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Corporate Governance under the South African Companies Act: A Critique

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Corporate governance in South Africa has traditionally been based on the shareholder value approach. In terms of this approach, directors are expected to manage a company in the best interests of the shareholders collectively. This approach is however, increasingly being questioned. With the surge of interest in the recognition of not only shareholder interests, but also the interests of other stakeholders, the corporate governance approach in South Africa merits a deeper analysis. This paper critiques the corporate governance approach under the Companies Act 71 of 2008. The main concern is whether the Companies Act protects the interests of different stakeholders and whether or not it reflects the enlightened shareholder value approach. The findings of this paper reveal two shortcomings of the Companies Act with regard to the protection of stakeholder interests in corporate governance. Firstly, that the scope of the Companies Act is very narrow as focus is more on employees to the exclusion of other stakeholders. Secondly, that the Act is not clear on its preferred corporate governance approach. The paper concludes with recommendations which address these shortcomings.

Name of Track: Management

1. Introduction

It is trite law that a director owes a duty to act *bona fide* in the best interests of the company in which he or she is involved.[1] However, the main question that follows from a duty formulated in this manner is what constitutes 'the best interests of the company?' Different theories such as the shareholder value theory, the stakeholder theory and the enlightened shareholder value theory have all been developed to address this question. In this paper, the development of the corporate governance debate in South Africa in the context of the shareholder value approach, the stakeholder approach and proposals by the Corporate Regulation Division of the Department of Trade and Industry during the company law reform process for the adoption of the enlightened shareholder value approach will be discussed. Further, the paper concentrates on section 76(3)(b) of the Companies Act 71 of 2008 which is the key provision in highlighting the interests to considered by directors when managing companies. It also discusses sections 7, 20(4), 144, 145, 162(2), 165(2) and 218(2) which are all relevant when determining the recognition of stakeholder interests in the Companies Act. From the analysis, two questions are sought to be determined. Firstly, whether the Companies Act has adopted the enlightened shareholder value approach as proposed during the company law reform process. Secondly, whether the Act has wide application in so far as the protection of stakeholder interests is concerned.

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The paper is organized as follows. Firstly, a review of literature related to the protection of stakeholder interests in corporate governance is presented. This is followed by a description of the methods used in undertaking this research. A historical background of the Companies Act 2008 then follows before proceeding with the critical analysis of the corporate governance approach under this Act. This is then followed by a reporting of key findings of the critical analysis. Finally, a conclusion is provided with a discussion on the findings and suggestions for law reform.

2. Literature Review

Literature highlighting the importance of the recognition of a wider variety of interests that should be considered in addition to those of the shareholders has been growing over the last many years. Several contributions note that while the traditional view holds that the function of directors is none other than that of profit maximization for the shareholders, there has been a shift in public opinion towards the recognition of the interests of a broader spectrum of stakeholders (Esser, 2009; Esser, 2005; Havenga, 2005; Mongalo, 2003; Rossouw, van der Watt and Malan, 2002; Shandu, 2005). There is mounting pressure on directors to take into account not only shareholder interests when they manage a company, but rather the interests of all stakeholders, such as employees, creditors, consumers, suppliers, the environment and the community (Esser and Du Plessis, 2007). In line with this view, Benade *et al*, 2008 states that corporate governance involves the balancing of the interests of all internal stakeholders and other parties who can be affected by the corporation's conduct. The *King Reports on Corporate Governance for South Africa* also place strong emphasis on the protection of stakeholder interests.

While the above cited authors provide interesting studies on corporate governance, the point of departure of this study is that it focuses specifically on the enlightened shareholder value approach and on relevant provisions contained in the Companies Act which are viewed as revealing this approach. The enlightened shareholder value approach encompasses the idea that corporations should pursue shareholder wealth with a long-run orientation that seeks sustainable growth and profits based on responsible attention to the full range of relevant stakeholder interests (Ho, 2010). The study through an analysis of the relevant provisions seeks to determine whether or not the enlightened shareholder value approach is reflected in the Companies Act. To the extent that the Act is found not to be in line with the enlightened shareholder value approach, recommendations are made that will ensure that the Act reflects the enlightened shareholder value approach. This study is therefore, significant in that it provides recommendations necessary to ensure that the Act is in line with the enlightened shareholder value approach. However, it is noteworthy that the issue whether or not this approach is appropriate to the South African context is not discussed. The reasons are two-fold. Firstly, the issue falls outside the scope of this study. Secondly, it forms the scope of yet another study.

