

Corporate Governance Practice In the GCC:
Kuwait As A Case Study

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Abstract

Corporate governance practice has recently become an important topic around the world and specifically within the emerging stock markets in order to avoid expropriation by corporate management at the expense of minority shareholders. Although corporate governance is considered to be tremendously important in many countries, whether developed or developing, corporate governance does not exist in Kuwait as a mean of shareholder protection. This thesis intends to provide a regulatory analysis to laws and regulations that should be implemented to regulate corporate governance practice in Kuwait in private companies and in the State-Owned Enterprises.

The second chapter draws a theoretical framework of corporate governance. These theories must be discussed, because this thesis is the first to address corporate governance from a legal perspective and will help Kuwaiti practitioners and those involved in corporate governance practice to gain a better and more comprehensive understanding of and appreciation for effective corporate governance.

The third chapter provides an overview of the corporate governance practice in the emerging markets.

The fourth chapter presents the characteristics of a corporate culture to lay the groundwork for adopting corporate governance that will fit within the Kuwaiti culture.

The fifth chapter offers an assessment of the institutional settings necessary to establish a sound corporate governance system in Kuwait, including legal and political institutions.

The sixth chapter will examine corporate governance practice in the State-Owned Enterprises in Kuwait.

The seventh chapter focuses on the best practices of corporate governance and the protection of shareholders in companies listed in the Kuwait Stock Exchange (KSE) by analysing the regulations and laws that apply to the KSE and that should relate to corporate governance.

Chapter eight offers recommendations for corporate governance reform that derive from the assessment made in this thesis in both public and private sectors in Kuwait.

Finally, chapter nine provides the general conclusion of the thesis and the contribution of this study.

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Chapter One: Introduction:

1.1 Introduction:

Recently, the corporate governance concept has become a major issue in the corporate practices of developed and developing countries alike. The importance of corporate governance emerged after several corporate collapses in the United States and Europe.¹ Moreover, such corporate scandals were attributed mainly to the failure of the corporate governance practice in such corporations.² These corporate scandals were the impetus for the discussion about the best practice of corporate governance.

A number of international organizations have introduced principles and guidelines for the best practice of corporate governance. For instance, in the international scope, the Organization for Economic Co-operation and Development (OECD) introduced principles of corporate governance in 1999. These principles were revised in 2004 to be compatible with financial and economic development around the world.³

Further, many countries, especially developed countries, have introduced a number of laws, regulations and enforcement mechanisms regarding corporate governance. Such legal infrastructure aims at achieving a variety of goals, such as ensuring a proper level of protection for investors by providing appropriate transparency with regard to financial and non-financial issues to enable shareholders to make appropriate decisions.

The situation in developing countries is different, since factors exist there that slow the improvement of corporate governance. For instance, the dominance of government ownership of the national economy is an obstacle to enhancing corporate governance due to the different nature of state-owned enterprises as compared to privately owned companies.

¹ Examples include the scandals of Enron and WorldCom in the United States and the collapse of Parmalat in Europe.

² See Salacuse, Jeswald W., Corporate Governance in the UNECE Region, Paper commissioned for the *Economic Survey of Europe, 2003 No. 1* by the secretariat of the United Nations Economic Commission for Europe. UN/ECE, Geneva, December 2002.

³ The OECD Principles of Corporate Governance (1999) and (2004), available at: www.oecd.org.

Moreover, because family businesses and concentrated ownership of companies are prevalent in emerging countries, stringent laws and regulations that aim at protecting the other shareholders are not applied in such countries. There, a relationship based system is dominant, which hinders new laws or regulations that would reveal malpractice by management, because a significant number of the companies are controlled by the major shareholder.

This is the case in Kuwait, where State ownership is predominant in addition to the fact that family businesses are also significant. In other words, concentrated ownership is a characteristic of the corporate ownership structure. Moreover, the legal infrastructure of the financial sector in Kuwait is inefficient. Although Kuwait shares most of the commercial characteristics of the other countries of the Gulf Co-operation Council (GCC),⁴ it is the only country that still has no corporate governance code.

The other GCC countries have appreciated the importance of corporate governance and proper protection for shareholders and other stakeholders by introducing the corporate governance code. In particular, Kuwait is in constant competition with the other GCC countries to be the best financial center that is able to attract foreign capital. Such competition entails first that there are laws and regulations that ensure appropriate protection for investors. Such protection could be achieved by implementing modern financial laws and regulations, such as a code of corporate governance, that enhance transparency and the accountability of company managers and that protect shareholder rights.

Accordingly, to achieve the goal of this study, the thesis will be organized as follows. Chapter two will discuss corporate governance definitions and theories to explain the theoretical framework of the concept of corporate governance before its application especially in Kuwait, where corporate governance is still absent. Therefore, it is important to mention the main theories that have been involved in the development of the

⁴ The GCC Countries are, the State of Kuwait, the Kingdom of Saudi Arabia, the Kingdom of Bahrain, the United Arab of Emirates, the State of Qatar and the Sultanate of Oman.

corporate governance practices, such as the agency, the stakeholder and the stewardship theories. Moreover, the definitions of corporate governance will be considered in this chapter, since corporate governance has a number of definitions and each theory has its own definition.⁵

Chapter three will consider the aspects of the corporate governance system in the developing countries, because Kuwait is considered one of the developing countries for the purposes of this thesis. Corporate governance in the developing countries differs from corporate governance in the developed countries. The difference can be attributed to the financial structures of these countries.⁶

Consequently, in the developing countries, for instance, concentrated ownership of the companies is prevalent, while in some prominent developed countries such as US and UK the dispersed ownership is predominant. In turn, each type of corporate ownership entails a different corporate governance system to achieve its object. Thus, in this chapter, the aspects of the corporate governance in developing countries will be mentioned as a point of focus for the Kuwaiti policymaker when it decides to establish corporate governance in Kuwait. In other words, this chapter will pave the way for the Kuwaiti policymaker to choose the most appropriate corporate governance system for Kuwait in light of the experiences of the other countries that share many aspects that relate to corporate governance in Kuwait.

Chapter four will discuss the nature of the Kuwaiti corporate culture, as it is important to understand such aspects of any economy before deciding the most suitable corporate governance system. This chapter will identify the specific nature of the Kuwaiti economy, which is important to shape the corporate governance system in Kuwait. Kuwait's economy enjoys a number of aspects that should be taken into account, such as

⁵ See Solomon Jill & Solomon Aris, *Corporate Governance and Accountability*, England, John Wiley & Sons Ltd, 2004, pp: 12-15. Hereinafter Solomon J & A.

⁶ See Gill, Amar, Corporate Governance Issues and Returns in Emerging Markets, in Robert E. Litan, Michael Pomerleano and V. Sundarajan (eds), *The Future of Domestic Capital Markets in Developing Countries*, Washington, Brookings Institute Press, 2003, at p: 313. Hereinafter Amar Gill.

the proliferation of concentrated corporate ownership and the predominance of family businesses.

Moreover, the chapter will explore Kuwait's status as a rentier state and the significance of that status in terms of establishing a corporate governance system in Kuwait. Its status as a rentier state might hinder the implementation of a sound corporate governance system.

Chapter five will explore the effectiveness of corporate governance political and legal institutions that are pre-requisites to establishing a sound corporate governance system in Kuwait. Many opinions have been expressed with respect to corporate governance and its importance. For example, it has been argued that corporate governance institutions are not similar in all countries and that the circumstances in each country shape the country's own corporate governance system. These circumstances include the country's culture, history and economic nature.⁷ Consequently, the political system of Kuwait will be examined to determine the possibility of establishing a sound corporate governance system.

Moreover, the legal institutions that should exist to ensure the proper application of corporate governance in Kuwait will be examined, such as the extent to which the judiciary in Kuwait is independent. In addition, the legal origin of Kuwait's legal system will be explored because of its important role in shaping the corporate governance system.⁸

The last legal element that will be examined in this chapter is the Commercial Companies Law No. 1960/15, which will be analyzed in terms of the issues that relate to

⁷ See Clarke, Thomas, *International Corporate Governance, A Comparative Approach*, Routledge, London, 2007, pp 85-88.

⁸ See Yuwa Wei, *Comparative Corporate Governance, A Chinese Perspective*, Kluwer Law International, London, 2003, at p. 182.

corporate governance and the protection of shareholders. This law is important to corporate governance, because it pertains to the main corporate governance issues.⁹

The economy in Kuwait is controlled by the government, as its ownership is significant. In particular, the government in Kuwait owns the oil sector, because the revenue derived from the sale of oil constitutes approximately 90% of the country's public budget. Thus, chapter six will explore the current practice of corporate governance in the State-Owned Enterprises in Kuwait. Moreover, this chapter will consider the challenges and opportunities to establish a sound corporate governance system to be applied to the SOEs in Kuwait, which is important for such enterprises for a number of reasons.

First, as mentioned above, the SOEs in Kuwait, especially those in the oil sector, control the backbone of the state's annual budget. Therefore, these enterprises should ensure the best corporate practices to maintain their sustained development. Second, because Kuwait intends to privatize a number of the public sector bodies, it is imperative that these bodies employ the best practice of corporate governance so that their price will be positively affected and investors will be encouraged to participate in the privatization process.

Furthermore, this chapter will explore the role of a variety of institutions in Kuwait that might participate significantly in establishing the best practice of corporate governance in the SOEs, such as the State Audit Bureau and the Public Funds Protection Law No. 1/1993.¹⁰

The aim of chapter seven is to investigate the current regulatory framework of the Kuwait Stock Exchange (KSE) and to concentrate especially on the issue of whether the existing rules of the KSE contain corporate governance that ensure the proper protection of investors. Consequently, this chapter will discuss the corporate governance situation

⁹ See Kraakman, Davies, Hansmann, Hertig, Hopt, Kanda and Rock, *The Anatomy of Corporate Law, A Comparative and Functional Approach*, 2004, Oxford University Press, UK, at p. 33.

¹⁰ The Public Funds Protection Law in Kuwait No. 1/1993.

within the financial crisis (2008). This chapter will also discuss the historical development of the KSE legal framework. Moreover, the existing rules that should relate to corporate governance and to shareholder protections will be discussed, such as the disclosure and transparency framework contained in KSE regulations.

Furthermore, this chapter will also compare developed and developing countries in their efforts to achieve optimal results with regard to protecting shareholders in the capital markets. In particular, Kuwait will be compared with the other GCC countries because of the similarities between them and because all of the other GCC countries have established their own corporate governance codes.

Chapter eight will focus on recommendations for the policymaker in Kuwait to facilitate the establishment of a corporate governance code for shareholding companies. Furthermore, the suggestion will be made to create new institutions that will foster the sound application of corporate governance in Kuwait. These recommendations will be compatible with the economic, legal and social conditions in Kuwait to avoid an inapplicable corporate governance system. In sum, the chapter will recommend changes to the Commercial Companies Law 15/1960 and the KSE regulations and the establishment of new institutions that facilitate the sound application of corporate governance.

1.2 The Research Question

This thesis will investigate whether corporate governance practices in Kuwait meet international standards of corporate governance and, if not, the main obstacles to implementing them. Kuwait has no comprehensive corporate governance code. Therefore, the investigation of the corporate governance issues will include evaluating a number of laws and regulations in Kuwait. Further, the thesis will investigate the main obstacles facing Kuwait as a developing country in developing and improving its corporate governance regime.

1.3 The Importance and The Aims of The Study

The initial hypothesis of this thesis is that corporate governance practices in Kuwait do not meet international standards and that corporate governance is not widely recognized in Kuwait. The main obstacles that Kuwait faces in embracing corporate governance are multifaceted. They include human-resources problems, social objections and the lack of a proper legal infrastructure.

Furthermore, the thesis will recommend for the policymakers the most appropriate corporate governance measures to be adopted or modified within the legal infrastructure of Kuwait. These will include recommendations for the companies' law in Kuwait and the financial regulations of the KSE. Moreover, the establishment of new institutions will be recommended that would enhance the application of corporate governance in Kuwait and would, in turn, improve shareholder protection while increasing investor confidence in the stock market.

Accordingly, this thesis is the first academic study of corporate governance in Kuwait from a legal perspective. Thus, this study will contribute significantly when Kuwait decides to establish its own corporate governance regime. Moreover, the importance of this study will emerge from the need for Kuwait to cope with other countries, since all of

the other GCC countries in the area have established their own corporate governance codes.

As a result, these countries provide better investor protection than Kuwait. Kuwait should pay attention to corporate governance as a system that will attract capital whether locally or internationally. In particular, this study will pave the way for the policymakers in the Kuwaiti government and the parliament to adapt regulations that provide for corporate governance to encourage investors to invest in the listed companies and to increase confidence in the stock market through regulations that provide shareholder protection.

Internationally, this study will contribute to the improvement of the legal infrastructure in Kuwait, which will provide greater transparency and clearer accountability for the management of Kuwaiti companies. In other words, the object of this study is to develop the laws and regulations that are important to establishing proper protection for investors in Kuwait whether they be foreign or domestic investors. Attracting international investors is especially important so that they may participate in the privatization process recently undertaken in Kuwait. The Privatization Law has been introduced that intends to privatize a number of state-owned enterprises and public authorities.

Consequently, a well-established corporate governance regime in Kuwait would make international investors more confident about investing in Kuwait, since the proper application of corporate governance will ensure that investors have appropriate protection. A sound corporate governance regime will encourage foreign capital to flow into Kuwait.

1.4 Research Methodology:

In this thesis, a critical analysis will be made of the laws and regulations that should relate to the practice of corporate governance in Kuwait. Moreover, possible reform will be suggested to establish a sound corporate governance system in Kuwait that will ensure the proper protection of local and foreign investors. Furthermore, comparative methodology will be used to achieve the objective of this study. One of the advantages of the comparative methodology is that it will “identify solutions to specific or novel legal problems already encountered in other jurisdictions”.¹¹

Furthermore, policymakers around the world appreciate the role of comparative methodology in developing laws, because one of the aims of comparative methodology is to enhance the development of laws.¹² Moreover, comparative methodology is aimed at criticizing existing laws as well as improving the efficiency of the law in general through reform.¹³

Therefore, this thesis will use comparative methodology to achieve its objectives. The comparison will be made within categories of jurisdictions. The first jurisdiction category will be the comparison of corporate governance and other relevant aspects of developed countries, such as the United States and the United Kingdom, due to their development of the issue under consideration. The other comparison category will be made with the other GCC countries for several reasons.

The first reason is that these countries are largely similar to Kuwait, although they are not identical. The benefit of comparing the corporate governance practice in Kuwait with the other GCC countries is highly important to suggest the proper reform for the laws that should relate to the application of corporate governance, especially since all of the other

¹¹ See Hutchinson, Terry, *Researching and Writing in Law*, Second Edition, Sydney, Lawbook Co, 2006, at p:106.

¹² See Hill, Jonathan, ‘Comparative Law, Law Reform and Legal Theory’, *Oxford Journal of Legal Studies*, 1989, Vol: 9, at p: 102, pp: 101-115.

¹³ See Zweigert, Konrad, & Kotz, Hein, *Introduction To Comparative Law*, Third Edition, United States, Oxford University Press, 1998, at p: 34.

GCC countries have already established their own code for corporate governance. Moreover, since all of the GCC countries share similar cultures and economies, Kuwait might benefit from the experience of the other GCC countries in terms of their implementation of corporate governance measures.

1.5 The Previous Studies:

Corporate governance as a mean of enhancing the protection of shareholders has been a main area of research during the last three decades, as each period differs from the others. The 1970s scholars discussed and debated the role of government in requiring managers and boards to be responsible. Later in the 1980s, market control mechanisms, such as the takeover, and the market control movement were seen as the best methods of corporate governance. In the 1990s, the activism of institutional investors emerged as a way to hold managers and boards responsible.

Ultimately, recent discussions have focused on the convergence of a global corporate governance regime.

The available literature on corporate governance in the GCC states is minimal when compared to the existing literature on corporate governance practices in the developed countries, especially in the United States.¹⁴ There is practically no available literature on Kuwait. This researcher has found no literature about corporate governance in Kuwait at least in Western writings.

Moreover, Arabic studies about corporate governance in Kuwait are minimal. Therefore, to this researcher's knowledge, this thesis is the first academic study that discusses corporate governance in Kuwait from a legal perspective.

¹⁴ Charles C. Okeahalam and Oludele A. Akinboade, *A Review of Corporate Governance in Africa: Literature, Issues and Challenges*, paper prepared for the Global Corporate Governance Forum 15 June 2003.

Chapter Two: Theoretical Framework of Corporate Governance

2.1 Introduction

The definition of corporate governance differs from country to country and from school to school,¹⁵ as each corporate system or theory has its own definition. The corporate governance definitions vary in terms of the accountability that the corporation should discharge, and to whom the accountability should be discharged.

Under a narrow definition of corporate governance, the corporation is only accountable to its shareholders. On the other hand, under a wider or a broad definition, the corporation is accountable to all its stakeholders, including, for example, its employees, creditors, the local communities, and the environment in some countries.¹⁶ In this chapter, the focus will be on the different definitions of corporate governance, taking into account the narrow and the broad definitions.

Several theories have participated in the evolvement of the corporate governance system.¹⁷ These theories are varies from multiple approaches; for instance, they differ because each approach considers different objectives for the corporation. Or the differences emerged from the identification of the managers from different ways, such as the agency theory considered the managers as agent for the principals the shareholders, whereas the stewardship theory have seen the managers as stewards of the shareholders wealth in the corporations.

Furthermore, in regard to the corporation's responsibility, the theories are different; the agency theory claims that the corporation's responsibilities must be discharged only toward its shareholders, whereas the stakeholder theory requires the corporation to discharge its responsibilities to all stakeholders rather than only its shareholders.

¹⁵ See Solomon J & A. *Supra* note: 5

¹⁶ *Ibid.*

¹⁷ See Mallin, Christine A., *Corporate Governance*, Second Edition (UK: University Oxford Press, 2007), at p.11. Hereinafter Mallin C.

Moreover, these theories analyze the same dilemmas in different ways.¹⁸ It is worth emphasizing that not all of the theories are suitable for every country.¹⁹ In other words, the theory to be applied in any country is dependent upon, among other things, the legal system and the economic structure.

In this chapter, an attempt will be made to analyze the three theories that have contributed to the evolution of the corporate governance theoretical framework, agency theory, stakeholder theory and stewardship theory.

2.2 What is Corporate Governance?

Corporate governance as system can provide the corporation with a sufficient degree of independence and efficiency to enable it to operate with a clear understanding and implementation of rights and responsibilities. There is yet no universally accepted or definite meaning of corporate governance. Many scholars and organizations have their own definition. Each such definition has been founded according to the understanding or the interests of the person provided the definition.²⁰

Some observers find the concept of corporate governance difficult to define.²¹ The differences among the definitions of the concept of corporate governance can be slight or fundamental.²²

Moreover, the definitions of corporate governance range between narrow and broad concepts. In other words, one definition of corporate governance focuses only upon the control and management of the corporation. Broader definitions, on the other hand, encompass such additional elements as the development of the shareholders' value and

¹⁸ See Solomon J & A supra note 5, at p. 16.

¹⁹ See Mallin C, supra note 17, at p. 11.

²⁰ See Dr. Spedding Linda S, *Due Diligence and Corporate Governance*, (UK: LexisNexis, 2004), p. 256.

²¹ See Du Plessis Jean Jacques, McConvill James, Bagaric Mirko, *Principles of Contemporary Corporate Governance* (United States of America: Cambridge University Press, 2005), at p.1.

²² *Ibid*, at p.3.

the protection of the stakeholders, as well as the business corporation's social responsibilities.²³

In turn, when considering a suitable definition of corporate governance, the policymaker, a legislator, or a practitioner must first give a consideration to the conditions of each country from many aspects, including the country's economy, its legal framework, and its society. In other words, the definition of corporate governance is varying from country to country. A narrow approach to defining corporate governance is reflected in the Agency Theory, which restricts the definition merely to the relationship between the business corporation's management and its owners, the shareholders.²⁴

From the same point of view, corporate governance can be defined simply "as an environment where individuals in control of a company provide quality management to advance the performance of the company in the interests of all shareholders, regardless of whether they are minority or majority shareholders".²⁵ This definition stresses that the interests of all shareholders, not their rights, must be protected by the management out of concern that the protection provided in the corporate by laws is not enough to ensure the full protection of the shareholders' interests.

On the other hand, approach to the definition of corporate governance takes a broader view, as it includes the stakeholders of the business corporation, such as its employees, suppliers, creditors and customers, in addition to the corporation management and its shareholders. This definition reflects the Stakeholder Theory.²⁶ Moreover, the application of the stakeholder model can be seen in Japan,²⁷ as they are considering the stakeholders as an element of the economy and deserve to be protected.

²³ See Smerdon Richard, *A Practical Guide To Corporate Governance*, (London: Thomson Sweet & Maxwell, 2004), at p.1.

²⁴ See Solomon J & A, *supra* note 5, at p.12.

²⁵ See Keong Low Chee, *Corporate Governance An Asia-Pacific Critique*, (Hong Kong: Sweet & Maxwell Asia, 2002), at p.41.

²⁶ See Solomon J & A *supra* note 5, at p.12.

²⁷ See Monks A.G. & Minow Nell, *Corporate Governance*, 4th Edition (England: John Wiley & Sons Ltd, 2008), at p. 381.

Corporate governance has also been defined as: “The system of checks and balances, both internal and external to companies, which ensures that companies discharge their accountability to all their stakeholders and act in a socially responsible way in all areas of their business activity”.²⁸ This is one of the broadest definitions of corporate governance, because it imposes upon the business corporation responsibility for its shareholders, stakeholders and its entire community.

Furthermore, it has been said that corporate governance revolves around the business corporation management and the exercise of its power to achieve the optimal interests of its shareholders. Moreover, the scope of corporate governance includes protection of the stakeholders in the corporation as defined above, who are eligible to exist in the corporate governance structure due to their contractual relationship with the corporation. Having a contract with the corporation, stakeholders are concerned with the happenings inside and outside of the corporation to protect their stake in it.²⁹

It has been argued that the best way to create a good corporate governance system and to ensure the effectiveness of the economy is the subject of debate. Some scholars and policymakers believe that maintaining good corporate governance requires the presence of the following essential elements:

- a) Management must pursue the welfare of the shareholders;
- b) The corporate board must be staffed primarily by non-executive directors;
and,
- c) Corporate rules must protect minority investors and minimize controlling shareholder diversions of the private benefits of control.

Guided by these points, it is apparent that, to ensure that a corporate governance regime is effective and well applied, the management must first devote its effort to maximize the wealth of the shareholders. Arguably, it is hard to align the interest of the management with those of the shareholders. In other words, the management self-interests as a human

²⁸ See Solomon J & A supra note 5, at p.14.

²⁹ See Pinto Arthur R. And Visentini Gustavo, *The legal Basis Of Corporate Governance In Publicly Held Corporations A Comparative Approach*, (London: Kluwer Law international, Volume 1, 1998), at p. 262.

being nature will make the alignment between the shareholders and the management interests are quasi-impossible.

Thus, convincing the management of a corporation to devote all their efforts to maximize the welfare of the shareholders can be seen as a difficult. Furthermore, the management structure must include non-executive directors and must ensure that corporate decisions are made with neutrality and objectivity. Lastly, the interests of minority shareholders must be protected against the decisions of the majority shareholders.³⁰ Consequently, when defining corporate governance, the definition must include the best practices of corporate governance, in addition to every constituent with a stake in the corporation's business, and the policy and decision making procedures.

The Organization for Economic Co-Operation and Development (OECD) has provided a practical definition of corporate governance, that is:

“Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined”.³¹

This definition includes many useful details that lead to an understanding of corporate governance. The OECD definition of corporate governance provides for a set of relationships among the business corporation elements (the board, the management, the shareholders and the stakeholders),³² in a way that helps each element understand its own rights and obligations. Furthermore, the OECD definition of corporate governance refers to the procedures that must be followed when management makes a decision. Lastly, the

³⁰ See McCahery Joseph A, Moerland Piet, Raaijmakers Theo, Renneboog Luc, *Corporate Governance Regimes Convergence and Diversity*, (NY: Oxford University Press, 2006), p.1.

³¹ See Clarke Thomas, *Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance*, (London: Routledge Taylor & Francis Group, 2004), at p.1. Hereinafter Clarke Thomas.

³² See OECD Principles of Corporate Governance 2004, at p. 11. Hereinafter The OECD Principles. <http://www.oecd.org/dataoecd/32/18/31557724.pdf>, retrieved on 16.Nov.2008

OECD definition expressly provides for setting the objectives of the business corporation and for monitoring its performance. This part of the OECD definition is derived from its principles of corporate governance, which are disclosure and transparency.

Ultimately, one of corporate governance definition may be considered as a summary of the OECD definition that is The Cadbury Report of the Financial Aspects of Corporate governance, December 1, 1992, defined corporate governance as “The system by which companies are directed and controlled”.³³ Accordingly, for the purpose of this thesis, the OECD definition of corporate governance will be used as the main definition, because it is very comprehensive and provides a complete notion of corporate governance.

2.3 Agency Theory.

Many important studies have been written regarding the agency relationship between the principal-agent in the corporate context. The agency theory deals with the firm and the managerial behaviour. The agency theory tackles the management moral hazard and agency cost.³⁴ The root of the agency theory can be found in the classical study of Berle and Means,³⁵ who found that when corporate capital is diffused, the control of the corporation rests in the manager’s hands. But, interestingly, in the eighteenth century, Adam Smith proposed that the separation of ownership and control in the business corporation would create problems.

He stated, ‘The directors of such joint-stock companies, however, being the managers rather of other people’s money than their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own’.³⁶

³³ www.ecgi.org/codes/country_pages/codes_uk.htm, retrieved on 12.Nov.2008

³⁴ See Solomon J & A, *supra* note 5, at p. 23.

³⁵ See Berle A. and Means G., *The Modern Corporation and Private Property* (New York: Macmillan, 1932). Hereinafter Berle and Means.

³⁶ Smith, Adam, *An Inquiry Into The Nature and Causes of Nations Wealth*, 1776.

Thus, Adam Smith predicted the problem of agency relationship long ago; when he revealed that the manager of other's wealth will never watch it with the same prudence as if he is watching his own wealth.

Centuries later, the seminal work of the Berle and Means study³⁷ has revealed the basis of the separation of ownership and control; as they stated that the separation of control and ownership are linked to the development of the industry and the markets. The notion of the separation of ownership and control developed in the UK and US in particular because they encouraged the divergence of shareholders. It has been argued that since the UK and the US are common law countries, minority shareholders avail from the good protection as investors in these markets. Whereas, in the civil law countries the minority shareholder's protection is inefficient.³⁸

The concept that the corporation management is separated from its ownership has faced critics, such as Maurice Zeitlin, who argued that the Berle and Means study about the corporate control in large corporation was incorrect, because they did not rely upon genuine information and two third of the 200 corporations in their study were analyzed according to their guesses.³⁹ In turn, Zeiltin also argued that large shareholders still exist, thereby reducing the results of the study.⁴⁰ Therefore, Zeitlin found that the question of the control conception is still undetermined.⁴¹

Shleifer and Vishny in their influential study, A Survey of Corporate Governance, found that the separation of control (the management) and ownership (the financiers) is the main reason behind the agency problem.⁴²

³⁷ See Berle and Means, *supra* note 35.

³⁸ See Mallin C, *supra* note 17, p.13.

³⁹ See Zeitlin, M., 'Corporate Ownership and Control: The Larger Corporation and The Capitalist Class', *American Journal of Sociology*, 1974, Vol. 79, No.5, at p. 1073.

⁴⁰ *Ibid.*

⁴¹ *Ibid.*

⁴² Shleifer, A. and Vishny, R.W., 'A Survey of Corporate Governance', *Journal of Finance*, 1997, Vol.52, No.2, pp. 737-783. Hereinafter S & V.

Thus, the agency problem emerged from the fact that the managers, the agents of the business corporation, need the shareholders, the principals, to finance their investments. However, at the same time, how can the investors be assured that the managers will get to them returns on their investments? In other words, how can the financiers of the capital guarantee that the corporation management will act to their best interests (shareholders interests), and there will be no conflict of interest between the management interest and the shareholders interest.⁴³

The agency relationship has been defined as `a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent`.⁴⁴ Furthermore, it has been stated by Jensen and Meckling that if principal and agent (as defined above) are wealth maximizers, then in some situations, the agent will grant a preference to his interest over the principal's interest.⁴⁵

The agency problem has been firstly found by Ross 1973. It is not essential that the agent, the manager of the corporation, will perform completely in the interest of the principal, the shareholder. That is attributed to the supposition that there is conflict of interests between the principal and the agent.⁴⁶ The conflict of interest can lead to a reduction of the corporate value.⁴⁷ From a financial point of view, the main objective of the corporation is to increase the shareholders value.⁴⁸ However, according to the agency problem, the agent, manager of the corporation, is working to maximize his own wealth by investing in projects that grant a high short-term return.⁴⁹

⁴³ *Ibid.*

⁴⁴ Jensen, M.C. and Meckling, W., 'Theory of The Firm: Managerial Behavior, Agency Costs and Ownership Structure', *Journal of Financial Economics*, 1976, Vol.3, No. 4, pp. 305-360. Hereinafter J & M.

⁴⁵ *Ibid.*

⁴⁶ See Solomon J & A, *supra* note 5, at p. 17.

⁴⁷ See S & V, *supra* note 42, at p. 308.

⁴⁸ *Ibid.*

⁴⁹ *Ibid.*

Another illustration shows that the agents, or managers, are minimizing the shareholders value by adding personal expenses on the corporation account, such as holidays through the corporation. One of the major differences between the principal, or shareholder, and the agent, or management, under the agency theory is how each approaches decisions regarding risk.⁵⁰ In other words, the principal and his agent may approach the risk from different thoughts, and, for this reason, each of them has his own risk preference.⁵¹

On the other hand, some have attributed the emergence of the agency problem to weaknesses in the ways that the contracts between the management and the corporation's owners are written and enforced.⁵²

There might be events unpredicted by these contracts; thus, there is a need for a decision to deal with them, and these decisions are confined in the manager's hands, the right to make these decisions so-called the residual control rights.⁵³ In turn, it has been argued that laying the residual control rights in the manager's hands may lead the managers to be more self-interested.⁵⁴ As a result of the conflict of interests between the corporation's management and the owners, and the residual control rights in the manager's hands, the shareholders need to monitor the management to ensure that the managers are making the decisions in appropriate manner, and that will cost the principal, the shareholder, resulting in the so-called agency cost.⁵⁵

The agency cost can be very high in the large corporation, and where the separation of ownership and control is great.⁵⁶

⁵⁰ *Ibid*, at p. 19.

⁵¹ Eisenhardt, K.M., 'Agency Theory: An Assessment and Review', *Academy of Management Review*, 1989, Vol.14, pp. 57-74. Hereinafter Eisenhardt.

⁵² Fama, E.F. and Jensen, M., 'Separation of Ownership and Control', *Journal of Law and Economics*, 1983, Vol.26, pp. 301-325. Hereinafter F & M.

⁵³ *Ibid*.

⁵⁴ See S & V, *supra* note 42, pp. 737-783.

⁵⁵ See J & M, *supra* note 52, pp. 305-360.

⁵⁶ See Dignam, Alan & Lowry, John, *Company Law*, 5th Edition (United Kingdom: Oxford University Press, 2009), at p. 368.

The concentration in agency theory is how the shareholders can decrease the agency cost.⁵⁷ Therefore, there are solutions that have been found to solve the agency problem, or at least to reduce the agency cost, by monitoring the agent's work. These solutions are not without any cost, but Jensen and Meckling defined these solutions as residual loss and bonding loss.⁵⁸ One of the solutions for the agency problem is that the managers must be given a long incentive contract, for example a share of ownership, stock option or a threat dismissal if the income is below expectations.⁵⁹

These solutions can motivate managers to align their interest with the shareholders' interests. Furthermore, Daniel R. Fischel states that the agency cost can be reduced through either direct monitoring or indirect monitoring.⁶⁰ Direct monitoring is exemplified by the appointment of independent directors or accountants. Indirect monitoring is exemplified by providing for incentive clauses in the manager's contracts.⁶¹ Moreover, the market can be seen as a major factor in reducing the agency costs, as takeovers deals minimize the agency cost because the managers will take all the necessary actions to keep the share value of the firm high; however, if the share price is low then other firms will attempt to take over the firm and they will remove the management to appoint a new management.

Accordingly, if the management operates the firm appropriately and in the shareholder's interests, then they will gain profits and the share price will be high and the others will not takeover it.⁶² Finally, the legal rules may play a significant role to reduce the agency cost. Also the fiduciary duty that is imposed upon the managers can be one of

⁵⁷ Huse, Morten., *Boards, Governance and Value Creation*, (USA: Cambridge University Press, 2007), at p. 30. Hereinafter Huse Morten. Notably, there are two schools in the agency theory, the first school the so-called the positive school, this school focus on the separation of ownership and control in large corporations and seeing the shareholders as a principal and managers as agents. The second school, called normative school, focuses on all the agency relationships in the corporation; according to this school, the board can be seen as an agent to the shareholders, and on the other hand, can also be seen as a principal to the management.

⁵⁸ See J & M., supra note 52, at p. 311.

⁵⁹ See S & V supra note 42, pp. 737-783.

⁶⁰ Fischel, Daniel R., 'The Corporate Governance Movement', *Vanderbilt Law Review*, 1982, Vol.35, No.6, pp 1259-1292.

⁶¹ *Ibid.*

⁶² *Ibid.*

the influential factors in minimizing the agency cost, since it restrains the managers from acting against or in conflict with the shareholders interests.⁶³

Agency theory has been criticized, and those critics have challenged the validity and the competence of the agency theory. The underlying assumption for agency theory has been questioned; it has been argued that there is no principal in reality.⁶⁴

The senior management of any business corporation will be its board of directors. The role of the board of directors is divided into two parts; firstly, as an agent when it comes to the management of the corporation and getting rewards for that, on the other hand, board of directors' role as principal since they directors may own shares of the firm.⁶⁵ Furthermore, in the modern corporate world, the shareholders and the managers are transitory in the corporation; therefore, none of them have loyalty to the corporation. The agency theory has been criticized because it is limited to the relationship between the shareholders (the principals) and the managers (the agents) and that is against the public policy.⁶⁶ One scholar has revealed that the negativity of the shareholder oriented conception behind the agency theory was one of the reasons for the Enron scandal, due to the fact that the conception of the agency theory has a deep negative impact on management practices.⁶⁷

Conversely, some scholars consider agency theory as valid; they argue it can be the foundation for corporate governance because it is easily understood by every one involved in the corporate governance as a mechanism.⁶⁸ Furthermore, the agency theory is recommended when it comes to examining problems, including the principal-agent relationship. In addition, agency theory presents an exclusive, practical and empirical testable perspective on problems of joint efforts.⁶⁹

⁶³ *Ibid.*

⁶⁴ See David Crowther and Renu Jatana, *Agency Theory: A Cause of Failure in Corporate Governance, International Dimensions of Corporate Social Responsibility*, Vol. 1: (Hyderabad: ICFAI University Press, 2005), pp. 135- 143.

⁶⁵ *Ibid.*

⁶⁶ See Huse, Morten, *supra* note 57. at p. 50.

⁶⁷ *Ibid.*

⁶⁸ *Ibid.*, at p. 46.

⁶⁹ See Eisenhardt, *supra* note 51. pp. 57-74.

2.4 Stakeholder Theory.

Over the time, the business corporation's role has changed toward the community, their employees, the environment and their shareholders. In other word, the business corporations today are required to play more significant role in the society.⁷⁰

Accordingly, deriving from the above concept, the stakeholder theory has emerged. The theory has drawn attention, particularly during the 1970's.⁷¹ However, Igor Ansoff and Robert Stewart were the first to use 'stakeholder theory' as a phrase.⁷² The foundation of the stakeholder theory is that the firms became very large in particular after the Second World War.⁷³

Thus, they will inevitably exert their influence over the community, and this influence, as a result, will require them to consider their accountability toward the community and not only to their shareholders. The stakeholder theory can be defined in many ways depending on perspective that defines it.⁷⁴ One of the broadest definitions of who is a stakeholder is set forth by Freeman who defined the stakeholder as: "A stakeholder in an organization is any group or individual who can affect or is affected by the achievement of the organization's objectives".⁷⁵ Furthermore, some of the stakeholder theory supporters are far-reaching, as they are claiming that the new generations and the animals must be included in the stakeholder definition.⁷⁶

An example can clarify one of the stakeholder theory definitions; this definition considered the theory as an exchange transaction, however the taxpayers are participating

⁷⁰ See Salomon J & A, supra note 5, at p.23

⁷¹ *Ibid.*

⁷² See Clarke Thomas, *The Stakeholder Corporation: A Business Philosophy for the Information Age*, in Thomas Clarke (ed), *Theories of Corporate Governance*, (London: Routledge Publications, 2004), at p.187.

⁷³ See Blair, M.M., *Ownership And Control: Rethinking Corporate Governance for The Twenty-First Century*, in Thomas Clarke (ed), *Theories of Corporate Governance*, (London: Routledge Publications, 2004) at p. 177.

⁷⁴ See Solomon J & A, supra note 5, at p.23.

⁷⁵ See Freeman, R. *Strategic Management: A Stakeholder Approach*, (Boston, MA: Ballinger, 1984) pp, 31-32.

⁷⁶ See Solomon J & A, supra note 5, at p. 24.

in the local infrastructure, therefore, they expected that the companies will help their lives to be better.⁷⁷ Moreover, the stakeholders are also defined as: ``Those has a legitimate stake in the company``.⁷⁸ In turn, the stakeholder theory as a notion is distinct from agency theory, since the agency theory attempts merely to maximize the shareholder value while, in contrast, stakeholder theory strives for the interests of everyone who has stake in the corporation.

In the UK, the Report of Hampe Committee on Corporate Governance revealed that the firm's managers were able to fulfill their responsibility toward the shareholders in a successful way, merely if they well-developed the relationships with their stakeholders.⁷⁹ There are many examples of successful firms, which have managers applying stakeholder theory, for instance *Built to Last and Good to Great*. In other words, they strenuously supporting the stakeholder theory as it lead the managers to operate the firm in an excellent manner.⁸⁰

Berle & Means argued that: ``neither the claims of ownership nor those of control can stand against the paramount interest of the community... It remains only for the claims of the community to be put forward with clarity and force``.⁸¹ Seemingly, despite their eminent discussion about the separation of ownership and control, they were aware of the importance of the community role.

Under the stakeholder theory, shareholders have only one privilege over the stakeholders: they are entitled to the cash dividends.⁸² Furthermore, in advocating stakeholder theory it has been stated that is it encompasses the shareholders theory, since

⁷⁷ *Ibid.*

⁷⁸ See Farrar, J.H. and Hannigan, *Farrar's Company Law*, Fourth Edition (London: Butterworths, 1998), at p. 386.

⁷⁹ The Report of Hampe Committee on Corporate Governance Final Report (January 1998), http://www.ecgi.org/codes/documents/hampel_index.htm, retrieved on 2 March 2009.

⁸⁰ See R.E. Freeman, A.C.Wicks, B. Parmar, "Stakeholder theory and "The Corporate Objective Revisited", *Organisation Science*, Vol. 15, No. 3, May-June 2004, pp. 364-369. Hereinafter FWP.

⁸¹ See Berle & Means, 1932: Supra note 35.

⁸² See Mallin C, supra note 17, at p. 16.

stakeholder theory aims to develop the stakeholder's value, and shareholders are one of the stakeholders.⁸³

An interesting application of the stakeholder theory can be found in Germany. German law stipulates that a specific group of stakeholders, such as employees, are entitled to be represented in the supervisor board in addition to the company's directors.⁸⁴ In some context, McCall has laid down an argument that the employees as stakeholders have ethical rights that entitle them to participate in the corporation strategy.⁸⁵ Stakeholders can be divided to two sections; the first section is the direct stakeholders such as employees, customers and creditors. On the other hand, the second section is the indirect stakeholders such as government and domestic entities in the country where the corporation's operations take place.⁸⁶

According to the stakeholder theory, the corporation is derived from the social entity conception.⁸⁷ Furthermore, Allen stated that the object behind the corporation is social but not individual according to the following statement: ``Contributors of capital (stockholders and bondholders) must be assured a rate of return sufficient to induce them to contribute their capital to the enterprise. But the corporation has other purposes of perhaps equal dignity: the satisfaction of consumer wants, the provision of meaningful employment opportunities and the making of a contribution to the public life of its communities. Resolving the often conflict claims of these various corporate constituencies calls for judgment, indeed calls for wisdom, by the board of directors of the corporation. But in this view no single constituency's interest may significantly exclude others from fair consideration by the board``.⁸⁸

⁸³ See FWP, *supra* note 80.

⁸⁴ *Ibid.*

⁸⁵ See McCall, John J., 'Employees Voice in Corporate Governance: A Defense of Strong Participation Rights', *Business Ethics Quarterly*, 2001, Vol.11, No.1: pp. 195-215.

⁸⁶ See Mallin, C, *supra* note 17, pp. 50-51.

⁸⁷ See Solomon J & A *supra* note 5, pp. 177-178.

⁸⁸ See Allen, W.T., 'Our Schizophrenic Conception of The Business Corporation', *Cardozo Law Review*, 1992, Vol:14 (2): at p.271.

In favouring the stakeholder theory Freeman and others in their study *Stakeholder Theory and “The Corporate Objective Revisited”*, have argued that stakeholder theory pushes managers to develop their relationships with everyone who has stake in the corporation in order to create a considerable value of the corporation.⁸⁹

The Organization for Economic Co-operation and Development (The OECD) identified the stakeholders in the preamble of 2004 OECD principles of corporate governance⁹⁰ when it is stated that: ‘corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders.

Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined’. Moreover, the fourth principle in the OECD 2004 Principles on Corporate Governance enshrined the role of the stakeholder in corporate governance. This principle provides that: ‘the corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises’.⁹¹

This assertion by the OECD principles reveals that the protection of the stakeholders rights to be based on the law to a significant extent.⁹²

The implications which may be stemmed from the application of the stakeholder theory is that the investors may become anxious regarding their investments, since the objective of the corporation is to balance between the interests of the shareholders and the stakeholders, rather than only maximizing the shareholder value as in the Agency theory.

⁸⁹ See FWP, supra note 80.

⁹⁰ See The OECD Principles, supra note 32.

⁹¹ See The OECD Principles of Corporate Governance 2004 at p. 21. Electronic resource can be found on: <http://www.oecd.org/dataoecd/32/18/31557724.pdf>, retrieved on 2 March 2009.

⁹² See Mallin, C, supra note 17, at p. 54.

Moreover, according to Elaine Sternberg, the weak point of the stakeholder theory is that the balance between the interests of the shareholders with the other stakeholders.⁹³

Stakeholder theory seems to be an idealistic theory as it is concerned with the whole community. But this theory receives a great deal of criticism. Stakeholder theory has been criticized from many perspectives, as this theory is incompetent in essence and cannot afford any enhancement for corporate governance or the corporate systems because it is fundamentally against the corporate goals.⁹⁴ In addition, one of the defects of stakeholder theory is that it undermines the corporation's goals, which is the maximization of the shareholders value, as it is mindful of the benefits of every stakeholder in the business corporation. Furthermore, the directors may enhance the shareholders value through taking into account the other corporation's stakeholders other than shareholders as a pattern of increasing the shareholders' wealth.

On the other hand, stakeholder theory proponents undermine this defect by saying that balancing the interests between shareholders and stakeholder of the corporation does not preclude the maximization of the shareholders value.⁹⁵ In contrast, critics argue that the numerous responsibilities according to the stakeholder theory will create difficulties for the management when it comes to achieving their corporation's goals.⁹⁶

Stakeholder theory sees the managers and the employees of the business corporation as stakeholders, arguing that they will be accountable to themselves. But the stakeholder theory does not provide for any demonstration of how this principle will be applied.⁹⁷ Furthermore, the method of selecting who is eligible to be a stakeholder is one of the undermining features of the stakeholder theory.⁹⁸ Good corporate governance depends on the accountabilities that have been discharged by the management toward the

⁹³ See Elaine Sternberg, *Corporate Governance: Accountability in the Marketplace* (London: Institute of Economic Affairs, 2004) at p.130. Hereinafter Elaine Sternberg.

⁹⁴ *Ibid.*, pp. 126-127.

⁹⁵ *Ibid.*, at.p.130.

⁹⁶ *Ibid.*, pp. 130-131.

⁹⁷ *Ibid.*, at.p.131.

⁹⁸ *Ibid.*, at.p.132.

shareholders, and the employees toward the corporation, but the stakeholder theory is contrary to these accountabilities.⁹⁹

However, based on the modern technology revolution, which makes the exchange of information easier than before, then everyone, anytime, everywhere could be considered as stakeholder.¹⁰⁰ Finally, it has been stated that if the corporation is accountable to everyone, it is in reality accountable to no one.¹⁰¹

2.5 Stewardship Theory.

Stewardship theory seems to be an idealistic theory, since its foundation depends on the physiological and sociological needs of the business corporation's managers. In this theory, the top management is seen as a steward and, therefore, they will exercise their best efforts to protect the corporation's interest.¹⁰² In other words, this theory purports that managers prefer the corporation's and the shareholder's interests over their own interests. Moreover, the stewardship theory assumes that there is no conflict of interest between the corporation's owner and the management.¹⁰³

On the same point, if there was any conflict of interest or problem between the owners and the management, stewardship theory claims that the manager will attempt to align this conflict of interest or solve the problem, and if he cannot solve this problem, he would prefer the solution that is in the owner's interest.¹⁰⁴

⁹⁹ *Ibid*, at.p.134.

¹⁰⁰ *Ibid*, at.p.128.

¹⁰¹ *Ibid*, at.p.135.

¹⁰² See James H. Davis, F. David Schoorman & Lex Donaldson, Toward a Stewardship Theory of Management, in Clarke Thomas (ed) *Theories of Corporate Governance*, at p. 120. Hereinafter Davis, Schoorman & Donaldson.

¹⁰³ Donaldson, L., 'Ethics Problems and Problems With Ethics: Toward a Pro-Management Theory', *Journal of Business Ethics*, 2008, Vol.78, pp: 299-311.

¹⁰⁴ Van Slyke, M., 'Agents or Stewards: Using Theory to Understand the Government Non-Profit Social Service Contracting Relationship', *Journal of Public Administration Research and Theory*, 2006. Vol.17: pp 157-187.

According to Maslow's Hierarchy of Needs theory,¹⁰⁵ the managers, as stewards, will not place their own interests in front of the corporation's interests; in addition, if there is a contradiction between their interests and the corporation's interests, the manager's first choice will be to give a privilege to the corporation's interests over his own interests. Hence, stewardship theory argues that managers chose the corporation's interests when there is a contradiction with their own interests because the manager believes that when he favours the corporation's interests, the benefits to him will be more than if he favoured his own interests.¹⁰⁶

Donaldson and Davis completed an empirical study regarding this theory.¹⁰⁷ They were rebelling against the agency theory, and, therefore, they were eager to bring in a new theoretical approach in terms of the management theory of corporate governance. The abovementioned study examined the relationship between the corporate structure and the investor's returns. In particular, the study focused on the impact of appointing one person for the CEO and the chairman positions, and separating these positions, i.e. two different persons appointed in each position. This study found that there is an optimal relationship between the good returns to the investor's contributions in case of the CEO and the Chairman positions are occupied by the same person. Whereas, agency theory proponents are claiming that if the positions of CEO and the chairman are held by the same person, then the returns to the shareholder investments will be reduced.¹⁰⁸ One of the important consequences of the stewardship theory is that the self-discipline of humanity will be the surveillance device over the manager's performance, and that would lead to the abolishment of the corporate governance system.¹⁰⁹

¹⁰⁵ For more discussion on Maslow's theory See Luis R. Gomez-Mejia, David Balkin & Robert Cardy, *Management*, (U.S, McGraw-Hill Irwin, 2005) pp.505-507.

¹⁰⁶ See Davis, Schoorman & Donaldson, *supra* note 83, at p.121

¹⁰⁷ See. Donaldson, Lex & Davis, James H., 'Stewardship Theory Or Agency Theory: CEO Governance And Shareholder Returns', *Australian Journal of Management*, June, 1991, Vol: 16, No.1, at. p 62. Notably, this study was conducted for 321 corporations in the US.

¹⁰⁸ For further discussion regarding the impact of the CEO duality and the separation between the chairman and the CEO positions, see *ibid*, at p. 52-53.

¹⁰⁹ See Dr. ALZumai, Fahad, 'Mafhoom Hawkamat Al-Sharekat Fi AL-Eqtasadat AL-Nashea`a, Ma`a Al-Eshara Ela Al-Qnoon Al-Kuwaiti', *Majalat Al-Mohami*, Jameyat Al-Mohameen Al-Kuwaiteya, (2007, April, May, June), Vol:2, at p.120. Hereinafter, Dr. Alzumai F.

The behavior that is assumed by the stewardship theory has a magnificent advantage over the behavior that is assumed by the other theories. It costs less than the behavior assumed by the other theories since it neither requires incentives for the executives nor requires costs for monitoring the management performance.¹¹⁰ This is due to the assumption underpinning the stewardship theory, i.e. the managers are always looking for the interests of the shareholders and the corporation, but not their self-interests.

The Model of the Man in the stewardship theory is pictured to show a collective not individualistic behavior.¹¹¹ Therefore, the steward is pursuing the collective objectives of the corporation and the shareholders, in contrast to the objectives that the agent pursues.

Stewardship theory has received some critiques. For instance, the main critique against the stewardship theory is that its underlying assumption that the managers would always prefer the shareholders and the corporation interests over their self-interests is not valid in the real world. And the motive behind this preference is that the human-self.¹¹²

Managers, in some cases, have revealed that the human-self is not a valid assumption for any theory, since they were the main reasons behind many corporate financial scandals in the business world, such as in Enron and World-com.¹¹³ In other words, the manager's self-discipline as the only monitoring device to ensure that managers will act in complete in the interests of the corporate shareholders, in reality, is not valid according to the real examples mentioned-above.

2.6 Conclusion.

In this chapter an attempt is made to explore the most appropriate definition of corporate governance for this thesis. In other words, an attempt is made to find a definition of corporate governance that is clear and detailed. Corporate governance definitions are varied, since each definition represents a different school or point of view.

¹¹⁰ See David Pastoriza & Miguel A. Arino, When Agents Become Stewards: Introducing Learning in the Stewardship Theory, It is a paper presented in the First IESE Conference on Humanizing the Firm and The Management Profession, Barcelona, IESE Business School, June 30-July 2, 2008. at p. 5. Visited on 31-Jan-09. <http://ssrn.com/abstract=1295320>.

¹¹¹ Davis, Schoorman & Donaldson, *supra* note 102.

¹¹² See Dr. ALzumai F., *supra* note109, at p. 120.

¹¹³ *Ibid.*

Thus, each school has its own definition; for instance, the corporate governance definition according to the agency theory school differs from the definition provided for by the school of the stakeholder theory.

Furthermore, the corporate governance definition may vary from country to country, i.e. corporate governance depends on the legal and economic systems of such countries. The OECD has provided a corporate governance definition that is detailed and clear, and, therefore, that definition has been chosen as the subject definition for this thesis. The OECD's definition of corporate governance accompanied by many provisions (individual OECD corporate governance principles) that help to understand and apply corporate governance appropriately.

In addition, an attempt in this chapter is made to present a general explanation for the theoretical framework of the corporate governance. There are some theories which have participated in the development of the concept and the scope of corporate governance. Agency theory has been the foundation for corporate governance since the emergence of the seminal study of Berle and Means in 1932 *'The Modern Corporation and Private Property'* where the ownership and the control of the corporation are separated. Consequently, agency theory regards the shareholders as principal to the agents that are the managers. As a result, to agency theory principle there will be conflict of interests between the agent and the principal, and the agent, as a human being, will prefer his own-interest, i.e. the agency problem.

Agency theory scholars have provided for some solutions to this problem, such as to monitor the management performance and create proper remuneration schemes for the executives. But these solutions will bring out costs which will be incurred by the shareholders, i.e. the so-called agency costs.¹¹⁴ Although, agency theory has been the dominant theory for decades, it has received critiques. Agency theory has been criticized for being narrow and concerned only with the agency relationship between the shareholders and the managers, thus ignoring the other stakeholders in the corporation.

¹¹⁴ See J & M., supra note 52, at p. 311

Therefore, the stakeholder theory has emerged which claims that the business corporation must not only discharge its accountabilities toward its shareholders, but it must be extended to reach the other stakeholders such as the employees, creditors, suppliers, in addition to the local communities and the environment. There are some arguments against the stakeholder theory; for instance, it has been argued that stakeholder theory has widened the scope of the corporation's accountability, and that will hinder the corporation from achieving its main objective, i.e. the maximization of shareholder value.

The third theory is stewardship theory. This theory relies upon an idealistic base, and the belief that managers are motivated by intrinsic factors which make them work in favour of the shareholders interests, even if there a conflict of interest exists between the shareholders and the managers. According to this theory, the manager will give preference to the shareholders interests over his own-interest. Accordingly, stewardship theory proponents argue that managers do not require monitoring devices because they have self-discipline, which is the main factor behind their motivation to work for the shareholders' complete interests.

Stewardship theory is just like the other theories. It has received criticism undermining its foundation. The foundation of stewardship theory is that the managers are motivated to work in the interest of the shareholders because they believe that their interests will be increased if they protect the shareholders interests. But, in reality, the business world has revealed that this foundation is invalid, and the self-discipline of the managers cannot be a factor underlying a theory. For instance, there were several real world examples, such as Enron and World-com., where the collapse of a corporation was due to the fact that the managers were working to enrich them.

Chapter Three: Corporate Governance in the Emerging Markets

3.1 Introduction:

There are differences between the corporate governance in the emerging markets and the developed markets that can be attributed to the differences in the financial structure of each market especially with regard to ownership structures.¹¹⁵ Moreover, corporate governance is no less important in the emerging markets than it is in the developed markets. In other words, corporate governance as a system is needed in the emerging and in the developed markets.

Firstly, corporate governance is needed to identify the meaning of an emerging market. The emerging markets can be defined as “Countries in the world that are expected to experience lots of growth. Investing in these countries has lots of potential for big returns, but it also carries lots more risk than typical domestic investing.”¹¹⁶

The Kuwaiti economy has undergone positive changes in recent years.¹¹⁷ For example, the stock market has grown by approximately sixty percent in the last two years, and more companies are going public. Notwithstanding this growth, the Kuwaiti government is in the process of conducting a major privatization reform to major industries.

Consideration of corporate governance in the emerging markets focused at the outset upon issues related to the privatization transaction.¹¹⁸ In other words, the discussion was about the conversion of corporate ownership from the public authority (the state) to the private sector. Thereafter, due to the development of the economy in the emerging

¹¹⁵ See Gill Amar, Corporate Governance Issues and Returns in Emerging Markets, in Robert E. Litan, Michael Pomerleano and V. Sundarajan (eds), *The Future of Domestic Capital Markets in Developing Countries*, (Washington, Brookings Institute Press, 2003) at p.313. Hereinafter Amar Gill.

¹¹⁶ See <http://www.teenanalyst.com/glossary/e/emergingmarkets.html>, retrieved on 4 March 2009.

¹¹⁷ Kuwait's situation must be mentioned here because it is the case study of this thesis.

¹¹⁸ See Cankar, Nina, “Transition Economies and Corporate Governance Codes: Can Self-Regulation of Corporate Governance Really Work?,” (October, 2005), *Journal of Corporate Law Studies*, Vol: 5, Part 2, at p. 297. Hereinafter Cankar Nina.

countries, new issues of corporate governance arose, such as the disclosure regulations and the rules which increasing the confidence of the capital market.¹¹⁹

In particular, corporate governance was necessary just before the Asian crisis in 1997. However, the Asians did not pay any concern to corporate governance, although this crisis crystallized the necessity of corporate governance in the emerging markets.¹²⁰ In addition, this crisis revealed much corporate misconduct within business corporations.¹²¹ In other words, serious steps must be taken to resolve the corporate governance issues. The emerging markets, especially those in the East-Asia countries, have made the corporate governance codes more effective following the Asian financial crisis in 1997.

Moreover, corporate governance codes have been adopted in markets that did not previously have them.¹²² However, corporate governance in the emerging markets is being hindered by certain obstacles, such as the concentration of ownership¹²³ created by the inadequacies of the privatization programme. Consequently, this concentration of ownership has placed control of the corporation in the hands of the major shareholder, which most commonly is an individual shareholder, a family, or the state. When corporate control is in the hands of a major shareholder, irregular actions will emerge, and the rights of minority shareholders will be at risk of being undermined.¹²⁴

In this chapter, the ownership structure in the emerging markets will be explained. Then, a general picture will be given about the privatization programme that has led to the ownership structure in the emerging markets. The latter section will refer to the challenges of corporate governance in the emerging markets and solutions to the aforementioned challenges.

¹¹⁹ *Ibid.*

¹²⁰ See Singh, A. 'Corporate Governance, Corporate Finance And Stock Markets In Emerging Countries', *The Journal of Corporate Law Studies*, (April, 2003) Vol: 90, Part: 1, pp 41-72.

¹²¹ See Johnson, Simon., La Porta, Rafael., Lopez-de-Silanes, Florencio., & Shleifer, Andrei., "Tunnelling," *The American Economic Review*, Vol. 90, No. 2. at p. 2. Hereinafter JLFS.

¹²² See Mallin, C, *supra* note 17, at p 220.

¹²³ See Gill, Amar *supra* note 6, at p.313.

¹²⁴ See La Porta, R., Lopez-de-Silanes, F., and Shleifer, A, "The Corporate Ownership Around the World," (1999), *Journal of Finance*, Vol. 54, at p. 33. Hereinafter LFS.

3.2 Ownership Structure:

The dispersion of corporate ownership in some developed markets made the control by shareholders as impossible as in the United States and UK.¹²⁵ In contrast, it is just the opposite in the emerging markets, in which ownership of the business corporations is concentrated in an individual shareholder, a blockholder, a family or the state. Therefore, the importance of corporate governance is increased in the emerging markets, because this concentration of ownership in one form or another endangers the rights of the minority shareholders. In other words, where ownership is concentrated, as in the emerging markets, the rights of the minority shareholders are at risk to be undermined by the major or the controlling shareholders.¹²⁶

When the ownership structure in emerging markets is concentrated,¹²⁷ such concentration facilitates the wrongdoing by the controlling shareholder, since there will be a lack of restrictions upon the controlling shareholder.¹²⁸ This is especially true in the emerging markets in Asia, where the ownership of the business corporations is mostly in the form of either a concentrated ownership or a united group of small shareholders who act strongly together to control the firm. For example, in Indonesia, 67.1% of the publicly listed corporations are family owned, while only 0.6 % of the listed corporations are widely held. In Singapore, the government owns approximately 23.6% of the corporations listed in their stock exchange market.¹²⁹

Accordingly, the principle of the separation of control and ownership is seldom followed in the emerging economies. As a result, the rights of the minority shareholders are at risk.¹³⁰

¹²⁵ See Oman, Charles, Fries, Steven and Buiters, Willem, *Corporate Governance in Developing, Transition and Emerging-Market Economies*, at p. 11. Hereinafter OCFSB. It is a research paper presented by OECD Developments Centre, Brief No: 23. It can be found on the following link: <http://oberon.sourceoecd.org/vl=1396685/cl=29/nw=1/rpsv/cgi-bin/wppdf?file=5l9t4hq19kxp.pdf> retrieved on 25 March 2009.

¹²⁶ See Gill Amar, *supra* note 6, at p.313.

¹²⁷ *Ibid.*

¹²⁸ See LFS, *supra* note 124, at p. 33.

¹²⁹ See Claessens, S., Djankov, S. and Lang, L.H.P., 'The Separation of Ownership and Control in East Asian Corporations', *Journal of Finance Economics*, 2000, Vol: 58 (1), pp 81-112. Hereinafter CDL.

¹³⁰ Clarke, Thomas., *supra* note 7, at p. 201.

Interestingly, the corporate ownership structure in emerging markets (as in China) seems to be complex, as the shareholders could be comprised of the state as investor, the local investors, and foreign investors. In other words, it must be taken into consideration that the kinds of owners in the emerging markets could be the state, the executive managers, employees other than managers, outsiders, and institutions.¹³¹ Notably, these different categories of owners may have different goals.

The variety of ownerships in the emerging markets enables the dominant shareholder to expropriate the rights of the minority shareholder in the corporation.¹³² Such conduct is facilitated, for example by the various classes of shares and the pyramid structure for controlling the corporations.¹³³

Furthermore, it has been stated that the main objective for an investor in the emerging markets is to control the company in contrast with the situation in such developed markets as exist in the United States and the United Kingdom.¹³⁴ Additionally, it is a fact that the private sector is more efficient in controlling the corporation than the public sector.¹³⁵ Remarkably, usually the concentration of ownership would change the agency problem which arises out of the conflict of interests between the management and the shareholders to a conflict of interests between the controlled shareholder, usually the manager, and the other shareholders.¹³⁶

From a corporate governance perspective, the voting rights role is significant in making corporate decisions that may affect the minority shareholders' rights, as it allows

¹³¹ See D'Orio, G., & Knudsen, T.T., 'Growth and Corporate Governance: An Adoption of Ramsey Model', 2002, at p. 1. Hereinafter DK. This article can be found on the following website link http://papers.ssrn.com/sol3/papers.cfm?abstract_id=307619, retrieved on 23 Mar. 2009.

¹³² See OCFSB *supra* note 125, at p. 11.

¹³³ See *ibid.* For more information of the concepts of pyramid structure and shares classes.

¹³⁴ Chen, Victor Zitian, Li, Jing, Papania, Lisa and Shapiro, Daniel M., "Effects of Ownership Structure on Innovation Performance of Firms in an Emerging Market," (7 December 2008), at p. 5. This article is available at SSRN: <http://ssrn.com/abstract=1299737>, Retrieved on 1 May 2009.

¹³⁵ See *ibid.* at p. 12 for more discussion with regard to the private sector being more efficient than the public sector in controlling the business corporation.

¹³⁶ See Claessens, Stijn & Fan, Joseph, "Corporate Governance in Asia: A Survey," *International Review of Finance*, June 2003, Vol. 3, at: p. 6. Hereinafter CF.

the controlling shareholder to decide many crucial issues, such as dividend policies, investments projects and personnel appointments.¹³⁷

In spite of the different development of the corporate governance systems in the emerging markets, there is still some similarity in the corporate governance issues among them (the emerging markets).¹³⁸ In the emerging markets, there are common issues of corporate governance that may exist in most of the emerging countries, such as:¹³⁹

1- Insider Ownership. The insiders can be employees, executive managers of the firm, or board members.

