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An Appraisal of the Protection of Stakeholder Interests under the South African Companies Act and *King III*

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In South Africa, company law traditionally enabled companies to be managed in such a way as to maximize the interests of shareholders ahead of those of other stakeholders. The King Reports on Corporate Governance have however, always advocated for the protection of the interests of other stakeholders such as the employees, creditors, consumers, the community and the environment. The protection of stakeholders' interests is one of the fundamental principles of corporate governance. While this principle is clear, there is often a tension between profit maximization (for the shareholders) and the social responsibilities of companies which require the consideration of the interests of other stakeholders. This study provides an appraisal of the protection of stakeholder interests under the Companies Act, 2008 and under the King Report on Corporate Governance 2009 (King III). The aim is to provide a holistic view of the protection of stakeholder interests in corporate governance in South Africa and to determine the corporate governance approach. It is concluded that there is protection of stakeholder interests under the Companies Act and King III. With regard to the corporate governance approach, it is concluded that it is enlightened shareholder value oriented.

Name of Track: Management

1. Introduction

Company law traditionally enabled companies to embark on the shareholder value approach. The emphasis has therefore, been on the role of directors in managing and overseeing the company's business primarily for the benefit of the shareholders. In terms of the shareholder value approach, the interests of the shareholders are paramount and interests of other stakeholders are considered only if their advancement will lead to shareholder value maximization, that is, 'through the prism of shareholder profit maximization.' While company law traditionally enabled companies to embark on the shareholder value approach, the *King Reports on Corporate Governance* have been influential in moving corporate governance in the stakeholder direction. The *King Reports* are however, not law and hence failure to comply therewith will not result in direct liability for directors. This study is based on the premise that good governance and the law are inseparables and that it is inappropriate to unhinge governance from the law.[1] The paper therefore, provides an appraisal of corporate governance under the Companies Act, 2008 and the *King Report on Corporate Governance 2009* (*King III*). The aim is to provide a holistic view of the protection of stakeholder interests in corporate governance in South Africa and to determine the corporate governance approach. This study is significant in that it investigates the issue of the protection of stakeholder interests

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particularly focusing on the nexus between compliance with the law and good governance.

The paper is organized as follows. Firstly, a review of literature related to corporate governance is presented. This is followed by a description of the methods used in undertaking the research. An analysis of the protection of stakeholder interests under the Companies Act and *King IIII* then follows. The analysis is followed by a discussion on good governance and the law. This is followed by a discussion on the corporate governance approach in South Africa. Finally, a conclusion is provided.

2. Literature Review

Generally, corporate governance refers to the way in which companies are directed and controlled (*Cadbury Report,* 1992). Thus, the emphasis is on the role of the boards of directors which play a vital role in corporate decision-making. The King Committee also used the *Cadbury* formulation as their working definition (*King I, 1994*).[2] However, authors such as Rossouw, van der Watt and Malan, 2002 amongst others, while acknowledging that corporate boards are important to the accountability of corporations and the way corporations comply with the triple bottom line, explicate that it is much too narrow a focus to equate corporate governance with the role of the boards of directors. A broader definition of corporate governance is given by the Organization for Economic Co-operation and Development (OECD).[3] The OECD states that corporate governance while involving a set of relationships between a company's management, its board, its shareholders and other stakeholders also provides the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined (OECD, 2004). 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. It is noted that various authors such as Esser, 2009; Esser and Du Plessis, 2007; Esser, 2005; Havenga, 2005; Mongalo, 2003; Shandu, 2005; Spisto, 2005 have investigated the issue of corporate governance in South Africa. However, this study is significant in that it investigates the issue of the protection of stakeholder interests particularly focusing on the nexus between compliance with the law and good governance. The rationale for this focus is, as has been stated, that corporate governance in South Africa is defined not only by the Companies Act but by both the Act and *King III.*

3. Research Methodology

The qualitative research method, which by definition is exploratory, has been employed in this study. The reason is that it is best suited to this type of study which entails a critical and comparative analysis. One of the strengths of qualitative research is that it allows the researcher to gain an in-depth perspective and to grapple with complexity and ambiguity. Qualitative research is also intended to penetrate to the deeper significance of the topic being researched. One of the main methods associated with qualitative research is the qualitative analysis of texts and documents (Welman, Kruger and Mitchell, 2006). This method has been used in this research.