3. Research Methodology

The qualitative research method has been employed in this study. This method is justified given the nature of the subject under discussion. The main methods associated with qualitative research are ethnography/participant observation, qualitative interviewing, focus groups and the collection and qualitative analysis of texts and documents (Welman, Kruger and Mitchell, 2006). The research method used in this study is the collection and qualitative analysis of texts and documents. Two approaches were employed, namely, the analytical approach and the critical approach. In the context of this study, an analytical approach enables one to gain insights through discovering meanings and understanding the theories behind the concept of the corporate governance by analyzing its depth and complexities. The critical approach seeks to challenge the status quo. In particular, a critical analysis of the corporate governance under the Companies Act 2008 is undertaken with the aim of understanding the enlightened shareholder approach, and to challenge and eliminate misinterpretations of the current law.

4. The Company Law Reform Process

In May 2004, the Corporate Regulation Division of the Department of Trade and Industry commenced with the reform of the national corporate law by issuing a *Policy Document* on the guidelines for corporate law review.[2] The *Policy Document* dealt with the scope of company law in Chapter 3. It started by acknowledging the fact that every company law reform process begins with the fundamental question, 'in whose interests should the corporation be run?'[3] The *Policy Document* discussed the enlightened shareholder value approach and the pluralist approach, the latter essentially providing for a stakeholder approach. In terms of the enlightened shareholder value approach directors should have regard, where appropriate, to the need to ensure productive relationships with a range of interested parties, the stakeholders, and to the longer term, but with shareholders' interests retaining primacy (Ho, 2010). The main aim of the enlightened shareholder value approach is therefore the maximization of shareholder wealth. The enlightened shareholder value approach suggests that the term 'the best interests of the company' relates to the interests of the shareholders, but with the possibility of other stakeholders being included if their interests promote the interests of shareholders.[4] However, in terms of the stakeholder approach, a company's existence and success are intertwined with the considerations of the interests of other stakeholders, such as employees, suppliers and consumers. Rather than the company working to maximize wealth for shareholders, the stakeholder approach adheres to the idea that the company works towards creation of value for all stakeholders (Keay, 2010). Directors therefore, have to consider the interests of all stakeholders.

The *Policy Document* favoured the enlightened shareholder value approach[5] and proposed that in the South African context, company law should take account of stakeholders such as the community in which the company operates, its customers, employees, suppliers and the environment, but only in circumstances mandated by the Constitution and related legislation. Thus, in terms of the *Policy Document* a company should have as its objectives the conduct of business activities with a view to enhancing the economic success of the corporation, taking into account, as appropriate, the legitimate interests of other stakeholder constituencies.[6]

4.1 The Companies Bill

In February 2007 a draft Companies Bill was published for public comment.[7] During September 2008 Parliament's Trade and Industry Portfolio Committee approved the Companies Bill of 2008. The Bill contained provisions regarding directors' duties. Clause 91(1)(b) which dealt with the interests to be considered by directors when managing their companies provided *inter alia* that a director has a duty to act honestly and in good faith and in a manner the director reasonably believes to be in the best interests of, and for the benefit of the company. However, what is meant by the 'best interests of, and for the benefit of the company' was never clarified. In terms of the Bill, it was therefore not clear whether directors should advance only shareholder interests when they manage or whether they should also consider the interests of other stakeholders.