2- Concentrated Ownership is the second widespread issue in the emerging markets and arises of the privatization process in the emerging markets, which will be discussed below, in addition to shareholder in-activism. Furthermore, the fact that the minority shareholders are not properly protected in the emerging markets can repel small and foreign financiers whether locals or outsiders. Accordingly, it has been suggested that increasing the protection of minority shareholders must be incorporated into the reform programme of corporate governance in the emerging markets.¹⁴⁰

3- Owner-Managed Company is the third familiar corporate governance issue in the emerging markets. The separation of ownership and control cannot be seen in the emerging markets, as in most of the corporations the manager either is the large shareholder or the founder of the corporation. In other words, the separation of ownership and control does not apply as well to emerging markets as it does to some developed markets. This lack of application in the emerging markets may result in emitting the so-called conflict of interest problem, as the major shareholder or the blockholder will also be the management at the same time.¹⁴¹ Therefore, the agency problem, which usually occurs between the management and the shareholders, does not exist. Instead of the agency problem, a conflict of interests arises between the controlling shareholder and the

¹³⁷ See CDL, supra note 129, at p. 24.

¹³⁸ See Cankar, Nina, supra note 118, at p. 293.

¹³⁹ *Ibid*, at p. 294.

¹⁴⁰ See Cankar, Nina, supra note 118, at p. 295.

¹⁴¹ See Hofstetter, Karl., One Size Does Not Fit All: Corporate Governance for "Controlled Companies", *North Carolina Journal of International Law & Commercial Regulation*, 2006, Vol. 31 at p.598. Hereinafter Karl Hofstetter.

minority shareholders. It transpired that the large shareholder in the emerging economies is a main player in the corporate governance reform or improvement.

This similarity in the issues of corporate governance has been strongly determined by the governmental programme of privatization in the emerging markets and not by private agreement.¹⁴² In addition, the nature of the governance structure in the emerging markets has been massively affected by the privatizations programmes. In turn, the validity of the privatization process depends greatly upon the availability of some factors, such as the political factor support, which becomes very important in this situation.¹⁴³

3.3 Privatization: As One of the Major Reasons Behind the Concentrated Ownership in the Emerging Markets:

Indeed, the success of the emerging economies can be attributed to the way ownership transferred from the state to the private sector. In other words, the privatization process that has converted the corporation's ownership from the government to the private sector has played a main role in the dispersion of the corporation's ownership and its control.¹⁴⁴ Further, it has been argued that control of the business corporation even after the privatization process is still in the government's hands, because the privatization programme has been imperfectly exerted.¹⁴⁵

In turn, one of the objectives of the privatization programme in the emerging markets is to enable managers and other workers in a corporation to purchase shares. This kind of privatization was made to benefit and encourage the workers to work more productively to the ultimate benefit of the corporation.¹⁴⁶ Furthermore, it has been found that the manager-owner and the worker-owner structure have disadvantages.¹⁴⁷

¹⁴² See Cankar, Nina, *supra* note 118, at p. 293.

¹⁴³ See Wright, Mike., Buck, Trevor, & Filatotchev, Igor., "Corporate Governance in Transition Economies", in Kevin Keasey, Steve Thompson & Mike Wright (eds), *Corporate governance Accountability, Enterprise and International Comparisons*, (England, John Wiley & Sons Ltd, 2005), at p. 415. Hereinafter WBF.

¹⁴⁴ See Mallin, Christine, *supra* note 17, at p. 188.

¹⁴⁵ See DK, *supra* note 131, at p. 2.

¹⁴⁶ *Ibid.*

¹⁴⁷ See *ibid* at p. 3, for more details regarding the disadvantages of manager-owner and worker-owner corporations.

Black and others have stated that corporations that are controlled by managers-owners have an imperfect corporate governance system.¹⁴⁸ Therefore, they allege, the post-privatization growth of such business corporations has been reduced in the emerging markets.¹⁴⁹

The privatization programmes have variable styles.¹⁵⁰ Firstly, so-called mass privatization occurs when the state gives out the corporation's assets to the public free of charge for traded ownership shares, which is a style used in Russia after the USSR dissolved. The second style of privatization occurs when the state-owned shares are bought by the managers and the employees of the corporation itself, which occurred in Poland. The last privatization style occurs when the large number of shares owned by the state is sold to a foreign investor, who is thus able to control the corporation. Notably, this last style of the privatization process has shown the best results among the other styles and has been adopted by Hungary.¹⁵¹

There is an obvious relation between the privatization process and ownership concentration in the emerging markets. In other words, the corporate governance level or the standard being implemented in emerging markets is linked to the privatization process.

Coffee has condemned the mass privatization process stating that "the more plausible explanation is that economic changes have produced regulatory changes, rather than the reverse... Mass privatization came overnight to the Czech Republic, and its securities market soon crashed, at least in part because of the absence of investor protections. Only then, several years later, were statutory reforms adopted to protect minority shareholders...."¹⁵² It is apparent from Coffee's statement that the mass privatization

¹⁴⁸ See Black, Bernard S., Kraakman, Reinier H. and Tarassova, Anna, 'Russian Privatization and Corporate Governance: What Went Wrong?', *Stanford Law Review*, 2000, Vol. 52, pp. 1731-1808.

¹⁴⁹ See DK, *supra* note 131, at p 3.

¹⁵⁰ See Mallin, Christine, *supra* note 17, at p. 207.

¹⁵¹ *Ibid.*

¹⁵² See Coffee, J.C. "Convergence and Its Critics In Corporate Governance Regime, *Convergence and Diversity*, J.A. McCahery, P. Moerland, T. Raaijmakers, and L. Renneboog (eds), Oxford University Press, Oxford, 2002, Hereinafter Coffee.

process must be accompanied by regulations and laws that ensure the major shareholder will not be able to expropriate the other shareholders rights.

As a result of the privatization programme, employees may become the dominant shareholders, which may create a problem. As managers, the employees may not believe in developing the long-term shareholders' value.¹⁵³ Even if the employees have a considerable share in the corporation, it has been evident that their involvement in the management is rare, such as in the privatised corporations in Russia.¹⁵⁴

A good example for a privatization process may be found in Brazil, which was considered one of the major emerging markets to adopt corporate governance.¹⁵⁵ Further, when Brazil privatized its aircraft corporation, "Embraer", few provisions were provided regarding the application of corporate governance, which helped to ensure that deficiencies would not occur during and after the privatization process. Subsequently, the condition of this corporation improved. In addition, the privatized company was able to expand its operation.¹⁵⁶

¹⁵³ See Buck, T., Filatotchev, I., and Wright, M., "Employee Buy-Outs and The Transformation of Russian Industry." *Comparative Economic Studies*, Palgrave Macmillan, United States, (1994), Vol. 36 (2), pp 1-15. Hereinafter BFW.

¹⁵⁴ See Filatotchev, I, Buck, T., Hoskisson, R., and Wright, M., "Corporate Restructuring in Russia Privatization: Implications for US Investors," *California Management Review*, (1996a), Vol. 38 (2): pp 87-105. Berkeley, CA. United States. Hereinafter FBHW.

¹⁵⁵ See Monks, Robert., & Minow, Nell., "*Corporate Governance*," Fourth Edition, (England, John Wiley & Sons Ltd, 2008), at p. 355. Hereinafter Monks Minow.

¹⁵⁶ See *ibid* at p 365, for more details of the example.

3.4 Corporate Governance Challenges in the Emerging Markets:

Corporate governance developments in the emerging markets encounter many barriers.¹⁵⁷ These barriers can be seen in several aspects, such as the private benefit control, which means that managers are working in the corporations to benefit themselves, not the corporation. Poor protection of the minority shareholders is considered another of the major obstacles in the emerging markets.¹⁵⁸ Furthermore, the emerging markets also suffer from the so-called “crony capitalist,” which is a phrase used to describe a capitalist economy in which government or corporate officials and insiders provide lucrative opportunities to their friends and relatives.¹⁵⁹

Consequently, these obstacles can be strongly attributed to the poor legal and financial foundations, which are widespread in the emerging countries.¹⁶⁰ In other words, these corporate governance dilemmas have been motivated by poor financial systems as well as poor implementation of property rights law.¹⁶¹ Moreover, the corporate governance systems in emerging markets were underdeveloped until the East Asia Financial Crisis in the 1990’s.

To address such dilemmas, solutions have been suggested to reduce the problem created by the private benefit of control.¹⁶² Disclosure is the first solution and can be divided into three types. First, financial disclosure can curtail insider trading¹⁶³ and limit the private benefit of control. The second type of disclosure relates to the steps taken by the company toward enhancing corporate governance.¹⁶⁴ Finally, the third type of

¹⁵⁷ See OCFSB, *supra* note 125, at p. 19.

¹⁵⁸ See Karl Hofstetter, *supra* note 141, at p.599

¹⁵⁹ See the following link for the definition of “crony capitalist” <http://www-personal.umich.edu/~alandear/glossary/c.html> retrieved on 25 Mar. 2009.

¹⁶⁰ See Cankar, Nina, *supra* note 118, at p. 292.

¹⁶¹ *Ibid*, at 294.

¹⁶² See Karl Hofstetter, *supra* note 141, at p.623.

¹⁶³ Insider trading can be defined as follow: The illegal dealing in shares by people who, because of their privileged position, have information, which materially impacts on the value of the shares, before that information has been made public.

<https://securities.standardbank.co.za/ost/nsp/Glossary/glossary.asp?strStartingLetter=I> , retrieved on 29 June 2009.

¹⁶⁴ See Karl Hofstetter, *supra* note 141, at p.623.

disclosure exposes related party transactions. This mechanism helps to lessen so-called tunnelling. Tunnelling is defined as “the transfer of assets and profits out of firms for the benefit of their controlling shareholders.”¹⁶⁵

Moreover, tunnelling includes price transfer, excessive executive compensations, loan guarantees and expropriation of corporate opportunities.¹⁶⁶ Indeed, if the disclosure procedures are ineffective, then the disclosure cannot be certain to be applied properly. Moreover Gugler has stated that “the task of prudential legislation is to secure benefits of large shareholders as effective monitors of management and, at the same time, to prevent them from consuming excessive private benefits from control.”¹⁶⁷ In his statement, Gugler is inviting the lawmakers to grant the large shareholders suitable benefits to curtail their expropriation of minority rights.

Additionally, it has been suggested that there are opponents to corporate governance reform in the emerging countries and that they are struggling to hinder the reform process to maintain the weaknesses of the current situation.¹⁶⁸ The blockholders are in the forefront of these opponents, because they are aware that corporate governance reform will stop them from utilizing minority shareholders’ rights.

In the emerging markets, especially in Asia, the relationship between the practitioners and the controller of the firms in the financial markets are usually closely related. They could be close as well with the officials, legislators, and regulators. This is the so-called relationship-based system,¹⁶⁹ which is the alternative to the so-called rules-based system, and the latter system is predominant in the western side of the world. Corporate

¹⁶⁵ See JLFS, *supra* note 121, at p. 1.

¹⁶⁶ See *Ibid*, at p.22. The authors believe that this phenomenon is mostly spread in civil law countries, including developed and developing countries.

¹⁶⁷ See Gugler, K. “Conclusion and Policy Implications”, In K Gugler (ed), *Corporate Governance and Economic Performance* (Oxford University Press, 2001), pp 201-202. Hereinafter Gugler.

¹⁶⁸ See Cankar, Nina, *supra* note 118, at p. 298.

¹⁶⁹ The rules-based system can be seen in the control that it imposes upon the companies. There are two types of control, internal and external. The internal control can be seen in the directors’ responsibility to exert a duty of care and diligence, which also ensure efficient financial control. On the other hand, external control exemplified by the laws and the regulations that the state authorities apply upon the companies. For more details see Clarke, Thomas, *supra* note 31, at p. 200.

governance systems have a major role with regard to the transformation of the economy from a relationship-based to a rules-based economy.¹⁷⁰ In other words, corporate governance as a system motivates the economies to operate based upon laws and regulations instead of relationships with others.

It has been argued that the transformation from the relationship-based system to the rules-based system in the emerging markets is hindered by two main issues.¹⁷¹ The first is the so-called expropriation problem, which refers to the ability of corporate insiders in emerging markets to exploit the other investor's rights for their own benefit. The second issue is presented by the so-called vested interest groups, which are powerful and hold executive positions whether in local political entities or in state-owned corporations, even in large private corporations. Thus, it has transpired that not only is corporate governance an important factor for the economy, but its significance has widened to reach the political sector as well.¹⁷²

There are rigorous asymmetries of information between the insiders of any company i.e., the controlling shareholder, and the outsider, i.e., the shareholders in the emerging markets. These asymmetries can be caused by the weak institutional foundations and the legal foundations.¹⁷³ In addition, in these countries the implementation of contracts is difficult and costly, although the proper enforcement of the law and the regulations could assist in protecting minority shareholders.¹⁷⁴

Business corporations in the emerging economies have used the self-regulatory pattern to create their own corporate governance systems and then to improve the best practice code of corporate governance systems.¹⁷⁵ Arguably, since the implementation of corporate governance depends upon the self-regulatory framework, the corporate governance application will be inefficient. It has also been argued that the blockholders in

¹⁷⁰ See FBHW, *supra* note 154, pp 87-105.

¹⁷¹ See OCFSB, *supra* note 125, at p. 7.

¹⁷² *Ibid.*, at p. 8.

¹⁷³ See Clarke, Thomas, *supra* note 31, at p. 200.

¹⁷⁴ *Ibid.*

¹⁷⁵ See Cankar, Nina, *supra* note 118, at p. 285.

the emerging economies are the central players in improving corporate governance practice.

Therefore, it will be very hard to improve corporate governance practice in these economies, because it is surely going to be against the blockholders' interests and will reduce their control over any corporation. Furthermore, the self-regulation framework of corporate governance in the emerging markets can be seen as an educational character that can be useful for the future of corporate governance practice.¹⁷⁶

Moreover, the deteriorated confidence of capital markets can be strongly restored by strengthening the corporate governance systems. In other words, where there is a poor corporate governance system in the markets, self-dealing will be exacerbated and the rights of the minority shareholders will be neglected.¹⁷⁷ Further, it has been stated that there is an inter-relation between the capital markets and the improvement of the corporate governance performance.

The augmentation of the capital markets will promote the governance system in corporations. Similarly, the development of corporate governance will lead to improvements in the capital markets.¹⁷⁸

Promoting corporate governance practice can be achieved by requiring the managers to be more accountable and by developing transparency to encourage the outside investors to invest in these capital markets. Nowadays, it has been said¹⁷⁹ that the number of qualified managers has increased in the emerging countries, which encourages the large shareholders to hand out the day-to-day jobs to those managers. In this case, supervision over the managers has emerged. The large shareholders can be the monitoring factor over the independent managers in the emerging markets. Therefore, the

¹⁷⁶ *Ibid*, at p. 286.

¹⁷⁷ *Ibid*, at p: 287.

¹⁷⁸ *Ibid*.

¹⁷⁹ *Ibid*.

large shareholders must be offered incentives that encourage them to monitor these managers in addition to maintaining the minority shareholders' rights inviolate.¹⁸⁰

Ironically, there is a special aspect of the corporate culture in Asia, which is that the businessmen or the business families strive to build a chain or corporate network of subsidiaries.¹⁸¹ Establishing such networks of corporations inevitably will require a pyramidal structure to control these corporations. It has been argued,¹⁸² however, that this kind of controlling structure might give rise to irregular and unfair treatment of small shareholders. Therefore, it has been suggested by the OECD report "White Paper on Corporate Governance in Asia"¹⁸³ that the reform of corporate governance in Asia, where most of the countries are considered emerging countries, must incorporate a more transparent structure of control in the business corporation.¹⁸⁴

Shleifer and Vishny have emphasized that, where the property rights laws are not adequately enforced by the public authority, the concentration of ownership in the corporations will favour the large shareholder at the expense of the minority shareholders.¹⁸⁵ Notably, the laws that protect the investors differ from country to another. This difference is attributed to the dissimilarity of the legal roots in each country. In addition, it has been found that the difference in laws between the countries plays a significant role with regard to the ownership structure of the corporations.¹⁸⁶

Corporate governance has a crucial importance for investment returns because of the deficiency in the disclosure systems in the emerging markets and the ineffective implementation of the insider dealing laws and regulations. It has become difficult to

¹⁸⁰ *Ibid*, at p. 296.

¹⁸¹ For more discussion of the businessmen and the family business initiations in Asia see Clarke, Thomas, *supra* note 31, at p. 201.

¹⁸² *Ibid*.

¹⁸³ OECD Report (2003), White Paper on Corporate Governance in Asia, Paris: OECD.

<http://www.oecd.org/dataoecd/4/12/2956774.pdf>

¹⁸⁴ See Clarke Thomas, *supra* note 31, at p. 201

¹⁸⁵ See Shleifer, A. and Vishny, R.W., 'A Survey of Corporate Governance', *Journal of Finance*, (1997), Vol.52, No.2, pp 737-783. Hereinafter SV.

¹⁸⁶ See Klapper, Leora F., & Love, Inessa., "Corporate governance, Investor Protection, and Performance in Emerging Markets", at p. 1, World Bank Policy Research Working Paper 2818, April, 2002. <http://econ.worldbank.org> retrieved on 16 Mar. 2009. Hereinafter KL.

study corporate governance in the emerging markets, because the validity of the published information in emerging markets is suspect. In other words, information released about any company, whether financial information or administrative information, in the emerging markets is vulnerable to manipulation. In the emerging markets, the treatment offered to the local investors is different from the treatment offered to foreign investors, and this situation can be changed with the application of good corporate governance mechanisms, where all investors, whether local or foreign, must be treated equally.¹⁸⁷

Private information trading is a realistic indication of the level of corporate governance in any specific economy.¹⁸⁸ It has been found that there is a relationship between the implementation of the insider trading laws and regulations and the level of the disclosure to shareholders. In other words, a country that enforces the law and regulations that govern private information trading always ranks well with regard to the disclosure of information to the shareholders. Furthermore, such countries also provide good protection of the shareholders.¹⁸⁹

It has been argued that the law in the emerging countries is only on the books and has no effect in reality.¹⁹⁰ Thus, the weakness in emerging countries can be attributed to poor enforcement of the law in these countries. Moreover, it has transpired that the past attempts to reform the laws toward better and compatible with the developments in the emerging markets were disregarded, but the adapted policies were preferred.¹⁹¹

Pistor and others have summed up the corporate governance problems in the emerging economies as follows:¹⁹²

¹⁸⁷ See Grishchenko, Olesya V., Litov, Lubomir P., & Mei, Jianping., Private Information Trading and Corporate Governance in Emerging Markets. at p. 3, October, 2002. Salomon Center for the Study of Financial Institutions. Working Paper Series Corporate Governance Research Group. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1295755 retrieved on 16 Mar. 2009.

¹⁸⁸ *Ibid.*

¹⁸⁹ *Ibid.*, at p 4.

¹⁹⁰ See Pistor, K., Raiser, M., & Gelfer, S., 'Law and Finance in Transition Economies', London *Economics of Transition*, (2000), Vol. 8, pp 325-368. Hereinafter PRG.

¹⁹¹ *Ibid.*

¹⁹² *Ibid.*

- 1- The almost total absence of external finance to replace state funding under a central plan.
- 2- The entrenched position of incumbent managers, who retain effective control over rights even where privatization has shifted ownership to outsiders.
- 3- The remaining influence of the state over corporate decision making through a nexus of subsidies, regulatory favour, and tax arrears provided in exchange for residual control rights.

The problem of corporate governance in the emerging markets according to Pistor is that there is a lack of external finance, which is important for the corporations in general. It has been said that this problem is due to frequent state interventions, which make outsiders hesitant or reluctant to invest.¹⁹³ It has been suggested that one of the most important legal reforms in the emerging markets is the protection of shareholders and creditors,¹⁹⁴ as their rights are always poorly protected in these emerging markets.

Law enforcement is very important in emerging markets especially when the motivation to comply is weak among the people who are related to the corporation. Indeed, enforcing the laws in efficient ways is needed at the outset to have effective legal institutions.¹⁹⁵

Attracting foreign private finance requires that the state show that shareholders' rights are highly respected and that the enforcement of the law is effective.¹⁹⁶ Furthermore, it has been argued that managers in emerging markets are getting private benefits from their positions in the corporations and that these markets are suffering from deficiencies in their institutions.¹⁹⁷ On the other hand, in the developed markets managers receive fewer private benefits due to the development of regulations in their markets as well as the perfection in their institutions.¹⁹⁸

¹⁹³ *Ibid.*

¹⁹⁴ *Ibid.*

¹⁹⁵ See PRG, *supra* note 190, pp 325-368.

¹⁹⁶ *Ibid.*

¹⁹⁷ See DK, *supra* note 131, at p. 1.

¹⁹⁸ *Ibid.*

The natures of the institutions may be categorized as follows:¹⁹⁹

- 1- Private bodies with a formal role promoted or facilitated by the state, such as self-regulated stock markets, arbitration courts and accounting standards boards.
- 2- Political institutions, such as the election process and legislatures.
- 3- State administrative entities, such as patent registration by patent organizations and criminal law enforcement by the ministry of justice.
- 4- Quasi-governmental authority, such as central banks that issue money and regulate banks.
- 5- The legal system, such as contract law for transactions, systems for the implementation of the property rights law and regulations, and corporate governance law and enforcement.

Due to their large size, the institutional investors' can play a major role with regard to a company's decision making process.²⁰⁰ In other words, the institutions can put pressure upon the companies to make a specific decision. For instance, in the United Kingdom, which has a developed market, the institutions own about sixty per cent of the shares in the listed corporations.²⁰¹ Moreover, it has been argued that institutional reform must occur at the outset of the improvements process of corporate governance in the emerging markets.²⁰² Further, it has been said that, in emerging markets, there are two mainstreams. The first mainstream works against corporate governance and is exemplified by the vested interest groups who benefit from the self-dealing in the corporations. The second stream encourages the implementation of the corporate governance systems.²⁰³

¹⁹⁹ See Murrell, P., 'Institutions and Firms in Transitions Economies', This paper is prepared for the Handbook Of New Institutional Economics and published in *The Journal of Economic Literature*, (2002), Vol. 40, No. 3, pp 975–1085.

²⁰⁰ See Short, Helen., & Kevin Kease, "Institutional Shareholders and Corporate Governance in the UK", in Kevin Keasey, Steve Thompson & Mike Wright (eds), *Corporate Governance Accountability, Enterprise and International Comparisons*, (England, John Wiley & Sons Ltd, 2005), at p. 65.

²⁰¹ *Ibid.*

²⁰² See Keong Low Chee, *Corporate Governance, An Asia-Pacific Critique*, (Hong Kong: Sweet & Maxwell Asia, 2002), at p54. Hereinafter Keong Low Chee.

²⁰³ See OCFSB, *supra* note125, at p. 16.

Ultimately, there are suggestions to promote the corporate governance in the emerging markets. In the light of the motivation to reform the situation in the emerging markets, slow functioning government procedures must be eliminated. This elimination will in turn lead the economy to be more efficient and to avoid any new political monopoly.²⁰⁴ Furthermore, transforming the corporate governance systems in the emerging economies from inefficient to good corporate governance depends upon various elements available in the local system for each country. In other words, the background of the economic and political custom for each country contributes to converting the corporate governance system from poor to good.²⁰⁵

Moreover, it has been submitted that the protection of the minority shareholders is poor in the emerging countries that are adopting the civil law. In contrast, the emerging countries that are adopting the common law system are providing minority shareholders more effective protection.²⁰⁶ Therefore, the countries who are adopting the civil law should increase the laws that provide more protection for the non-controlling shareholders and should enact laws and regulations that will require more transparency and disclosure with regard to corporate operations.

Prevailing of crony capitalism (clientelism), the ineffective property rights laws, and the weaknesses of the judicial systems in the emerging countries had led the contract enforcement to be unreliable in terms of protecting investors' rights.²⁰⁷ Additionally, the mechanisms of corporate governance in emerging economies differ from those in the developed economies. However, emerging economies must enforce specific laws and regulations to ensure that the corporate governance mechanism is viable.²⁰⁸ In other words, the legal infrastructure in the emerging markets might not be proper or it is weak and unable to implement corporate governance structures. For instance, the important legislations that must be applied and should relate closely to the corporate governance are

²⁰⁴ *Ibid*, at p. 9.

²⁰⁵ *Ibid*.

²⁰⁶ See La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny. "Law and Finance", *Journal of Political Economy*, 1998, Vol.106, pp. 1113-55. Hereinafter LLSV.

²⁰⁷ See OCFSB, *supra* note 125, at p.10.

²⁰⁸ See WBF, *supra* note 143, at p. 415.

property rights law, bankruptcy law, and regulations related to the financial report disclosure.²⁰⁹

It is also a fact that corporate governance is less complicated in the emerging economies than in the developed economies. Thus, it is not difficult to determine the procedures required to improve the corporate governance mechanisms in the emerging economies, provided that the political department is encouraging this direction.²¹⁰

Notably, with regard to the development of the corporate governance system in the emerging markets, important changes are required in the first instance. For example, the behaviour of the people engaged in the implementation of corporate governance must be changed, and such changes take time.²¹¹ In addition, an impressive endeavour has been made by the international and local institutions, the World Bank and the OECD,²¹² with regard to these changes, which has resulted in investors becoming eager to invest in high risk opportunities. In spite of these changes and developments, however, corporate governance in the emerging markets is still below the acceptable level.

Arguably, in the emerging markets, while there is an understanding of what the notion of corporate governance means, there is no implementation. In addition, the reformer must take into account that a large number of the corporations in the emerging markets are family-based businesses. Therefore, implementation must pay attention to the conditions in each country.²¹³

Since the emerging markets are passing through a transitional stage, reforming corporate governance should be implemented within an acceptable pattern to ensure that the corporate culture is able to adapt.²¹⁴ Berglof and Von Thadden have stated that, “...

²⁰⁹ *Ibid.*

²¹⁰ See Corporate Governance: Easy to Advanced Markets And Difficult to Emerging Markets, By Maged Shawky, November, 2002, at p. 4. The Full article can be found on the following link: <http://www.hawkama.net/files/pdf/art0702.pdf> retrieved on 24 Mar. 2009.

²¹¹ See Keong Low Chee, *supra* note 203, at p. 53.

²¹² *Ibid.*

²¹³ *Ibid.*, at 54.

²¹⁴ *Ibid.*, at 55.

to make policy recommendations therefore requires defining the corporate governance problem in a particular country with regard to its prevailing institutions. The predominant corporate governance problem in a transition country is likely to differ from what in developing country, which in turn differs from that in a developed market economy... These differences will affect the implementation policies to improve corporate governance.”²¹⁵ In this passage, they have emphasized that the policy makers must analyse each country’s condition before they reform the corporate governance system. Moreover, reformation of corporate governance might not be viable in every country.

In spite of the abovementioned challenges of corporate governance in the emerging markets, Brazil provides an idealistic example of an emerging market where a state-owned corporation was privatised through a corporate governance best practice code. Brazil has been considered to have a very prominent economy with regard to the adoption of corporate governance between the emerging economies, as it established the Institute for Corporate Governance in 1995 and produced a code of best practice.²¹⁶

Furthermore, the new Brazilian market (novo Mercado) has a listing section for corporations that accept more regulations and rules provided for compliance with the best practice of corporate governance exceeding what is required by the law. These additional rules and regulation enhance transparency and shareholder protection.²¹⁷ Moreover, the corporations are entitled to additional services when they accept the listing in the abovementioned section, such as access to the Arbitration Panel for conflict resolution between shareholders and the corporations, which is an alternative to the court litigation.²¹⁸

²¹⁵ See E Berglof and EL Von Thadden, “*The Changing Corporate Governance Paradigm: Implications for Developing and Transition Economies*,” in S Cohen And G Boyd (eds), *Corporate Governance And Globalizations* (Cheltenham, Edward Elgar Press, 2000) at p. 278.

²¹⁶ See Monks Minow, *supra* note 155, at p. 355.

²¹⁷ *Ibid.*

²¹⁸ *Ibid.*

3.5 Conclusion:

In this chapter, the idea of corporate governance mechanisms and the challenges facing them in the emerging markets have been explored. In addition, solutions have been suggested to resolve the deficiencies of corporate governance in the emerging markets. An emerging market has been identified as follows: “Countries in the world that are expected to experience lots of growth. Investing in these countries has lots of potential for big returns, but it also carries lots more risk than typical domestic investing.”²¹⁹

Furthermore, the ownership structure in the emerging markets is concentrated, which is strongly attributed to the privatization programme and the family business firms. The privatization programme in the emerging markets has played a major role in transferring the ownership of the state-owned corporations from the state to the private sector. However, this transfer of ownership has not been adequately exercised in the developing countries, as many deficiencies have emerged.

Therefore, the privatization programme should have been accompanied by efficient regulation in addition to the adoption of a corporate governance code as occurred in Brazil when the Embraer Corporation privatized. The importance of corporate governance has been increased significantly in the emerging markets because of the concentration of ownership. Moreover, the concentration of ownership is facilitating misconduct in the market, since the controlling shareholder does not face strong regulations and laws that protect the other shareholders. Accordingly, it has transpired in the emerging markets that there is no place for the so-called agency problem posed by the principle of the separation of ownership and control. In addition, there are more kinds of ownership structure in the emerging markets, i.e. the various classes of shares and the pyramid structure. These two structures enable the controlling shareholder to expropriate the minority shareholders’ rights.

²¹⁹ <http://www.teenanalyst.com/glossary/e/emergingmarkets.html>, retrieved on 4 March 2009.

The concentration of ownership has created a conflict between the interests of the controlling shareholder and the other shareholders instead of the usual conflict of interests between the shareholders and the management.

In spite of the different development of corporate governance in the emerging markets, common issues exist among the emerging markets that are related to corporate governance. These issues include insider ownership, the concentration of ownership, and the owner-managed company. This similarity in corporate governance issues in the emerging markets is attributable to the government programme of privatization.

Furthermore, in this chapter an attempt is made to determine the corporate governance obstacles in the emerging markets. It has been found that the development of corporate governance in the emerging markets has confronted several barriers. The private benefit of control by the manager, who is most commonly the controlling shareholder in the emerging markets, illustrates one of these obstacles. On the other hand, solutions have been suggested to curtail the private benefit of control, one of which is proper disclosure. Another obstacle to the development of corporate governance in the emerging markets is “crony capitalism,” which enhances the opportunities available to the relatives of government officials and to corporate insiders to undermine the positions and opportunities that would otherwise be available to minority shareholders.

Also, the system in the emerging markets is relationship-based, which means that these markets are running according to the relationships between the related people. It is contrary to the rule-based system in which the regulations and the laws are the dominant factors in relation to the markets’ operation and which are prevalent in the developed markets. It has been found that corporate governance has a major role with regard to transforming the markets from a relationship-based to a rules-based system. Such a transformation from one system to the other has been hindered first by expropriation, which is exercised by the insiders of a corporation against the minority shareholders, and secondly by the placement in executive positions within a state-owned corporation or within the local political entities of powerful and vested interest groups.

Asymmetries of information between the insiders of the corporation, who are the controlling shareholders, and the outsiders, who are the minority shareholders, illustrate one of the corporate governance obstacles in the emerging markets.

Many corporations in the emerging markets have used self-regulation to establish their own corporate governance system. It has been argued, however, that corporate governance implementation is weak when it is based upon self-regulation and not upon laws and regulations. Moreover, confidence in the capital markets can decline if corporate governance is weak, since this weakness can exacerbate the self-dealing by the managers at the expense of the minority shareholders.

Accordingly, these corporate governance deficiencies in the emerging markets are strongly attributed to the weaknesses of the institutions. These institutions, which can be legal, financial or political, can play a major role with relation to the existence of corporate governance one way or another. In other words, the above mentioned obstacles exist as the result of the failure or refusal to apply property rights laws and regulations, which has encouraged the controlling shareholders to infringe the laws and regulations at the expense of the minority shareholders' rights.

Therefore, the emerging markets must start reform by implementing corporate governance through the effective application of their laws and regulations. Furthermore, the policy makers in the emerging countries must take into account the different conditions of each country. In other words, the application of corporate governance differs from country to country, and choosing the appropriate corporate governance system should depend upon the legal root of the country, as well as its financial structure and its political culture. Only upon the completion of such efforts will corporate governance systems in the emerging markets be relieved of the harmful effects that result from the failure to enforce the laws and regulations.

Chapter Four: The Corporate Culture in Kuwait

4.1 Introduction:

Kuwait, as an official state, is among the more modern; it is similar to the other Arabian Gulf Countries.²²⁰ These countries, which are known as the Gulf Cooperation Council Countries (GCC), share many common characteristics, including their location, their sources of income, and their societal customs.²²¹ This chapter attempts to provide an introduction picture for the Kuwaiti corporate culture. Therefore, it is necessary to explore some of the aspects that are related to the commercial life in Kuwait. Accordingly, section one of this chapter is devoted to the historical development of modern business corporations in Kuwait.

Kuwait has been officially known as a state for approximately three hundred years.²²² The commercial activities were small and simple in the early era of the constitution of Kuwait. Notably, these commercial activities were comprised mostly of pearl diving and the carriage of goods or persons.²²³ The situation in Kuwait changed as the result of the exploration and exportation of oil. The Kuwaiti government has since been receiving an influx of profit from the sale of petroleum products by foreign corporations that have been granted concessions for the exploration of oil.²²⁴ Hence, during this time i.e. the 1950's, the shareholding corporations began emerging among the Kuwaiti merchants.

In 1960, the first Commercial Company Law Decree No: 15/1960 was enacted by the Kuwaiti government due to the need for a legal regulator of new or modern commercial life in Kuwait.²²⁵ This has been amended, among the most important of which amendments granted permission to foreign investors to incorporate their own

²²⁰ See Rosemarie Said Zahlan, *The Making of the Modern Gulf States... Kuwait, Bahrain, Qatar, The United Arab Emirates and Oman*, (Ithaca Press, United Kingdom, 1998), pp 2-3. Hereinafter, Rosemari.

²²¹ *Ibid.*

²²² See Dr Tummah AL-Shammari, *AL-Waseed fe Derasat Qanoon AL-Sharekat AL-Tejareya AL-Kuwaiti w Ta'adeelato*, Third Edition, (1999, the State of Kuwait), at p 24. Hereinafter, Dr Tummah AL-Shamari.

²²³ See Jacqueline, Ismael, S., *Kuwait Dependency and Class in A Rentier State*, University Press of Florida, USA. 1993. at p24. Hereinafter, Jacqueline.

²²⁴ See Dr Tummah AL-Shamari, *supra*, a note 222, at p 37.

²²⁵ Kuwait Commercial Companies Law No. 15/1960

shareholding corporations in Kuwait and to own 100% of the capital. This amendment was intended to encourage the investment of foreign capital in Kuwait.

The nature of the Kuwaiti economy constitutes an important pillar in understanding the commercial corporate culture in Kuwait. Thus, in the second section of this chapter the rentier²²⁶ nature of Kuwait's economy will be explored.²²⁷ The Kuwaiti Government planned to invest its huge returns derived from oil sales into the flourishing private sector in Kuwait. In reality, however, consumption was raised, and few business individuals benefited from this flood of money.²²⁸ And that because these individuals have relations with the government, thus as consequences the other individuals have not been affected by the flood of money. This way of benefiting entrenches the relationship based system in Kuwait. In other words, the crony capitalism was dominating the business in Kuwait.

Furthermore, many aspects show entrenchment of the rentier state in Kuwait. For instance, the public sector in Kuwait employs the majority of the employees, which has resulted in salaries becoming a huge amount of the government's annual budget.²²⁹ Furthermore, the Kuwaiti government depends upon the returns derived from the sale of crude oil and petroleum products to finance its fiscal budget, as such returns constitute approximately 80% of the public budget of Kuwait.²³⁰

As in the majority of the world's countries, the family business is a major player in Kuwait's economy. It had been said that the family business has existed since the early days of the state of Kuwait.²³¹ As a result, the family business is the oldest form of business corporation in Kuwait. In addition, the family business in Kuwait was

²²⁶ The rentier economy can be defined as follow: Those countries that receive on a regular basis substantial amounts of external rent.

²²⁷ See Yates, Douglas, *The Rentier State in Africa: Oil Rent Dependency and Neocolonialism in the Republic of Gabon*, 1996, Trenton, NJ, Africa World Press, at p 12. Hereinafter, Yates.

²²⁸ See Jacqueline, *supra*, note 223, at p 102.

²²⁹ See the Statement of the Kuwait Minister of Finance On the Economic, Monetary and Financial Conditions And the Draft Budget for the Fiscal Year 2008/2009. www.mof.gov.kw retrieved on October 20, 2009.

²³⁰ See the Statement of the Kuwait Minister of Finance On the Economic, Monetary and Financial Conditions And the Draft Budget for the Fiscal Year 2008/2009. www.mof.gov.kw retrieved on October 20, 2009.

²³¹ The family business, and its role in the human and economic development, Article by Mahmud Essa, on April 29, 2007, <http://www.alukah.net/articles/85/734.aspx>. Retrieved on October 3, 2009. Hereinafter, Mahmoud Essa.

encouraged by the government and is the second biggest investor after the government.²³² Therefore, it is necessary to outline the family business situation in the context of the Kuwaiti economy in the third chapter to recognize the business corporate culture in Kuwait.

In the fourth section of this chapter, the emergence of Islamic investment corporations in Kuwait is explored. Islamic corporations are governed and regulated by the Shari`a. In Kuwait, the Kuwait Finance Bank was the first Islamic commercial organization. The historical development of Islamic corporations in Kuwait shows that the formation of this type of business organization has enjoyed a steady and accelerated development.

4.2 The Historical Development of Modern Corporations in Kuwait:

Kuwait has been known as a state officially since 1756. Since that time, Kuwaiti society has exercised simple businesses and industries.²³³ These industries were exemplified by Pearl diving and the carriage of goods and people.²³⁴ Pearling was regarded as the most important commercial activity, because most Kuwaitis were involved in that commercial activity. Pearling involves three parties: the ship-owner, the divers, and the financier of the trip. The profit of the trip was distributed among the three parties un-equally. Hence, it has been said that the whole transaction among the three parties can be deemed as a corporation.²³⁵ The pearl industry in Kuwait grew quickly during the first quarter of the 20th century, which was the reason why pearl merchants are able to control the pearling boats. Furthermore, a tax was levied upon the pearl industry due to the overflow of the returns derived from this commerce.²³⁶

Such relatively uncomplicated business ventures did not give rise to issues that required formal regulations to administer Kuwaiti commerce. Such disputes that did arise out of commercial activities were resolved by a specialized panel, which was considered

²³² See The Family Corporations in the Gulf. Chances and Challenges, a study conducted by the Diplomatic Center in Kuwait, Volume 36, September 7, 2009, and published in AL-Watan Newspaper on September 23, 2009.

²³³ See Dr Tummah AL-Shammari, *supra*, note 222, at p 24.

²³⁴ *Ibid* at p 34.

²³⁵ *Ibid*.

²³⁶ See Jacqueline, *supra*, note 223, at p 61.

a commercial court, AL-Mahakem AL-Tejareya. The panel resolved such commercial disputes according to traditions and commercial customs.²³⁷

The socio-economic culture in Kuwait began to progress, as the result of which business corporations began to emerge. An early notable example occurred in 1923, when the Amir of Kuwait, Shiekh Ahmed AL-Jaber AL-Sabah, granted a license to the Transportation by Motors Corporation to be formed as a joint-stock corporation.²³⁸

Oil was discovered in Kuwait in the early 1930's. The Second World War caused the first commercial shipment launch to be postponed until 1946.²³⁹ In 1934, Shiekh Ahmed Al-Jaber AL-Sabah granted a monopoly exploitation concession to the Kuwait Oil Company, a joint-venture corporation, which was owned by the Gulf Oil Corporation, an American Corporation, and Anglo Persian Oil Company, a British Corporation.²⁴⁰ In the 1940's, some other foreign corporations were granted oil exploitation concessions in different areas in Kuwait.²⁴¹

In addition to the oil corporations, the British Bank for Middle East opened a branch in Kuwait in 1942. The revenue derived from the sale of oil was deposited in this bank. The National Bank of Kuwait was established in 1952 as the first Kuwaiti bank. The Kuwait Airways Corporation and the National Cinema Company were also established in 1954 as joint-stock corporations.²⁴² It has been submitted²⁴³ that the emergence of public corporations in Kuwait is attributable to the Protectorate Agreement between Kuwait and the United Kingdom, in addition to the existence of the foreign corporations in Kuwait.

The significant number of corporations formed in Kuwait in the 1950's led by the middle of the decade to an overflow of income derived from the sale oil.²⁴⁴ Thus, it

²³⁷ See Nathan Brown, *The Rule of Law in the Arab World; Courts in Egypt and the Gulf*, (Cambridge, Cambridge Press, 1997), p. 130.

²³⁸ See Dr Tummah AL-Shammari, *supra*, note 222, at p 34.

²³⁹ See Dr Tummah AL-Shammari, *supra*, note 222, at p 36.

²⁴⁰ *Ibid*, at p 37.

²⁴¹ *Ibid*.

²⁴² *Ibid*, at p 35.

²⁴³ *Ibid*.

²⁴⁴ It is noteworthy that the number of the limited liability companies incorporated in Kuwait during the mid 1970's reached 1,087 corporations, in addition to which there were 1,542 limited liability corporations in Kuwait, 103 closed shareholding corporations, and 39 public joint-stock corporations. The government

became necessary officially to regulate corporate activities. To address this need, the first Company Law was enacted in 1960 under the Law No: 15/1960.²⁴⁵ Soon thereafter, in June of 1961, Kuwait and the United Kingdom signed a treaty to terminate the protection treaty, which gave the state of Kuwait its full independence. At the same year, Kuwait joined the United Nations.

Article 5 Section (VI) of the Kuwait Company Law No: 15/1960 stipulated that at least 51% of the capital of every corporation incorporated in Kuwait must be owned by Kuwaitis. The Article stated:

“The amount of the capital and each partner's contribution, provided the percentage of the Kuwaiti partners' holdings in partnerships that are formed after the operation hereof, shall not be less than 51 (fifty-one) per cent of the capital”.²⁴⁶

In other words, if a foreigner intended to set up a company in Kuwait, he could not own more than 49% of the company's capital. The rest of the capital had to be a Kuwaiti contributor. A similar restriction was imposed upon the foreigners' equity ownership in joint-stock corporations by Article (68) of the Law No. 15/1960, which stated:²⁴⁷

“Every joint stock company, which is incorporated in Kuwait, shall be of Kuwaiti nationality; all partners shall be Kuwaiti and the company's head office shall be in Kuwait. However, as an exceptional measure, a number of persons who are not Kuwaiti nationals may be partners in a joint stock company (but not banking and insurance companies) if it is necessary to invest foreign capital or exploit foreign expertise, provided that the capital holdings of Kuwaitis shall not be less than 51 (fifty-one) per cent and provided also a license to that effect is obtained from the government department concerned”.

participated in more than half of the capital. For more details, see Dr Abu Zaid Redhwan, *the Commercial Corporations in the Kuwaiti Comparative Law*, the year, the publisher, the place of publication are not mentioned. pp. 21-22. Hereinafter, Dr Abu Zaid.

²⁴⁵ Kuwait Companies Law No: 15/1960.

²⁴⁶ Kuwaiti Companies Law No: 15/1960, Article (5) Section (VI), Official translation.

²⁴⁷ Kuwaiti Companies Law No: 15/1960, Article (68), Official translation.

In 2001, a new Investments Law was enacted in Kuwait under the Law No.8/2001.²⁴⁸
Article 4 of this law provides:

“In exclusion of the provisions of Article 68 of Law No. 15 of 1960 referred to a license may be given by order of the Minister upon the recommendation of Investment Committee to incorporate Kuwaiti companies where the share of foreigners therein shall be 100% of their capital in accordance with the conditions and circumstances placed by the Council of Ministers”.

This law regulated the entrance of foreign capital in Kuwait and demolished the restrictions imposed upon each foreigner’s participation in the capital of each corporation. Obviously, the motives behind the promulgation of such a law were to attract foreign investment in Kuwait, to generate more opportunities for domestic employers in the private sector, and to benefit from the development and the expertise of foreigners investors.²⁴⁹

According to Article 4²⁵⁰ of the Foreign Investment Law, foreigners are now able to incorporate a company in Kuwait without a Kuwaiti partner. In other words, the law in Kuwait allows foreigners to own a 100% of a corporation in Kuwait. This Article superseded the provisions of the Kuwait Companies Law 15/1960 (Articles 5 sub-section VI, 68) with regard to foreign contribution to a Kuwaiti company’s capital. In addition, the Kuwait Foreign Investment Law, Article 8, includes provisions that guarantee full compensation for foreign investors in the event that their investments are confiscated.²⁵¹ The principle of an adequate compensation against confiscation has also been mentioned in Article 18, provision (1), of the Kuwait Constitution as follow:²⁵²

“Private property is inviolable. No one shall be prevented from disposing of his property except within the limits of the law. No property shall be

²⁴⁸ The Kuwaiti Foreign Investment Law No: 8/2001.

²⁴⁹ The Explanatory Memorandum of the Kuwaiti Foreigner Investment Law No: 8/2001.

²⁵⁰ The Kuwaiti Foreign Investment Law No: 8/2001. Article 4.

²⁵¹ The Kuwaiti Foreign Investment Law No: 8/2001. Article 8.

²⁵² Kuwait Constitution (1962), Article (18), Provision (1)

expropriated except for the public benefit under the circumstances and in the manner specified by law, and on condition that just compensation is paid”.

Furthermore, a foreign corporation that is doing business in Kuwait is subject to a mandatory tax system. According to Income Tax Law No: 3/1955,²⁵³ a foreign corporation in Kuwait is subject to a tax in the amount of 55% of the yearly taxable profit. In 2008, and in accordance with the Kuwaiti government’s plan to encourage foreign investors to do business in Kuwait, the tax rate imposed upon foreign corporations in Kuwait was reduced to a lower flat rate in the amount of 15% of the annual taxable profit. This was accomplished when the National Assembly promulgated Law No: 2/2008.²⁵⁴

In addition, foreign corporations are subject to another tax only if they are listed on the Kuwait stock market. Listed corporations are subject to a tax rate in the amount of 2.5% of their yearly net profit in compliance with the provisions provided for in the National Labour Support Law.²⁵⁵ This Law encourages domestic workers in Kuwait to be employed in the private sector.

Trading in shares of companies in Kuwait has passed through historical stages since the emergence of the public corporation from the 1960’s on. In 1970, Kuwait enacted Law No: 32 to regulate the trading of stock in public corporations.²⁵⁶ The official Kuwait Stock Exchange Market was first established in 1977. Interestingly, at the same time, an unofficial stock exchange market, known as Suq AL-Manakh, was established by investors.²⁵⁷ The purpose of Suq Al-Manakh was to circumvent the regulations and the resolutions issued by the government that govern shares trading. Sug Al Manakh collapsed in 1982 due to the irregularities that were committed by the major Kuwaiti

²⁵³ Kuwait Income Tax Law No: 3/1955

²⁵⁴ New Kuwait Income Tax Law No: 2/2008

²⁵⁵ National Labour Support Law No: 19/2000.

²⁵⁶ Law No: 32/1970, in regard the stock trading in public corporations in Kuwait.

²⁵⁷ See ‘Ali al-Hamdan, *Al-Kuwait wa Azmat al-Manakh*, (Kuwait, Om-AlQoura Publications, 1984), pp. 10-11.

investors.²⁵⁸ Furthermore, after the collapse of Suq AL-Manakh, the Amiri Decree in 1983 was passed that provided for the establishment of a new Stock Exchange Market in Kuwait, which still exists today.

Foreign investors were not permitted to own shares in corporations that are listed in the Kuwaiti Stock Exchange market. Through the promulgation of Law No: 20/2000, non-Kuwaitis were permitted to own stocks in the listed shareholding corporations.²⁵⁹ Article (1) states the following:

“It will be permitted for non-Kuwaitis to own shares in the Kuwaiti shareholding companies existent during the undertaking of this law or that shall be established after its implementation”.

Non-Kuwaitis also have been granted permission to participate in establishing these companies according to the above mentioned article provisions.²⁶⁰ In addition, this law allows non-Kuwaiti investors to participate in forming shareholding corporations to encourage foreign capital to do business in Kuwait.

4.3 The Rentier Nature of The Kuwaiti Economy:

As noted above, during the pre-oil era, Kuwait relied upon two sources of revenue, pearling and uncomplicated commercial activities.²⁶¹ The pearl industry in Kuwait grew quickly during the first quarter of the 20th century, which empowered the pearl merchants over the pearling boats. Interestingly, a tax was levied upon the pearl industry due to the excessive profits that it enjoyed.²⁶² During the post-oil era, the Kuwaiti government has

²⁵⁸ For more details regarding the collapse of Suq AL-Manakh, see Ali al-Hamdan, *Al-Kuwait wa Azmat al-Manakh*, (Kuwait, Om-AlQoura Publications, 1984).

²⁵⁹ Kuwait Law No 20/ 2000, concerning the approval for non-Kuwaitis to own shares in The Kuwaiti shareholding companies.

²⁶⁰ *Ibid*, Article (1).

²⁶¹ See. Jacqueline, *supra*, note 223, at p 24.

²⁶² *Ibid* 61. For details of the way the earnings of the pearls were distributed.

invested the state earnings from the prosperity of the oil sales into the domestic private sector.²⁶³

Seemingly, the government of Kuwait has failed to accomplish the transformation process which was intended to make the private sector active, since local consumption has increased, which has resulted in enlarging individual wealth and the entrenchment of the bureaucracy.²⁶⁴ Thus, the income derived from oil sales has converted the Kuwait economy from a productive economy to a rentier economy.²⁶⁵ Therefore, the Kuwaiti economy has been classified as a rentier economy.²⁶⁶

The rentier state was defined by H. Mahdavy in 1970 as “Those countries that receive on a regular basis substantial amounts of external rent.”²⁶⁷ Furthermore, external rent has been defined as rentals paid by foreign individuals, concerns or governments to individuals, concerns or governments of a given country.²⁶⁸ The economy of a rentier state has been defined by Beblawi: “A rentier economy is thus an economy where the creation of wealth is centered around small fractions of the society.”²⁶⁹ To be considered a rentier state, certain key characteristics must, therefore, exist.²⁷⁰ The first aspect is the centering of wealth creation around a small fraction.

The Kuwaiti government owned all of the revenue derived from the sale of petroleum products, which constitute the main source of Kuwait’s income. Currently, the revenue derived from crude oil and other petroleum products amount to nearly 95% of export revenues and 80% of government income.²⁷¹ Moreover, the dependence on the sales of

²⁶³ See. Jacqueline, *supra*, note 223, at p 102.

²⁶⁴ *Ibid.*

²⁶⁵ See Al-Zumai, Fahad, ‘Rentier States and Economic Regulation Infrastructure: Kuwait as a Case Study’, *Journal of Law*, University of Kuwait, September 2007, No: 3, Vol: 31, at p 13. Hereinafter AL-Zumai.

²⁶⁶ *Ibid.* at p 11. Also see Yates *supra* note 7, at p 12.

²⁶⁷ See H. Mahdavy, *The Patterns and Problems of Economic Development in Rentier States: The Case of Iran*, in M.Cook (ed) *Studies in the Economic History of the Middle East*, (Oxford University Press, Oxford, 1970), at p 428.

²⁶⁸ *Ibid.*

²⁶⁹ See Hazem Beblawi, *The Rentier State in the Arab World*, in Hazem Beblawi and Giacomo Luciani (ed), *The Rentier State*, Routledge, London, 1987, at p 51.

²⁷⁰ See AL-Zumai *supra* note 265, at p 22.

²⁷¹ See the Statement of the Kuwait Minister of Finance On the Economic, Monetary and Financial Conditions And the Draft Budget for the Fiscal Year 2008/2009. www.mof.gov.kw retrieved on October 20, 2009.

the petroleum products is dangerous and instable. In this regard Douglas Yates has stated²⁷² that rentier states that rely upon only one external income are exposed to oil market shocks. It is also a fact that the Kuwaiti government owns shares in many public corporations in the Kuwait stock market.²⁷³

Another characteristic of a rentier economy is that most of the citizens in a state are employing by the government, as in Kuwait. In other words, when the wealth is distributed, most of the citizens receive a distribution. Moreover, most Kuwaiti residents benefit from the revenues gained from the oil sales. They also benefit by the fact that the Kuwaiti government pays for most of the benefits conferred upon its citizens. For example, many services and goods are subsidizing by the Kuwaiti government. Furthermore, the salaries paid to the employees in the public sector are around 40% of the government's expenses in fiscal year 2008/2009.²⁷⁴ In addition, health care and education are offered to the citizens for free according to the Kuwaiti Constitution.

The third aspect of a rentier economy and the rentier state is the favorable taxation system. A rentier state commonly has a low taxation system. Kuwait has the most favorable taxation system among the Middle East countries, especially that there is no individual income tax, but there is only corporate tax.²⁷⁵ During the tax year of 2003/2004, for example, revenue generated from taxes in Kuwait constituted only 1.9% of the government's total revenue. Interestingly, the Ruler in Kuwait levied a tax upon the pearling business when there was no legal framework for Kuwait as a state. This is evidence of the transformation of the Kuwait economy from a productive economy to a rentier economy.

The fourth aspect that shows that Kuwait is a rentier state can be illustrated in the Kuwaiti government's involvement in the creation of the country's gross domestic

²⁷² See Yates, *supra* note 227, at p 22.

²⁷³ *Ibid.*

²⁷⁴ The Statement of The Kuwaiti Minister of Finance on the Economic, Monetary and Financial Conditions and the draft Budget for the fiscal year 2008/2009.

²⁷⁵ See Ahmed Jalali-Naini, *The Structure and Volatility of Fiscal Revenue in MENA Countries*, WorldBank Working Paper, 2000, at p 46.

product (GDP). From 1995 through 2001, the Kuwaiti government's participation in the GDP was approximately 70%.²⁷⁶

The goal of making the Kuwaiti economy a productive economy is easier said than done, which is another indicator that Kuwait is a rentier state. In 2008, the Kuwait government recruited 75% of the new national employees in Kuwait.²⁷⁷ Apparently, the majority of the workers in Kuwait are employed in the public sector. These public sector employees are a majority that leads the political life in Kuwait. Thus, they feel that any economic reform would bring an end to their lavish lives in the public sector.²⁷⁸

The domination of the rentier economy and the size of the governmental bureaucracy hinder the goal of the Amir of Kuwait to convert the State of Kuwait to be an international financial centre.²⁷⁹ Because Kuwait's economy depends upon oil sales as the sole source of the state's entire revenues, as the oil exportation constitutes 90% of all Kuwaiti exports and is the source of 80% of the Kuwaiti government's revenues.²⁸⁰ Thus, many economists believe that Kuwait must diversify its sources of income. However, the energy markets have been through a period of great volatility. As a result, it is not easy to predict selling prices especially during the current worldwide financial crisis.²⁸¹

In line with its steps toward correcting its economy, the Kuwaiti government has introduced the National Labour Support No: 19/2000,²⁸² which is intended to encourage Kuwaitis to work in the private sector by paying them a specific amount of money each

²⁷⁶ *Ibid.*

²⁷⁷ See Kuwait News Agency, www.kuna.net.kw retrieved on October 3, 2009.

²⁷⁸ Herb, Michael, "Parliaments, Rentier Labor Markets, and Economic Diversification in Kuwait and the UAE", at p 2. *Paper presented at the annual meeting of the APSA 2008 Annual Meeting, Hynes Convention Center, Boston, Massachusetts*, August 28, 2008. Retrieved on May 23, 2009. http://www.allacademic.com/meta/p278469_index.html.

²⁷⁹ See Amer dhyab AL-tamimi, *Al-Alam, AL-Eqtasad AL-Kuwaiti w Emkanateh*, Awan Newspaper, Vol: 99, February 26, 2008. <http://www.awan.com/pages/world/37932>. retrieved on October 3, 2009.

²⁸⁰ See Emad Harb, *The Political Life in Kuwait and The Democracy's Abilities in The Rentier State*, ECSSR- Emirates Center for Strategic Studies and Research, December 11, 2007. <http://www.ecssr.ac.ae/CDA/ar/FeaturedTopics/PFFeaturedTopics/0,3123,734,00.htm> retrieved on October 3, 2009.

²⁸¹ Ahmed AL-Haron, *Al-dawr AL-Tanmawi Lel Qeta'a AL-Khas AL-Kuwaiti Fe AL-Qarn AL-Qadm*, Paper Presented for the Fourth Conference for the Kuwaiti Economists, April, 1999.

²⁸² National Labour Support Law No: 19/2000.

month in addition to their salaries. The funds required to make the payments called for in this law are derived from deducting 2.5% from the net profit of the companies listed on the Kuwait Stock Market.²⁸³ Although the law has been in effect for more than eight years, its implementation has not changed the situation, as the public sector in Kuwait still recruits more than 80% of the new Kuwaiti graduates. Currently, 92% of Kuwait's manpower is work for governmental ministries or corporations owned by the Kuwaiti government.²⁸⁴

This fact has been facilitated the governmental program to "Kuwaitize"²⁸⁵ government jobs. Accordingly, the Kuwaitize program implementation resulted in a shortage of manpower in the private sector and an overstaffed public sector. Hence, the governmental budget will be overloaded.

On the other hand, the Kuwait economy has many good aspects. There is a very advanced stock exchange market according to the system that this market is using. Moreover, the Kuwaiti economy is open to the global economy, according to the fact that there are no restrictions upon the movement of capital in or out of Kuwait.²⁸⁶

4.4 The Domination of Family Businesses in Kuwait:

Family businesses have played a major role in the development of many countries.²⁸⁷ The family business represents the oldest form of business organization in the world. Family businesses amount to 70% of the economy in most countries in the world.²⁸⁸ In fact, approximately two-thirds of the public companies in Asia are controlling by

²⁸³ *Ibid*, Article (9).

²⁸⁴ See <http://www.infoprod.co.il/country/kuwait1c.htm> retrieved on October 12, 2009.

²⁸⁵ Kuwaitize program intends to make all the employees in the public sector Kuwaitis.

²⁸⁶ See Pro. Khaled Zagloul, Qanon AL-Estethmar AL-Mobasher w Dawroh fe Tafeel AL-Qetaa AL-Khas AL-Kuwaiti, *Majalat AL-Mohami*, (Kuwait, Kuwait Bar Society, January, February and March 2005), at p. 29.

²⁸⁷ See Mahmud Essa, *supra*, note 231.

²⁸⁸ International Finance Corporation (A Member of the World Bank Group), IFC Family Business Governance Handbook, 2008. At p 11. Available at www.ifc.org, hereinafter, IFC Handbook.

families.²⁸⁹ Further, the decision making in family owned businesses is quick.²⁹⁰ Remarkably, the majority of family businesses do not continue to exist, because the succeeding generations mismanage the family business.²⁹¹

The family business constitutes a bright part of Kuwaiti economic history, as this type of business was well established before the State of Kuwait was legally established. The establishment of family businesses is rooted to the early days of the formation of Kuwait as a state.²⁹² The number of family businesses in Kuwait reached around 110,000 companies,²⁹³ which makes them one of the main pillars of the Kuwaiti economy.

The confidence and honesty of family members was the back-bone of the family business' culture in the ancient Kuwaiti economic society.²⁹⁴ Furthermore, the family businesses in Kuwait have followed the same pattern of family business in other countries in the world, since they have begun to convert their family businesses to public companies.

The development of the business world entails access to new experiences that might not have been available to the first generation that founded the family businesses. In addition to the conflicts that might arise among family members, despite the close relations between the one family members in Kuwait society.²⁹⁵ In other words, the family business in general is vulnerable, because the passing of the first generation has revealed many shortcomings in the management of the family owned corporation. Moreover, converting from the old family business to a public company is encouraged and enhanced by applicable Kuwaiti laws that ease this kind of transformation.

²⁸⁹ See Gilson, Ronald, *Controlling Family Shareholders in Developing Countries: Anchoring Relational Exchange*, Rock Center for Corporate Governance Stanford University Working Paper Series No. 10, January, 2007, at p 1

²⁹⁰ See Mahmud Essa, *supra*, note 231.

²⁹¹ See IFC Handbook, *Supra* note: 288, at p 11.

²⁹² See Mahmud Essa, *supra*, at note 231.

²⁹³ *Ibid.*

²⁹⁴ See Al-Abraj Newspaper, Volume: 09-04-2007, *The family business... are they going to disappear in the light of the changes*. <http://www.alabraj.org/NewsDetails.aspx?NewsID=606> retrieved on October 3, 2009.

²⁹⁵ See Al-Abraj Newspaper, Volume: April 9, 2007, *The family business... are they going to disappear in the light of the changes*. <http://www.alabraj.org/NewsDetails.aspx?NewsID=606> retrieved on October 3, 2009.

Significantly, the family business attracts the second largest amount of investment in Kuwait after the government, largely because the family business in Kuwait operates within many types of businesses, such as real estate, investing and industries.²⁹⁶ After oil prices increased dramatically in the 1970's and Kuwait's economy developed, family businesses made many investments and reaped quick and plentiful profits. This prosperity resulted from the business opportunities that were available at that time.

Moreover, the government was facilitating and supporting local investors from many directions. These factors encouraged some of the family business owners in Kuwait to ignore many economic principles when they set up and run their business. For example, they ignored the importance of conducting a feasibility study for their business projects, and they did not ensure the availability of competent management for the projects.²⁹⁷ In other words, these family business owners depended entirely upon the facilitation and the support that was provided by the Kuwaiti government. They did not think of expanding their investments. Moreover, the family businesses in Kuwait most often take one of the following forms: a sole trader, a partnership, or a limited liability company.²⁹⁸ Furthermore, the concentration of management in the owner's hand is the dominant type of management in family owned businesses in Kuwait. Also it has been stated that 90% of the family owned businesses in Kuwait vanish before the third generation of owners.²⁹⁹

In general, the family business usually passes through stages. The first stage is the first establishment and development of the business by the first generation. The second stage is the transfer of the management of the business by the first generation to the second generation; and the third stage occurs when the management is transferred to the third generation. The third stage is considered the most difficult, because many family

²⁹⁶ See *The Family Corporations in the Gulf... Chances and Challenges*, a study conducted by the Diplomatic Center in Kuwait, Volume 36, September 7, 2009, and published in AL-Watan Newspaper on September 23, 2009. Hereinafter *The Family Corporation In the Gulf*.

