The Laws on Regulators Takeover and Protection of Bank shareholders Rights in Uganda

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DECLARATION

I OJWEE SYDNEY, declare that the contents of this research paper titled "The Laws on Regulators Takeover and Protection of Bank shareholders Rights in Uganda" has never been presented and or submitted to any other university or higher institution for any award of Bachelors Degree of Laws. Except where due acknowledgment is made in the text. I now forward it for assessment to Kampala International University.

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APPROVAL

I certify that I have read this thesis and that in my opinion, it conforms to the acceptable standards of scholarly presentation and is fully adequate in scope and quality as a proposal for the intended thesis for partial fulfillment for the award of the degree of Master of Laws of Kampala International University.

Signature of the Supervisor: ......................................................

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Date : 29/4/19
DEDICATION

According to Waite Phillips, "Nothing worthwhile was ever accomplished without the will to start, and the enthusiasm to continue and, regardless of temporary obstacles, the persistence to complete without the help of others".

This research paper is dedicated with love and gratitude to my mother who on many occasions offered encouragement and advised me not to settle for nothing less than a law degree, and whose abundant love, extreme tolerance and deep understanding have sustained me throughout.

I also dedicate to my wife and the love of my life. You complete me.
ACKNOWLEDGMENT

It is customary for authors to thank all those who rendered help and or assistance to ensure that their works come to the final production.

In a special way, I thank the Almighty God for enabling me to write this research proposal. Secondly, I thank all the following for having rendered moral support and courage to enable this research proposal to come to its final production, my lecturers at Kampala International University, my family for the free time you gave me to write this proposal as you play my part at home, my fellow students for giving me reasons and incentives to write this book.

I acknowledge with thanks and appreciation the generosity, love, and caring of my dear wife Irene Ojwee. I also thank my dear children, Sydrene and Kyle for giving me space to work and Kampala International University, whose financial assistance has enabled me to have this research paper produced, otherwise, it would have been a myth.

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LIST OF STATUTES

DOMESTIC STATUTES

Bank of Uganda Act 2000
Companies Act of Uganda 2013
Financial Institution Corporate Governance Regulations of Uganda 2005
Financial Institution Credit Classification Regulations of Uganda 2005
Financial Institution Credit Concentration Exposure Limits of Uganda 2005
Financial Institution Credit Reference Regulations of Uganda 2005
Financial Institution External Auditors Regulations of Uganda 2010
Financial Institution Insider Lending Limits of Uganda 2005
Financial Institution License Regulations of Uganda 2005
Financial Institution Ownership Control Regulations of Uganda 2005
Financial Institution Amendment Act of Uganda 2016
Financial Institution Act of Uganda 2004
Micro Deposit Institution Act of Uganda 2003
The Financial Institutions Anti-Money Laundering of Uganda 2016
The Financial Institutions Consolidated Supervision of Uganda 2004
The Financial Institutions Capital Adequacy of Uganda 2005
The Anti-money Laundering Act of Uganda 2013
Tier-4 Microfinance Institutions Money Lenders Act of Uganda 2016
INTERNATIONAL INSTRUMENTS

- Basel Committee Report on Banking Supervision
LIST OF CASES

Matthew Rukikaire vs Incafex Limited (Civil Application No. 11 of 2015 UGSC 42 (2017)


Belgium v. Belgium, the judgment of the European Court of Human Rights of 23 July 1968.


Pender v Lushington (1877) 6Ch.d 70 C.A at 81

Cheff v. Mathes, (1964)199 A.2d at 548, 554

Hasan and Chaush v. Bulgaria, the judgment of the European Court of Human Rights of 26 October 2000.

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Sporrong and Lonnroth v. Sweden, the judgment of the European Court of Human Rights of 23 September 1982

Zeitlin v. Hanson Holdings, Inc., 397 N.E.2d (N.Y. 1979) at 387 and 388

Chesapeake Corp. v. Shore,( 2000) Del. Ch. 771 A.2d 293, 328
LIST OF ACRONYMS

BOU – Bank of Uganda

FIA – Financial Institution Act

IMF- International Monetary Fund

CAR - Capital Adequacy Ratios

ICB – International Credit Bank.

CBL – Crane Bank Limited

DIS – Depositors Insurance Scheme.

COSASE - Committee on Statutory Authorities and State Enterprises

OECD – Organization of Economic Co-operation and Development

ECHR – European Court of Human Rights

DIS – Deposit Insurance Scheme

ECJ – European Court of Justice

FDIC – Federal Deposit Insurance Corporation
## TABLE OF CONTENTS

DECLARATION .................................................................................................................. i
APPROVAL .......................................................................................................................... ii
DEDICATION ....................................................................................................................... iii
ACKNOWLEDGMENT ......................................................................................................... iv
LIST OF STATUTES ......................................................................................................... v
INTERNATIONAL INSTRUMENTS ..................................................................................... vi
LIST OF CASES ................................................................................................................ vii
LIST OF ACRONYMS ....................................................................................................... viii
TABLE OF CONTENTS ..................................................................................................... ix
ABSTRACT ......................................................................................................................... xiii

### CHAPTER ONE:

INTRODUCTION .................................................................................................................. 1

1.0 Introduction ................................................................................................................. 1
1.1 Background to the Study ............................................................................................ 1
1.2 Statement of the Problem ........................................................................................... 7
1.3 General objective ....................................................................................................... 10
1.3.1 Specific objective ................................................................................................. 11
1.4 Research questions ................................................................................................... 11
1.6 Scope of the Study ..................................................................................................... 12
CHAPTER TWO:......................................................... 23
SHAREHOLDERS RIGHTS........................................... 23
2.1 What are the shareholders' rights?..................................... 23
2.2 Shareholder rights under existing law............................... 24
  2.2.1 Economic Rights .............................................. 24
  2.2.2 Control Rights .............................................. 27
  2.2.3 Information Rights .......................................... 30
  2.2.4 Litigation Rights ........................................... 31
2.3 Liabilities of the shareholders .......................................... 34
2.4 How are shareholder rights protected?................................. 36
CHAPTER THREE ................................................................................................................. 44
LEGAL FRAMEWORK FOR REGULATORY TAKEOVER ................................................. 44
3.1 What is Regulatory Takeover? .................................................................................. 44
3.2 Problem Bank Resolution ....................................................................................... 46
3.2.1 Intervention ......................................................................................................... 47
3.2.2 Conservatorship .................................................................................................. 47
3.2.3 Final Resolution ................................................................................................ 48
3.2.4 Receivership ....................................................................................................... 48
3.3 Guiding Principles for the Resolution of Weak Banks ............................................ 49
3.4 Regulatory Action Prior to Closure ........................................................................ 50
3.5 Resolution after Intervention ................................................................................ 54
3.6 Procedures for Regulatory Intervention and Takeover of a Bank ......................... 57

CHAPTER FOUR ............................................................................................................... 61
ACTIONS THAT AFFECT SHAREHOLDER RIGHTS ............................................... 61
4.1 Speedy Regulatory Actions. .................................................................................... 61
4.2 Moral suasion and regulatory pressure ................................................................. 61
4.3 Temporary derogation from corporate governance requirements .... 62
4.4 Derogations that permanently affect economic interests .................................. 63
4.5 Termination of rights ............................................................................................ 64
4.6 Public assistance and shareholders’ rights ............................................................ 64
CHAPTER FIVE ............................................................................. 66

RECOMMENDATIONS AND CONCLUSION .............................. 66

5.1 Respect for legal principles ...................................................... 66
5.1.1 Predictability and legal certainty ........................................... 66
5.1.2 Due process ........................................................................ 68
5.1.3 Public interest ...................................................................... 71
5.1.4 Proportionality and adequate compensation ......................... 72
5.1.5 Adhering to International Regulatory Standards .................. 73
5.1.6 Improving Corporate Governance Mechanism .................... 74
5.1.7 Accurate and timely information ............................................ 75
5.1.8 Creation of bridge Institutions .............................................. 75
5.1.9 Government should Bail-out the banks ................................. 76
5.1.10 The Regulatory body should be more independent and Take Timely decisions ................................................. 77
5.1.11 There should be a pre-packaged resolution ......................... 77
5.1.12 Shareholder divestiture at positive net worth ....................... 78

5.2 Conclusions .......................................................................... 79

REFERENCES .............................................................................. 80
ABSTRACT

This study examines the "The Laws on Regulators Takeover and Protection of Bank Shareholder’s Rights in Uganda". The study was guided by the need for an effective Regulators takeover of a bank, the appropriate practice requires taking action while the bank still has positive net worth and shareholder claims still have economic value. Such actions raise a number of legal issues with respect to the rights of shareholders. This paper aims to consider how to strike a balance between the need to protect the legitimate rights of shareholders and the need for a prompt and rapid action of regulatory takeover that minimizes disruptions to the financial system and preserves market discipline. The paper is designed in such a way that it examines the nature of the shareholders' rights and the legal protection afforded to them particularly during takeover. In Uganda, the relevant sources of law are The 1995 Constitution of Uganda, The Acts of Parliament, International Conventions on Human Rights and the applicable subsidiary legislation in the banking sector and the Companies Act of Uganda. It considers different options for regulators takeover within the legal framework ranging from receivership to liquidation once certain regulatory thresholds are breached while the bank still has a positive net worth. The study concluded that the curbing of shareholder rights should seek to generate appropriate incentives for shareholders and other stakeholders and achieve broad objectives of enhancing predictability and maintaining public goods, while at the same time providing for due process, proportionality, and adequate compensation. The practical implications of this paper, therefore, is that it presents options on how to reform existing frameworks in order to facilitate bank restructurings in a crisis. It also discusses key elements that policymakers need to consider in the design of a regulatory framework for early intervention and resolution.
CHAPTER ONE:

INTRODUCTION

1.0 Introduction

The study examines the extent to which the rights of bank owners, herein referred to as bank shareholders, during the process of Regulators takeover of banks in Uganda are protected. In this chapter we shall discuss the background of the study, statement of the problem, the purpose of the study, the research objectives, research questions, research hypotheses, literature review, Methodology, the scope of the study, gender consideration, ethical consideration and limitation of the study.

1.1 Background to the Study

Banking problems exist throughout the world. These normally lead to bank Failures and eventual regulatory takeover has characterized the world banking sector over the past years. An International Monetary Fund (IMF) study by Lindgren, Garcia, and Saal (1996) revealed that during the 1980–spring 1996 period, 133 of the IMF’s 181 member countries had experienced significant banking sector problems.\(^1\) One of the biggest bank failures in the world was that of Northern Rock Bank in the United Kingdom that eventually led to the Global Recession of 2008. In August 2007 the United Kingdom experienced its first bank run in over 140 years. It was on

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\(^1\) Benton E. Gup, Bank failures in the major trading countries of the world: causes and remedies (1998) 1.
Northern Rock which was not a particularly large bank; it was nevertheless a significant retail bank and a substantial mortgage lender.\(^2\) This set the stage for many more bank failures in the world. In Africa, we have also seen a number of closures noticeable being that of African Bank of South Africa in 2014. It was closed due to bad management and liquidity problems, particularly around unsecured lending. East Africa has also seen its own share of bank failures. African Bank was initially very profitable for quite a number of years but then matters started going seriously downhill. The reason for its financial demise was to a large extent its unsustainable unsecured lending business and its acquisition of a large furniture retailer, Ellerines Furnishers (Pty) Ltd, for an amount of R9,2 billion just before the 2008 Global Financial Crisis (GFC).\(^3\) In East Africa, we have also had a number of bank failures and regulatory takeovers. In 1999 Trust Bank, the sixth largest bank in Kenya - in terms of deposits - collapsed due mainly to insider lending to directors and shareholders. The most recent bank failure was witnessed Euro Bank in 2003 and Daima Bank in 2005 collapsed.\(^4\)

Brownbridge in his 2002 work pointed out that Uganda had witnessed several large scale corporate failures in recent years; for example, The Co-operative Bank, The Greenland Bank, The Trans-Africa Bank, and The Trust Bank all collapsed in 1998 and 1999.\(^5\) Other banks like Teefe Trust Bank was affected in 1993, Global Trust Bank Uganda in September 2014,

\(^3\) BERTUS ROUX BURGER, Bank Rescue in South Africa( 2017) 14.

This rampant closure, therefore, necessitates government to come up with checks on the Banks. An effective bank supervision system is critical to a country’s financial stability. Prudential regulations set forth the framework within which banks must operate, and the Regulatory authority is responsible for enforcing these regulations. When a bank faces financial difficulties or operates in an unsafe and unsound manner, the Regulatory authority is responsible for taking action to resolve these problems. In Uganda, the banking institution is regulated by the Bank of Uganda. The Bank of Uganda Act states that the bank shall supervise, regulate, control and discipline all financial institutions. Control means the relationship between the parent undertaking and a subsidiary undertaking or similar relations between an individual and an undertaking or the power to determine the financial and operational policy of a financial institution pursuant to its charter or to an agreement, or direct or indirect influence by a person over decision-making and the management of a financial institution. With such powers entrusted to the regulators, there has to be a sound legal and regulatory mechanism that should adequately protect the interests of the Bank Shareholders.

