RESEARCH PROPOSAL

FOR A DEGREE OF DOCTOR OF PHILOSOPHY, (Ph.D)
(COMMERCIAL LAW) AT THE UNIVERSITY OF CAPE TOWN,
SOUTH AFRICA (2017-2020).

Regulatory and Judicial Responses to Managerial Fraud in Uganda and South Africa: A Case for Theoretical Review of State intervention to strengthen Free Market Corporate Systems for Managerial Accountability in Relation to Employee and Creditor Interests.

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November 2017
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Abstract

MANAGERIAL fraud in corporate firms, private or public, by directors and managers who are entrusted with company affairs, remains a complex issue and a challenge to modern corporate law. It puts to question the theoretical and structural foundations upon which corporate firms are established and run. While it is well established that firm managers who perpetrate fraud have no protection in law, Uganda continues to witness manifestations of managerial fraud arising primarily, from regulatory and institutional inadequacies. The controversial question is how best, to regulate firms in general, and in particular, their managers, so that interests of non-shareholder constituencies of employees-creditors who traditionally do not constitute firm managerial structure, are protected from dubious personal interests of firm managers. This study builds on emerging views that a corporate firm is a collection of interests, for which employee-creditor interests is part, and firm managers are obliged to look after and protect as firm interests. It is, however, somewhat blurred, and it is contested, whether that protection necessarily entails a self-enforcing corporate model with direct employee-creditor participation in decision making on matters which might affect them, especially, where regulation or market for corporate controls is either weak or has failed. From the Hansards, managerial fraud was


2 See Note 35, infra.

3 See Dodd M E, Jr, “For Whom are Corporate Managers Trustees?” Harvard Law Review (1932)45 No. 7 pp 1145-1163 at 1151-1152. See also Keay A, and Donaldson, infra, Note 76.

4 See Black infra, especially pp 249-251; Dodd, opcit, and generally Kraakman et al. pp 100-104;
central in the debate and final enactment of the Companies Bill, 2009, which came to be Uganda’s Companies Act 2012. For the first time in the history of independent Uganda, fraud has been enacted, as a standalone reason, to lift the veil of incorporation. The Act also codified director’s fiduciary duty in its substantive provisions, and a generic code of corporate governance, ‘the Code’. These provisions are progressive and conform largely, at least in text, to the reform agenda of the Bill. A close look at the Act however, there is doubt about its efficacy to deal with managerial fraud, beyond the codification: What constitutes managerial fraud is not defined. That role, as before, has been left for the courts. Assigning a specific meaning to managerial fraud or an indication of it, than just generalizing it, was desirable. The same holds for the director’s fiduciary duty. There is no apparent difference with common law fiduciary duty of firm managers. Secondly, is the disparity in treatment of closed firms from publicly held ones in regards to application and utility of the Code. Mandatory compliance by closed firms only arises upon adoption of the Code which may be in part, or in whole. For a country with predominantly closed largely-family owned firms, some aspects of the Code should have been made progressively obligatory as a deliberate strategy to grow good corporate culture in closed firms. Similarly, declaration of financial transactions to non-shareholder