4. The Companies Act and the Protection of Stakeholder Interests

In South Africa and internationally the board of directors is regarded as the "directing mind and will" of the company. The company therefore operates through its board of directors as articulated in the case of **i**n *R v Kritzinger.*[4] Section 66(1) of the Companies Act provides that the business and affairs of a company must be managed by or under the direction of its board, which has the authority to exercise all the powers and perform any functions of the company, except to the extent that the Act or the company's Memorandum of Incorporation provides otherwise. Company directors are subject to various duties. Of particular interest is the directors' duty to act in the best interests of the company which is provided for in section 76(3)(b) of the Companies Act. This provision is important as it highlights the interests to be considered by directors when managing their companies. It is noteworthy that for purposes of this study, other provisions in the Act which may indicate a departure from the traditional shareholder value approach are not discussed as focus is purely on section 76(3)(b).

Section 76(3)(b) provides that 'directors must exercise their powers and perform the functions of director in the best interests of the company.' However, what is meant by 'the best interests of the company' is not defined. A matter of concern that arises is which interests must be promoted by directors in order to comply with this duty. Should directors promote the interests of shareholders collectively, to the exclusion of the interests of the various stakeholders that have an interest in the company or should broader interests be promoted? In light of section 76(3)(b) the Companies Act appears not to have provided clarity on these questions.

At common law, the phrase 'the best interests of the company' has generally been interpreted to mean the interests of the shareholders collectively. In this light, one may argue that the traditional view point, that is, the shareholder value approach, still applies and consequently, that stakeholder interests are therefore not protected in terms of the Act. The shareholder value approach requires a company to be run in such a way as to maximize the interests of the shareholders ahead of the interests of any other stakeholders. In terms of this view, a director has no general duty to consider the interests of stakeholders. Obviously directors are allowed to consider the interests of stakeholders and sometimes good management will require this, but ultimately the interests of stakeholders are subordinate to those of the shareholders.

It is noteworthy that while the shareholder value has often been taken for granted it is increasingly being questioned. There is pressure on companies and directors to take into account not only the shareholders when they manage a company, but rather the interests of all stakeholders. It therefore, comes as no surprise that the protection of the interests of different stakeholders such as shareholders, creditors and employees were seen as fundamental to the review process of South African corporate law. However, section 76(3)(b) of the Act should have been framed in ways that clearly indicates that directors must now take cognizance of the interests of stakeholders when managing their companies. In this regard, it is recommended that section 76(3)(b) 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 to the interests of all relevant stakeholders." In this way it will be clear that directors are to take the interests of stakeholders into consideration when managing their companies.

However, in the absence of the above recommended amendment, two submissions are made. Firstly, it is submitted that the best interests of the company must be interpreted in a manner that promotes compliance with the Bill of Rights[5] contained in Chapter Two of the Constitution of the Republic of South Africa, 1996. Important to note in this regard is section 8 of the Constitution which imposes responsibilities upon individuals and juristic persons for the realization of fundamental rights.[6] In this light, the notion of creating a company that can pursue shareholder profit maximization at the expense of human rights is therefore, legally untenable as the Bill of Rights applies to companies in a manner that goes beyond mere financial considerations.[7] In this regard, acting in best interests of the company can therefore, not mean anything else other than that the board should take into account the legitimate interests of all stakeholders in its decision making.

Secondly, it is submitted that the best interests of the company must be interpreted in the context of *King III* which advocates for a stakeholder oriented corporate governance. The reasons for this submission are three-fold. Firstly, with the surge of interest in the recognition of stakeholder interests, it cannot be taken for granted anymore that the best interests of the company mean the shareholders collectively. Secondly, corporate governance in South Africa is defined not only by the Companies Act but by both the Companies Act and *King III.* Thirdly, good governance and the law are complimentary concepts which should work in tandem to promote the development of the South African economy by *inter alia* encouraging high standards of corporate governance and re-affirming the concept of the company as a means of achieving benefits to a broader spectrum of stakeholders.