In recent years we have seen many banks taken over and sold by the Bank of Uganda under questionable circumstances. The Auditors Generals report of 2018 recommended that the parliament of Uganda looks into the closure

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6 David C. Parker, Closing a Failed Bank (2011) 1.
7 The Bank of Uganda Act (Cap 51)1993, S4(2)(j).
of seven defunct banks as they had found irregularities in the takeover process.\(^9\) The parliament referred the matter to a committee of parliament which came up findings confirming that the bank of Uganda had disregarded the practice, regulations, and laws as regards regulatory takeover. Among other findings, it was established that: "BOU did not carry out valuation of the assets and liabilities of CBL BUT relied on the inventory report and due diligence undertaken by DFCU to accept their bid to arrive at the Purchase and Assumption of Assets and Liabilities (P&A)", BOU disclosed confidential information of distressed financial institutions to potential purchasers who are competitors without their knowledge in contravention of section 40 (3) of the Bank of Uganda Act", "BOU did not keep the asset movement ledgers and all records relating to the liquidation of the three financial institutions in distress i.e. ICB, Greenland, and Cooperative Banks).\(^10\) This, therefore, shows that the bank did pay close attention to the rights of the bank shareholders as they carried out their mandates.

Basel Committee on Banking Supervision in 2012 came up with 26 Core Principles for Effective Banking Supervision among which include: An effective system of banking supervision has clear responsibilities and objectives for each authority involved in the supervision of banks and banking groups, The regulator should possess operational independence, transparent processes, sound governance, and adequate resources, and is accountable for the discharge of its duties, The permissible activities of

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\(^{9}\) Auditor General, Special Audit Report of Bank of Uganda on Defunct Banks (2018-09-12).

institutions that are licensed and subject to supervision as banks should be clearly defined. Although these principles of banking seem to be catered for in the Ugandan legal framework relating to bank regulator, it is very apparent that the regulators are not adhering to them.

Some of the key conceptual definitions in this study are here and will guide this research. A Bank means any company licensed to carry on financial institution business as its principal business, as specified in the Second Schedule to this Act and includes all branches and offices of that company in Uganda.

A Regulator is an institution that is mandated to supervise and control the activities of banks to conform to a certain set of Bank regulations. Bank regulations are a form of government regulation which subject banks to certain requirements, restrictions, and guidelines designed to create market transparency between banking institutions and the individuals or Banks with whom they do business.

The regulatory takeover is when the regulator takes over the management of a private commercial bank. Most effective banking laws contain provisions that allow the Regulatory authority to take such corrective action. Action can range from moral suasion (appealing to the bank management and board of directors for their sense of public responsibility), informal and formal enforcement (including fines and removal of

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11 Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision(2012), 10.
personnel), and appointment of a conservator to license revocation and appointment of a receiver.¹³

Shareholders are the owners of the company and provide financial backings in return for potential dividends over the lifetime of the company. Supreme Court of Uganda in Matthew Rukikaire vs Incafex Limited, which ruled that a person who has not fully paid up their shares may be considered a member and shareholder of a company with rights to full participation in the affairs of the company to the extent allowed by the types of shares they hold.¹⁴ The European Court of Human Rights defines the right of a shareholder as the right to a share in the company’s assets in the event of its being wound up, and other unconditioned rights, especially voting rights and the right to influence the company’s conduct.¹⁵ During the takeover of the banks, most of these rights are however not taken into account, therefore, being abused.

The court distinguishes between pecuniary rights – the right to receive any remaining value in a company when it is wound up – and governance rights, i.e. the right to shape the company’s strategic direction.¹⁶ Although the Ugandan laws provide for these rights they seem not to be taken into account during the various takeovers, therefore, informing my decision to carry out this research.

¹³ David C. Parker, Closing a Failed Bank (2011) 1.
¹⁴ Matthew Rukikaire v Incafex Limited (Civil Appeal No.3 2015) (2017) UGSC 42.
¹⁵ Olczak v. Poland, the decision of the European Court of Human Rights (on admissibility) of 7 November 2002.
1.2 Statement of the Problem

Unlike other countries like the United Kingdom, South Africa, and Kenya that have had Bank failures and solved the problems without necessarily pushing out the bank shareholders or failing to compensate them in time. Such is government effort is seen in Banque Copine of Belgium in 1982. Here the Bank Commission insisted on reorganizing this bank because of its financial condition and weak management. Adverse press comments led to a run on the bank's deposits. The government's Rediscount and Guarantee Institute opened a line of credit to the bank and gave it a loan of 500 million francs.\[^{17}\] In Uganda however, these bank failures have resulted in grave consequences to the shareholders. The Auditor General's report of 2018 shows that all the banks that have been closed since 1998 are still being wound up to date yet some of the bank shareholders are dead like Mr. Kigundu of Greenland Bank that was closed in 1999. On the status of the bank, the report says: Closed and the process of winding up is ongoing.\[^{18}\] This is a total abuse of the rights of the shareholders.

The Bank failures in Uganda started in the early nineties and continue to hunt the country to as recent as 2017 with the closure of Crane Bank. Brown bridge pointed out that Uganda had witnessed several large scale corporate failures in recent years; for example, The Co-operative Bank, The Greenland Bank, The Trans-Africa Bank, and The Trust Bank all collapsed in 1998 and 1999.\[^{19}\] It is key to note that a bank facing the prospect of

\[^{17}\text{Benton E. Gup, Bank Failures in the Major Trading Countries of the World: Causes and Remedies-Quorum Books (1998) 17.}\]
\[^{18}\text{Auditor General, Special Audit Report of Bank of Uganda on Defunct Banks (2018-09-12) vi.}\]
\[^{19}\text{Brownbridge, 2002; Wanyama et al., 2006.}\]
failure may be a source of significant public concern given the potential costs to its depositors and, more importantly, to the rest of the economy. The problem here is that as the banks, the people who are more venerable to abuse are the shareholders. This study will, therefore, look at the current legal framework as regards regulators takeover and ascertain the extent to which it protects Bank shareholders rights during regulatory takeovers. The study seeks to find the rationale of closing banks by Central Bank of Uganda and to suggest interventions for effective protection of Bank Shareholders' rights.

Uganda's legal framework just like any other ordinary insolvency procedures provides highly developed mechanisms to deal with the interests of different classes of stakeholders in circumstances where a shortfall of financial resources prevents an economic agent from meeting all of its financial obligations on time and in full. This, however, comes at a cost of the right of one group against the other. Uganda has the Insolvency Act that deals only with institutions that are already drained of economic value. One would consider using it for the failed banks, but for a bank, this is too late because its capacity to perform its essential functions will have been compromised by then. Since general corporate Insolvency law is not well-suited to dealing with distress in financial institutions, a number of countries, including Uganda, has adopted special Regulatory Legal framework for banks. One feature common to all regulatory legal

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20 (Bank of England, HM Treasury, Financial Services Authority, 2008a, b, c).
frameworks is that they provide for pre-insolvency intervention and the curtailment of shareholder rights. Authorities need to intervene early when there is loss of market confidence and counterparties begin to entertain doubts about whether the bank will be able to honor its commitments.\textsuperscript{23} These early interventions are provided for in Section 82 of the Financial Institution Act 2014.\textsuperscript{24} The problem, however, is that there is a lot of government interference and the Bank of Uganda seems not to stick to the laid down laws and regulation, therefore, leading to the abuse of Shareholder's rights.

The taking of such action when the bank still has positive net worth raises a number of legal issues with respect to shareholders rights. For instance, the appointment of an administrator to take control of the bank’s business operations compromises the shareholders’ rights of corporate control and a decision to bring in outside capital, transfer part of the bank’s business to another financial institution or to merge the bank with another institution affects their pecuniary interests (equity dilution).

To understand the nature of shareholder rights and the legal protection afforded to them it is useful to examine the relevant sources of law in Uganda including international conventions on Human Rights and Banking. Where market solutions fail, a public sector solution may need to be considered. The size of the institutions under stress and the fact that they provided functions that were critical for the domestic financial systems led authorities to resort to extraordinary measures which included extensive

\textsuperscript{23} (Bliss and Kaufman, 2007; Benston and Kaufman, 1998).

\textsuperscript{24} Financial Institution Act, (2014) Section 82.
liquidity support and the injection of public funds. This is seen in the case of Northern Rock Bank in London where the bank was nationalized during the crisis.\textsuperscript{25}

However, contrary to action taken in the past, as for instance in the Scandinavian crisis, which resulted in completely wiping out shareholders,\textsuperscript{26} the initial actions left shareholders largely in place though they suffer significant dilution and loss of dividends. More recently, a more intrusive form of recapitalization with state funds and defacto bank nationalization gained grounds in a number of jurisdiction hit by the financial crisis. Shareholder rights' issues were at the center of many rescue operations leading to significant delays and legal uncertainty.

The laws adopted by Uganda regarding Regulator takeover has curtailed shareholder rights or resulted in outright abuse of shareholder rights. This study, therefore, will look into the extent to which regulators' takeover affects the rights of bank shareholders.

\textbf{1.3 General objective}

To ascertain the protection of Bank shareholders Rights during regulatory takeovers


1.3.1 Specific objective

(i) To review the Ugandan laws that inform the regulatory takeovers of Banks
(ii) To assess specific Ugandan laws that protect Bank shareholders' rights
(iii) To discuss the rationale of closing banks by Central Bank of Uganda
(iv) Examine the interventions for the effective protection of Bank Shareholders' rights

1.4 Research questions

(i) What are the legal frameworks that govern the rights of Bank shareholders in Uganda?
(ii) What is the Legal framework relating to regulators takeover of Banks in Uganda?
(iii) What are the gaps and shortcomings in the protection, promotion, and observation of the right of bank shareholders in Uganda?
(iv) What are the interventions for the effective protection of Bank Shareholders' rights in Uganda
1.6 Scope of the Study

The scope of this study will include;

1.6.1 Geographical Scope

The study will be limited to protection, promotion, and observation of the rights of shareholders in Uganda. Except for exhaustive and elaborative study to be carried out, the researcher will consult texts on protection, promotion, and observation of the right of bank shareholders from other jurisdictions which apply the common law.

1.6.2 Content scope

The study will be limited to the law governing the protection, promotion, and observation of the rights of bank shareholders in Uganda, by the bank of Uganda during the Regulatory takeover process.

1.6.3 Time scope

The research will cover the period from the closure of Teefe Trust Bank in 1993 to the closure of Crane Bank in 2016.

The research will also be conducted in two months, including the analysis of both primary and secondary sources of data. These include; domestic and international statutes or instruments, court decisions, and review of related literature.

1.7 Justification of the study

1. The research will contribute to the existing knowledge in the area of Regulators takeover of banks for future use by researchers and
students to investigate further the risks associated with the takeovers as regards the rights of the bank owners generally.

2. It will provide a platform for policymakers and stakeholders to find ways of improving the performance of Bank of Uganda as a Regulator in Uganda.

3. There is a very large information gap for Bank Owners on how their rights must be protected during the regulators’ takeover process.

4. The study will reduce the information gap by adding more knowledge to the already available knowledge on the regulatory takeover.

5. The study will hopefully attract more researches in the area of Regulatory take over in Uganda.

1.8 Purpose of the study

With the current waves of Bank closure across the country, the paper seeks to pinpoint the challenges that are faced by the bank shareholders during the Regulators takeover. It also looks at Bank of Uganda and its efforts to remain neutral and carry out its duties under relentless political scrutiny and corruption from its officials. It is hoped the paper will be of interest to other researchers, members of civil society, students of law and Ugandans in general with the activities of Bank of Uganda as regards banks.
1.9 Conceptual framework

This study looks at the laws, practices, policies, guidelines and regulations applied during regulatory takeover as the independent variables. It will take a deep look at when they are applied, how they are applied and why each of them is applied. It goes on to look at the Shareholders’ rights as the dependent variables. Focusing on how the laws and their application affect the bank shareholders’ rights during the takeovers. It will look at rights like ownership, the right to elect, right to sell shares, right to access information, right to fair and recapitalization. The study will therefore aim at discovering how these rights are protected during the takeovers. Intermediate Variables like a functional Central bank, and efficient Executive, legislative and judicial system shall inform this study.

1.10 Methodology

The researcher will carry out doctrinal legal research. This is research about what the prevailing state of legal doctrine, legal rule or legal principle is. In this study, the researcher will be considering the prevailing state of the rights of bank shareholders during regulators takeover in Uganda.

