A personal perspective by SHEILA KHAMA

GOOD CORPORATE GOVERNANCE BLOG SERIES

BOARDS OF PARTNERSHIPS AND STATE-OWNED ENTITIES IN MINERALS, OIL AND GAS INDUSTRIES

Blog 5

Corporate Legal Structures and Governance

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August 2025

1. Introduction

In previous blogs in the series, I discussed the origins of a company as a separate legal personality, the concept of perpetual succession and duties of directors among others. Overtime the original legal structure of a company has taken different forms including those that are privately owned, listed on the stock market, owned by the State and different forms of partnerships. The outcome being that though all companies are subject to conventional principles of corporate governance, from a regulatory perspective each of these entities has different laws or aspects of company law that regulate them. This also means that, often a company's legal structure is as much a strategy as it is a legal consideration based on the activities that it is intended to undertake, how these align with the vision of the founders and how the company's operations will be impacted by regulatory requirements. Other considerations on the choice of a company's legal structure include ease of raising capital, the extent of compliance obligations on the business (and its owners), as well as degree of disclosure required. Regardless of the choice that the founders opt for, together, thes factors lay the foundation for a company's corporate governance ecosystem. The intersection of the resulting ecosystem and a company's legal structure is the subject of discussion of this blog starting with brief highlights on the relevance legal formats to corporate governance under paragraphs 1.1, 1.2 and 1.3below.

1.1

Company Legal Structure and Corporate Governance

As stated above, the establishment of all types of companies is the basis for how they will be regulated and governed. In compliance terms, between the laws establishing a company and a company's own constitution are the two most important foundations for corporate governance. Generally, types of companies include, but are not limited to privately owned companies, publicly listed entities, Limited Liability Companies (LLCs), partnerships, joint-ventures (JV) and SOEs. A unique feature of SOEs is that such companies are typically created based on a specific piece of legislation enacted for the sole purpose of their creation, operation and governance. Most other types of companies are regulated through a series of laws that are enforced uniformly to specific types of legal structures. The laws govern ways in which companies can be constituted, operated and if necessary, how the company can be wound up. In addition, laws relating to company operations tend to derive from the peculiarities of an industry. Generally, such laws focus on the interaction of the company with the social and physical environments as well as forms of taxation to which they are subject. Commonly the focus is on environmental protection, employee rights, safety, land rights, water rights, dispute resolution, imports and exports and more.

Generally, the more a company is deemed to potentially expose society to risk, the more onerous the compliance requirements and operational standards governing it. Good examples are publicly traded companies, those in extractives, pharmaceuticals, food processing and banking. Taken on face value, SOEs and especially those responsible for natural resources wealth should logically fit into this category. But relatively to others, they tend to escape scrutiny based on the false assumption that by nature they serve public interest.

1.2

Ownership and Corporate Governance

Ownership of a company is important for governance because it impacts fundamental governance frameworks, namely the vision of the company, the legal structure (and therefore regulatory environment), corporate values and governance culture. Based on the same factors, ownership becomes a source of power extending to the right to appoint directors and senior leadership. Put another way, ownership of a company correlates directly with decision-making authority and therefore potential company's impacts on society. The law is intended to moderate the actions of the owners in order to protect interests of other stakeholders, including the public and host governments using specific regulations. In the case of privately owned companies, the owners are custodian of corporate values which are invariably interchangeable with personal ethos. Seen this way and specifically with respect to ownership, governments and private individuals exhibit similar characteristics because political leaders too manifest their vision through the companies they create and oversee. By contrast, publicly listed companies are regulated to guard against potential dominance of interest groups by decentralizing power. Regulators use the concepts of balance of power and avoidance of conflict interests to achieve this, and both will be revisited in later blogs in the series.

1.3

Company Legal Structure and the Board

Different factors influence the structure and composition of a board and two of the most important are the company's legal structure and ownership. To be both legally compliant and effective, the structure and composition of any board should align to its goals and respond to its business environment. Once in place, legal structures dictate the parameters for board composition, mandate, appointment processes and procedures. It should not come as a surprise therefore, that family-owned companies, partnerships, public companies and SOE boards are structured and function differently from one another.