²⁹⁷ See Mahmud Essa, *supra*, note 231.

²⁹⁸ *Ibid.*

²⁹⁹ *Ibid.*

businesses do not survive it.³⁰⁰ Many family businesses in Kuwait are currently in the third stage, as the result of which many disputes have emerged among family members. Such disputes arise primarily because there is no plan for the transfer of management responsibilities among the third generation of owners.³⁰¹

This unfortunate situation may be attributed to the fact that Kuwait resembles other Gulf countries in that it has special social customs. One such custom is that the management of a family business will be transferred to the oldest son even if he is not qualified, competent, or willing to take control over the family business.

4.5 The Islamic Corporations in Kuwait:

In general, the emergence of Islamic finance in Kuwait dates back to the establishment of the Kuwait Finance House (KFH) in 1977 by Law Decree No: 72/1977.³⁰² The Kuwait Finance House was the first Islamic bank in Kuwait.³⁰³ It has been said³⁰⁴ that the government of Kuwait encouraged the incorporation of the first Islamic bank in Kuwait, since the government contributed 49% of the paid capital. The Kuwait Finance House received deposits that totaled approximately six billion dollars. However, the Kuwaiti economy did not have enough opportunities that were compatible with the Islamic provisions,³⁰⁵ even though many conventional banks and investment corporations in Kuwait conduct business in accordance with Islamic finance principles.

Kuwait now has three Islamic banks, one of which was a conventional bank that converted to an Islamic bank. In addition, the Bank of Kuwait and the Middle East (BKME) is a conventional bank that has been granted permission by the Central Bank of

³⁰⁰ The Family Corporation in the Gulf, *supra* note 296.

³⁰¹ See Mahmud Essa, *supra*, note 231.

³⁰² Law Decree No: 72/1977 regarding the establishment of Kuwait Finance House in Kuwait.

³⁰³ To be an Islamic Bank requires that the bank exercise its financial activities in compliance with a Shari`a provisions.

³⁰⁴ See Henry, M. Clement & Wilson, Rodney (eds). (2004), *The Politics of Islamic Finance*, Edinburgh, Edinburgh University Press Ltd. Hereinafter Clement & Wilson.

³⁰⁵ *Ibid.*.

Kuwait to convert to an Islamic. In other words, the number of conventional banks in Kuwait has decreased in comparison to the number of Islamic banks and corporations.³⁰⁶

In the early 1990's, the Islamic corporations in Kuwait were not an important part of Kuwait's economy. As a result, they were regulated simply by resolutions issued by the Central Bank of Kuwait. However, the increase in the number of Islamic corporations in Kuwait necessitated that their business activities should be regulated by law.³⁰⁷ Thus, the National Assembly of Kuwait passed Law No.30/2003,³⁰⁸ which empowered the Central Bank of Kuwait to supervise the Islamic corporations and banks doing business in Kuwait.³⁰⁹

Islamic finance tools are not similar to traditional finance tools. For example, Islamic corporations differ from conventional corporations primarily in their structures. Islamic corporations have a Shari'a Supervisory Board (SSB).³¹⁰ The task of the SSB is to ensure that all contracts and the day-to-day transactions conducted by Islamic corporations are compatible with Islamic Law. Therefore, the SSB members are mostly scholars in the Shari'a. SSB members have wide authority to accomplish their duties. It has been said³¹¹ that, when there is a conflict between a decision of the SSB and the wishes of the corporation's management or shareholders, the SSB's decision will be paramount.

The SSB renders its decisions in accordance with the provisions presented in the Holy Quran as the main source and the Sunnah as the second source or according to Islamic jurists where available. The SSB also analyze the Islamic jurisdiction (The Fiqh) for find out existence and treatment transactions which are equivalent modern transactions.³¹² It is noteworthy that the SSB's decisions must not violate domestic laws under any circumstances.

³⁰⁶ At www.cbk.gov.kw/PDF/book6Eng/sub1.pdf , retrieved on October 11, 2009.

³⁰⁷ *Ibid.*

³⁰⁸ Law No. 30 of 2003, regarding the supervision of the Central Bank of Kuwait over Islamic banks.

³⁰⁹ See Warde, Ibrahim, (2000) *Islamic Finance in the Global Economy*, Edinburgh, Edinburgh University Press.

³¹⁰ See the Dissertation for Bjaklund, Irene, & Lundstrom, Lisbeth, *Islamic Banking; An Alternative System*. December, 2004, Kristianstad University, Sweden. at p 72.

³¹¹ *Ibid.*

³¹² See Abdullah, Saeed, (1996), *Islamic Banking and Interest: A Study of the Prohibition of Riba and Its Contemporary Interpretation*. The place of publication and the publisher are not mentioned.

The history of Islamic corporations in the Kuwait Stock Exchange Market shows that their number has steadily and rapidly increased.³¹³ The development of Islamic corporations has been through unpredictable growth that even the specialists in that field did not anticipate. In 2003, there were only nine Islamic corporations in the Kuwaiti Stock Exchange Market, which represented 8% of the capital market value.³¹⁴ The number of listed Islamic corporations increased to fourteen corporations in 2004 with a value of 11% of the Kuwaiti capital market. Further, in 2005, there were 27 Islamic corporations, which constituted 18% of the capital market.

In 2007, 45 Islamic corporations constituted 23.6% of the listed corporations in the Kuwaiti Stock Exchange Market. In 2009, there are 51 Islamic corporations in the Kuwait Stock Exchange Market, and their value amounts to approximately 20 Billion USD.³¹⁵

Interestingly, in addition to the listed Islamic corporations in the Kuwait Stock Market, there are conventional corporations that have transactions that are not in conflict with the Islamic finance provisions.³¹⁶ In other words, even the traditional corporations in Kuwait offer financial services that are compatible with the Islamic provisions. Recently, however, it has been revealed that the Kuwait Stock Exchange Market is receiving listing requests mostly from Islamic corporations.³¹⁷

The trend toward Islamic finance tools is not just in Kuwait but in most of the countries in the commercial world. The estimation of Islamic finance value is approximately 729 Billion USD, which is expected to grow to 1 trillion in the year of 2010.³¹⁸ Furthermore, Islamic finance has not been shocked during the recent financial

³¹³ AL-Qabas Newspaper on August 6, 2007, *An Islamic Stock Market... Is It A Dream or A Miserable Reaction?*. Retrieved on October 3, 2009.

³¹⁴ *Ibid.*

³¹⁵ <http://kuwaitse.com/Portal/A/>, retrieved on October 18, 2009.

³¹⁶ AL-Qabas Newspaper on August 6, 2007, *An Islamic Stock Market... Is It A Dream or A Miserable Reaction?*. Retrieved on October 3, 2009.

³¹⁷ *Ibid.*

³¹⁸ See Hoepner, Andreas, Rammal, Hussain & Rezac, Michael, *Islamic Mutual Funds' Financial Performance and Investment Style: Evidence from 20 countries*, September, 2009, United Kingdom, at p 2. Electronic copy available at: <http://ssrn.com/abstract=1475037>, retrieved on October 20, 2009.

crisis as much as conventional finance, which might be attributed to many reasons. For instance, Islamic finance law forbids high risk services.³¹⁹

4.6 Conclusion:

This chapter has highlighted the main influential elements that affect the commercial corporate culture in Kuwait. The Kuwaiti commercial society has passed through several stages. At the ancient time of Kuwait before the exploration of oil in the 1930's, the commercial activities were simple and small. The huge amounts of profit gained from oil exportations in Kuwait were not expected by the government; as a result, the government of Kuwait has not used the profits properly to develop the country.

Instead, these profits have changed Kuwaiti society from productive to rentier. Kuwait has been classified as a rentier state, since it is highly dependent upon oil to finance its public budget. In addition, the public sector in Kuwait employs the majority of the workers as compared to the number of workers employed in the private sector. Moreover, the Kuwaiti business culture is dominated by family businesses, as compared to the pre-oil era during which the majority of the commercial activities in Kuwait were found by families.

However, nowadays there is a trend in Kuwait among family businesses to convert to shareholding corporations. This conversion is occurring out of a need to increase corporate capital to expand investment or to allow new individuals to join the management of the corporation.

Furthermore, Islamic corporations are seen as a phenomenon in Kuwait, since many of this kind of corporation have been established since the early 1990's. At the same time, more than half of the listed corporations in the Kuwait Stock Exchange Market are Islamic corporations.

³¹⁹ *Ibid.*

Chapter Five: Corporate Governance Political and Legal Institutions in Kuwait

5.1 Introduction:

The countries of East Asia that suffered from Asia's financial crisis in 1997 and 1998 learned from their experience the importance of establishing institutions of corporate governance to prevent any future crisis in their financial sectors.³²⁰

Each country that is willing to establish a sound corporate governance system can determine the essential institutions required for such corporate governance from specific features of the country. These features are the country's culture, history, and economic condition.³²¹ While corporate governance institutions must exist to ensure the sound application of any corporate governance system, they are not similar in all countries. Accordingly, to determine which institutions should be established in a country requires an examination of the history, the culture and the financial circumstances of the country.

Kuwait is similar to the other countries of the Middle East and North Africa region (MENA) in that it suffers from slow economic growth.³²² Moreover, the financial trend of MENA countries is to attract foreign capital, which requires sound corporate governance systems.³²³ Further, a sound corporate governance system is a major component of sound capital and securities markets, because good corporate governance inspires confidence among foreign and local investors.³²⁴ The application of a sound corporate governance system in a country entails the existence and proper functioning of institutions, which involves considerations that are political and legal among others.

³²⁰ See Clarke Thomas, *International Corporate Governance, A Comparative Approach*, Routledge, London, 2007, at p 85.

³²¹ *Ibid.*, at p 88.

³²² See Tricker, Bob, *Corporate Governance Principles, Policies and Practice*, Oxford University Press, 2009. New York, at p 207.

³²³ *Ibid.*

³²⁴ See The Importance of Good Corporate Governance for The Middle East and North Africa, report of MENA- OECD Investment Programme, available at: www.oecd.org/daf/corporate-affairs, or at: www.oecd.org/mena/investment. Hereinafter MENA.

This chapter will examine the political and legal institutions in Kuwait and their effectiveness in applying sound corporate governance. Political institutions are inter-related to corporate governance practice.³²⁵ Consequently, it is important to investigate the condition of the political institutions in Kuwait to determine the extent to which sound corporate governance is or can be practiced there.

Kuwait political system makes it the most democratic country among the Gulf Cooperative Council countries (GCC).³²⁶ According to the Kuwait Constitution, the political system is a hereditary Emirate State with a parliamentary system of government.³²⁷ Accordingly, in the political institutions section that follows, the nature of the relationship between the government and the parliament in Kuwait will be examined, in addition to their influence upon establishing a sound corporate governance system.

With regard to the importance of establishing institutions to monitor the soundness of the financial markets of developing countries, “the developing countries themselves are at the end responsible for developing their institutions. In particular, the effectiveness of their policies and institutions is central to their development successes and failures and the eventual attainment of self-reliance.”³²⁸ In other words, developing countries must develop their institutions, especially their legal institutions, to attain sound financial markets. Such legal development is intimately related to the economic development in any country.³²⁹

³²⁵ See The Estimate Political & Security Intelligence Analysis of the Islamic World and Its Neighbors, Kuwait Political System, Part 2, Volume XI, Number 13, June, 1999, available at: <http://www.theestimate.com/public/061899.html>, retrieved on November 23, 2009.

³²⁶ *Ibid.*

³²⁷ Kuwait Constitution (1962), Article (4).

³²⁸ See World Bank, Comprehensive Development Framework Questions and Answers Meeting. At <http://www.worldbank.org/cdf/cdf-faq.htm>, retrieved on November 17, 2009, (last modified, September 13, 1999).

³²⁹ See Daniel Berkowitz, Katharina Pistor, and Jean-Francois Richard, “Economic Development, Legality and the Transplant Effect,” CID Working Paper No. 39, 2000 Centre of International Development at Harvard University, at p 1.

In the context of the relationship between corporate governance and legal institutions, Shleifer and Vishny³³⁰ have stated that the legal institutions are major players in mitigating or seizing the so-called private benefit control of the corporate managers and the major shareholders. Furthermore, the Organization of Economic and Development Cooperation, in its report entitled “*The Importance of Good Corporate Governance for the Middle East and North Africa*,” found that, according to the cultural conditions in MENA countries, the legal and regulatory roles are the most suitable tools of corporate governance for preventing misbehavior by managers.³³¹

This section will also explore the corporate governance legal institutions in Kuwait. First, the origins of the Kuwaiti legal system will be explored, since it was an important factor that shaped the corporate governance system.³³² Secondly, the current legal system in Kuwait will be discussed in light of the fact that the reasons behind the adoption of a specific legal system can be attributed to the country’s history and culture.³³³ In addition, the main differences between common law and civil law systems, which are tightly related to corporate governance, will be explored in relation to the level of protection afforded to shareholders. Also, the judicial system of Kuwait will be investigated in terms of the independence of the judiciary and the ability of the judges to absorb the corporate governance concept.

Finally, the Kuwaiti Companies Law 15/1960 will be analyzed in terms of the corporate governance tools that it includes. In this vein, the Companies Law is important to the corporate governance issues, because it contains corporate governance provisions,³³⁴ such as the structure and composition of the board of directors, in addition

³³⁰ See Shleifer, A., Vishny, R., ‘A Survey of Corporate Governance’, *Journal of Finance*, 1997, Vol:52, pp. 737–783.

³³¹ See The Importance of Good Corporate Governance for The Middle East and North Africa, report of MENA- OECD Investment Program, available at: www.oecd.org/daf/corporate-affairs, or at: www.oecd.org/mena/investment, retrieved on March 3, 2010.

³³² See Yuwa Wei, *Comparative Corporate Governance, A Chinese Perspective*, Kluwer Law International, London, 2003, at p. 182. Hereinafter, Yuwa.

³³³ *Ibid.*

³³⁴ See Kraakman, Davies, Hansmann, Hertig, Hopt, Kanda and Rock, *The Anatomy of Corporate Law, A Comparative and Functional Approach*, 2004, Oxford University Press, UK, at p. 33.

to the directors' duties and the shareholders' rights that are stipulated in the aforementioned law.

Accordingly, the last section of this chapter will examine the extent to which the Kuwaiti Companies Law contains corporate governance tools and to which such tools are effective.

5.2 The Political Institutions in Kuwait:

The political system of Kuwait makes it the most democratic country amongst the Gulf Cooperative Council Countries (GCC),³³⁵ although the political life in Kuwait has lagged behind the political life in the most democratic countries in the world such as the European countries and the United States. Furthermore, it has been found that sound corporate governance practice has an interdependent relationship with public governance practice.³³⁶ Indeed, it could be submitted that the public governance is the cornerstone for the application of the corporate governance, since good public governance is intimately related to two main issues, the voice in the public debate and the entrenchment of the so-called Rule of Law.

As regard the functioning of the political institutions in Kuwait (e.g. the public governance), it would be useful to apply the exit or voice theory. The exit or voice theory was introduced by Hirschman in 1970 and elaborates the impact of dissatisfaction in many perspectives.³³⁷ In other words, a person will exit or leave the relationship when he is not satisfied or the person will use his voice to try to change the relationship once he is not satisfied.³³⁸

The voice and exit theory can be illustrated in the public governance in Kuwait in the context of Parliamentary elections. Voters should vote for the candidate whom they

³³⁵ See The Estimate Political & Security Intelligence Analysis of the Islamic World and Its Neighbors, Kuwait Political System, Part 2, Volume XI, Number 13, June 1999, available at: <http://www.theestimate.com/public/061899.html>, retrieved on November 23, 2009.

³³⁶ See *supra*, note 324.

³³⁷ See Hirschman, Albert O., *Exit, Voice and Loyalty: Response to Decline in Firms, Organization and States*, Harvard University Press, USA.

³³⁸ See David, Saunders M, Introduction to Research on Hirschman's Exit, Voice, and Loyalty Model, *Employee Responsibilities and Rights Journal*, Vol. 5, No:3, 1992, at 187.

believe will legislate and supervise the work of the executive branch. In reality, however, the situation in Kuwait in terms of the voice is poor, because the voters vote most often for those members of Parliament who are able to supply them with the services they need.³³⁹

The needed services are either illegal services or legal services achieved through illegal procedures and that undermine the Rule of Law.³⁴⁰ In other words, the voice is absent from the Parliamentary elections in Kuwait, and the members of Parliament are among the main factors that undermine the Rule of Law in Kuwait. Hence, through the interdependence or the parallelism between the public governance and the corporate governance, the public governance in Kuwait has gained an influential role in corporate governance, i.e. the voice in the corporate governance context can be envisaged in the general meeting of the corporation by the shareholders. However, in Kuwait, the shareholders' general meeting is not efficient, because most of the corporations are controlled by the major shareholder.

Furthermore, the absence of the voice in Kuwait has rendered the general meeting of corporations inactive,³⁴¹ which has resulted in the encouragement of the corporation's directors to undermine the shareholders' rights and benefits. Additionally, when the shareholders' voice is absent in the corporation's issues, the corporation's directors will be able to reap private benefits at the expense of the shareholders' benefits.

³³⁹ For more discussion see Al Rashid, Dr Jalal, *To Know....The Services` MPs At The Top of The Political Corruption*, Al-taleea Newspaper on 23 June 2003.

http://local.taleea.com/archive/column_details.php?cid=1075&aid=45&ISSUENO=1583

Retrieved on 25/09/2011

³⁴⁰ For more details see Al Abraj Newspaper, *The Services` MPs are The Government`s Industry to Address the Government`s oppositions In The National Assembly of Kuwait*, 10-4- 2007,

<http://www.alabraj.org/NewsDetails.aspx?NewsID=1775>, retrieved on 25-9-2011

³⁴¹ See Abu Zaid Redhwan, *the Commercial Corporations in the Kuwaiti Comparative Law*, the year, the publisher, the place of publication is not mentioned, pp 524-525. In addition, Vice chairperson in AL-Mulla Investment Group, Mr Abdullah AL-Mulla have revealed that shareholders in the annual general meeting in the corporation in Kuwait are not activists, therefore the corporation management are not worried from being held accountable during the financial crisis. Interview in Al-Watan Newspaper on 14-Feb-2010.

5.2.1 The Political System in Kuwait:

The political system in Kuwait is determined by the fact that the State of Kuwait is an hereditary Emirate State with a parliamentary system of government according to Article 4 of the Kuwaiti Constitution. Furthermore, Article 80 of the Kuwaiti Constitution provides that Parliament shall consist of fifty elected members, and the mandate of the Parliament is four years.³⁴² In addition, the government ministers are ex officio members of Parliament as provided in Article 79 of the Kuwaiti Constitution.³⁴³

The Kuwaiti political life can be seen as unstable to some extent. The Kuwait Parliamentary life endured political struggles with the government during the last decade, which resulted in the dissolution of Parliament in 1999, 2006, 2008 and 2009. In addition, the government has resigned and re-constituted six times since 2006.³⁴⁴ The stability in the relationship between the government and Parliament resulted in the enactment of proper laws and regulations. The implementation of economic laws and regulations can be seen as a guaranty of long term investment by foreigners, provided that these laws and regulations are compatible with each foreigner's standard expectations of the application of the related laws and regulations, which are the so-called "legitimate expectations".³⁴⁵ Moreover, foreign investors make investment decisions by relying upon the way the government applies the laws and regulations in the host state.³⁴⁶

The tribunal in *Saluka v Czech Republic* stated: "An investor's decision to make an investment is based on the assessment of the state of law and the totality of the business environment at the time of investment as well as on the investor's expectations that the

³⁴² For more details about Kuwait Constitution, See Professor Othman AlSaleh, *Al-Nitham Al-Distori W Al-Mosadat Al-Seyaseyah fi Al-Kuwait*, (Kuwait, Kuwait University Press, 1994), at p 204. Hereinafter Professor Othman.

³⁴³ See Kuwait Constitution, 1962.

³⁴⁴ See http://www.cmgs.gov.kw/netahtml/main.htm?frame_page, retrieved on January 25, 2010.

³⁴⁵ Reinisch, August, *Standards of Investment Protection*, Oxford University Press, New York, 2008, at p: 124.

³⁴⁶ *Ibid*, 124.

conduct of the host State subsequent to the investment will be fair and equitable.”³⁴⁷ It can be inferred, therefore, that the minimum standard of foreign investor protection requires that each investor be treated fairly and equitably, which can be achieved when the laws and regulations in the host state for investments respect the legitimate expectations of investors. The equitable treatment principle with regard to investors is one of the corporate governance principles. Therefore, it can be achieved through political stability in Kuwait between the government and Parliament, which can result in the issuance of proper laws and regulations.

For example, the regulatory authorities such as the capital Market Authority should be independent of the political sphere.³⁴⁸ In other words, to ensure that the regulatory authorities will produce regulations and will supervise, they should be not affected by any external factors. The protection of a regulatory regime against improper political involvement is difficult in countries in which self-interest has long been entrenched.³⁴⁹

Also the government and Parliament should expedite the issuance of laws that relate to the financial sector to restore the confidence of investors and shareholders. For example, the Congress in the United States passed the Sarbanes-Oxley Act immediately after the corporate scandals involving Enron and WorldCom. This Act has made corporate control more affective, and tried to tackle the legal vacuum in the previous Laws.³⁵⁰

³⁴⁷ *Saluka Investment BV (The Netherlands) v The Czech Republic*, Partial Award, November 17, 2006. Available at <http://ita.law.uvic.ca>.

³⁴⁸ Jeffrey Carmichael, Alexander Fleming and David Llewellyn, *Aligning Financial Supervisory Structures With Country Needs*, World Bank Institute, USA, 2004, at p. 217.

³⁴⁹ *Ibid.*

³⁵⁰ See Coglianese, Cary, Thomas J. Healey, Elizabeth K. Keating and Michael L. Michael, “The Role of Government in Corporate Governance,” Regulatory Publicly Program Report RPP-08(2004). Cambridge, MA: Center for Business and Government, John F. Kennedy School of Government, Harvard University.

5.2.2 Kuwaiti Constitution as a Base for the Corporate Governance:

Kuwait has a codified Constitution that was established in 1962,³⁵¹ which has been classified as a rigid constitution.³⁵² It would be argued that the Kuwaiti Constitution includes several articles that can be seen as the backbone for the corporate governance system.³⁵³

First, Article 6 stipulates that the system of governance in Kuwait shall be democratic. In addition, one of the most important principles in the political system that underpins the existence of a sound corporate governance system is the separation between the authorities in Kuwait to ensure the checks and balances at the top political level in the country as is addressed in Article (50) of Kuwait Constitution (1962). Moreover, Article (7) provides for three main pillars in the society: justice, liberty and equality.

Furthermore, private property is protected by Article (18). Moreover, Article 19 added that general confiscation is not permitted, and a particular confiscation should be exercised only by a court judgment. Also, Article 20 states that the national economy is built upon social justice. Social justice has also been mentioned in Article 22, which stipulates that the relations between employers and employees shall be based upon social justice. Article 166 instructs that the right to litigate is guaranteed for all people whenever their rights are violated. Accordingly, in theory, the Kuwaiti Constitution has been embedded with articles that can be considered fertile ground for the application of sound corporate governance.

5.2.3 The Current Obstacles of the Political Life in Kuwait:

5.2.3.1 The Interest Groups and Political Parties:

The absence or the rigidity of the production of laws in Kuwait, especially economic laws that are related to the application of the corporate governance system, can be attributed to the fact that no interest groups exist to take the initiative in demanding that

³⁵¹ Kuwait's Constitution has been published in especial volume of the official Kuwait Gazette on November 12, 1962, and the application date was January 29, 1963.

³⁵² See Professor Othman *supra*, note 342 at p 187.

³⁵³ See Kuwait Constitution's Articles No: 6, 7, 18, 19, 20, 22 and 166.

the members of Parliament issue such laws. Indeed, interest groups in many countries are activists, as they pay or support politicians to vote to pass specific legislation.³⁵⁴ For example, in the United States, if a political party wants to pass a piece of legislation it must convince 51 senators and at least 223 members of the House of Representatives. Whereas, passing legislation in Austria requires the interest group to buy just two parties.³⁵⁵ But this type of process to produce legislation would be very expensive in Kuwait, because the formation of political parties is still not regulated.

Therefore, the interest group must coordinate with a majority of the members of Parliament to pass legislation, which can be very difficult and very expensive, because most of the MPs in Kuwait are independents. That because the Kuwaiti Constitution does not ban or allow for the formation of political parties. But, the explanatory memorandum of the Constitution considered that the formation of political parties would endanger the democratic system in Kuwait. On the other hand, Professor Othman criticized the explanatory memorandum and said that the notion of democracy is intimately related to the existence of political parties.³⁵⁶ In that context, it has been suggested that the time to form political parties in Kuwait is due.³⁵⁷

In reality, political parties have existed in Kuwait unofficially, although they are known to the public authorities, they have domicile places, and their members are known to the public. In addition, the unofficial political parties in Kuwait have their own administrative structure (e.g. political division, social division, etc.). The Islamic Constitutional Movement and the Kuwait Democratic Forum are examples of such unofficial political parties. The formation of political parties is still not regulated, which may be attributed to the underdevelopment of the political environment in Kuwait and the

³⁵⁴ Mueller, C. Dennis, *The Economics and Politics of Corporate Governance in the European Union*, Law Working Paper No: 37/005 of the European Corporate Governance Institute, presented for the Law Making Conference in Cambridge. At p 19. Hereinafter Mueller.

³⁵⁵ *Ibid.*

³⁵⁶ See Professor Othman, *supra*, note 342 at p 736.

³⁵⁷ See Saleh AL-Mulla Kuwaiti MP, interview in www.zawya.com on August 11, 2008, retrieved on November 22, 2009.

domination of the tribal society. Accordingly, the majority of the members of Parliament in Kuwait are independents. Nonetheless, there are small groups of parliament members (conglomerates) constitute occasionally.³⁵⁸

Moreover, the absence of the political parties in Kuwait has scattered the efforts of the MPs. On the other hand, the government in Kuwait can be seen as the only political party in Parliament. As a result, it is able to manipulate the parliamentary process through, for example, what we have mentioned before as the services that the MPs offer to their voters. In other words, if the government wants an MP to vote with the government, the cost will be the approval of more or heavier illegal transactions in the public sector. In these days in Kuwait, it can be said that Parliament and the government are responsible for the proliferation of administrative corruption.

5.2.3.2 Parliamentary Deviations:

One of the most prominent constitutional experts in Kuwait, Professor Othman AL-Saleh, in his seminal book called *The Constitutional System and The Political Institutions in Kuwait*,³⁵⁹ has criticized the members of Parliament for not using their parliamentary tools appropriately, such as through the use of parliamentary questions, interpellations, and parliamentary investigative committees. The parliamentary tools have been used only on a few occasions from the inception of the political era in 1962 until 1989. Thus, Parliament's role in terms of supervising the executive branch has been weakened. According to Professor Othman, Parliament's failure to exercise any of its tools in Kuwait has allowed the executive branch to dominate over all of the country's sectors.³⁶⁰

Moreover, Professor Othman has revealed that most of the parliamentary questions were posed for personal benefit.³⁶¹ Ironically, since 1988, the situation has changed,

³⁵⁸ For example, the conglomerate of reformation and development consists of four members.

³⁵⁹ See Professor Othman *supra*, note 342, pp: 727-723.

³⁶⁰ *Ibid.*

³⁶¹ *Ibid.*

because some of the members of Parliament in Kuwait have abused the parliamentary tools. Furthermore, these tools clearly have been used by members of Parliament mostly to reap personal benefits. For example, one of the members posed 251 questions for the Minister of Kuwait Municipality in November, 2009. In addition, the same member submitted his interpellation request for the same minister in the same month without waiting for the minister's answers.³⁶²

Seemingly, the members of the Parliament in Kuwait has been deviated from their main responsibilities to legislate and to supervise the government's ministers when they are implementing the government's strategic plan. Instead, the members of Parliament are greatly involved in finalizing transactions with their supporters in the government's departments, which transactions are divided into two categories.³⁶³ The first category is comprised of those transactions that are illegal but that are usually accepted by the voters through their district members of Parliament. The other category is comprised of transactions that are legal but are usually finalized by the voters through their district member of Parliament to avoid government bureaucracies.

In other words, most of the members of Parliament in Kuwait provide services rather than carrying out their legislative and supervisory roles as stipulated in the Constitution. It is worth noting that MPs who refuse to finalize services for their voters are rarely re-elected.³⁶⁴ Members of Parliament have attached new tasks to their positions, even though this is not provided for in the Constitution, just to ensure that they will not lose their membership in Parliament.

In this context, Jonathan Marcey theorized this situation when he said that the legislators are acting as entrepreneurs, because they are adopting new tasks to create groups that will support them in the political elections.³⁶⁵ Furthermore, this relationship

³⁶² See <http://www.majlesalommah.net>, retrieved on January 18, 2010.

³⁶³ These transactions are public services offered by government ministries, for instance, and not exhaustive health treatment overseas, recruitment in special places in the government.

³⁶⁴ Dr Fahad ALzumai, 'Rentier States and Economic Regulation Infrastructure: Kuwait as a Case Study', *Journal of Law*, Kuwait University Press, Kuwait, 2007, Vol: 31, No: 3, at p. 35.

³⁶⁵ See Jonathan R. Marcey, 'Public Choice: The Theory of The Firm and The Theory of Market Exchange', (1998), *Cornell Law Review*, pp. 46-74.

between Parliament and the government in Kuwait has led to so-called administrative corruption. The members of Parliament are obliged to supervise the executive branch to ensure that it is following the laws, and, yet, they encourage the ministers to breach the laws and regulations for the sake of their own voters. Moreover, it is worth noting that Kuwait now is the least corrupt of the GCC States, and it has been ranked 66th in the world according to the Transparency International Organization.³⁶⁶

Moreover, Article 121 of the Kuwaiti Constitution provides:³⁶⁷

“During his mandate a member of the National Assembly shall not be appointed on the board of directors of a company...”.

Although this ban went into effect during the mandate of the then current members of Parliament, some of the members in Kuwait undermined the Rule of Law. Some of them are board members in listed companies, which is against the above mentioned constitutional Article.³⁶⁸ Accordingly, it can be inferred from these facts that the members of Parliament in Kuwait constitute an obstacle to the entrenchment of the so-called Rule of Law. Additionally, they underpin the relationship-based system instead of the rule-based system. Thus, the current behavior of the members of Parliament in Kuwait seems to hinder the application of a sound corporate governance system, which entails essentially the existence of the rule-based system.

Hence, it is essential to reform the corporate governance institutions to maintain a good corporate governance system in any country. Thus, the political institutions must be reformed because of the significant role that these institutions play, since they are the

³⁶⁶ See http://www.transparency.org/policy_research/surveys_indices/cpi/2009/cpi_2009_table and Kuwait Slips in Global Corruption Index, by Velina Nacheva. November, 18, 2009. Available at: http://www.kuwaittimes.net/read_news.php?newsid=MTI3NTU0MzI5OA== retrieved on November 24, 2009.

³⁶⁷ Kuwait Constitution (1962), Article (121)

³⁶⁸ For example, one member of Parliament has been elected to the board of the ALimtiarz Investment Company on January 24, 2010, which is during his mandate which started on May 16, 2009. <http://www.alimtiarz.com/alimtiarz/Profile/Board-of-Directors.aspx> retrieved on January 25, 2010.

legislatures.³⁶⁹ In another words, sound political governance can be seen as a prerequisite for sound corporate governance.³⁷⁰ Also, the proper system of corporate governance can play an important role when converting the system from a relationship-based system to a rule-based system in any country.³⁷¹ As this true because the corporate governance supports the checks and balances between the related parties in any transaction.

5.3 Corporate Governance Legal Institutions in Kuwait:

With regard to the importance of establishing institutions to monitor the soundness of the financial markets of developing countries, it has been argued that: “the developing countries themselves are ultimately responsible for their own development. In particular, the effectiveness of their policies and institutions is central to their development successes and failures and the eventual attainment of self-reliance.”³⁷² In other words, developing countries are required to develop their institutions, especially their legal institutions, in order to attain sound financial markets. It has also been said that legal development is intimately related to the economic development in any country.³⁷³ Similarly, the legal institutions of a country greatly influence the financial development that country.³⁷⁴

Therefore, it is a fact that the corporate finance and the financial development will face many obstacles if the legal institutions are not capable to control the financial markets, for example if they are not able to protect the investors.³⁷⁵ In other words, the

³⁶⁹ Oman, Charles, Fries, Steven and Buiter, Willem, *Corporate Governance in Developing, Transition and Emerging-Market Economies*, at p 33. It is a research paper presented by OECD Developments Centre, Brief No: 23.

³⁷⁰ *Ibid*, at p 34.

³⁷¹ *Ibid*, at p 36.

³⁷² See World Bank, Comprehensive Development Framework Questions and Answers Meeting. At <http://www.worldbank.org/cdf/cdf-faq.htm>, retrieved on 17 November 2009, (last modified, Sept. 13 1999)

³⁷³ See Daniel Berkowitz, Katharina Pistor, and Jean-Francois Richard, “Economic Development, Legality and the Transplant Effect,” CID Working Paper No. 39, 2000 Centre of International Development at Harvard University, at p1.

³⁷⁴ See La Porta, R., Lopez-de-Silanes, F., Shleifer, A., Vishny, R., ‘Law and Finance’, *Journal of Political Economy*, 1998, Vol: 106, pp 1113–1155.

³⁷⁵ See Thorsten Beck & Ross Levine, Legal Institutions and Financial Development, in C. Menard and M. Shirely (eds), *Handbook of New Institutional Economics*, (Springer, Netherlands, 2005), pp 251-278. Hereinafter Beck & Ross.

legal institutions must be able to enforce the property rights and contractual rights to encourage the developments of the corporate sector.

In regard to the relationship between corporate governance and legal institutions, Shleifer and Vishny³⁷⁶ have said that corporate managers and major shareholders often undermine the other shareholders' rights in corporations; therefore, legal institutions are major players to mitigate or seize the so-called private benefit control of the corporate managers and the major shareholders. Further, Coase has stated that legal institutions allow the participants in the financial markets to provide for better private contracts to align the managers' interests with shareholders' interests.³⁷⁷

In other words, the legal institutions have prominent role toward the solution of the agency problem. However, in order to improve the private contracts to solve the agency problem, there is a main condition that must be available: the court must be capable to deal with the complex clauses in such contracts.³⁷⁸

Furthermore, the Organization of Economic and Development Cooperation, in their report "The Importance of Good Corporate Governance for the Middle East and North Africa," found that according to the cultural conditions in MENA countries, the legal and regulatory role are the most suitable tools of corporate governance for preventing managers misbehavior.³⁷⁹ In other words, according to the MENA countries culture condition, the most suitable method to prevent the manager from violating the laws is by imposing laws and regulations.

In this section, an attempt will be made to explore the corporate governance legal institutions in Kuwait. Firstly, the legal origins of the Kuwaiti legal system, which is an

³⁷⁶ See Shleifer, A., Vishny, R., 'A Survey of Corporate Governance', *Journal of Finance*, 1997, Vol:52, pp 737–783.

³⁷⁷ Glaeser, Edward, Simon Johnson, and Andrei Shleifer. "Coase versus the Coasians." *Quarterly Journal of Economic*, 2001, Vol: 116, pp 853–899.

³⁷⁸ *Ibid.*

³⁷⁹ See The Importance of Good Corporate Governance for The Middle East and North Africa, report of MENA- OECD Investment Program, available at: www.oecd.org/daf/corporate-affairs, or at: www.oecd.org/mena/investment, retrieved on 3-3-2010

important factor toward shaping the corporate governance system, will be explored.³⁸⁰ Secondly, the current legal system in Kuwait will be mentioned. The reasons behind the adoption of a specific legal system can be attributed to each country's history and culture.³⁸¹ In addition, the main differences between the common law and civil law systems, which are tightly related to corporate governance, will be explored in relation to the shareholders protection level. Lastly, the judicial system of Kuwait will be investigated in terms of the judiciary independence in Kuwait, and its judges' ability to absorb the corporate governance concept.

5.3.1 Kuwait Legal Origin:

It has been said that the legal origins and its supplementary institutions in any country affect the corporate governance system that is applied in that country, for example the level of protection for investors and corporate finance.³⁸² Moreover, the financial development and the protection of private property are weaker in countries adopting the civil law system in comparison with countries adopting the common law system according to the law and finance theory.³⁸³

Since the foundation of Kuwait, it has been said that the governance system was subject to two principles: The principle of consultation between the ruler and the citizens in regard the issues that relate to national affairs; and the applicable law. In other words, the ruler of Kuwait did not enjoy an absolute authority over Kuwait, but he was obliged to consult his citizens before making any decisions in regard to the country's affairs.

³⁸⁰ See Yuwa Wei, *Comparative Corporate Governance, A Chinese Perspective*, Kluwer Law International, London, 2003, at p 182. Hereinafter Yuwa.

³⁸¹ *Ibid.*

³⁸² See Meredith, Jones & Richards, Mitchell, Legal Origin, Legal Families and the Regulation of Labour in Australia, in Shelly Marshall, Richard Mitchell & Ian Ramsay (ed), *Varieties of Capitalism, Corporate Governance and Employees*, 2008, Melbourne University Press, Australia, pp 60-94.

³⁸³ See Beck & Ross, *supra* note 4.

However, it was a fact that the executive authority and the judicial authority were confined in the ruler's hand.³⁸⁴

Moreover, when it comes to the applicable law in Kuwait, there were two main sources: the first was the *Islamic Shari`a*; and the second source was the customs. Thus, it can be said that there was no place for substantive laws.<sup>385</sup> But, according to Dr. Alshamari, the *Islamic Shari`a* provisions were the applicable law in Kuwait from 1756 till 1960 (or from the foundation of Kuwait to the independence of Kuwait).³⁸⁶

Kuwait was a territory of the Ottoman Empire. In 1876, the Ottoman Empire successfully developed the applicable laws by the issuance of the so-called *the Majalat AL-Ahkam AL-Adleya*,³⁸⁷ which contains sixteen sections included company law. It has been stated the issuance of the *Majala* in 1876 can be considered as the first step toward the development of legal systems in the Arabian Gulf countries.³⁸⁸ Moreover, it is worth noting that the *Majala* provisions were legislated based on Abu-Haneefa doctrine. Furthermore, it has been submitted that the enactment of the *Majala* provisions in Kuwait was delayed until 1938, as the first Parliament in Kuwait came and ratified it.

Also, the promulgation of the *Majala* in Kuwait was necessary to fulfill the legal vacuum from which Kuwait was suffering. The delay of the implementation of the *Majala* was attributed to two main reasons: the weakness of the Ottoman Empire; and the signature of the Protection Treaty between Kuwait and Great Britain.³⁸⁹

During the era of the Treaty of Protection between Kuwait and Great Britain, the commercial activities in Kuwait underwent political developments that in turn resulted in the development of the legal system. But, it is worthy to note that during the above-

³⁸⁴ See Professor Othman AlSaleh, *Al-Nitham Al-Distori W Al-Mosadat Al-Seyaseyah fi Al-Kuwait*, (Kuwait, Kuwait University Press, 1994), pp 39-42. Hereinafter Professor Othman.

³⁸⁵ *Ibid.*

³⁸⁶ See AL-Shammari, Dr Tummah *AL-Waseed fe Derasat Qanoon Al-Sharekat AL-Tejareya AL-Kuwaiti w Ta`adeelato*, Third Edition, the State of Kuwait, 1999, at p 25. Herein after Dr. Tummah.

³⁸⁷ Hereinafter the *Majala*.

³⁸⁸ See Brian Russell, *An Introduction to Business Law in the Middle East*, (New York, Drake Publications, 1976), at p 7.

³⁸⁹ See Dr Tummah, *supra* note: 222, pp 26-27

mentioned time, a parallel legal system was developed in Kuwait.³⁹⁰ In other words, there were two legal systems applied in Kuwait to two different persons in similar situations. For example, the judicial jurisdiction of the British administration in Kuwait applied when the parties to the dispute were not Kuwaitis; on the other hand, the jurisdiction of the ruler of Kuwait and the local judicial system applied when the parties to the dispute were Kuwaitis.³⁹¹ In addition, and according to the protection treaty between Kuwait and Great Britain, non-Muslim foreigners were not subject to the Kuwaiti judicial authority.³⁹²

Many significant events took place after the signature of the protection treaty between Kuwait and Great Britain in regard to the legal system in Kuwait. First, the legislation authority was established in 1932 when the Amir of Kuwait Sheikh Ahmed AL-Jaber AL-Sabah issued the Kuwait Municipality Law.³⁹³ In other words, the first substantive laws emerged in Kuwait in 1932. In addition, the first parliament in Kuwait was formed in 1938; this parliament brought many developments in relation to the judicial system in Kuwait. For instance, this parliament has assured judicial independence. Furthermore, the promulgation of the provisions of the *Majala* became mandatory when it comes to solve any dispute.³⁹⁴

Although Kuwait was under the British extra-territorial rule for nearly 50 years, Kuwait has not been heavily influenced by the British legal system; rather, some other GCC countries were influenced by the British legal system to a larger extent.³⁹⁵ For example, Bahrain was greatly influenced by the British legal system to the extent that the British Advisor Charles Belgrave sat in the Bahraini local court as a judge.³⁹⁶

³⁹⁰ See Baudouin Dupret, Maurits Berger & Laila Al-Zwaini, *Legal Pluralism in the Arab World*, London, Kluwer Law International, 1999, at p 4.

³⁹¹ See George N. Sfeir, *Modernization of the Law in Arab States: An Investigation into Current Civil Criminal and Constitutional Law in the Arab World*, San Francisco, Austin and Winfield Publications, 1998, at p 47.

³⁹² See Professor Othman, *supra* note: 342, at p 87.

³⁹³ *Ibid.* at p 84.

³⁹⁴ *Ibid.* pp 111-112.

³⁹⁵ See William Ballantyne, *Legal Development in the Arabia*, London, Graham & Trotman, 1980, at p 8. Hereinafter Ballantyne.

³⁹⁶ See Nathan Brown, *The Rule of Law in the Arab World: Courts in Egypt and the Gulf*, UK, Cambridge University Press, 1997, pp 136-137. Hereinafter Brown.

It is a fact that the British withdrawal from the Gulf region caused a legal gap in the region's countries, which, as reaction, urged them to adopt compatible laws with the Kuwaiti culture condition. The laws were mainly adopted from Egypt, which is attributed to the reason that Egypt enjoys a sound reputation among the Arab countries with respect to legal culture.³⁹⁷

Although Britain tried to transplant the Anglo-Saxon system in the Gulf countries, they have not succeeded.³⁹⁸ Accordingly, in order to modernize its legal system, Kuwait has adopted a French style, which is a civil law system. The modern laws in Kuwait were drafted by the pioneer Egyptian law draftsman, Abd al-Razzaq al-Sanhuri.³⁹⁹

As set forth above, the existing legal systems in the Gulf countries are adopted from the Egyptian legal system, which is, in turn, adopted from the French civil law legal system. It has been argued that the judges in common law systems are able to correct the deficiencies that appear in corporate law. Whereas, the civil law systems reduce the judges' role with regard to corporate law corrections by over-legislating. Consequently, judges are prevented from contributing to the development of the corporate law.⁴⁰⁰

In the same vein, Dr. Al-Zumai has found that the adoption of the civil law system is one of the reasons behind the under-development of the legal system in the Gulf countries. As he revealed, the civil law system prevents judges from contributing to the legal system development process, in contrast to countries that adopted the common law system. Further, judges are able to infer solutions for the deficiencies that are embedded in the current laws because they are in daily contact with the problems that emerge from the application of the current laws when they are dealing with the disputes that are

³⁹⁷ See Ballantyne, *supra* note 395, at p 10.

³⁹⁸ See Brown, *supra* note 396, at p. 130

³⁹⁹ See Amin, S.H, *Middle East Legal Systems*, Royston Limited, Glasgow, 1985, at p 276. Hereinafter Amin.

⁴⁰⁰ See Coffee, Jr., John C, 'The Rise of Dispersed Ownership: The Roles of Law and the state in the Separation of Ownership and Control', *Yale Law Journal*, 2001b, Vol: 111, pp 1-82.

remitted to them.⁴⁰¹ Furthermore, the corporate law in the civil law jurisdiction is always comprehensive to cover every possible dispute arising out of corporate issues.⁴⁰²

Accordingly, Kuwait is a civil Law system country, which, not surprisingly, provides poor protection for the investors in Kuwait; in the same context, Rafael La Porta et al. argued: “Countries whose legal rules originate in the common-law tradition tend to protect investors considerably more than the countries whose laws originate in the civil-law tradition”.⁴⁰³ Moreover, it has also been argued that the adoption of the civil law system in any country makes the production of laws subject to the inefficiency of the political institution. To elucidate this argument, it has been alleged that the statutory based law system progresses slowly and it is affected by the inefficient political interferences, which is highly likely to be considered as an obstacle to the financial progression.⁴⁰⁴

The above-mentioned situation can be illustrated in the case of Kuwait, where the statutory based law system is adopted and the parliament legislates the laws according to the Kuwait Constitution. However, many statutes have been spent many years in the Kuwaiti parliament due to several reasons. For example, the parliament composition can be seen as one of the reasons behind the failure to enact new laws. That is because the object of many members of the parliament is to legislate consumptive laws, such as those that provide for writing off the interest on loans.

⁴⁰¹ Unpublished PHD thesis titled, Protection of Investors in the Gulf Cooperation Council Stock Market: A Case Study of Kuwait, Bahrain and United Arab Emirates. Submitted to the Law Department School of Oriental and African Studies, University of London, 2007.

⁴⁰² See Yuwa, supra note: 332, at p 183.

⁴⁰³ See R. La Porta, F. Lopez-de-Silanes, and A. Shleifer and R. Vishny, ‘Legal Determinants of External Finance’, (1997) 52 *Journal of Finance*, at p 1131. Also See Rafael La Porta & Florencio Lopez-de-Silanes & Andrei Shleifer, “The Economic Consequences of Legal Origins,” *Journal of Economic Literature*, *American Economic Association*, 2008, vol. 46(2), pp 285-332. For more details about the comparison between the common law system and the civil law system in terms of the Laws that should relate to the corporate governance of the shareholders protection, see Simeon Djankova, Rafael La Portab, Florencio Lopez-de-Silanes, Andrei Shleiferd, ‘The Law and Economics of Self-dealing’, *Journal of Financial Economics*, Vol: 88, 2008, pp 430-465

⁴⁰⁴ Bailey, M. J., Rubin, P. H., ‘A Positive Theory of Legal Change’, *International Review of Law and Economics*, 1994, Vol: 14, pp 467-477.

5.3.2 The Judiciary Authority in Kuwait:

5.3.2.1 The Judicial System in Kuwait:

As stated previously, in the past, the ruler of Kuwait held the judiciary authority and solved legal disputes according to the *Islamic Shari`a*. As a consequence of the modernization of the Kuwaiti legal system, the judiciary shari`a based system has been replaced with a civil legal system⁴⁰⁵ pursuant to the promulgation of the Judicial Organization under the Amiri Law Decree No: 19/1959, as amended in 1980 and superseded by the Law Decree No: 23/1990, as amended by the Law Decree No: 10/1996.⁴⁰⁶

The Kuwaiti Constitution (1962), in Articles 162-73, outlines the organization of the courts, in addition to relationship between the courts and the other organizations in the state. Although Kuwait has a long judicial history and a well-established Law School in Kuwait University, Kuwait still relies on foreign judges.

The Kuwaiti court system consists of three levels, the Court of First Instance, The Court of Appeal and the Court of Cassation. In addition, there is a constitutional court that is entitled to investigate whether laws and regulations violate the Kuwait constitution.⁴⁰⁷ Furthermore, the awards rendered by the cassation court in Kuwait are not binding to the lower courts in future disputes, but in reality, the lower courts follow the cassation courts and awards seldom contradict the cassation court award.⁴⁰⁸ Moreover, the Maliki Islamic School is the applicable school in the Kuwaiti courts with respect to the personal status disputes and when there is no applicable statutory law.⁴⁰⁹

⁴⁰⁵ See Brown, *supra* note 396, at p 145.

⁴⁰⁶ Amiri Law Decree No. 19/1959, Published in *Al-Kuwait Al-Yuum*, the Official Gazette, Vol: 255, on 28-December 1959. And the amended Law Decree No. 10/1996

⁴⁰⁷ See the Amiri Law Decree No: 19/1959, as amended in 1980 and has been superseded by the Law Decree No: 23/1990, as amended by the Law Decree No: 10/1996, *Al-Kuwait Al-Yuum*, the Official Gazette, Vol: 255, on 28-December 1959.

⁴⁰⁸ See AL-Hajeri, Mashael, 'Judiciary and the Administration of Justice in Building and Construction Disputes Under the Kuwaiti Law', *Arab Quarterly Law*, Kluwer Law International, (2008), Vol:22, Part:2, pp 199-214

⁴⁰⁹ See Amin, *supra* note: 399, at p 275.

5.3.2.2 The Judiciary Independence in Kuwait:

The independence of the judiciary in general can be found in the basic principles of the United Nations as article 1 states: “The independence of the judiciary shall be guaranteed by the state and enshrined in the constitution or the laws of the country”.⁴¹⁰ Further, in regards to the relation between the business environment and the judicial system in any country, the World Bank has revealed that in order to improve the business environment in any country some conditions must be met; one of these conditions is judicial reform, which refers to the training of judges and judicial rights.⁴¹¹

Also, the independence and the impartiality of the judiciary are considered to be cornerstones of justice.⁴¹² Therefore, judges who are involved in securities markets disputes should be trained properly to deal with such cases, particularly since judges may use their own discretion when a specific disputed issue is not regulated under the corporate law.⁴¹³ In addition, it has been submitted that the corporate governance system requires some essential institutions to ensure effective application in any country. One of these institutions can be illustrated by the legal infrastructure that ensures the independence of judges and the appropriate enforcement of contracts.⁴¹⁴

Consequently, article (163) of the Kuwait constitution (1962) provided for the following: “In regards to guarantee the judges independence: In administering justice judges shall not be subject to any authority. No interference whatsoever shall be allowed with the conduct of justice. Law shall guarantee the independence of the judiciary and shall state the guarantee and provisions relating to judges and the conditions of their

⁴¹⁰ See U.N. Basic Principles on the Independence of the Judiciary Adopted by the Seventh United Nations Congress on the Prevention of Crime and the Treatment of Offenders held at Milan from 26 August to 6 September 1985 and endorsed by General Assembly resolutions 40/32 of 29 November 1985 and 40/146 of 13 December 1985, it can be found at http://www.supcourt.ru/mpo/judicial_reform_un_principles_independence_judiciary_english.pdf, retrieved on 11-March-2010.

⁴¹¹ See the World Bank Legal Department, Initiative in Legal and Judicial Reform.

⁴¹² See Solaiman, S.M., ‘Investor Protection and Judicial Enforcement of Disclosure Regime in Bangladesh: A Critique’, *Common Law World Review*, 2005, Volume 34/Issue 3, pp 229-250. Hereinafter Solaiman.

⁴¹³ *Ibid.*

⁴¹⁴ See Bob Tricker, *Corporate Governance: Principles, Policies and Practices*, Oxford University Press, 2009, at p 210.

irremovability.”⁴¹⁵ Accordingly, it is clear that the Kuwaiti constitution is compatible with the United Nation’s basic provisions, as Kuwait provided for the judiciary independence in the constitution.

Moreover, in order to ensure that judges are satisfied with respect to their life needs and in order to prevent corruption threats Kuwait has recently raised judges’ salaries. Also, the independence of the judiciary is a condition that must exist to guarantee the entrenchment of the rule of law in any country.⁴¹⁶ But, there are a few indicators that can undermine the independence of the judicial system in Kuwait, such as the fact that the executive authority still maintains some administrative and budgetary control.⁴¹⁷ However, the judiciary system in Kuwait can be considered a quasi-absolute independent.⁴¹⁸

5.3.2.3 Can the Judicial System in Kuwait Absorb the Corporate Governance Concept?

Kuwait has established the Kuwait Institute for Judiciary and Legal Studies, which is in turn providing training and further legal education for the judiciary authority members. Also, Kuwait is similar to some other countries in the Arab world in that the law school graduates are intended to work in a variety of jobs.⁴¹⁹

Consequently, it could be submitted that the judges in Kuwait are competent to tackle any legal dispute based upon the suitable training they are receiving after their appointment to the judiciary. But, corporate governance as a concept is not yet common in the Kuwaiti corporate culture.

⁴¹⁵ Article (163) of Kuwait Constitution, official translation.

⁴¹⁶ See Mahmoud Sami Gamal El-Din, Democracy and Human Rights in Kuwait: The Role of The Constitution, in Eugene Cotran & Mai Yamani (ed), *The Rule of Law in the Middle East and the Islamic World; Human Rights and the Judicial Process*, I.B.Tauris Publisher, London, 2000, pp 91-106.

⁴¹⁷ See Brown, *supra* note 396, pp 159-160.

⁴¹⁸ See, The Judiciary Status in Some of the Arab States, the Comparative Regional Report, February/ 2005, by Adel M. Abdulatif, the Regional Coordinator for the Governance Program in the Arab States Program and the Development Program of the United Nation, at p 16.

⁴¹⁹ See Nathan J. Brown, Arab Judicial Structures, A study presented to the United Nations program, A program on governance the Arab Region, Pogar, August 2001.

In that vein, it could be mentioned that the corporate law module at the Law School of Kuwait University, has not yet mentioned the corporate governance in any academic module, but despite this situation, some lecturers in the law school are introducing corporate governance issues to their law students voluntarily. Moreover, Professor Ahmed AL-Melhem stated in the preamble of his pioneer book, “*Kuwait Commercial Companies Law and Comparative*,” that corporate governance concept has not yet been mentioned in the existing Kuwaiti laws or regulations.⁴²⁰

Therefore, it could be argued that training courses must be established to enhance the business education of Kuwaiti judges. This will, in turn, enhance the judicial approach toward corporate governance, as it will provide them with knowledge regarding the legal issues surrounding corporate governance that exist in the developing markets.

Furthermore, it could be submitted that the aforementioned education for the judges in Kuwait is particularly necessary because the Kuwaiti society is very new in dealing with corporate governance. Corporate governance as a notion or even as a phrase is strange among Kuwaitis. Since judges in the Kuwaiti courts are subject to an annual rotation system between the court’s divisions, it could be argued that there are no specialized judges in Kuwait and a judge’s effort to improve his competency is scattered among the many laws. For example, if Judge X is sitting in the commercial court this year, next year the same judge may be sitting in the personal status court.

Recently, the Capital Markets Law has been legislated in Kuwait under Law No: 7/2010.⁴²¹ In the Capital Markets Law, articles 108 to 116 stipulate for the creation of specialized courts (called: Capital Markets Courts) that have the jurisdiction to solve every dispute arising out of the capital market transactions.⁴²² However, the legislation does not seem to solve the problem as it has not provided for the judges to specialize; in other words, the judges will be still subject to the annual rotation. Further, it is

⁴²⁰ See AlMelhem, Ahmed, *Kuwaiti Commercial Companies Law and the Comparative*, Kuwait University Press, Kuwait, 2009, at p 9.

⁴²¹ Capital Market Law in Kuwait No. 7/2010, Published in *the Kuwait al-Yuum*, the official Gazette, Vol:964, on 28-02-2010.

⁴²² See Kuwait Capital Markets Law No: 7/2010, articles 108, 109, 110, 111, 112, 113, 114, 115 and 116. Published in *the Kuwait al-Yuum*, the official Gazette, Vol:964, on 28-02-2010.

worthwhile to note that the Kuwaiti Capital Markets Law will enter into force in late 2011. Eventually, it could be submitted that the judges in Kuwait will be competent enough to absorb the corporate governance concept. Moreover, the judges' specialization will facilitate their job and allow their judgments to be rendered with greater ease and accuracy.

5.3.3 Corporate Governance Tools in the Light of the Kuwaiti Companies Law No. 15/1960:

Company's law can be seen as the backbone of the corporate governance system as it provides the framework for corporate governance mechanisms.⁴²³ It contains provisions that regulate the relationships between all of the involved parties in the corporation (i.e. the relations between the corporation's insiders, managers, employees and auditors in the one hand, and the relations between the corporation's insiders and the corporation's outsiders, the client, creditors and the community, on the other hand).⁴²⁴

In other words, corporate law includes among its contents corporate governance principles. This fact is also apparent from the corporate governance definition provided for in the Organization for Economic Cooperation and Development Principles of Corporate Governance: "Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders.

Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring".⁴²⁵

⁴²³ See Sanjai Bhagat, Brian J. Bolton, Roberta Romano, The Promise and Peril of Corporate Governance Indices, ECGI - Law Working Paper No. 89/2007, at p 6. <http://ssrn.com/abstract=1019921>

⁴²⁴ See Kraakman, Davies, Hansmann, Hertig, Hopt, Kanda and Rock, *The Anatomy of Corporate Law, A Comparative and Functional Approach*, 2004, Oxford University Press, UK, at p 33.

⁴²⁵ See OECD Principles of Corporate Governance 2004, at p 11.

Accordingly, the following is an attempt to examine whether the Kuwaiti Companies Law contains corporate governance tools or no, if so; to what extent these tools are efficient.

5.3.3.1 Board of Directors Composition or Board Structure under Kuwaiti Law:

It has been said that the structure of the company's management is the key factor to ensure the best practice of the company as it controls the management and aids in the development of the company.⁴²⁶ The country's legal system determines the suitable board structure type for its commercial culture.⁴²⁷ There are two structures for the company's board of directors. The unitary board consists of one single board where the directors are elected at the Annual General Meeting of the company. Also, this type of board encompasses the executive, non-executive, and non-executive independent directors and this board is responsible for all the corporation's affairs. The unitary board of directors is predominant structure in the USA and UK.⁴²⁸

The dual board structure can be found in countries such as Germany, Netherlands, and Denmark.⁴²⁹ This dual board system refers to the existence of two boards in one company, a management board and a supervisory board. The supervisory board is entrusted with supervision of the management board i.e. which supervising how the latter board performs in the day-to-day management functions. Also, there is a clear separation between the two boards from the viewpoint of composition; for example, the member of one board cannot be a member of the other board at the same time.

The management board is elected by the shareholders and includes representatives from the employees; in turn, the supervisory board is appointed by the supervisory board.⁴³⁰

⁴²⁶ See AlMelhem, Ahmed, *Kuwaiti Commercial Companies Law and the Comparative*, Kuwait University Press, Kuwait, 2009, at p 322.

⁴²⁷ *Ibid.*

⁴²⁸ See Mallin, Christine A., *Corporate Governance*, Third Edition, Oxford University Press, UK, 2009, at p 162.

⁴²⁹ *Ibid* at p 161.

⁴³⁰ *Ibid* at p 162.

In addition, the French system gives the company the right to choose between adopting the unitary or dual board for its company structure. But the company is required to provide for the structure in its memorandum of association.⁴³¹

Consequently, the board of directors can be considered an important element in the defence line when it comes to shareholder protection issues. Further, the corporate governance system plays a major role in its success since the board of director's role is to set the company's strategic plan.⁴³² In addition, the board of directors also monitors the management with regards to strategic plan implementation. Interestingly, Jill and Aris Solomon have pictured the board of directors as follows:

*“A company's board is its heart and as a heart it needs to be healthy, fit and carefully nurtured for the company to run effectively. Signs of fatigue, lack of energy, lack of interest and general ill health within the board's functioning require urgent attention and care. The free and accurate flow of information in and out of the board is as essential to the healthy operating of the corporate body as the free and unhindered flow of blood is to the healthy functioning of the human body”.*⁴³³

Thus, it appears from the previous passage that the board of directors is a main player for any corporation. Consequently, the board of directors can be either a corporate governance tool or, on the contrary, can be seen as a tool to expropriate the rights of shareholders. Furthermore, in the context of the expropriation of the minority shareholders' rights by the controlling shareholder, it has been stated that the starting step for expropriation by the controlling shareholders in the emerging economies can take place through the appointment of unqualified family members or friends in the board of directors to control the board of director's decisions.⁴³⁴

⁴³¹ See AlMelhem, Ahmed, *Kuwaiti Commercial Companies Law and the Comparative*, Kuwait University Press, Kuwait, 2009, at p 335.

⁴³² See Solomon Jill & Solomon Aris, *Corporate Governance and Accountability*, (England: John Wiley & Sons Ltd, 2004), at p 65.

⁴³³ *Ibid.* pp 65-66.

⁴³⁴ See Claessens, S., Djankov, S., & Lang, L.H.P., 'The Separation of Ownership and Control in East Asian Corporations', *Journal of Financial Economics*, (2000).58(1-2), 81-112.

For instance, if the directors are not independent and are influenced by the management or a controlling shareholder, then it is most likely that the board will be ineffective and will be the source of expropriation.⁴³⁵

Accordingly, a number of methods are usually used to ensure the independency of the board, such as the independent directors; this method is seen by regulators as the most favourable method to ensure the independency of the board. Furthermore, international organizations such as the OECD have highlighted the important role of independent directors; specifically, it has mentioned that:

“Independent board members can contribute significantly to the decision-making of the board. They can bring an objective view to the evaluation of the performance of the board and management”.

In addition, they can play an important role in areas where the interests of management, the company and its shareholders may diverge such as executive remuneration, succession planning, changes of corporate control, take-over defenses, large acquisitions and the audit function”.⁴³⁶ Moreover, in Korea, after the Asian financial crisis in 1997, several reforms were introduced for the corporation listing rules; these reforms required 25% of the board of directors to be independent.⁴³⁷

As a consequence, it has been said that evidence has been found in Korea positively supporting the appointment of independent directors in the company’s board.⁴³⁸ Moreover, evidence has also been found that Australian companies benefit from the existence of independent directors on their boards.⁴³⁹

⁴³⁵ See Stephen M. Davis, Leading Corporate Governance Indicators, in Low Chee Keong (ed) *Corporate Governance: An Asia-Pacific Critique*, at p. 59.

⁴³⁶ See The OECD Principles of Corporate Governance 2004, at p 46.

⁴³⁷ See The Securities Listing Regulations in Korea Stock Exchange, effective April, 1999.

⁴³⁸ See Park, Sae Woon, Choi, Jongmoo Jay and Yoo, Sean Sehyun, ‘The Value of Outside Directors: Evidence from Corporate Governance Reform in Korea.’, *Journal of Financial and Quantitative Analysis*, Vol., 42, No. 4, December 2007, pp. 941-962, page 942

⁴³⁹ See Cotter, J. and Silvester, M., "Board and Monitoring Committee Independence". *Abacus*, 2003, Vol: 39, pp 211-232.