The study will thus involve;

(1) The systematic analysis of various statutory provisions relating to regulators takeover of banks in Uganda; and
(2) The logical and rational review of the legal propositions and principles of law relating to the rights of Bank shareholders in Uganda.

In the study, therefore, the researcher will focus on substantive laws, doctrines, concepts and court decisions. The study will further consider other legal materials like the Hansard of the Parliament of Uganda and works of prominent legal scholars in the area of Bank shareholders’ rights and Regulators takeover of Banks in Uganda.

The foregoing information or data will be got from both primary and secondary sources to be consulted by the researcher;

(a) Primary sources refer to sources that contain original information or data or observations. These will include the Constitution of the Republic of Uganda, 1995, various Acts of Parliament, Uganda Gazette that publishes the Acts of Parliament and other government pronouncements, subsidiary legislations like rules, regulations, orders, and directives by different government agencies, law reports where courts decisions are reported and international legal instruments.

(b) Secondary sources refer to sources of information that furnish information from primary sources. These sources organize the information in a systematic manner and in a planned way. Such sources include; textbooks, commentaries on statutes, abstracts, bibliographies, dictionaries, encyclopedic, reviews, thesauri, treatises among others.
1.11 Research Design

A cross-sectional correlation research design was used in the study employing a qualitative approach. The cross-sectional research design enabled the researcher to study two or more variables at a single point in time and is useful for describing a relationship between two or more variables (Break well, Hammond & Fife-Schaw, 1995). This is because research will focus on how the rights of bank shareholders are affected by irregular Regulators takeover. A cross-sectional study was used because it emphasizes detailed contextual analysis of a limited number of events or conditions and their relationships at a single point in time.

1.12 Data Sources

The research was carried out using secondary data. The secondary data was collected from existing relevant literature from the libraries in the form of textbooks, journals, articles, reports, dissertations, and the Internet.

1.13 Literature Review

This section contains the reviews of relevant literature by other scholars who have taken studies or wrote about the subject under study and also highlight what areas have not been covered by the various studies that this study will have to cover.

According to IMF Working Paper (2003): What Happens After Regulatory Intervention? Considering Bank Closure Options; Closure of a bank is not capricious action taken to punish shareholders or the bank itself, nor is the
decision to close a bank generally an isolated or sudden event. Although serious problems can suddenly come to light, in the "normal times" circumstance of dealing with one or a few problem banks in an otherwise sound system, the decision to close a bank is usually the culmination of efforts over time to remedy the problems of a weak bank.\(^{27}\) The fact however in Uganda is that the cumulative actions are not necessarily taken in the order they should be therefore ending up punishing the bank shareholders. The journal only presupposes that the all laid down legal framework would be followed to the dot. Specific approaches vary among jurisdictions, but there are two generic legal approaches to dealing with weak banks: (1) discretionary; and (2) rules-based. In jurisdictions with a discretionary approach\(^{28}\), the regulator is generally bound by broad objectives such as taking timely remedial measures but has wide latitude regarding specific corrective actions and the timing of Regulatory Actions. There are other jurisdictions have a rules-based approach. An example of the rules-based approach is the prompt corrective action (PCA). PCA requires the banking regulator to take certain minimum actions in response to specified trigger points, usually defined by capital adequacy ratios (CARs). Even with the PCA approach, the regulator generally has wide latitude to take steps in addition to the minimum required. Thus, when the regulator is of the opinion that the situation requires that management and shareholders be removed, there is no need to wait until capital is depleted.


\(^{28}\) Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision(2012), Article 22.
to the level that would trigger mandatory conservatorship or receivership. This means that in both approaches, the bank regulators have a lot of discretion to do to the bank shareholders as they deem fit. This, therefore, exposes them to the risk of having their rights abused.

Sheng and Andrew in their book; Bank Restructuring: A lesson from the 1980s, states that when intervention becomes necessary it is almost certain that existing owners did not have the financial resources or the willingness to inject capital or institute needed reforms, and probably also failed to find new investors or a merger partner. This can be viewed as a clear confirmation of the poor financial condition of the intervened bank, which while not precluding the possibility of a turnaround after Regulatory intervention, makes a closure option more likely. The assumption that the bank has failed to inject more capital or look for a partner is unfair to the bank shareholders as the time given is normally quite short.

Michael Andrews and Mats Josefsson states that when existing owners and management accept that the best option to maintain the value of the bank is for the Regulatory agency to assume control and find a solution, it normally should be sufficient if the Regulatory agency appoints an administrator or management team, which will determine which of the senior staff of the bank may be retained, and which should be replaced. Depending on the legal requirements to exercise control in a specific jurisdiction, directors of the bank may be removed so the bank functions

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under the direct control of the Regulatory agency, or the board may be replaced by appointees of the Regulatory authority. However, sometimes even when the bank improves after these actions, the Regulators still go ahead and closes the bank.

Goode R, in his book states that ordinary insolvency procedures provide highly developed mechanisms to deal with the interests of different classes of stakeholders in circumstances where a shortfall of financial resources prevents an economic agent from meeting all of its financial obligations on time and in full. In Uganda, although the mechanism is in place, they are not yet well developed therefore leading to a lot of mistakes by regulators during the takeover hence abusing the rights of bank shareholders.

In both Bliss and Kaufman (2007) and Benston and Kaufman (1998), it is pointed out that one feature common to all special bank resolution frameworks is that they provide for pre-insolvency intervention and the curtailment of shareholder rights. Authorities need to intervene early when there is loss of market confidence and counterparties begin to entertain doubts about whether the bank will be able to honor its commitments. The taking of such action when the bank still has positive net worth raises a number of legal issues with respect to shareholders rights. For instance, the appointment of an administrator to take control of the bank’s business operations compromises the shareholders’ rights of corporate control and a

decision to bring in outside capital, transfer part of the bank’s business to another financial institution or to merge the bank with another institution affects their pecuniary interests.

Eva Hupkes in her work; Special bank resolution and shareholders’ rights: balancing competing interests stated that where market solutions fail, a public sector solution may need to be considered. The recent financial crisis highlighted the relevance of adequate crisis management and resolution frameworks. The size of the institutions under stress and the fact that they provided functions that were critical for the domestic financial systems led authorities to resort to extraordinary measures which included extensive liquidity support and the injection of public funds. This action once taken may result in completely wiping out shareholders as seen in the Scandinavian crisis. This action, however, leaves shareholders largely in place though they suffer significant dilution and loss of dividends.

Ignacio Mas and Thomas Glaessner in their journal: Incentives and the Resolution of Bank Distress state that the framework for resolving bank failures should be insulated from political influence and vested in an appropriate regulatory group with professionally trained staff who can identify problems before they get out of hand. The legal framework should force regulators to act in a timely fashion by assigning them responsibilities and giving them strong legal backing and protection against pressures from political or other special interest groups. It should specify the policies and

procedures to be pursued under a range of possible scenarios.\textsuperscript{36} I agree with them on the matter as most of the problems that the Bank shareholders are facing is due to external influence from politicians. The politicians though without technical knowhow always tend to influence the actions taken by the central government.

Ignacio Mas and Thomas Glaessner further contend that despite the need to resolve financial distress quickly, the authorities tend to delay the decision. A growing body of literature stresses the importance of incentives that encourage the parties to bank distress to ignore the problems as long as they can, delaying recovery, and leading to four types of regulatory failures: inaction, which permits losses of insolvent banks to mount; a bias favoring rehabilitation over liquidation; the adoption of policies that are designed to prevent actual failure but that undermine financial discipline; and a loss in the authority of regulators.\textsuperscript{37} I, however, find agree with the authorities as no bank deliberately sets out to fail its business and should, therefore, be given ample time to correct their mistakes. It is, however, apparent that the Regulators in Uganda have bought into this argument and most banks have been taken over without following the necessary steps to allow its rehabilitation.

Timothy J. Curry, John P. O Keefe, Jane Coburn, and Lynne Montgomery in their work Financially Distressed Banks: How Effective Are Enforcement Actions in the Supervision Process? State that the chartering agencies for commercial banks and thrift institutions have the authority to place troubled

\textsuperscript{36} Ignacio Mas and Thomas Glaessner, Incentives And The Resolution Of Bank Distress 1995, 54.
\textsuperscript{37} Ignacio Mas and Thomas Glaessner, Incentives And The Resolution Of Bank Distress 1995, 63.
and uncooperative or recalcitrant institutions into an FDIC conservatorship or receivership in preparation for the sale or liquidation of the institution. This type of action is the most severe inasmuch as it results in the termination of the charter, or the right of private parties to operate a financial institution. This can also be said of the Ugandan situation as regards regulatory take over as such actions prevent the private owner of the bank from further carrying out banking business. the shareholders and without such information the shareholder approval is invalid.

CHAPTER TWO:

SHAREHOLDERS RIGHTS

2.1 What are the shareholders’ rights?

The European Court of Human Rights defines the right of a shareholder as the: right to a share in the company’s assets in the event of its being wound up, and other unconditioned rights, especially voting rights and the right to influence the company’s conduct.\(^{40}\) Julian Velasco defines the fundamental rights of shareholders as the right to elect directors and the right to sell shares. He goes on to say they are more important than any others, that these rights should be considered “the fundamental rights of the shareholder,” and that, as such, they deserve a great deal of respect and protection by law\(^{41}\). For a person to be considered as a shareholder and their rights to be protected, his name must be entered into register of the current beneficial holders of all shares in the financial institution in such form and manner as the Central Bank may approve and the financial institution must provide the Central Bank with the most up-to-date returns of the register every six months.\(^{42}\)

The European Court of Human Rights distinguishes between pecuniary rights which is the right to receive any remaining value in a company when it is wound up and governance rights, which is the right to shape the

\(^{40}\) Olczak v. Poland, the decision of the European Court of Human Rights (on admissibility) of 7 November 2002.


\(^{42}\) The Financial Institutions Act, 2004. S.23
There is some variation of shareholder rights among national jurisdictions. Among those found in most jurisdictions including Uganda are discussed below.

2.2 Shareholder rights under existing law

Shareholder rights are numerous and varied. I will assess the various rights, considering the limits of each, both in law and in fact. Specific Legal Rights shareholders legal rights are categorized into four groups. These are economic rights, control rights, information rights, and litigation rights.

2.2.1 Economic Rights

Shareholders invest in banks primarily for economic gain. There are two main ways in which shareholders can profit from a bank: by receiving distributions of the company’s profits and by selling all or part of their interest in the bank. These methods correspond with the two main economic rights of the shareholder: the right to receive dividends and the right to sell shares. The right to receive dividends is a limited one, both in law and in fact. Legally, shareholders only have the right to receive such dividends as are declared by the bank’s board of directors. Directors have no obligation to declare dividends and may reinvest the bank’s profits rather than distribute them to shareholders. Shareholders only have a legal right to the payment of dividends after, and to the extent that, the board of

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directors declares any. In practice, many banks do declare and pay dividends regularly. However, most companies distribute only a modest portion of their profits to shareholders. Generally, shareholders do not expect to receive the bulk of the return on their investment in the form of dividends. In fact, many banks pay little or no dividends. Thus, the right to receive dividends has not been crucial for many shareholders. Shareholders also can benefit economically by selling their shares at a profit. One of the key characteristics of banks is the free transferability of shares: shareholders can sell shares at will. This right of alienation flows from the fact that shares are a form of personal property. Share ownership does not directly impact the bank because the business is managed by a board of directors rather than by shareholders. As a bank increases its profits; the value of its shares rises, creating a profit potential for the selling shareholder. Moreover, because shareholders generally do not have fiduciary duties to one another or to the bank, they may keep for themselves any profit that they make. The law does allow for some restrictions on the right to sell shares. To the extent that the bank is closely held, the law may impose some fiduciary duties on a shareholder. Thus, for example, a controlling shareholder may not sell her shares to a known or suspected looter because this carries too great a risk of harm to minority shareholders. Nominee shareholdings have a potential for the misuse of

depositor's funds by unscrupulous owners, and it is, therefore, important to know the actual or intended beneficial shareholders of financial institutions.\footnote{The Financial Institutions (Ownership And Control) Regulations, 2005. Regulation 5e} In addition, directors' ability to prevent shareholders from selling their shares is limited to tender offer situations: shareholders always remain free to sell shares on the open market. Thus, directors may be able to block a change in control and prevent shareholders from receiving a premium in a tender offer, but they cannot actually prevent shareholders from selling their shares at the market price.\footnote{Chesapeake Corp. v. Shore,( 2000) Del. Ch. 771 A.2d 293, 328}