For instance, privately owned companies do not operate under similar checks and balances imposed on publicly listed companies. This includes specifications on the composition of the board and requirements for the creation of certain committees. In the case of SOEs, the provision of a specific law means that the State (or one administration) can enact a law creating an SOE, such that the State consolidates all aspects of corporate governance under a single entity, being the Government that created the SOE. So, unless addressed within the SOE law, such a corporate environment could contradict principles of separation of duties and conflict interests as explained in **Blog 1**. The former refers *'to the principle that noone should be given enough privileges to (be able to) misuse the system on their own.'* [1]

2. Governance and Legal Structure of Partnerships and SOEs

As can be seen from the above introduction, company legal structures and associated regulatory frameworks give rise to a unique corporate governance environment and unique relationship between the company and its stakeholders. In this section, I discuss corporate governance as relates to two types of companies in minerals, oil and gas industries. That is SOEs as well as partnerships between governments and private entities. Though cognizant of the fact that partnerships can legally be constituted differently as Limited Liability Companies (LLCs) and companies, among other options, for simplicity's sake, under paragraph 2.1, I discuss governance of partnerships from a generic perspective. This is followed by a discussion of SOEs under paragraph 3.

2.1

Boards of Partnerships and Governance

There is no single definition of a corporate partnership but for purposes of this discussion, I opted for one that defines it as; '*a commercial activity by which the Authority forms a partnership with a business (the 'corporate partner') for mutual benefit.'* [2] In the industries in question, partnerships between Governments and private companies are often a function of national laws that grant the State a right to equity in minerals, oil and gas projects. As a result of the legal provisions, in case of an investor proceeds to development of minerals, oil and gas resources, the State's entitlement to equity in the development company is one of the most common non-negotiable conditions for licensing as can be seen from a database of mineral laws in Africa.[3]

1. https://csrc.nist.gov/glossary/term/separation_of_duty
2. https://www.lawinsider.com/dictionary/corporate-partnership
3. https://www.aflsf.org/publication/african-mining-legislation-atlas-amla-brochure

These provisions are based on the State being the owner of the resources and essentially result in legislated partnerships. For purposes of this blog, it is assumed that the State is not a silent partner but one with seats on the board and therefore potentially having a meaningful strategic and governance voice. In mining, good examples of such partnerships are CBG[4] in Guinea and Debswana[5] in Botswana. While brought together by a common goal to unlock the economic value of the resources companies and governments each operate in organizational structures with unique hierarchies and chains of command. If this can be harmonized, the partnership succeeds. However, if not, the outcomes can be counterproductive to the goals of the very company and essence of their mission. Boards of partnerships are the main gatekeepers with a responsibility to safeguard against this risk.

For their part most companies prefer to go it alone. However, investors also often create partnerships for strategic reasons. The rationale for the arrangements includes the need to raise finance, the need to access resources discovered by others, the need to secure markets for commodities and a desire to leverage technology by partnering with competitors and other third parties. Regardless of their basis, such arrangements create an additional layer of governance parameters based on an agreed governance structure and operating model for the partnership company as well as the rights and obligations of each party. Together with regulatory frameworks, the agreements can be the start of a unique corporate governance framework with its own set of opportunities and challenges for the board. This environment also extends to the day-to-day management of the operations of the entity. To highlight impacts of such arrangements, I discuss some of the practical corporate governance challenges arising from the unique circumstances.

2.1.1 Common Governance Challenges

Misalignment

National governments and private investors exist for fundamentally different purposes. As such when in partnership, differences in strategic priorities, long term corporate goals and organizational cultures emerge. If one adds interests of different stakeholders and their concerns, the environments in which boards of such entities lead and oversee company operations can be some of the most difficult. This is especially true for the roles of the chairperson, who presides over boards and a CEO leading a team both of whom must be aligned for the company to succeed.

4. https://cbg-guinee.com/
5. https://www.debswana.com/

National Political versus Foreign Commercial Interests

In case of partnerships with foreign investors, the clash of interests based on differences between national political and foreign commercial organizational goals is an overarching source of tension in boardrooms of partnerships between sovereigns and foreign investors. Representatives of foreign investors often view the company through a global lens, are motivated by a profit motive and individual careers depend upon delivery of financial results. By contrast, representatives of public shareholders derive their mandate from national leaders who are concerned with national economies and political survival. However, both want to leverage the resources of the company to achieve their respective objectives. The inherently conflicting ways and means by which each partner wishes to leverage the resources to promote separate interests is the main source of the company's governance challenges. Specifically, the problem makes reconciliation of strategic and corporate governance decisions difficult. Common areas of conflict are policies on long term investment strategy, supply chains policies, budgeting, dividend payment and appointment of executives.