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5 See Hansards of 11.05.2011 pp 9, 17, 18, and 19. See also Note 7, infra.
6 Section 198(c) provides that directors shall act in good faith in the interest of the company as a whole which shall include: ‘treating all shareholders equally’, ‘avoiding conflicts of interests’, ‘declaring any conflicts of interests’, ‘not making personal profits at the company expense’, ‘and not accepting benefits that will compromise him or her from third parties’, and ‘ensure compliance with [the Act] and any other law. Section 14 read together with Schedule ‘F’ provides for the Code of Corporate Governance which is mandatory only for public firms. Surprisingly, Annual General Meetings (AGM) under section 138(2) is optional for closed firms, a departure from the earlier position in the repealed law Cap 110. Traditionally, AGM is a check and balance on management. See Fama E & Jensen Michael, “Agency Problems and Residual Claims” (1983)26 Journal of Law and Economics 327 cited in Kraakman et al at p13.
7 Hansards of 21.03.2012 p7.
8 Section 20. Prior, the courts applied common law in establishing existence or otherwise of fraud.
9 See Hansard of 11.05.2011, 21 and 22. 03.2012; mismanagement was a big concern in the House.
10 South Africa’s Companies Act No, 71 2008 in its Section 7 (2) on ‘Liability of directors and prescribed officers’ specifically refers to common law principles on breach of a fiduciary duty.
11 The Act has 324 sections with equally elaborate schedules of elective substantive articles.
12 Section 14.
14 For example, Article 17 on Accounting and Audit. From the Hansards of 11.05.11 and 21.03.2012, no particular reason was given for making the Code optional for closed firms.
constituencies is critical\textsuperscript{15}. This can be tied to the age, financial base or employee size of a firm so as not to overly burden small-medium size firms with compliance costs\textsuperscript{16}.

Thirdly, under the Act, as already said, the enforcement role is principally with the courts, and the regulator, Uganda Registration Services Bureau (URSB)\textsuperscript{17}. The latter oversees registration of corporate firms and is the custodian of the company register and other corporate firms’ records. Courts and regulators like, URSB are however considered ‘indirect participants’ and are a less effective corporate model (in developing economies), due to endemic institutional challenges\textsuperscript{18}. Moreover, most times, courts come in \textit{posthumously}. These apparent regulatory and institutional deficiencies lend credence, and this study sets out to interrogate, the feasibility and application of alternative interventions founded on stakeholder theory\textsuperscript{19}. A self-enforcing model with employee-creditor direct participation in decision making on matters which affect them; Public recognition and reward for good managerial behaviour informed by clear policy frameworks; and Tax incentives in form of tax credits or rebates for properly managed firms.

\textbf{1.0. Research Problem.}

Traditionally, conventional response to managerial fraud has been largely through regulation and judicial processes other wards ‘\textit{outword}’ interventions. The presupposition for this type of intervention is that there are in place robust institutions adequately facilitated to carry out their regulatory and judicial function. This institutionalized approach to managerial fraud is characteristic of formalities which have tended to create more operating space for managerial

\textsuperscript{17} Section 4(2) of the URSB Act. Comparatively, South Africa’s Companies Act 2008 has more institutions which administer the Act outside the Courts. These include: The Companies and Intellectual Property Commission, a Take Over Regulation Panel, the Companies Tribunal, and the Financial Reporting Standards Council.
\textsuperscript{18} See Note 32, \textit{infra}. However, it is also agreed that the functionality of the courts is critical.
fraud. Coupled with director privacy which has over the years developed to grant firm managers near absolute powers, there have been emerging proposals cloth around the stakeholder theory, that perhaps, considerations need to be had on non-shareholder constituencies of creditors and employees. It has been particularly argued that economies with modest resource envelopes and with systemic deficiencies, may have to rethink their interventions on managerial fraud and focus on inward approaches which is self enforcing\textsuperscript{20}. The theoretical underpinnings of these arguments have been the stakeholder theory which views a firm as a collection of interests in contrast with shareholder primacy which presupposes superiority of the shareholder constituencies over other firm interests.

It is claimed here that, if the stakeholder theory were to hold, there is no particular clash between creditor and employee interests on the one hand with interests of other stakeholders. In fact, to the contrary, the convergence appears to be continued existence and profitability of the corporate firm. If employee-creditor participation can enhance this economic function of corporate law and function, perhaps, it is not in vain.

Where there is divergence and jurisdictions have tended to respond differently on the nature and extent of participation of creditors and employees in corporate management.

2.0. **Research Question**

2.1. The specific question in this study is whether by enacting section 20 of the Companies Act 2012 on fraud read together with section 198 on fiduciary duty of directors, and the code of corporate governance, Uganda has put in place, a regulatory and institutional framework to respond to, and contain, managerial fraud.