Minority shareholders have a put option (may demand that their shares are bought by the company at fair value) in case they have voted against major transactions, including mergers, reorganization, sale of major assets, charter changes and other key bank decision.\footnote{Eva Hupkes, Journal of Financial Regulation and Compliance Vol. 17 No. 3, 2009 pp. 279} Shareholders have the right to receive a proportionate share of a company's property, after payment of creditors, in the event of its liquidation and are not personally liable for any of the debts of the company, other than for the value of their investment in the company and are insulated from any legal actions against the company.\footnote{Eva Hupkes, Journal of Financial Regulation and Compliance Vol. 17 No. 3, 2009 pp. 280}
2.2.2 Control Rights

One of the key characteristics of banks is the separation of ownership and control. Although shareholders may "own" the bank, they do not have the right to manage the business. The authority to manage the business is vested in the board of directors. Nevertheless, it would be wrong to conclude that shareholders have no control rights. Shareholders have the right to vote on important matters relating to the business, which gives them some control over the bank. Chief among their voting rights is the right to elect directors and determine their pay, who in turn manage the business. Fundamental decisions which involve a change of the company's statutes, including charter changes, liquidation of companies, sale of major assets, require a shareholder vote. Shareholders elect the (Regulatory) board members. In theory, this should give shareholders ultimate control over the business. In practice, however, it does not. It is common knowledge that individual shareholders generally are not interested in — or, at least, not capable of — exercising their control rights effectively. This because each individual shareholder owns only a very small percentage of the outstanding shares of a bank, she does not have a stake sufficient to make monitoring worthwhile. After all, becoming informed is costly; it is also futile because one shareholder's meager vote is unlikely to affect the outcome. Thus, shareholders tend to be rationally apathetic and support the incumbent board on the theory that the directors are experts and have

56 Companies Act No.1 of 2012, 2nd Schedule, Table A, Article 75 and 76.
57 Eva Hupkes, Special Bank Resolution, And Shareholders’ Rights: Balancing Competing Interests Vol. 17 No. 3, 2009 at 279.
access to greater information.\textsuperscript{58} Even if they wanted to oppose the incumbents, however, shareholders would have a difficult time. Shareholders generally do not attend shareholders' meetings, but rather exercise their right to vote by proxy.\textsuperscript{59} Directors have control over the proxy mechanism and, in many ways, the process is stacked against the shareholders. For example, the incumbent directors are permitted to use corporate funds to solicit proxies for their own reelection.\textsuperscript{60} In order to oppose them, a shareholder would have to incur the considerable expense of a proxy contest. Otherwise, the proxy rules limit shareholders' options to either voting in favor of the incumbent directors or withholding consent; they can neither vote against board-sponsored candidates nor propose alternatives. Although shareholders face many obstacles in exercising their right to elect directors, the fact remains that only shareholders can elect directors. As shareholder dissatisfaction with existing management grows, it becomes easier for someone to wage a proxy contest to convince shareholders to vote against the incumbent directors. Thus, under certain circumstances, the right to elect directors can become quite meaningful. Shareholder voting rights are not limited to the election of directors. Shareholders also are permitted to vote on certain fundamental matters.\textsuperscript{61} The right to vote on fundamental matters gives shareholders a voice in corporate affairs. However, this voice is limited. First, shareholders generally can vote only on matters submitted to them by the directors.

\textsuperscript{58} Robert C. Clark, Corporate Law (1986) at 390-392.
\textsuperscript{60} Cheff v. Mathes, (1964)199 A.2d at 548, 554.
\textsuperscript{61} Offerhaus and Offerhaus v. The Netherlands, decision (on admissibility) of the European Court of Human Rights of 16 January 2001.
Shareholders can neither propose their own transactions or charter amendments nor modify those proposed by directors. Moreover, directors often can find ways around the shareholder approval requirement. For example, a possible merger could be restructured as an asset purchase. The end result can be virtually identical, but there is no requirement of shareholder approval for an asset purchase. Shareholders have preemptive rights. Here when a corporation, acting through its board of directors, proposes to increase the number of its shares then outstanding, existing shareholders have a variety of rights with respect thereto. For instance, a shareholder has a right that statutory provisions be complied with in the matter of the creation of additional shares; he has a right that there be no "overissue" of shares; under some circumstances, he has a right that no new shares be created for less than their reasonable sale value; and under other circumstances, he has a right to have offered to him (to "subscribe" for) a proportion of the proposed shares before such opportunity is offered to others.

Although the conditions are numerous and fairly strict, shareholders often are able to include nonbinding proposals for director consideration. Thus, the proxy rules enable shareholders to "send a message" to the directors. Directors increasingly are taking shareholder proposals seriously. Thus, shareholder access to management’s proxy materials has the potential to enhance the shareholder’s role in corporate governance.

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63 Alexander H. Frey, Shareholders' Pre-Emptive Rights, 38 Yale L.J. (1929) 563.
Shareholders who have from between 5 or 10 percent have a right to place items on the agenda of a shareholder meeting and the right to call an extraordinary meeting of shareholders.\footnote{David J Bakibinga, Company Law in Uganda (2001) at 207.} The Companies Act of 2012 states that notices of general meetings shall explain the effect of all items of special business and reasonable time shall be allowed for discussion at general meetings.\footnote{Companies Act 2012, Table F, (20)(3).}

2.2.3 Information Rights

Shareholders also have the right to at least some information about the bank’s affairs. Under state law, this right is not very broad. In many countries, including Uganda, shareholders have no general right to information, only certain specific rights. For example, shareholders generally do have the right to inspect the bank’s books and records. The board shall report to the shareholders on significant and relevant matters, in a balanced and understandable manner. Reports shall be transparent, reflect accountability, objective and comprehensive.\footnote{Companies Act 2012, Table F, (21)(1-2).}

However, this right is not as impressive as it may sound. Shareholders bear a “not insubstantial” burden of demonstrating a proper purpose. In addition, they are entitled to review only basic documents, such as the charter, bylaws, minutes of board meetings, and the list of shareholders of record. Generally, the law does provide that the board of directors must affirmatively disclose information when seeking action on the part of In truth, shareholders of banks get the bulk of their right to information from

\footnote{David J Bakibinga, Company Law in Uganda (2001) at 207.}

\footnote{Companies Act 2012, Table F, (20)(3).}

\footnote{Companies Act 2012, Table F, (21)(1-2).}
the financial institution laws and regulations in Uganda. In particular, the Financial institution Act of 2004, Companies Act 2012 among others which create an elaborate framework of ongoing mandatory disclosures about virtually every aspect of the company’s business. Section 14 of the Companies Act of Uganda provides for the adoption and application of Table F which in its article 21 provides that there should be clear communication to the shareholders. Armed with this information, shareholders are empowered to protect their economic and control interests.

2.2.4 Litigation Rights

Shareholders also have the ability to seek judicial enforcement of their other rights under certain circumstances. Most significantly, they have the right to seek enforcement of, and redress for breach of, management’s fiduciary duties to “the bank and its shareholders” by means of derivative litigation. This is especially noteworthy because, technically speaking, derivative actions are brought on behalf of the bank, and it is the directors who are entitled to decide whether or not to pursue legal action. When directors are conflicted, however, shareholders are permitted to take legal action on behalf of the bank. This permits them to enforce the duties of which they are the indirect beneficiaries. In Pender v Lushington, the English Court of Appeal held that whether a shareholder votes with the majority or minority, he is entitled to have his vote recorded—an individual right of which he has a right to sue. Unfortunately for shareholders, the conditions

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70 Pender v Lushington (1877) 6Ch.d 70 C.A at 81.
71 David J Bakibinga, Company Law in Uganda (2001) at 204.
under which they are permitted to maintain derivative actions are severely limited, as are the chances for success on the merits. In the first place, the law imposes a number of procedural obstacles to the initiation and maintenance of a derivative lawsuit. For example, the contemporaneous ownership rule denies standing to anyone that was not a shareholder at the time of the action complained of; the demand requirement insists that directors be given the opportunity, in most cases, to decide whether a lawsuit is appropriate. Even after an action has been initiated properly, a special litigation committee of the board of directors may be able to have it dismissed. Obstacles such as these are not necessarily unjust: the ability of shareholders to pursue derivative actions is an exception to the general rule that directors should manage the bank, and it seems reasonable to have protections against various forms of abuse. However, such procedures clearly limit shareholders' ability to pursue derivative actions. In addition, the substantive standards under which directors' actions are judged in derivative litigation are quite lenient. One of the most basic principles of corporate law is that the business judgment rule provides directors with tremendous deference and great protection against liability. Thus, even if shareholder plaintiffs overcome the obstacles to derivative litigation, they face considerable difficulty on the merits. The challenges that apply to derivative actions are not applicable when shareholders sue to enforce their own legal rights. Nevertheless, shareholders' right to legal action is not much more significant in the context of direct actions.

The circumstances under which shareholders may bring actions in their own name are limited. For example, they may sue for the nonpayment of
dividends. However, this is true only if they have a legal right to dividends (i.e., after dividends have been declared by the board of directors). Shareholders also have the right to petition the court for dissolution of the bank under certain circumstances. Although state laws vary, the standards typically require egregious behavior or other extreme circumstances, and courts generally are hesitant to order dissolution. If a bank engages in certain fundamental transactions, such as a merger, its shareholders often have appraisal rights: they can forego the contractual consideration due under the merger agreement and petition a court for the fair value of their shares.

Although shareholders' right to take legal action under state corporate law is rather limited, their rights under federal securities law are significantly more robust. Shareholders generally do have the right to sue directly and to initiate class actions. Not only does federal law provide shareholders with various explicit causes of action, but the courts have supplemented them with implied causes of action. However, financial laws in Uganda only go so far. They generally cover only the right to information. Shareholders have broad protection against deception, but very little protection against substantive misconduct, such as breach of fiduciary duty or unfairness.\(^2\)

The content and scope of shareholders' rights vary across different jurisdictions depending on which legal tradition the jurisdiction belongs to. Despite the fact that the USA is often seen to be the citadel of capitalism, the rights of shareholders are more firmly anchored in law in Europe. US law only requires a few decisions to be made by the general meeting of

\(^2\) Santa Fe Indus., Inc. v. Green, (1977) 430 U.S. 462, 474-476.
shareholders and leaves the distribution of powers up to the bank. The law permits the charter to be written in a way so that the board holds primary management power.\textsuperscript{73} This can also be said of Uganda where the law states that; the Board of Directors shall ensure that the senior management of the financial institution implements policies that prohibit or strictly limit activities and relationships that diminish the quality of corporate governance, such as conflicts of interest and other forms of self-dealing with substantial shareholders, directors, officers and employees and related parties.\textsuperscript{74}

In Uganda, shareholders’ substantive powers of shareholders are basically limited to the election of directors and approval of charter or bylaw amendments, mergers, sales of substantially all of the bank’s assets and voluntary dissolution.\textsuperscript{75} These powers as limited as they are still curtailed.

\textbf{2.3 Liabilities of the shareholders}

A critical feature of stock ownership is that the holder is not personally liable for any of the debts of the company, other than for the value of their investment in the company and are insulated from any legal actions against the company.\textsuperscript{76} In the USA, double liability was an important and widespread feature of banking in the nineteenth and early twentieth centuries.\textsuperscript{77} It provided security for creditors and tended to prevent directors of a bank from engaging in too risky operations. In case of failure, each bank shareholder was held liable up to the amount of the par value of

\textsuperscript{74} The Financial Institutions (Corporate Governance) Regulations, 2005, Regulation (6)(4).
\textsuperscript{75} Winifred Tarinyeba Kiryabwire, Company Law: A guide to the Companies Act No.1 of 2012 of Uganda, 2015 at 227.
\textsuperscript{76} Arinaitwe vs African Clays Ltd (2017) Civil Suit No.376 Of 2013, UGCOMMC 93.
the shares held by him, in addition to the amount invested in such shares. At the time, double liability was seen as an effective tool to protect creditors' interests and to prevent the shareholders and directors of a bank from engaging in hazardous operations.78

Double liability was eventually repealed following the banking crisis of 1930 although it has largely guided the regulatory laws in Uganda today. There is some vestige of a higher standard for bank corporate liability that has remained. In Uganda many banks are organized as bank holding companies. As such, the largest banks, like Stanbic Bank and Centenary Bank are wholly owned subsidiaries of holding companies. To avoid the risk that the holding places more risk into the bank, the Bank of Uganda developed and applied a regulatory doctrine to require bank holding companies to provide financial strength to their bank subsidiaries.

The Banks are required to maintain some minimum level of capital so as to meet their obligation in case of bank failure. The Central Bank is primarily concerned about the solvency and liquidity of the financial institutions it supervises and seeks to address solvency and liquidity concerns in accordance with these Regulations.79 The regulation herein talked about in the financial institution Liquidity Regulation of 2005 which specifically states that; A financial institution shall maintain liquid assets amounting to not less than 20% of deposit liabilities denominated in local and foreign currencies on a weekly average basis. Principle 16 of the Basel Core Principles for Effective Banking Supervision specifically addresses this. It states that the

regulator has to set prudent and appropriate capital adequacy requirements for banks that reflect the risks undertaken by, and presented by, a bank in the context of the markets and macroeconomic conditions in which it operates. The regulator defines the components of capital, bearing in mind their ability to absorb losses.\textsuperscript{80} This means that the liability of the bankers may be slightly above what is expected of shareholders of other companies.