5. King III and the Protection of Stakeholder Interests

It has been highlighted that while the Companies Act directs the board to act in the best interests of the company, it does not provide clarity on what is meant by the best interests of the company. *King III* however, recommends that the best interests of the company should be interpreted within the parameters of the company as a sustainable enterprise and the company as a good corporate citizen.[8] In light of this recommendation, it will not be an overstatement that acting in the best interests of the company can no longer mean acting in the interests of the shareholders but acting in the interests of all stakeholders. *King III* further recommends that in striving to achieve an appropriate balance between the interests of various stakeholders, the boards should take into account, as far as possible, the legitimate interests and expectations of its stakeholders in its decision-making. [9] In balancing of the interests of stakeholders, the board should be guided by the aim of ultimately advancing the best interests of the company, taking into consideration the triple bottom line context in which companies now operates in as well as the notion of good corporate citizenship. Furthermore, *King III* recommends that the board of directors should be sensitive to the impact of the company on all its internal and external stakeholders and give direct rather than incidental consideration to the legitimate interests and expectations of their stakeholders.[10] In this regard, boards should therefore embrace a shared future with all the company's stakeholders.

King III favours the inclusive stakeholder approach which considers, weighs and promotes the interests of all the company's stakeholders and thus, ensures the co-operation and support of all stakeholders the company depends on, for its sustainable success.[11] The stakeholder approach recognizes that stakeholders such as the community in which the company operates, its customers, employees and suppliers need to be considered when developing the strategic intent of the organization. *King III* notes that the stakeholder approach recognizes that a company has many stakeholders and that they can have an important effect on the long-term growth of the corporation.[12] In this regard, the board should time from time identify important stakeholder groupings, as well as their legitimate interests and expectations, relevant to the company's strategic objectives and long-term sustainability.[13] However, guidance is not given on the criteria that can be used by directors to identify these important stakeholder groups.

King III observes that while the notion of creating value by companies was viewed narrowly as financial value for shareholders, this has evolved into the notion of value in terms of the triple bottom line: social, economic and environmental performance.[14] Boards are now therefore, not only responsible for the company's financial bottom line, but also for the company's performance in respect of its triple bottom line. Thus, companies now operate in the triple context. The triple bottom line is based on the notion that the modern company is so ubiquitous in the world that it is undisputed that it affects not only investors, but various stakeholders such as employees, consumers, suppliers, governments, communities and the environment in which it operates and therefore a need arises for accountability on these aspects. Thus, triple bottom line reporting goes beyond financial results by providing information on economic, social and environmental performance (profit, people and planet). The triple bottom line reporting is based on the premise that reporting on social and environmental outcomes alongside the financial aspects of a corporation's performance would give a more holistic view of the state of its affairs, as well as highlighting the potential risks associated with its operations.

King III emphasizes the fact that while a company is an economic institution, it is also a corporate citizen and as such, has social and moral standing in society. The concept of corporate citizenship flows from the fact that a company is a person (*Salomon v Salomon Co Ltd*)[15] and should operate in a sustainable manner. There are increasing expectations on companies to operate as good corporate citizens due in part to the influence they have on the lives of various stakeholders. Corporate citizenship and sustainability therefore, require the boards of directors to adopt a holistic approach to economic, social and environmental issues in their core business strategy.

6. Good Governance and the Law

It has been submitted above that the best interests of the company must be interpreted in the context of *King III.* In other words, the courts should use *King III* as a tool to assist in the interpretation of the Companies Act. A matter of concern that arises is on what basis should the courts use *King III* to interpret the Act. It is noted that section 5 of the Act, which deals with the rules regarding the general interpretation of the Act does not expressly provide for the use of corporate governance codes such as *King III* when interpreting the Act. It is however, argued that section 5 of the Act must be interpreted within a broader context. In this light, it is submitted that section 5(1) read together with section 7(b)(iii) and 7(d) provides a ground of justification for reliance on corporate governance codes by the courts. Section 5(1) provides that the Companies Act must be interpreted and applied in a manner that gives effect to the purposes set out in section 7. Section 7(b)(iii) provides as one of the purposes of the Act, 'to promote the development of the South African economy by encouraging transparency and high standards of corporate governance as appropriate, given the significant role of enterprises within the social and economic life of the nation.' Section 7(d) provides as one of the purposes of the Act, to reaffirm the concept of the company as a means of achieving economic and social benefits. It is argued in light of section 5(1) read together with section 7(b)(iii) and 7(d) that the starting point for the courts when giving meaning to the phrase 'the best interests of the company' should be *King III*.