Rights and Obligations of Partners

Partnership agreements embed rights and obligations that are intended to protect the interests of each partner and stabilize the operating environment. But for several reasons some of which are discussed in the paragraphs below, in case of partnerships between governments and investors, from a governance perspective they can have the opposite effect. To start with, an important influencer of the rights and obligations of each party is that they correspond to statutory provisions and the material contributions of each party to company resources. As stated before, this discussion assumes that the State's shareholding is a legal condition while the investor's shareholding is based the principle of right of first refusal to develop a deposit following a discovery. The principle means that a contract, lease agreement, or other formal agreement grants its holder the first opportunity to make an offer before the right is open to others or goes on the market. In this case the investor's privileges are based on the acceptance that companies have earned the right to recoup investment from exploration costs.

But development and operationalizing of minerals, oil and gas projects needs more than exploration by a company and resource ownership by the State. In many cases therefore, the private investor has the obligation to develop the project. This requires mobilizing finance for project infrastructure, recruiting teams, securing an offtake agreement for the commodity and more. This is especially true for new projects, but it means that at this stage the State's material contribution to project development costs and the partnership is lower relative to that of the private investor. Because material contribution correlates to rights, it also influences the relative degree of leverage (but not financial gains as the State also receives different forms of tax revenue). Some rights include shareholding, voting, board nominations and the right to appoint contractors and suppliers. nother important aspect of such partnerships is that (at least in early project lifecycle stages), the private investor manages the day-to-day affairs of the company based on management contracts (sometime known as a operators' agreement). In case of a right to appoint executives, multinationals often select candidates from the group's pool of talent. Even if selected from the open market, such executives answer to the private investor and therefore view this partner and not the partnership entity as their employer.

Not surprisingly, loyalty therefore accrues to the former. These factors add to company policy challenges and can erode trust and increase tension between the partners. Importantly, they detract the board from its ideal focus being the wellbeing of the company rather than minimizing adverse effects of shareholder divergence.

Conflicting Interests

The notion of fiduciary duty refers to the obligation that a director has to the stakeholders of the company and aligns to the concept of the triple bottom line. It is based on the trust placed by the stakeholders on directors (individually and collectively). Among others, this assumes that the directors' actions will be guided by regard for all interested parties and not special interests of those that they may have ongoing relationship with. This should not be difficult to abide by, (or flag), if a conflict of interest arises. However, in the case of partnerships between private companies and governments, the concept is irreconcilable because representatives of both are conflicted on an ongoing basis. To start with, representatives of governments are often also regulators, which means they wear the two hats of a fiduciary and a regulator. On occasion officials serving as directors expediently use the law of the land to force decisions in favour of the State. While this may be tactically shrewd, it exemplifies conflict of interests and goes against corporate governance principles.

For their part, representatives of the private investors also often speak for holding company interests and not the entity on whose board they serve. This is especially true in cases where the private sector also assumes the role of project operator (an arrangement that is common in minerals, oil and gas projects). Under these circumstances, the private investor performs a valuable role in leveraging parent company technical, commercial and financial resources. To a large measure, this benefits the partnership entity and host country. In fact, it is the basis for the rationale for having a technically competent partner. But unless restrained, this can be used to give the investor advantage relative to the State.

Global Versus Local Interests

Depending on the investor's corporate footprint, operating strategy and scope of investments in and out of a host country, the investor might be a competitor to the State. An obvious case is one in which the private investor has subsidiaries in the same business line as the partnership. In some cases, the private investor might also have other subsidiaries that are clients or suppliers to the partnership. Such overlapping interests give rise to potential conflict and even with the best will in the world make monitoring and trust building between the two shareholders and their representatives on the board difficult to achieve. A heightened sense of awareness on the part of the directors helps moderate risk of conflict but cannot eliminate the governance challenges completely.

Knowledge Asymmetry

The fact that the representatives of the private investor are typically industry professionals while those of the government are not, leads to knowledge asymmetry. This adds to the complex governance environment. Some of the most significant effects of this emanate from a lack trust based on some of the factors discussed above.

In some cases, to avoid a deadlock, the partnership company board makes decisions based on compromise and not based on the merits of a case as one might expect in properly governed companies. Indeed, unless representatives of either partner are willing to take each other's views on face value, compromises erode value and become common place.