2.4 How are shareholder rights protected?

Under the European Convention of Human Rights, a share in a company’s capital stock is subject to economic assessment and, as such, protected as the property of a shareholder.\textsuperscript{81} The Ugandan Constitution of 1995 provides that nobody shall be deprived of their right to property.\textsuperscript{82} A company is regarded as a separate legal entity is therefore entitled to own its own property.\textsuperscript{83} Shares are further protected against deprivation and certain forms of governmental control and interference in Sovtransavto Holding v. Ukraine where it was held that government cannot interfere in the shares of another without proper cause.\textsuperscript{84} Property rights in shares also constitute “civil rights” within the meaning of Art. 6 (1) ECHR. This means that disputes concerning property rights in shares must satisfy due process guarantees.

The Companies act, Table A, Article 8 (1) states that every person whose name is entered as a member in the register of members shall be entitled

\textsuperscript{80} Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision(2012), Article 15.
\textsuperscript{82} The Ugandan Constitution of 1995, Article 26.
\textsuperscript{83} Salmon Vs Salmon, Macharua Vs Macharua.
without payment to receive within two months after allotment or lodgment of transfer or within such other period as the conditions of issue shall provide one certificate for all his or her shares or several certificates each for one or more of his or her shares upon payment.\textsuperscript{85} This is the title of ownership and therefore what guarantees one's right as a shareholder.

The rights conferred upon the holders of the shares of any class issued with preferred or other rights shall not, unless otherwise expressly provided by the terms of issue of the shares of that class, be taken to be varied by the creation or issue of further shares ranking \textit{pari passu} with those shares.\textsuperscript{86} In \textsc{Olczak} v. \textsc{Poland},\textsuperscript{87} the shares initially held by the applicant represented about 45 percent of a bank's equity capital. Following measures undertaken by the Board of Receivers appointed by the National Bank of Poland, the applicant's shareholding declined to 0.4 percent. Initially, the nominal value of the bank's share capital was reduced in order to cover the bank's losses. Next, the bank's share capital was increased through the issue of new shares. The new shares were to be paid up entirely by funds provided by the National Bank of Poland. The existing shareholders, including the applicant, were prevented from acquiring new shares. As a result of these operations, the value of the applicant's shares was significantly reduced. Moreover, the applicant's powers to influence the company resulting from his ownership of shares were also seriously reduced. The Court concluded that in this particular case the applicant, as a shareholder in a public company, could claim that his rights under Article 1 of Protocol No. 1 had

\begin{itemize}
\item \textsuperscript{85} Companies Act No.1 of 2012 2\textsuperscript{nd} Schedule Table A, Article \textbf{8(1)}.\textsuperscript{85}
\item \textsuperscript{86} Companies Act No.1 of 2012 2\textsuperscript{nd} Schedule Table A, Article \textbf{5}.\textsuperscript{86}
\item \textsuperscript{87} \textsc{Olczak} v. \textsc{Poland}, (2002) European Court of Human Rights on 7\textsuperscript{th} November 2002.\textsuperscript{87}
\end{itemize}
been affected, but it also ruled that the restriction of the right could be justified on public interest grounds.

The Financial Institutions Ownership And Control Regulations of shareholding in Uganda states that a financial institution should be diversified among many individuals to ensure that there are as many interested parties as possible to allow a multiplicity of views, adequate debate and a system of checks and balances in the board of directors. In so doing the rights of the shareholders are protected from directors who may abuse their powers.

As prescribed by sections 18(1) and (2), 19 and 20 of the Act of the Financial Institution Act, an individual or body corporate owned or controlled by one individual other than a reputable financial institution or a reputable public company approved by the Central Bank shall not directly or indirectly own or acquire more than 49% of the shares of a financial institution. This is geared at protecting shareholders from companies with disrepute that could end up mismanaging the bank. It further states that a financial institution shall not allot, issue or register a transfer of 5% or more of its shares to any person without the Central Bank's approval and also that the Registrar of Companies shall not register any transfer of shares of a financial institution exceeding 5% of the total shares of a financial institution without receiving a notice of no objection from the Central Bank. A person shall not also acquire more than 5% of the total shares of a financial institution without the Central Bank's approval. These

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88 The Financial Institutions Ownership And Control Regulations (2005) Regulation 5(B).
powers given to the central bank to control the shareholding of the banks help the shareholders from entering into business with the wrong people who would have eventually abused their rights. According to section 24 of the Financial Institution Act, no person other than a reputable financial institution or in exceptional cases, a reputable public company, shall exercise control over a financial institution.\textsuperscript{90}

Companies Act No.1 of 2012 in the second Schedule, Table F provides for codes that must be followed by the directors of the company. It bid to protect shareholders, Article 20 of the same provides for their relations with shareholders. It states among others that there shall be Dialogue with institutional investors, Institutional investors should take all relevant factors into account, there should be notices of general meetings and such shall explain the effect of all items of special business and reasonable time shall be allowed for discussion at general meetings. It also states that the use of a poll at general meetings shall be considered for contentious issues, and the results of decisions shall be published.\textsuperscript{91} This protects the shareholders' rights to attend meetings, vote and their decisions respected.

The same table F of the companies act, states that the board shall report, on significant and relevant matters, in a balanced and understandable manner. It emphasizes that the reports shall be: transparent, reflect accountability, objective and comprehensive.\textsuperscript{92} In the report balance between positive and negative is required to ensure a full, fair and honest account of performance and it must contain a statement that there is no

\textsuperscript{91} Companies Act No.1 of 2012 2\textsuperscript{nd} Schedule Table F, Article 20.
\textsuperscript{92} Companies Act No.1 of 2012 2\textsuperscript{nd} Schedule Table F, Article 21.
reason to believe that the company will not be a going concern in the year ahead it that is what the audit has revealed.

In an effort to reinforce the shareholders’ right to vote and control what goes on in a bank, Table A, Article 80(2) of the Companies Act No.1 of 2012 provides that a regulation made by the company in general meeting shall invalidate any prior act of the directors which would have been valid if that regulation had not been made.\textsuperscript{93} These general meetings are normally that of shareholders, therefore, it gives them their right to determine how their bank is managed.

The Board of Directors shall ensure that the senior management of the financial institution implements policies that prohibit or strictly limit activities and relationships that diminish the quality of corporate governance, such as conflicts of interest and other forms of self-dealing with substantial shareholders, directors, officers and employees and related parties.\textsuperscript{94} This goes a long way into protecting the rights of the shareholders.

The Financial Institutions Corporate Governance Regulations of 2005 also goes a long way in protecting the rights of the shareholders by clearly stipulating the roles of the board of governors. It states; In conducting corporate governance in a transparent manner; the Board shall satisfy itself that procedures are in place to ensure that the financial institution is satisfying its disclosure obligations and that the information being disseminated is true and accurate; It shall, through transparency, reinforce sound corporate governance and feedback received from stakeholders of

\textsuperscript{93} Companies Act No.1 of 2012, 2\textsuperscript{nd} Schedule Table A, Article 80(2).

\textsuperscript{94} The Financial Institutions (Corporate Governance) Regulations (2005), 6(4).
the financial institution shall be properly documented and procedures established to deal with its concerns.\textsuperscript{95}

Basel Committee on Banking Supervision in 2012 came up with Core Principles for Effective Banking Supervision which includes Principle 6 which state that the regulator has the power to review, reject and impose prudential conditions on any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties. This helps small shareholders from being swallowed up by major shareholders.\textsuperscript{96}

When banks show the first signs of trouble, a meaningful restructuring plan should be developed by the board of directors in the long run interest of shareholders. Under the governance policy principles developed above, the governance priority should first of all lie with shareholders: any firm showing signs of trouble should first of all be steered back to a course of virtue in the long-term interest of shareholders.\textsuperscript{97}

Management compensation contracts should be included early into an analysis of shareholder and regulatory policy towards banks.\textsuperscript{98} The reason that shareholder designed incentive contracts exacerbate the risk-shifting incentives of bank managers. Ang, Lauterbach, and Schreiber (2001), however, argue that bank regulations can reduce the amount of incentive

\textsuperscript{95} The Financial Institutions (Corporate Governance) Regulations (2005), 14.
\textsuperscript{96} Basel Committee on Banking Supervision (2012) Core Principles for Effective Banking Supervision.
pay granted to executives.\textsuperscript{99} Recently, Osano (2002) has argued that stock option incentives for banks managers may stand in the way of achieving socially optimal allocations in bank bail-outs.\textsuperscript{100} This, however, ends up protecting the rights of the shareholders.

In the Panagis Pafitis case\textsuperscript{101}, the ECJ reached conclusions that are frequently cited in connection with the protection of shareholder rights in bank reorganization.\textsuperscript{102} The National Bank of Greece had appointed a provisional administrator for a problem bank. The administrator had decided to increase the capital of the bank without prior formal approval by the general assembly of shareholders and without respecting the shareholders’ pre-emption rights. The ECJ ruled that member states must not adopt bank re-organization measures that infringe the minimum level of protection for shareholders, including, in particular, the shareholders’ right to decide upon changes in the capital structure of a banking bank. This means that a reorganization involving a change in the capital structure must be voted upon by the shareholders’ meeting.


\textsuperscript{100} Osano, Hiroshi (2002): "Managerial compensation contract and bank bailout policy", 26, 1 Journal of Banking and Finance 25–49.

\textsuperscript{101} Pafitis and Others v. TKE and Others [1996] ECR 1-1347.

\textsuperscript{102} Hadjilemmannuil, Ch. (2004), "Bank resolution policy and the organization of bank insolvency proceedings: critical dilemmas", in Mayes, D. et al. (Eds), Who Will Pay for Bank Insolvency?, Palgrave, New York, NY.
From the above, it is therefore apparent that the bank shareholders rights are protected under both local and international legal framework. The key question that remains in Uganda’s case, however, is whether the authorities entrusted to enforce these laws are doing the necessary.
CHAPTER THREE

LEGAL FRAMEWORK FOR REGULATORY TAKEOVER

3.1 What is Regulatory Takeover?

The purpose of this section is to survey the empirical literature on bank regulation in order to gain an understanding on the validity of the various theoretical arguments reviewed or derived above, and whether the prescriptions for regulatory behavior are accurate. In the end, this should further our understanding of the actual nature of regulatory policy versus banks and their shareholders.

The regulatory takeover is when the regulator takes over the management of a private commercial bank. Most effective banking laws contain provisions that allow the Regulatory authority to take such corrective action. Action can range from moral suasion (appealing to the bank management and board of directors for their sense of public responsibility), informal and formal enforcement (including fines and removal of personnel), and appointment of a conservator to license revocation and appointment of a receiver.\footnote{David C. Parker, Closing a Failed Bank (2011) 1.} Intervention is defined as the authorities assuming control of a bank, taking over the powers of management and shareholders. In some regimes, there is a concept of conservatorship where the Regulatory...
authority may assume day-to-day control of a bank, but shareholder consent would be required for major decisions.  

In Uganda, the banking institution is regulated by the Bank of Uganda. The Bank of Uganda Act states that the bank shall supervise, regulate, control and discipline all financial institutions.  

Control means the relationship between the parent undertaking and a subsidiary undertaking or similar relations between an individual and an undertaking or the power to determine the financial and operational policy of a financial institution pursuant to its charter or to an agreement, or direct or indirect influence by a person over decision-making and the management of a financial institution.  

"Bank closure" is used generically in this paper to mean the act whereby the preexisting legal bank entity ceases to carry on the business of banking. Closure in this context is a tool to achieve Regulatory objectives, and should not be construed with the specific legal connotation ascribed to the term in some banking laws. A closure may be partial, with the bank ceasing to do new business and running down its existing assets and liabilities over time, or the bank may be left with a rump of bad assets to be worked out after a purchase and assumption transaction. A well-planned closure can be part of the legal process of achieving the orderly exit of a weak bank through a

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range of resolution options including liquidation or a complete or partial transfer of its assets and liabilities to other institutions.\textsuperscript{108}

In very general terms, the small and medium-size bank failures are resolved by liquidation or the banks are acquired by other banks. Large bank failures are frequently resolved by restructuring, which means downsizing by selling off assets and reducing the number of employees. In addition, the larger the bank, the more likely it is that the government will provide capital, acquire nonperforming loans (bad bank), facilitate acquisitions (bridge bank), and use other techniques to minimize the disruption of the failure on macroeconomic activity and the payments system.\textsuperscript{109}

3.2 Problem Bank Resolution

When progressive enforcement action in conjunction with private efforts by a bank’s owners and managers has failed to rehabilitate the bank, the Regulatory authority can place the bank in conservatorship or receivership. Hoping that a bank will generate enough earnings to recover or that capital will inexplicably grow is not an effective approach to bank resolution.\textsuperscript{110}

Scenarios involving the liquidation of domestic banks include cases where a bank suffers from poor management or asset quality, or both, and is slowly deteriorating, with no chance of recovery. If it is intrinsic, or franchise,

\textsuperscript{108} Asser, Tobias M.C., 2001, \textit{Legal Aspects of Regulatory Treatment of Banks in Distress} (Washington: International Monetary Fund).