4.2 The Companies Act

The Companies Act, 2008 was assented to by the President on 9 April 2009 and became effective on 1 May 2011. The Act deals in Chapter 2 with the formation, administration and dissolution of companies. Part F of Chapter 2 deals with the governance of companies. It introduces a number of provisions relating to the standards of conduct of directors. These include a partial codification of the common law duties of directors. This means that the Companies Act does not replace the common law duties of directors that are not expressly amended or are not in conflict with it. It is noteworthy that Chapter 1 and Chapter 7 are also relevant when discussing corporate governance issues. Chapter 1 deals with *inter alia* the purposes of the Act.[8] Chapter 7 deals with remedies available to various parties such as shareholders, creditors and employees.[9]

Section 76(3)(b), section 7, section 20(4) and sections 162(2) and 165(2) are important for purposes of the topic under discussion. These provisions deal respectively with directors' duties, purposes of the Act, validity of company actions and remedies available to shareholders and other stakeholders in holding directors accountable. Section 76(3)(b) is of specific importance as it highlights the interests to considered by directors when managing the company.

Section 76(3)(b) provides that 'directors must exercise their powers and perform the functions of director in the best interests of the company.' The main question that follows from a duty formulated in this manner is what constitutes 'the best interests of the company.' Does the phrase mean that the directors should use their powers to promote the welfare of the legal entity and would that mean, divorced from the interests of the various stakeholders that have an interest in it or should broader interests be promoted?[10] Furthermore, if the interests of specified stakeholder groups should be advanced which stakeholder groups should it be, should it be shareholders alone, or shareholders and other stakeholders?[11] If only shareholder interests should be advanced, what of the interests of other stakeholders?[12] In light of section 76(3)(b) the Companies Act appears not to have provided clarity on these questions.

The meaning of 'the best interests of the company' is not clear and various South African academics have debated its precise meaning (Esser and Du Plessis, 2007; Spisto, 2005; Mongalo, 2003 and Havenga, 1997). It has been noted that irrespective of excellent research by South African academics, there is still considerable uncertainty as far as the meaning of this concept is concerned (Esser and Du Plessis, 2007). While the company law reform process created the ideal opportunity to clarify this issue, it still remains unclear from the wording of section 76(3)(b) whether directors should provide shareholders with primacy when they manage or whether they should also consider the interests of other stakeholders. On the basis that the phrase 'the best interests of the company' has generally been interpreted in various English cases,[13] which is part of our common law to mean the interests of the shareholders collectively (Du Plessis, 1992; Havenga, 1997), one may conclude that the traditional view point, that is, the shareholder value approach still applies.

However, the above conclusion is one that should not be arrived at by merely looking at section 76(3)(b) in isolation as through all the stages of the company law reform process the enlightened shareholder value approach was favoured and furthermore, some authors hold that the Companies Act adopted[14] the enlightened shareholder value approach (Davies, *et al*, 2011).[15] In this light, one must therefore, in the alternative, look to the other provisions in the Companies Act in order to determine firstly, whether the Companies Act gives recognition to a broader spectrum of stakeholders and secondly, whether it in fact, reflects the enlightened shareholder value approach. In this regard, sections 7, 20(4), 144, 145, 162(2) and 165(2) are of importance and will be dealt with.

Section 7 sets out an impressive list of legislative purposes. The section provides that the purposes of the Act are *inter alia* to: encourage high standards of corporate governance as appropriate, given the significant role of enterprises within the social and economic life of the nation; reaffirm the concept of the company as a means of achieving economic and social benefits; and to provide for the efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders.[16] However, section 7(e)(i) states as one of the purposes of the Act, the balancing of the rights and obligations of shareholders and directors within companies. The exclusion of stakeholders in this provision raises issues of concern. Be that as it may, in light of section 7 the Companies Act generally seeks to promote the interests of stakeholders.

Section 20(4) of the Act is viewed as an example of the enlightened shareholder value approach (Davies *et al*, 2011). It provides that shareholders, directors and prescribed officers or a trade union representing employees may take proceedings to restrain a company from doing anything inconsistent with the Act. It is therefore, now clear that a trade union representing employees now has rights in terms of the Act. In terms of section 162(2), a shareholder, director, company secretary or prescribed officer of a company, a registered trade union that represents employees of the company or another representative of the employees of a company may apply to a court for an order declaring a person delinquent or under probation if *inter alia* the person is a director of that company. Section 165(2) states that a person may serve a demand upon a company to commence or continue legal proceedings, or take related steps, to protect the legal interests of the company if the person is either a shareholder, director, registered trade union or another representative of employees of the company. From both section 162(2) and section 165(2) it is again clear as with section 20(4) that a trade union or any representative of the employees now has rights.

