<sup>173</sup> Ibid at 5.

## Chapter Six: Conclusion

Corporate Governance as a topic has attracted many scholars and professionals. It has been addressed widely in different countries over the past two decades. This shows the significance of the corporate governance and the way it affects the process of investment and development in the countries. Countries are still taking steps to develop corporate governance codes.

Further, there is no definition of Corporate Governance that could be regarded or described as a comprehensive one, but definitions of Corporate Governance could be illustrated as to what has been adopted by different intellectual schools in the specified country. Moreover, It is clear that there is no particular system for the good corporate governance that it could be applied in all countries and on all enterprises and that there is still a gap of application concerning the Corporate Governance standards among the countries, but most importantly, it is plain that the lack of good Corporate Governance will cause the collapses that we are seeing today on the twenty first century which led eventually to the loss of deposits, pensions, and sometimes lives on the less development countries due to the lack of transparency. However, promoting transparency, independency, fairness, justice and accountability are things what corporate governance is all about.

In addition, it has been examined how corporate governance basic attributes are interlinked with each other in a way that shows that no existence of one attribute in the absence of the other. It have been seen also that there are some certain global attributes that gradually rose like fairness, transparency, responsibility and accountability, and that they basically constitute the essence of corporate governance.

Finally, the thesis has discussed whether there are corporate governance standards in Sudan or not. It has been noticed also the growth of the Corporate Governance in the United Kingdom in the light of the financial crisis that hit the world over the past years, and how this could be compared with

Sudan. It was found that no effective corporate governance measures could be implied from the Sudanese Companies Act 1925, and that the said Act need to be amended since it's a procedural Act which did not address the issue of corporate governance at all. But, this gap was filled as the Sudan judiciary in few cases relied on the English judicial precedents that handled the issues of the director's duties and shareholders rights. This shows that relying on the English precedents would be practically helpful and English precedents could always be referred to by the Sudanese courts where there is no contradiction. However, three aspects should be taken into consideration when addressing the issue of corporate governance in the Companies Act 1925:

1. Upgrading and developing the Act to comply with the current commercial and economic changes.
2. Embodying the unfair prejudice and derivative action in the Act so there could be remedies for the breach of the directors' duties or where there is oppressive conduct on the minority.
3. Taking into account certain provisions in the English Company Act 2006 particularly those relating to the duties of directors and shareholder rights.
4. When amendments and changes are made to the Companies Act in Sudan, then it is the time to train judges and even lawyers on the company law and companies major cases in the English courts that have laid down the main principles in companies.

There are also provisions on the Khartoum Stock Exchange Market Act 1994 that could fill some gaps on the legislations. Furthermore, the Act should ensure transparency, integrity, and justice as well as the development of the investment awareness. Other Stock markets has provided for the listing of the financial reports. Publications and explanatory regulations are issued from time to time to organize the transactions inside the market. Therefore, a code of corporate governance should be enacted in Sudan to organize the operations and transactions of the public listing companies. Prosperity of investments depends on the protection of cash which could be approached by

precise, accurate and strict observance and control.

On the other side, the only corporate governance guidelines in Sudan are referred to only in one of the circulars issued by the Central Bank of Sudan. The circular has listed the objectives of good corporate governance. Moreover, the circular stated among other things, the elements of corporate governance and the proposed roles of the board of directors and their duties which considered a guarantee in the financial sector. Most importantly, the circular has called for independency and knowledge to be exercised inside the board.

Therefore, the absence of corporate governance may lead to collapses like Enron and might be worse, particularly on the time that all the developed countries were gathered to discuss the implications of the current financial crisis which has been described as the most drastic waves that ever hit the international economy since the eighties.

Finally, corporate governance becomes a necessity and not an accessory for the corporations. It has increasingly become a main component for stability of the companies, economics and individuals. The flow of cash and investments will basically depend on how corporate governance standards are observed in the companies and to what extent shareholders, stakeholders and other people who are closely connected with the company's affairs are satisfied with the company performance and that the board of directors is accountable for its actions?

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