2.2. And if not, whether non-legal but state driven market-like interventions might remedy the problem. This include: adopting a self enforcing model of corporate law which secures employee-creditor participation and incorporating them to an extent, into the corporate management structure; Recognitions and rewards of good managerial behavior; allotment of shares to employees as a group to entitle them vote for a director designate; and tax incentives and rebates on sensitive sectors or goods on clear policy framework which promotes good managerial behavior.

\textsuperscript{20} Kraakman, opcit.
3.0. Chapterisation

In terms of structure, it is proposed to divide this study into seven (07) chapters. Chapter one will be an introduction which contain: An Introduction to the legal and structural forms of corporate firms and how they operate, the economic and political functionalities of corporate firms. To be canvassed briefly, since it is not the intended purpose of the study, will include the attributes of corporate firms such as corporate personality, limited liability, delegated management through a periodically elected board of directors, transferability of shares and investor ownership. Of the five attributes, the proposed study will focus more on delegated management, while others such as corporate personality, limited liability, and investor ownership will be referred to as and when it is justified. For example, a reference to limited liability is relevant because it is the incentive for management to take decisions without fear of personal liability of course with exceptions such as fraud which is the concern of the study. On the other hand, a connective discussion of investor ownership is considered relevant because, stakeholder theory arguments which has been considered in this proposed study to the effect that other stakeholders who are infected and affected by managerial decisions such as employees, and creditors, among other must be taken care of, and in justified circumstances, their participation in decisions on critical matters where their interests are at stake, is obtained. This is intended to offer a holistic approach to the research question and to seek solutions in context of Uganda.

Chapter Two is an attempt at a critical review of existing literature in the research area of managerial fraud. The problems identified by earlier works will be the basis upon which the efficacy of regulatory and judicial interventions in Uganda will be assessed specifically sections 20, and 198 of the Companies which have respectively codified fraud, generally, as one of the reasons where the courts in Uganda may order for the lifting of the corporate veil. The focus of this review will be local literature and those from South Africa, United Kingdom, and the United States. Preliminary findings so far also show that some good amount of work on the subject is from Germany and Japan and will be utilized.
This review will also highlight the existing corporate theories and regulatory models and their viewpoint on how managerial fraud can be dealt with. These include the Concessionist, Contractual, Organic, Stakeholders and Shareholder Primacy in the main, and on the other hand; self enforcing, enabling and prohibitive regulatory corporate models.

Chapter Three will be in-depth analyses of the regulatory and institutional framework in Uganda compared with that of South Africa. The focus will be on sections 20 and 198. Decisions of courts which have dealt with managerial fraud will be traced, analyzed and conclusions drawn from them. Fortunately, in the Uganda context, there is a recent decision of the High Court of Uganda whose facts give partial dimension of managerial fraud, but also a confirmation of the statement in the abstract that ‘managerial fraud is something which is insider and transactional21’.

Under this Chapter, the study also proposes to canvas in significant detail, corporate regulatory models as known seeking to establish which of them might work for a developing economy like Uganda. Under this sub discussion, the study intends to consider why, despite attempts at international regulation of corporate firms and by extension, corporate firm managers, these initiatives keep failing resulting into self regulation by the corporate firms, and non state actors such as the International Labour Organisation (ILO), United Nations, and World Trade Organizations (WTO). Some of the clear reasons discerned from existing literature on why there has not been much progress in regulating corporate firms at the international level are: lack of consensus among nation states on the form the regulation should take, disparities in economic levels, much influence of the corporate firms especially the multinationals, have a bearing on why state regulations are in the text that they are namely default provisions and in some cases, optional provisions of the law.22 The other observation from the