It has been noted above that section 20(4) is viewed as an example of the enlightened shareholder value approach (Davies *et al*, 2011). In terms of content, section 20(4) is similar to sections 162(2) and 165(2). By logical deduction, it can therefore be concluded that if section 20(4) is an example of the enlightened shareholder value approach, then sections 162(2) and 165(2) are also examples of the enlightened shareholder value approach. However, two issues arise for determination. First, whether these sections indeed reflects the enlightened shareholder value approach to justify the conclusion that the Act has adopted this approach. Secondly, whether the Companies Act gives recognition to a broad spectrum of stakeholders and reflects the new thinking in corporate governance.

In terms of sections 20(4), 162(2) and 165(2), the Companies Act appears to give recognition to only one stakeholder group, namely employees to the exclusion of other stakeholders such as consumers and suppliers. Its scope is therefore very narrow. In this regard, it is argued that it cannot, on the basis of the recognition of the interests of *only* one stakeholder group, be concluded that the Companies Act has adopted the enlightened shareholder value approach. Indeed, the issue is not about the number of stakeholder groups that must be recognized but is about the Companies Act embracing the interests of a broad range of stakeholders. To the extent that the Companies Act fails to do so, it is argued, it reflects a shareholder value oriented corporate governance approach.

Furthermore, while sections 20(4), 162(2) and 165(2) provide trade unions representing employees or any representatives of employees with a right of enforcement, it is important to note that the right is not with regard to the interests of the employees *qua* employees, but is with regard to the interests of the company. In other words, these sections provide the specific stakeholder group with certain remedies regarding the interests of the company, as opposed to remedies regarding their own interests. For example, section 162(2) relates to an application to declare a director delinquent or place a director under probation. The question that then arises is, on what basis can it be said that this stakeholder group, the employees, have interests that are protected in the Act when all they have are remedies regarding the interests of the company and no direct rights of their own to enforce. In this regard, it would therefore not be an overstatement that employees are not in any better position as a remedy without a right is worthless.

The rights of employees are however recognized and protected during business rescue proceedings. Of relevance in this regard is section 144 and section 145 of the Act. Section 144 provides an opportunity for employees or their trade unions to make a business rescue initiative in circumstances where their proposal might be the only viable option available to rescue the company (Davies *et al*, 2011). In this way, the interests of employees are taken into consideration. Section 145 *inter alia* provides that as affected persons, the creditors (including those employees who have become preferred unsecured creditors because of their unpaid remuneration due before rescue proceedings commenced) have the right to be notified of, and formally and informally participate in all stages of the proceedings. They play a particularly important role in voting on the amendment, approval or rejection of the business rescue plan.

Section 218 of the Companies Act dealing with civil actions is also relevant to the issue of the protection of stakeholder interests. In particular, section 218(2) provides that 'any person who contravenes any provision of this Act is liable to any other person for any loss or damage suffered by that person as a result of that contravention.' In light of this section, stakeholders can therefore argue that by not considering their specific interests, directors did not act in the best interests of the company. In this regard, section 218(2), together with sections 144 and 145 therefore evidence the enlightened shareholder value approach as the Companies Act extends its concerns beyond the traditional scope of shareholders. It is however, emphasized that these are the only instances in the Companies Act where the enlightened shareholder value approach is evident.