\textsuperscript{109} Benton E. Gup, Bank Failures in the Major Trading Countries (1998) at 66.

\textsuperscript{110} David C. Parker, Closing A Failed Bank: Resolution Practices and Procedures-International Monetary Fund (2011) at 12.
value to the bank, such a case might call for conservatorship. In other cases, where a bank has severe financial problems as a result of taking huge risks in order to grow or is engaging in illegal activities, it is probably best to go directly to receivership to minimize further losses.

3.2.1 Intervention

The primary goal of a bank intervention is to control and inventory the assets of a bank, prepare a final balance sheet and, as applicable, compensate insured depositors. The Regulatory authority and the DIS must work closely to accomplish these goals. Regulatory authority personnel are responsible for the inventory and control of assets. A bank intervention team should be prepared to accomplish functional duties related to security, cash operations, asset control, deposit operations, facilities, information technology, and legal matters. Depending on the size of the bank, some of these functions may be combined. Depending on the number of branches, branch teams must be prepared to perform the same functions at each branch.

3.2.2 Conservatorship

If the Regulatory authority believes that there is a chance to rehabilitate the bank then conservatorship may be a good option. When a conservator is appointed, that person should be granted management control over the institution, with powers that replace those of the board of directors and senior management. The conservator should be given a specific time frame (usually 60 days, but could be longer depending on size and complexity) in which to thoroughly analyze the bank’s condition and prepare a feasible
rehabilitation plan. During conservatorship, the bank should remain open to maintain confidence in the banking system by allowing depositors access to their funds. The conservatorship should perform limited functions, (e.g., there should be no new lending) and focus on cost-saving measures and asset collection. If deposit outflow is overwhelming, causing operations to halt, then the bank should be put into receivership even if the conservatorship period has not run its course

3.2.3 Final Resolution

To provide prompt repayment to insured depositors, the DIS should work with the Regulatory authority's bank supervision department or the conservator, or both, to market the bank via a purchase and assumption (P&A) agreement. A P&A agreement provides for another bank to take certain assets and assume the first bank's insured deposits, acting as paying an agent for the DIS to compensate insured depositors. In some instances, depending on the competitive environment, banks may bid for the right to assume the deposits because it is an inexpensive method to increase market share. In other instances, the DIS or Regulatory authority may have to pay a bank a fee to act as paying an agent

3.2.4 Receivership

If it is determined that it is not cost-effective to rehabilitate a bank, then liquidation through receivership should begin. The DIS is responsible for insured deposit repayment, whether directly or via a paying agent bank. The receiver should responsibly liquidate the failed bank’s assets with the
goal of maximizing recovery to uninsured depositors and creditors of the receivership, using present value concepts in asset sales and collections.

3.3 Guiding Principles for the Resolution of Weak Banks

The need for speed, cost efficiency, avoiding market distortions and the creation of perverse incentives in the banking markets all mean that banking regulators have to consider closing banks when depositors and creditors face imminent risk of loss due to insolvency. The preferred resolution of a weak bank occurs long before this need would arise. In normal times well-managed banks will themselves take corrective action to deal with emerging financial problems or prudential violations, frequently before these issues come to the attention of the regulator. However, owners and managers hoping that a general improvement in economic conditions will solve bank-specific problems, or that the bank may grow out of its problems, may have an incentive to try to conceal the true financial condition of the bank from the regulator. The regulator will have to take more formal action in these circumstances or in the case when the owners and managers of the bank, acting in good faith, are unable to remedy the problems. Principle 8 of the Basel Committee on Banking 2012 emphasizes this. It states that an effective system of banking supervision requires the regulator to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance; identify, assess and address risks emanating from banks and the banking system as a whole; have a framework in place for early intervention; and have plans in place, in partnership with other
relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable.\textsuperscript{111}

### 3.4 Regulatory Action Prior to Closure

Specific approaches vary among jurisdictions, but there are two generic legal approaches to dealing with weak banks: (1) discretionary; and (2) rules-based. In jurisdictions with a discretionary approach, the regulator is generally bound by broad objectives such as taking timely remedial measures but has wide latitude regarding specific corrective actions and the timing of Regulatory Actions.\textsuperscript{112} In part to address concerns that banking regulators may use discretionary powers to defer decisive actions, and in part to foster greater consistency in the approach to weak banks.

Some jurisdictions have a rules-based approach. An example of the rules-based approach is the prompt corrective action (PCA) provisions adopted in Uganda and East Africa. PCA requires the banking regulator to take certain minimum actions in response to specified trigger points, usually defined by capital adequacy ratios (CARs). Part three of The Financial Institutions (Capital Adequacy Requirements) Regulations, 2005 provides for prompt mandatory corrective actions and measures.\textsuperscript{113} Even with the PCA approach, the regulator generally has wide latitude to take steps in addition to the minimum required. Where the Central Bank determines that a financial institution which complies with all the capital requirements has incurred or is likely to incur large losses within any financial year, it shall take the

\textsuperscript{111} Basel Committee on Banking Supervision; Core Principles for Effective Banking Supervision (2012) pg. 11.


\textsuperscript{113} The Financial Institutions (Capital Adequacy Requirements) Regulations (2005) Part 3.
prompt corrective actions. Thus, when the regulator is of the opinion that the situation requires that management and shareholders be removed, there is no need to wait until capital is depleted to the level that would trigger mandatory conservatorship or receivership. The range of responses to a weak bank may be viewed as a continuum of increasingly intrusive actions by the banking regulator. The prompt, mandatory corrective actions shall take precedence over any discretionary corrective actions available to the Central Bank under this Act or any other law.

The actions to be taken prior to regulatory takeover is laid down in the Financial Institution Act of 2004 in section 82 (1) which states that if the Central Bank has reason to believe or finds that the affairs of the financial institution are conducted in a manner detrimental to the interests of the depositors or prejudicial to the interests of the financial institution or in contravention of this Act, or any other written law or that the financial institution has refused to submit to inspection, or has provided false information, the Central Bank may, without prejudice to any other course of action:

- Order in writing that the financial institution takes remedial action to comply with this Act or regulations, notices, or orders.
- Issue directions regarding measures to be taken to improve the management, financial soundness or business methods of the financial institution.

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• Require the directors or management of the financial institution to execute an agreement concerning their implementation of orders or directions issued.
• Perform or appoint an agent to perform a special examination of the financial institution to determine the financial condition of the institution and evaluate resolution options, at the cost of the financial institution.\textsuperscript{116}

Where a financial institution fails, refuses or neglects to comply with an order, direction, or agreement issued or made above then the Central Bank may do any or all of the following;\textsuperscript{117}

• Initiate a legally binding cease and desist order, of either temporary or indefinite duration requiring the financial institution and its management to stop the improper or unacceptable practice, put a limit to lending or stop any declaration of dividends.
• Remove or suspend any person from the management of the affairs of the financial institution.
• Impose penalties on the offending member of the management to be met personally.
• Appoint a person who, in the opinion of the Central Bank is, suitably qualified and competent to advise and assist the institution generally or for the purposes of implementing the orders, directions or agreements under paragraph.

\textsuperscript{116} The Financial Institutions Act (2004) Section (82)(1).
\textsuperscript{117} The Financial Institutions Act (2004) Section (82)(1).
• Appoint a person, suitably qualified and competent in the opinion of the Central Bank, to manage the affairs of the financial institution for such period as shall be necessary to rectify the problem.
• Require the financial institution to reconstitute its board of directors within such period as shall be specified;
• Withhold approvals on the establishment of new branches.
• Withdraw the foreign exchange dealers’ license.
• Require the financial institution to add such capital as may be specified.
• Impose any other sanctions as the Central Bank may deem appropriate in the circumstances.

A breakpoint on the continuum occurs at the moment of regulatory intervention. Up until this point, the owners and managers of the bank retain control of the institution, notwithstanding specific directions or restrictions imposed by the regulator. During the period preceding intervention, the existing shareholders have their opportunity to try to solve the problems facing the bank and should be strongly motivated by the potential loss of their investment. Thus, when intervention becomes necessary it is almost certain that existing owners did not have the financial resources or the willingness to inject capital or institute needed reforms, and probably also failed to find new investors or a merger partner. This can be viewed as a clear confirmation of the poor financial condition of the intervened bank, which while not precluding the possibility of a turnaround after the regulatory intervention, makes a closure option more likely. The Financial Institution Act states that if the financial institution fails to rectify its significant undercapitalization within ninety days and to restore capital
adequacy within one hundred and eighty days then the Central Bank shall without having to wait for the expiry of that period, close the financial institution and place it under receivership, or where the closure of the financial institution would pose a systemic risk to the stability of the financial system.118

3.5 Resolution after Intervention

Despite the best efforts of the regulators, there will be cases where it becomes evident that the bank is unable to continue its operations without jeopardizing the safety of depositors' funds.119 In such cases, the regulators must intervene. While other options may be available, as outlined above there is a strong likelihood that a closure option should result. The Central Bank shall, on taking over management of a financial institution, have exclusive powers of management and control of the affairs of the financial institution.120 The essential functions of a bank and confidence in the banking system can be preserved through a well-planned closure. Prompt closure can preserve any going concern value that would otherwise erode through ongoing operating losses. Decisive action can actually enhance confidence in the regulatory regime and banking system by ensuring that only sound banks are permitted to continue operating.121

Following Regulatory intervention, it is crucial that well qualified and experienced staff take effective control of the bank and immediately assess

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the operations and financial condition of the bank, and undertake a review of available options. The Central Bank shall as soon as possible after taking over management of a financial institution, appoint an auditor at the cost of the financial institution to make an inventory of the assets and liabilities of the financial institution and submit a report to the Central Bank. The regulators further have powers to appoint a person to be known as a statutory manager to manage, control and direct the affairs of the financial institution.

The review of an intervened bank may indicate that restructuring is feasible, but these conclusions need to be critically examined. A willingness to undertake more radical restructuring that was palatable to the bank's owners and managers may be sufficient to achieve the turnaround that escaped the shareholders during the early warning period. If the Central Bank considers that the retention of a certain shareholding in a financial institution by a person is detrimental to the financial institution or its depositors, the Central Bank may order that person to reduce the shareholding in the financial institution to such percentage of the total nominal value of all the issued shares of the financial institution as the Central Bank shall determine and may limit, with immediate effect, the voting rights that may be exercised by such shareholders. Here the Regulators may take over management but retain some of the shareholders.

It is more likely, however, that the failure to fix the bank prior to the intervention is an indication that new capital, not just restructuring and

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reorganization, was required, and that the expected return was insufficient to attract new equity investors, or a purchaser or a merger partner. Restructuring an intervened bank may improve its attractiveness to investors, but it may be more cost efficient to sell all or parts of the bank on an as-is basis, at a discount, or possibly by providing a stop-loss or some other guarantee to the new owner. The regulators or contract management or consultants retained to manage the intervened bank may be able to make improvements, but the incremental costs of restructuring may not be fully recouped in a subsequent sale. Quickly disposing of the intervened bank has the benefit of checking ongoing operating losses and permitting a more precise estimate of the costs of resolution than a longer-term restructuring plan with uncertain results.

For even the largest banks where recapitalization or restructuring has not been successful prior to intervention, possible solutions to preserve the essential functions of the bank include: sale of individual businesses of the bank on a going concern basis, liquidation and piecemeal or en bloc sales of individual assets and business lines, and an outright sale of the bank to another financial institution. Particularly if the bank has a large share in certain business lines or regions, its assets should be attractive to purchasers.