Relations with Executive Management

Though I discuss the role of executives and public officials in ensuring effective governance in a later blog, it's worth addressing the role of the CEO briefly for now. The role is the link between the board and the company. As such it is vital for the governance of a company especially as relates to implementation of long term strategy and mitigation of operational risk. However, lack of shareholder and board alignment can make the position of the CEO particularly untenable as the partners compete to influence the incumbent's operational priorities. Under these circumstances, a CEO spends time trying to mend bridges instead running the company. Ultimately, the board of directors of the partnership is at risk of being consumed by the tension that ensues at the expense of providing strategic direction to company executives. Not surprisingly, research shows that misalignment is a common cause of partnerships failure and should not be taken lightly.[6]

3. State-Owned Enterprises Boards and Governance

The definition of an SOE differs based on context and one that aligns to the discussion on legal structures and corporate governance of minerals, oil and gas companies defines it as '*a body formed by the government through legal means so that it can take part in activities of a commercial nature*'.[7] SOEs are for all intends and purposes therefore commercial agents of the State expected to give a financial return to the State and ultimately citizens. Though SOEs can be legally formed using laws applicable to other companies, for purposes of this discussion, the assumption is that the SOEs are created by a special law. From a governance perspective, this creates a unique corporate environment which like that of partnerships results in several governance challenges of its own. Nevertheless, in minerals, oil and gas, industries, SOEs are some of the largest companies, nationally and globally. So, unless properly governed, the potential financial loss (and economic damage) to a country can be far reaching. The State's role as a steward of natural wealth places a burden on public institutions to manage SOEs for public benefit and to ideally set an example for other investors to emulate.

Sadly, the Natural Resources Governance Institute (NRGI) reports that, *'research shows that most SOEs are poorly governed.*[8] *This creates risks of wasted public resources, corruption and negative impacts in producing communities.'*[9] In mining, the Democratic Republic of the Congo's (DRC), the SOE Gécamines is reportedly poorly governed and its contribution to the country's economic performance negligible.[10]

6. *https://medium.com/@water.street/why-joint-ventures-fail-and-how-to-prevent-it-f20d9e7e9e68*
7. *https://corporatefinanceinstitute.com/resources/career/state-owned-enterprise-soe/#:~:text /*
8. *https://resourcegovernance.org/topics/state-owned-enterprises*
10. *https://resourcegovernanceindex.org/country-profiles/COD/mining?years=2021*

Effective national and corporate leadership through governance are two major missing links. In the context of SOEs, bridging this gap is the responsibility of the State as sole shareholder and the company's board of directors to whom it delegates authority. But in part due to the actions of the State, the board also faces challenges, some of which I discuss below.

3.1

Common Challenges

Lack of a Clear Vision

Given the emphasis on commercial outcomes (and not other legitimate purposes for which such entities may be create), it is reasonable to assume that the vision of those who establish such SOEs and all matters relating to the affairs of the company are guided by commercial viability. This should start with a clearly articulated corporate vision based on a national policy. Done this way, the frameworks would reinforce rules of engagement between the shareholders and the board as well as others in the chain of command. Among others this would empower the board to develop a strategy to guide the executives based on some consensus of what success looks like. This clarity and regard for rules of engagement in a commercial setting is the gap between effective and ineffective SOE boards. Stated differently, the clearer the State is about the board's responsibility to deliver tangibly, rather than simply complying with the law, the greater the chances the board will be effective. It is inconceivable that SOEs can be properly governed without first dispensing with this foundational principle, yet some governments rely only on the law. The outcome is poor governance based on a lack of direction for the board and the SOE itself.

Regulatory Frameworks

The creation of SOEs based on a specific law has its own governance constraints. For one, this means that despite being considered commercial entities, because the SOEs operate under special laws, such companies are not regulated based on tried and tested regulatory parameters and governance standards applicable to other commercial enterprises. Instead, the companies are subject to laws based on the aspirations and views of those that create them. This raises the question of objectivity given the challenges of the political economy. In addition, under these circumstances, this means that accepted standards for governance including financial reporting, financial disclosure, appointments and removal of directors and executives many not always be based on the SOEs' interests. So, unless the State puts additional measures in place to compensate for this gap and strengthen oversight standards, governance systems for transparency and accountability could be compromised. The absence of requirements to apply International Accounting Standards in financial reporting and financial audits as well as failure to publish financial statements by some SOEs are a case in point. Further, disregard for international benchmarks and watchdogs shields SOEs from public scrutiny.