But, the obstacle that faces the independent director notion is that the definition of independent director is still a disputed issue among regulators and the judiciary as well.⁴⁴⁰ In fact, it is argued that the definition is still under development; according to Professor Brudney, “no definition of independence yet offered precludes an independent director from being a social friend of, or a member of the same clubs, associations, or charitable efforts as, the persons whose compensation or self-dealing transaction he is asked to assess.”⁴⁴¹

A number of models have been introduced to draw the parameters of the independent director definition. In the U.S, an independent director is “one who has no material relationship with the listed company.”⁴⁴² In addition, detailed criteria have been adopted in the U.S to determine what constitutes a material relationship.⁴⁴³

Kuwait has adopted the unitary board of director structure according to Article 146 of the Companies Law.⁴⁴⁴ The board of directors in Kuwait enjoys wide powers in relation to the conduct of the company`s affairs, and the Annual General Meeting has no rights to challenge board decisions already taken by the board according to its authority, unless the AGM restricts the board authority by ordinary resolution.⁴⁴⁵ Furthermore, the board of directors is elected by the AGM in a secret ballot. The minimum number of directors has been stipulated in Article 138 of the company law as three directors, but the law has allowed the determination of the maximum number of the directors to be provided for in the company`s memorandum of association.

Because of the Kuwait Companies Law is silent about the independent directors, it could be submitted that the Kuwaiti legislator has not imposed an obligation upon the

⁴⁴⁰ See Beyond "Independent" Directors: A Functional Approach to Board Independence, *Harvard Law Review*, 2006, Vol 119, at p.1556

⁴⁴¹ See Victor Brudney, The Independent Director - Heavenly City or Potemkin Village?, 95 *Harvard. Law Review*. 1982, at p.613.

⁴⁴² Guy P. Lander, *What is Sarbanes-Oxley*, (New York, McGraw Hill Publications, 2004) at p.48.

⁴⁴³ *Ibid.*

⁴⁴⁴ Kuwait Companies Law No: 15/1960, Article 146.

⁴⁴⁵ See AlMelhem, Ahmed, *Kuwaiti Commercial Companies Law and the Comparative*, Kuwait University Press, Kuwait, 2009, at p 341.

companies to appoint independent directors in their boards of directors. However, Article 145 of the Kuwaiti Companies' Law permits the board of directors to be composed of only executive directors, in turn, this article can be seen undermining the best practice of corporate governance in Kuwait. In this vein, one may argue that the absence of independent directors in the Kuwaiti companies law is due to the fact that the law was enacted in 1960. This argument is refutable since this law has been amended several times; however, none of the amendments have touched upon the independency of the board of directors.

By contrast, while the Saudi company law was enacted in 1965 with no mention of the independency of the company's board directors, Saudi Arabia issued a Corporate Governance Code in 2006, which the companies in the Saudi Capital Market are required to follow. In relation to the independence of directors, the Corporate Governance Code stipulated: "The independent members of the Board of Directors shall not be less than two members or one-third of the members, whichever is greater".⁴⁴⁶

It could be argued that the absence of independent directors is weakening the best practice of corporate governance in Kuwait. As a result of the absence of independent directors in Kuwaiti companies, the controlling shareholder usually appoints his representatives to the board and they mainly act as his agents and not as agents of all the shareholders. Another issue that indicates the best practice of corporate governance is the separation between the posts of chairman and CEO. It has been argued that splitting the roles of chairman and CEO can be seen as a good practice of corporate governance, which enhances the independence of the board of directors. Also, it has been stated that this separation between the CEO and chairman posts would minimize potential conflicts of interest.⁴⁴⁷

⁴⁴⁶ See Capital Market Authority, Corporate Governance Regulations in the Kingdom of Saudi Arabia Issued by the Board of Capital Market Authority Pursuant to Resolution No. 1/212/2006 12/11/2006 based on the Capital Market Law issued by Royal Decree No. M/30 Part 4, Article 10 (e).

⁴⁴⁷ See Falgi, Khaled, Corporate Governance in Saudi Arabia: A Stakeholder Perspective, unpublished PHD thesis submitted to the School of Law of Dundee University, May 2009.

Furthermore, several international organizations have recommended the separation of the CEO and the chairman positions. For instance, the OECD's Corporate Governance Principles 2004 stated that: "Separation of the two posts may be regarded as good practice, as it can help to achieve an appropriate balance of power, increase accountability and improve the board's capacity for decision making independent of management".⁴⁴⁸

Moreover, the UK Combined Code (2006) also recognized the separation of the role of CEO and chairman by stating: "There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business. No one individual should have unfettered powers of decision".⁴⁴⁹ Further, the Corporate Governance Code 2006 of the Saudi Capital Market Article 12 (d) has provided for the prohibition of the combination of the two posts in the same corporation. Unsurprisingly, the Kuwaiti Companies Law has no provisions that deal with splitting the role between the chairman and CEO, which could be submitted here as another defect preventing the best practice of corporate governance in Kuwait.

It is worth noting that there are several opinions that disagree that the separation of the CEO and Chairman posts in the one company has significant effects on that company.⁴⁵⁰ Furthermore, it has been stated that the evidence supporting the argument that the duality of the two posts has negative consequence upon the company is weak.⁴⁵¹

Instituting committees in the boards has been recognized greatly in countries that aim to have the best practice of corporate governance. These committees include the audit

⁴⁴⁸ See OECD Corporate Governance Principles 2004, at p 63.

⁴⁴⁹ See UK Combined Code 2006, at p 4.

⁴⁵⁰ See Brickley, J., Coles, J. and Jarrell, G., "Leadership Structure: Separating the CEO and Chairman of the Board". *Journal of Corporate Finance*, (1997). Vol: 3 (3): pp 189-220.

⁴⁵¹ See Baliga, B., Moyer, R. and Rao, R., "CEO Duality and Firm Performance: What's the Fuss?" *Strategic Management Journal*, (1996). Vol 17 (1): pp 41-53.

committee,⁴⁵² compensation committee, and nomination and corporate governance committee.⁴⁵³ It could be submitted that the practice of creating committees is weak in Kuwait even if there are companies that have taken that step because the efficiency and the impartiality of these committees can only be achieved when they are composed of only independent directors, whereas the companies' law in Kuwait does not recognize such a notion.

5.3.3.2 Director's Duties

The company law does not refer to every corporate governance tool; however, several corporate governance issues are encompassed in the company law.⁴⁵⁴ Director's duties are an important corporate governance issue, since the board of directors in many jurisdictions enjoys very wide authority. Moreover, the director's legal responsibilities are subject to being increased due to their important role in the corporation's performance.⁴⁵⁵ Furthermore, it has been argued that the corporate scandals that occurred in last decade, such as Enron, WorldCom, and Adelphia, encouraged shareholders to cast a close eye upon their agent's behavior, that is upon the behavior of their managers.⁴⁵⁶ Also it has been alleged that when managers are working under tough liability then no one will accept such posts.⁴⁵⁷

Consequently, within this section, director's duties as one of the corporate governance tools will be tackled in light of the Kuwait Companies Law. In other words, in this section, an attempt will be made to examine whether the director's duties that are provided for in Kuwait Companies Law are suitable to ensure that the directors will not

⁴⁵² For directors liability emerging from the audit committee report in the U.S see Gregory S. Rowland, Earnings Management, the SEC, and Corporate Governance: Directors Liability Arising from the Audit Committee Report, 2002 Columbia Law Review, Vol 102 at p.168

⁴⁵³ See Jonathan P. Charkham & Helene Ploix, Keeping Better Company Corporate Governance Ten Years on, (Oxford, Oxford University Press, 2005) at p.244-247.

⁴⁵⁴ See Brian, Coyle, *Corporate Governance Essentials*, (London, ICSA Publishing, 2008), at p 43.

⁴⁵⁵ See Wei, Yuwa, Directors' Duties Under Chinese Law: A Comparative Review, *UNELJ* (2006) Vol: 3, at p 31, pp 31-56.

⁴⁵⁶ See Nadelle Grossman, 'Directors Compliance with Elusive Fiduciary Duties in A Climate of Corporate Governance Reform', *Fordham Journal of Corporate & Financial Law*, 2007, Vol: XII, pp 393-466.

⁴⁵⁷ *Ibid*, at p 395.

misbehave, or if reform is needed to enhance the corporate governance practice in Kuwait.

5.3.3.3 The Director's Power Limitations:

The corporation's director has wide authority in relation to the corporation's affairs. But this authority is subject to the following restrictions: a) restrictions imposed by law, b) restrictions imposed by the company constitution, and c) restrictions by the general meeting resolution.⁴⁵⁸ For example, the director's powers in the UK have been restricted explicitly in Article (171) of UK Company Act 2006, which states the following:⁴⁵⁹

Duty to act within powers:

“A director of a company must: (a) act in accordance with the company's constitution, and (b) only exercise powers for the purposes for which they are conferred”.

Accordingly, the abovementioned Article has clearly provided for the patterns that the company's directors must follow when it comes to the management of the company. In other words, the director's power in regard to the company's management is subject to the provisions of the law, the Article of Association, and any resolution rendered by the company's annual meeting.⁴⁶⁰

In the same vein, the Kuwaiti Companies Law No: 15/1960 has stipulated for limitations upon the director's power in Article 146, as it states that:

‘The director shall carry on all activities required for the management of the company according to its objects; the said powers are not restricted as provided for in the law, the company's Articles of Association or resolution passed by the general meeting.

⁴⁵⁸ See Ross Grantham, The Content of the Director's Duties of Loyalty, *Journal of Business Law*, March 1993, at p 150.

⁴⁵⁹ Article (171) English Companies Act (2006)

⁴⁶⁰ See Birds, J., Boyle, A.J., Clark, B., MacNeil, L., McCormack, G., Twigg-Flesner, C., & Villiers, C, Boyle & Birds' Company Law, United Kingdom, Jordan Publishing Limited, 2009, at p: 591

The Articles of Association shall be set for the directors' powers - to borrow, to mortgage the property of the company and to give guarantees'.

The above-referenced Article in the Kuwait Companies Law restricts the director's power to the law, the Articles of Association, and a resolution passed by the General Meetings. But, a problem has emerged from the reading of the provisions of the Article. That is, this article makes reference to the law as one of the restrictions to the director's power; in other words, the directors are prohibited from breaching the law, but anyone might ask which law was meant in this article; is it only the company law or all laws those are applicable in Kuwait?. Accordingly, there is a division in the opinions regarding the proper interpretation of this provision.⁴⁶¹

The first school has argued that the legislator meant that the directors would be held liable only when they breached laws related to commerce. On the other hand, the second school went further, as they believe that the legislator meant that the directors would be held liable when they breached any of the laws that are enacted in Kuwait.⁴⁶² Consequently, this division in interpreting the article might have a detrimental effect upon the directors. In other words, the directorship of a company will be considered an unwanted profession.

5.3.3.4 The Director's Duties:

According to the wide authority that is vested in the company director's hand in order to manage the company, there is a chance for the director to diverge from the company's objectives and mismanage the company.⁴⁶³ Therefore, corporate governance, as a system, imposes several duties upon the company's directors to ensure that they are managing the company properly, i.e. in accordance with its plan to achieve its objectives. The company's director is considered an agent of the company, as in the UK, in order to

⁴⁶¹ See Inas Al-Azmi, 'The Reasons of Civil Responsibility for members of board of directors in joint-stock companies,' *Legal Advice and Legislation Journal*, Vol No: 11, 2003 pp 188-189.

⁴⁶² *Ibid.*

⁴⁶³ See AlMelhem, Ahmed, *Kuwaiti Commercial Companies Law and the Comparative*, (Kuwait, Kuwait University Press, 2009), at p 351.

elucidate the relationship between the company and its directors. It has been stated by Lord Johnson in the case *McIntock v. Campbell*⁴⁶⁴ that:

‘The directors’ functions are in one view those of the agent, and in another those of the trustee. But the former predominate over the latter’.

In Kuwait, it has not been clearly stated that the legal framework for the relationship between the directors and their company is an agency relationship, but the Cassation Court in Kuwait in its judgment has revealed that the company chairman practices his authorities as an agent of the company.⁴⁶⁵ Furthermore, there are jurisdictions where the law explicitly states that the relationship between the company and its directors is principal-agent relationship, such as the Japanese Commercial Law, as they have mentioned that the directors are agents for the shareholders in directing the company.⁴⁶⁶

As a consequence of the principle-agent relationship between the company and its directors, the directors owe the company the so-called fiduciary duties.⁴⁶⁷ Moreover, it has been argued that the notion of fiduciary duty is undeveloped in the Middle East.⁴⁶⁸

In the OECD Principles of Corporate Governance 2004, it has been said that the company’s directors are required to act on a fully informed basis, in good faith with due diligence and care in addition to working in the best interest of the company and shareholders.⁴⁶⁹ These principles constitute the two elements that are embedded in the

⁴⁶⁴ [1916] S.C. 966 at p.980.

⁴⁶⁵ The Kuwait Cassation court case No: 93/23 Commercial, 1994-02-14, Collection of the Decided Legal Principles by the Cassation Court in Kuwait, Vol: 3, July 1999, at p 40.

⁴⁶⁶ See Wei, Yuwa, Directors' Duties Under Chinese Law: A Comparative Review, *UNELJ* (2006) Vol: 3, at p 42.

⁴⁶⁷ See AlMelhem, Ahmed, *Kuwaiti Commercial Companies Law and the Comparative*, (Kuwait, Kuwait University Press, 2009), at p 352.

⁴⁶⁸ See Al-Rimawi, Lu’ayy Minwer “Emerging markets of the middle east: A critique of selected issues in Arab securities regulation,” *Journal of Financial Regulation and Compliance*, Vol. 7, No. 2, 1999, at p. 160.

⁴⁶⁹ OECD Corporate Governance Principles 2004 at p 24

fiduciary duty, i.e. the duty of care and the duty of loyalty, which will be discussed respectively below.⁴⁷⁰

5.3.3.4.1 The Duty of Care:

The duty of care is attached with the director's position due to the huge authority that is rested in his hands to manage the company and to work in the best interest of the company and the shareholders. In other words, the director must show reasonable care and skill when it comes to making business decisions. This concept exists in the majority of legal systems, and the breach of this duty is entail to hold the directors liable. But, there is divergence between many countries' laws in regard to what extent the director should be prudent to avoid the liability when it comes to the corporation management. In this vein, there are laws that adopt the objective criterion. For instance, the Spanish Companies Law adopted the Ordinary Businessmen principle, whereas German law seems to be stricter since it requires the director to exercise the so-called Diligence of a Prudent Businessman.⁴⁷¹

On the other hand, there are countries that adopt other criterion, i.e. subjective criterion, such as the United Kingdom's Companies Act 2006,⁴⁷² which requires the director to exercise "a degree of skill and care which may be reasonably expected from a person of his knowledge and experience".⁴⁷³ Moreover, it has been found that applying the subjective criterion to determine whether the director is in breach of his duty of care that he owes to his company will make it difficult to hold the director in breach of his duties toward his company as revealed from most of the reported cases in the UK.⁴⁷⁴

⁴⁷⁰ *Ibid* at p 59

⁴⁷¹ See AlMelhem, Ahmed, *Kuwaiti Commercial Companies Law and the Comparative*, (Kuwait, Kuwait University Press, 2009), at p 357.

⁴⁷² UK Companies Act 2006

⁴⁷³ See Andrew Hicks & S.H Goo, *Cases and Materials on Company Law*, Blackstone Press Ltd, 1994, pp 304-336.

⁴⁷⁴ See Stephen Griffin, *Company Law Fundamental Principles*, Fourth edition, (England, Pearson Education Limited, 2006), at p 297.

The directors duty of care has not been stipulated for clearly in the Kuwait Companies Law, thus it could be submitted that the Kuwait Companies Law failed to specify the standard of care for the company's directors. In other words, it is not easy to hold the directors liable for breach of their duty of care in Kuwait; whereas, the company's directors in Kuwait could be held liable in the case of mismanagement. But, the law's deficiencies will emerge again in this case as the law also has failed to define what constitutes mismanagement. Hence, to provide a definition for mismanagement, it has been argued that mismanagement would take place when there is gross negligence, which also has no clear definition.⁴⁷⁵

Consequently, it has been said that the company's director's care should be measured against an average person, in accordance with Article (705) of the Kuwait Civil Law which requires the agent to exercise an average person's care when he acts on behalf the principal.⁴⁷⁶ In other words, would an *average* person have done what the director did when he made the business decision? Thus, it could submitted that the average person measurement test undermines the *special skills* that is needed to manage the company because the average person test according to the case law in Kuwait means the ordinary person in the society.⁴⁷⁷

Furthermore, as a result of applying the ordinary person test, the company's directors in Kuwait will be quasi-immune from being held liable when they make wrong decisions even if the wrong decisions were take deliberately. Accordingly, the Kuwait Companies Law should be reformed in order to eliminate the current ambiguity, i.e. to explicitly provide for a definition of the director's duty of care. In this context, it is recommended to adopt the same pattern that is used in the English Companies Act 2006, as Article 174 states the following:

Duty to exercise reasonable care, skill and diligence:

⁴⁷⁵ See Inas Al-Azmi, 'The Reasons of Civil Responsibility for members of board of directors in joint-stock companies', *Legal Advice and Legislation Journal* Vol No: 11, 2003 at p 171.

⁴⁷⁶ Kuwait Civil Law Decree No: 67/1980, Article (705)

⁴⁷⁷ See Ibrahim Abu-elail, *Civil Liability under the Kuwaiti Law*, (Kuwait, Kuwait University Press, 1993).

- (1) A director of a company must exercise reasonable care, skill and diligence.*
- (2) This means the care, skill and diligence that would be exercised by a reasonably diligent person with—*
- (a) 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*
- (b) The general knowledge, skill and experience that the director has.*

It transpired from the above article that this duty of care definition is clear and creates no confusion for the directors to handle their duties properly.

In Kuwait, the court may hold the company's directors liable to pay the company debts in the case that the company becomes bankrupt, provided that the existing assets of the company are not enough to cover at least twenty percent of the debts. On the other hand, the directors may be relieved from liability if they prove that they exercised due care when they managed the company.

This director liability does not exist in the Kuwait Companies Law, but has been provided for in Article 684 of Kuwait Commercial Code No: 68/1980,⁴⁷⁸ which states as follow:

'Where, after a company is adjudicated bankrupt it is revealed that its assets are not sufficient to discharge at least twenty percent of its debts, the court may, pursuant to an application by the bankruptcy manager, order the managers, directors or some of them to pay jointly or otherwise all or part of the debt of the company, unless they prove that in administrating the company's affairs they had exercised due care'.

The abovementioned article seems to give protection for the company's continuance if the company becomes bankrupt, as it gives the court the right to hold all or some of the directors liable to compensate the company depending on the facts of the case. In other

⁴⁷⁸ Kuwait Commercial Code No: 68/1980, Article (648)

words, this provision can be linked partially to the corporate governance Stakeholder Theory, as it is designed to encourage the directors to exercise due care in relation to the company management or they will be held liable to compensate a category of the company's stakeholders, i.e. the company's creditors.

A comparison will be made below regarding creditor's protection. In the UK, the case law identifies the creditor interest. In the case '*Winkworth v Edward Baron Development Co Ltd*',⁴⁷⁹ Lord Templeman stated that:

*'A duty is owed by the directors of the company to the company and the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors.'*⁴⁸⁰

Furthermore, in Australia, the creditor's interests have clearly been mentioned in many decisions. In the case of '*Walker v Wimborne*',⁴⁸¹ Mason J stated:

'It should be emphasized that the directors of a company must take account of the interest of its shareholders and its creditors. Any failure by the directors to take into account the interest of creditors will have adverse consequences for the company as well as for them.'

Accordingly, it could be submitted that it would be better if the legislator in Kuwait incorporated clear provisions in the company law regarding the creditor's protection and not to entrench the law in ambiguity with respect to the director's duties and liabilities.

⁴⁷⁹ [1986] 1 WLR 1512.

⁴⁸⁰ *Ibid*, at 1516 E-F.

⁴⁸¹ [1976] 50 ALJR 446.

5.3.3.4.2 Duty of Loyalty:

The unity between the interests of the company and its shareholders is an important principle when it comes to achieving the company's objectives.⁴⁸² Therefore, the company management is required to work in the best interests for the company and the shareholders. In other words, the company's directors are obliged to exercise a duty of loyalty toward the company and its shareholders and not to do any act that might be detrimental to interests of the company. The sanctions against the breach of duty of loyalty by a director vary among the legal systems.

In some of the European legal systems, the remedy against the violation of the duty of loyalty is merely compensation for the company for the damages incurred as a result of the conflict of interest with the director; whereas, the sanctions against the breach of duty of loyalty by the company's director in the US and the UK seem to be harsher.⁴⁸³ Several legal systems stipulate for a specific disclosure framework when there is a transaction involve a conflict of interest.⁴⁸⁴ Furthermore, since in civil law system's the director's duties are based on agency law to a large extent, the breach of any director's duties will subject to tough penalties.⁴⁸⁵

According to the corporate developments in Germany, the duty of loyalty that the director owes is not solely to the company but also to the shareholders.⁴⁸⁶ The duty of loyalty can be achieved according to the following patterns: prevention from entering into a conflict of interest with company and prevention from competing with the company.⁴⁸⁷

⁴⁸² See AlMelhem, Ahmed, *Kuwaiti Commercial Companies Law and the Comparative*, (Kuwait, Kuwait University Press, 2009), at p 404.

⁴⁸³ See Luca, Enriques, 'The Law on Company Directors' Self-Dealing: A Comparative Analysis', *International and Comparative Corporate Law Journal*, Kluwer Law International, 2000, Vol: 2, Issue:3, at p 303

⁴⁸⁴ *Ibid*, at p 307

⁴⁸⁵ See James A Fanto, France in AR Pinto and G Visentini (eds), *The Legal Basis of Corporate Governance of Publicly Held Corporations: A Comparative Approach* (1998), 1,22.

⁴⁸⁶ See Wei, Yuwa, 'Directors' Duties Under Chinese Law: A Comparative Review', *UNELJ* (2006) Vol: 3, pp 51-52.

⁴⁸⁷ See Erich Schanze, 'Directors Duties in Germany', *Company, Financial and Insolvency Law Review*, (1999), Vol: 3, at p 294

In this context, the duty of loyalty can be inferred from several articles in the Kuwait Companies Law. For instance, Article 132 Section 3 of Kuwait Companies Law has stated that the directors of a company must avoid doing any action that is intended to damage the company. Furthermore, Article 140 Section 2 of the Kuwait Companies Law requires the company's director to refrain from disclosing the company's secrets or making benefits from them.

It would be argued that the abovementioned provision in the Companies Law of Kuwait constitutes the idea that the directors are required to exercise their work in good faith toward their company. Also, it has been argued that in the civil law jurisdictions the duty to act in good faith entails that the directors to carry out their duties faithfully and prefer the company's interests over their personal interests and to exercise a reasonable care of duty.⁴⁸⁸ In turn, the principle to act in good faith can be seen as the first element of the duty of loyalty and to avoid conflict of interests between the directors and their company can be seen as the second element of the duty of loyalty.

The conflict of interest cases between a director and his company may take place in the following instances:⁴⁸⁹

- a) When there is a transaction between the company and a director, or
- b) When there is a transaction between the company and a third party and the director has a personal interest.

The conflict of interest between companies and their directors has gone through a number of historical developments. Consequently, and due to the importance of curtailing the director's conflicts of interest, several legislatures and courts have adopted different approaches to deal with this problem. In the eighteenth century, the court of law in the US adopted the absolute prevention rule in conflict of interest cases regardless of the transaction's fairness or unfairness;⁴⁹⁰ also, the transaction is voidable even if it is

⁴⁸⁸ See Peter E Nygh (ed), *Business and Law Dictionary*, Second Edition 2002, at p 232.

⁴⁸⁹ See Luca, Enriques, 'The Law on Company Directors' Self-Dealing: A Comparative Analysis', *International and Comparative Corporate Law Journal*, Kluwer Law International, 2000, Vol: 2, Issue:3, at p 299

⁴⁹⁰ See Harold Marsh Jr, 'Are Directors Trustees?', *Business Lawyer*, 1966, Vol: 22, pp 35-36.

economically feasible.⁴⁹¹ The House of Lord in the UK in 1854 followed the US approach toward the director's conflict of interest cases; moreover, in the UK, the director who has entered into a conflict of interest case with his company was required to resign once he entered the transaction.⁴⁹²

The aforesaid legal approach illustrated the first stage of evolution in the conflict of interest cases. In contrast, the second stage of the director's conflict of interest cases was seen as less restrictive as the conflict of interest transaction at this stage was considered valid once it was approved by a majority of the uninterested directors.⁴⁹³ The third stage of the director's conflict of interest development occurred as awareness between the legislators and the judiciary members increased with regard to the need to validate some conflict of interest cases, but this validation is subject to specific conditions.⁴⁹⁴ For example, Article 175 (Duty to avoid conflicts of interest) of the English Companies Act 2006 in its provisions stipulated that:

(1) 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.

*(2) 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).*⁴⁹⁵

Furthermore, as conditions to validate the conflict of interest transactions according to the same Act, Article 177 requires that the director must declare his interest in an intended transaction whether his interest is direct or indirect. Moreover, Article 182, imposes an obligation upon a director where he has an interest in a transaction that has already been concluded with the company.

⁴⁹¹ See Henn & Alexander, Law of Corporation, (U.S, West Publishing co, 1983) at p.637.

⁴⁹² See Robert Pennington, Director's Personal Liability, (Oxford, BSP Professional Books, 1989) at p.41

⁴⁹³ See Maimone Block & Ross, 'The Duty of Loyalty and the Evolution of the scope of Judicial Review', Brooklyn Law Review, 1993, Vol 59, at p.77

⁴⁹⁴ See Harold Marsh, 'Are Directors Trustees? Conflict of Interest and Corporate Morality', Business Law Vol 22, 1966, at p.35-40

⁴⁹⁵ UK Companies Act 2006, Chapter 46, Part 10, Chapter 2, Article 175.

Consequently, if the director infringed the provisions stipulated for in the aforesaid Articles, he will be considered guilty and be subject to a fine as a penalty for his infringement.

5.3.3.5 The Director's Conflict of Interest legal Framework in the Light of the Kuwaiti Companies Law:

The director's conflict of interest in the Kuwaiti Companies Law can be inferred from Article 151, as it reads as follows:

'The chairman and members of the board of directors may not have any direct or indirect interest in contracts and transactions which are concluded with or for the company, except pursuant to an authorization granted by the general meeting, none of the foregoing officers may participate in the management of a company similar to or competitive with their company'.

It can be inferred from the said article that the company's director will breach his duty of loyalty to his company in two cases. The first case occurs when there is conflict between the director's personal interest and the company's interest. And, the second breach occurs when the director is in competition with the company; for example, when a director is involved in managing another entity conducting the same work as his company.

Consequently, it could be submitted that the Kuwaiti legislator in the Companies Law has adopted the procedural justice theory to govern the conflict of interest between the company and its directors. Since the Kuwait Companies Law requires merely the General Meeting's consent for related party transactions, it is worthwhile to note that the practice in Kuwait is that the board of directors obtains consent from the General Meeting one year in advance for their transactions with the company, which is easily accomplished

because ninety per cent of the listed companies in Kuwait are managed by the major shareholders.⁴⁹⁶

Moreover, the Companies Law in Kuwait does not require the board of directors to disclose any details about related party transactions, which in turn, could be seen as a defect when it comes to applying the corporate governance system. Also, the non-disclosure of related party transactions will encourage the directors to abuse their powers at the expense of the company and its shareholders. Whereas, when comparing the Kuwaiti Companies Law with other GCC countries, it is transpired that these laws provided for more efficient procedures that the directors oblige to follow in order to validate their transactions with the company.

For example, the United Arab Emirates Companies Law stipulates that the director who is involved in a transaction with his company must disclose his interest to the board of directors to approve it; in addition, this director has no right to vote on his transaction.⁴⁹⁷ Furthermore, the Saudi Companies Law requires the director who has an interest in a transaction with his company to disclose his interest in the transaction and requires the chairman of the board of directors to present the interested director's disclosure to the shareholders in the next General Meeting; in addition, the interested director is prevented from voting on his transaction.⁴⁹⁸

In regards to enhancing the director's ability to manage the corporation properly, the Cadbury Report has recommended that the managers be offered training courses to keep themselves updated with the new laws and regulations. The report stated the following: "The weight of responsibility carried by all the directors and the increasing commitment which their duties require emphasis the importance of the way in which they prepare themselves for their posts. Given the varying backgrounds, qualifications and experience

⁴⁹⁶ See the Corporate Governance in Kuwait....The Fourth Impossible Study Published in Alqabas Newspaper on 11-4-2010 <http://www.alqabas.com.kw/Article.aspx?id=593903&date=11042010> retrieved on 13-4-2010.

⁴⁹⁷ United Arab Emirates Federal Companies Law No: 8/1984.

⁴⁹⁸ Saudi Royal Decree No: 6/1965. Also see provision 18 of the Corporate Governance Regulations in the Kingdom of Saudi Arabia Issued by the Board of Capital Market Authority Pursuant to Resolution No. 1/212/2006

of directors, it is highly desirable that they should all undertake some form of internal or external training”.⁴⁹⁹

In the meantime, it could be submitted that the director’s duties as a corporate governance tool is paralyzed in Kuwait, due to the ownership structure in Kuwait, i.e. concentrated ownership, in addition to the fact that the major shareholder is the manager in most of the companies. In other words, because of that the controlling shareholder controls the company and has the majority in the company’s general meeting then it is difficult to be held accountable for any malpractices.

Consequently, Kuwait has an excellent chance to improve the director’s duties due to the fact that the improvements are coming now, which will enable the Kuwaiti legislature to examine the experiences of the other countries in this field. The recommended improvements to the Kuwait Companies Law are that this law should include a definition for the director’s duties, the one came in the UK Companies Act 2006, Article 174, where the director’s duties have been defined clearly.

Furthermore, the director’s Conflict of Interests with the company should be regulated in a more strictly manner. In other words, the related parties’ transactions must be governed by provisions that ensure more transparency through imposing more disclosure requirements as regard the related parties transactions, which is in turn enhancing the supervision of non-controlling shareholders.

5.3.3.6 The Shareholder’s Rights Under Kuwait Companies Law:

The company’s general meeting constitutes the supreme authority to make decisions in relation to the company’s affairs, and this authority is usually provided by companies’ law or the company’s constitutions. In addition, it has been suggested that the companies’ law should balance the shareholders rights against the management’s authority that is

⁴⁹⁹ The Cadbury Report, 1992, at p 24.

given by the companies' law.⁵⁰⁰ Nonetheless, the company's directors are primarily required to act in the best interests of the company through maximizing the value of the firm. Thus, to achieve this objective, the directors should consider the interests of several stakeholders, including the shareholders,⁵⁰¹ because the shareholders are the owners of the companies.⁵⁰²

In this vein, it has been submitted that Gower has reconciled the argument that the shareholders are not the company's owners, in stating "there is no doubt that the shareholders are supposed to be the supreme organ in the company as they are supposed to raise the necessary capital of the company, they are involved in the initiation, formation and direction of policy and they have a duty or role to protect their investment in the company and in such a situation, no doubt that shareholders constitute the governing force in the company and the law is emphatic on this where it says that the general meeting is the company, directors are subordinates".⁵⁰³

But, it has been argued by Bebchuk that increasing the shareholders' rights has resulted in minimizing the agency cost and increasing the shareholders investment value.⁵⁰⁴ Accordingly, as stated above, there must be a balance between the shareholders' rights and the managers' authority.

Thus, the shareholders' rights should be protected by the law as it has been argued that: "Legal rights are important because they protect economic rights and define the basic context for the exercise and transfer of rights. In particular, legal rules are the foundation of modern corporate governance, as the property rights of shareholders are created and

⁵⁰⁰ See Black, B.S., 'Agents Watching Agents: the Promise of Institutional Investor Voice', *UCLA Law Review*, (1992), pp 811-893.

⁵⁰¹ See Remus D. Valsan & Moin A. Yahya, 'Shareholders, Creditors, and Directors' Fiduciary Duties: A Law and Finance Approach', *Virginia Law & Business Review*, U.S, 2007, Vol: 2, No: 1, at p 18.

⁵⁰² See Thomas Lee Hazen, 'Silencing the Shareholders' Voice, U.S', *North Carolina Law Review*, 2002, Vol; 80, at p 1900.

⁵⁰³ Daniel, Angualia, Balance of Power between Shareholders and the Board in Corporate Governance (May 21, 2010). Available at SSRN: <http://ssrn.com/abstract=1612962>

⁵⁰⁴ See Bebchuk, L.A., 'The Case for Increasing Shareholder Power', (2005), *Harvard Law Review*, pp 833-917.

defined by federal securities regulations and case law”.⁵⁰⁵ In this context, it has been claimed that the legal framework of any corporate governance system differs from country to country depending upon the legal origins of each country.⁵⁰⁶

Furthermore, in regards to the shareholders’ protection, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny (LLSV) in their seminal work *Law and Finance*,⁵⁰⁷ have analyzed the laws related to the protection of the company’s shareholders in 49 countries. Also, they have analyzed the legal background of each country and their law enforcement strengths. LLSV found that the countries with the French civil legal system offer the weakest protection to the company’s shareholders whereas the company’s shareholders enjoy the best protection in the common law countries. Furthermore, their findings show that the law enforcement in the French civil law countries is considered very weak when it compares with the law enforcement quality in the common law countries.⁵⁰⁸

Moreover, it has been claimed that a country’s legal system crucially affects the ownership structure of the company.⁵⁰⁹ Hence, among the LLSV results, they claimed that the very high ownership concentration in the French civil law countries resulted from the poor protection of the shareholders.⁵¹⁰

The family business constitutes around 35 per cent in the worldwide. Also, it could be argued that the manager shareholder who is a family member has the right to excess the company’s cash flow; in addition, the controlling families manage the company they

⁵⁰⁵ See Kang, D.L. and Sorensen, A.B., “Ownership Organization and Firm Performance”. *Annual Review of Sociology*, (1999), Vol: 25, Issue: (1), pp 121-144. At p 126.

⁵⁰⁶ OECD Corporate Governance Principles (2004), at p 30.

⁵⁰⁷ Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny, ‘Law and Finance’, *Journal of Political and Economy*, (1998), Vol: 106, Issue 6, pp 1113-1150.

⁵⁰⁸ *Ibid*, at p: 6.

⁵⁰⁹ See Mallin, A.Christine, *Corporate Governance*, Third Edition, United States, Oxford University Press, 2010, at p 84

⁵¹⁰ Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny, ‘Law and Finance’, *Journal of Political and Economy*, (1998), Vol: 106, Issue 6, at p 7.

own.⁵¹¹ Also, it has been stated that the family business could increase the agency cost if the managers are working for the interest of the family or the major shareholders only.⁵¹²

In linking the corporate governance and the family business or the ownership concentration, David Webb, a western citizen who is domiciled in Hong Kong, has stated the following in regards to the difference between cultures when corporate governance is approached:

“People who defend bad corporate governance on the grounds of Asia values or some cultural difference are talking nonsense. Yes, there is a different structure of ownership; it’s somewhat Victorian in that most companies (in Asia) are family controlled, but had I been in Victorian times in England I think I would have seen similar bad corporate governance”.⁵¹³

Kuwait shares some ownership characteristics with MENA and GCC Countries, as it has been argued that the great concentration of ownership between the companies in the MENA countries can be attributed to the fact that these businesses started as family businesses.⁵¹⁴ In addition, most of the businesses in the GCC Countries are owned by families, approximately 85 per cent.⁵¹⁵ Moreover, it has been argued that the family business type is predominant around the world.⁵¹⁶

Moreover, the major shareholders in many countries control a significant amount of shares. The family ownership structure is prevalent in many countries in Europe and Asia

⁵¹¹ See Mallin, A.Christine, *Corporate Governance*, Third Edition, United States, Oxford University Press, 2010, at p 84.

⁵¹² See Morck, R. and Yeung, B., “Agency Problems in Large Family Business Groups”, *Entrepreneurship Theory & Practice*, 2003, pp: 367-382.

⁵¹³ See Bob Tricker, *Corporate Governance, Principles, Policies, and Practice*, United States, Oxford University Press, 2009, at p 183.

⁵¹⁴ MENA- OECD Investment Program, *Advancing the Corporate Governance Agenda in the Middle East and North Africa: A Survey of Recent Developments*, <http://www.oecd.org/dataoecd/37/46/36086926.pdf>, retrieved on 10, June, 2010.

⁵¹⁵ The GCC study at p 44. And See Bob Tricker, *Corporate Governance, Principles, Policies, and Practice*, United States, Oxford University Press, 2009, at p 207.

⁵¹⁶ See Mallin, A.Christine, *Corporate Governance*, Third Edition, United States, Oxford University Press, 2010, at p 83.

as well.⁵¹⁷ Also, it has been noted that in many listed companies the managers are agents for the controlling shareholder and not for the other shareholders.⁵¹⁸

5.3.3.6.1 Shareholders Basic Rights:

Shareholders enjoy several rights as a result of their participation in the company's capital, including: The right to sell, buy and transfer shares; the right to receive returns out of their investment in the company; the right to receive information about the company to assist the shareholder in making the right decision in regards to the company; and the right to attend the general meeting of the company.⁵¹⁹ These shareholders rights are named the basic rights to which the shareholder in any company should be entitled. More rights for shareholders can be found in any countries company's law. The OECD Corporate Governance Principles (2004) have stipulated for the shareholders basic rights as follow:⁵²⁰

1. Shareholders rights should include the right to: a) secure methods of ownership registration; b) convey or transfer shares; c) obtain relevant and material information on the corporation on a timely and regular basis; d) participate and vote in general shareholder meetings; e) elect and remove members of the board; and f) share in the profits of the corporation.
2. Shareholders should have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as: a) amendments to the statutes, or articles of incorporation or similar governing documents of the company; b) the authorization of additional shares; c) extraordinary transaction, including the transfer of all or substantially all assets, that in effect result in the sale of the company.
3. Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures,

⁵¹⁷ See Christoph Van der Elst, 'Law and Economics of Shareholder Rights and Ownership Structures: How Trivial Are Shareholder Right to Shareholders?', *Corporate Governance & Law E-Journal*, (January, 2010), Vol: 2, No:7.

⁵¹⁸ See ALessio, Paccas, 'Controlling the Corporate Controller's Misbehaviour', *Corporate Governance & Law E-Journal*, (June, 2010), Vol:2, No:15.

⁵¹⁹ OECD Corporate Governance Principles 2004, at p 33.

⁵²⁰ OECD Corporate Governance Principles 2004, pp 34-36.

that govern general shareholder meetings: a) shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting; b) shareholders should have the opportunity to ask questions relating to the annual external audit, to place items on the agenda of general meetings, and to propose resolutions, subject to reasonable limitations; c) effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members, should be facilitated; d) shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

4. Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

Additionally, in most of the jurisdictions around the world, company law usually provides for devices that are available to the shareholders to exercise supervision upon their company. For example, in the Chinese Company Law, the shareholders are entitled to examine and copy (a) the company's articles of association, (b) financial reports and (c) board meeting minutes, and are also entitled to discuss the company's accounting report. Moreover, within sixty days, a shareholder may challenge in the court of law any resolution made by the shareholders meeting or the board of directors meeting, provided that this resolution violates the company's Article of Association.⁵²¹

In the following section, the shareholders' rights will be discussed in light of the Kuwaiti Companies Law 15/1960.

⁵²¹ Implementing the White Paper on Corporate Governance in Asia, Stock-Take of Progress on Priorities and Recommendations for Reform, done by OECD Asia Roundtable on Corporate Governance, October 2006, <http://www.oecd.org/dataoecd/32/42/41968280.pdf>, retrieved on 23 June 2010.

5.3.3.6.2 Shareholders' Rights under the Kuwaiti Law:

Shareholders are the foundation of capitalism as they are the ones that provide the needed resources for all companies.⁵²² Also, shareholders' rights and the equal treatment between all shareholders are essential components that corporate governance system aims at protecting.⁵²³ In many jurisdictions, the core of the shareholders protection mostly takes place in the company laws provisions that are provided for in the companies laws. Accordingly, in this section, an attempt will be made to examine the shareholders' rights provisions that are embedded in the Kuwaiti Companies Law No: 15/1960.

5.3.3.6.2.1 Equitable Treatment Between Shareholders:

In regards to equivalent treatment between the shareholders, it has been provided in Article 130 of Kuwait Companies Law that: "the incorporating members who sign the article of incorporation of the company, and shareholders who subscribe in its shares, shall be considered members of the company, and all shall benefit of equal rights and shall be subject to the same liabilities, provided that the provisions of law shall be observed". The above article acknowledges that the company's founders and any future shareholder who subscribe in its shares are and will be subject for the same rights. In addition, with regard to the voting rights, Article 156 of Kuwait Companies Law provided for the principle of one share one vote. In other words, "Each shareholder shall have a number of votes equivalent to the number of his shares...".

Also, it is transpired from the reading of Article (131) of the Kuwait Companies Law that all the company's shareholders are to enjoy the same benefits; the article is read as follow:

A member shall, particularly, benefit of the following rights:

First- Receipt of profits and interests determined to be distributed among shareholders.

⁵²² See Mallin, A.Christine, *Corporate Governance*, Third Edition, United States, Oxford University Press, 2010, at p 73.

⁵²³ Daniel, Angualia, Balance of Power between Shareholders and the Board in Corporate Governance (May 21, 2010). Available at SSRN: <http://ssrn.com/abstract=1612962> , retrieved on 15, June, 2010.

Second- Receipt of a portion of all the company's properties upon liquidation.

Third- Participation in the management of the company's business whether in the general assemblies or in the board of directors, in accordance with the policy of the company.

Fourth- Obtainment of a print book including the balance sheet of the ended accounting round, profits and loss accounts, the report of the board of directors and the report of the auditors.

Fifth- Proceeding an action of invalidity of each decision, issued by the general assembly or the board of directors, violating the law, public order, the article of incorporations or the policy.

Sixth- Disposition of the shares owned by him and the priority in subscription in the new shares, in accordance with the provisions of the law.

Accordingly, it could be argued that the legislator in Kuwait has stipulated for the basic shareholder's rights and equivalent treatment between the shareholders as it transpired from the abovementioned provisions.

5.3.3.6.2.2 Minority Shareholders Protection:

Although the Kuwaiti Companies Law incorporated several provisions in favor of the minority shareholders, it failed to protect the minority shareholders in many other instances as will be discussed below. Kuwait Companies Law has stipulated for the preemptive rights in Article 111; this article provides that the current company's shareholders have priority with regard to the subscription to new shares in the company's capital; whereas, the same article allows the articles of incorporation to incorporate a provision that waives the preemptive shareholders right.

Thus, it could be argued that the permission to waive the shareholder's preemptive rights is a weakness in the corporate governance system because the main aim of preemptive rights is to offer protection to minority shareholders against any minimizing

scheme that might be taken by the controlling shareholder.⁵²⁴ When the waiver provision comes without determinant factors then it would undermine the effectiveness of the pre-emptive right notion, since the controlling shareholder is able to call for an extraordinary meeting and vote to incorporate a provision to waive the pre-emptive right before the issuance of new shares. For instance, the UK, one of the most developed countries, has stipulated requirements that must be fulfilled before waiving the shareholder's pre-emptive right.⁵²⁵

In other words, the UK Companies Act 2006 is similar to the Kuwaiti Companies Law 1960 as they permit the shareholders to waive their preemptive rights. But, in the UK, the directors are allowed only to issue a specific number of new shares, whereas, in Kuwait, the numbers of the new shares are open and the Kuwait Companies Law has not posed any restriction with respect to waiving the existing shareholders of their preemptive right.

Article 133, Provision 4, prohibits any restriction to the shareholder's right to seek remedy for the damages he suffered against the board of directors whether the violation has been done collectively by the directors or singly by an individual director. Furthermore, the Kuwait Companies Law allows the minority shareholder to file a lawsuit against any decision rendered by the general meeting of the company, provided that some conditions are fulfilled, i.e. the Plaintiff, who is the minority shareholder, must own shares constituting not less than 15% of the company's capital and they should have not approved the disputed decision.

The above-mentioned article gives the shareholders the right to challenge the general meeting resolution, which means that this article offers protection to the shareholders. Nonetheless, it could be argued that this protection is ineffective for several reasons; first, because the 15% threshold cannot be gathered easily in Kuwait for the fact that most of the companies are managed by the majority shareholder. The second is that this article

⁵²⁴ See Jerry W. Markham & Thomas Lee Hazen, *Corporate Finance; Cases and Materials*, (U.S., Thomson West, 2003) at p.291

⁵²⁵ UK Companies Act 2006, (c.46), Part 17, Chapter 3, Articles (560-573).

allows the shareholders to challenge the general meeting resolutions but not the business decisions that are taken by the board of directors.

In relation to the shareholders rights to obtain information about the company in which they are investing, Articles 178-179 of Kuwait Companies Law entitle any shareholder to obtain information about the company, but this right allows the shareholders to obtain the information that is submitted by the company to the ministry of commerce and industry only, and right to obtain information does not extend to the right to investigate the information that is available in the company itself.

Moreover, the board of director's report does not usually include detailed information, and also the auditor's report is not required to mention all the details about the company pursuant to the Kuwait Companies Law.⁵²⁶ Hence, the Kuwaiti Companies Law does not require the company to provide its shareholders with detailed information on a timely and regular basis. In other words, the corporate governance in Kuwait is not applicable with respect to the shareholder's ability to obtain full information about the company.

As to the shareholder's right to remove the board of directors under the Kuwait Companies Law, Article 152 provides that the absolute majority of the company's shareholders in the general meeting can propose for the removal of either the Chairman or any other member of the board of directors. And, the removal of the Chairman or any other board member can be done by a request signed by shareholders owning not less than 25% of the subscribed company's capital. In addition, the duplicate article 152, which has been added by the Law Decree No: 52/1999, provides that the shareholders owning not less than 25% of the company's capital have the right in the company's general meeting to propose for the dissolution of the board of directors, and the dissolution resolution must be approved by shareholders owning more than 50% of the company's shares.

⁵²⁶ See AL-Shammari, Dr Tummah *AL-Waseed fe Derasat Qanoon Al-Sharekat AL-Tejareya AL-Kuwaiti w Ta`adeelato*, Third Edition, the State of Kuwait, 1999, at p 442.

In the case where the general meeting disapproved the removal request of the chairman or any other member of the board of directors, Dr. Alshammari argued that in this situation the aggrieved shareholders have the right to ask the court to investigate the removal request and to decide whether to remove the directors or not; he added that the removal request that is submitted to the court must be supported by legal evidence or otherwise the court will dismiss the case.⁵²⁷

Accordingly, it could be submitted that the Kuwaiti Companies Law has stipulated for provisions that are *Prima facie* in favor of the shareholders, whereas the application of these provisions seems to be difficult because it requires a very high threshold (absolute majority), especially in Kuwait where the ownership is very concentrated. In comparison with one of the developed countries, according to Section 168 of the UK Companies Act, the shareholders can remove the directors by an ordinary resolution in the general meeting when they are not satisfied with his performance.⁵²⁸

Furthermore, one of the protections that is available to the minority shareholders is the Extraordinary General Meeting where the shareholders can challenge the company management. Therefore, it is considered one of the corporate governance tools that should be offered to the shareholders, specifically to minority shareholders; accordingly, the threshold to call for an extraordinary general meeting should be reasonable. But, according to the Kuwait Companies Law, the threshold is set very high at 25% of the company's capital, whereas, in Saudi Arabia, the threshold to call an extraordinary meeting is 5% of the company's capital pursuant to the Saudi Arabia Capital market corporate governance code 2006, Article (5), ss. B.

Furthermore, the right to call an extraordinary meeting has been given significant importance by the European Union as they issued a directive requiring that all member countries reduce the threshold to call the extraordinary meeting to 5%.⁵²⁹ For example,

⁵²⁷ See AL-Shammari, Dr Tummah *AL-Waseed fe Derasat Qanoon Al-Sharekat AL-Tejareya AL-Kuwaiti w Ta'adeelato*, Third Edition, the State of Kuwait, 1999, at p 401.

⁵²⁸ UK Companies Act 2006 (c.46), Part 10, Chapter 1, Article 168.

⁵²⁹ European Community Directive on Shareholders' Rights (URN 08/1362).

the UK Companies Act 2006 stipulated for 10% as a threshold to call for an extraordinary meeting, but in accordance with the EU Directive, it has been amended to be 5%.⁵³⁰

In Kuwait, also as regards to the protection of the shareholders, the shareholders relieve the board of directors from liability in the general meeting according to the Kuwait companies Law.

But, in Kuwait, the shareholders who have voted against the relief from liability have the right to file a lawsuit against the boards' members. In other words, the relief from liability has no legal effect against the minority shareholders.⁵³¹ This provision could be seen as a means of protection for any shareholder, as he can challenge the director's liability in court even if the said director has been relieved, which is always in Kuwait the controlling or the majority shareholder.

5.3.3.6.3 The Derivative Claims:

It has been argued that to ensure the effectiveness of the shareholders protection some requirements should be met, such as a condition that the shareholders should be able to challenge the director's expropriation in the court of law.⁵³² Therefore, the derivative action has a significant role to protect the shareholders. Accordingly, the derivative action is a lawsuit that can be brought by an individual shareholder on behalf of the company to hold the directors liable for a breach of their duties.⁵³³

Also the derivative action is considered one of the corporate governance tools that must be available to the shareholders to protect their rights. Furthermore, the derivative

⁵³⁰ UK Companies Act 2006 (c.46), Part 13, Chapter 3, Article 303, has been amended by the EU Directive in 2009.

⁵³¹ See the Cassation Court Appeal No: 239/1986, Commercial Court, on 20/5/1987, *the Judiciary and Law Journal*, Vol: 1, October 1994.

⁵³² See S Djankov, R La Porta, F Lopez-de-Silanes, and A Shleifer "The Law and Economics of Self-Dealing" (2008), *Journal of Financial Economics*, Vol: 88, at p 430.

⁵³³ See Kershaw, David, *Company Law in Context Text and Materials*, U.S, Oxford University Press, 2009, at p 546.

action's emergence always refers to the UK case between *Foss v. Harbottle*.⁵³⁴ In this case, the court imposed rules that must be available in any derivative suit to be valid. The first rule is that the derivative suit must be brought in the company name, as the company is the proper plaintiff with regard to any misconduct toward the company. The rule's condition is that the individual shareholder cannot bring a derivative action on behalf of the company if the misconduct can be ratified by the majority votes of shareholders in the general meeting.⁵³⁵

The derivative actions have now become statutory and the rules in *Foss v. Harbottle* have been overridden as it now been included in the 2006 Companies Act in the UK, in Section 260.⁵³⁶ Further, in Hong Kong, China, the derivative action rights to shareholders were provided for in 2005.⁵³⁷

In this context, it has been argued that regulating the derivative actions in the UK Companies Act 2006 has strengthened the shareholder position. In other words, codifying the derivative actions in the Companies Act 2006 made the shareholders' position better than it was been in the previous era. But, it is still not easy to bring successful derivative action.⁵³⁸

Furthermore, ss. 261-264 of UK Companies Act 2006 regulates the procedures of the derivative claims. The derivative action should not be given to the shareholders without restriction; otherwise there will be excessive litigation. The Kuwaiti Companies Law does not acknowledge derivative actions; in addition, the reality in Kuwait shows that the courts so far have not intervened in any company's decisions.⁵³⁹ Whereas, in the UK

⁵³⁴ (1843) 2 Hare 462.

⁵³⁵ See Kershaw, David, *Company Law in Context Text and Materials*, U.S, Oxford University Press, 2009, at p 547.

⁵³⁶ UK Companies Act 2006 (c.46), Part 11, Chapter 1, Article 260

⁵³⁷ Implementing the White Paper on Corporate Governance in Asia, Stock-Take of Progress on Priorities and Recommendations for Reform, done by OECD Asia Roundtable on Corporate Governance, October 2006, <http://www.oecd.org/dataoecd/32/42/41968280.pdf>, retrieved on 23 June 2010.

⁵³⁸ See Gavin, Davies & Tom Platts, 'Shareholders Activism in Practice', *Journal of International Banking & Financial Law*, February 2008, Vol: 23, Issue 2, pp 100-102.

⁵³⁹ AL-Shammari, Dr Tumamah AL-Waseed *fe Derasat Qanoon Al-Sharekat AL-Tejareya AL-Kuwaiti w Ta`adeelatoh*, Third Edition, the State of Kuwait, 1999, pp: 444-446.

Companies Act 2006 s. 994, a single shareholder can challenge a company's decision before the court if this decision is against all or some of the company's shareholders. The court in this case is entitled to render an order to prevent the harmful decision from taking place.⁵⁴⁰

Thus, the only legal tool accessible to shareholders in Kuwait is the liability suit under Kuwait Civil Law.⁵⁴¹ On the other hand, it has been stipulated in Kuwait Companies Law that the ballot by the general assembly to acquit the board of directors shall not prohibit bringing an action of liability.⁵⁴² Additionally, it has been noted that this article gives rise to the director's responsibility before the shareholders provided that there is direct damage to the shareholders. Likewise, this point is stipulated clearly in the Spanish Corporation Law Article 135 as it reads as follows: "... suits of damages by shareholders and third parties against administrators may be brought where the actions of the administrators directly affected their interests".

Most of the AGMs in Kuwait are controlled by the majority shareholder who is at the same time controlling the company's management. In addition, several aspects are weakening the corporate governance practices in Kuwait, such as the weak transparency and the disclosures regulations between the company and the shareholders.⁵⁴³

Furthermore, Article (161) of the Kuwait Companies Law vested the right to appoint the auditors in the hand of the shareholders in the general meetings. However, the practice among the Kuwaiti companies is that the auditors are always appointed in the general meeting according to the recommendation from the Board of Directors; thus, in this case the auditor's loyalty would be to the board of directors not to the shareholders or the company.⁵⁴⁴

⁵⁴⁰ UK Companies Act 2006 (c.46), Part 30, Article 994.

⁵⁴¹ As mentioned in the previous Section.

⁵⁴² Unofficial translation by ASAR Law Firm.

⁵⁴³ See AlMelhem, Ahmed, *Kuwaiti Commercial Companies Law and the Comparative*, Kuwait University Press, Kuwait, 2009, at p 344.

⁵⁴⁴ See AlMelhem, Ahmed, *Kuwaiti Commercial Companies Law and the Comparative*, Kuwait University Press, Kuwait, 2009, at p 346.

The abovementioned reality between the companies in Kuwait obviously undermining one of the corporate governance issues that is the independent auditor.

As to the board's responsibility before the company's shareholders, Article 148 of the Kuwait Companies Law provided that: "The chairman and members of the board of directors shall be liable before the company, the shareholders and third parties, for any act of fraud and abuse of authority, any violation to law or to the policy of the company and mismanagement".

Finally, Kuwait Companies Law does not incorporate any provision regarding the merger and acquisitions transaction. However, the corporate governance system is concerned about the merger and acquisitions transactions because, when there are no regulations protecting the shareholders rights in the transaction, the minority shareholders' interests could be largely undermined. An illustration of the minority right being undermined by the controlling shareholder in an acquisition transaction in Kuwait can be found in the following example: The major and controlling shareholder in one of the most active telecommunication in Kuwait, who held 51% of the company's capital, sold his stake and his collaborator shareholders to another investor for a premium amount of around 50% of the share price.⁵⁴⁵

The minority shareholders rights were undermined because the share price was very high and they had not been given the chance to enter into this deal as it was concluded between the manager, controlling shareholder and his collaborator shareholders.

However, there is no single law in Kuwait that obliges the controlling shareholder to distribute the deal among all the shareholders. Whereas, the best practice entails, for example, in the abovementioned case, that the deal should be distributed among the company's shareholders *pro rata* to their stake in the company's capital.

⁵⁴⁵ The Deal parties are AL- Watanya Telecommunication Company (the seller) and Qatar Telecommunication Company (the buyer) March 2007, the deal cost is 1.075 Bilion Kuwaiti Dinar = 3.5 Billion USD.

But, in reality, the business culture in Kuwait has revealed the weakness of the general meetings. This weakness could be attributed to the fact that many small investors are short-term investors.⁵⁴⁶ In other words, the majority of small investors in Kuwait are particularly focused on the returns from the selling and buying the shares, but not the company's management or the company's strategy.

Moreover, the fact that the majority shareholders manage the majority of the companies in Kuwait can be a reason for the ineffective general meetings in Kuwait

To this end, it could be submitted that the legislator in Kuwait has failed in many occasions to provide for provisions that ensure the shareholders protection. Therefore, it is recommended that the legislator must pay attention to this failure and issue a new company law that is combating and cure the current situation.

5.4 Conclusion:

In this chapter, the political and legal institutions in Kuwait were examined to evaluate the possibility of implementing sound corporate governance. First, examination of the political institutions in Kuwait revealed that reform is needed, because the current practice in these institutions does not and cannot provide a base for sound corporate governance, primarily because of the entrenchment of administrative corruption in the government and the parliament in Kuwait.

The relationship-based system is predominant in Kuwait. Productive change can be realized only by converting instead to a rule-based system. Such a conversion can be achieved in Kuwait through the strict implementation of the principle of the Rule of Law. The proper system of corporate governance plays an important role when converting the system from a relationship-based system to a rule-based system in any country.⁵⁴⁷

⁵⁴⁶ See Faisal, AL-Kuraibet, *The New of Commercial Companies, Between the People and the Money*, Kuwait, 2005, pp 93-94.

⁵⁴⁷ Oman, Charles, Fries, Steven and Buitter, Willem, *Corporate Governance in Developing, Transition and Emerging-Market Economies*, at p 33. It is a research paper presented by OECD Developments Centre, Brief No: 23.

Secondly, the corporate governance's legal institutions in Kuwait were investigated in this chapter.. The legal origins and systems of any country tend to play a significant role in the implementation of corporate governance, since corporate governance aims at protecting shareholders.⁵⁴⁸ Kuwait is adopting the civil law system, which, according to LLSV findings, provides weak protection to shareholders.⁵⁴⁹

Furthermore, the independence of the judicial authority was examined. The judicial authority in Kuwait enjoys very high independence as provided in the Kuwait Constitution. Nevertheless, judges in Kuwait may encounter a problem in relation to corporate governance in that the judges there are subject to annual rotation, as the result of which the judges are not specialized. Therefore, to ensure that the judges are able to address any corporate governance case, they should be specialized, at least the judges in the Commercial Courts. In addition, the judges must be provided with training courses regarding corporate governance, since corporate governance is a new notion in the Kuwait business culture and because there is no mention of corporate governance in the education sector in Kuwait.

The last legal institution that has been examined in this chapter is the Companies Law in Kuwait. The examination aim was to determine whether the Companies Law 15/1960 contains corporate governance provisions and, if so, the extent to which they are efficient. Kuwait Companies Law 15/1960 contains some corporate governance tools, such as the basic rights of shareholders. However, the Kuwaiti Companies Law fails in several respects to ensure the effectiveness of corporate governance tools. For example, the separation between the position of a company's CEO and the board chairman has not been required in Kuwait, which is an obstacle to achieving the best practice of corporate governance.

In addition, the Kuwaiti Companies Law does not oblige the companies to establish audit, nomination or compensation committees. Although, some companies may

⁵⁴⁸ See R. La Porta, F. Lopez-de-Silanes, and A. Shleifer and R. Vishny, 'Legal Determinants of External Finance', (1997) 52 *Journal of Finance*, at p. 1131.

⁵⁴⁹ *Ibid.*

constitute committees, they cannot be considered corporate governance practice, because they are not required to be composed of independent directors, as independent directors are not mentioned in the Companies Law. Furthermore, the Kuwait Companies Law has not provided a clear definition of the directors' duties, which can only be inferred from the law's wording. This situation is likely to result in confusion when holding directors accountable for their actions.

Therefore, it is recommended that the Companies Law clearly define the directors' duties. Finally, the examination found that, although the Kuwait Companies Law has provided so-called basic shareholder's rights, the actual practice in Kuwait leaves the concentration of ownership and control in the hands of the major shareholder. In turn, the controlling shareholder will extract benefits at the expense of the minority shareholders.

For that reason, it is recommended that the shareholders in Kuwait must be afforded legal remedies to prevent the controlling shareholder from undermining their rights, the legal rights that are not provided for in Kuwait's Companies Law. Such rights could be provided through such means as derivative suits or actions. These legal actions should be available to the shareholders and should be subject to specific conditions to avoid excessive litigation.

Chapter Six: The Current Best Practice of Corporate Governance in the State-Owned Enterprises in Kuwait

6.1 Introduction:

The importance of establishing institutions of corporate governance in any country is to maintain proper governance to prevent a future crisis in the financial sectors.⁵⁵⁰ Thus, the previous chapter can be seen as a foundation to any institutional examination regarding the corporate governance system in Kuwait. The previous chapter “the political and legal institutions in Kuwait” examined and assessed the possibility of implementing sound corporate governance in Kuwait. The examination of the political institutions of corporate governance in Kuwait revealed that reform is needed since the current practice in these institutions does not and cannot provide a proper base for sound corporate governance, primarily because of the entrenchment of administrative corruption in the government and the parliament in Kuwait.

Moreover, the legal institutions of corporate governance in Kuwait have been also examined in the previous chapter as regards the legal origin of the Kuwaiti legal system in addition to the judiciary independence and the corporate governance tools that is included in the Kuwait Companies Law No: 15/1960. The examinations of the aforementioned institutions of corporate governance are a very important pillar to ensure the implementation of the best practice of corporate governance in the state-owned enterprises in Kuwait. Consequently, in this chapter, an attempt will be made to examine the current corporate practice in the state-owned enterprises in Kuwait. Starting with corporate governance issues in general, the definition of state enterprises, the objective of the establishment of such enterprises, and the manager’s accountability in such type of enterprises will be discussed.

Moreover, due to the fact that there is no single code or guideline for corporate governance principles around the world, the OECD guidelines established in 2005 in

⁵⁵⁰ See Clarke Thomas, *International Corporate Governance, A Comparative Approach*, Routledge, London, 2007, at p 85.

addition to some of the codes that have been created by different countries will be addressed.⁵⁵¹ As regards Kuwait, an attempt will be made to give an explanation to the way that the public sector should be created, such as in South Africa.