5. Findings

The above analysis has identified two shortcomings of the Companies Act with regard to the protection of stakeholder interests in corporate governance. Firstly, that the Companies Act does not give recognition to a broad spectrum of stakeholders. Secondly, that the Act is not clear on its preferred corporate governance approach. It has been highlighted that while the Companies Act is not clear on the interpretation of the phrase 'the best interests of the company,' in terms of the common law, the phrase has been interpreted to mean that directors must act in 'in the interests of the company as a whole,' being the shareholders collectively. In this context, section 76(3) of the Companies Act creates the impression that the shareholder value approach is preferred. However, on the other hand, it is evident from sections 20(4), 162(2), 165(2), 144, 145 and 218(2) that stakeholder interests are to a certain extent protected. Confusion is therefore created as to the approach that the Act prefers, whether it is the shareholder value approach or the enlightened shareholder value approach. This confusion needs to be eliminated.

6. Conclusion

In light of the shortcomings identified above, the following recommendations are made. Firstly, it is recommended that to reflect an enlightened shareholder value approach, section 76(3)(b) must be amended to read as follows, "A director of a company, when acting in that capacity, must exercise the powers and perform the functions of director in the best interests of the company, having regard, where appropriate, to the interests of relevant stakeholders." It then becomes clear that directors should pursue shareholder wealth maximization but with a long-run orientation that seeks sustainable growth and profits based on responsible attention to the full range of relevant stakeholder interests.

Secondly, and in the alternative, it is recommended that the Companies Act should define what is meant by 'the best interests of the company.' This will clarify the preferred corporate governance approach in South Africa. If the enlightened shareholder value approach is the preferred approach, then the definition of 'the best interests of the company' should state that 'the best interests of the company' refers to the shareholders of the company collectively, with the possibility of including relevant stakeholders but only when aimed at profit maximization for the shareholders. In this way the provision will be in line with the enlightened shareholder value approach.

Thirdly, it is recommended that section 7(e)(i) be amended to provide for the balancing of the rights and obligations of not only shareholders and directors but also relevant stakeholders. This will then clarify the fact directors must also take into account the interests of stakeholders. Lastly, it is recommended that the Companies Act must give recognition and protection to a wide range of stakeholders. As has been highlighted, in terms of sections 20(4), 162(2) and 165(2), the Companies Act appears to give recognition to only one stakeholder group, that of employees. In this regard, its scope is therefore very narrow and needs to be broadened.

Endnotes

[1] See for example, *Robinson v Randfontein Estates Gold Mining Co Ltd* AD 168; *Sibex Construction (SA) Pty Ltd v Injectaseal CC* 1988 (2) SA 54 (T); *CyberScene Ltd v i-Kiosk Internet and Information (Pty) Ltd* 2000 (3) SA 806 (C).

[2] See *South Africa Company Law for the 21st Century, Guidelines for Corporate Law Reform May 2004*, pp1-54 (hereafter, the Policy Document), viewed 16 September 2012, < http://www.pmg.org.za/bills/040715companydraftpolicy.pdf>.

[3] *The Policy Document* p 20.

[4] *The Policy Document* p 24.

[5] *The Policy Document* p 26.

[6] *The Policy Document* p 26.

[7] *Companies Bill 2007*, viewed 14 February 2012, < http://www.companylaw.uct.ac.za/usr/companylaw/downloads/legislation/Companies_Bill_2007.pdf>. The Explanatory Memorandum issued with the Bill referred to five economic growth objectives, namely simplification, flexibility, corporate efficiency, transparency and predictable regulation – see Companies Bill.

[8] See section 7 of the Companies Act.

[9] Focus will however be on section 162(2) and 165(2).

[10] *The Policy Document* p 18.

[11] *The Policy Document* p 18.

[12] *The Policy Document* p 18.

[13] See for example *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407 and *Hutton v West Cork Railway Company* (1883) 23 Ch D 654.

[14] The term 'enlightened shareholder value' was first introduced in the United Kingdom to describe its stakeholder-oriented approach. The enlightened shareholder value is enshrined in section 172(1) of the United Kingdom's Company's Act 2006 (c 46).

[15] See Davies, D, Cassim, F, Geach, W, Mongalo, T, Butler, D, Loubser, A, Coetzee, L & Burdette, D 2010, *Companies and Other Business Structures in South Africa,* Oxford University Press, Southern Africa.

[16] Section 7 of the Companies Act.

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