Separation of Powers

I discussed this concept in previous blogs, and as with the value of guarding against conflict of interests, the need to separate powers based on different layers in the governance hierarchy of SOEs is one of the cornerstones of good governance. In this context, separation of powers relates to role definition between several guardians of public interest. The first is the lawmakers that created the laws leading to the formation of the company and as such also custodians of the law. It also refers to the Executive Branch that runs the day to day affairs of the State including overseeing SOEs and other institutions. It relates to the regulatory institutions charged with enforcing the law that established the company and all matters pertaining to the SOE's operations. In most cases, the Executive Branch centralizes power around a single minister weakening the other functions. This concentration of power is one of major reasons for poor governance based on the absence of checks and balances. That is, *'a system that allows each branch of a government to amend or veto acts of another branch so as to prevent any one branch from having too much power.'* [11] This definition makes it abundantly clear why regard for the principles of separation of powers is vital for governing SOEs responsibly.

The Political Economy

The political economy is defined as *"a study of how politics and the economy influence each other, and how economic systems are governed by political systems".*[12] This phenomenon embodies some of the root causes of poor governance of SOEs. A common challenge is the government's interference in the day to day affairs of a SOE. By so doing governments continuously undermine the board and impose politically (and not commercially) motivated decisions that favour those in power or others who stand to benefit rather than the company and therefore citizens. In other cases, SOE directors are surrogates who serve short-term political objectives and not long term commercial goals such that executive management and board appointments are made along political lines to foster political goals. For their part, the appointees reward their political masters with cronyism and a lack of professional integrity. Many fail to use legal powers vested in them by law, or to exercise their authority and deploy company resources at their disposal to challenge authoritarianism as the need arises. The outcome is lack of corporate leadership and poor governance of SOEs resulting from abdication of responsibility.

11. https://www.merriam-webster.com/dictionary/checks
12. Kenton W, Boyle M.J and Kazel M – "Political Economy Definition, History and Application" June 2024

Financial Independence

A major justification for creating SOEs in minerals, oil and gas sectors is to enable countries to assume control of national resources and to use the control to maximize value. That is to say, to outperform private investors on matters of national interest. Among others, SOEs can achieve this through their contribution to the national fiscus and other economic deliverables. So, while reasonable for the State to raise some seed capital or grant shareholder loans periodically, perpetual funding of poorly run SOEs defies logic, but is nonetheless a common occurrence. From a corporate governance perspective, this speaks to two failures. The failure of the State to discharge its duties as custodian of natural assets and the failure to hold the board responsible to deliver returns on investment. For its part, the board fails to provide strategic leadership. This failure to deliver value based on an inability to govern brings into question the very merits of creating an SOE.

Team Selection

In addition to the appointment of political elites to the boards and executive teams of SOEs, it is common practice to select nominees exclusively from the public service. Though some nominees have distinguished public service careers, the ability of the incumbents to adequately discharge their duties in a commercial setting should not be taken for granted. In cases where all directors are selected from public officials therefore, the SOE is not only deprived of commercial knowhow, but of the value of a diverse skills mix on boards. Yet studies show that diverse boards perform better relative to those that are not. This is in part because the board does not benefit from friendly critics who provide an outsider's perspective of the company's strategy, risk and rewards.[13]

4. Conclusion

Regardless of the type of company, governance of mineral oil and gas companies presents many challenges all be it largely influenced by the nature of the industries and the laws that govern them. For partnerships, divergence of interests are a major factor. For SOEs short-term political interests are a common stumbling block. Both undermine governance in the short term and erode economic deliverables in the long term. That said, national sentiment for countries to have a direct say in the day-to-day running of minerals, oil and gas projects remains very strong. It suggests that State equity will continue to be part of national investment policies for a long time. Hence the importance of SOEs setting the tone for governance through stronger financial performance and greater accountability based on corporate governance frameworks. Otherwise, it is hard to justify the continued investment in commercial entities by national governments.

13. https://hbr.org/2019/03/when-and-why-diversity-improves-your-boards-performance

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This blog is part of on series on:

Good Corporate Governance in Oil, Gas and Mineral Industries.

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