Further, sound corporate governance practice is necessary for the SOEs in Kuwait especially in the current era because the Development Plan of Kuwait for the next five years is aiming at privatize several vital governmental bodies.⁵⁵² Accordingly, in this case, the best practice of corporate governance in SOEs would encourage investors to support these projects, which, in turn, will positively affect the price of the public bodies that are candidates to be privatized. Furthermore, the opportunities and challenges to the application of the best practice of corporate governance in the SOEs in Kuwait will be examined.

The challenges to find a sound corporate governance system in the SOEs in Kuwait will be discussed, particularly two issues: political interference and the absence of a clear legal framework for the state-owned enterprises, which in turn will help in identifying the objective and the SOEs managers' accountabilities. In addition, the legal framework for the SOEs would minimize the roles of the politicians and their great interference in SOEs affairs. For instance, the parliament interference in the appointment of the board of director among other aspects will be discussed below.

Furthermore, the exiting opportunities to implement the best practice of corporate governance in the state-owned enterprises will be discussed, including the roles that some of the entities of Kuwait may play. The entities that are discussed in this chapter are the State Audit Bureau and the Kuwaiti Law No: 1/1993 regarding the protection of public funds. Since such entities combats the corruption and the embezzlements that the SOEs suffering from.

⁵⁵¹ OECD Guidelines on Corporate Governance of State-Owned Enterprises 2005, at p: 3

⁵⁵² Kuwait Development Plan Law No:38/2010.

6.2 The Corporate Governance of State-Owned Enterprises:

The state-owned enterprises are dominant in Kuwait since such enterprises are folly owned by the Government and provide the people with all the necessary and unnecessary wants. Such needs for example the electricity, water and subsidized food. Accordingly, it has been argued that to attain sound corporate governance system in any country, the government must show it willingness to reform the economy by adopting or reforming the corporate governance system in the state-owned enterprises especially where the SOEs are dominant as in the case of Kuwait.⁵⁵³

6.2.1 Different Definitions of The State-Owned Enterprises:

The establishment of state-owned enterprises (SOEs) could be attributed to several reasons or motivations. Moreover, it has been argued that the reasons behind establishing state-owned enterprises may differ from country to country. These differences could be because the state administration or the government reflects the cultural environment in its country, so the pattern to achieve such objective is also different.⁵⁵⁴ In other words, state-owned enterprises are not similar in all countries because the SOE`s structure whether from legal, financial or administration perspectives depends on each country`s culture to ensure that they are protecting national interests.

Consequently, the state-owned enterprises in Kuwait are a major player in the country`s economy for the reason that these SOEs are fully owned by the state, and they nearly provide the people in Kuwait with all necessary and unnecessary goods or services. Accordingly, it must be mentioned in this stage that the public sector importance differs from country to country depending on the adopted system in such countries; thus, in countries where nationalization has taken place, the public sector will trigger considerable attention and importance. Conversely, if a country is adopting a

⁵⁵³ See Khoza, Reuel J, & Mohamed Adam, *The Power of Governance, Enhancing the Performance of State-Owned Enterprises*, Palgrave Micmillan, New York, 2007, at p: 21

⁵⁵⁴ See Belkaoui, A., *Accounting in the Developing Countries*, London: Quorum Books, 1994, at p 171.

stronger market-centered approach, then the private sector will be more important than the public sector.

Moreover, there are countries trying to find the middle ground between the public and private sectors.⁵⁵⁵ Kuwait could be seen as one of the countries that is adopting a middle ground; this was evident when The Amir of Kuwait late Alshiekh Jaber AL-Ahmed AL-Sabah (1977–2006) addressed the nature of the Kuwaiti economy when he said:⁵⁵⁶

“ We have accepted the freedom of economy as a principle in our society, because we believe that this system is the most suitable economic system to us, as it provides for the incentives for individuals, and demonstration of the true cost, but at the same time we are concerned about the disciplinary of our economy, and to avoid any conflict of interest between the private and public sectors, if our customs, traditions and our constitution devoted only for the principle of the freedom of economy, therefore, there are conditions cannot be ignored necessitated the state interference to protect the national economy and to achieve the public interest in terms of welfare and the stability to all the citizens and to establish the rules of the social relations. Since then we established the public sector and the joint sector along with the private sector which is working in the light of the public interest and prescribed law. Accordingly, our experience proves its effectiveness and usefulness toward our society...”

Thus, it has been said that the governance of state-owned enterprises is also not similar in all countries as the laws that govern such enterprises may differ. In some countries, the laws provide that the objective of the SOE is to maximize the assets and profit value, and, in order to achieve such goals, these countries provide that the composition of the board of directors must encompass directors with business experience. Whereas, there are countries where board of directors of the SOEs include political representatives.⁵⁵⁷ Furthermore, the state-owned enterprises (SOEs) have been defined in many ways; in other words, it could be submitted that there is no convergence as regards the definition of state-owned enterprises.

⁵⁵⁵ See Dr ALShammari, T., *The Public Sector Enterprises in the Kuwaiti and Egyptian Laws, Analytical and Critical Study*, Kuwait Foundation for the Advancement of Science, Kuwait, 1990, at p:15.

⁵⁵⁶ The Amir of the State of Kuwait speech at the opening ceremony for the Central Bank of Kuwait on April, 10, 1977. Quoted in Dr ALShammari, T., *The Public Sector Enterprises in the Kuwaiti and Egyptian Laws, Analytical and Critical Study*, Kuwait Foundation for the Advancement of Science, Kuwait, 1990. At p: 17, unofficial translation by the Author.

⁵⁵⁷ See D. Daniel, Sokol, ‘Competition Policy and Comparative Corporate Governance of State-Owned Enterprises,’ *Brigham Young University Law Review*, 2009, at p 1754.

Accordingly, the SOE can be defined as follows: “enterprises where the state has significant control, through full, majority, or significant minority ownership.”⁵⁵⁸

Moreover, the state-owned enterprise has also been defined as a legal corporate entity that the government owns the whole or part of, and it is operating as a separate business organization with the aim to be a profitable organization or at least break even.⁵⁵⁹ Egypt Law No: 1983/79 regarding the Public Authorities and Public Sector Corporations has defined the state-owned enterprises as follows: it is an entity executing an economic project pursuant to the public policy of the state and the socio-economic development plan.⁵⁶⁰ But, according to the legal institutions weaknesses (especially the outmoded laws in Kuwait), there is no single definition for the SOE in the Kuwait Laws; therefore, it has been suggested that the SOE in Kuwait is an enterprise that is wholly owned by the state.⁵⁶¹

6.2.2 Differences Between The State-Owned Enterprises And The Private Corporations:

The state-owned enterprises differ from private corporations in several ways. The OECD has outlined the differences between SOEs and private companies. These differences are i) the respective authority and power of the board, management and ministries, ii) the composition and structure of these boards, iii) the extent to which they grant consultation or decision making rights to some stakeholder, more particularly employees, and iv) disclosure requirements and in terms of insolvency and bankruptcy. In addition, the SOEs legal forms usually provide strictly for its definition of activities, which has been taken as a safeguard against the misuse of the public funds.⁵⁶²

⁵⁵⁸ OECD Guidedlines for Corporate Governance of State-Owned Enterprises, at 11.

⁵⁵⁹ See Sexty, R., ‘Autonomy Strategies of Government Owned Business Corporations in Canada’, *Strategic Management Journal*, 1980, Vol:1, Issue:4, pp 371-384.

⁵⁶⁰ Egyptian Law No: 1983/79 regarding the Public Authorities and Public Sector Corporations.

⁵⁶¹ See Dr ALShammari, T., *The Public Sector Enterprises in the Kuwaiti and Egyptian Laws, Analytical and Critical Study*, Kuwait Foundation for the Advancement of Science, Kuwait, 1990, at p: 33.

⁵⁶² OECD Guidedlines for Corporate Governance of State-Owned Enterprises, at p 19.

One of the special features of the wholly state-owned enterprises is that it does not have shareholders meetings. In addition, the management task is delegated usually to the company's board of directors, but the autonomy of the board of directors of such type of company is in question.

Furthermore, the SOE's board of directors cannot be changed through what is so called market control such as takeovers and bankruptcy processes, which in turn leads to reduce the director's motivation to maximize the value of their corporation.⁵⁶³ In other words, the state-owned enterprises are usually immune from two major threats bankruptcy and takeovers.⁵⁶⁴

6.2.3 State-Owned Enterprises Establishment Objectives:

As regards the objective behind establishing SOEs, it has been argued that these objectives are not similar in all countries as one of the purposes behind establishing state-owned enterprises is that the state is willing to maintain control over an important source of income to its budget or to control some utilities that are important to the so-called national security.⁵⁶⁵ In this context, it has been submitted that the state-owned enterprises have a significant role in the Middle East and North Africa (MENA) countries. Because the SOEs in MENA countries mostly provide services and goods usually produced by the private sector companies in markets at issue find themselves in a competitive key role to play.

The MENA-OECD Investment Program has touched upon some of the deficiencies in the SOEs in MENA countries; for example, the SOEs suffer from great political interference and no commercial incentives.⁵⁶⁶ Consequently, it is a fact that the

⁵⁶³ See Estrin, Saul, 1998, State Ownership, Corporate Governance and Privatization. *Corporate Governance, State-Owned Enterprises, and Privatization*. Paris: OECD Proceedings.

⁵⁶⁴ OECD Guidedlines for Corporate Governance of State-Owned Enterprises, at 10.

⁵⁶⁵ See Wei, Yuwa, *Comparative Corporate Governance...An Chinese Perspective*, Kluwer Law International, Netherlands, 2003, at p 198

⁵⁶⁶ See Advancing The Corporate Governance Agenda In The Middle East And North Africa: A Survey of Recent Developments, MENA-OECD Investment Programme at p 19. Available at <http://www.oecd.org/dataoecd/37/46/36086926.pdf>, retrieved on 17 January 2011.

governments usually have an important role to play to ensure good economic growth and good practice of governance particularly in state-owned enterprises.⁵⁶⁷ One of the most serious challenges facing the best practice of corporate governance in SOEs is the multiple and/or the conflicting goals of such enterprises.⁵⁶⁸

For instance, Act 1986/124,⁵⁶⁹ in New Zealand stipulates for that state-owned enterprises should be profitable as if it was a private corporation; in addition, these SOEs should take into account social responsibility and be a good employer.⁵⁷⁰ Further, South Africa recently distinguished state-owned enterprises in the recent Companies Bill 61 of 2008,⁵⁷¹ but there are no differences with respect to the corporate governance provisions between SOEs and private firms.⁵⁷²

As a result, it could be submitted that the state-owned enterprises in South Africa seek to maximize the value of their enterprises, but it is not surprising that there are more objectives such as corporate social responsibility due to the reason that there is political interference in South Africa SOEs. As regards Kuwait, it has been said that the SOEs in Kuwait are established to achieve several objectives, such as offer services and goods for a suitable price to the consumers and to contribute greatly to human and industrial development through providing jobs and training courses for the nationals.⁵⁷³

Therefore, there is a recommendation that the state must revisit and, if necessary, change the objectives of its SOEs to be compatible with the development of national

⁵⁶⁷ See Khoza, Reuel J, & Mohamed Adam, *The Power of Governance, Enhancing the Performance of State-Owned Enterprises*, Palgrave Macmillan, New York, 2007, at p: 14.

⁵⁶⁸ See The World Bank Corporate Governance Department study, *Held By Visible Hand, The Challenges of SOE Corporate Governance For Emerging Markets*, Prepared by David Robinett, May 2006. Available at <http://rru.worldbank.org/Documents/Other/CorpGovSOEs.pdf>, retrieved on 15-Dec-2010, at p .4

⁵⁶⁹ State-Owned Enterprises Act No: 1986/124 in New Zealand.

⁵⁷⁰ See D. Daniel, Sokol, , 'Competition Policy and Comparative Corporate Governance of State-Owned Enterprises', *Brigham Young University Law Review*, 2009, at p 1756

⁵⁷¹ South African Companies Bill 61 of 2008.

⁵⁷² See D. Daniel, Sokol, , 'Competition Policy and Comparative Corporate Governance of State-Owned Enterprises', *Brigham Young University Law Review*, 2009, pp: 1762-1764

⁵⁷³ See Dr AlShammari, T., *The Public Sector Enterprises in the Kuwaiti and Egyptian Laws, Analytical and Critical Study*, Kuwait Foundation for the Advancement of Science, Kuwait, 1990, at p: 29.

priorities. But, this revision should not be frequent because frequent revision would have a detrimental effect on stakeholders' trust in such enterprises.⁵⁷⁴

6.2.4 State-Owned Enterprises Accountability And Performance:

Turning to the accountability of the SOEs, they are subject to the public and the governmental entities' scrutiny. Thus, it is a fact that the SOEs are accountable to a broader community, while, on the other hand, private corporations are only accountable to their shareholders. Therefore, it has been argued that the agency problem arising from the separation between ownership and control is greater in the state-owned enterprises than the private companies.⁵⁷⁵ In this vein, the government could be seen as the agent when it acts as a shareholder, and the people are the ultimate principal.

Thus, in the light of this agency relationship framework, the government must align its interests with the people's interests to mitigate the agency problems.⁵⁷⁶ Whereas, and in relation to the agency problems in the state-owned enterprises, it has been said that the agency problem in this case is with the politicians and not with the managers of such enterprises of government, which in turn will be reflected in the enterprise performance.⁵⁷⁷

As regards the managers autonomy, it has been affirmed that the SOE's managers should be accountable for the decisions that are taken in such enterprises, and also it has been added in this vein that:

“Accountability means a responsibility or liability to reveal, explain and justify what one does to account for one's action, to report on the actions and the results arising from the exercise of authority. Since

⁵⁷⁴ See Bhattacharyya, A. K., *Public Enterprises: Corporate Governance and the Role of Government* (March 10, 2005). Available at: <http://ssrn.com/abstract=697381>, retrieved on 18-Oct-2010, pp 11-12.

⁵⁷⁵ See Wei, Yuwa, *Comparative Corporate Governance...An Chinese Perspective*, Kluwer Law International, Netherlands, 2003, at p 75.

⁵⁷⁶ See Ulrich, F.W. Ernst, , 'Methods for Resolving Problems of responsibility and Transparency in The Activities of SOE in Market Economies: Models and Results', *Corporate Ownership & Control*, 2004, Vol: 1, Issue: 3, at p: 39, pp 37-43.

⁵⁷⁷ See Boycko, M., Shleifer, A., & Vishny, R.W., A, 'Theory of Privatization', *Economic Journal*, 1996, Vol: 106, pp 309-319, p 318.

managers of SOEs have the authority to exercise discretion over the use of public funds and to exercise economic power associated with diverse social consequences, they must be accountable for their decisions to the representatives of the public”.⁵⁷⁸

On the other hand, it has been argued that the managers of SOEs cannot be held accountable simply because they don't enjoy the proper autonomy in term of making decisions as regards their enterprise. Therefore, Pallot said that:

” it is unfair to hold managers accountable in terms of efficiency for what they do not control, such as when they are prohibited from disposing of or making replacement decisions about certain assets. They, instead, can be assessed in terms of the availability and accessibility of the assets to the public”.⁵⁷⁹

Furthermore, it has been stated that the accountability is pointless without autonomy as the question arises as to how can the managers be held accountable for their decisions, unless such decisions have been freely taken by the SOE's managers themselves.⁵⁸⁰ Moreover, the manager's autonomy as regard taking decisions is aiming at a better performance for the enterprise because the decisions will be made by experienced managers without any interventions whether directly by the government or indirect by strict laws and regulations.⁵⁸¹

In relation to the performance of state-owned enterprises, some may argue that the failure of state-owned enterprises is not attributed to the poor idea of creating such enterprises but is due to the circumstances that the government has not implemented the idea under consideration as it should be.⁵⁸² Plane has elucidated why state-owned enterprise performance is not efficient from a theoretical perspective as follows:

⁵⁷⁸ See Aharoni, Y., 1986, *The Evolution and Management of State Owned Enterprise*, Cambridge, Ballinger Publishing Company, US. At p 249.

⁵⁷⁹ See Pallot, J., , 'The Role Of Accounting In The Privatization Of State Trading Enterprises In New Zealand', *Advances In Public Interest Accounting*, 1998, Vol:7, pp:161-191.

⁵⁸⁰ See Shirley, M., & Nellis, J., *Public Enterprise Reform: The Lessons of Experience*, Economic Development Institute of the World Bank, Washington, D.C. 1991, at p 26.

⁵⁸¹ See OECD, 1994, *Performance Management in Government: Performance Measurement and Results-Oriented Management*, Public management Occasional Papers No. 3, Paris, pp 59-63.

⁵⁸² See Ramamurti, R., 1991, *Controlling State-Owned Enterprises*, in Ramamurti, R., and Vernon, R. (ed.), *Privatization and Control of State-Owned Enterprises*, Economic Development Institute of the World Bank, Washington DC, at p: 206.

“Public Choice Theory suggests that the public managers may collude with civil servants in supervising ministries in order to gain larger budget allocations, with mutually beneficial effect to both groups in terms of power, prestige and pay. Property rights theory suggests that public enterprises are less efficient than their private counterparts because a non-profit objective reduces the correlation between the efforts of the individual and the reward-cost schedule, and because there is no ultimate monitoring managerial achievement by self-interested shareholders. X-efficiency theory suggests that the public enterprises are inefficient because they are protected from direct competition, they cannot in practice be allowed to go bankrupt, and they are not at risk of a commercially-inspired take-over bid.”⁵⁸³

It would be argued, therefore, that these theories are impliedly encouraging that the state-owned enterprises should be corporatized through clear legal framework where the definition of the SOEs is identified in addition to the enterprise's objective and the managerial accountability.

6.3 The Corporate Governance of State-Owned Enterprises:

Concerning the application of corporate governance in state-owned enterprises, there might be an argument that the government tendency to control its enterprises in a way that may be at the expense of achieving a proper economic performance could be seen as an obstacle to implement the best practice of corporate governance in the SOEs. However, it has been stated that the success of a state-owned enterprise is to balance between the control and the commercial performance, which is the optimal goal of good corporate governance.⁵⁸⁴ Furthermore, the quality of the leadership in a state-owned enterprise is very important to attaining a good governance practice in such enterprises. Because good quality leadership will lead to good performance of several issues underpinning good governance in the state owned enterprises, good leadership will enhance the organizational integrity and transparency.⁵⁸⁵

⁵⁸³ See Plane, P., 'Productive Efficiency of Public Enterprises - A macro-economic Analysis Based on Cross-section Estimating of a Neo-classical Production Function', *Applied Economic Journal*, 1992, Vol:24, pp: 833-844.

⁵⁸⁴ See Khoza, Reuel J, & Mohamed Adam, *The Power of Governance, Enhancing the Performance of State-Owned Enterprises*, Palgrave Macmillan, New York, 2007, at p: 23.

⁵⁸⁵ Ibid, at p 58 and 52.

Additionally, and due to the importance of the good practice of corporate governance to any economy, and in particular to the Asian economies (where the State of Kuwait based), it has been stated by the Vice Chairperson of Transparency International:

“If we Asians are profit from the lessons of the devastation that effectively wiped many of our countries of the global economic radar screen, we must embrace the fact that the unbridled excesses that underpinned our bubble economies were really no substitute for high ethical business standards and good corporate governance”.⁵⁸⁶

Moreover, one of the most important issues in state-owned enterprises is the management structure or the legal framework of these types of enterprises. The management structure for the SOEs in terms of the explanation about the government control may vary from country to country, as in each country the form of the management structure for SOEs can take one of the following forms.

The centralized management structure exists when there is only one single governmental entity in a country exercising the ownership right instead of the government as shareholder in all the SOEs in this country; for example, Jordan, Indonesia, and Singapore are adopting the centralized form.⁵⁸⁷ The second management structure is the decentralized form where the SOEs are managed by different governmental entities and not all of the SOEs are monitored by the same ministries. The third management structure can be found as a mixture of the centralized and decentralized form, as in this case two or more governmental entities or ministries have responsibility toward the SOEs.

But, it is recommended that the SOEs should take the legal form of corporations, which means to establish the SOEs under the Companies Law which special issues that compatible with the nature of such enterprises, to make the government’s role in

⁵⁸⁶ Aziz, TA, (2002) “Good Governance is a global Business necessity”. Paper delivered at the Fourth Meeting of the Asian Programme of the International Institute of Finance, June 2002, Kuala Lumpur.

⁵⁸⁷ See The World Bank Corporate Governance Department stud, Held By Visible Hand, The Challenges of SOE Corporate Governance For Emerging Markets, Prepared by David Robinett, May 2006. Available at <http://rru.worldbank.org/Documents/Other/CorpGovSOEs.pdf>, retrieved on 15-Dec-2010, at p 11.

managing such SOEs should be played within a clear legal framework, where the way of appointing the board of directors is obvious; moreover, the SOEs' objective should be identified in a transparent manners as has been recommended by OECD.⁵⁸⁸

However, in some countries, the board members of the SOEs are not properly qualified and lack independent judgment. Further, the SOEs' board members in many instances are state officials or administrators. Therefore, improving the composition of the state-owned boards can be seen as one of the main steps toward the best practice of corporate governance in state-owned enterprises.⁵⁸⁹ As regards the state-owned enterprises in Kuwait, it was found in 1990, by Dr. Alshammari, one of the oldest and most prominent lecturers for the Companies Law Module in the School of Law in Kuwait University, that Kuwait needs new legislation to manage SEOs apart from the existing Companies Law No: 1960/15.⁵⁹⁰ Thus, it could be submitted that the state-owned enterprises in Kuwait are missing a clear integrated legal framework. In other words, there is no legislation regulating the state-owned enterprises in Kuwait.

Consequently, the SOEs in Kuwait are subject to two laws—the establishment law for each enterprise and the Companies Law no: 1960/15. Furthermore, it has been argued that the provisions of the Kuwait Companies Law are not suitable for the organization or the subject of the SOEs in Kuwait.⁵⁹¹ This is for several reasons, such as the differences between state-owned enterprises and private corporations with respect to the board of director's composition, the governing laws and regulations, and the objectives of the private corporations and the SOEs.

⁵⁸⁸ See Ulrich, F.W. Ernst, 'Methods for Resolving Problems of responsibility and Transparency in The Activities of SOE in Market Economies: Models and Results', *Corporate Ownership & Control*, 2004, Vol: 1, Issue: 3, at p: 40, pp 37-43.

⁵⁸⁹ OECD Guidelines on Corporate Governance of State-Owned Enterprises, at p 47.

⁵⁹⁰ See Dr ALShammari, T., *The Public Sector Enterprises in the Kuwaiti and Egyptian Laws, Analytical and Critical Study*, Kuwait Foundation for the Advancement of Science, Kuwait, 1990, at p: 12.

⁵⁹¹ Ibid, at p 22.

Furthermore, the Institute of International Finance and the Institute for Corporate Governance issues that are related to the improvement of corporate governance practice in the Kuwaiti state-owned enterprises are as follows:⁵⁹²

- Increase autonomy for management.
- Independent board-level Nomination Committees to appoint directors.
- Reduce interference from Sector ministers.
- Linking senior management compensation to company performance.

6.3.1 Guidelines for Corporate Governance in State-Owned Enterprises:

It has been argued that still there is no ideal model for the governance in the SOEs, but the most important key is the availability of a strong base in any country to build up the governance system in the SOEs.⁵⁹³ Therefore, in some countries, there are initiatives by state-owned enterprises to find guidelines for corporate governance. For example, the Chairman and the Company Secretary of the South African electricity company Eskom, which is a state-owned enterprise, has pointed out that they have found principles that aid in introducing good governance in their company; the principles are as follows:⁵⁹⁴

- Role Clarity: this principle identifies a clear responsibility for the board of directors and the government as a sole shareholder.
- Leadership: this principle addresses the requirements that should be available to any of the leaders (directors) of the state-owned enterprises to achieve effective performance.
- The Independence of the Board: this principle identifies the role of the responsible minister in appointing the board of directors of a state-owned enterprise, in this case how the board of directors can be immune against undue political interference.

⁵⁹² See the Institute of International Finance, Inc. and Hawkamah, the Institute for Corporate Governance, *Corporate Governance in Kuwait- An Investor Prospective*, 2006, at p: 6.

⁵⁹³ See Khoza, Reuel J, & Mohamed Adam, *The Power of Governance, Enhancing the Performance of State-Owned Enterprises*, Palgrave Macmillan, New York, 2007, at p: 83.

⁵⁹⁴ See Khoza, Reuel J, & Mohamed Adam, *The Power of Governance, Enhancing the Performance of State-Owned Enterprises*, Palgrave Macmillan, New York, 2007, at pp 4-5.

- Setting Performance Objectives: this principle deals with the fact that state-owned enterprises have multiple objectives, including commercial and community objectives.
- Duties of Directors: this principle clarifies that the directors should work in the interest of the sole shareholder, which is the government or the company itself.
- Transparency: this principle addresses the transparency issue of the state-owned enterprise toward the community and at the same time the necessity to protect the confidential information.
- Public Procurement: this principle attempts to exercise public procurement, and, at the same time, it tries to reduce the corruption risk arising out of this kind of transaction.

Furthermore, in South Africa, a Protocol of Corporate Governance was adopted in 1997 for the governance of state-owned enterprises. Moreover, the Government of South Africa found *shareholders compacts*, which identify the relationship between the government and the state-owned enterprises.⁵⁹⁵ In the same vein, it has been argued that in Malaysia the strict laws and regulations are not a solution to find a sound corporate governance practice, whereas there are elements that should be available such as legal, political, economic, and the cultural ethics, which mainly depend on the transparency and accountability.⁵⁹⁶

These initiatives are compatible with the allegation that in order to attain a sound corporate governance system in any country the government must show willingness to reform the economy by adopting a sound practice of corporate governance in state-owned enterprises in the first stage.⁵⁹⁷

⁵⁹⁵ See Ulrich, F.W. Ernst, 'Methods for Resolving Problems of responsibility and Transparency in The Activities of SOE in Market Economies: Models and Results', *Corporate Ownership & Control*, 2004, Vol: 1, Issue: 3, at p 42, pp 37-43.

⁵⁹⁶ See Kevin, L.L.T., David, Y.G.F & Shanmugam, B., 'the Enigma of Corporate Governance', *Corporate Ownership & Control*, 2004, Vol: 1, Issue: 3, at p 18, pp 13-19.

⁵⁹⁷ See Khoza, Reuel J, & Mohamed Adam, *The Power of Governance, Enhancing the Performance of State-Owned Enterprises*, Palgrave Macmillan, New York, 2007, at p: 21.

6.3.1.1 The OECD Corporate Governance Guidelines for State-Owned Enterprises:

Due to the argument that there is no single code or guideline for the best practice of corporate governance in state-owned enterprises, the OECD has developed principles of corporate governance for state-owned enterprises, and these principles are playing a significant role in this context. Accordingly, in 1998, the OECD recognized that the weakness of governance in state-owned enterprises is due to several reasons⁵⁹⁸:

- Corporate governance is exercised by a chain of agents without identifiable principals.
- Insufficient market incentives and disciplines.
- No threat of take-over and replacement of incumbent management.
- Shareholder exit is not possible.
- Monitoring of performance by the state equity-holder is weak, mainly due to the lack of economic motivation.
- Lack of a credible threat of bankruptcy.
- Accounting and disclosure generally do not meet private sector standards.
- The non-commercial objectives of SOEs are considered a source of inefficiency.

Consequently, and because of the importance of the corporate governance issue in SOEs due to the fact that the state-owned enterprises constitute a major share in many countries' economies. The Organization for Economic Co-operation and Development (OECD) has launched corporate governance guidelines for enterprises owned by the government in order to improve the corporate governance best practice in the government corporations:⁵⁹⁹

- Ensuring an effective legal and regulatory framework for state-owned enterprises.
- Separation between state ownership function and other state functions.

⁵⁹⁸ OECD, 1998, Corporate Governance, State-Owned Enterprises and Privatization, Organization for Economic Co-operation and Development (OECD).

⁵⁹⁹ OECD Guidelines on Corporate Governance of State-Owned Enterprises- 2005, at p 3.

- The government should ensure a legal framework that allows the creditors to claim against the SOEs and bring an insolvency case against it.
- The state acting as an owner.
- Equitable treatment of shareholders.
- Relations with stakeholders.
- Transparency and disclosure.
- The responsibilities of the boards of state-owned enterprises.

Accordingly, the State-Owned Enterprises should have a separate legal form, as they should be incorporated under the country's Companies Law despite the government is the only owner or the controller.⁶⁰⁰ The important of the separate legal form for the State-Owned Enterprises has been justifies as follows:

` To free the enterprise from rules and regulations of the government that may prevent flexibility and reduce operating efficiency, and to achieve some sort of separation of the activities of the government as both a rule of the country and as owner of economic units engaged in production, exchange and distribution. It is hoped that these legal forms will permit public accountability combined with maximum management freedom and flexibility`.⁶⁰¹

6.4 The State-Owned Enterprises in Kuwait:

6.4.1 The Public Sector in Kuwait:

The public sector in Kuwait consists of approximately thirty ministries, authorities and governmental institutions. Due to the nature of Kuwaiti society, in addition to governmental policy, the government is responsible to provide many services to its citizens. For example, the government of Kuwait must meet the housing demands of its citizens through the Public Housing Authority. Further, the government controls the

⁶⁰⁰ See Belkaoui, A., 1994, *Accounting in the Developing Countries*, London: Quorum Books. At p: 169.

⁶⁰¹ See Aharoni, Y., 1977, *Market, Planning and Development*, Cambridge, Mass: Ballinger Publishing Company. At p: 27

tourism sector through the state owned Touristic Enterprise Company, which is responsible for funding and managing most of the entertainment facilities in Kuwait.

The Kuwait Investment Authority is entrusted with government investment in holding companies, whether within or outside of Kuwait. Furthermore, the few state-owned enterprises in Kuwait play a very important role in the Kuwaiti economy and participate significantly in the annual state fiscal budget. Such companies include the Kuwait Airways Company and the Kuwait Petroleum Corporation and its subsidiaries. For the most part, other major companies were nationalized by the Kuwaiti government in the 1960s and 1970s as will be developed later.

The State of Kuwait is reserving approximately 96 billion oil barrels, which amounts to 10% of the world's oil reserves. The oil revenues in Kuwait constitute around 50% of the state's GDP and 90% of the government's income.⁶⁰² Moreover, the government of Kuwait owns the entire oil sector. As a result, therefore, the oil state-owned enterprises (SOEs) participate significantly in the Kuwait GDP. Accordingly, and for the purpose of this work, the focus will be upon the oil SOEs more than the other SOEs in Kuwait.

6.4.2 Nationalization and the creation of State-Owned Enterprises in Kuwait:

In the first place it should be noted that the Kuwait constitution (1962) allows for the nationalization of private property provided that an equivalent compensation must be paid. Article 18 of the constitution provides the following: "Private property is inviolable. No one shall be prevented from disposing of his property except within the limits of the law. No property shall be expropriated except for the public benefit under the circumstances and in the manner specified by law and on condition that just compensation is paid."

At the beginning of the Twentieth Century, Kuwait was suffering from the shortage of many needs, including people educated and experienced in exploring the country's oil

⁶⁰² See http://www.kuwait-info.com/a_economy/economy_overview.asp retrieved on October 4, 2010.

supplies. Consequently, the Kuwaiti government granted several foreign oil corporations the authority to exploit and explore the oil within Kuwaiti territory.⁶⁰³ The Kuwait Oil Company (a British company) was granted such a concession in 1934, as well as the American Independent Oil Corporation (American Corporation) has been granted the concession in 1948.

Thereafter, the government of Kuwait realized the importance of the oil, and it participated in establishing private companies. The Kuwait National Petroleum Company (KNPC) was established in 1960 as a public company. The government of Kuwait subscribed 60% of the capital, and the remaining 40% was sold publicly to the Kuwaitis.⁶⁰⁴ In 1975, according to Law No: 8/1975, the 40% was nationalized, and the company became fully owned by the State. Clause 4 of the abovementioned Law provided that the company would continue to be governed by its Articles of Association and not government regulations.

Furthermore, the Kuwait Oil Company (KOC) was established in 1934 as a joint venture between the Anglo-Persian Oil Company (which has since become BP) and the Oil Gulf Company. These companies were each granted a concession for oil exploitation over the whole land of Kuwait as previously mentioned in this section.

The concessions were thereafter criticized. In addition, the concessions were for 93 years and prohibited any renegotiation of each agreement's provisions. In 1974, the government of Kuwait nationalized KOC, which became fully owned by the government of Kuwait. The Petrochemical Industries Company (PIC) was created in 1963 by an Amiri Decree to handle the industries of the petrochemical products in Kuwait. In 1976, the PIC was nationalized, and all of its shares were transferred to the State of Kuwait.⁶⁰⁵ The Kuwait Oil Tanker Company formed by Kuwaiti businessmen in 1957, this company

⁶⁰³ See Dr ALShammari, T., *The Public Sector Enterprises in the Kuwaiti and Egyptian Laws, Analytical and Critical Study*, Kuwait Foundation for the Advancement of Science, Kuwait, 1990, at p: 11.

⁶⁰⁴ See Dr. Khaled Zaghlol, *The Legal And Political Framework For the Arabic Oil*, Kuwait University, Kuwait, 1997. At p: 80.

⁶⁰⁵ See Stevens, Paul, 2008, Kuwait Petroleum Corporation: Searching for Strategy in a Fragmented Oil Sector, The Program on Energy and Sustainable Development (PESD), Stanford University working paper number 78. At p: 11.

was created to transport the oil products. The government of Kuwait in 1976 decided to buy 49% of the company's equity. In 1979, the government of Kuwait bought the rest of the company's shares, which made the company fully owned by the state. Moreover, The Kuwait Aviation Fuelling Company (KAFCO) established as a joint venture in 1963 by KNPC and BP to provide fuel to the Kuwait International Airport. In 1977, KPNC decided to purchase BP's shares to make the company wholly owned by the State of Kuwait.⁶⁰⁶

Consequently, it could be said that the oil sector in Kuwait was wholly nationalized in the late 1970s. In addition, it should be noted in this instance that there are several oil companies were formed as SOEs in Kuwait, such as the Kuwait Foreign Petroleum Exploitation Company, the Kuwait Petroleum International Limited, and the Kuwait Gulf Oil Company. However, the major establishment occurred in 1980, when the Kuwait Petroleum Corporation (KPC) created by Law Decree No: 6/1980. KPC was formed to be a holding corporation for the whole oil sector in Kuwait and to coordinate between the entire oil sector's entities in order to reach the integration in the sector and to compete in the global oil industries market. The founding law for KPC provided for that KPC would be an independent commercial entity to enable it to work independently of the government bureaucracy.

The nationalization of the oil sector in Kuwait was completed in 1977 via the issuance of Law Decree No: 124/1977, whose provisions stipulated that all of the private shares in the oil companies were to be transferred to the State of Kuwait, provided that a fair compensation was to be paid to the shareowners.

In general, there are several reasons for establishing the SOEs, the most prominent one being the government's intention to impose its control over a vital source for the country's income.⁶⁰⁷ Therefore, it could be submitted that this is likely the case in Kuwait, where the government decided to nationalize the oil sector and establish new oil

⁶⁰⁶ Ibid, at p: 12.

⁶⁰⁷ See Fernandez, P., 1986, *Managing Relations Between Government and Public Enterprises: A Handbook For Administrators and Managers*, International Labor Office, Geneva, pp: 220-221.

companies to integrate the oil sector and to compete in the global oil market. Moreover, there are also several other factors that could have facilitated the Kuwaiti government's decision to nationalize, such as the Constitution of Kuwait. Article 21 says:

“Natural resources and all revenues there from are the property of the State. It shall ensure their preservation and proper exploitation, due regard being given to the requirements of State security and national economy.”⁶⁰⁸

Therefore, it would be argued that the establishing state-owned enterprises, particularly those involved in oil, was consistent with the state's strategy to control a source that is very important in terms of its national security.

The oil is a major source of revenue for the government of Kuwait. Thus the logical result of the nationalization of enterprises is the creation of a natural monopoly in that particular enterprise. In other words, the existence of state-owned enterprises is the result of the government's intention to control a very important source of its income and to control its national security.⁶⁰⁹ In addition, the government must monopolize this vital source or business.

6.4.3 Privatization of State-Owned Enterprises in Kuwait:

Recently, the Kuwait government changed its policy of expenditure after the discovery and exportation of oil in the 1930s and 1940s. Further, it is a fact that the government of Kuwait became the only provider for the essential needs for everyone in the State of Kuwait, such as health care, employment education, electricity, water, and housing for all Kuwaiti citizens. The government also provides complementary services, such as marriage loans and transportation. In other words, the government of Kuwait provides for all of the needs of its citizens through its ministries or other public authorities. These

⁶⁰⁸ Kuwait Constitution (1962), Article: (21)

⁶⁰⁹ See Fernandez, P., 1986, *Managing Relations Between Government and Public Enterprises: A Handbook For Administrators and Managers*, International Labor Office, Geneva, pp: 220-221.

realities led to the fact that the state of Kuwait is a real rentier state as stated in the third chapter of this thesis work.

In simple words, Kuwait is a rentier state, because it depends solely upon an external source, which is revenue derived from the sale of oil. Therefore, one may argue to what extent the Kuwaiti government can continue to provide nearly all services to its citizens either for free or for a price below their actual cost? In other words, how long can the Kuwaiti government spend its income without seeking any real return? Due to these facts, the Kuwaiti Government is currently going to privatize many of its public sectors, such as the electricity ministry and Kuwait Airways Company, among many other sectors.

The purpose of privatizing the state's owned enterprises is to minimize the government's role in such enterprises on the one hand, and, on the other hand, to unleash the private sector to participate in the national economy and to create a competitive sphere.⁶¹⁰ In Kuwait, the government was encouraged to reduce the dependence upon oil revenue due to the rise and fall of the price of oil. Consequently, it was argued that the privatization of public entities was the main solution for the Kuwaiti government to achieve its goals.⁶¹¹

Accordingly, the Kuwaiti Parliament passed the Privatization Law at the beginning of 2010 as the government had proposed. According to the new Privatization Law, the government will transfer many public authorities into the hands of private companies, which will in turn undertake a huge development plan in Kuwait. Any privatization success will depend upon the form of the privatization process that is going to be used. The form of privatization depends upon the social, economic, legal and political condition of each country. In other words, the so-called 'one size fits for all' cannot be applied in this situation. Therefore, the new Kuwait Privatization Law contains several provisions that cannot be found elsewhere except in countries such as Kuwait. An

⁶¹⁰ See Sheshinski, E., & Lopez-Calva, L.F., 'Privatization and Its Benefits: Theory and Evidence', *Oxford Journals of Economics*, 2003, Vol: 49, Issue: 3, pp: 429-459.

⁶¹¹ See Madzikanada, D.D., & Njoku, E.I., 'Employee Attitude Towards The Privatization of Kuwait's Government Departments and State Owned Enterprises', *International Public management Review*, 2008, Vol: 9, Issue:1, at p 107. pp: 107-129.

example of such a provision pertains to employee protection, which will be discussed below.

The Kuwait government sold some of its shares in several listed companies in the Kuwait stock market in the 1990s and early 2000s, as it was the outset of its privatization plan.⁶¹² The privatization plan in Kuwait was subject to severe criticism from several parties or stakeholders. The primary opponents were the Workers Union and members of Parliament. The National Assembly of Kuwait was concerned about a number of issues. For instance, not all of the members agreed that the government needed to go ahead with the privatization. Moreover, those members who agreed with the privatization plan did not agree upon which state-owned enterprises should go into privatization.⁶¹³

Furthermore, it can be argued that the main obstacle to privatization in Kuwait was the problem of the overstaffed enterprises, as the politicians were primarily concerned about the future of the Kuwaiti workforce after the privatization took place.⁶¹⁴

Unsurprisingly, the privatization was not favorable to more than one party, especially the public workers or public servants, because privatization was expected to destabilize their careers. Therefore, these workers aimed to hinder or postpone the privatization as much as they could.⁶¹⁵

In many countries, privatization has taken place to reduce the country's expenditures and to develop the services offered from the public sector in a positive way.⁶¹⁶ Ironically, the concern that the employees had about post-privatization was serious, because most, if

⁶¹² See Fasano, U., & Iqbal, Z., 2003, GCC Countries: From Oil Dependence to Diversification, International Monetary Fund, available at: <http://www.imf.org/external/pubs/ft/med/2003/eng/fasano/index.htm>. Retrieved on 22-Oct-2010.

⁶¹³ See Madzikanada, D.D., & Njoku, E.I., 'Employee Attitude Towards The Privatization of Kuwait's Government Departments and State Owned Enterprises', *International Public management Review*, 2008, Vol: 9, Issue: 1, at p: 108.

⁶¹⁴ See AlEnezi, A.K., 'Kuwait's Employment Policy: It's Formulation, Implications and Challenges', *International Journal of Public Administration*, 2002, Vol: 25, Issue: 7, pp: 885-900.

⁶¹⁵ Cam, S., 1999, Job Security, Unionization, Wages and Privatization: A Case Study in the Turkish Cement Industry, *Sociological Review*, Vol: 47, Issue: 4, pp: 695-714.

⁶¹⁶ See Pendleton, A., 'What Impact Has Privatization Had on Pay and Employment?', *Industrial Relations*, 1997, Vol: 52, Issue: 3, pp: 554-582.

not all, of the public entities in Kuwait were overstaffed. Consequently, each new private owner of such entities was expected to cut jobs to reduce the entity's expenditures. In addition, not all of the Kuwaitis employees were qualified or suitable for the jobs they were holding. The true reason for the overstaffing in the Kuwait public sector can be found in the heart of Law No.: 16/1960, which entitles all Kuwaitis to be employed by the public government.⁶¹⁷

In addition, the termination of each employee's contract in the privatized SOEs is subject to management discretion, while in the public sector in Kuwait, the termination of each employee's contract is not an easy task.⁶¹⁸

It has also been stated that Kuwaiti employees in the public sector believe that their salaries are not compensation for their effort or work but rather a kind of distribution of the State's wealth and to help them maintain a good standard of living.⁶¹⁹ Therefore, it would be argued that the privatization would change the layout of the privatized entities in terms of structure, expenditures and efficiencies and would push toward curing corruption in the distribution of employment.⁶²⁰ This was also not preferable to the public workers. Thus, the government of Kuwait had to interfere to make the privatization law compatible with the cultural of the public servants. As a result, the Kuwaiti government assumed the role of protecting the employees in the SOEs that were to be privatized.

This situation has been predicted by Madzikanda & Njoku in their studies of the response of the Kuwaiti employees toward the privatization of the SOEs. They wrote: 'Privatization will shake out surplus and inefficient labour, and we would therefore expect to witness negative employment effects around the time of privatization. A shake

⁶¹⁷ See AlEnezi, A.K., 'Kuwait's Employment Policy: It's Formulation, Implications and Challenges', *International Journal of Public Administration*, 2002, Vol: 25, Issue: 7, pp: 885-900.

⁶¹⁸ See Dereli, T., & Isik, U., 'Public Sector Industrial Relations on the Eve of Mass Privatization in Turkey', *International Labour Review*, 1993, Vol: 132, Issue: 5 & 6, pp: 689-703.

⁶¹⁹ See Madzikanda, D.D., & Njoku, E.I., 2008, Employee Attitude Towards The Privatization of Kuwait's Government Departments and State Owned Enterprises, *International Public management Review*, Vol: 9, Issue: 1, at p: 111.

⁶²⁰ See Tetreault, Mary. A., 'Pleasant Dreams: The WTO as Kuwait's Holy Grail', *Critical Middle Eastern Studies*, 2003, Vol: 12, Issue: 1. At p: 80.

out effect would be necessary in order to remove excessive redundancies and drive efficiency gains unless the government intervenes to protect employees.’⁶²¹

Furthermore, the Privatization Team of Kuwait stated in their report entitled “*Privatization Advantages, Disadvantages and The Obstacles of Transferring The Government Welfare State Enterprises To The Private Sector and The Preconception of The Necessary Legislation*,” which they submitted to the Financial and Economic Affairs Committee of the National Assembly of Kuwait, that privatization was important for Kuwait to balance between the large domination of the public ownership and the small private sector in Kuwait.⁶²² Moreover, it has been argued that privatization is one of the methods that can combat corruption and the employment of unqualified individuals in the governmental departments and the SOEs. Privatization was recommended for Kuwait in the early 1990s by such international institutions as the World Bank.⁶²³

The politicians in Kuwait have initially rejected this recommendation, but nowadays there is a tendency among the politicians and the economists in Kuwait to support the privatization of many governmental departments, such as the mail service. At the same time, however, there is a strong political opposition against the privatization of the certain sectors, such as the oil and gas sectors, the health services sector, and the education sector.

Accordingly, in 2010, the Parliament of Kuwait passed a law regarding the Arrangement of Privatization Operations and Programmes under Law No: 37/2010.⁶²⁴ This law, which contained thirty-two articles, tackled several main issues, such as the

⁶²¹ See Madzikanada, D.D., & Njoku, E.I., ‘Employee Attitude Towards The Privatization of Kuwait’s Government Departments and State Owned Enterprises’, *International Public Management Review*, 2008, Vol: 9, Issue: 1, At p: 110.

⁶²² See The Privatization Team, 1996, Report Titled “*Privatization Advantages, Disadvantages and The Obstacles of Transferring The Government Welfare State Enterprises To The Private Sector and The Preconception of The Necessary Legislation*”, submitted to the Financial and Economic Affairs Committee of the National Assembly of Kuwait.

⁶²³ See Tetreault, Mary. A., ‘Pleasant Dreams: The WTO as Kuwait’s Holy Grail’, *Critical Middle Eastern Studies*, 2003, Vol: 12, Issue: 1. At p: 90.

⁶²⁴ Law No: 37/2010 regarding The Arrangement of Privatization Operations and Programmes, Published in *Kuwait Al-Yum Gazette* on 13 June 2010, Issue No: 979. Kuwait.

consumer protection regarding fair prices and the quality of services. In addition, the Privatization Supreme Council was established under this law, which was to be composed of five Ministers and three competent experts and was to be chaired by the Prime Minister as provided in Article (5) of the law. Furthermore, according to Article (7), the Council is responsible for setting the general policy regarding the privatization process in Kuwait. Protection of national workers in the candidate SOEs was one of the main issues addressed in this law.

The National labor protection was the most important issue presented by the privatization of any SOE, as it attracted the attention of many legislators, because it was their responsibility to protect the interests of their constituents. Consequently, Articles (18) to (21) of this law pertain to the protection of national workers and provide for workers' rights and benefits. These rights were enough to convince the workers to transfer to the privatized company.⁶²⁵ For example, the law provides that the new owner of the privatized public project cannot terminate the employment of any employee for five years from the privatization date except where there is a legal violation committed by the employee. In addition, the salary and the benefits of the national workers cannot be adjusted unless increased during that five years period.

The new privatization law also gives every national worker the right to choose not to transfer their position to the privatized company, in which event the government was obliged to appoint such employee to any governmental department with the same salary and benefits. The law also nullified and voided any agreement between a national employee and the new owner of the privatized firm if the agreement provides for less salary or benefits for the employee.

Article (21) provides the following: "...The Council shall determine the minimum percentage of the national workers number in the privatized firm provided that the percentage shall not be less than the percentage of the same firm before the privatization

⁶²⁵ Kuwaiti Law No: 37/2010 regarding The Arrangement of Privatization Operations and Programmes, Article 8 & 21 Published in *Kuwait Al-Yum Gazette* on 13 June 2010, Issue No: 979. Kuwait.

took place...” Article (8) stipulates the following: “The Council shall provide both the Council of Ministers and the State Audit Bureau with a biannual report regarding its work... The president of the State Audit Bureau shall provide the National Assembly with a copy of the previous report associated with his observations within a month of the delivery date.”⁶²⁶

The regulatory environment in Kuwait suffers from the weaknesses and the outdated nature of the current law and regulations. Therefore, there are pre-requisites before successful privatization can take place in Kuwait, for example, the taxation law, the anti-corruption law, the executive manager’s financial disclosure law, modern commercial companies law. The discussion of the privatization law in the Kuwait National Assembly revealed the differences among the visions of the parliament members regarding privatization. Opposing members argued that this law would open the Kuwaiti markets to embezzlement whether by local or foreign investors.

Moreover, some of the opponents justified their opposition to the privatization law as temporary until the legal infrastructure allowed for the adoption of such privatization law. In other words, the objection against the privatization law can be attributed to the weakness of the legal infrastructure in Kuwait that should ensure the sound application of the privatization process, therefore those opponents would support the privatization in Kuwait once the legal infrastructure improved and allow for the sound application of the privatization process.

While on the other hand, the other members were against the privatization law, because it would increase the number of unemployed citizens in Kuwait. Proponents of the privatization law countered that this law embodied many provisions that guaranteed job stability for the Kuwaiti employees in the privatized sector.⁶²⁷

⁶²⁶ Article (8) Law No: 37/2010 regarding The Arrangement of Privatization Operations and Programmes, Published in *Kuwait Al-Yum Gazette* on 13 June 2010, Issue No: 979. Kuwait.

⁶²⁷ See Al-Mojz Electronic source available at <http://www.almogz.com/news/news.php?action=view&id=1948>, retrieved on 18 November 2010.

Because of privatization has brought about significant effects upon corporate governance. It has been argued that the privatization and the development of the capital market are greatly related to each other. Therefore, corporate governance reform in the SOEs is highly important to any state ownership reform.⁶²⁸

In this context, MENA-OECD Investment Program suggested the following prerequisites for any successful privatization process to the SOEs: corporatization, improving corporate governance, guaranteeing full transparency protection of minority shareholders, and better management culture.⁶²⁹ Additionally, the report suggested that, due to the important role of state ownership in MENA countries, the government must improve corporate governance in the SOE`s in addition to providing a clear vision toward the privatization process. Also, the government should be an example to the private companies in terms of implementing and improving the corporate governance system in the companies that are listed or not listed in the stock market.

Furthermore, in MENA countries, improving the corporate governance practice in the SOEs has had a significant effect upon the success of the privatization process. As it has been reported that the corporate governance in SOEs has helped the public sector to reduce corruption and to minimize political interference, because corporate governance has provided an effective transparency in the companies.⁶³⁰ Moreover, the SOEs' corporate governance can be seen as an important element to any economy and it helps to attract potential buyers when the government intends to privatize its enterprises.⁶³¹

In relation to the importance of the corporate governance for the state-owned enterprises in Kuwait, and in accordance with the objective of the Kuwait Development Plan⁶³² (issued by Law No: 38/2010) which is to convert the State of Kuwait to a

⁶²⁸ See Advancing The Corporate Governance Agenda In The Middle East And North Africa: A Survey of Recent Developments, MENA-OECD Investment Programme at p 20. Available at <http://www.oecd.org/dataoecd/37/46/36086926.pdf>, retrieved on 17 January 2011.

⁶²⁹ Ibid, at p: 21. Also it been discussed in *Privatizing State-Owned Enterprises: An Overview of Policies and Practice in OECD countries*, Paris, OECD, 2003.

⁶³⁰ Ibid, at p: 22. <http://www.oecd.org/dataoecd/37/46/36086926.pdf> retrieved on 4 October 2010.

⁶³¹ OECD at p: 9.

⁶³² Kuwait Development Plan, Law No: 38/2010.

commercial and financial regional center. This plan's budget amounts to thirty one billion KD (equal to approximately 120 billion USD). Further, it provides for legislating new organizational regulations and new laws, such as the Public-Private Partnership, the Privatization Law and the Competition Law. And since the government of Kuwait is one of the major owners in the Kuwait Stock Exchange,⁶³³ it should decrease its ownership to help improving the corporate governance practice in these companies to attract foreign capital during the privatization process.

The SOEs in developing countries, such as Kuwait, have certain characteristics. They usually suffer from an inefficient system of governance, improper delivery of services, and excessive and unnecessary bureaucracy.⁶³⁴ Additionally, the current corruption in the Kuwaiti SOEs will have a detrimental influence over the price of the privatization candidates of the Kuwaiti SOEs.⁶³⁵ In other words, the corrupted SOE will suffer that its price will be lower than the SOE that is not suffering from such corruption. Thus, it could be submitted that the corporate governance in the SOEs in Kuwait should be improved before the privatization is done. Accordingly, in the next section the obstacles against the implementation of the best practice of corporate governance in SOEs in Kuwait will be explored.

⁶³³ See the Institute of International Finance, Inc. and Hawkamah, the Institute for Corporate Governance, *Corporate Governance in Kuwait- An Investor Prospective*, 2006, at p: 3.

⁶³⁴ See Khoza, Reuel J, & Mohamed Adam, *The Power of Governance, Enhancing the Performance of State-Owned Enterprises*, Palgrave Macmillan, New York, 2007, at p: 3.

⁶³⁵ Ahmed AL-Otaibi, *Privatising Public Utilities and State Owned Enterprises in The State of Kuwait: An Analytical Study in A Constitutional and Administrative Perspective*, Unpublished PHD Thesis submitted to the University of Essex, the School of Law in 2008, at p: 26.

6.5 The Main Challenges Facing the Application of the Best Practice of Corporate Governance for the State-Owned Enterprises in Kuwait:

The state-owned enterprises (SEO) in developing countries are usually exposed to great political interferences and operate without respect to formal regulations.⁶³⁶ Thus, it has been argued that giving the board of directors of an SOE adequate authorization would decrease the political interference in SOEs. The government has several rights with respect to SEOs, subject to limitations, such rights include setting performance objectives, appointing directors, and monitoring the performance of the SOE and its board.

It has been argued that one of the major problems facing the corporate governance practice in state-owned enterprises is the overlapping role of the board of directors and the government as a shareholder.⁶³⁷ In other words, one of the obstacles toward the implementation of good governance of the SOE's is the ambiguity of the role of the government and the board of directors in managing or leading the SOE.

In the context of the relationship between the SOE management and the government as the only shareholder, it has been argued that the government should determine clearly what it requires to be achieved from every enterprise.⁶³⁸

Consequently, it is preferable to reach an agreement between the government as the sole shareholder and the board of the SOE regarding the priorities of the goals that should be attained. This sort of agreement may lead to the independence of the management to a large extent against the governmental or political interference on the one hand. On the other hand, the infringement of such agreement from the management side will grant the government a legitimate right to interfere as a shareholder to protect its rights. For

⁶³⁶ See Vagliasindi, Maria, The Effectiveness of Boards of Directors of State Owned Enterprises in Developing Countries, The World Bank.. Sustainable Development Network, Policy Research Working Paper No: 4579, March 2008, at p 2, available at: <http://econ.worldbank.org>

⁶³⁷ See Khoza, Reuel J, & Mohamed Adam, *The Power of Governance, Enhancing the Performance of State-Owned Enterprises*, Palgrave Macmillan, New York, 2007, at p: 59.

⁶³⁸ Ibid, at p 63.

example, the board of directors of Eskom, which is a state-owned enterprise in South Africa, has proposed a statement of intent to the government that their strategy is to be one of the best enterprises in the world, and this statement has been approved by the South African government as a sole shareholder. In addition, the same enterprise has reached an agreement with government regarding its key objectives.⁶³⁹

Also, in New Zealand, there is specific legislation regulating SOEs' activities—The State-Owned Enterprises Act 1986 and the Companies Act 1993. The SOEs Act provided that the government must own all of the SOE shares; it also stipulated for the accountabilities of the related ministers toward the SOE. In addition, this act identified the objectives of the SOEs as it provided that the SOE must operate as a successful business entity, as it should be profitable, a good employer, and responsible toward the community.⁶⁴⁰

However, in developed countries, it has been claimed⁶⁴¹ that the separation between the governments and the SOE is very important as are improvements to find a good corporate governance system, whereas in the developing countries, this separation is not so important because there are other factors that would undermine the good performance of the SOE; for instance, in such countries, a number of qualified directors is not enough; in addition, the appointment mechanism of the SOE's directors has always been conducted according to the relationship of the appointee with the political governing party. As a result, it has been stated that in these countries many the SOE's directors are mostly suffering from a lack of experience and skills to manage such enterprises.⁶⁴²

In turn, the appointment of the board of the directors for an SOE in developing countries could be seen as a weakness issue to the application of sound corporate

⁶³⁹ Ibid, at p 66.

⁶⁴⁰ See Ulrich, F.W. Ernst, 'Methods for Resolving Problems of responsibility and Transparency in The Activities of SOE in Market Economies: Models and Results', *Corporate Ownership & Control*, 2004, Vol: 1, Issue: 3, at p: 41, pp 37-43.

⁶⁴¹ ee Vagliasindi, Maria, The Effectiveness of Boards of Directors of State Owned Enterprises in Developing Countries, The World Bank.. Sustainable Development Network, Policy Research Working Paper No: 4579, March 2008, at p 3, available at: <http://econ.worldbank.org> .

⁶⁴² Ibid

governance. Ironically, it has been argued that managers of the SOEs should learn the management skills from the managers in the private sector since the appointment of directors in the private corporations depends on the qualification not the relationships.⁶⁴³ Thus, there must be a clear set of procedures to nominate and appoint the directors in the SOEs to ensure that the chosen criterion is competency and nothing else, such as in Sweden and New Zealand.⁶⁴⁴

Furthermore, it has been argued that it is best practice for the SOEs to establish a specialized nomination committee for the board and management nominations.⁶⁴⁵ The appointment and the nomination processes for the board members in the SOEs vary from one country to another, as in South Africa there is a committee appointed by the SOEs; this committee is responsible for nominating suitable persons to be appointed to the vacant positions in the SOEs to the Executive Authority where the final decision for the appointment is vested.

In India, there is an independent governmental entity “The Public Enterprises Selection,” which handles the appointment of the board members in the SOEs.⁶⁴⁶ In Chile, the law prevents the appointment of any director to the board of state-owned enterprises if he has any relation with any political party or political union.⁶⁴⁷ In this regard, the nepotism and favoritism is a common practice for the appointment in higher positions in the state-owned enterprises in Kuwait.⁶⁴⁸

⁶⁴³ See Dopson, S. & Stewart, R., ‘Public and Private Sector Management: The Case for A Wider Debate’, *Public Money and Management*, 1990, Vol: 10, No: 1, pp 37-40.

⁶⁴⁴ See Vagliasindi, Maria, The Effectiveness of Boards of Directors of State Owned Enterprises in Developing Countries, The World Bank.. Sustainable Development Network, Policy Research Working Paper No: 4579, March 2008, at p 9, available at: <http://econ.worldbank.org>.

⁶⁴⁵ The OECD Guidedlines for Corporate Governance of State-Owned Enterprises, at p 30.

⁶⁴⁶ See The World Bank Corporate Governance Department stud, Held By Visible Hand, The Challenges of SOE Corporate Governance For Emerging Markets, Prepared by David Robinett, May 2006. Available at <http://rru.worldbank.org/Documents/Other/CorpGovSOEs.pdf>, retrieved on 15-Dec-2010, at p 25. Also see Reddy, Y.R.K., 2001, The First Principles of Corporate Governance in Public Enterprises in India: The Yaga Report. Standing Conference on Public Enterprises and Yaga Consulting.

⁶⁴⁷ See D. Daniel, Sokol, , ‘Competition Policy and Comparative Corporate Governance of State-Owned Enterprises’, *Brigham Young University Law Review*, 2009, at p 1755.

⁶⁴⁸ See Madzikanada, D.D., & Njoku, E.I., ‘Employee Attitude Towards The Privatization of Kuwait’s Government Departments and State Owned Enterprises’, *International Public management Review*, 2008, Vol: 9, Issue:1, at p 111. Also see Cunningham, R.B., & Sarayrah, Y.K., ‘Taming Wasta to Achieve Development,’ *Arab Studies Quarterly*, 1994, Vol: 6, Issue: 3, pp 29-39.

Turning to another important issue as regards the SOEs, it has been noted that to attract public confidence in the SOEs, the role of such enterprise must be clarified as a governmental body to the public.⁶⁴⁹ Moreover, it is important for the SOEs to open a channel with the highest audit institutions to enhance the public confidence because, ultimately, the citizens are the owners of this type of enterprises. In the same vein, state-owned enterprises should be held accountable before the parliament and its committees because they represent the public interests and with limitation of the prescribed laws.

6.5.1 The Absence Legal Framework for State-Owned Enterprises in Kuwait:

It has been submitted that state-owned enterprises should have a separate legal form, as they should be incorporated under the country's Companies Law, and the government is the only owner or the controller.⁶⁵⁰ Additionally, the importance of a separate legal form for state-owned enterprises has been justified as follows: "To free the enterprise from rules and regulations of the government that may prevent flexibility and reduce operating efficiency, and to achieve some sort of separation of the activities of the government as both a rule of the country and as owner of economic units engaged in production, exchange and distribution. It is hoped that these legal forms will permit public accountability combined with maximum management freedom and flexibility."⁶⁵¹

Consequently, it could be argued that a clear legal framework for state-owned enterprises is necessary to achieve their objectives and to allow the directors of such enterprises to perform these activities as much effectively as possible. For example, in Egypt Law No: 1983/79 regarding the Public Authorities and Public Sector Corporations, the legal form of state-owned enterprises in Egypt is identified and defined as follows: it is an entity executing an economic project pursuant to the public policy of the state and the socio-economic development plan. On the contrary, in Kuwait, there is still no legal single definition for the SOE; therefore, it has been suggested that the SOE in Kuwait is

⁶⁴⁹ *Ibid*

⁶⁵⁰ See Belkaoui, A., 1994, *Accounting in the Developing Countries*, London: Quorum Books. At p: 169.

⁶⁵¹ See Aharoni, Y., 1977, *Market, Planning and Development*, Cambridge, Mass: Ballinger Publishing Company. At p: 27

an enterprise that is wholly owned by the state.⁶⁵² Moreover, New Zealand has a special legislation that governs SEOS—the Crown Companies (The State-Owned Enterprises) Act 1986/124.

The state-owned enterprises should not be exempted from the application of general laws and regulations, as any stakeholders to such enterprises should be able to seek proper compensation once their right has been infringed.⁶⁵³ Hence, the SOEs should work in a competitive economic environment and should be exposed to market threats such as takeovers and bankruptcy.⁶⁵⁴ In contrast, in Kuwait, the state-owned enterprises are immune from such market threats; for example, the establishment law for the Kuwait Airways Company in article 13 provided that the Kuwait government is responsible to cover the losses in this company.⁶⁵⁵ Similarly, the Egyptian legislators have forbidden the insolvency of SOE's pursuant to article 47 of Law No: 1983/79 regarding the Public Authorities and Public Sector Corporations.