Another viable option may be to split the intervened bank's assets, liabilities, staff and branch network into perhaps one or two new banks,

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which would be offered for sale to potential investors. If a banking system is too concentrated and dominated by a few large banks this could be a good opportunity to split it up, increasing the number of competitors.\textsuperscript{128}

Where the closure of the financial institution would pose a systemic risk to the stability of the financial system, the Central Bank shall take the financial institution into statutory management.\textsuperscript{129} The Central Bank exercises statutory management over a financial institution for the minimum time necessary to bring the financial institution into compliance with prudential standards. Where the financial institution does not comply with prudential standards within six months after its being placed under statutory management, the Central Bank shall close the financial institution and place it under receivership.\textsuperscript{130}

3.6 Procedures for Regulatory Intervention and Takeover of a Bank

Regulatory intervention and takeover of a bank can take place with full cooperation with the existing owners and management or can be imposed against their will. When existing owners and management accept that the best option to maintain the value of the bank is for the regulatory agency to assume control and find a solution,\textsuperscript{131} it normally should be sufficient if the regulatory agency appoints an administrator or management team, which will determine which of the senior staff of the bank may be retained, and

\textsuperscript{128} The Financial Institutions Act (2004) Section (89) (2) (l).
\textsuperscript{129} The Financial Institutions Act (2004) Section (87) (3) (b).
\textsuperscript{130} The Financial Institutions Act (2004) Section (87) (5) and (6).
\textsuperscript{131} The Financial Institutions Act (2004) Section (82) (2) (e).
The legal requirements to exercise control in a specific jurisdiction, directors of the bank may be removed so the bank functions under the direct control of the regulatory agency, or the board may be replaced by appointees of the regulatory authority. When existing owners and management have explicitly opposed the regulatory intervention, or if there is a possibility that confusion or temporary lack of full internal controls might provide an opportunity for owners or staff of the bank personally to benefit through asset stripping or destruction of records, the regulatory agency needs take physical as well as legal control of the bank. In addition to removing the board and replacing existing management and other key persons as quickly as possible, the Regulatory agency needs to secure the bank's premises and moveable assets. A summary of the key steps in such an intervention follows. More detailed information, including guides to planning, staffing requirements and detailed checklists for task completion can be found in the government of Uganda and Bank of Uganda came up with an intervention policy and the following steps to be taken during the regulatory processes.

(i) The intervention will take place if a bank fails to meet BOU requirements and to agree with BOU on corrective measures to be taken within an agreed timetable, not to exceed 6 months. Failure to

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134 The Financial Institutions Act (2004) Section (89) (2) (g).
meet interim targets during such period will justify immediate intervention.

(ii) Once intervention takes place, the intervened bank will be closed while an auditing firm nominated by BOU review the bank’s financial position and identifies its assets and liabilities.

(iii) The list of deposits eligible for protection under the Deposit Insurance Scheme, excluding depositors that have debts to the bank, shareholders (other than holders of a small number of shares with non-influence in the bank conduct of business), the bank directors and officials, will be established and steps taken to repay depositors their protected deposits within 90 days from intervention.

(iv) The collection of all debt and sale of assets will be undertaken by a liquidator that will then repay residual amounts of deposits and other liabilities (according to the priorities decreed by Uganda laws) of the intervened bank in instalments when the revenue from the sale of assets and collections of loans will provide enough funds after all funds provided from the Deposits Insurance Scheme are repaid.

(v) If the liquidator will find that the policy of selling the bank as a going concern to new owners is feasible and will result in the better financial outcome, the bank will be sold and opened for business under the management of the new owners, once the sale and the new owners are approved by BOU.

(vi) Prompt legal action will be taken against the intervened bank major shareholders, directors, officials and auditors for any fraudulent actions for which they are responsible.
From the above, it appears that Ugandans have a comprehensive legal framework as regards regulatory takeovers. The key question, however, is whether these laws are being used to the benefit of all stakeholders in the banking sector.
CHAPTER FOUR

ACTIONS THAT AFFECT SHAREHOLDER RIGHTS

4.1 Speedy Regulatory Actions.

The speed needed to restructure a failing bank makes it impractical under standard corporate governance arrangements to seek the ex-ante approval of shareholders for measures that affect both their governance and pecuniary interests. The Prompt corrective action is said to take precedence over any discretionary corrective actions available to the Central Bank under the financial Institution Act or any other law. Many jurisdictions, including Uganda, have in place special bank resolution regimes that provide for intervention measures that affect shareholder rights. These measures present various degrees of intrusiveness. Whereas some merely suspend certain governance rights for a limited period, others have a more profound impact on the shareholders' financial position.

4.2 Moral suasion and regulatory pressure

In moral suasion and regulatory pressure before taking regulatory action, the authorities will call upon the bank and its owners to undertake measures to strengthen the capital by their own means. In some jurisdictions, provision is made for the authorities to call on bank shareholders to recapitalize the bank. For instance, in Uganda, the Governor

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of the Bank of Uganda, during regulator takeover, invites the shareholders or members of that institution to provide it with the support that it requires. The authorities’ leverage to require actions from shareholders depends on the general market conditions as well as the willingness and ability of the authorities to impose more stringent measures and penalize shareholders.

4.3 Temporary derogation from corporate governance requirements

Regulatory authorities have a number of powers to constrain shareholder rights in the course of their regulatory activities. For instance, shareholders that do not qualify may be barred from acquiring or required to sell a shareholding. Regulators also have the powers to dismiss managers and directors that no longer meet the fit and proper criteria. In a crisis situation, Special bank resolution derogations from the shareholders’ corporate governance rights may go even further. A number of jurisdictions provide for conservatorship or special administration whereby an appointed official assumes full control of the bank’s operations. This compromises the rights of corporate control. Shareholders normally elect the (Regulatory) board, approve the financial statement and have the right to place items on the agenda of a shareholders’ meeting and the right to call an extraordinary meeting of shareholders. All these rights can be temporarily suspended by

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143 Eva Hupkes, Special Bank Resolution, And Shareholders’ Rights: Balancing Competing Interests Vol. 17 No. 3, 2009 at 279.
144 The Financial Institutions (Ownership And Control) Regulations (2005) Regulation 12.
the regulatory authority.\textsuperscript{147} They are restored once the bank's weaknesses have been remedied and its viability, safety, and soundness restored. Statutory Management\textsuperscript{148} suspends the functions of the general meeting of shareholders. Only the appointed special administrators, subject to authorization by the Bank of Uganda, may convene the general meetings and establish the agenda.\textsuperscript{149} These measures leave the economic rights and some related governance rights of shareholders in place. As a consequence, restructuring measures would need to be negotiated with the shareholders. This may have been one of the reasons why the "conservatorship" was no longer used in the 1990s.\textsuperscript{150}

4.4 Derogations that permanently affect economic interests

Sometimes the authorities can implement more intrusive measures, which permanently affect the shareholders' economic interests. Once certain regulatory thresholds have been breached, they can suspend the shareholders' right to determine the capital structure, to decide on whether to bring in outside capital, to transfer part of the bank's business to another financial institution or to merge the bank with another institution.\textsuperscript{151} This obviously affects both the pecuniary interests of shareholders and their governance rights.

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\textsuperscript{147} Financial Institutions Act (2004) Section 89 (2). \\
\textsuperscript{148} Financial Institutions Act (2004) Section 89 (5). \\
\textsuperscript{149} Financial Institutions Act (2004) Section 89 (2) (j). \\
\textsuperscript{150} Eva Hupkes, Special Bank Resolution, And Shareholders' Rights: Balancing Competing Interests Vol. 17 No. 3, 2009 at 284. \\
\textsuperscript{151} Financial Institutions Act (2004) Section 89 (2) (f) (k) (L). 
\end{flushright}
4.5 Termination of rights

The appointment of a receiver or bankruptcy trustee ends all shareholder governance rights and leaves the shareholder as equity creditor with only a monetary claim that ranks behind all other creditors' claims.\(^{152}\) Section 95 of the Financial Institutions Act that the Central Bank shall, within twelve months from the date of taking over as a receiver, consider and implement any or all of the following options either singly or in combination: arrange a merger with another financial institution, arrange for the purchase of assets and assumption of all or some of the liabilities by other financial institutions, arrange to sell the financial institution and liquidate the assets of the financial institution.\(^{153}\) These actions eventually end up taking away all the rights of bank shareholders.

4.6 Public assistance and shareholders' rights

Where market solutions fail, a public sector solution may be needed. As illustrated in the recent Banking crisis in Uganda, the size of the institutions under stress and the fact that they provided functions that were critical for the domestic financial systems led authorities Special bank resolution to resort to extraordinary measures which included extensive liquidity support and the injection of public funds. As authorities recognized that these actions might lead to increased moral hazard, they took action to offset the adverse effect on market discipline. During the statutory management period, BOU injected funds amounting to Four hundred seventy-eight billion

\(^{152}\) Financial Institutions Act (2004) Section 94.

and eight hundred thirty million, six hundred nine thousand nine hundred and ten shillings only (UGX.478,830,609,910) for the purpose of liquidity support and other intervention activities. Out of this amount, UGX.466,626,262,000 was requested by the Statutory Manager and injected into CBL between 21st October 2016 and 9th January 2017 as liquidity support.154 The decisions by the authorities had a significant effect on shareholders. In some cases, shareholders were completely wiped out; in others, they were significantly diluted. As the crisis worsened, the government implemented rescue plans in order to ensure the continued operation of these large financial institutions. These rescue plans consisted of the State injecting capital into the financial institution subject to a number of conditions that affected shareholders' governance rights and responsibilities like the determination of compensation packages and pecuniary interests.

154 Auditor General, Special Audit Report of Bank of Uganda on Defunct Banks (2018-09-12) at 57.
5.1 Respect for legal principles

Shareholder rights are not absolute. They are subject to a number of legal conditions contained in the banking law, corporate laws and insolvency laws. However, because shareholder rights are well protected, any curtailment of them needs to respect broad principles. The ECHR itself is built upon a careful equilibrium of public and private concerns. Early intervention and special regulatory measures must, therefore, observe certain legal requirements if they have the effect of curtailing shareholder rights. In addition, they need to be designed in a way to provide shareholders with incentives both to exercise corporate control, in particular over management and management incentives, and to take early action to recapitalize the bank or implement other measures that restore market confidence.

5.1.1 Predictability and legal certainty;

There should be predictable procedures for regulatory takeover and intervention. The predictability of the procedure of regulatory intervention or the absence of arbitrariness is a general legal principle. Interference with property rights must not be arbitrary. The conditions under which it occurs must be clearly set out in the law. The rule of law is one of the fundamental principles of a democratic society.
confirmed that the first and most important requirement of Article 1 of Protocol No. 1 is that any interference by a public authority with property rights should be lawful: the second sentence of the first paragraph authorizes a deprivation of such rights only “subject to the conditions provided for by law”.  

The requirement of lawfulness, within the meaning of the ECHR presupposes among other that domestic law provides legal protection against arbitrary interferences by the public authorities with the rights safeguarded by the ECHR

The challenge in defining regulatory triggers for the application of special resolution measures is to achieve greatest possible predictability while at the same time taking account of the fact that the economic conditions generating the distress can vary substantially. The predictability of the resolution process shapes the behavior of shareholders ex-ante. Setting clear expectations builds discipline. The prospect of loss in bad times increases the willingness of shareholders to exercise corporate control and take early action to recapitalize the bank or implement other measures to restore market confidence. Ex post, a predictable resolution process will permit the orderly and efficient re-allocation of economic resources in a manner that fosters growth and increases welfare. In a world of securitized lending and wholesale funding, liquidity may be a particularly

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155 Olczak v. Poland, decision of the European Court of Human Rights (on admissibility) of 7 November 2002.  
relevant indicator of impending distress. The central Bank should strengthen the supervision function to ensure that it is able to adequately supervise financial institutions in real time. However, since funding liquidity depends on the confidence of market participants, it is virtually impossible to establish a mechanical, quantitative trigger. If mandatory quantitative triggers are poorly calibrated there is a risk that viable banks could be wrongly put into a special resolution regime. This raises the question of how much discretion and scope for a qualitative assessment should be left to the authorities. Giving greater discretion to the authorities increases the risk of regulatory forbearance. At the same time, it is necessary to provide for some flexibility in order to be able to respond to a wide range of scenarios. Since it is practically impossible to set out in advance the precise circumstances in which bank resolution powers will be invoked, it is important to have multiple triggers and to create more stages along the path to resolution for the authorities to work their way through. The objective is to alert the bank and its shareholders in advance of the consequences of the worsening financial position of the bank and to provide them with the last chance to remedy the situation before they intervene.