21 HCCS No. HCT 00-CC-CS-254-2009’ CitiBank Uganda Limited v Uganda Fish Packers Ltd dated 15.07.16 (Hon. Wangutusi J).
22 As said for example, the Uganda Companies Act provides for the code of corporate governance. The code is fairly elaborate and progressive in text. Unfortunately, it is optional for closed firms. The preliminary observation in this proposed study is that Uganda, a country whose registered closed firms constitute over 85%, this was a lost opportunity for government to spear head the growth of a corporate culture and facilitate small-medium size firms to run their businesses
preliminary reading in the preparation for this proposal is that at international level, the concern has been on human rights complicities in areas of labour standards, and environment and not managerial fraud *per se*. The nearest the international community has come to addressing the topic under study is discussing bribery. It is intended for this chapter and chapter Four to take a comparative approach so that Uganda is afforded an opportunity to benchmark best practices, if any, from South Africa. This study is not intended to dedicate a substantive chapter to the South African legal and institutional framework for two reasons: Firstly, the study is primarily intended for Uganda, but secondly, what would have otherwise been a substantive chapter for South African legal and institutional framework will be remedied, in appropriate circumstances, throughout the study, and ultimately the report itself, through specific reference to South Africa’s position of the law on given issue under discussion. This is the context in which the study should be understood as comparative.

Chapter Four will look at Uganda’s Courts and the URSB as institutions in the lead in fighting managerial fraud. The jurisprudence so far build locally on the subject since the enactment of the Companies Act in 2012 will be assessed with those from South Africa as an attempt to understand how managerial fraud has been dealt with elsewhere. Of the High Court Divisions in place, the study will focus on the Anti Corruption, Criminal, Commercial, Land and Civil Divisions. South Africa is a deliberate choice, because as pointed out in the abstract of the proposed study, there has been a consistent pattern for law makers and judicial officers alike, in Uganda, to bench mark the South African models of regulation and judicial processes, among other jurisdictions. In making adjudication of cases, courts make pronouncements on matters of policy. These policy considerations if any, and their impact on managerial fraud, will be analyzed and reported on. This can be found in the awards, fines and sentences in criminal cases. Other concerns will be, on the quality of prosecution, the length of time the

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ethically and professionally. In the interim, this is one initiative, which the study seeks to interrogate and propose that parts of the code be made obligatory either based on the age of the private firm or its liquidity or size of employees so as to ensure transition from village corporate culture to standard globally acceptable corporate norms and practices.

23 The Judiciary has created specialised divisions of the High Court. Currently, the divisions: Criminal, Civil, Family, International War Crimes, Commercial, Executions and Bailiffs, Land, and Commercial Divisions.
cases take and outcome. Courts view point on the relevant sections of the Companies Act 2012, if any, will be considered in this chapter. The concrete example intended to be provided in this chapter and Five, infra, will form the basis for validation of any proposals for regulatory and institutional reforms to be reported on in Chapter Six and partly, Chapter Seven on conclusions and the way forward.

Chapter Five will consider market corporate governance structures and how they play into the wider corporate law so as to establish whether in the context of Uganda with developing systems, there is validity in the arguments against a largely free market model of managerial control.

Chapter Six intends to report on the critical gaps that will have been discovered in the study arising from the discussion in Chapters Four and Five and make out a case for Uganda’s own model of management of managerial fraud. For example, it ought to be observed in the preliminary that a regulatory model couched along the organic theory which advocates for a centralized strong and independent Board and managerial team may be less effective in a developing country like Uganda whose systems are not well structured to deal with errant and elusive corporate firm managers. It is an observation that such models only works in systems like South Africa which operates a structured economy and there are in place, state apparatus which are functional. It also ought to be observed that for the case of Uganda, managerial fraud will not be contained by merely codifying common law positions in its legislations. In the absence of effective enforcement mechanisms, Uganda may want to consider a model couched around the stakeholder theory where for example, employees and creditor participation is paramount in critical decisions of the corporate firm. It appears cheap and effective rather than posthumous interventions such as courts which apply after the event. It will be investigated and reported on, the viability of this model of controlling managerial fraud as middle position for less regulation in a free market economy.

Chapter Seven is proposed to be the last and final chapter which will contain a summary of conclusion, key findings and recommendations and way forward.