One of the important issues that should be decided regarding the legal framework of state-owned enterprises is the legal duties and the accountability of the directors and manager of such enterprises. The SOEs' directors' legal duties have a significant role in determining the responsibility of these directors, as these duties provide for the directors' missions and the objectives that should be pursued by them. Further, it has been submitted that the SOEs usually have not clearly outlined board members' legal duties, and, for that reason, the SOEs' legal forms are vague in most instances.⁶⁵⁶

⁶⁵² See Dr ALShammari, T., *The Public Sector Enterprises in the Kuwaiti and Egyptian Laws, Analytical and Critical Study*, Kuwait Foundation for the Advancement of Science, Kuwait, 1990, at p: 33.

⁶⁵³ OECD Guidedlines for Corporate Governance of State-Owned Enterprises at p 21.

⁶⁵⁴ Ibid.

⁶⁵⁵ Article (13) of Kuwait Airways establishment Law No. 21/1965.

⁶⁵⁶ See The World Bank Corporate Governance Department stud, *Held By Visible Hand, The Challenges of SOE Corporate Governance For Emerging Markets*, Prepared by David Robinett, May 2006. Available at <http://rru.worldbank.org/Documents/Other/CorpGovSOEs.pdf>, retrieved on 15-Dec-2010, at p 23

One of Eskom's (SOE in South Africa) directors explained in this regard how the directors of an SOE should deal with their dual positions when the legal framework of the enterprises is not clear or not available, he said:⁶⁵⁷

“ Unlike any private sector organization, a board of a state-owned enterprise needs to ensure that the state-owned enterprise is run as an effective and sustainable business, whilst acknowledge that the shareholder may expect that a broader role to be fulfilled. This may require decisions that make sense from a broader shareholder perspective of South Africa, but are not always optimal from a purely financial bottom-line perspective. This in turn must be reconciled with fiduciary duties that the director owes to the State-owned enterprise. There is therefore a need for the shareholder to clarify its expectations in this regard as soon as possible and establish appropriate processes that provide an effective framework within which to make these broader ‘South Africa’ decisions”.

Furthermore, it has been affirmed that the SOEs' managers should be accountable for the decisions that are taken in such enterprises, and it has been said in this vein that:

“Accountability means a responsibility or liability to reveal, explain and justify what one does to account for one's action, to report on the actions and the results arising from the exercise of authority. Since managers of SOEs have the authority to exercise discretion over the use of public funds and to exercise economic power associated with diverse social consequences, they must be accountable for their decisions to the representatives of the public”.⁶⁵⁸

On the other hand, it has been argued that the managers of SOEs cannot be held accountable simply because they do not enjoy the proper autonomy in terms of making decisions regarding their enterprise. On this matter, Pallot said, “It is unfair to hold

⁶⁵⁷ A statement for Wendy Lucas-Bull director in Eskom a South African State-Owned Enterprises, quoted in Khoza pp 60-61.

⁶⁵⁸ See Aharoni, Y., *The Evolution and Management of State Owned Enterprise*, Cambridge, Ballinger Publishing Company, US. 1986, at p 249.

managers accountable in terms of efficiency for what they do not control, such as when they are prohibited from disposing of or making replacement decisions about certain assets. They, instead, can be assessed in terms of the availability and accessibility of the assets to the public.”⁶⁵⁹ Further, it has been observed that accountability is pointless without autonomy, because the issue is how the managers can be held accountable for their decisions, unless the SOE’s managers have freely taken such decisions.⁶⁶⁰

Also, the managers’ autonomy with respect to decision-making is aimed at better performance for the enterprise because experienced managers without any interventions will make the decisions whether directly by the government or indirectly by strict laws and regulations.⁶⁶¹ In this regard, it has been noted that there are three issues that demonstrate the differences between the successful and poor performance of SEOs; the extent of competition in which the enterprises are operating, financial autonomy, and the managerial autonomy.⁶⁶²

As regards the legal framework of the state-owned enterprises in Kuwait, the focus will be upon the legal framework of the oil enterprises due to the fact that these enterprises play a significant role in the Kuwaiti economy as they participate significantly in the State of Kuwait revenue as mentioned above and also for the reason that the oil sector in Kuwait is composed of enterprises not governmental authorities.

It could be submitted that the legal framework for the oil sector enterprises in Kuwait is confusing as the parent corporation, which is Kuwait Petroleum Corporation, is governed by its founding law (Law No: 6/1980), whereas its subsidiaries are governed by the Kuwait Commercial Laws, such as the Companies Law No: 15/1960. It could be argued that due to the severe political interventions in the oil sector in Kuwait, amendments of

⁶⁵⁹ See Pallot, J., ‘The Role Of Accounting In The Privatization Of State Trading Enterprises In New Zealand’, *Advances In Public Interest Accounting*, 1998, Vol:7, pp:161-191.

⁶⁶⁰ See Shirley, M., & Nellis, J., 1991, *Public Enterprise Reform: The Lessons of Experience*, Economic Development Institute of the World Bank, Washington, D.C. at p 26.

⁶⁶¹ See OECD, 1994, *Performance Management in Government: Performance Measurement and Results-Oriented Management*, Public management Occasional Papers No. 3, Paris, pp 59-63.

⁶⁶² See Ayub, M. & Hegstad, S., ‘Public Industrial Enterprises: Determinants of Performance’, *Industry and Finance Series*, 1986, Vol:17, the World Bank, Washington, D.C., US.

the KPC founding law cannot be accomplished without strong confrontation with the parliament members. In this vein, interventions by parliament member in the oil sector have been justified as these members are not wishing to change the KPC Law to protect their constituencies interests in the first place as any changes in the oil sector might affect the employees situation and their benefits might be reduced; thus, it could be submitted that this objection by the parliament is apparent whenever the government talks about the privatization in this sector. On the other hand, the recent high oil prices were seen as a blockage or a motivation against any reform in the oil sector.⁶⁶³

There are several undecided matters in the oil sector where the government and/or the parliament must intervene such as the dispute between Kuwait Petroleum Corporation and the Ministry of Oil in Kuwait as there is a disputed regulatory issue that needs a legislative intervention. It has been argued that the bureaucracy that the KPC and its subsidiaries must go through with respect to issues such as procurements is hindering the KPC to achieve its objectives.⁶⁶⁴ The employment of Kuwaitis in the oil sector is a crucial issue permanently under a parliament scrutiny. Therefore, it could be said that the employment of Kuwaitis in state-owned enterprises is crucially influenced by political interventions.⁶⁶⁵

Unsurprisingly, it has been stated that the oil state-owned enterprises in Kuwait are suffering from overstaffed employees and middle management; in addition, the KPC, and its subsidiaries are inefficient because the promotion criteria are dependent upon the favoritism and nepotism, which are mostly exercised through the politicians; thus, this detrimental issue cannot be overcome in the absence of a proper legal framework of such enterprises.⁶⁶⁶ In this regard, Nader Al-Sultan (a former CEO of KPC) elucidated one of

⁶⁶³ See Stevens, Paul, 2008, Kuwait Petroleum Corporation: Searching for Strategy in a Fragmented Oil Sector, The Program on Energy and Sustainable Development (PESD), Stanford University working paper number 78. At p 6.

⁶⁶⁴ Ibid, at p: 7.

⁶⁶⁵ Ibid, at p: 8.

⁶⁶⁶ Ibid, at p: 9.

the obstacles that emerged from the inefficient or missing legal framework of the oil enterprises in Kuwait when he stated:⁶⁶⁷

“ It is crucial that the oil minister stays in his post in a supervisory capacity for as long as possible, because this means continuity of long-term policies. The role of the minister is important and crucial in the interpretation of government policies... It is important to explain here that every minister needs time to understand the oil sector and to implement government policy. Because of the continual changes of ministers, one should not be surprised that there are substantive or minor differences in interpreting public policies. There are also differences in priorities. This, of course, halts the work of KPC. We go ahead, and then we stop. If you ask any KPC official about this issue, he will tell you that he wants ministers to be stable in their posts. And if they cannot keep ministers in their posts, then they have to think of other solutions”.

As regards the application of the best practice of corporate governance in state-owned enterprises, it has been suggested that, as a minimum arrangement regarding the legislation and policy that must be acquired to implement a sound corporate governance system in the SOEs, there must be an appropriate legal framework for the SOE that ensures its ability to enforce a minimum standard of conduct; also, there must be governmental policy framework and there should be an agreement between the government as a sole shareholder and the enterprise.⁶⁶⁸

Moreover, it has been found by OECD that the legal framework of the SOEs is not always clear. Thus, there must be a transparent division of responsibility and accountability for the management, which in turn will help the development of corporate governance in such enterprises.⁶⁶⁹

⁶⁶⁷ Quoted in Stevens, Paul, 2008, Kuwait Petroleum Corporation: Searching for Strategy in a Fragmented Oil Sector, The Program on Energy and Sustainable Development (PESD), Stanford University working paper number 78. At p 60.

⁶⁶⁸ See Khoza, Reuel J, & Mohamed Adam, *The Power of Governance, Enhancing the Performance of State-Owned Enterprises*, Palgrave Macmillan, New York, 2007, at p:73.

⁶⁶⁹ OECD Guidelines for Corporate Governance of State-Owned Enterprises (2005), at at p 18.

In this context, Al-shammari, one of the oldest and most prominent lecturers for the Companies Law Module in the School of Law in Kuwait University, has emphasized that the SOEs in Kuwait need new legislation to manage it apart from the existing Companies Law No: 1960/15.⁶⁷⁰ Thus, it could be submitted that the state-owned enterprises in Kuwait are missing a clear integrated legal framework. In other words, there is no legislation regulating the state-owned enterprises in Kuwait. Consequently, the SOEs in Kuwait are subject to two laws the establishment law for each enterprise and the Companies Law no: 1960/15.

Furthermore, it has been argued that the provisions of the Kuwait Companies Law are not suitable for the organization or for the subject of the SOEs in Kuwait.⁶⁷¹ This occurs for several reasons such as the difference between state-owned enterprises and private corporations as regards the board of directors' composition, the governing laws and regulations, and the objectives of the private corporations and the SOEs.

Consequently, it could be submitted that the application of best practices of corporate governance in the state-owned enterprises in Kuwait is missing an important pillar, i.e., a clear legal framework. As a result, the SOEs in Kuwait are subject to several laws and regulations in Kuwait that undermine corporate governance in such enterprises. This fact would have a detrimental effect especially where these enterprises are going to be privatized in accordance with the development plan 2010 in Kuwait since the absence of proper corporate governance application in these enterprises will shake the confidence of investors during the privatization process. This will consequently negatively affect the price of such enterprises.

⁶⁷⁰ See Dr ALShammari, T., *The Public Sector Enterprises in the Kuwaiti and Egyptian Laws, Analytical and Critical Study*, Kuwait Foundation for the Advancement of Science, Kuwait, 1990, at p: 12.

⁶⁷¹ See Dr ALShammari, T., *The Public Sector Enterprises in the Kuwaiti and Egyptian Laws, Analytical and Critical Study*, Kuwait Foundation for the Advancement of Science, Kuwait, 1990, at p:22.

It could be submitted that Kuwait in this vein could arguably be advised now to take measures to find solutions for this situation, as India did when it has launched the Principles of Corporate Governance for Public Enterprises in 2001.⁶⁷²

Similarly, New Zealand has special legislation, the Crown Companies (The State-Owned Enterprises) Act 1986/124,⁶⁷³ which provides for some mandatory provisions regarding the applications of the corporate governance in the state-owned enterprises in New Zealand, and there is a special unit established to ensure that these SOEs are complying with such provisions, i.e., Monitoring Advisory Unit.⁶⁷⁴ Moreover, in South Africa, a Protocol of Corporate Governance has been adopted in 1997 for the governance of the state-owned enterprises. Moreover, the Government of South Africa established shareholders compacts, which identify the relationship between the government and the state-owned enterprises.⁶⁷⁵

6.5.2 Political Interference in the State-Owned Enterprises in Kuwait:

The MENA-OECD Investment Program has highlighted some of the deficiencies in the SOE's in MENA countries, such as suffering from great political interference and a lack of commercial incentives.⁶⁷⁶ Moreover, it has been mentioned that state-owned enterprises follow political objectives.⁶⁷⁷ In this vein, the politicians can be described as

⁶⁷² The Principles of Corporate Governance for Public Enterprises in India (2001)

⁶⁷³ The Crown Companies Act No: 1986/124, New Zealand.

⁶⁷⁴ See D. Daniel, Sokol, 'Competition Policy and Comparative Corporate Governance of State-Owned Enterprises', *Brigham Young University Law Review*, 2009, at p 1757. Also see the New Zealand State Owned Enterprises Act No: 1986/124, available at: http://www.legislation.govt.nz/act/public/1986/0124/latest/DLM97377.html?search=ts_act_state-owned+enterprises_resel&p=1&sr=1, retrieved on December, 7, 2010.

⁶⁷⁵ See Ulrich, F.W. Ernst, 'Methods for Resolving Problems of responsibility and Transparency in The Activities of SOE in Market Economies: Models and Results', *Corporate Ownership & Control*, 2004, Vol: 1, Issue: 3, at p: 42, pp 37-43.

⁶⁷⁶ See Advancing The Corporate Governance Agenda In The Middle East And North Africa: A Survey of Recent Developments, MENA-OECD Investment Programme at p 19. Available at <http://www.oecd.org/dataoecd/37/46/36086926.pdf>, retrieved on 17 January 2011.

⁶⁷⁷ See Shleifer, A. & Vishny, W., 'Politicians and Firms', *the Quarterly Journal of Economics*, 1994, Vol:109, No:4, at p 996.

self-interested persons as they seek their self-enrichment even if it is at the expense of the public.⁶⁷⁸

It has been mentioned that the history of the oil sector in Kuwait has a fundamental impact upon deciding the current practice framework. Moreover, the oil sector history in Kuwait shows that this sector is exposed to political interventions all the time. Also, as the oil sector in Kuwait is composed of state owned enterprises, these SOEs experience excessive political interference in addition to the unnecessary governmental bureaucracy. In terms of the strategy of the state owned enterprises in Kuwait, it has to go through a prolonged negotiation process.⁶⁷⁹

The oil sector in Kuwait needs the stability to achieve its objectives and the efforts by the government in Kuwait must work parallel to the oil sector in order to achieve the objective; the oil sector importance emerged from the fact that oil is the major product that Kuwait produces, and according to the Kuwait State Annual Budget, oil revenues amount to more than 85% of Kuwaiti revenues per annum. But, it is a realization that the oil sector in Kuwait is not stable since, for instance, the Minister of Oil has changed six times from 2000 to 2010. Mr. Adel Al-Sabeeh, a former Oil Minister, stated the following:⁶⁸⁰

“... There are many matters hindering the running of KPC on a purely commercial basis, and this is contrary to the aims and goals for which it was established. In the absence of the application of radical solutions guaranteed to give the oil sector a commercial and economic character, and similar measures to review the structure of this sector by separating the chairmanship of KPC from

⁶⁷⁸ See Anwar, S. & Sam, C., ‘Singapore Style of Public Sector Corporate Governance: Can Private Sector Corporations Emulate Public Sector Practice?’, *New Zealand Journal of Asia Studies*, 2006, Vol: 8. No:1, pp 41-68.

⁶⁷⁹ See Stevens, Paul, 2008, Kuwait Petroleum Corporation: Searching for Strategy in a Fragmented Oil Sector, The Program on Energy and Sustainable Development (PESD), Stanford University working paper number 78. At p 5.

⁶⁸⁰ Quoted in Stevens, Paul, 2008, Kuwait Petroleum Corporation: Searching for Strategy in a Fragmented Oil Sector, The Program on Energy and Sustainable Development (PESD), Stanford University working paper number 78. At p: 62

the rank of oil minister, and removing all the burdens of government regulations from it, in addition to preventing any outside interference or pressures on the methods and regulation of work in this sector ...”

Consequently, it could be submitted that political interventions in oil sector decisions are great, which in turn results in creating problems such as the inadequate decisions to be taken. Thus, it has been recommended by the liberals in Kuwait that privatization would minimize the governmental role in the corporation, which, in turn, would result in more checks and balances; the corruption would also be reduced in Kuwait and in particular in the oil sector.⁶⁸¹ But there are current setbacks in Kuwait, which might be attributed to the mentality of the politicians. Because of this, element the Politicians are now exerting great influence upon their electors in the constituencies in Kuwait.

One of the detrimental effects is that the Politicians are pushing the electors (the public servants) to believe that the new development plan for Kuwait is just a dream and the government cannot handle the implementation of such a development plan; its budget for the five years is approximately thirty seven billions Kuwaiti Dinar, which are equals to one hundred and forty billion US dollars. Accordingly, it would be argued that the politicians in Kuwait are contributing to the entrenchment of the relationship-based system but not the rules-based system amidst the public servants.

Further, the public sector employees in Kuwait enjoy generous benefits regardless of their effort and qualifications. In this context, Mr. Ali Al-Ghanim, the president of the Kuwait Chamber of Commerce and Industry, explained the situation as that:

“ The ballot box in Kuwait is dominated by an overgrown bureaucracy with an absolute majority. This bureaucratic majority [of state employees] enjoy lavish benefits far beyond any measures of productivity or qualifications. It owns the political arena, and it feels that the economic reform threatens its selfish interests

⁶⁸¹ See Tetreault, Mary. A., ‘Pleasant Dreams: The WTO as Kuwait’s Holy Grail’, *Critical Middle Eastern Studies*, 2003, Vol: 12, Issue: 1. At p: 82

both in terms of income and influence.... The executive and legislative branches (including the parliamentary blocs) compete to win the loyalty of this majority by satisfying its desires for consumption... at the expense of the future of Kuwait and coming generations”.⁶⁸²

As a consequence, it has been stated that the Kuwaiti employees in the public sector believe that their salary is not considered as a compensation for their effort or work, but they believe that the salary is a kind of distribution of the State wealth and to help them to live in a good standard of life.⁶⁸³

Therefore, it could be submitted that the shortcomings of the qualifications and competencies of the public servants will last as long as they are depending on the politicians' interferences. Also, it has been claimed that the political interference in the state-owned enterprises can be seen as a reason for the SOEs' poor performance, which in turn leads to minimized production efficiency and will make the monitoring efforts over the SOEs deficient.⁶⁸⁴

Furthermore, it should be noted that political interference in state-owned enterprises can be found worldwide, as it has been argued that one of the great political interventions in the decision making process of the state-owned enterprises occurred in France when the politicians pressed upon the public enterprise to produce the Concorde instead of the Jetliner, although the market demand at that time preferred the Jetliner not the Concorde.⁶⁸⁵

⁶⁸² Ali Al-Ghanim the president of the Kuwait Chamber of Commerce and industry, quoted in Michael Herb, 2009, A Nation of Bureaucrats: Political Participation and Economic Diversification in Kuwait and the United Arab Emirates, *Int. J. Middle East Studies*, Vol:41, at p 375, pp 375-395. Also has been published in Al-Qabas Kuwaiti newspaper on 13 March 2007.

⁶⁸³ See Madzikanada, D.D., & Njoku, E.I., 'Employee Attitude Towards The Privatization of Kuwait's Government Departments and State Owned Enterprises', *International Public management Review*, 2008, Vol: 9, Issue:1, at p 111.

⁶⁸⁴ See Hemming, R., & Mansoor, A.M., 1988, 'Privatization and SOEs', Washington, US, IMF Occasional Paper, No:56.

⁶⁸⁵ See Shleifer, A., & Vishny, R.W., 'Politicians and Firms', *The Quarterly Journal of Economics*, 1994, at p 996. And See Anastassopoulos, J.P., "The French Experience: Conflicts With Government" in Raymond Vernon and Yair Aharoni (eds), *State-Owned Enterprises in the Western Economies*, London, Croom Helm, 1981, pp 99-116.

Occasionally, the political interference might have positive effects when it is exercised duly. For instance, in Kuwait, one of the positive parliamentary tools is the parliament question, which is posed by a parliament member to the minister in order to clarify any issue under suspicion for the MP. In July 2009, Mr. Ahmed Alsa`adon, the Oldest MP in Kuwait, asked the Oil Minister about whether any of the members of the Supreme Petroleum Council had any contract with the Kuwait Petroleum Corporation and or with any of its subsidiaries during his mandate term in the Council. After one year, the Oil Minister replied with the fact that six members of the SPC had contracted commercially with the oil sector during their mandate term in the council.⁶⁸⁶

Accordingly, these members can only be blamed ethically because they did not timely disclose their contracts. On the other hand, one can argue that the blame in this case should be for the shortcomings of the laws that were applied in this context.

6.5.2.1 Projects Cancelled Due To Political Interference:

In Kuwait, the political interferences by the Parliament Members were clear and obvious as many projects have been cancelled or delayed. Below are examples of the cancelled projects according to the political interferences in Kuwait.

6.5.2.1.1 AL-Zour Refinery:

The Government of Kuwait has rescinded a major project in the oil sector; the project was to build a new refinery in Al-Zour in the south of Kuwait. The project was going to cost around 15 Billion US Dollars. This refinery project was going to be the largest refinery in the Middle East and the fourth largest refinery in the world.⁶⁸⁷ Ultimately, the project has been canceled due to political interferences from the Kuwaiti parliament.

But the question is that whether the political interference was due or undue. This interference would be appropriate or due if the allegations of the Audit bureau that the

⁶⁸⁶ See <http://www.zoomkw.com/zoom/Article.cfm?ArticleID=86046> Retrieved on 21-Dec-2010

⁶⁸⁷ See Kuwait Cancels Al-Zour Refinery, available at www.tcetoday.com, retrieved on 20-Oct-2010.

Kuwait National Petroleum Company had not followed the required procedures and regulations of the tender committee were true. But, on the other hand, it could be argued that the refinery was canceled because the political interference was attributed to personnel benefits of some members of the parliament.

6.5.2.1.2 K-Dow Deal:

In December 2007, the Kuwait Petroleum Corporation entered into a joint venture agreement through its subsidiary Petrochemical Industries Company with Dow Chemical Company. The deal negotiation had taken around two years, and the deal had gone successfully through regulatory requirements in Kuwait, the European Union, and the United States. Internally, KPC and PIC had gone through all of the legal requirements for approval in Kuwait, the boards of directors of the two companies, the Supreme Petroleum Council, and the Ministry of Oil. The Kuwaiti Companies appointed several prominent advisors at the world level in different areas. It was said that this deal would have a strong positive results to the both parties, especially for the Kuwaiti party. Moreover, it had been claimed that this deal had the following benefits for the Kuwait Oil Sector:⁶⁸⁸

- o Leading market positions in several petrochemical product families, including the #1 position in polyethylene, the world's most common plastic, OVERNIGHT
- o If K-Dow were a publicly traded company, it would be a Fortune 200 company on Day 1.
- o A strong global footprint in petrochemicals
- o Significant growth prospects
- o The Polyethylene business historically has grown above GDP on an annual basis and has been one of Dow's most profitable, cash-generating businesses.

⁶⁸⁸ See The Statement of The Dow Chemical Company on Joint Venture Agreement with Petrochemical Industries Company (PIC) of Kuwait. December, 24, 2008. Available at <http://www.dow.com/news/corporate/2008/20081224a.htm>, retrieved on December 6, 2010.

- o This transaction also fits PIC's strategy and Kuwait's desire to diversify its economy by integrating downstream in the chemical chain.

Although on the December 26, 2008, the Oil Minister Mr. Mohammad Al-Olaim and Mrs. Maha Mulla Hussain, the Managing Director of Petrochemical Industries Company, were on AL-Rai TV channel advocating the deal with Dow Chemical, on December 27, 2008, Kuwait Petroleum Corporation announced the cancellation of the joint venture agreement with Dow Chemical, which was worth 17.5 Billion US dollars, due to the resolution of the Council of Ministers.⁶⁸⁹

Therefore, it should be noted here that the oil sector should be a major issue in any country's development plan, specifically when it is dependent upon the oil sales profits as a major source if not the sole source for its fiscal budget as is the case of Kuwait. But, it would be argued that the legal and regulatory framework for Kuwait Petroleum Corporation and its subsidiaries is conflicting and confusing because there are several regulatory bodies allowed by law to issue policies for the oil sector, such as the government, the parliament, and the Supreme Petroleum Council.⁶⁹⁰

Consequently, the ineffective monitoring system, the lack of proper information, and the overlapping or unclear objective of the state-owned enterprises, which resulted from such overlapping laws and regulations, will give the managers wider scope to avoid the accountability.⁶⁹¹ Furthermore, it could be submitted that the application of the best practice of corporate governance in the state-owned enterprises in Kuwait is confronted with two major obstacles i.e. the great political interference and the absence of a clear legal framework for the SOEs.

⁶⁸⁹ See Reuters: Kuwait Decided on Sunday to Scrap A Deal to Form A \$17.4 Billion Petrochemical Joint Venture with U.S. Company Dow Chemical. Available at <http://www.reuters.com/article/idUSTRE4BR1M920081229>, retrieved on 6, December 2010.

⁶⁹⁰ See Stevens, Paul, 2008, Kuwait Petroleum Corporation: Searching for Strategy in a Fragmented Oil Sector, The Program on Energy and Sustainable Development (PESD), Stanford University working paper number 78. At p 45.

⁶⁹¹ See Aharoni, Y., *The Evolution and Management of State Owned Enterprise*, Cambridge, Ballinger Publishing Company, US. 1986, At p 378.

Therefore, it could be submitted that Kuwait is recommended to legislate a special law regulating state-owned enterprises. The aforementioned law should stress upon the prohibition of political interference in the SOEs in Kuwait. Further, such law must indicate clearly the objective of such SOEs. In addition, the directors and the managers' authority and responsibilities must be identified.

6.6 Initiatives Enhance the Application of Best Practice of Corporate Governance in the State-Owned Enterprises in Kuwait:

Although there are no codes or principles as regards the corporate governance of the state-owned enterprises in Kuwait, it would be argued that there are some initiatives and entities that may enhance the application of corporate governance in the SOEs in Kuwait as indicated below:

6.6.1 Code of Conduct for Oil Sector Employees:

Kuwait Petroleum Corporation has launched self-initiatives toward the application of the best practice of corporate governance as a Code of Conduct has been implemented in the corporation. Also, it is worth noting that these principles are applied to all employees of Kuwait Petroleum Corporation and its wholly owned subsidiaries. The Principles of Kuwait Petroleum Corporation Code of Conduct are as follows:⁶⁹²

- Valuing People
- HSE Policy & Commitment
- Good Citizenship & Social Responsibility
- Ethical Business Conduct
- Confidentiality

⁶⁹² See <http://www.kpc.com.kw/AboutKPC/OurCodeofConduct/default.aspx>, Retrieved on 21-Dec-2010

These principles of the Code of Conduct can work as a vehicle for the implantation of the best practice of corporate governance in the Kuwait Petroleum Corporation, especially because the principle of ethical business conduct provides that the employees must obey the local law, and KPC will work on updating the employees with any new laws or regulation promulgated in Kuwait.

Furthermore, the principle of confidentiality provides for more than one issue that should relate to the best practice of corporate governance. One of the issues is the avoidance of conflict of interests; specifically, the employee is responsible to act in the best interest of the Kuwait Petroleum Corporation, and, should an employee have an interest against KPC interests, then these interests must be disclosed.

Moreover, there is a provision of the code of conduct prohibiting the employees from accepting bribes or from conducting any other corrupt activities. Consequently, this Code of Conduct can be workable and useful particularly where there is no law or regulation addressing for the application of corporate governance as in the case of the oil sector in Kuwait.

6.6.2 Corporate Governance Seminar for Executives in the Oil Sector:

Kuwait Petroleum Corporation organized a corporate governance seminar held in February 2010 for the executive employees of KPC and its subsidiaries. The seminar organized by Denton Wilde Sapte, a leading law firm in the world. The seminar objective was to introduce the notion of corporate governance to executive employees in the oil sector as a first initiative. Accordingly, the seminar began with the introduction of corporate governance and how its importance is increasing nowadays. Then, the lecturers addressed the role of the board of directors in addition to meetings of the board in the implementation of the best practice of corporate governance.

Finally, a general introduction was given to the attendees about the OECD guidelines for corporate governance in state-owned enterprises.⁶⁹³ This initiative revealed the professionalism that Kuwait Petroleum Corporation is working within and the compatibility of KPC with the modern issues in the business world. But these self-initiatives by KPC cannot be successful unless there are laws and regulations supporting such initiatives, such as the legislation of new laws concerning the legal framework of the state-owned enterprises.

6.7 The Roles of Several Entities Regarding the Application of Corporate Governance Issues in the State-Owned Enterprise in Kuwait:

6.7.1 The State Audit Bureau of Kuwait (SAB):

The State Audit Bureau was established according to Law No.: 30/1964 in accordance with Article (151) of the Kuwait Constitution, which prohibits any violation against the Kuwaiti public funds.⁶⁹⁴ The established law of the SAB, Article (1), provided for the establishment of an independent entity responsible for the financial control of the public funds and that this entity shall belong to the National Assembly. The President of the SAB must be appointed by the National Assembly. Furthermore, Article (5) stipulated the entities that are subject to SAB control, and SOEs are among them. Article (6) of the SAB Establishment Law addressed the SAB functions as follow:

“ The SAB shall, in general, exercise control over the collection of the State revenues and expenditures within the limits of the budget allocations and shall examine the adequacy of the regulations and methods adopted for the safeguarding of public funds and prevention of their abuse.

The SAB control shall, in particular, include the accounts of the Ministries, Government organizations and departments and all their branches, as well as the accounts of the

⁶⁹³ The Handout of *Kuwait Petroleum Corporation... The Corporate Governance Seminar* held in Kuwait on the 16-February 2010 organized by Denton Wilde Sapte Law Firm.

⁶⁹⁴ Law No: 30/1964, as regard establishing the State Audit Bureau in Kuwait, Issued on 7/7/1964.

bodies which have independent or supplementary budgets, including the National Assembly and all other bodies mentioned in the preceding Article”.⁶⁹⁵

Article (10) granted the SAB authority to examine the proper application of the administrative regulations in the governmental entities and in the SOEs. Investigating the application of the regulations in the SOEs protects against violations in appointments, promotions and incentives. In other words, the SAB is a safeguard to ensure that SOEs will appoint and promote public servants on the basis of their merit, which in turn will enhance the application of the rule-based system as opposed to the relation-based system, in which favoritism and nepotism play a detrimental role. Further, the SAB is also assigned the role to discover wrongdoing conducted in the SOEs, such as embezzlement, negligence and contravention according to Article (16) of the SAB Law.

Moreover, Article (20) empowers the SAB to investigate the financial and administrative regulations in the SOEs, to ascertain the extent to which these regulations are sufficient and efficient, and to suggest solutions to improve these regulations.

According to Article (21), the SAB is entrusted with the shareholders’ role in the General Meetings, as this article gives the SAB the right to examine the final fiscal budget for SOEs from a financial perspective and to determine whether each such budget has been completed in accordance with the applicable laws. To ensure the effectiveness of the SAB reports made about the governmental entities at the end of every fiscal year, Article (22) provides that the reports made by the SAB shall be submitted annually to the President of the State of Kuwait, the National Assembly, the Council of Ministers and the Financial Minister to take actions against the deficiencies mentioned in the SAB’s reports.

⁶⁹⁵ Article (1) of the Audit Bureau of Kuwait founding law No. 30/1964

6.7.2 Kuwait Law No: 1/1993 Regarding Protection of The Public Funds:⁶⁹⁶

This Law has been introduced in Kuwait in order to impose the proper protection as regards the public funds. This needed protection emerged particularly after Kuwait liberation from the Iraqi invasion in 1991, as there were allegations about the embezzlements of the Kuwaiti public funds outside Kuwait.⁶⁹⁷

Article (1) of the protection of the public funds law in Kuwait stipulated that Public funds have inviolability and their protection, support and guarding is the duty of every citizen. Whereas, article (2) has defined the public funds as follow: “ The public funds means, in the application of the provisions of this law, what is owned or is subject to the law of any of the following bodies, wherever the location of these funds, inside or outside the country:

A- The State.

B- Public Organization and Establishments.

C- Companies and Establishments in which the bodies indicated in the previous two articles participate by a percentage not less than 25% of their capital either directly or indirectly through companies or establishments in which the State, public organization or others of public corporate bodies participate by some kind of share in its capital. Determining the percentage of capital referred to is judged by the total of quotas belonging to the State or other public corporate bodies or companies referred to”.

Consequently, it could be submitted that the state-owned enterprises are under the umbrella of the public funds protection law. Therefore, and as regards the corporate governance on the SOEs in Kuwait it transpired that the workers of the SOEs are subject to severe penalties mentioned in the said law. As a result, it could be argued that the application of the public funds protection law in Kuwait could enhance the application of

⁶⁹⁶ Kuwaiti Law No: 1/1993 Regarding the Protection of the Public Funds.

⁶⁹⁷ Almelhem, A.A., ‘Kuwait: Law on the Protection of Public Funds’, *Journal of Financial Crime*, 1995, Vol:3, No:1, pp: 113-116.

corporate governance in SOEs as its provisions force the public servants or workers to exercise their job in the SOEs in a manner that would achieve the best interest of such enterprises and not in a manner that would only profit for their self-interest. The following are some crime and penalties provided for in the Kuwaiti Law No: 1/1993 on the protection of the public funds.

The Law of protection of public funds in Kuwait has provided for penalties of imprisonment for not less than 3 years for the public servants or public workers in the following crimes:

- Article (9) provides for a penalty of imprisonment for not less than five years in the case of embezzlements of money or papers by the public workers or servants from any of the entities mentioned above in article (2).
- Article (11) provides for a penalty of imprisonment for not less than seven years in the case of that a public servant or worker has intentionally performed an agreement in a manner harmful to the public entity to gain profit for him.
- Article (12) provides for a penalty of imprisonment for not less than seven years when the public servant or worker gains or attempt to gain for himself for interests or profits by illegal manner from the authority he entrusted with because of his job.
- Article (13) provides for a penalty of imprisonment for not exceeding three years in the case that the public servant or worker has divulged confidential information by their nature of by instruction, and as a result of divulging such information he caused damages for the public entity or he gained personnel profits.
- Article (14) provides for a penalty of imprisonment not exceeding three years in the case that the public servant or worker has caused grave damages to the public entity by his fault, negligence or breach of his duties.

Therefore, it could be submitted that the aforementioned law is playing a prominent role as regard the application of best practice of corporate governance in the SOEs in

Kuwait. since its contains provisions which provide for the prohibition of the embezzlements of the public funds and penalizes the wrongdoings, the misconducts and the negligence or the public servants when he/she exercise his job.

6.8 Conclusion:

In this chapter, an attempt had been made to examine the current corporate governance practice in the state-owned enterprises in Kuwait. According to the abovementioned examination, it has been revealed that the best practice of corporate governance is weak and inefficient in the state-owned enterprises in Kuwait. The weakness of such practice in the SOEs in Kuwait is attributed to two main reasons. The first weakness is the absence of a clear legal framework for the state-owned enterprises in Kuwait.

As a result, it could be submitted that the SOEs in Kuwait are working within an improper environment since the objectives of establishing such enterprises are lost. In addition, the clear legal framework for SOEs is important because of its role in identifying several issues that should enhance the best practice of corporate governance in such enterprises.

For example, the legal framework should provide for the legal duties and responsibilities of the SOEs' managers; as a result, the managers of the SOEs can be held accountable for any mismanagement or violations committed by them. In this chapter, it has been highlighted that the managers of the SOEs in Kuwait are governed by several laws and regulations; for instance, the managers in the state-owned oil enterprises are subject to Kuwait Commercial Companies Law No: 15/1960, and, at the same time, they are subject to the administrative regulations that are introduced by the government.

Furthermore, it could be argued that the absence of a clear legal framework for the SOEs in Kuwait has exacerbated the political interference in a way that hinders achieving the goal of establishing state-owned enterprises in Kuwait. For example, the political interferences in Kuwait have made the SOEs overstaffed in addition to encouraging SOEs

to adopt the nepotism and favoritism as a preferred criterion for the appointment of the employees in such enterprises. Moreover, political interference in Kuwait was behind the cancellation of projects with international parties for reasons not approved to date, such as the K-Dow petrochemical deal between Petrochemical Industries Company and Dow-Chemical.

Although the best practice of corporate governance of the state-owned enterprises in Kuwait suffers from the absence of a clear framework and great political interferences, there are several institutions that should enhance the application of the best practice of corporate governance in the SOEs in Kuwait. The State Audit Bureau (SAB) in Kuwait has been entitled with functions such as supervision over the governmental bodies in terms of the application of financial and administrative regulations. As a result, it could be submitted that the SAB has a significant role in supporting the application of corporate governance within the SOE context, especially because the SAB is required to report any infringements to the Parliament, the Prime Minister, or the Ministry of Finance.

On the other hand, another institution can be seen as an element that enhances the application of corporate governance in the SOEs in Kuwait, i.e., Law No: 1/1993 regarding the protection of Kuwaiti public funds since this Law has provided for severe penalties against public servants or workers who commit violations toward public funds inside or outside of Kuwait whether due to negligence or intentional acts. Furthermore, the oil state-owned enterprises in Kuwait have made initiatives towards the application of corporate governance in this vital sector in Kuwait. This sector has applied a code of conduct for employees encouraging them to act in an ethical manner that supports the business of such enterprises; in addition, this code of conduct also provides that the workers should maintain the required confidentiality for such business.

Further, the same sector in Kuwait has arranged a seminar for the executives in the oil sector in Kuwait regarding the best practice of corporate governance in such enterprises. Consequently, although there are initiatives by the SOEs toward the application of corporate governance in such enterprises, it could be submitted that Kuwait has no code

or guidelines regarding the application of corporate governance in the state-owned enterprises, and Kuwait needs corporate governance in SOEs especially after introduction of the privatization law, which revealed the government intention to transfer the title of public bodies to the private sector.

Therefore, the investors must be confident that the candidate entities for privatization are working appropriately before they propose to buy them. As a consequence, the privatized enterprises are going to be listed in the stock market as holding corporations. Therefore, for the sake of this work, the next chapter will examine the application of the best practice of corporate governance in the private corporations that are listed in the Kuwait Stock Market.

Chapter Seven: The Corporate Governance as An Investors' Protection mechanism Under The Current Kuwait Stock Exchange Laws and Regulations:

7.1 Introduction:

As mentioned in the previous chapter, the Kuwait government is intending to, in addition to the privatization of many state-owned enterprises, incorporate new shareholding companies to implement Kuwait's development plan.⁶⁹⁸ The foreign capitals in addition to the local capitals are also invited for the participation in the incorporations of such shareholding companies that will be listed in the Kuwait Stock Exchange market (KSE). Therefore, it is a must that such foreign and local capitals will not participate in such companies' incorporations unless they are confident that there are efficient laws and regulations that ensure proper protection to them as shareholders.

Accordingly, it could be noted at this stage the contribution that expected from this work to the international society.

Thus, in this chapter, an attempt will be made to explore the current situation of KSE in terms of the available protection for the shareholders. In other words, the exploration will touch upon whether or not there are laws and/or regulations that should relate to corporate governance, and if so, to what extent such laws and regulations are efficient. Further, and in order to conduct such exploration the importance of the corporate governance as a preventive mechanism against financial crises will be discussed in light of the 2008 financial crisis. Then, an indication will be made to the historical development of the KSE's organization in terms of its laws and regulations.

Moreover, corporate governance has been identified by all the Gulf Co-operation Council (GCC) countries, except Kuwait, as every GCC countries has incorporated its own corporate governance system whether through code or law, but it should be noted

⁶⁹⁸ See the Kuwait Development Plan Law No. 38/2010 and the New Privatization Law No. 37/2010 in Kuwait.

that the Central Bank of Kuwait (CBK) has circulated instructions for corporate governance that are to be adhered to by the banks and investment companies.⁶⁹⁹

Furthermore, due to the absence of the corporate governance code in KSE the laws and regulations that should be related to corporate governance and the investors' protection will be analyzed.⁷⁰⁰ The analysis will touch upon KSE's regulations and laws of disclosure of information whether financial and non financial by the listed companies. Additionally, the listing rules in KSE will be discussed to examine its efficiency and as a corporate governance tool that enhances the investors protection. Moreover, some corporate governance tools that might play prominent role toward the improvement of the shareholders protection KSE will be explored such as the role of Institutional Investors.

This chapter also compares other laws and regulations of developed and developing countries to achieve optimal results as regards the current legal framework of the KSE. In particular, the comparison will be made with the other GCC countries because of the similarity between them and Kuwait in terms of the legal, culture and economic structure. In other words, in addition to the object of this chapter that is to shed a light on the current laws and regulations of KSE that should provide proper protection to the investors, developed laws and regulations in the same vein will be brought about such as the ones applicable in the GCC countries to benefit of its experience especially where the socio-economic conditions are similar to the one in Kuwait.

7.2 The Financial Crisis (2008) and the Corporate Governance Failure:

Generally speaking, the companies laws around the world provides for provisions as regards the supervision over the companies' management; these provisions in particular deal with the shareholders' rights within the company's ordinary and extraordinary general meetings. However, the legal framework of the corporate governance is designed

⁶⁹⁹ See The Central Bank of Kuwait Instruction to the Banks and Investment Companies in Kuwait as regards the corporate governance practice, issued on May 2004.

⁷⁰⁰ In this chapter the focus will be on KSE regulations of disclosure and the listing rules as corporate governance tools. While there are other important corporate governance tools have been discussed in chapter (5) such as the directors' duties and the shareholders' other rights.

to enhance the supervision upon the companies' management since it imposes stricter provisions that should achieve the objective that is expected from such supervision. For instance, corporate governance encourages the appointment of independent directors in the companies' boards, which could result in better board resolutions in terms of impartiality and quality.

Furthermore, corporate governance as a system urges the companies to adopt a transparency and disclosure practice that should grant the shareholders a better discretion to determine their decisions as regard the companies they investing or willing to invest in.⁷⁰¹ Thus, it has been argued that the sound application of corporate governance could be considered as a preventive mechanism against any financial crisis due to its role in protecting the shareholders interests and confronts any malfeasances from the management or the board of directors in the case of the concentrated ownership and the controlling shareholder.⁷⁰²

In other words, corporate governance enhances the investors' ability to take the appropriate investment decision since it requires the companies' managements to disclose the information that is needed for the investors to make the decision to invest. Also, it has been claimed that the causes behind the financial crisis in 2008 could be attributed to the inefficient of a number of issues that are related to the corporate governance system.⁷⁰³

In other words, the corporate governance principles have not been adequately exercised before the financial crisis has been happened hence the crisis became widespread. Moreover, the corporate governance recommendations as regard the board of directors' responsibilities were not effectively exercised because there was a failure in monitoring the company's strategy implementation.

⁷⁰¹ See Jahlol, Dr Amar Habib, *The Legal Framework for Corporate Governance*, First Edition, Publications of Zain Alhaqoqiya, Lebanon, 2011, pp 57-58

⁷⁰² *Ibid*, at p:13

⁷⁰³ See Kirkpatrick, Grant, 'The Corporate Governance Lessons from the Financial Crisis', *OECD Journal: Financial Market Trends*, Vol: 2009, at p 2

In addition to the above noted causes, it has been stated that the accounting standards were apparently not efficient; also, the directors' remuneration system was related to the cause of the financial crisis in some cases.⁷⁰⁴ Accordingly, several opinions have been expressed as regards the cause of the financial crisis (2008). For example, it has been claimed that from a corporate governance perspective the risk management failure in the financial crisis can be attributed to the reason that the risk management reports were not transmitted to the board of directors, which results in that the board could not exercise his responsibilities to confront any expected financial failure.⁷⁰⁵

In this context, the OECD principles of corporate governance emphasized that the board of directors should be exercise their duties in an informed basis.⁷⁰⁶ A principle I.D of the OECD corporate governance principles (2004) provides for that:

“Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfill their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained.”⁷⁰⁷

In addition, *The OECD Steering Group on Corporate Governance* argued that the OECD principles of corporate governance of joint stock companies are efficient, whereas the financial crisis revealed that the weakness was confined in the implementation practice to a large extent.⁷⁰⁸ Therefore, it was their recommendation to ensure that the proper implementation of these principles to avoid any future crisis. In this context, it has been suggested that the regulatory authorities should measure the enforcement implementation by the authority in regular basis and intervene to ensure the implementation of the corporate governance best practice within the companies is efficient.⁷⁰⁹

⁷⁰⁴ *Ibid.*

⁷⁰⁵ *Ibid.*, at p 6

⁷⁰⁶ See the OECD Principles of Corporate Governance (2004), at p 24

⁷⁰⁷ Principle (I.D) of OECD Principles of Corporate Governance (2004), at p 31

⁷⁰⁸ See *Corporate Governance and the Financial Crisis, Conclusion and Emerging Good Practices to Enhance Implementation of the Principles*, Paper by Directorate for Financial and Enterprise Affairs, OECD Steering Group on Corporate Governance, February 2010, at p 6

⁷⁰⁹ *Ibid*

Furthermore, the executives' remuneration has been seen as one of the causes of the financial crisis since it has been stated that the financial crisis showed that the executives' remunerations should be conducted in a transparent manner, i.e., the incentives scheme for the executive management in the companies should be disclosed for the shareholders and such schemes should object to entrench the notion of long terms investment by such executives as it has been stated by David Landes that: "*Easy money is bad for you. It represents short-run gain that will repaid for in immediate distortions and later regrets.*"⁷¹⁰

Further, the OECD principles suggests that the company's executives and board of directors should align their interests with the company and shareholders interests by ensuring that they are managing the company not on the short term investment basis; rather, they should secure the benefit of a long term investment for the company and its shareholders. Accordingly, it has been claimed that it is a good practice for the company's board to improve the disclosure mechanism of the executive management and the board of directors remuneration scheme because the disclosure of such information would enhance the shareholders' rights and make them able to take a proper decision toward the board's responsibilities and accountabilities.⁷¹¹

In addition, Coffee has argued that the financial crisis (2008) has taken place because of the failure of the called *gatekeepers* (auditors, investment bankers, lawyers, etc.) in exercising their jobs that resulted in boosting the crisis effects.⁷¹² Therefore, it would be argued that the causes of the financial crisis (2008) as discussed above have happened due to the weakness of a number of corporate governance issues. Whereas, the same financial crisis has showed that the companies listed in KSE are exposed to such crisis due to the lack of the proper laws and regulations that intend to monitor the companies'

⁷¹⁰ See Landes, David, *the Wealth and Poverty of Nations, Why Some Are So Rich and Some So Poor*, New York, W.W. Norton, 1998, at p 173. Quoted in Moore, Pete, W., *Doing Business in the Middle East: politics and Economic Crisis in Jordan and Kuwait*, the university of Cambridge, United Kingdom, 2004, at p: 120.

⁷¹¹ OECD Principles of Corporate Governance (2004), principle: VI.D.4. at p 24

⁷¹² See Coffee, J., 'What Went Wrong? An Initial Inquiry Into The Causes of The 2008 Financial Crisis', *Journal of Corporate Studies*, 2009, VoL: 9, Part: 1, pp: 1-2

management practices.⁷¹³ In particular, the companies in the investment sector were the most affected in Kuwait stock exchange, and they are important to a large extent because they constitute the largest sector since the investment companies investing in many other sectors in the KSE, especially the real estate sector.⁷¹⁴ Consequently, it could be admitted that any financial crisis in the investment companies in KSE might lead to detrimental effects for the KSE in general. Thus, it has been found that these companies have suffered since the financial crisis in 2008 for a variety of reasons.⁷¹⁵

One of the main reasons could be the overlapping of jurisdictions between the KSE, the Central bank of Kuwait, and the Ministry of Commerce and Industry. Moreover, the International Monetary Fund in their report “*Kuwait: Financial System Stability Assessment*” found that the corporate governance practice in the investment companies in KSE is ineffective due to a variety of reasons. For instance, the boards’ members and the senior managers in the banks’ management in Kuwait mostly appointed by the majority shareholders of the banks. However, it should be pointed out here that the Central Bank of Kuwait is playing a significant role to improve the corporate governance practice in the investment companies through strengthening the supervision regulations as it will be discussed later.⁷¹⁶

Inadequate corporate governance application was a significant element as regards the widespread aftereffects of the financial crisis (2008) especially in Kuwait where the legal and financial infrastructures were suffering from several elements that undermined the sound application of corporate governance. Mainly, it would be argued that the concentrated ownership in most of the joint stock companies in Kuwait and the management is in the hands of the controlling shareholder has revealed that checks and balances by the shareholders were not effective and weak because of the dominance of

⁷¹³ See *Kuwait: financial System Stability Assessment*, International Monetary Fund Country Report No: 10/239, July 2010, Washington D.C., at p 6, available at : <http://www.imf.org/external/pubs/ft/scr/2010/cr10239.pdf>, retrieved on 15/2/2011.

⁷¹⁴ See www.kuwaitse.com

⁷¹⁵ See *Kuwait: financial System Stability Assessment*, International Monetary Fund Country Report No: 10/239, July 2010, Washington D.C., at p 6, available at : <http://www.imf.org/external/pubs/ft/scr/2010/cr10239.pdf>, retrieved on 15/2/2011.

⁷¹⁶ *Ibid.*

the management and the CEO of the company,⁷¹⁷ in addition to the fact that the enforcement of the authorities in Kuwait is weak.⁷¹⁸

Consequently, the sound application of corporate governance could result in re-acquiring the investors' confidence in the companies listed in the capital markets and prevent future financial crises.⁷¹⁹ Therefore, the crisis should foster the improvements of issues that relate to corporate governance because it has been stated that the failures in such markets have encouraged the financial regulators to adopt mechanisms that enhance the financial markets stability against the financial crises.⁷²⁰

Moreover, the history shows that the corporate governance developments usually take place according to issues that have been identified by the financial crises. For instance, the auditor and the auditing committee independence in addition to the accounting standards development were pointed out after the financial scandals of Enron and WorldCom. Moreover, it has also been argued that the financial scandals of Parmalat and Ahod companies have revealed weaknesses and failures that encouraged international and national institutions to take actions to improve the corporate practice to prevent such crises in the future.⁷²¹

For example, the U.S. legislation Dodd-Frank Act 2010 (DFA 2010) (signed in 22 July 2010) stipulates in section 957 brokers are prohibited from using a proxy to vote for the appointment of the company's directors unless the broker is directed by the

⁷¹⁷ See Yeoh, Peter, 'The Impact of the Global Financial Crisis on Corporate Governance and Executive Pay in the US and the UK', *Business Law Review*, 2010, Vol: 31, Issue: 11, at p: 238, also see Cheffins, B.R., 'Is Berle and Means Really a Myth? European Corporate Governance Institute Law Working Paper No: 121/2009.

⁷¹⁸ See Golberman, S, Peng, M & Shapiro, D., 'Corporate Governance and Asia Companies', *Asia Pacific Journal of Management*, 2010, Vol: 28, pp: 1- 4.

⁷¹⁹ A Statement on the Financial Crisis by the International Corporate Governance Network, on 10 November 2008, available at <http://www.iasplus.com/resource/0811icgn.pdf>, retrieved on 27/2/2011.

⁷²⁰ See Koldertsova, Alissa, 2010, The Second Corporate Governance Wave in the Middle East and North Africa, *OECD Journal: Financial Market Trends*, Vol: 2010, Issue: 2, at p 3

⁷²¹ See Kirkpatrick, Grant, 'The Corporate Governance Lessons from the Financial Crisis', *OECD Journal: Financial Market Trends*, Vol: 2009, at p 3

shareholders to vote in a specific way. This provision came to impose more protection for the shareholders rights after the recent financial crisis.⁷²²

Furthermore, the shortcomings in corporate governance system may result in managers or directors or any other party looting the company. Therefore, it has been claimed that the investors have suffered from the financial crises; hence, in the meantime and in future, they will not commit to any investment unless the corruption and mismanagement are confronted.⁷²³ In other words, the investors, whether locals or foreign, are looking for investment opportunities in markets that implement their corporate governance system in a sound manner since this system will enable them to oversee the management of the company in which they are invested.

However, such investors are in the developed countries, whereas, in the developing countries such as Kuwait, the investors lack experience as regards the corporate governance practice and benefits. Therefore, they need to be educated as will be discussed below.

7.3 Establishment of Kuwait Stock Exchange Market:

Kuwait have experienced one of the most serious financial crises in the world in 1982 when the unofficial stocks market in Kuwait “*Suq Almanakh*” collapsed, and the loss amounted to 22 Billion US Dollars. Moreover, the writer Fida Darwiche in her book, *The Rise and Falls of The Souq Al-Manakh*, has stated that the collapse of this market was the first of its kind.⁷²⁴ This unofficial stock market in Kuwait was started in 1976, and the huge profits of the stock market had attracted Kuwaitis and GCC citizens to participate in stock trading. In essence, the deals conducted in this market were done through postponed cheques that had led to the unreasonable inflation of the traded shares’

⁷²² See Yeoh, Peter, ‘The Impact of the Global Financial Crisis on Corporate Governance and Executive Pay in the US and the UK’, *Business Law Review*, 2010, Vol: 31, Issue: 11, at p: 238

⁷²³ See *Instituting Corporate Governance in Developing, Emerging and Transitional Economies A Handbook*, by the Center for International Private Enterprise, 2002, at p 2, available at: http://www.cipe.org/programs/corp_gov/pdf/CGHANDBOOK.pdf, retrieved on 16/2/2011

⁷²⁴ See Darwiche, Fida, *the Gulf Stock Exchange Crash, the Rise and Falls of the Souq Al-Manakh*, Croom Helm Ltd, England, 1986, at p 86

prices. Consequently, the share prices fell, and the unofficial stock market collapsed, which in turn motivated the Kuwait government to intervene before the situation got worsened.

It is worth noting at this point that the traded companies in the unofficial market were companies established and registered in Kuwait and other companies established and registered outside Kuwait.⁷²⁵ Ironically, it has been stated that the government of Kuwait refused to impose regulations to manage the trading during the era of *Suq-ALmanakh*, and they justified that on the ground that the Kuwait economy should be freely oriented market.⁷²⁶

Afterwards, as a result, the Kuwaiti government had to implement strict regulations as it suspended the incorporation of holdings companies. Consequently, in 1979, and because of rising oil prices, the financial situation of the Kuwaitis improved again and the trading of stocks was continued; the shares prices were inflated again to an unreasonable level until 1982 when the huge collapse hit the Kuwaiti stock exchange market, as consequences, Kuwait government paid around 3 million USD to bail out small investors. Thereafter, it decided to regulate the securities market in the country in a manner that prevents such financial crises in the future.⁷²⁷ To elaborate the situation during *Suq Almanakh* era, it could be submitted that it was predominant, since there were allegations that the ministers of the Kuwait government left their duties as ministers and traded in shares instead, as it has been mentioned in *AL-Watan Newspaper*:⁷²⁸

“We do not like see minister getting involved in share dealing. We blame the members of the National Assembly for having let such a matter pass unnoticed, the more so if it is proved that Minister`s dealings in shares affected the discharge

⁷²⁵ See Dr. AL-Sabah, S.M., *Kuwait: Anatomy of A Crisis Economy*, Eastlords Publishing Ltd, London, 1984, at p 10.

⁷²⁶ *Ibid*, at p 9.

⁷²⁷ See Alqabas newspaper on 18/01/2009. *Azmat ALmanakh Bayn ALams w alyawm, ALmanakh Crisis Between Today and Yesterday*. <http://www.alqabas.com.kw/Article.aspx?id=465705&date=18012009>, retrieved on 8/2/2011.

⁷²⁸ *ALwatan Newspaper Article on 26/8/1982*, quoted in Darwiche, Fida, *the Gulf Stock Exchange Crash, the Rise and Falls of the Souq Al-Manakh*, Croom Helm Ltd, England, 1986, at p 92.

of their ministerial duties. Some say the market crashed because the ministry spent their time hunting bargains on the stock markets leading to fears that they took advantage of public office to realize private gains. It is for such reasons that Article (131) of the constitution expressly prohibits any person from combining a ministerial post and commercial practice”.⁷²⁹

In addition, it is a fact that not only the ministers as politicians were engaged in this dealing but also most of the politicians and the ruling family members in Kuwait were participating significantly in the stock markets trading during this time. Furthermore, it should be noted here that the companies “boards of directors” have participated also in creating the crisis, as illustrated from the fact that the Council of Ministers in Kuwait issued Decree No. 10/1983,⁷³⁰ which stipulated the formation of an investigation committee to examine the board of directors’ violations in 39 joint stock corporations before and during the financial crisis in Kuwait *Suq AL-Manakh*. As a result, the investigation committee discovered many violations committed by the companies’ directors against the Commercial Companies Law (15/1960). These violations included: a number of board members did not own shares in the company as required by the companies law; related party transactions were concluded between the directors and their company without the shareholders’ approval; some companies raised up their company’s capital without following the require legal procedures; mergers between companies were done without the shareholders’ approval; loans had been lent to persons on the basis of relationships without guarantees.

Consequently, the Kuwait government has realized the importance of introducing laws and regulations aiming to organize and ensure that the stock market in Kuwait operates in a correct and properly manner due to its important affect upon the national economy. Hence, Kuwait Stock Exchange Market (KSE) was established pursuant to the Law Decree issued on 14 August 1983.⁷³¹ Further, the Ministerial Resolution’s No:

⁷²⁹ Kuwait Constitution (1962), Article (131)

⁷³⁰ The Council of Ministers in Kuwait issued a Decree No. 10/1983, issued on 13/3/1983

⁷³¹ Kuwaiti Law Decree regulating Kuwait Stock market, Published in Kuwait Official Gazette Issue No: 1492/1983. This Law Decree has been amended by Law Decree No. 158/2005

35/1983 was issued as regard the regulations of KSE.⁷³² The previous Decree of Law has recognized the KSE as a legal independent entity.

Moreover, a committee must be established to handle the setting up of the rules and regulations to administrate the KSE; in addition, this committee is responsible for determining the general policy of the KSE and achieving its objectives. Further, the committee is chaired by the Commerce and Industry Minister, and the general manager of the KSE is the vice chairman, and this committee is the controller over the KSE according to the establishment law decree, which has given the right to this committee to investigate any suspicious transactions and to impose penalties on any person committed violations to its regulations or resolutions. But, in general, to date as regards the penalties that the KSE has imposed it could be submitted that these penalties are very lenient and not deterrent as illustrated in article (14) of the KSE Establishment decree of law.

Further, when KSE was established, the investors were only Kuwaitis; afterwards, the Law Decree No: 33/1988 has permitted the Gulf Council Countries (GCC) citizens to own shares in the publicly held companies listed in the KSE. Furthermore, the Law No: 2/2000 was introduced, and it permitted for non-Kuwaitis to own shares in the publicly held companies in Kuwait since Clause (1) of this law stipulates for the following:⁷³³

“Non-Kuwaitis may own shares in Kuwaiti shareholding companies existing at the operative date of this Law or which shall be established after its enforcement and operation. Moreover, they may participate in establishing such companies in accordance with the provisions of the clauses in this Law.”⁷³⁴

The other provisions of the said law have provided for that the Minister of Commerce and Industry shall render regulations as regards the number of shares that the Non-Kuwaiti is entitled to own.

⁷³² Ministerial Resolution No: 35/1983 concerning the KSE regulations.

⁷³³ Law No. 2/2000 concerning permission for the Non-Kuwaitis to own shares in the listed companies in KSE.

⁷³⁴ The translation of This Clause was made by *Arab Law Quarterly*, 2001, Vol: 16, Part: 2, pp 211-212.

7.4 The Developments of the Capital Markets and The Corporate Governance Codes Amongst The GCC Countries:

The regulatory reform for the capital markets refers to the design of rules and actions that enhance the improvements of the regulation's legal quality to develop the efficiency of the capital market.⁷³⁵ Thus, the legal and regulatory framework of any capital market is fundamental element since it provides for the penalties for any violation in the corporate practice. Further, the agency problem in the holding companies can be confronted by the regulations of the capital market.⁷³⁶

In other words, the regulations of capital markets enhance the investors' protection against the managers or the controlling shareholders' wrongdoings. In particular, as the situation of Kuwait where the ownership is concentrated, the capital market's role is important to curb the controlling shareholders actions, specifically those that detrimentally affect the other shareholders' rights.

The GCC capital markets are significantly smaller as compared with the rapidly growing capital markets in Far East of Asia, South Korea, Taiwan, Hong Kong, and Singapore.⁷³⁷ However, the significant growth in the GCC stock exchange markets has been the motive behind the importance to make improvements to these markets to be compatible with the international standards; in particular, those issues that should relate to the application of the best practice of corporate governance and such implementation of international standards in the GCC stock markets will attract more capital of foreign investors to the area.⁷³⁸

⁷³⁵ See Limam, Imed., 'Challenges and Reforms of Economic Regulation in MENA Countries', The American University in Cairo Press, Egypt, 2003, at p 1.

⁷³⁶ See Drobetz, W., Schillhofer, A., & Zimmermann, 'Corporate Governance and Expected Stock returns: Evidence From Germany', *European Financial Management*, 2004, Vol: 10, Issue: 2, pp: 267-293.

⁷³⁷ See Askari, H., Nowshirvani, V., & Jaber, M., *Economic Development in the GCC: The Blessing and The Curse of Oil*, JAI Press INC, London, 1997, pp 59-60.

⁷³⁸ The Institute of International Finance and the Institute for Corporate Governance, *GCC Comparative Corporate Governance Survey: An Investor Perspective*, 2006, at p 3.

In other words, corporate governance best practice should play an important role as regard the attractiveness of the foreign capital to be invested in the GCC stock exchange markets since the corporate governance might be to a large extent an illustration of the stock exchange markets' credibility and efficiency. In this regard, it could be noted that all the GCC countries have created their own corporate governance codes except Kuwait.

For example, Saudi Arabia is a proper illustration as regard the developments in the GCC countries' economies; it has been claimed that the softness of the disclosure rules and the weak efficiency of the enforcement mechanism in the Saudi Stock Exchange was an obstacle of the stability and the efficiency of such market.⁷³⁹ But, the transformation from Stock Exchange Market to a Capital Market Authority (CMA) has shown efficient changes as the capital market regulations concerning the disclosure and transparency became compatible with the international standards and as a result the investors' protection improved.

However, the enforcement also has been improved since the establishment of the Capital Market Authority in Saudi Arabia when it is compared with the situation in the Saudi Stock Exchange.