5.1.2 Due process

There should be proper due process on the side of the regulators during the regulatory intervention. Article 1 of Protocol No. 1 ECHR implies that shareholders must be afforded a reasonable opportunity to challenge

measures interfering with their property rights. It is important to note that time is of the essence during regulatory takeover although this does not dispense the regulator of this need which is lawful. The requirement of lawfulness, within the meaning of the ECHR, presupposes, among other things, that domestic law must provide a measure of legal protection against arbitrary interference by the public authorities, with the rights being safeguarded by the ECHR.\footnote{Hasan and Chaush v. Bulgaria, the judgment of the European Court of Human Rights of 26 October 2000.} Article 1 of Protocol No. 1 implies that any interference with the peaceful enjoyment of possessions must be accompanied by procedural guarantees affording to the individual or entity concerned a reasonable opportunity of presenting their case to the responsible authorities for the purpose of effectively challenging the measures interfering with the rights guaranteed by this provision. In addition, Article 6 ECHR provides: In the determination of his civil rights and obligations, everyone is entitled to a fair and public hearing by an independent and impartial tribunal established by law. Article 13 ECHR provides: Everyone whose rights and freedoms as set forth in this Convention are violated shall have an effective remedy before a national authority notwithstanding that the violation has been committed by persons acting in an official capacity. As noted earlier, property rights in shares also constitute “civil rights” within the meaning of Art. 6 (1) ECHR. A shareholder whose rights are affected by official action must be afforded the opportunity to object before the action is taken. The Strasbourg Court, however, concedes the possibility of dispensing with the opportunity to make objections in exigent and urgent cases, noting that especially in the context
of a banking crisis there may be a need to act expeditiously and without advance notice in order to avoid irreparable harm to the bank, its depositors and other creditors, or the banking and financial system as a whole. In **Capital Bank AD v. Bulgaria**, a decision to revoke a bank's license had been made without informing the bank beforehand and without affording it the opportunity to make objections or providing for any subsequent possibility for administrative or judicial review. The Strasbourg Court found that the decision had serious and far-reaching consequences for the bank, which automatically ceased to operate as a going concern and was placed in compulsory liquidation, and that such an act would only be legitimate if the bank had been afforded a reasonable opportunity to present its case to the competent authorities. It noted that such a procedure could have been confidential and closed to the public. It could also have been expedited, so as to avoid the damaging consequences of any undue delay. Alternatively, the authorization could have been provisionally suspended pending the examination of the bank's objections and representations before taking its final decision. This could have also been achieved through, for instance, an internal administrative appeal.

In **Capital Bank AD v. Bulgaria**, the Court noted that an action in tort against the administrative authority could constitute an alternative avenue of redress since the courts would be able to verify, whether the administrative act was defective and, if so, award compensation.\(^{162}\)

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5.1.3 Public interest

Regulatory takeover measures must balance the rights of the shareholders against the public, not individual interest. This means that affect the rights of shareholders must be justified on the basis of legitimate public policy interests, not just the interest of some few individuals. It, therefore, must not be to satisfy the interest of a few individuals or people in power. The consideration of the public interest is also enshrined in the ECHR.\(^ {163} \) The Convention implies a just balance between the protection of the general interest of the Community and the respect due to fundamental human rights while attaching particular importance to the latter.\(^ {164} \)

Bank resolution under the system of protection established by the Convention, it is up to the national authorities to make the initial assessment both of the existence of a problem of public concern and of the remedial action to be taken. The national authorities accordingly enjoy a certain margin of appreciation. In Offerhaus and Offerhaus vs The Netherlands, the Court observed that: Because of their direct knowledge of their society and its needs, the national authorities are in principle better placed than the international judge to appreciate what is "in the public interest".\(^ {165} \) In Olszak v. Poland\(^ {1} \) the Court acknowledges that a wider public interest in the prevention of damage to financial stability and protection of depositors' interests may indeed justify interference in the property rights of a shareholder. The National Bank of Poland had written

\(^ {163} \) European Court of Human Rights: Art. (2)-11(2);17 and 18.
\(^ {164} \) Belgium v. Belgium, the judgment of the European Court of Human Rights of 23 July 1968.
\(^ {165} \) Offerhaus and Offerhaus v. The Netherlands, decision (on admissibility) of the European Court of Human Rights of 16 January 2001.
down the share capital of a bank and recapitalized it with its own funds. The measures taken by the National Bank of Poland were intended to protect the interests of the bank’s customers and to avoid the heavy financial losses that the bank’s bankruptcy would have entailed for its customers. One important question is how to determine whether the “public interest” justifies a curtailment of shareholder rights and what type of intervention is adequate and proportionate. Special resolution measures may have a drastic impact on shareholders’ rights and effectively terminate them. It is therefore important to design the decision-making process in a way to ensure that the decision enjoys wide legitimacy and that adequate consideration is given to all stakeholders’ interests.

5.1.4 Proportionality and adequate compensation

The actions taken to meet public interest needs during regulatory takeover must be fair and proportional in the sense that they do not unduly interfere with a person’s individual rights. The European Court stated that they must strike a “fair balance” between the demands of the general interest of the community and the requirements of the protection of the individual’s fundamental right. In Lithgow v. the UK (1986) the Court stated: Clearly, compensation terms are material to the assessment whether a fair balance has been struck between the various interests at stake and, notably, whether or not a disproportionate burden has been imposed on the person who has been deprived of his possessions. On the issue of the standard

166 Sporrong and Lonnroth v. Sweden, the judgment of the European Court of Human Rights of 23 September 1982.
167 Lithgow and others v. the United Kingdom, the judgment of the European Court of Human Rights of 8 July 1986.
of compensation, the Court stated that: Article 1 of the ECHR does not, however, guarantee a right to full compensation in all circumstances, since legitimate objectives of "public interest", such as pursued in measures of economic reform or measures designed to achieve greater social justice, may call for less than reimbursement of the full market value.\textsuperscript{168} Nevertheless, even in such cases, the court "cannot abdicate its power of review and must determine whether the requisite balance was maintained in a manner consistent with the applicants' right to the peaceful enjoyment of their properties". Compensation terms are material in determining whether the measure is justifiable and does not impose a disproportionate burden on specific individuals. Taking property without paying adequate compensation could constitute disproportionate interference.\textsuperscript{169}

5.1.5 Adhering to International Regulatory Standards

In a bid to protect the rights of bank shareholders, the Regulatory Authority in Uganda should stick to international as regards bank supervision and regulatory takeover. International standards and guidelines on corporate governance have been established by many multilateral organizations including the OECD and the Basle Committee in the effort to ensure improved legal; the institutional and regulatory framework for enhancing corporate governance in institutions such as banks and financial markets.\textsuperscript{170}


\textsuperscript{169} Former King of Greece and Others v. Greece, the judgment of the European Court of Human Rights of 23 November 2000.

This would help to avoid irregular intervention by the Bank of Uganda that has tremendously affected the rights of shareholders.

5.1.6 Improving Corporate Governance Mechanism.

The banks must improve their corporate governance. The third set of potential structural solutions would be to address governance and control problems at source and post-crisis, a number of proposals have already been put forward to strengthen bank governance. These include increasing board expertise and performance and upping the power of bank risk committees.\(^{171}\) This is one of the best ways of protecting the rights of the bank shareholders has it would make the regulators work easier, therefore, preventing them from taking the step of closing the bank that would ultimately affect the rights of shareholders. The COSASE committee recommended that BOU should strictly adhere to the requirements of section 106 (1) of the FIA by keeping proper financial ledgers and financial records in a manner prescribed by the Central Bank in which shall be recorded all financial transactions relating to the liquidation. In banking, the two prevailing ownership and control models are the public limited company and the mutually-owned co-operative. Under the first, ownership and control are vested in a small minority of the liability-holders, with voting rights assigned according to portfolio weights – an equity dictatorship. Under the second, ownership and control are vested in a much wider set of liability-holders, with voting rights unrelated to portfolio weights – a liability democracy

5.1.7 Accurate and timely information

Regulators need accurate and timely financial information from banks that they supervise, for the early detection of troubled banks. This requires sound accounting and reporting systems that fairly present the banks’ true financial conditions.\(^\text{172}\). When the regulators get information early enough, it is always easier to advise the bank management in time before it becomes necessary to take over the institution. However, research has found that even when such information was available, and despite the availability of enforcement tools, regulators were reluctant to use the tools because of their desire “to work cooperatively with management whenever possible,” and “their perceived need to obtain irrefutable evidence of capital deterioration should their actions be contested.” The Bank of New England is a case in point.\(^\text{173}\) The COSASE report also pointed out that BOU should immediately put in place procedures and guidelines for the proper functioning of all liquidation related activities.\(^\text{174}\)

5.1.8 Creation of bridge Institutions

The Bertus research suggests that resolution authorities should have the power to transfer selected assets and liabilities of the failed firm to a third-party institution or to a newly established bridge institution.\(^\text{175}\) Such transfer of assets or liabilities should not require the consent of any third party or creditor to be valid. It should also not constitute a default or termination

\(^{175}\) Bertus Roux Burger, Bank Rescue In South Africa (2017) 24.
event in relation to any obligation relating to such assets or liabilities or under any contract to which the failed firm is a party.

5.1.9 Government should Bail-out the banks

From this study, it appears clear that bail-out is the preferred approach to resolving a failed institution without necessarily drastically affecting the rights of the shareholders. Accordingly, bank of Uganda should have bail-out powers that enable it to write down in a manner that respects the hierarchy of claims in liquidation, equity or other instruments of ownership in the firm and unsecured and uninsured creditor claims to the extent necessary to absorb the losses. It must also include the power to convert into equity or other instruments of ownership of the firm that is being resolved (or any successor in resolution or the parent company within the same jurisdiction) all or parts of unsecured and uninsured creditor claims in a manner that respects the hierarchy of claims in liquidation. Further, it must have the power, upon entry into the resolution to convert or write-down any contingent convertible or contractual bail-in instruments whose terms had not been triggered prior to entry into resolution and treat them in line with the two powers previously mentioned in this paragraph. It is provided that the resolution regime should make it possible to apply bail-out within the resolution in conjunction with other resolution powers to ensure the viability of the firm or newly established entity pursuant to the implementation of the bail-out.


5.1.10 The Regulatory body should be more independent and Take Timely decisions.

An independent central bank is likely to have more credibility with businesses as well as the general public and hence is likely to be more effective at regulatory supervision. The problem with the central Bank of Uganda which is the regulator is that there is so much interference from the political wing. This means that some of their decisions are informed by them. For the interest of the bank shareholders to be protected, the Bank of Uganda must be more independent as the law prescribes. The information gathered from this research confirms that the winding up process is taking un abnormally long period of time. The auditor general report showed that all the banks that were closed in Uganda from 1991 are still in the process of winding up. This is a very big abuse of the rights of shareholders as some of them die off before they are handle. The MPs in their report further recommended that there should be amendments in the FIA to make specific provision for the timelines of undertaking all the activities related to and connected with resolution of financial institutions.

5.1.11 There should be a pre-packaged resolution

This approach operates within the context of existing corporate governance arrangements. Instead of relying solely on the statutory resolution powers authorities could seek to commit the institutions themselves to a solution.

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The authorities could require that those institutions which are too complex or too critical to the financial system to be closed and liquidated to develop contractual pre-packaged crisis resolution arrangement. Such arrangements could set out contingency plans for circumstances in which the institution becomes financially distressed and include a series of pre-commitments to reorganization measures. For example, the bank’s shareholders could pass a resolution empowering the board to bring in new investors quickly without having to seek the approval of the shareholders. Also, the shareholders could waive their rights to vote on the acquisition of the bank by another institution or commit to a share-deal under certain pre-determined conditions. The exercise of the delegated powers by the board could be made subject to prior regulatory approval. Such an approach could also include the introduction of a separate requirement that banks put in place contingent capital.180

5.1.12 Shareholder divestiture at positive net worth

As a measure of last resort, the law could provide for the outright divestiture of shareholders when certain conditions are met. In this case, the bank and all its assets would be transferred to a trustee or receiver. The law would specify the circumstances in which such divestiture could occur. This procedure would be a form of compulsory administration that ends the existence of the firm as a legal entity and extinguishes the shareholders' rights. However, if the bank still has a positive net worth, shareholders should be paid adequate compensation. Compensation could consist of a

monetary payment or take other forms which would give the former shareholders a claim on the future earnings of the bank.

5.2 Conclusions

Shareholders have legitimate interests that need to be respected. These interests must be weighed against the interests of other stakeholders and the wider public interest. Balancing these interests creates challenges for any corporate resolution framework. In normal conditions, there should be little conflict between shareholders' interest in maximizing the value of their shares and the depositor's interest in making sure that his money is safe. In a crisis situation, shareholders' interests may diverge from those of depositors and of the wider public. Shareholders and management may have an incentive to take greater risks and take a more optimistic or opportunistic view of the bank's future prospects. By contrast, the depositor may prefer risk minimization actions such as slower expansion of the balance sheet and the injection of new capital which could lead to the dilution of existing shareholders' rights. The legal framework should create appropriate incentives and the necessary powers for shareholders to monitor the performance of the management and to discourage undue risk-taking. The powers of the authorities to restrict or eliminate shareholder rights in order to resolve a bank must be predictable and clearly set out in the law. Shareholders must enjoy due process and be able to have ex-post recourse by shareholders in a manner that does not threaten the finality of the outcome but provides fair financial compensation.
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82