Reliance by the courts on *King III* is undeniably pivotal if the Companies Act is to be interpreted in a manner that promotes the development of the economy by encouraging transparency and high standards of corporate governance. The corporate governance codes serve a crucial role in promoting good corporate governance in South Africa alongside compliance with the law. *King III* highlights the fact that in addition to compliance with legislation, the criteria of good governance, governance codes and guidelines will be relevant to determine what is regarded as an appropriate standard of conduct for directors.[16] In this regard, the more established governance practices on the protection of stakeholder interests become, the more likely a court would regard for instance, the board's failure to consider the interests of its stakeholders when developing the strategic intent of the organization as not acting in the best interests of the company. Corporate governance practices, codes and guidelines therefore lift the bar of what can be regarded as appropriate standards of conduct and "consequently, any failure to meet a recognized standard of governance, albeit not legislated, may render a board or individual director liable at law."[17] In light of this link between good governance and compliance with the law, it is therefore evident that stakeholder interests are protected in corporate governance in South Africa.

7. Stakeholder Oriented or Enlightened Shareholder Value Oriented Corporate Governance

Having determined that stakeholder interests are protected in corporate governance in South Africa, the next logical question that arises is with regard to the corporate governance approach. In particular, the question is whether corporate governance in South Africa is stakeholder oriented or whether it is enlightened shareholder value oriented. In my opinion, and based on the approach that has been recommended in interpreting what is meant by the directors' duty to act in 'the best interests of the company,' in section 76(3)(b) of the Act, corporate governance in South Africa is enlightened shareholder value oriented. However, it is questionable whether this approach is appropriate for South Africa.

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 enlightened shareholder value still recognizes the priority of shareholder interests and therefore differs from the stakeholder theory based on balancing of all stakeholder interests.[18] However, because the enlightened shareholder value recognizes that long-term business success depends on regard for the interests of all stakeholders; it has been argued, it represents an alternative to a narrow conception of shareholder primacy (Ho, 2010). The enlightened shareholder value approach has been seen as a possible 'third way,' an alternative to strict shareholder value approach, on the one hand, and also, on the other, to the stakeholder approach that elevates stakeholders to the same plane as shareholders (Loughrey, Keay and Cerioni, 2008). It is worth noting that the enlightened shareholder value approach was preferred during the company law reform process.[19]

8. Conclusion

An effort has been made in this study to provide a holistic view of the protection of stakeholder interests in corporate governance in South Africa. This aim has been achieved through an analysis of the protection of stakeholder interests under the Companies Act and under *King III*. In particular, the focus has been on the link between compliance with the law and good governance. As has been highlighted, the rationale for this focus is that the corporate governance in South Africa is defined not only by the Companies Act but by both the Companies Act and *King III.* While *King III* is not law, and failure to comply therewith will not result in direct liability for directors, the Companies Act and *King III* nonetheless work in tandem to promote the development of the South African economy by *inter alia* encouraging high standards of corporate governance and re-affirming the concept of the company as a means of achieving benefits to a broader spectrum of stakeholders.

Endnotes

1 *King III* p 7.
2 See *King I* p 1.
3 Preamble to the '*OECD Principles of Corporate Governance,'* 2004. viewed on 26 July 2012, <http://www.oecd.org/daf/corporateaffairs/corporategovernance>.
4 *R v Kritzinger* 1971 (2) SA 57 (A).
5 See section 7(a) of the Companies Act which states that one of the purposes of the Act is 'to promote compliance with the Bill of Rights.'
6 See section 8 of the Constitution of the Republic of South Africa, 1996.
7 *King III* p 13.
8 *King III* p 13.
9 *King III* p 103.
10 *King III* p 20.
11 *King III* p 13.
12 *King III* p 100.
13 *King III* p 100.
14 *King III* p 30.
15 *Salomon v Salomon Co Ltd* [1897] AC 22 (HL). In this case the court confirmed that one of the most fundamental consequences of incorporation is that a company is a juristic entity separate

from its members. See also *Airport Cold Storage (Pty) Ltd v Ebrahim and Others* 2009 (2) SA 303 (C).

16 *King III* p 8.

17 *King III* p 8.

18 See The Company Law Review Steering Group, Department of Trade and Industry *Modern Company Law for a Competitive Economy: The Strategic Framework* (1999) 34 viewed on 25 August 2012, <http://www.berr.gov.uk/files/file23279.pdf>.

19 See *South Africa Company Law for the 21st Century, Guidelines for Corporate Law Reform (May 2004)*, p 26, viewed on 16 September 2012, <http://www.pmg.org.za/bills/040715companydraftpolicy.pdf>.

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