In terms of the listing requirements in Saudi Arabia, it has been argued that the listing rules during the era of the Stock Exchange in Saudi Arabia were ambiguous and hindering the companies listing in such markets, Whereas, the new listing rules in the Saudi Stock Exchange under the CMA have improved the disclosure by describing the information that should be disclosed before the company is listed; further, the aforementioned disclosure requirements are similar to the ones implemented in developed economies; for instance, the Saudi stock market adopted the same disclosure requirements as those of the London Stock Exchange (LSE).⁷⁴⁰

⁷³⁹See Baamir, A. Y, 'Issues of Transparency and Disclosure in the Saudi Stock Market', *Arab Law Quarterly*, 2008, at p: 64,

⁷⁴⁰ *Ibid*, at p 66

Moreover, it has been stated that the CMA came with provisions confronting the insider dealing with international standards, which in turn increases the efficiency of the stock market and had made the environment suitable for a sound financial system.⁷⁴¹ The similarity between the Saudi CMA and LSE can be seen in particular in the disclosure requirements that should be exercised in the Initial Public Offers (IPO) prospectus in particular with regard to the information that should be contained in the prospectus, as this information must be accurate and important to the investors to make the decision to participate or not.

Also Oman was the first GCC country that took developmental steps in 1998; the Capital Market of Oman has been established as an independent entity, and the code of corporate governance introduced in 2002 by Capital Market Resolution No. 11/2002.⁷⁴² This code focused upon several governance issues. For instance, the conflict of interests between the directors and the corporation was tackled by requiring more disclosures as regards the related party transactions.

Furthermore, the Oman Capital Market required a report of the corporate governance practice of each listed corporation to be incorporated in the annual report for the information of the shareholders. This report should mention the executives' management and the board of directors' compensations and information about the board of directors.⁷⁴³ The development in Oman continued as regards corporate governance application in particular the development of the shareholders' protection as the Omani corporate governance code was revised in 2003 in order to improve the investment environment in Oman by providing for adequate protection of the minority shareholders, improving the transparency and disclosure of information in addition to clarifying the board of directors responsibility and accountability.⁷⁴⁴

⁷⁴¹ *Ibid*, at p 67

⁷⁴² Corporate Governance Code of the Listed Corporations in Oman Capital Markets, <http://www.cipe.org/regional/menacg/pdf/Oman%20Code%20of%20CG.pdf>, retrieved on 8/2/2011.

⁷⁴³ See The Institute of International Finance and the Institute for Corporate Governance, *Corporate Governance in Oman: An Investor Perspective*, 2006, at p: 1

⁷⁴⁴ See The Institute of International Finance and the Institute for Corporate Governance, *Corporate Governance in Oman: An Investor Perspective*, 2006.

Another example is Qatar as the financial development practically came into reality in 2005 when the government of Qatar founded the Qatar Financial Center. Thereafter, the financial development in Qatar continued, and the Qatar Financial Center establishment Law has provided for the establishment of Qatar Capital Market Authority (QCMA).⁷⁴⁵ QCMA enacted corporate governance code in (2009); this code is based on the *Comply or Explain* principle. The corporate governance code of QCMA stipulates for provisions that enhance the shareholder protection and provisions that relate to the transparency in addition to the protection of the stakeholders' rights and other corporate governance issues.⁷⁴⁶ It is worth noting here that the Central Bank of Qatar has imposed regulations that should relate to corporate governance practice upon the banking sector in Qatar before the corporate governance code was enacted.

Notwithstanding, it would be argued that the situation in Kuwait is still lagging behind in terms of the economic developments in the GCC countries since for instance the overlapping between the supervisory roles over the listed companies in KSE. The listed companies in KSE are subject to the Ministry of Commerce and Industry supervision pursuant to the Commercial Companies Law (15/1960),⁷⁴⁷ as article (178) provided that the Ministry of Commerce and Industry has the right to investigate any joint stock company situation once there is suspicion that the company has violated the Commercial Companies Law or the company's Articles of Association.

Moreover, the listed companies are subject to the law and regulations of the KSE. It could be submitted that such overlapping between the roles of the two entities in Kuwait became apparent in these days as several meetings are being held between these entities to clarify each party's role after the issuance of the capital market authority Law in Kuwait, which might be effective at the end of 2011.⁷⁴⁸ Also, and in accordance with the

⁷⁴⁵ See The Institute of International Finance and the Institute for Corporate Governance, *Corporate Governance in Qatar: An Investor Perspective*, 2006, at p 2.

⁷⁴⁶ Qatar Capital Markets Authority Corporate Governance Code Issued in 2009, available at the following link: http://www.qfma.org.qa/mritems/streams/2010/9/16/1_317_1_11.pdf, retrieved on 9/2/2011.

⁷⁴⁷ Kuwait Commercial Companies Law No. 15/1960, and the Amiri Decree issued on 12 August 1985 concerning the Ministry of Commerce and Industry role toward the listed companies in the KSE.

⁷⁴⁸ The Parliament of Kuwait has passed the Capital Market Authority Law No. 7/2010 and according to its provisions it will not be completely become effective before 2012.

founding law of the Central Bank of Kuwait (CBK) No. 32/1968 and the Article (16) of the Finance Minister resolution issued on January 8, 1987, the CBK has the supervisory role over the banks and investment companies in Kuwait.

The CBK in May 2004 issued corporate governance instructions for the banks and the investment companies listed in the Kuwait Stock Exchange. The corporate governance circulation identified the importance of corporate governance for the banks and the investment companies after the financial scandals that shocked the world. Furthermore, the OECD's corporate governance definition has been adopted in order to identify the proper instructions of corporate governance by the CBK circulation.⁷⁴⁹

The corporate governance principles that are imposed by the CBK upon the banks and the investment companies in Kuwait includes:

- a) The protection and the equitable treatment between the shareholders. In this principle aim at treating all the shareholders equally whether they are locals or foreigners and whether minority shareholders or controlling shareholders. In addition, this principle provided for that any disposal of a vital asset for the company should be disclosed in details for all the shareholders and make them contribute in the decision making process. In other word, the previous case the decision must be taken from the shareholders' general meeting.
- b) The role of stakeholders. The CBK encourages the banks and the investment companies under consideration of this circulation to cooperate with the stakeholders in order to create healthy financial environment that attracts the capital whether from local or foreigner investors. Further, the instructions also urges for the contribution and the emergence of the corporate social responsibility towards the society.
- c) The disclosure and transparency. CBK provides for that the disclosure of the important information must be adequately disclosed to the shareholders and in fair and timely manner. Moreover, the require disclosure of information inclusive the

⁷⁴⁹ See The Central Bank of Kuwait Instruction to the Banks and the Investment Companies in Kuwait as regards the Corporate Governance Practice, issued on May 2004, at p 29

important information which is the information that affect the company`s share price whether up or down. Also the information is important if non-disclosure of such information would result in improper assessment as regards the investor`s decision.

- d) The board of directors and the executive management responsibilities. Amongst other thing this principle instruct the board of directors to take into consideration the candidate experience in the financial and banking sectors when it comes to the appointment of the executive managers. Moreover, the board of directors should exercise his authority in a way that support the achievement of the company`s strategy. As each department`s role should be identified and the authority and the responsibility should be clarified. Also the board of directors should ensure the effectiveness and the independence of the internal auditor of the company. Under this principle the board of directors responsible with the supervision of the board`s directors conflict of interests with the company and the board is require to ensure that the company`s directors are not using the insider information to gains private profits. The board of director is responsible before the company`s shareholders and the monitory authorities in Kuwait such as the Central bank of Kuwait as regards the accuracy of the financial information of the company that requires by such authorities.
- e) The audit committee and the board`s committees. According to this principle the board of directors should appoint audit committee report to the board of directors and constitute of three non-executive directors. The member of this committee should maintain financial experience and the function of this committee is to ensure the adequacy of the role of the internal and the external auditors. Furthermore, the committee should meet at least every three months and should furnish the board of directors with its reports on frequently basis. The CBK instructions best practice of corporate governance at the end recommended for the companies and banks under consideration to create nomination and remuneration committees.

It could be submitted that the corporate governance instructions that the CBK is recommending the investment companies and the banks in Kuwait to adopt are similar to a large extent to the OECD corporate governance principles (2004). However, imposing such instructions cannot be helpful unless it combines with proper enforcement mechanism to ensure that these instructions are reaping its benefits. While the practice showed that these instructions enforcement are obeyed like for example not all the companies have appointed audit committees.

Moreover, not all the board members appointments have taken into consideration the business experience of the candidate as recommended in CBK Corporate Governance instruction (D). Further, it is worth noting at this point that the CBK corporate governance instructions are applicable over the investment companies and banks that are listed in KSE and the non listed. In other words, not all the listed companies in KSE are subject to these instructions; thus, it would be argued that most of the KSE listed companies have been left without any corporate governance instructions.

Consequently, it would be suggested that the way of developing the practice in any stock market to increase the investors' confidence does not require a transplantation of a sound system that is applicable in a developing market. But the priority should be granted first to the cultural condition and the nature of the investors in such market. In other words, the corrections in a stock market should take into consideration the investors' behavior and then it should adopt a proper system that is compatible with the understanding of the investors under consideration.

Therefore, as stated in the previous chapters the fact that the GCC economies are mostly owned by either the State or business families could be one of the main reasons of the weaknesses of the corporate governance culture in these countries, and it will continue with the same condition until the shareholders of such countries be educated as regard their rights that are attached to their ownership of the shares. As a result, the corporate financing mechanism in the GCC hinders the application of the corporate governance in these countries companies since the excess for finance for these

corporations is based on the controlling shareholder name and not the company's condition. In other words, the relationship-based system is entrenched since there are no strict requirements imposed by the lender bank; thus, the investigatory role of the bank toward the application of the corporate governance will be absent, such as in the situation of Kuwait. Whereas, in developed countries such as Germany and Japan, the banks are playing a strong role toward the application of corporate governance in their companies because they require that some regulations must be implemented before they accept to offer the finances to such corporations.⁷⁵⁰

In this vein, the United Arab Emirates and Oman have taken steps in educating their investors about for example the dealing of shares according to rumors but not genuine and legally disclosed financial information about the corporation.⁷⁵¹ Accordingly, the corporate governance codes became important for the Kuwait Stock Exchange to protect the investors against the expropriations of the controlling shareholders since the ownership structure of the listed companies in KSE are concentrated and the management is in the major shareholder's hand in a large number of the companies provided that there must be adequate implementation for such codes.

In this context, *The Institute of International Finance* has proposed several elements for improving the corporate governance practice in the GCC; these elements are as follow:⁷⁵²

- Develop a strong regulatory structure by clearly separating and defining the roles of the regulator and the stock exchange.
- Increase effectiveness of regulators by making them fully independent of government.
- Issue meaningful corporate governance codes and require mandatory compliance.
- Build institutional capacity and strengthen surveillance and enforcement mechanisms to ensure compliance.

⁷⁵⁰ The Institute of International Finance and the Institute for Corporate Governance, *GCC Comparative Corporate Governance Survey: An Investor Perspective*, 2006, pp: 5-6

⁷⁵¹ *Ibid*, at p: 4

⁷⁵² *Ibid*.

- Strengthen the underlying corporate governance infrastructure by updating laws and creating specialized courts to deal with financial cases.
- Promote training programs for directors of listed companies.
- Promote investors education and enhance public awareness of good corporate governance principles and practices.
- Introduce corporate governance best practices for state-owned and family owned companies.
- Grant foreign investors full access to equity markets and promote shareholder activism by foreign and domestic institutional investors and the media.
- Create a regional level corporate governance task force to promote convergence and harmonization of laws and codes among GCC Countries.

In this vein, It could be submitted that the majority of the GCC countries have achieved the majority of the abovementioned recommendations, while Kuwait did not take any development steps except the introduction of the Capital Market Authority Law 7/2010, and it still not completely applied. Accordingly, it might be alleged that the underdevelopment of the Kuwaiti stock market can be attributed to the unrest relationship between the government and the parliament. Further, it has been argued that the condition of the political and governance institutions have a significant effect upon the private investment decisions since the good quality of such institutions could enhance the investment climate and improve the efficiency of the market of any country.⁷⁵³

Therefore, it could be stated that Kuwait should go faster as regards the application of the new Capital Markets Law to cope with developments and the competition with the other capital markets in the region. As in reality, it is a fact that the scope of the competition in relation to the way to attract the foreign capitals is wider than the GCC countries since the MENA countries are also in the development race towards the application of better investors' protection. In Egypt, for example, the corporate

⁷⁵³ See Aysan, A. F., Ange, Marie & Vezanzones-Varoudakis, 'Do Political and Governance Institutions Matter for Private Investment Decisions? The Case of the Middle East and North Africa', in Sayan, Serdar (ed), *Economic Performance in the Middle East and North Africa, Institutions, Corruption and Reform*, Routledge, USA, 2009, at p:94

governance code was issued according to the Investment Minister Resolution No. 332/2005; the code is not compulsive according to clause (1) subsection (1.4).⁷⁵⁴

7.5 Kuwait Stock Exchange (KSE) and its Laws and Regulations that should relate to Corporate Governance:

The related laws and regulations to corporate governance can be found in the stock market's regulations and in other laws, such as the company law, bankruptcy and takeovers law. Further, the laws and regulations that relate to the shareholders' protection differ from one jurisdiction to another. Moreover, the enforcement of these laws and regulations is important and is divided among three parties, the market regulator, the court and the stakeholders and shareholders themselves.

Furthermore, regulating the enforcement of the capital market regulations is better than leaving the enforcement to the market.⁷⁵⁵ Accordingly, the next section will consider the laws and regulations regarding the disclosure and the listing rules as corporate governance tools in the Kuwaiti Stock Exchange (KSE).⁷⁵⁶

7.5.1 Disclosure and Transparency:

The good stock exchange market is the one that committed to a well-established corporate governance practice that provides for a proper protection for the shareholders' rights and that maintains high standards of disclosure and transparency.⁷⁵⁷ The importance of the disclosure has been illustrated in the developed economies a long time ago. For example, the United States established disclosure in 1933 in the Securities Act

⁷⁵⁴ The Investment Minister Resolution No. 332/2005 in Egypt.

⁷⁵⁵ See La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R., 'Investor Protection and Corporate Governance', *Journal of Financial Economics*, 2000, Vol: 58, at p. 7.

⁷⁵⁶ In this chapter the corporate governance regulations in Kuwait Stock Exchange will be examined e.i., the disclosure and the listing rules only because the other corporate governance elements have been examined in chapter five such as the directors duties and the shareholders rights.

⁷⁵⁷ See A Corporate Governance Survey of Listed Companies and Banks Across the Middle East and North Africa, Published by International Finance Corporation, World Bank Group and The Institute of Corporate Governance (2008), pp. 11-12.

that deals with Initial Public Offerings (IPOs) and in the continuing reporting requirements found in the Securities and Exchange Act of 1934.⁷⁵⁸ Additionally, the importance of disclosure as an instrument for protecting the shareholders' rights, the Basle Committee on Banking Supervision and the IOSCO Technical Committee jointly recommended that the disclosure and transparency are strong pillars for monitoring the financial system and that accurate information be disclosed to the market's participants provided that this disclosure must be applicable in a timely manner to enhance the investor's ability to make an appropriate investment decision.⁷⁵⁹

Moreover, the OECD suggests in the same context that timely and accurately disclosure of information by the listed companies is important to maintain a sound corporate governance system.⁷⁶⁰ Furthermore, it has been argued that the proper disclosure by the company would minimize the risk level that the company might suffer because of any financial crisis.⁷⁶¹ Thus, the investors will take into consideration the disclosure practice by the company when they decide whether to invest or not, because good governance practice in any company provides proper protection for the shareholders.

In other words, the relationship between the best practice of corporate governance and investor confidence is twofold: the good practice of corporate governance by any company will lower the risk and unexpected problems and, at the same time, will enhance investor confidence that the managers will act in a manner that protects the shareholders and the company's interests.

⁷⁵⁸ See Al-Zumai, F., 'Comparative Study of the Legal Framework of Securities Disclosure Requirements in Kuwait and the U.S.', *Arab Law Quarterly*, 2007, at p: 234.

⁷⁵⁹ The Recommendations for Public Disclosure of Trading and Derivative Activities. Paper jointly issued by the Basel Committee on Banking Supervision and Technical Committee of the International Organization of Securities Commission (Basel, IOSCO,1999). Available at: <http://www.bis.org/publ/bcbs48.htm>, retrieved on 15/2/2011.

⁷⁶⁰ OECD Principles of Corporate Governance (2004).

⁷⁶¹ See A Corporate Governance Survey of Listed Companies and Banks Across the Middle East and North Africa, Published by International Finance Corporation, World Bank Group and The Institute of Corporate Governance (2008), pp. 11-12.

In contrast, the improper or inadequate disclosure of information by the listed companies may lead to unfair practices, since the asymmetry of information between the company's insiders and outsiders can affect the price of the company's shares up or down and could, as a result, may harm the investors' interests.

Additionally, the non-disclosure of important information might foster the deterioration of the investors' confidence in the stock market.⁷⁶² Further, the accurate and timely disclosure of information, whether financial or non-financial, supports the improvement of the economy's efficiencies.⁷⁶³ Therefore, the efficient disclosure rules could curtail fraudulent activities by company managers or controlling shareholders.⁷⁶⁴ Consequently, well-established disclosure requirements would in turn make fraudulent acts difficult to commit. Disclosure is, therefore, an important element of the corporate governance framework to achieve proper investors' protection.

7.5.2 The Disclosure: Compulsory v. Voluntary:

The consideration is being given to whether disclosure should be mandatory or should be regulated by the market forces through voluntary management decisions of companies. The provider of the information can do the voluntary disclosure through self-regulation. In contrast, mandatory disclosure is provided for in legislation and is enforced by the authorities empowered to do so.⁷⁶⁵ Furthermore, mandatory disclosure can be seen from one perspective as a detriment to the provider of information, as it may result in a free ride for the other competitors to take advantage in the competition between them.

On the other hand, the perspective that supports mandatory disclosure states that it might be better for the provider of the information if the disclosure regulations specify

⁷⁶²See Baamir, A. Y, 'Issues of Transparency and Disclosure in the Saudi Stock Market', *Arab Law Quarterly*, 2008, at p. 73.

⁷⁶³ *Ibid*, pp: 63-87.

⁷⁶⁴ See Meier-Schatz, Christian, 'Objectives of Financial Disclosure Regulation', *Journal of Comparative Business and Capital Market Law*, 1986, Vol: 8, at p. 221.

⁷⁶⁵ See Lannoo, Krel, 'The Emerging Framework for Disclosure', *The Journal of Corporate Law Studies*, 2003, Vol:3, Part:2, pp. 330-331.

the required information precisely.⁷⁶⁶ Hence, any capital market should ensure by its regulations at least that all of the major or minority investors receive the needed information regarding the companies in which they are investing.

Accordingly, those who support making the disclosure mandatory argue that the mandatory disclosure rules will protect the smaller investors. In addition, the mandatory disclosure rules will significantly restore the investors' confidence in the securities markets, because in these capital markets the investors would consider themselves in a fair game and the mandatory disclosure of information by the companies will enhance lessening the fraudulent acts in such markets.

Furthermore, it has been stated that there is a relation between the corporate governance and the financial disclosure regulations, as both aims to improve the supervision of each company's managers in the interests of the shareholders.⁷⁶⁷ Moreover, the mandatory financial disclosure can enhance the awareness of the shareholders and enable them to take efficient decisions, such as voting at the company's general meetings, which in turn indirectly improves the corporate practice and the capital market's effectiveness as an end result.⁷⁶⁸

Further, the mandatory financial disclosure regulation is a prominent factor in fighting self-dealing by company's managers and in encouraging them to discharge their duties in a better manner, such as their fiduciary duties to the company and the shareholders.⁷⁶⁹ In this regard, Bernard Black argues that, to make the security markets strong, the applicable laws and regulations must ensure two things: the investor should receive sufficient information about the companies, and each company's managers or controlling shareholders must not cheat the other shareholders.⁷⁷⁰

⁷⁶⁶ *Ibid*, at p. 330,

⁷⁶⁷ See Meier-Schatz, Christian, 'Objectives of Financial Disclosure Regulation', *Journal of Comparative Business and Capital Market Law*, 1986, Vol: 8, at p. 226.

⁷⁶⁸ *Ibid*, at p. 227.

⁷⁶⁹ *Ibid*, at p. 228.

⁷⁷⁰ See Black, Bernard, 'The Core Institutions That Support Strong Securities Markets', *Journal of Business Lawyer*, 2000, Vol: 55, at p. 1566.

Furthermore, an example of mandatory disclosure can be found in one of the developed markets, as the information asymmetry between the companies' insiders and outsiders has been addressed in the United States through the introduction of laws and regulations that enhance the credibility of the companies. As the so-called reputational intermediaries such as the market's brokers became subject to civil liability and to criminal prosecution in the United States once they were proven to have personally benefited from insider information in an intentional manner or to have disclosed the required information falsely. On the other hand, even with the existing strict laws and regulations in the United States to enforce the asymmetry of information, false disclosures continue, although their occasions and degree have been reduced.⁷⁷¹

Consequently, the information disclosed by any listed corporation should be maintained at a high standard of quality and credibility, because this should be the goal affirmed by sound corporate governance. In this context, the credibility of the disclosed information is an internal corporate control against the behavior of opportunistic managers and will control to a large extent the asymmetry of information between company insiders and outsiders.⁷⁷² Thus, it is a fact that disclosure and transparency have a significant influence upon curbing the controlling shareholders from benefitting privately from their control of the company at the expense of the other shareholders by using information that is not available to the other shareholders, especially when the business is family owned.⁷⁷³

Accordingly, the importance of disclosure stems from the fact that the disclosure of financial information, for example, can be an effective determinant factor when either an investor is willing to invest in a company or when an investor is choosing the company in which he wishes to invest. In addition, disclosure of a company's financial and non-financial information can improve shareholder monitoring of the company's management.

⁷⁷¹ *Ibid*, at p. 1568.

⁷⁷² See Li, Hongxia, & Qi, Ainian, 'Impact of Corporate Governance on Voluntary Disclosure in Chinese Listed Companies', *Corporate Ownership & Control*, 2008, Vol:5, Issue:2, at p. 360.

⁷⁷³ See Golberman, S, Peng, M & Shapiro, D., 'Corporate Governance and Asia Companies', *Asia Pacific Journal of Management*, 2010, Vol: 28, at p. 8.

Therefore, there should be a disclosure of accurate and credible information to the investors of a company.⁷⁷⁴ Again, Bernard Black asserts in this context: ‘Delivering information to investors is easy; but delivering credible information is hard.’⁷⁷⁵ Therefore, to facilitate the disclosure of credible information regarding companies requires the imposition of mandatory provisions that compel companies to disclose accurate and credible information.⁷⁷⁶ Moreover, the laws and regulations that require mandatory disclosure usually contain penalties for violation of their provisions.

Consequently, the mandatory disclosure regulations are important to attain the investor confidence in the capital market. Also it has been argued that the access to a company’s information by all investors is an anti-fraud mechanism, which, in turn, restores investor confidence and makes investors sure that no one is exploiting their investments.⁷⁷⁷

Turning to the other way of disclosure is the voluntary disclosure of information by companies. Companies usually improve their voluntary financial disclosure when they intend to offer their equity to the public to attract investors.⁷⁷⁸ The voluntary disclosure by a company’s managers can play a significant role in minimizing the agency costs that the shareholders supposed to pay to monitor the company’s managers, as the managers can provide satisfactory information in the annual report to the shareholders. In contrast, the agency cost will rise if the company’s managers prepare the annual statement without disclosing useful information about the company’s situation to the shareholders.⁷⁷⁹

⁷⁷⁴ See Gilson, Ronald J., Transparency, Corporate Governance and Capital Markets, The Latin American Corporate Governance Roundtable, 26-28 April, 2000, The Sao Paulo Stock Exchange, Brazil. at p. 5.

⁷⁷⁵ Bernard Black statement Quoted in Gilson, Ronald J., Transparency, Corporate Governance and Capital Markets, The Latin American Corporate Governance Roundtable, 26-28 April, 2000, The Sao Paulo Stock Exchange, Brazil. at p. 5.

⁷⁷⁶ See Gilson, Ronald J., Transparency, Corporate Governance and Capital Markets, The Latin American Corporate Governance Roundtable, 26-28 April, 2000, The Sao Paulo Stock Exchange, Brazil. at p. 7.

⁷⁷⁷ See Easterbrook, F., & Fischel, D., *The Economic Structure of Corporate Law*, Harvard University Press, U.S., 1991, at p. 296.

⁷⁷⁸ See Beyer, Anne & Guttman, Ilan, Voluntary Disclosure, Disclosure Bias and Real Effects, 2010, *Rock Center for Corporate Governance at Stanford University Working Paper No. 85*. Available at SSRN: <http://ssrn.com/abstract=1647808>, retrieved on 8/3/2011.

⁷⁷⁹ See Al-Shammari, Bader & Al-Sultan, Waleed, ‘Corporate Governance and Voluntary Disclosure in Kuwait’, *International Journal of Disclosure and Governance*, 2010, Vol: 7, Issue: 3, at p. 266.

In this regards, several studies have identified the relationship between voluntary disclosure by companies and other elements. For instance, these studies have suggested that non-executive boards of directors will provide better checks and balances of opportunistic executive directors and the company`s management.⁷⁸⁰

Moreover, when the number of non-executive directors on a company`s board is more than the number of executive directors, disclosure will be improved. Other studies have revealed that there is no relationship between the number of non-executive directors on the company`s board and voluntary disclosure. In particular, in Singapore and Hong Kong, several studies disprove the relationship between voluntary disclosure and the number of the non-executive directors on the company`s board.⁷⁸¹

Another factor that could influence the voluntary disclosure of a company`s information is the number of family directors that sit on the company`s board. In the stock market where the ownership structure is concentrated, and family ownership is entrenched, voluntary disclosure is minimal if it not occurs at all.⁷⁸² In this regard, the appointment of the independent directors and the non-executives directors emerges as *the OECD Steering Group on Corporate Governance* suggested the importance of appointing independent directors to ensure impartial decisions:

‘The board should consider assigning a sufficient number of non-executive board members capable of exercising independent judgments to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of

⁷⁸⁰ See Franks, Mayer, & Renneboog, L., ‘Who Discipline Management in Poorly Performing Companies’, *Journal of Financial Intermediation*, 2001, Vol: 10, Issue 3-4, pp. 209-248.

⁷⁸¹ See Al-Shammari, Bader & Al-Sultan, Waleed, ‘Corporate Governance and Voluntary Disclosure in Kuwait’, *International Journal of Disclosure and Governance*, 2010, Vol: 7, Issue: 3, at p. 267. For more detailed information about these studies, see, Eng, L., & Mak, T., 2003, Corporate Governance and Voluntary Disclosure, *Journal of Accounting and Public Policy*, Vol: 22, No: 4, pp. 325-345. And Ho, S., & Wong, K., 2001, A Study of the Relationship Between Corporate Governance Structure and the Extent of Voluntary Disclosure, *Journal of International Accounting, Auditing and Taxation*, Vol: 10, No: 2, pp. 139-156.

⁷⁸² See Al-Shammari, Bader & Al-Sultan, Waleed, ‘Corporate Governance and Voluntary Disclosure in Kuwait’, *International Journal of Disclosure and Governance*, 2010, Vol: 7, Issue: 3, at p. 267.

financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives, and board remuneration.⁷⁸³

Furthermore, the independent directors are efficient corporate governance mechanisms, since they represent the shareholders.⁷⁸⁴ Also the non-executives directors markedly curtail the conflict of interest between the company's directors and the shareholders, since they are the shareholders eyes in the boardroom. In the same vein, Fama described non-executives as 'professional referees whose task is to stimulate and oversee the competition among the firm's top management'.⁷⁸⁵

In addition, since it is not easy to enact laws and regulations that can change the behavior of company board members, it is important that self-regulation contribute to such development.⁷⁸⁶ Accordingly, a large number of the listed companies in the KSE are owned by the founding family, and consequently the board of directors of such companies are composed of a substantial number of the owning family members whether as executives directors or as non-executives.

Furthermore, AL-Shammari et al, having examined the annual report (2007) of 170 companies listed in the KSE, hypothesized: 'Companies with a higher proportion of family members on the board are more likely to have a lower level of the voluntary disclosure.' They also suggested that the CEOs of the listed companies in the KSE, who are also the chairman of the board of directors, disclose less information to the

⁷⁸³ See *Corporate Governance and the Financial Crisis, Conclusion and Emerging Good Practices to Enhance Implementation of the Principles*, Paper by Directorate for Financial and Enterprise Affairs, OECD Steering Group on Corporate Governance, February 2010, at p. 10.

⁷⁸⁴ Samaha, Khaled, 'Do Board Independence and Audit Committees Motivate Disclosure on Different Corporate Governance Information Categories in the Annual Reports in Developing Countries?', *International Research Journal of Finance and Economics*, 2010,, Issue: 57, at p. 210, also see Pincus, K., Rusbarsky', M., & Wong, J., 'Voluntary formation of corporate audit committees among NASDAQ firms', *Journal of Accounting and Public Policy*, 1989, Vol: 8, pp: 239-265.

⁷⁸⁵ Fama, E, 'Agency problems and the theory of the firm', *Journal of Political Economy*, 1980, Vol: 88, at p. 294.

⁷⁸⁶ See *Corporate Governance and the Financial Crisis, Conclusion and Emerging Good Practices to Enhance Implementation of the Principles*, Paper by Directorate for Financial and Enterprise Affairs, OECD Steering Group on Corporate Governance, February 2010, at p. 17.

shareholders.⁷⁸⁷ In addition, they suggested that the listed companies that voluntarily appointed an audit committee have a higher level of voluntary disclosure of information to the public.

Yet, some studies argue that there is a relationship between the voluntarily appointment of the audit committee and the voluntary disclosure of information. Other studies disagree with such findings.⁷⁸⁸

According to the findings of *the Corporate Governance Survey of Listed Companies and Banks Across the Middle East and North Africa* the disclosure of information by banks and the listed companies is weak, due to the absence of the legal and the regulatory requirements that call for the company's disclosure of information to its shareholders.⁷⁸⁹ As the finding also have revealed that 62% of the managers and the directors benefited from insider information at the expense of other shareholders.⁷⁹⁰ Furthermore, disclosure and transparency are aims of all of the security markets around the world in order to entrench the confidence and fairness among all investors and it should promote protection of the shareholders and enhance the best practices of corporate governance.⁷⁹¹

7.5.3 Disclosure of Ownership Interests:

The disclosure of ownership interests aims at protecting the investors, ensuring the safety of dealing in the stock market, and building confidence between investors. In

⁷⁸⁷ See Al-Shammari, Bader & Al-Sultan, Waleed, 'Corporate Governance and Voluntary Disclosure in Kuwait', *International Journal of Disclosure and Governance*, 2010, Vol: 7, Issue: 3, at p. 268.

⁷⁸⁸ See Al-Shammari, Bader & Al-Sultan, Waleed, 'Corporate Governance and Voluntary Disclosure in Kuwait', *International Journal of Disclosure and Governance*, 2010, Vol: 7, Issue: 3, at p. 269, for further details, see Ho, S., & Wong, K., 'A Study of the Relationship Between Corporate Governance Structure and the Extent of Voluntary Disclosure', *Journal of International Accounting, Auditing and Taxation*, 2001, Vol: 10, No: 2, pp. 139-156, and Abdullah, S, & Mohd- Nasir, N., 'Accrual Management and the Roles of Boards of Directors and Audit Committee Among Malaysian Listed Companies: Evidence During the Asian Financial Crisis', *IIUM Journal of Management and Economic*, 2004, Vol: 12, No: 1, pp. 49-80.

⁷⁸⁹ See *A Corporate Governance Survey of Listed Companies and Banks Across the Middle East and North Africa*, Published by International Finance Corporation, World Bank Group and The Institute of Corporate Governance (2008), at p. 55.

⁷⁹⁰ *Ibid*, at p: 59.

⁷⁹¹ See Meire-Schatz, Christian, 'Objectives of Financial Disclosure Regulation', *Journal of Comparative Business and Capital Market Law*, 1986, Vol: 8, pp. 220-227.

practice, the disclosure of ownership entails the disclosure of the name of the shareholder and the number of shares he or she has acquired. However, these requirements vary between countries, since some countries require more information, such as the purpose of acquiring the number of shares.⁷⁹² Moreover, the disclosure of interest of a company's shares brings the investor's attention to the new shareholder or shareholders, as they may bring with them new changes to the company, since they may intend to change the board of directors and to appoint their own staff.⁷⁹³

Thus, disclosure may support the company's investors by making them aware of the newcomer shareholder and to enable them to resist if the new shareholder will adversely impact their interests. Since any new shareholder, who purchases a block of shares, must either intend solely to invest or to invest and make changes to the company, the shareholders should be aware of such intentions to protect their own interests either by securing their own positions or by selling their interests. In the same vein, many national and international organizations have experienced the consequences of such disclosure requirements. The European Community has stated that the proper disclosure of information concerning the transfer of share ownership improves investor protection.⁷⁹⁴ Further, one of the U.S.A federal courts stated that 'the disclosure is created for proper protection of investors and to ensure fair dealing in the securities.'⁷⁹⁵

In addition, OECD Principles on Corporate Governance state: 'One of the basic rights of investors is to be informed about the ownership structure of the enterprise and their rights vis-à-vis the rights of other owners.' Moreover, the requirement to disclose the ownership structure enhances the best practice of corporate governance, since it supports the supervision of the shareholders over management and the controlling

⁷⁹² See Schouten, M., & Siems, M., 'The Evolution of Ownership Disclosure Rules Across Countries', *The Journal of Corporate Law Studies*, 2010, Vol: 10, Part: 2, at p. 477.

⁷⁹³ Ahmed Al-Melhem, 'Comment on Kuwait Law No: 2/1999 Concerning the Disclosure of Interests in Shares in the Light of Comparative Laws', *Arab Law Quarterly*, 2000, Part 3, Vol: 15, at p. 226.

⁷⁹⁴ See European Community Council Directive of 12/12/1988 on information that should be disclosed when someone acquires a major number of shares in a listed company (88/627/EEC).

⁷⁹⁵ *DuPont v. Wyly D.G. Del*, 61 F.R.D. 615 (1973). Quoted in Ahmed Al-Melhem, 'Comment on Kuwait Law No: 2/1999 Concerning the Disclosure of Interests in Shares in the Light of Comparative Laws', *Arab Law Quarterly*, 2000, Part 3, Vol: 15, at p. 228.

shareholders, and it also detects any conflict of interest, insider trading, and transactions between related parties.⁷⁹⁶

The UK Financial Services Authority (FSA) regulations require shareholders to give the FSA a notification of acquiring or disposing of major shareholding, as DTR 5.3.1 requires the notification to be given when the shareholder's shares reach 3% or more of the company's capital after acquiring or disposing shares.⁷⁹⁷ Notably, the threshold for the ownership interest disclosure varies between countries. In the UK, the ownership interest is 3%, Italy 2%, France 5%, Canada 10%, US 5%, and in Russia 25%.⁷⁹⁸ There is almost a convergence among the countries around the world at a threshold of 3% for the disclosure of ownership.⁷⁹⁹

The disclosure of ownership can vitally improve the financial markets from the perspective that the disclosure of the ownership required at the initial public offers encourages the investors to make their investment decisions duly, as it will identify the major shareholder, and such identification will inform the investor about the extent of the agency cost that they will pay if a specific investor becomes the controlling shareholder. Consequently, ownership disclosure improves the corporate governance practice that in turn minimizes agency cost.⁸⁰⁰

In particular, the importance of the disclosure of interest emerges in countries that the ownership structure in concentrated the minority shareholders protection particularly against the controlling shareholders malpractices is paramount amongst other issues.⁸⁰¹ Kuwait, the country under consideration in this work, is one of the countries in which ownership is heavily concentrated among the companies listed in the KSE.

⁷⁹⁶ OECD Principles of Corporate Governance (2004), at p. 51.

⁷⁹⁷ The UK Financial Services Authority Handbook, Section DTR 5.3.1.

⁷⁹⁸ See Schouten, M., & Siems, M., 'The Evolution of Ownership Disclosure Rules Across Countries', *The Journal of Corporate Law Studies*, 2010, Vol: 10, Part: 2, at p. 460.

⁷⁹⁹ *Ibid*, at p: 474.

⁸⁰⁰ *Ibid*, pp: 454-455.

⁸⁰¹ See Schouten, M., & Siems, M., 'The Evolution of Ownership Disclosure Rules Across Countries', *The Journal of Corporate Law Studies*, 2010, Vol: 10, Part: 2, at p. 453.

A recent comparative study regarding the ownership structure in the KSE market and the Saudi Capital Market revealed that the declared ownership in the Saudi market is 61% of the market capital, while the percentage in Kuwait is 46%. Furthermore, the study identified that the Kuwaiti government ownership in the Kuwaiti stock markets is about 13%, and that the Saudi government ownership in the Saudi market is about 37%.⁸⁰² Therefore, the disclosure of ownership interests of the listed companies in the KSE is vital to the protection of investors.

In Kuwait, the Disclosure of Interests Law passed under No: 2/1999 and is composed of five articles. The first article stipulates the conditions for disclosing the interests in shares of a listed shareholding. The second article defines the interests in a listed shareholding. Article three provides for the procedures, the date and the way to disclose the interests of a listed shareholding. Article four requires the KSE management to take the necessary actions to ensure the accuracy of the disclosed interests information by the shareholder. Article 5 states the penalties for infringements against the Disclosure of Interests Law.

In detail, the listed companies in the KSE are required to disclose every shareholder interest that reaches five percent or more of the company's capital, whether the ownership is direct or indirect, and all changes in the interest's percentage of any listed company in the KSE must be disclosed as well.

Furthermore, the Law of Disclosure of Interests in Kuwait requires the shareholder to disclose his interest in every company in which he owns 20% or more if that company at the same time owns 5% of a company listed in the KSE. This law is the only clear legal instrument that relates to disclosure as regards the companies that are listed in the KSE. The penalties for violating the disclosure law provisions are: the exclusion of shares under violation of the required quorum for convening the General Assembly or to vote at

⁸⁰² A statistical comparison between the capital markets of Kuwait and Saudi Arabia, as in 28/02/2011, conducted by Al-Joman Center for Economic Consultations, available at <http://www.aljoman.net/aljomanar/newsr/ViewReportsUsers.aspx?&repId=322>, retrieved on 8/3/2011.

its meetings for two consecutive terms or to prevent the violator from standing for membership on the board of directors for two consecutive terms.

The Transparency Society in Kuwait has argued in their report “*Kuwait Stock Exchange Market, the Determination of the Weaknesses and the Shortcomings and the Optimal Solutions and Recommendations*” that the lenient penalties provided for in the Disclosure Law No: 2/1999 have encouraged the listed companies’ management not to disclose the information and to accept the penalties, because they might see that accepting the penalty for nondisclosure of the information that should be disclosed is better than disclosing such information.⁸⁰³ However, if the penalties were stricter, then the companies’ managements would be in greater compliance with the disclosure requirements. On this point, Professor Al-Melhem has recognized several imperfections in the Disclosure of Interests Law No: 2/1999, as the legislator did not take sufficient time and consultation during the legislative process for this law.

Moreover, the law came with a very short explanatory note, which may affect the interpretation of its provisions.⁸⁰⁴

In this regard, the investors in the KSE benefit in terms of the disclosure of interests, since such disclosure in the listed companies can provide a more transparent image to the investors in such companies. Such disclosure gives the investors sufficient information upon which to base their investment decision properly. Likewise, the new shareholders who become owners of a significant amount of shares also might affect the determination of a potential investor’s investment decision.⁸⁰⁵ Further, the Kuwaiti Law of the Disclosure of Interest is preserving the secrecy of the trade in the Stock Exchange Markets, because the registry of the shareholders names is maintain by the stock

⁸⁰³ See The Transparency Society of Kuwait, ‘*Report of Kuwait Stock Exchange Market, the Determination of the Weaknesses and the Shortcomings and the Optimal Solutions and Recommendations*,’ Kuwait, June 2006, at p. 10.

⁸⁰⁴ Ahmed Al-Melhem, ‘Comment on Kuwait Law No: 2/1999 Concerning the Disclosure of Interests in Shares in the Light of Comparative Laws’, *Arab Law Quarterly*, 2000, Part 3, Vol: 15, at p. 224.

⁸⁰⁵ *Ibid*, at p. 221.

exchange authority. Dr. ALmelhem has condemned such provisions and encourages that disclosure be made to all shareholders.⁸⁰⁶

In other words, it is better for the protection of the shareholders' rights if the registry of their names and share numbers are available to all shareholders, which in turn would enhance the best practice of corporate governance.

The disclosure of interests in Kuwait is not dissimilar to the practice in other GCC countries. For instance, disclosure in Bahrain is required to be only for the stock exchange authority, as the result of which the investors are not entitled to benefit from such information to evaluate the company in which they want to invest.⁸⁰⁷ Accordingly, if the disclosure of interests in the KSE is regulated, but the penalties imposed upon violators are weak, which results in hindering the enforcement of the law. Therefore, to ensure the proper application of the law, the penalties should be sufficiently severe to deter violations of the law's provisions especially in Kuwait, where the enforcement mechanisms are weak and inefficient.

7.5.4 The Disclosure of Financial and Non-Financial Information:

In order to examine the level of shareholder protection under the KSE laws and regulations that relate to disclosure requirements, several facts should be addressed. Firstly, the Companies Law in Kuwait No. 15/1960 requires that the financials of joint-stock companies be subject to auditing by two registered financial auditors, and their reports must be submitted to the Ministry of Commerce and Industry within than three months after the end of the company's financial year. In addition, the same statement must be submitted to the KSE.

Moreover, this financial statement must also be circulated amongst the company's shareholders. However, the Kuwaiti Companies Law has not addressed the way that the

⁸⁰⁶ *Ibid*, at p. 238.

⁸⁰⁷ See The Bahraini Disclosure Standard Guideline (2004), Article 35.5.1.

financial statement should be prepared. The Kuwait Stock Exchange Market Law 1983 requests the applied company to be listed to show that some specific accounting standards have been met.⁸⁰⁸ For example, the company that seeks to be listed in the KSE must have issued its annual financial accounts for the previous two years and have verified a proper financial structure with a reasonable profit.

The standard by which the accounting report should be conducted by the companies listed in the KSE is regulated outside of the scope of the Companies Law, since the standards have been provided for by the Ministry of Commerce and Industry. Further, Ministerial Resolution No. 18 of 1990 stipulated that all listed and non-listed companies must adhere to the International Financial Reporting Standards.⁸⁰⁹

Accordingly, the disclosure of the financial or non-financial information that relate to the affairs of the listed companies is one of the most important issues in enhancing the best practice of corporate governance. In other words, disclosure is a fundamental tool in significantly increasing the shareholders' protection, especially since the other laws and regulations that relate to shareholder protection are weak or absent.

Hence, the company's disclosure of information and its transparency are significant factors in facilitating shareholder monitoring of the company. Disclosure is important to the investment decision, since 69% of the investors in a study recognized transparency and disclosure as among the most importance factors that determine their investment decision.⁸¹⁰ Further, the information that should be disclosed by the company to enhance the shareholders' protection can be categorized into two types of information: financial information and non-financial information.

⁸⁰⁸ Visit Kuwait stock Exchange website at www.kuwaitse.com

⁸⁰⁹ Ministerial Resolution No. 18 of 1990 stipulated that all listed and non-listed companies in KSE must adhere to the International Financial Reporting Standards

⁸¹⁰ See A Corporate Governance Survey of Listed Companies and Banks Across the Middle East and North Africa, Published by International Finance Corporation, World Bank Group and The Institute of Corporate Governance (2008).

The financial information can be provided to the shareholders through the company's general assembly, the annual report and the company's website. Non-financial information that must be disclosed to the investors includes, for example, the company's ownership structure, stockholder voting rights, the company's article of association, and its by-laws. In Kuwait, the required disclosure of financial and non-financial information regarding the companies listed in KSE is distributed among the provisions of several laws and regulations.

Article (17) of the Amiri Decree, for example, the regulations for the KSE and requires the listed companies to disclose to the market management all information and resolutions that affect securities prices. Furthermore, in the same context, every company should sign a commitment form before it becomes listed in the KSE, article (4) of which stipulates that the company is committed to inform the KSE management of all information that might affect the share prices before such information is published in the media.

The required disclosure must satisfy the following points: the information must be genuine, the information must be sufficient to enable the investors to evaluate the company's condition, and the disclosure must avoid the omission of any information, even if this information is against the company. In general, the disclosure rules that govern the companies listed in the KSE are sufficient and impose correctly the duties upon the companies under consideration. However, the enforcement of the disclosure rules in the KSE seems to be ineffective, and the shareholders' rights have consequently been greatly undermined.

In particular, shareholder protection in Kuwait is below the proper standards because of inadequate enforcement of the disclosure requirements amongst other things. Consequently, the disclosure requirements that have been imposed upon the KSE listed companies have failed on several occasions, which has undermined shareholder protection. This failure is particularly acute, since ownerships are concentrated and most

of the listed companies in the KSE are family owned.⁸¹¹ Moreover, many of the listed companies are controlled by the major shareholders. But, when there is no controlling shareholder, and the control is diffused among all or most of the board members, expropriation or the private benefit of control will be minimized, because decisions will require the agreement of all or the majority of the board members.⁸¹²

The disclosure regime in the KSE failed to control two main areas of disclosure, the Executives Remunerations and the related party transaction. The Greenbury Report in the UK recommended that company annual reports should contain each company's directors' remuneration policy and detailed information regarding the way the remuneration is determined.⁸¹³ These recommendations were included in the UK Combined Code (2008).⁸¹⁴

Consequently, the previously stated disclosure requirements, due to their importance, were exempted from the Comply and Explain and became compulsory for the companies in the London Stock Exchange (LSE) according to section 420 of the UK Companies Act 2006. Any violation of this section's provisions is a criminal offence. Kershaw has elaborated the motive behind the companies' directors' remunerations as follow:

'Disclosure makes it easier for shareholders to have an informed view of the company's executives' pay arrangements and to judge whether such arrangements reflect an abuse of managerial power or are arrangements appropriately tailored to attract the best managers and maximize the efforts of those managers. Disclosure reduces the cost of gathering information about pay and thereby facilitates shareholder action...'.⁸¹⁵ Moreover, the Saudi Companies Law provides in Article 74/3 regarding this issue:

⁸¹¹ www.Kuwaitse.com, retrieved on 7/4/2011.

⁸¹² See La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R., 'Investor Protection and Corporate Governance', *Journal of Financial Economics*, 2000, Vol: 58, at p. 13. Also see Bennedsen, M., and Wolfenzon, D., 'The Balance of Power in Closely Held Corporations', *Journal of Financial Economics*, 2000, Vol: 58, pp. 113-139.

⁸¹³ The UK Greenbury Report, Recommendations, Section B, available at: <http://www.ecgi.org/codes/documents/greenbury.pdf>, retrieved on 23/2/2011.

⁸¹⁴ The UK Combined Code (2008).

⁸¹⁵ See Kershaw, David, *Company Law in Context, Cases and Materials*, Oxford University Press, UK, 2009, at p. 274.

“The board of directors’ report to the regular GM must include a comprehensive statement of all the amounts received by directors during the financial year in the way of emoluments, share in the profit, attendance fees, expenses, and other benefits, as well as of all the amounts received by the directors in their capacity as officers or executives of the company, or in consideration of technical, administrative, or advisory services”.

The current disclosure requirements regarding the remunerations of the directors of the company boards and the top managements are inefficient in Kuwait because of the moderation of the applicable laws and regulations. Furthermore, elements have participated in worsening the current disclosure defects in the KSE, the concentrated ownerships and control by the major shareholders.⁸¹⁶ Therefore, Kuwait should develop disclosure regulations about executive remunerations to enhance the shareholders’ protection by enabling them to access the information required to enable them to determine the fairness of such remuneration.

In addition, disclosure of the remunerations of directors of the companies listed in the KSE will support the supervision by the shareholders and will improve the shareholders’ confidence in the KSE will be improved as they will be aware of how the remuneration of the directors is calculated. Further, such disclosure will deter the executives of a company from benefiting illegally by taking excessive remunerations, as all of the information will be in the hands of the shareholders, who may investigate any compensation irregularities.⁸¹⁷

The applicable laws in Kuwait are also weak with regard to the disclosure of information about related party transaction. The disclosure requirement of such transactions in Kuwait is weak and ineffective, because the only legal requirement for the legitimacy of related party transaction is the approval at a general meeting of shareholders as required by the Companies Law of Kuwait.⁸¹⁸

⁸¹⁶ *Ibid.*

⁸¹⁷ *Ibid.*

⁸¹⁸ See Article 151 of the Kuwaiti Commercial Companies Law 15/1960.

In practice, the board of directors gains this approval from the shareholders in the general meeting a year in advance. This practice undermines the rights of the shareholders, because the annual report of the listed companies does not provide sufficient information to the shareholders to enable them to exercise their fair judgment and make proper decisions regarding such transactions. The annual report of the companies listed in the KSE usually mentioned just the amount of the related party transactions and no other information.⁸¹⁹

In this regard, many countries have dealt with the related party transaction in a stricter manner. In the UK, the FSA's listing rules require the listed companies to disclose full and detailed information about any related party transaction to the company's shareholders pursuant to Rule 11.1.7. In addition, this rule requires each company to obtain the shareholders' approval of every related party transaction. Moreover, to clarify the meaning of a related party transaction, the FSA listing rules define the related party and the related party transaction in a separate section.

The related party is defined in Rule No. 11.1.4, and the related party transaction in Rule No. 11.1.5. Further, Rule No. 13.6 mentions the information that should be provided to enable the shareholders to decide about the related party transactions.⁸²⁰ Whereas, the same situation is governed in the United Arab Emirates by Article 108 of the Companies Law No: 8/1984, which requires only one condition for the validity of the related party transaction i.e. to obtain the prior shareholders' approval at the general meeting of the company.

In contrast, in Bahrain, the listing requirements of the stock markets require the companies to disclose material information about the related party transactions in the company's annual financial report.⁸²¹ Accordingly, shortcomings in the disclosure system regarding related party transactions definitely hinder the corporate governance practice,

⁸¹⁹ www.Kuwaitse.com. Retrieved on 22/4/2011

⁸²⁰ Listing Rules of the Financial Services Authority in the UK. Available at <http://fsahandbook.info/FSA/html/handbook/LR>, retrieved on 23/2/2011.

⁸²¹ See Bahraini Disclosure Standards Guidelines (2004), Article 35.4.

as the shareholders are not entitled to investigate such transactions due to the absence of the legal requirement for full disclosure of this kind of transaction.

7.5.5 Listing Rules in Stock Markets and Their Role Regarding the Application of Corporate Governance:

The listing rules in many securities markets have participated prominently in increasing investor protection by providing a better application of corporate governance in the listed companies, since the listing rules are a prerequisite or a requirement that must be fulfilled by the candidate company to list its securities in the capital market. Moreover, in some countries, the listing rules incorporate a code of the best practice of corporate governance, while the corporate governance codes in other countries provide for corporate governance in a separate document, and, at the same time, the listing rules usually contain a variety of provisions that enhance the shareholders' protection. In the same vein, La Porta et al argued that the quality of a capital markets depends upon the rules that govern the companies and the disclosure.⁸²²

Further, the American experience in improving the listing rules can be recognized after the financial crisis in the United States (2008), as there was a recommendation that the listing rules must be revised to include more rules to enhance corporate governance practice in the listed companies to protect the investors against any financial crises in the future.⁸²³ Furthermore, following the 2002 crisis in the United States, stricter instructions were imposed over the accounting control of the listed companies than the other issues.⁸²⁴

The Sarbanes Oxley Act (SOA 2002) obliges the stock market not to list any securities if the company does not comply with certain corporate governance

⁸²² See Rafael, La Porta, ilanes, Lopez, Shleifer, Andrei and Vishny, Robert W., 'Law and Finance', *Journal of Political Economy*, 1998, Vol: 106, No: 6, pp 1113-1155.

⁸²³ See Karessa, Cain, 'New Efforts to Strengthening Corporate Governance: Why Use SOR Listing Standard', *Columbia Business Law Review*, 2003, at p 620.

⁸²⁴ See Coffee, J., , 'What Went Wrong? An Initial Inquiry Into The Causes of The 2008 Financial Crisis', *Journal of Corporate Studies*, 2009, Vol: 9, Part: 1, at p. 2.

standards.⁸²⁵ Section 301 of SOA provides that no company will be listed in the stock exchange unless it has an audit committee composed only of independent directors, and these members of the audit committee are required to have financial experience at the time of appointment as provided for in both the Nasdaq and the American Stock Exchange (Amex) rules.⁸²⁶ Moreover, as regards corporate governance in Australia, the Australian Stock Exchange (ASX) requires that every company that wants to be listed in its stock market must comply with the listing rules. Such listing rules in section 4.10.3 require the listed companies to contain in the company's annual report information about the company's compliance with the best practices of corporate governance. Section 4.10.3 requires:

‘A statement disclosing the extent to which the entity has followed the best practice recommendations set by the ASX Corporate Governance Council during the reporting period. If the entity has not followed all the recommendations, the entity must identify those recommendations that have not been followed and give reasons for not following them...’⁸²⁷

Article (9) of the applicable rules for listing in the KSE provides:

“ The company's board members shall pledge to adhere to all the rules and regulations set by the Kuwait Stock Exchange and to provide the KSE management with all of the required data and information, provided that this information is correct and reliable”.⁸²⁸

Accordingly, listing rules under the existing laws and regulations of the KSE do not impose any requirement regarding the disclosure of information except that the board of directors of the company that applied to be listed in the KSE must undertake to comply

⁸²⁵ See Karessa, Cain, ‘New Efforts to Strengthen Corporate Governance: Why Use SOR Listing Standard’, *Columbia Business Law Review*, 2003, at p. 621.

⁸²⁶ *Ibid*, at p: 631.

⁸²⁷ Australia Stock Exchange Listing Rules No: 4.10.3 regarding additional information to be included in the listed companies' annual report, available at <http://www.asxgroup.com.au/media/PDFs/Chapter04.pdf>, retrieved on 3/3/2011.

⁸²⁸ Kuwait Stock Exchange Committee decision no. (2) for the year 2008 concerning the rules and conditions for listing shareholding companies in the Official Market Article (9), available at <http://kuwaitse.com/PORTAL/KSE/LISTING.ASPX>, retrieved on 22/2/2011.

with the resolutions and the regulations of the KSE and that they provide all of the information requested by the KSE management.⁸²⁹

Therefore, the listing rules of the KSE have no provisions that might enhance the shareholders' protection, whereas, many other markets have benefits from the flexible nature of the listing rules and adjust them in a manner that increase the shareholders' protection by providing for corporate governance issues. Although the securities markets in the United Kingdom and Saudi Arabia have separate corporate governance rules, both listing rules could incorporate more provisions that would increase the shareholders' protection as well.

In the UK, the listing rules, for example, provide for full disclosure of every related party transaction pursuant to Rule No. 11.1.4. Furthermore, in Saudi Arabia, the disclosure obligations stipulated in the listing rules add significantly to investors' protection. In addition, Article (29) of the Saudi Capital Markets listing rules provides that the capital market authority has the power to require every listed company to comply with the specific rules of corporate governance that are important for the protection of each company's investors.⁸³⁰

Moreover, within MENA securities market, the corporate governance practice in Egypt is notable and can be traced to 2002, as new listing rules were issued that focus primarily on the compliance with corporate governance practice. These Egyptian listing rules provide for a variety of issues that intend to improve the corporate governance practice as the disclosure requirements have been improved regarding the financial statements, the board members' transactions, the audit committees, and the auditors. Moreover, Articles 34-35 of the Egyptian listing rules stipulate that a company will be de-listed if it fails to comply with the corporate governance requirements provided for in

⁸²⁹ See the Resolution of the Market Committee of Kuwait stock Exchange Market No: 2/2008 regarding the Listing Rules, available on: <http://kuwaitse.com/PORTAL/A/KSE/LISTING.ASPX> retrieved on 15/3/2011.

⁸³⁰ The Saudi Listing Rules were issued pursuant to the Boards of the Saudi Capital Market Authority's Resolution No. 3-11-2004, dated 20811425 H (04.10.2004). Also, the Listing Rules were amended by Resolution of the Board, No. 2-128- 2006, dated 22/1/2006.

the listing rules.⁸³¹ The securities market listing rules can be an enforcement mechanism that confronts the violations of the disclosure rules by providing for fines or de-listing of the violated company as a punishment,⁸³² such practice is not recognized under the KSE laws and regulations. In other words, the KSE has not identified the benefits that can be obtained from providing provisions that increase the investors' protection in the listing rules, as have other countries recognized. In particular, the KSE should have benefited from the flexibility of changing the listing rules without the need for legislative amendment from Parliament.

In fact, such a change is very difficult due to the fact that the Parliament of Kuwait is not exerting its legislative role properly. Correspondingly, the difficulty of legislative amendments can be demonstrated by the fact that the Commercial Companies Law in Kuwait was introduced in 1960 and has since been amended only a few times. Consequently, the listing rules of the KSE should have played a more prominent role regarding shareholders' protection, since some provisions should have been incorporated as has been done in other developed and developing countries.

7.5.6 The weakness of The Legal Infrastructure of The Investors' Protection In The KSE:

The capital markets' laws and regulations that relate to the investors' protections are important mainly where the market's participants are not well educated as regard their rights and duties which is in turn would result in undermining their rights, as it has been stated in terms of the investors educations that:

“The extent that the problem of investor protection is seen to lie with unsophisticated investors themselves, rather than with the quality of information that they receive, only

⁸³¹ Egypt Listing Rules available at: http://www.efsa.gov.eg/content/efsa2_en/efsa2_merge_cma_en/efsa_cma_role_en.htm, retrieved on 11/3/2011.

⁸³² See Black, Bernard, 'The Core Institutions That Support Strong Securities Markets', *Journal of Business Lawyer*, 2000, Vol: 55, at p. 1577.

direct and paternalistic market regulation can protect investors from themselves.”⁸³³

Also in *The Corporate Governance Survey of Listed Companies and Banks Across MENA*, it has been found that, although the majority of the respondents considered corporate governance to be very important, but the majority of the respondents were unable to define what corporate governance means.⁸³⁴

Thus, it would be argued at this point that the laws and regulations that support the investors protection is significant in MENA countries and in particular in Kuwait in addition and in relation to the investors educations it has been mentioned that the company shareholder meetings in Kuwait are weak in terms of its supervisory role over the board of directors actions and resolutions and the management of the company, therefore, the shareholders general meetings in Kuwait have been referred to as ‘*The Absent Parliament*’, moreover, the board members of the joint-stock companies in KSE are used to exercise much more authority than they should according to the Companies Law and the Companies` Article of Association.⁸³⁵

Furthermore, the Council of Ministers in Kuwait constitutes an investigative committee to find violations that have been committed by boards of directors that resulted in the financial crisis in 1982 (*Suq Almanakh*). Despite this fact, no shareholders at a general meeting at that time have held the board of directors liable for such violations, which reflect the weakness of the shareholders education in Kuwait.⁸³⁶

⁸³³ See Reinier Kraakman, Paul Davies, Hary Hansmann, Gerard Hertig, Hideki Kand & Edward Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach*, (Oxford, Oxford University Press, 2006) at p. 207.

⁸³⁴ See A Corporate Governance Survey of Listed Companies and Banks Across the Middle East and North Africa, Published by International Finance Corporation, World Bank Group and The Institute of Corporate Governance (2008), at p. 15.

⁸³⁵ ⁸³⁵ See Dr. AL-Shamari, Tummah, *The Joint-Stock Company's Board of Directors: A Comparative Legal Study Between Kuwait & The US*, First edition, Kuwait Foundation for Advancement Science, Kuwait, 1985, pp: 17-18

⁸³⁶ *Ibid.*

7.5.6.1 The Directorship of Companies' board:

Turning to another issue that lessens the opportunity to establish sound corporate governance system in Kuwait is the appointment of independent directors in the shareholding companies as in the United States such regulation can be found in the listing rules of the markets as in the NASDAQ and the NYSE, which requires that the majority of the board members be independent. In contrast, such practice in MENA markets would be impractical because of the nature of the business culture and the ownership structure in these countries.

Hence, some factors should be examined before imposing any such rule over the listed companies in such countries. These factors include for instance the ownership structure, the business culture in each country and the availability of qualified independent corporate directors.⁸³⁷ For example, in the United States, any person can be appointed to the board of directors of any company, whether he is a shareholder or not. However, the company's articles of association can require that a director be a shareholder.⁸³⁸

Furthermore, it could be submitted that one of the main reasons for the lagging behind of KSE is the market's committee composition and the conflicting role between the members of the committee. Since this committee is handling the issuance of the regulations and supervision of the KSE at the same time that a number of the members are representing the listing companies, therefore it would not be surprising if such a committee has not issued regulations that lessen the power of the controlling shareholders or that provide for more disclosure that may affect the autonomy of the controlling shareholders.

⁸³⁷ See A Corporate Governance Survey of Listed Companies and Banks Across the Middle East and North Africa, published by International Finance Corporation, World Bank Group and The Institute of Corporate Governance (2008), at p. 30.

⁸³⁸ See Dr AL-Shamari, Tummah, *The Joint-Stock Company's Board of Directors: A Comparative Legal Study Between Kuwait & The US*, First edition, Kuwait Foundation for Advancement Science, Kuwait, 1985, at p. 62.

Moreover, Another obstacle to the application of the best practice of corporate governance is that the directorship requirements for appointment to the board of any joint stock companies that are listed in the KSE can be an obstacle for providing better protection for the companies' shareholders, since the appointee to such a position need not possess any qualifications. In other words, anyone is able to be a director of a listed company in the KSE, and no relevant qualifications are required.

The absence of specific qualifications that a listed company's director must have is not surprising in Kuwait due to aspects of corporate culture. In this context, it would be argued that a prominent aspect that the corporate culture in Kuwait is enjoying is that the relationship based system. An illustration can be found in the fact that many former politicians have been appointed chairmen of listed companies, bearing in mind that the majority of these politicians do not hold any qualifications that relate to business affairs. Such a practice reveals that the appropriate qualifications are not as important as the relationship to the appointee.

Also, the appointment of a companies' directorship in Kuwait is greatly influenced by the fact that the ownership of these companies is concentrated mostly in the hands of founding families. Consequently, the family members and their relatives have the priority amongst others to be appointed to these positions.

7.5.6.2 The Enforcement of The Current KSE`s Regulations:

The disclosure means that specific information should be disclosed to investors that enhance the attainment of their confidence in the securities markets and that such information must be disclosed in a timely and accurate manner.⁸³⁹ Hence, the enforcement of the disclosure regulations is an important factor to increase the market's credibility before the investors whereas KSE enforcement is considerably weak as in the Kuwait Transparency Report emphasizes that disclosure must be required of the

⁸³⁹ See Black, Bernard, 'The Core Institutions That Support Strong Securities Markets', Journal of Business Lawyer, 2000, Vol: 55, at p. 1579.

Companies listed in the KSE, because in the KSE, spreading information about a company's profits, for example, is a common practice especially between the boards of directors of these companies.⁸⁴⁰ The shareholders and the stakeholders' rights are specified in several laws, such as in the contract, company and securities laws.

However, the existence of these laws is not enough to ensure the appropriate protection of the shareholders and the stakeholders, but, the quality of the enforcement mechanisms is very important to determine the efficiency of the protection that the investors enjoy in a specific country.⁸⁴¹

For example, of the non disclosure practice in the KSE, the Mobile Telecommunications Company (MTC) did not disclose the information that the Court required in its judgment of 19 April 2006, in a case in which the MTC was a party. Only when the judgment was announced in a newspaper on 9 May 2006 did the MTC disclose the information to the KSE that same day. The MTC's share price dropped from 2,850 KD on 18 April 2006 to 2,580 KD on 9 May 2006. The MTC justified the non-disclosure for the reason that its management considered the judgment to be unclear and vague.

In addition, the *Transparency Report* revealed that, in 2006, ten companies listed in the KSE announced the first quarter financial information to KSE. Even though the announced information was incorrect, none of the companies was penalized for such action even though the shareholders of such companies suffered damages.⁸⁴² Consequently, it could be submitted that the disclosure requirements and practice are very minimal in the KSE. Therefore, there must be legislative intervention to enhance the legal effectiveness that should playing major role in determining the investors' protection and the level of corporate governance practice.⁸⁴³ In this vein, La Porta et al argues that

⁸⁴⁰ See The Transparency Society of Kuwait, "Report of Kuwait Stock Exchange Market, the Determination of the Weaknesses and the Shortcomings and the Optimal Solutions and Recommendations," Kuwait, June 2006, at p. 12.

⁸⁴¹ See La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R., 'Investor Protection and Corporate Governance', *Journal of Financial Economics*, 2000, Vol: 58, at p. 5.

⁸⁴² See The Transparency Society of Kuwait, "Report of Kuwait Stock Exchange Market, the Determination of the Weaknesses and the Shortcomings and the Optimal Solutions and Recommendations," Kuwait, June 2006, at p. 14.

⁸⁴³ See La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R., 'Investor Protection and Corporate Governance', *Journal of Financial Economics*, 2000, Vol: 58, at p. 5.

investor protection via legal instruments leads to less expropriation by the managers or the controlling shareholders. Further, they stated about the relation between the investor protection and the firms finance that:

“At the extreme of no investor protection, the insiders can steal a firm`s profits perfectly efficiently. Without a strong reputation, no rational outsider would finance such a firm. When investor protection improves, the insiders must engage in more distorted and wasteful diversion practices, such as setting up intermediary companies into which they channel profits. Yet these mechanisms are still efficient enough for the insiders to choose to divert extensively. When investor protection is very good, the most the insiders can do is overpay themselves, put relatives in management, and undertake some wasteful projects. After a point, it may be better just to pay dividends. As the diversion technology becomes less efficient, the insiders expropriate less, and their private benefits of control diminish. Firms then obtain outside finance on better terms...”⁸⁴⁴

Moreover, the above statement have driven us to another obstacle for the sound application of corporate governance as investor protection mechanism that is the bank-based system, in which the banks participate significantly in the companies` finances, is also named as a relationship based system, in contrast to the market based system, in which the companies` finances are based upon a significant number of investors that participate in the company`s capital.⁸⁴⁵

In this context, the KSE listed companies depend on easy bank financing, because the financing transactions can be concluded based upon the relationship between the parties. Accordingly, the good financial reputation is not a concern for the controlling shareholder in the KSE listed companies which is results in that the companies` management would not voluntarily apply regulations that urge them to impose more obligations upon themselves.

⁸⁴⁴ *Ibid*, at p. 6.

⁸⁴⁵ *Ibid*, at p. 17.

7.5.6.3 Institutional Investors` Role:

Furthermore, one mechanism of corporate governance that is not available in Kuwait is the regulatory framework of the institutional investors. Such a mechanism has been recognized in several countries and organizations, such as The International Corporate Governance Network. These countries and organizations maintain that the institutional investors should play a greater role toward enhancing the corporate governance practice by paying closer attention to the corporate governance issues in the companies in which they are investing.

Further, the institutional shareholders can participate significantly in the sound application of corporate governance, since they hold a considerable number of shares invested in the companies. In the same context, with regard to shareholders and in particular the institutional shareholders, the OECD corporate governance principle II.F provides:⁸⁴⁶

“ The exercise of ownership rights by all shareholders, including institutional investors, should be facilitated. 1. Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policy with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights. 2. Institutional investors acting in a fiduciary capacity should disclose how they manage material conflict of interest that may affect the exercise of ownership rights regarding their investments”.

Accordingly, the disclosure by the institutional investors of their voting records is a good practice, since it makes the other shareholders act in an informed manner with regard to the institutional investor situation.⁸⁴⁷ Therefore, the institutional shareholders in the UK became an important pillar toward corporate governance reform and in light of the agency problems that usually emerge from the separation of ownership and control of

⁸⁴⁶ OECD Principles of Corporate Governance (2004), principle II.F.

⁸⁴⁷ See *Corporate Governance and the Financial Crisis, Conclusion and Emerging Good Practices to Enhance Implementation of the Principles*, Paper by Directorate for Financial and Enterprise Affairs, OECD Steering Group on Corporate Governance, February 2010, at p. 25.

any company, moreover, the importance of the institutional shareholders' roles in the UK as one of the corporate governance factors that aim at reducing the agency cost that is usually paid by the non-controlling shareholders.⁸⁴⁸ Further, intervention or activism of the institutional shareholders toward the companies in which they invest can bring financial benefits, and their activism can also benefit the society at large.⁸⁴⁹

In Kuwait, several investment institutions are able to serve as institutional investors with regard to the application of the best practice of corporate governance. In other words, the huge government ownership in the KSE creates several institutional investors through more than one public authority, such as the Kuwait Investment Authority and the Public Authority for Social Insurance. Yet, such institutional investors have not played any role that should relate to the other investors' protection. As an example, the Kuwait Investment Authority is the major investor in the Mobile Telecommunications Company (MTC) and has two representatives on the MTC board of directors. An investors' consortium offered to buy MTC shares in the Saudi Mobile Telecommunications Company (the stake amounted to 25% of the capital of the Saudi Telecommunications Company).

The MTC board of directors called the board members to decide whether to accept the offer. Ironically, the Kuwait Investment Authority representatives did not attend the meeting and the majority of the board members decided to accept the offer tentatively, while the minority members strongly opposed the decision and will proceed with the legal actions against this offer due to the fact that the shares under consideration were a vital contributor to MTC's annual profit. Interestingly, a member in the parliament, who asked about the Kuwait Investment Authority's role and why it did not attend such an important board meeting, has discovered this failure by the institutional investor. Accordingly, the institutional investors in Kuwait are not exercising their role toward ensuring the listed companies perform the best practices of corporate governance. This can be attributed to a variety of factors, such as the absence of the legal framework for

⁸⁴⁸ See Solomon, J., *Corporate Governance and Accountability*, Third Edition, John Wiley & Sons Ltd, United Kingdom, 2010, at p. 337.

⁸⁴⁹ *Ibid*, at p. 338.

proper corporate governance and to the lack of knowledge by managers regarding corporate governance and their role in maintaining a proper standard for the protection of other investors.

It has been argued that the expropriations by the controlling shareholder or the managers can take one of the following ways i.e. for example the controlling shareholder or the managers can steal the profits and/or they can sell assets of the controlled company to another company owned by the controlling shareholder. In addition, executives may take excessive remuneration and/or appoint unqualified relatives or friends to top management positions.

Thus, the legal mechanisms of corporate governance that are important to protect the investors can be achieved within the laws and regulations and the efficient enforcement of such laws and regulations.⁸⁵⁰ In other word, the investor's appropriate protection can be achieved within a well-established regulatory framework of the capital market, since such a framework will restore investor confidence that their rights are protected and that market participants cannot expropriate them. In this context, it has been stated that China, for example, has made several serious moves to find a sound corporate governance system through implementing disclosure and transparency regulations that furnish the investors with the appropriate protection.⁸⁵¹

This because China has appreciated that the securities markets are seen not only as a place for creating fortunes but also as a place for the economic development of the country. Hence, it has been mentioned that the experience of the Chinese securities market is evidence of the interdependence between the existence of sound corporate governance system and a well-established securities market.⁸⁵² The need for a sound corporate governance system in the developing countries stemmed from the weakness of the legal infrastructure in such countries in such areas as contract enforcement, property

⁸⁵⁰ See La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R., 'Investor Protection and Corporate Governance', *Journal of Financial Economics*, 2000, Vol: 58, at p. 4.

⁸⁵¹ See Wei, Yuwa, *Securities Markets and Corporate Governance, A Chinese Experience*, Ashgate Publishing Company, England, 2009, at p. 1.

⁸⁵² *Ibid*, at p. 2.

rights, insider dealing, and protection of the interests of minority shareholders.⁸⁵³

Therefore, the inefficiency of the Stock Exchange Market in Kuwait might be attributed to several reasons, including the behavior of the investors themselves, the minimal, if any, standard of transparency, and the weakness of the infrastructure for the appropriate market, as it would be argued that the government of Kuwait is required to establish the important institutions to provide a good corporate governance system. Moreover, Implementing international standards for transparency would enhance the clarity of each company's transactions in the investors' eyes, since transparency can play a key role in the investor's decision whether to invest in a company.⁸⁵⁴

In this regard, several countries have established institutions that enhance the corporate governance practice and the shareholders protection as an ultimate objective. The *Mudara Institute of Directors* (2008) and the *Hawkamah Institute of Corporate Governance* (2006), based in the UAE that aim at improve the corporate governance practice in the region. Also in Egypt for instance, The Institute of Directors was established in the drive to educate directors regarding corporate governance.⁸⁵⁵

Moreover, as stated before all of the GCC countries have codes for corporate governance for the companies listed in the stock market, except that Kuwait still has not issued a corporate governance code for joint stock corporations. Furthermore, the reasons why a corporate governance code has been issued in MENA countries vary. For example, the corporate governance code in Saudi Arabia was the culmination of the efforts of governmental institutions, whereas.⁸⁵⁶

Further, most, if not all, of the initiated corporate governance codes in the MENA region are voluntary. However, over the years, some of the new recommendations

⁸⁵³ See *Instituting Corporate Governance in Developing, Emerging and Transitional Economies A Handbook*, by the Center for International Private Enterprise, 2002, at p. 6 available at: http://www.cipe.org/programs/corp_gov/pdf/CGHANDBOOK.pdf, retrieved on 16/2/2011.

⁸⁵⁴ See *Instituting Corporate Governance in Developing, Emerging and Transitional Economies A Handbook*, by the Center for International Private Enterprise, 2002, at p. 4, available at: http://www.cipe.org/programs/corp_gov/pdf/CGHANDBOOK.pdf, retrieved on 16/2/2011.

⁸⁵⁵ See Koldertsova, Alissa, 'The Second Corporate Governance Wave in the Middle East and North Africa', *OECD Journal: Financial Market Trends*, Vol: 2010, Issue: 2, at p. 4.

⁸⁵⁶ *Ibid*, at p. 5.

regarding corporate governance have become more binding, since some of these matters have been included in regulations and the legal framework. For example, the independence of the directors in Egypt was provided for in the corporate governance codes and has now become one of the company's listed requirements. The companies' listing requirements in some stock market exchanges in MENA are lenient when compared with other companies' listing requirements in the international scope. In addition, in the near past, some of the capital market authorities, such as those in Saudi Arabia, Qatar and UAE, have provided for more disclosure issues that relate to compliance with the national corporate governance codes.

As an aim for more development, in the MENA countries and in particular the GCC countries are now in the phase of reviewing their existing corporate governance codes to amend the ineffective provisions or to add more provisions depending upon future developments.⁸⁵⁷ For example, the Capital Market Authority in Saudi Arabia in 2009 added a provision to the corporate governance code 2006 regarding the definition of the independent director in the listed companies' boards that is compatible with the concentrated ownership in the Saudi listed companies. In comparison, Kuwait still has not issued or even discussed the issuance of any corporate governance code for the listed companies. The enforcement of the corporate governance code's provisions is very important to ensure that these provisions are applied and not ignored. Hence, the enforcement in the MENA region's capital markets regarding corporate governance codes is developing. The Saudi Capital Markets announced all of the penalties imposed upon violators of corporate governance code provisions.⁸⁵⁸

As a result, the Saudi experience is remarkably positively in evolving toward the international best practice. It is very important for Kuwait to benefit from the Saudi experience in creating sound corporate governance when the intention is to adopt or incorporate corporate governance codes. But it should be noted that there is no one corporate governance model that can fit in all countries. Thus, some elements should be

⁸⁵⁷ See Koldertsova, Alissa, 'The Second Corporate Governance Wave in the Middle East and North Africa', *OECD Journal: Financial Market Trends*, Vol: 2010, Issue: 2, at p 6.

⁸⁵⁸ *Ibid*, at p 7

taken into account when a specific corporate governance model is adopted, such as the culture of the country in which the corporate governance is being developed.⁸⁵⁹

Developing countries experience specific aspects that differentiate them from the developed countries such aspects include the dominance of state ownership, the proliferation of family businesses, and inefficient institutions.⁸⁶⁰

In relation to the school of thought that holds the opinion that no single model of corporate governance fits everywhere, Commissioner McCreevy noted in the context of the European goal of harmonizing corporate governance that:

‘Europe has a role to play. That role is to co-ordinate where possible Member States’ efforts to improve corporate governance practices through changes in their national company law, securities law or in corporate governance codes. There are different traditions in different Member States and those should be respected...’.⁸⁶¹

Such an argument can be substantiated from the fact that, in Oman and all of the GCC countries, there is an obstacle to finding independent corporate directors, because families own most of the listed companies, which raises concerns from the standpoint of someone from outside of their group.⁸⁶²

Thus, adapting the corporate governance system that works correctly in a developed country to a developing country might not be compatible with the political, legal or economical aspects of the developing country’s corporate governance environment. Therefore, when a country is willing to adopt an external corporate governance system, some conditions must be taken under consideration, such as the political, legal and

⁸⁵⁹ See Solomon, Jill, *Corporate Governance and Accountability*, Third Edition, John Wiley & Sons Ltd, United Kingdom, 2010, at p. 233.

⁸⁶⁰ See Samaha, Khaled, ‘Do Board Independence and Audit Committees Motivate Disclosure on Different Corporate Governance Information Categories in the Annual Reports in Developing Countries?’, *International Research Journal of Finance and Economics*, 2010, Issue: 57, at p. 207, pp. 206- 225. Also see Young, M., Peng, M., Ahlstrom, D., Bruton, G., & Jiang, Y., ‘Corporate Governance In Emerging Economies: A Review of the Principal-Principal Perspective’, *Journal of Management Studies*, 2008, Vol: 45, Issue:1, pp. 196-220.

⁸⁶¹ See Girvin, S, Frisby, S & Hudson, A., *Charlesworth’s Company Law*, Eighteen Edition, Sweet & Maxwell, England, 2010, at p. 411.

⁸⁶² See Solomon , Jill, *Corporate Governance and Accountability*, Third Edition, John Wiley & Sons Ltd, United Kingdom, 2010, pp. 228-232. In Saudi Arabia, for example, 75% of the listed companies are owned by the founding family, and the other companies are owned by the government.

cultural aspects of the country.⁸⁶³ In other words, although the transplantation of the rules in developed economies is not guaranteed to be successful in developing economies, due to the fact that the culture or the behavior of the investors is a major determinant in order to improve the shareholders protection.

Consequently, it has been found that after the investigation of 60 corporate business failures in Europe that the causes of these failures were the unethical conduct by the controlling shareholder or by managers that was not challenged by the board of directors.⁸⁶⁴ Therefore, it is a must for Kuwait to establish corporate governance code that ensure a proper protection for the investors in KSE due to that fact that the corporate governance is important for the investors as it can be evident from that McKinesy Consulting in 2002 conducted a survey in Egypt, the sample of which was comprised of 200 institutional investors and according to the survey results, 80% of the participants accepted having to pay a 40% premium on their investment in well-governed companies.⁸⁶⁵

In the same vein, a survey conducted by Thomas Financial in 2002 showed that 68% of the institutional investors in New York considered the corporate governance practice in any company as the second pillar for their investment decision.⁸⁶⁶ Accordingly, it could be submitted that Kuwait should benefit from the experience of the countries that similar to its aspects before adopting any inapplicable corporate governance elements in order to establish capital market that credible to import the foreign capitals. In other words, Kuwait should take into consideration when it comes to establish corporate governance code several elements such as the ownership concentration in the listed

⁸⁶³ See *Instituting Corporate Governance in Developing, Emerging and Transitional Economies A Handbook*, by the Center for International Private Enterprise, 2002, at p. 5, available at: http://www.cipe.org/programs/corp_gov/pdf/CGHANDBOOK.pdf, retrieved on 16/2/2011.

⁸⁶⁴ The business failures ranged between formal bankruptcies or a free fall of the share price. See A Corporate Governance Survey of Listed Companies and Banks Across the Middle East and North Africa, published by International Finance Corporation, World Bank Group and The Institute of Corporate Governance (2008), at p. 20.

⁸⁶⁵ See McKinsey & Company (2002) Global Investor Opinion Survey: Key Findings, quoted in Samaha, Khaled, 2010, Do Board Independence and Audit Committees Motivate Disclosure on Different Corporate Governance Information Categories in the Annual Reports in Developing Countries?, *International Research Journal of Finance and Economics*, Issue: 57, at p. 207.

⁸⁶⁶ See Karessa, Cain, 'New Efforts to Strengthening Corporate Governance: Why Use SOR Listing Standard', *Columbia Business Law Review*, 2003, at p. 638.

companies. Accordingly the next chapter will include proposal for corporate governance code for Kuwait that should enhance the investors' protection in Kuwait Stock Market.

7.6 Conclusion:

In this chapter an attempt has been made to find out the current level of investor protection that should be delivered by the KSE's laws and regulations. In other words, do KSE laws and regulations ensure the proper protection of the shareholders of the listed companies or not, despite the fact that KSE has not yet established corporate governance codes, even though most of MENA countries and GCC countries with similar conditions as Kuwait have done so.

Furthermore, the importance of the sound application of corporate governance rules that provide for proper disclosure and transparency has been identified in light of the reasons that support the corporate failures in 2008. Afterwards, and in order to measure the shareholders' protection level in the light of KSE's laws and regulations, several issues have been examined, i.e., the level of disclosure and the listing requirements as a corporate governance mechanisms. Accordingly, the examinations of these issues revealed that the level of disclosure under the KSE legal framework is considerably low and inefficient. Despite the fact that there is a law of disclosure of interests in Kuwait, there are failures in other occasions.

For example, the disclosure about the companies' executives' remunerations is not adequately exercised in KSE listed companies, in addition to the disclosure of the related party transactions, which also constitutes another failure in the legal framework of the KSE. Hence, it could be submitted that such failures in the disclosure of the KSE can be seen as a major weakness in the shareholders' protection level. Moreover, the examination of the listing requirements of the KSE as a corporate governance mechanism has revealed that these requirements are outdated and do not incorporate provisions that support shareholders' protection, except for a general disclosure requirement.

Therefore, and as a result of this chapter's findings, it could be suggested that Kuwait should incorporate corporate governance code to develop shareholders' protection in the capital market, especially because the majority of the listed companies are ownership concentrated and controlled, and managed by the major shareholders. Further, Kuwait should take into consideration certain aspects of their corporate culture when it comes to incorporating such codes to avoid inapplicable issues, such as the appointment of the independent directors in the companies' boards. Due to the corporate culture nature in Kuwait and the other GCC countries it is difficult to define the independent director as the one that does not own shares in the company.

The first obstacle will be the Companies Law in Kuwait, as it requires the board member to own at least one percent of the company's capital in order to qualify for appointment in the company's boards. Thus, it has been suggested in this chapter that to be viable, the incorporation of any laws or regulations that should improve shareholder protection should be compatible with the legal and social conditions of Kuwait. Consequently, the next chapter will be devoted to the recommendations that resulted from the analysis of this work. The purpose of these recommendations is to facilitate the incorporation and the application of corporate governance in Kuwait and to enhance the shareholders' protection in KSE whether foreign or locals.

Chapter Eight: Corporate Governance Practice In Kuwait: The Way Forward:

A Set of Recommendations to Facilitate The Establishment of Sound Corporate Governance in Kuwait:

8.1 Introduction:

The best practice of corporate governance is to guarantee each company's long-term investment, ensure the proper protection of the shareholders, and to specify the duties and responsibilities of the board of directors. Thus, creating an efficient corporate governance system in any country must be well grounded in at least some aspects as legal, financial, political and cultural.⁸⁶⁷ In other words, while no convergence of the corporate governance system is applicable to all countries, establishing a corporate governance system must be compatible with a country's business, legal and political cultures.⁸⁶⁸ Corporate governance in Kuwait as identified in this work is weak in relation to the laws or regulations that should protect the shareholders in joint stock companies in Kuwait.

Moreover, Kuwait is the only GCC country that still has not yet adopted a corporate governance code. In contrast, the other GCC countries are amending their codes to be compatible with international business developments.⁸⁶⁹ Nonetheless, the parliament in Kuwait has introduced the new Capital Market Law 7/2010 that will hopefully improve the Kuwaiti Stock Exchange (KSE) in terms of corporate governance. This law requires disclosure and includes provisions that enhance shareholder protection and reduce corporate management malpractice. However, this capital market law has not contained a corporate governance code. Accordingly, this chapter will recommend elements that should facilitate in general the sound application of corporate governance in Kuwait and in particular will stress on provisions that should be incorporated into a corporate

⁸⁶⁷ See Salacuse, Jeswald, 2004, 'The Cultural Roots of Corporate Governance,' in Norton and Rickford eds., *Corporate Governance Post-Enron: Comparative and International Perspectives*, The British Institute of International and Comparative Law, 2006, pp. 433-434, pp. 433-466.

⁸⁶⁸ See Solomon, Jill, *Corporate Governance and Accountability*, Third Edition, John Wiley & Sons Ltd, United Kingdom, 2010, at p. 233.

⁸⁶⁹ For example the UAE new Corporate Governance Law (2009)

governance code for the shareholding companies in Kuwait. In addition, recommendations will also be made for the amendment of some provisions of the Companies Law 15/1960 or to be incorporated into a new companies law in Kuwait, because the existing Commercial Companies Law is outdated.

8.2 Recommendations for Improving The Corporate Governance Practice In The State-Owned Enterprises In Kuwait:

According to the discussion of this thesis, there are several proposals that should facilitate the sound application of corporate governance in the state-owned enterprises in Kuwait (SOEs). In general, the OECD suggested a set of principles for the proper application of corporate governance in the SOEs.⁸⁷⁰ Two of these principles are not applied to SOEs in Kuwait, which in turn makes the proper application of corporate governance impossible.⁸⁷¹ These two principles are a clear legal framework for the SOEs and the prevention of political interference in their affairs. The absence of a clear legal framework for SOEs in Kuwait has created confusion.

For example, the duties and responsibilities of the directors and managers of SOEs are not clear, as they are governing by the Commercial Companies Law 15/1960 and the regulations introduced by the government. Consequently, the directors and the managers of SOEs in Kuwait are not aware of the exact rules that apply to them, and, in addition, overlapping rules may subject the directors and managers to be held accountable easily against claims of malpractice. Moreover, the absence of a clear legal framework for SOEs in Kuwait has facilitated political interference in their commercial or administrative affairs in the SOEs.

Such political interference has caused several detrimental consequences to SOEs in Kuwait, such as the cancelation of a major project in the oil sector. Furthermore, political interference in SOEs in Kuwait is manifested in management appointments, since

⁸⁷⁰ OECD Principles of Corporate Governance For State-Owned Enterprises (2005).

⁸⁷¹ For details see the discussion in chapter six.

relationships with politicians dominate over other qualifications.⁸⁷² As a result, management of the SOEs has fallen into the hands of unqualified managers, whose decisions will not promote efficiency in the affairs of many SOEs. Accordingly, the Kuwaiti legislature should introduce a special law regarding SOEs in Kuwait that will, among other issues, provide for clear definitions of the duties and responsibilities of directors and managers. In addition, the SOE special law must incorporate provisions that ensure the prohibition of political interference. Such interference may be reduced if the SOE special law provides that the appointment of SOE management should be accomplished through a special committee that has clear requirements for qualifications.

Such qualifications must be fulfilled for the appointment to any specific position to prevent political interference and at the same time ensure that the proper candidates take these positions. The role of the SOEs in Kuwait is important in terms of their contribution to the annual budget of the State of Kuwait.⁸⁷³ As a result, any new law that would organize such enterprises must not ignore parliamentary supervision of the enterprises. Thus, the special law regarding SOEs should incorporate provisions that ensure proper supervision by the parliament through a special committee.

For example, the parliament should supervise by having its committee discuss and approve the SOEs' annual budgets and investigate whenever the parliament suspects any fraudulent act that happens in the SOEs.

8.3 Several Recommendations Regarding the Commercial Companies Law in Kuwait:

The corporate governance institutions in Kuwait especially those that have been examined such as Kuwait Commercial Companies Law No. 15/1960 from the perspective of corporate governance, have found that the Commercial Companies Law does include

⁸⁷² For instance the political interference regarding the top management appointment in the Oil sectors, <http://arabic.arabianbusiness.com/business/energy/2010/jan/17/34964/>, retrieved on 21-11-2011

⁸⁷³ See the annual Budget Report (2010/2011) for the Minister of Finance in Kuwait <http://mof.gov.kw/Budget/PDF/Minister-stat10-11.pdf>, retrieved on 21-11-2011

some corporate governance provisions (discussed in chapter Five). At the same time, other corporate governance issues were either not included or were included but not in a manner that supports the efficient application of corporate governance and enhances shareholder protection.

Therefore, the recommendations regarding the Commercial Companies Law 15/1960 will range from abolishing, amending or incorporating aspects that should relate to the application of an efficient corporate governance system in Kuwait. In other words, the recommendations will exemplify solutions that the legislature should adopt to amend the existing Commercial Companies Law or, in enacting a new companies law, to achieve sound investor protection in the shareholding companies in Kuwait.

8.3.1 The Company`s Directors:

The board of directors is an important pillar in the integration of the corporate governance system, since the directors are the shareholders' eyes in terms of monitoring the company's management. Thus, the directors must exercise their responsibilities that have been provided by the laws and/or regulations. Otherwise, the directors will be held accountable if they exercise excessive authority. In this context, to ensure the proper and adequate exercise of responsibilities by the directors, the law should incorporate provisions that deal with such situations. Accordingly, recommendations below touch upon the directors and should be incorporated in the Kuwaiti Companies Law or be incorporated in a new companies law in Kuwait.

8.3.2 Recommendations regarding The Directors' Duties:

The failure of the Kuwaiti Commercial Companies Law No. 16/1960 to state clearly the duties of company directors was mentioned in chapter five. In contrast, many other countries such as the UK have stipulated the directors' duties either in their laws or

regulations, because the definition of such duties is key to a variety of things.⁸⁷⁴ For instance, the directors must be clearly aware of the duties and responsibilities that attach to their position as directors and as agents of the shareholders of the company.

Further, when they exercise their duties, the directors are considered significant players in implementing the best practice of corporate governance and in protecting the shareholders because of the wide authority that they enjoy as directors. In Kuwait, the duty of care of company directors is measured against an average person as stipulated in Article 705 of the Kuwait Civil Law, which provides that the agent is required to exercise the care of an average person when he acts on behalf of his principal.⁸⁷⁵ In the UK, the Companies Act (2006) has a better approach to the director's duty of care, as it states that it is "a degree of skill and care which may be reasonably expected from a person of his knowledge and experience."⁸⁷⁶

Therefore, the companies' law in Kuwait should incorporate provisions that clearly define the directors' duties as is done in Article 174 of the UK Companies Act (2006). There, the duties of care are been mentioned without ambiguity. Without such clarity in defining their duties of care, the company directors in Kuwait will continue to be immune from liability for neglectful business decisions that deteriorate shareholder rights. Moreover, the duty of loyalty of company directors has not been stipulated in the Companies Law 15/1960 to prohibit directors from harming the companies, disclosing company secrets, or benefiting from such secrets.

A director's duty of loyalty prohibits him or her from having a conflict of interest with the company that he or she directs. Therefore, it is recommended that the clear definition provided in Article 175 of the UK Companies Act (2006) be adopted in the Kuwaiti Companies Law to provide the directors and shareholders with a determinant base upon which to decide whether a director has breached his or her duties toward the

⁸⁷⁴ See The Companies Act (2006) Article (174)

⁸⁷⁵ Kuwait Civil Law No. 67/1980 Article (705).

⁸⁷⁶ See Andrew Hicks & Goo, S.H, *Cases and Materials on Company Law*, UK, Blackstone Press Ltd, 1994, pp. 304-336.

company and the shareholders.⁸⁷⁷ A clear definition of the director's duty of care or of loyalty would encourage the directors to manage the company properly and ensure that they are accountable for all violations that they commit.

Another important recommendation to be incorporated in the Kuwait Companies Law is that the related party transactions approval should be stricter in a manner that ensures the shareholders are fully aware of all the transaction information before they approve such transactions. Therefore, the companies' law should provide that each related party transaction must be approved at the shareholders general meeting and that all of the information should be disclosed to the shareholders, such as the name of the parties to the transaction, the amount of the transaction, and the purpose of the transaction.

In contrast, currently in Kuwait, the Companies Law No. 15/1960 requires only a shareholders general meeting without any further requirements. In addition, the interested party should be prevented from voting on the matter in which he or she is interested to ensure the impartiality of the decision made regarding such transaction. Regulating the related party transaction in Kuwait is important to protect the shareholders, because, in Kuwait, the major shareholder usually controls the company's management. Therefore, the proper disclosure to the shareholders is highly significant to ensure their protection.

In another context, the recommendation should be made to amend the Kuwaiti Companies Law to include provisions that identify the independence of some directors to ensure that the controlling shareholders do not make decisions at the expense of other shareholders, who are not represented on the board. The importance of each independent director's role in protecting the shareholders has been recognized in the corporate laws and regulations of many countries and by many international organizations, such as the OECD.⁸⁷⁸

⁸⁷⁷ See Article 175 of the UK Companies Act (2006),

⁸⁷⁸ See OECD Corporate Governance Principles (2004)

In Kuwait, however, no independent director is identified. Good corporate governance appreciates the importance of independent directors when encouraging boards to create committees that ensure appropriate protection for shareholder rights. The Companies Law in Kuwait has no provisions that require company boards to create such committees. Therefore, the Companies Law should incorporate provisions that require boards of directors to include a number of independent directors to ensure the impartiality of decisions and to create several committees composed of independent directors to ensure the best practice of corporate governance within the company and to guarantee the adequate protection of shareholder rights.

Such committees should include a remuneration committee, a nomination committee, an audit committee and a corporate governance committee.

Moreover, it is important that the position of independent director is clearly defined, as each country has its own definition depending upon the condition of the country. Thus, the Companies Law in Kuwait should first abolish the requirement of ownership of 1% of the company's capital to be qualified to be a company's director, because such a requirement makes it difficult to define the independent director.

Instead, the Companies Law in Kuwait should be amended to establish the qualifications required of directors and managers to achieve their proper appointment. In other words, all directors and managers should be suitably qualified, including having adequate experience in the business and management of companies and educational qualifications that are related to the business of the company. Imposing such a requirement for the directorship and management of companies will help to ensure that the business of the company will be conducted in a professional manner, which will in turn maintain a strong level of shareholder protection.

Furthermore, to protect the shareholders against the malpractices of the company's management, especially with regard to the compensation of the directors and managers, remunerations should be disclosed clearly to the shareholders during the annual meeting

to enable them to make an informed decision regarding such remuneration. Accordingly, the Companies Law should incorporate disclosure provisions, which will increase the shareholders' supervision of their company during the Annual General Meeting.

8.3.3 Recommendations to Enhance Shareholder`s Rights and Protection in Kuwait:

The Kuwait Companies Law No. 15/1960 has failed in several stages to introduce provisions that ensure the protection of the shareholders.⁸⁷⁹ In fact, provisions that should relate to corporate governance and the proper protection of shareholders are nearly absent from the Kuwait Companies Law. Therefore, this section will provide some recommendations for the policymaker to consider as important to enhancing shareholder protection. Such recommendations might be incorporated in a new companies law in Kuwait or be incorporated in the existing Companies Law. Further, the recommendations might also be incorporated into the capital market regulations.

Corporate governance encourages proper protection of company shareholders by including in the laws and regulations provisions that are fundamental to ensuring that such protection is well defined. As stated above, the Kuwait Companies Law failed to incorporate a number of important provisions in one place, while in another place important provisions are incorporated but not in an efficient way. To appreciate the recommendations, it should be noted that the ownership structure of the companies in Kuwait is concentrated and the companies' management is in the hands of the major shareholders.

Article 111 of the Companies Law in Kuwait provides for the preemptive right of the company's shareholders,⁸⁸⁰ whereas the same article also stipulates that the shareholders may restrict their preemption right. Such restriction could undermine the shareholders' rights, especially where the major shareholder controls the company. Therefore, the policymaker should abolish the right to restrict to ensure that the controlling shareholder

⁸⁷⁹ Kuwait Companies Law 15/1960, also see the discussion in Chapter Five,

⁸⁸⁰ Kuwait Companies Act No. 15/1960 Article (111)

will not diminish or destroy the minority shareholders' preemptive rights. The shareholders of a company should have the right to access the information about the company that they need to evaluate the company's condition.

In this context, Articles 178 and 179 of the Kuwait Companies Law provide that the shareholders have the right to get the information about the company that the company submits to the Ministry of Commerce and Industry, but not any further information.⁸⁸¹ Moreover, the information that must be submitted to the Ministry does not render the shareholders sufficiently well informed to exercise their supervisory role during the company's general meeting before the company's board of directors. Consequently, the policymaker in Kuwait should incorporate provisions that ensure that every Kuwaiti company provides its shareholders with all of the required information including director and manager remuneration. Such needed information should not include company secrets.

The shareholders have the right during the general meeting to appoint the auditor for their company based upon the recommendation of the company's board of directors pursuant to Article 161 of Kuwait Commercial Companies Law.⁸⁸² However, this right in Kuwait is meaningless, because the independence of the auditor is jeopardized and undermined by the fact that his appointment is based upon the recommendation of the board of directors. Instead, the recommendation for the appointment of the auditor should be made during the shareholders' general meeting, and a committee that includes independent directors should make the appointment.

Alternatively, since the notion of independent directors still does not exist in Kuwait,⁸⁸³ the recommendation might be that the board of directors should recommend at the general meeting more than two auditors and leave the choice for the shareholders depending upon the quality of the candidate auditors. In other words, the current practice

⁸⁸¹ Kuwait Companies Act No. 15/1960 Articles (178) & (179)

⁸⁸² Kuwait Companies Act No. 15/1960 Article (161)

⁸⁸³ The Independent director has not been provided for neither in the Kuwait Companies Law No. 15/1960 nor Kuwait Stock Exchange regulations. See Chapter Five and Seven.

among Kuwaiti companies regarding appointing auditors is showing weaknesses regarding corporate governance practice and the protection of the shareholders, because the independence of the company's auditor is in doubt. Thus, enhancing the independence of the company's auditor should ensure strong supervision over the company's management and properly protect the shareholder rights.

In other issue, the right to call for an extraordinary general meeting by the company's shareholders to discuss urgent matters that might affect the company is important to ensure the sound application of corporate governance by giving the shareholders the right to discuss issues related to the company in which they own shares. However, such a right will be exercised efficiently when the threshold for calling the extraordinary meeting is reasonable and affordable by the minority shareholders. In the UK, for instance, the threshold was amended from 10% to 5%, whereas in Kuwait the Companies Law still requires 25% of the paid capital as a condition to call an extraordinary meeting, which is difficult for the minority shareholders to achieve.

Thus, it is recommended that Kuwait reduce the threshold required to call such meeting to 5% to enhance the shareholders' rights. Moreover, another illustration of difficulty for the shareholders in exercising their rights in Kuwait is the right to remove the chairman of the board of directors or one of the board members of the company. Article 152 stipulates that a shareholder who owns 25% of the company's shares has the right to propose at the general meeting to remove the chairman of the company and to remove one of the directors of the company's board.⁸⁸⁴ The Article further provides that 50% of the company's shares must approve of such a resolution. Since such a matter is very sensitive in light of the concentrated ownership in Kuwait, the threshold of the required shares should be reduced for the proposal and for the approval of the removal resolution to a percentage deemed by the policymaker to be appropriate.

The last recommendation that the thesis suggests be incorporated in the companies law in Kuwait that should enhance the protection of the shareholders is to provide the

⁸⁸⁴ Kuwait Companies Act No. 15/1960 Article (152)

individual shareholder with the right to sue the company's directors for the breach of their duties in the company's name. In other legal jurisdictions, such a right is known as the right to pursue a derivative action.⁸⁸⁵ Such a right should encourage the shareholders to pursue such an action whenever a shareholder suspects any wrongdoing by the company's directors. In addition, the right to sue the company's directors and hold them liable for the breach of their duties could balance the wide authority that the directors enjoy as compared to the shareholders' right to supervise them.

Accordingly, it is suggested that the policymaker in Kuwait include such a shareholder right in the Companies Law to ensure their proper protection, provided that certain conditions be fulfilled before a shareholder may exercise the right to bring a derivative action thereby guaranteeing that it will not be used excessively. Such conditions might include, for example, the availability of serious evidence supporting such a claim by the shareholder against a company director.

8.4 Education of Corporate Governance Practitioners in Kuwait:

In chapter Five, it was mentioned that the judicial authority in Kuwait enjoys a great level of independence as provided in the Constitution of Kuwait (1962).⁸⁸⁶ Accordingly, the Court of Law in Kuwait could participate in establishing a sound corporate governance system. Furthermore, it is further recommended that specialized judges be appointed to serve in the new capital markets court in Kuwait to ensure that judges be properly educated should they encounter the complexity of lawsuits involving these issues.

As noted above, the new Capital Market Law 7/2010 provided for the formation of a new court dedicated to adjudicating disputes that arise out the implementation of the capital markets law. In other words, it is important that cases related to companies and to their securities be heard by judges who have received a proper education in this field to

⁸⁸⁵ See Kershaw, David, *Company Law Context Text and Materials*, U.S, Oxford University Press, 2009, at p. 546.

⁸⁸⁶ Kuwait Constitution (1962)

facilitate the rendering of correct judgments, which will in turn ensure the proper protection of shareholders. Providing the capital markets judges with the proper education about corporate governance is important, especially because this notion is relatively new to the Kuwait business and legal cultures.

Thus, corporate governance training courses should be introduced to guarantee that the judges absorb corporate governance elements before deciding any dispute.

Since the notion of corporate governance is still absent, it is recommended that all who participate in addressing corporate governance issues should receive the same education, including, for example, employees in each of the shareholding companies regardless of whether the company is listed in the KSE. The lawyers who represent business practitioners in cases before the court should participate in training courses that present the significant role of corporate governance in providing better protection to shareholders and in enhancing a healthy investment environment.

Moreover, corporate governance as an academic module taught in the universities has been introduced in many countries due to its importance in the contemporary effect upon the business society. In the UK, for example, many universities are teaching corporate governance as a supportive element to develop a business society that appreciates the importance of corporate governance and its benefits. Consequently, it is recommended that Kuwait University and the other private universities in Kuwait begin teaching the corporate governance academic module to raise awareness of corporate governance benefits among the potential practitioners in the law and business sectors.

Educating future participants in the business and the legal cultures regarding corporate governance would enhance the best practice, as they will combat against company wrongdoing and will acknowledge the importance of protecting the shareholders of the companies.

8.5 Institute of Directors:

According to the New Capital Market Authority in Kuwait,⁸⁸⁷ corporate governance is one of the objectives of creating such a capital market. Therefore, to foster and facilitate the application of proper corporate governance in the Kuwaiti stock market, it is recommended that an Institute of Directors be established. This Institute would play a significant role in establishing a sound system of corporate governance among the shareholding companies in Kuwait, raise the awareness of the advantage of corporate governance among the directors, and develop the management skills required to direct a company.

Moreover, the Institute of Directors could increase the number of independent directors by establishing a registration for independent directors who hold specific qualifications and who could be nominated by companies to serve as independent directors on their corporate board. Furthermore, such an institution should require companies to offer training courses, specialized seminars and conferences that relate to the improvement of the directors' professional skills. For example, the Institute may invite directors who have been successful internationally to share their experiences with the directors in Kuwait. A mixture of professionals should manage the Institute of Directors in business, the law and administration to broaden the benefit.

A research department should also be part of the Institution to produce studies that are important for business, that will bring attention to the newly developed capital markets, and that will keep the participants updated regarding international development in related issues. The Institute may also participate in the policymaking process or at least serve as a consultant regarding legislation or regulation related to corporate affairs.

⁸⁸⁷ Capital Market authority in Kuwait 7/2010.

Institutes of directors have been established in several countries ranging from developed to developing countries, such as the UK, Egypt and the United Arab Emirates.⁸⁸⁸

8.6 Shareholders` Association:

Several important recommendations have been advanced above that should enhance shareholder rights. Such shareholder rights are especially important in Kuwait, where company ownership is concentrated and the major shareholder is the manager in most Kuwaiti companies. To a certain extent, such recommendations might be efficient, but to reap a significant benefit from such recommendations, the shareholders themselves should actively exercise their rights to confront the major shareholder, who is usually also the company's manager. Shareholders in Kuwait are not active especially in the companies' annual general meetings.

This lack of shareholder activism in Kuwait may be attributed to a number of reasons, such as ownership concentration and management by the major shareholder of the company along with restrictions on the rights of shareholders and the high percentage threshold required for other shareholders' rights. Accordingly, the above-mentioned recommendations regarding shareholder rights should encourage shareholders to exercise their rights in the companies, reduce management malpractice, and increase shareholder protection. Another important suggestion is that a shareholders association be established to ensure that the shareholders are protected and that they adequately exercise their proper rights. Such an association will also enhance shareholder education in relation to both their rights and the proper way to exercise those rights.

In terms of corporate governance, the shareholders association will raise shareholder awareness of corporate governance especially in Kuwait, where such a notion is still largely absent. Furthermore, the shareholders association is recommended to provide

⁸⁸⁸ The United Kingdom Institute of Directors available at: <http://www.iod.com/home/>. The Egypt Institute of Directors available at: <http://www.eiod.org/>. the United Arab Emirates Institute of Directors available at: <http://www.mudara.org/>, all retrieved on 20/5/2011.

shareholders with important training courses regarding the way their rights are exercised and the importance of several significant issues, such as attending the annual general meeting and their rights against company wrongdoing. Moreover, if shareholders in Kuwait gain the right to pursue derivative suits, the association should offer seminars that address this important right and to ensure that they do not exercise the right excessively.

Accordingly, establishing a shareholders association will also lead to increasing shareholder knowledge about corporate governance that will in turn achieve the goals of properly protecting shareholders and sustaining development of the companies' business. Establishment of a shareholders association will enhance the sound application of corporate governance in Kuwait.

The shareholders association concept is available around the world in many countries, such as the shareholders association in the UK.⁸⁸⁹

8.7 Establishing Corporate Governance Code For Kuwait:

Kuwait still has no corporate governance code for listed or unlisted companies in the KSE. However, the new capital market will require that such a code be established, as it has been mentioned in the Capital Market Law 7/2010. Accordingly, Kuwait should adopt a corporate governance code to cope with the regulatory developments implemented by neighboring states.⁸⁹⁰ Kuwait should complete the legal and financial regulatory development after producing the capital market law and create its own integrated corporate governance code to ensure company management discipline and the proper protection of shareholders in Kuwait.

Consequently, to ensure the success of corporate governance in Kuwait, it is recommended first that the market participants i.e. the board of the capital market, the boards of directors of the companies, the companies' shareholders, and the stakeholders should appreciate the importance of the best practice of corporate governance.

⁸⁸⁹ The UK Shareholders Association, the Independent Voice of the Private Shareholder available at: <http://www.uksa.org.uk/>, retrieved on 20/5/2011.

⁸⁹⁰ Examples are Saudi Arabia, United Arab of Emirate, Qatar and Oman.

Furthermore, the corporate governance code should gather the related rules instead of borrowing rules from other laws and regulations in Kuwait. Hence, the code of corporate governance would ease the mission among the participants to comply with the best practice of corporate governance.

Therefore, it is recommended that Kuwait benefit from the experience of other countries such as UK Corporate Governance Code 2010,⁸⁹¹ whereas its better to benefit from the experience of the Saudi Arabia and the United Arab Emirates regarding codifying corporate governance rules,⁸⁹² since both codes incorporate rules that enhance the discipline of company management and thereby improve shareholder protection. These countries have the same economic culture as Kuwait, which makes the adoption of their rules viable. Their codes address several important issues that support the application of a sound corporate governance system. For instance, shareholder rights are clearly mentioned.

The duties and responsibilities of the board of directors have been specified to avoid any confusion. Further, they provide for the formation of the board's committees and the way to appoint the members of such committees. Ultimately, it is recommended that Kuwait establish its own corporate governance code and take into account the experiences of other similar countries to ensure the success of the implementation of its new code.

8.8 Conclusion:

In this chapter, several aspects were proposed to be amended or, if they do not exist, to be incorporated into the legal infrastructure for corporate governance in Kuwait. The recommended aspects have been inferred from the discussion through the chapters of this

⁸⁹¹ UK Corporate Governance Code 2010, available at:

http://www.frc.org.uk/documents/pagemanager/corporate_governance/uk%20corp%20gov%20code%20june%202010.pdf, retrieved on 6/12/2011

⁸⁹² The Ministerial Resolution No. (518) of 2009 Concerning Governance Rules and Corporate Discipline Standards in the United Arab of Emirates and the Corporate Governance Regulations in the Kingdom of Saudi Arabia Issued by the Board of Capital Market Authority Pursuant to Resolution No. 1/212/2006.

work regarding the current level of corporate governance in Kuwait. Consequently, this work has revealed that corporate governance in Kuwait is minimal with regard to some issues and absent with regard to other issues. Thus, the aim of this chapter was to recommend whether to amend or to establish new legal provisions or regulations that should facilitate the sound application of corporate governance in publicly held companies and in state-owned enterprises.

In state-owned enterprises, it is recommended that the Kuwaiti legislature introduce a special companies law for state-owned enterprises instead of the current situation in Kuwait, as such enterprises are governed by a variety of laws and regulations in addition to the overlapping role of the governing authorities. Establishing a special law for state-owned enterprises will ensure good management, because the directors' duties will be clear and political interference in such enterprises will be significantly reduced. Curbing political interference in state-owned enterprises would support the effective application of corporate governance among these enterprises. In terms of publicly held companies, the recommendations were divided among the provisions of the Companies Law and stock exchange market regulations.

The Companies Law in Kuwait failed to introduce several issues that should relate to the application of sound corporate governance. In turn, such failure undermines shareholder rights. For example, a recommendation was made to incorporate into the Companies Law a clear definition of the duties and responsibilities of directors in shareholding companies to determine when breaches occur and to facilitate the check and balance by their shareholders. Moreover, the disclosure of the executives' remunerations and related party transactions were major obstacles to the application of corporate governance.

Therefore, the recommendation was made to ensure that the new regulations provide for proper disclosure to the companies' shareholders about such transactions to enable them to make informed decisions whether to approve such transactions at the shareholders' general meeting. Furthermore, the recommendation also has been made that

the Companies Law require the creation of board of directors' committees, such as a remuneration committee, an audit committee, and a nomination committee in addition to the appointment of directors in the board. The appointment of the directors in the companies' board has been addressed by the appointment of independent directors and that board committee should consist of independent directors. Further, it is also recommended that the specific qualifications should be the criteria for appointing the directors. In this regard, the proposal was made to establish the Institute of Directors, through which directors could develop their skills by attending seminars or conferences organized by that institution.

The association of shareholders is also recommended to improve the shareholders' knowledge of corporate governance benefits to protect their rights against the malpractice of company management and to improve the shareholders' activism at company general meetings. Accordingly, the recommendations mentioned in this chapter will enhance the application of corporate governance in Kuwait to protect shareholder rights and to ensure the sustainable development of each company's business in Kuwait.

Chapter Nine: Conclusion

9.1 Conclusion:

Corporate governance is becoming an integral part of the corporate practices in the developed and developing countries. This is especially true after the collapse of Enron and WorldCom. Moreover, corporate governance as a concept has become increasingly common in public debate. The malpractice and scandals in companies are the main sources of this concept. Thus, corporate governance as a system is curtailing expropriation by the management of companies at the expense of the shareholders. Furthermore, due to the importance of establishing a sound corporate governance system, each of the Gulf Cooperation Council (GCC) countries has adopted its own corporate governance code.

The purpose of adopting a corporate governance code is to achieve two objectives. The first objective is to impose proper protection for the shareholders against malpractice by management, especially in the GCC countries, where the ownership structure is concentrated and management is mostly in the hands of the major shareholders. The other objective is to ensure that the investors have confidence in the market's system to attract local and foreign capital.

Kuwait is still the only country among the GCC countries that has no corporate governance code. Therefore, this work has examined whether there are corporate governance practices within the laws and regulations in Kuwait that ensure the proper protection of investors, and, if so, to evaluate the extent to which they are efficient.

To achieve the objective of this work, the **second chapter** explored the most appropriate definition of corporate governance for this thesis, a definition that is clear and detailed. There are numerous definitions of corporate governance, as each definition represents a different school. For instance, the definition of corporate governance according to the agency theory school differs from the definition provided by the

stakeholder theory school. Furthermore, the definition may vary from country to country, because corporate governance depends on the legal and economic systems of each country. The Organisation for Economic Cooperation and Development (OECD) has provided a corporate governance definition that is detailed, clear and useful in understanding and applying corporate governance appropriately.

In addition, this chapter presented a general explanation for the theoretical framework of corporate governance. Some theories have participated in the development of the concept and the scope of corporate governance, such as agency theory, stakeholder theory, and the stewardship theory. These theories were discussed to facilitate the understanding of the corporate governance foundation.

In **chapter three**, the idea of corporate governance mechanisms and the challenges encountering them in the emerging markets were explored. In addition, solutions were suggested to resolve the deficiencies of corporate governance in the emerging markets, such as the Kuwait Stock Exchange (KSE). Furthermore, the ownership structure in the emerging markets is concentrated, because of the privatization programmes in host countries and the involvement of family businesses. Privatization programmes have played a major role in transferring the ownership of state-owned corporations from the state to the private sector. Moreover, the privatization process has not been properly implemented in the emerging countries, and many deficiencies have surfaced. Therefore, the importance of corporate governance has increased significantly in the emerging markets in large part due to the concentration of ownership.

The concentration of ownership is facilitating misconduct in the market since the controlling shareholder is not governed by strong regulations or laws that protect the other shareholders. Consequently, the concentration of ownership and the role of the major shareholder as manager have caused a conflict between the interests of the controlling shareholder and the other shareholders instead of the usual conflict between the shareholders and the management.

The development of corporate governance in the emerging markets is confronted by a number of obstacles. For instance, the private benefit of control by the owner manager, who is most commonly the controlling shareholder in the emerging markets, illustrates one of these obstacles in particular where there weak legal infrastructure to protect the other shareholders. Also, the system in the emerging markets is relationship-based, which means that these markets function according to the relationships between and among the related parties. It is contrary to the rule-based system, in which the regulations and the laws are the dominant factors in the operation of the markets and are prevalent in the developed markets.

Accordingly, corporate governance is a major factor with regard to transforming the markets from a relationship-based to a rules-based system. Such a transformation is encountering a number of barriers, such as the expropriation that is exercised by the insiders of a company against the minority shareholders and the placement in executive positions within state-owned enterprises or within the local political entities of powerful and vested interest groups.

Such corporate governance deficiencies in the emerging markets are strongly attributed to the weaknesses of the institutions. These institutions, which can be legal, financial or political, can play a major role with relation to the existence of the corporate governance system. Furthermore, this chapter demonstrated that the emerging markets must begin to improve the implementation of corporate governance through the effective application of their laws and regulations.

Notably, the policy makers in the emerging countries must take into account the differences between the countries, since the application of corporate governance differs from country to country. Accordingly, choosing the appropriate corporate governance system should depend upon the legal roots of the country, as well as its political culture.

Chapter four highlighted the main influential elements that affect the corporate culture in Kuwait. Before the exploration of oil in the 1930's, Kuwait's commercial

activities were simple and small. However, the profits from the oil sales changed Kuwaiti society from a productive to a rentier society, as Kuwait became highly dependent upon oil to finance its public budget. In addition, this chapter explored the significance of the fact that the public sector in Kuwait employs the majority of Kuwaiti workers and that the Kuwaiti business culture is dominated by family businesses. However, the family businesses in Kuwait are now going to be shareholding companies. This conversion is expanding the size and importance of the stock market in Kuwait, which requires that it should be protected through proper laws and regulations.

Consequently, **chapter five** examined the political and legal institutions in Kuwait to evaluate the possibility of implementing sound corporate governance. First, examination of the political institutions in Kuwait revealed that reform is needed, as the current practice in these institutions does not and cannot provide a base for sound corporate governance primarily because of the entrenchment of administrative corruption in the Kuwaiti government and parliament.

The corruption among the political institutions has entrenched the relationship-based system in Kuwait, since the politicians have deviated from the proper functions that are expected from them. However, changing Kuwaiti society from a relationship-based system to a rules-based system can be achieved through the strict implementation of the principle of the Rule of Law. Furthermore, the proper system of corporate governance plays an important role in the conversion process from a relationship-based system to a rule-based system in any country.⁸⁹³

The corporate governance's legal institutions in Kuwait were also examined in this chapter due to their importance to the establishment of a proper corporate governance system. The legal origins and systems of any country tend to play a significant role in the

⁸⁹³ Oman, Charles, Fries, Steven and Buiters, Willem, *Corporate Governance in Developing, Transition and Emerging-Market Economies*, at p 33. This is a research paper presented by OECD Developments Centre, Brief No: 23.

implementation of corporate governance.⁸⁹⁴ Whereas, according to LLSV findings, Kuwait provides weak protection to shareholders because of its civil law system.⁸⁹⁵

The other legal institution that was examined is the judicial authority and particularly the extent of its independence. The judicial authority in Kuwait enjoys very high independence as provided for in the Kuwait Constitution (1962).⁸⁹⁶ However, the judges in Kuwait may find it difficult to absorb the corporate governance concept, since it has not been recognized in Kuwait to date. Thus, Kuwaiti judges must be trained regarding corporate governance, since it is a new notion in the Kuwait business culture, and there is no mention of corporate governance in Kuwait's education sector.

This chapter also investigated another important legal institution, the Commercial Companies Law No. 15/1960. The examination of such law is very important to determine whether the Kuwaiti legal infrastructure encompasses corporate governance provisions or not and, if so, what is the extent to which they are efficient. Accordingly, examination of Kuwait Commercial Companies Law 15/1960 includes a number of corporate governance issues, such as the basic rights of shareholders. However, the examination of this law showed the failure to include important issues that should relate to corporate governance. For instance, Kuwaiti law does not require that the positions of a company's CEO and the board chairman be separate, which is an obstacle to achieving the best practice of corporate governance. In addition, the Kuwait Companies Law does not oblige companies to establish audit, nomination or compensation committees. Although, some companies may constitute committees, they cannot be considered corporate governance practice, because they are not required to be composed of independent directors, as independent directors are not mentioned in the Companies Law. Another failure is that there is no clear definition of the directors' duties, as the result of which the directors will not be held accountable for their malpractice.

⁸⁹⁴ See R. La Porta, F. Lopez-de-Silanes, and A. Shleifer and R. Vishny, Legal Determinants of External Finance, (1997) 52 *Journal of Finance*, at p. 1131.

⁸⁹⁵ *Ibid.*

⁸⁹⁶ The Kuwaiti Constitution was created in 1962.

Finally, the investigation of this institution revealed that the Kuwait Companies Law has provided for only basic shareholder rights, as the result of which the actual practice in Kuwait allows the concentration of ownership and control in the hands of the major shareholder, who benefits at the expense of the other shareholders. Existing shareholders rights are inadequate to permit minority shareholders to confront the major shareholders effectively. Therefore, recommendations have been made to strengthen the shareholders to enable them to protect their rights against the controlling shareholders in Kuwait.

In the **sixth chapter**, the current corporate governance practice in the state-owned enterprises (SOE) in Kuwait was examined because of the importance of this type of companies in Kuwait. The discussion in this chapter revealed that two main barriers confront the application of the best practice of corporate governance in Kuwait's State Owned Enterprises. The first obstacle is that the absence of a clear legal framework for the SOEs in Kuwait as has been suggested by the OECD's principles for the corporate governance in the state-owned enterprises. The absence of such a legal framework for the SOEs creates in many instances overlapping between the applicable laws and regulations over the SOEs issues. Therefore, the best practice of corporate governance is weak and inefficient in the state-owned enterprises in Kuwait. Hence, the SOEs in Kuwait are working within an improper legal environment, since the objectives of establishing such enterprises are lost.

This chapter also revealed that the absence of a clear legal framework for the SOEs has intensified the political interference in a way that obstructs achieving the objectives of establishing state-owned enterprises in Kuwait. For example, political interference in Kuwait has resulted in overstaffing the SOE's and encouraged SOEs to adopt nepotism and favoritism as preferred criteria for the appointment of their employees. Moreover, political interference in Kuwait caused the cancellation of projects with international parties for reasons not approved to date, such as the K-Dow petrochemical deal between Petrochemical Industries Company and Dow-Chemical.

Although the best practice of corporate governance of the state-owned enterprises in Kuwait suffers from the absence of a clear legal framework and from great political interference, there are several institutions that should relate to the enhancement of the application of the best practice of corporate governance in the SOEs in Kuwait. For example, the State Audit Bureau (SAB) in Kuwait has been empowered to supervise governmental bodies in terms of the application of financial and administrative regulations. As a result, the SAB has a significant role in supporting the application of corporate governance within the SOE context, especially because the SAB is required to report any infringements to the Parliament, the Prime Minister, or the Ministry of Finance.

On the other hand, Law No: 1/1993 is another element that enhances the application of corporate governance in the SOEs in Kuwait, since this Law provides severe penalties against public servants or workers who commit violations toward public funds inside or outside of Kuwait whether due to negligence or intentional acts. Law No. 1/1993 is playing a major role in protecting the rights of shareholders in the SOEs, as the residual shareholders are the Kuwaiti citizens. Furthermore, the state-owned oil enterprises in Kuwait have made initiatives toward the application of corporate governance. This vital sector has applied a code of conduct for employees encouraging them to act in an ethical manner that supports the business of such enterprises. In addition, this code of conduct requires workers to maintain confidentiality for such business. Further, the same sector in Kuwait has arranged a seminar for its executives regarding the best practice of corporate governance in such enterprises.

In contrast, although there are initiatives by the SOEs for the application of corporate governance in such enterprises, Kuwait has no code or guidelines regarding the application of corporate governance in the state-owned enterprises. Kuwait needs corporate governance in SOEs, especially after introduction of the privatization law, which revealed the government's intention to transfer the title of public bodies to the private sector. Therefore, investors must be confident that the employees of the candidate

entities to be privatized are working appropriately. As a consequence, the privatized enterprises are going to be listed in the stock market as holding corporations.

Chapter seven investigated the applications of the best practice of corporate governance in the joint stock companies that are listed in the Kuwait Stock Exchange (KSE) to determine the current level of investors' protection that is delivered by the KSE's laws and regulations. Chapter seven considered the extent to which those laws and regulations ensure the appropriate protection for the shareholders of the listed companies, notwithstanding the fact that the KSE has not yet established corporate governance codes for the listed companies even though most Middle East and North Africa (MENA) countries and GCC countries with similar conditions as Kuwait have adopted such codes.

In this context, to evaluate the level of shareholder protection in light of the KSE's laws and regulations, several issues were examined, including the level of disclosure and the listing requirements as a corporate governance mechanism. The evaluation of these issues revealed that the level of disclosure under the KSE legal framework is considerably low and inefficient. For instance, the disclosure about the remunerations received by company executives is not effectively exercised in the listed companies. Moreover, the inadequate disclosure of the related party transactions also constitutes another failure in the legal framework of the KSE. Therefore, such failures in the disclosure regulations of KSE are considered as significant weaknesses in relation to the level of shareholders' protection. Furthermore, the examination of the listing requirements of the KSE as a corporate governance mechanism has disclosed that these requirements are out-dated, as they do not incorporate provisions that enhance shareholder protection, except for a general disclosure requirement.

Therefore, the findings of this chapter suggest that Kuwait should incorporate a corporate governance code to develop shareholder protection in the capital market, especially because the majority of the listed companies are ownership concentrated and are controlled and managed by the major shareholders. Further, several issues should be

considered when incorporating corporate governance codes, such as the corporate culture aspects to avoid enviable issues.

Consequently, **chapter eight** offered recommendations that were found during the discussion of this work. The purpose of these recommendations is to facilitate and foster the incorporation and the application of corporate governance in Kuwait and to enhance shareholder protection in the KSE whether the shareholders are foreign or locals.

An important guideline has been taken into account regarding the proposed regulations, which is not to incorporate any laws or regulations that are not compatible with the legal and social conditions of Kuwait. In other words, consideration has been taken to ensure that the suggested recommendations are viable in Kuwait and would not contradict its legal and social conditions. Otherwise, the recommendations will not be effectively implemented.

9.2 The Contribution of the Study:

This study is the first study to consider corporate governance in Kuwait from a legal perspective. This study investigated the legal infrastructure in Kuwait to examine the efficiency of the current laws and regulations that should relate to the application of corporate governance. The examination was made to the legal system of the state-owned enterprises in Kuwait and to the legal system that governs the joint stock companies in Kuwait stock Exchange. Moreover, this study also addressed the importance of corporate governance before the privatization of the state-owned enterprises begins to attract investors to participate in such privatization. Furthermore, Kuwait has not yet adopted a corporate governance code for either the state-owned enterprises or for the listed companies in the KSE. Accordingly, this study contributes in bringing the attention of the policy makers in Kuwait to the importance of adopting corporate governance to provide proper protection for investors in addition to the important steps that should be taken to facilitate the application of a sound corporate governance system in Kuwait to avoid the enviable issues.

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