WERKSMANS
ATTORNEYS

INSOLVENCY & BUSINESS RESCUE

Spotlight on boards and shareholder activism

2 June 2016 *19 min read*

INTRODUCTION

Corporate activism places public pressure on boards to improve both financial and non-financial performance of companies. Non-financial performance would include corporate governance, ethics, executive remuneration and environmental practices.

Historically, in South Africa corporate activism has taken different forms. In certain instances, one faction of management may fight with another faction for control of an asset or of the company. In other instances, minority shareholders may band together to block actions by the board and to seek greater control of the company for their own benefit. For example, hedge funds may help to drive outcomes in favour of minority shareholders.

In recent times we have seen another form of activism, namely short activism, in which high-profile attacks on companies are launched. For example, Dave Woollam's brawl with the Lewis Group (where he published a lengthy critique of Lewis' accounting practices and the lack of due process by Lewis's sales agents in July 2015) resulted in a 40% fall in the share price that month.

ACTIVISM THROUGH SHAREHOLDER CONTROL

Shareholders, as the owners of companies, are best placed to control and ultimately hold directors accountable by attending annual general meetings and exercising their rights to appoint and remove directors of the company. Shareholders are encouraged to actively participate in companies and exercise their rights.

For instance, the King III report notes that retirement funds have become the largest category of shareholders in JSE-listed companies and recommends that these funds exercise their rights. In addition, the Financial Services Board circular PF130 insists that retirement funds compile investment-policy statements, inclusive of mandates to asset managers. Principle 5.2 of the draft King IV report now also provides that the governing body of an institutional investor (such as a retirement fund, insurance company, or the custodians, nominees and service providers who act under mandate in respect of any investment decision and investment activities exercised in relation to these securities) should ensure that that it *responsibly* exercises its rights, obligations, legitimate and reasonable needs, interest and expectations, as holder of beneficial interest in the securities of a company.

However other stakeholders must not be overlooked. The Companies Act 71 of 2008 ("the Act") has adopted the "enlightened shareholder value approach", as an acceptable standard of conduct for all companies. It requires boards to promote the success of companies in the collective best interest of their shareholders and to take into account the legitimate interests of other stakeholders including the community, employees, customers and suppliers.

In essence, all companies must develop a social conscience and behave like responsible corporate citizens.

SHORT-TERMISM VERSUS LONG-TERMISM

Shareholders are becoming increasingly aware of the power they wield.

Some wield this power with caution and with a long term strategy in mind, whereas others wield it with force in order to ensure significant changes in the short term.

On the one hand, as explained in the draft King IV report, a shift from short-termism to long-term thinking arises from the need to create value in a sustainable manner. However, some boards (and some institutional investors) may have a biased infatuation with long-term projects where benchmarks are rare and interim results obscure. They become too invested in their own visions, and too quick to dismiss alternative (and shorter-term) proposals of shareholder activists.

On the other hand shareholders may fixate on the short-term and overvalue immediate pay-offs, even at the cost of more lucrative long term alternatives.

Short-termism and long-termism can each be divisive on their own, but if a harmony can be struck between the two, then it can lead to enhanced corporate governance and profitability.

It is therefore imperative for boards to communicate their corporate strategies to their shareholders and make shareholder (and stakeholder) engagement a top priority. In this regard, the draft King IV report recommends, *inter alia,* that the board should ensure pro-active engagement and development of relationships with shareholders and encourage attendance of general meetings of the company.

FINANCIALLY DISTRESSED ENTITIES

In some instances communication between the board and it shareholders are legislated, for instance, should a company's board decide not to pass a resolution for a company's business rescue, then the board is required to send out a notice in terms of section 129(7) of the Companies Act 71 of 2008 advising all stakeholders of the company's financial distress together with reasons why it has elected not to file for business rescue.

In such instances, notwithstanding a board's optimism that in the long term the company will be able to continue to trade profitably as a going concern, past failures by the board to clearly communicate the company's corporate strategies going forward may result in stakeholders taking a short-term view.

Some stakeholders such as creditors may, for instance, no longer be willing to supply goods and services on favourable credit terms, while banks and financial institutions will, in all likelihood, withdraw all credit facilities or at least substantially reduce such facilities. Other stakeholders may opt to place the company in business rescue or liquidation and take what they can.

BUSINESS RESCUE – A NEW MECHANISM TO RESOLVE SHAREHOLDER DISPUTES

Often, a majority shareholder has cause to "fall out" with other shareholders (and directors) of a company for various reasons. These may include the inability of minority shareholders to continue to meet their funding obligations to support the ongoing business of the company. This might leave the majority shareholder in the unenviable position of having to fund a company on an ongoing basis.

There may then come a point where the majority shareholder says "enough is enough" and resolves to reject any further funding requests made by the company. Once the majority shareholder is no longer willing to continue to fund the company, then the company may be deemed to be financially distressed in that it is reasonably unlikely to be in a position to pay its debts in the next ensuing 6 month period and further is likely to become insolvent (factually) in that it's liabilities will exceed its assets in the next 6 month period.

If a company is financially distressed, the company can (and indeed should) be placed under business rescue either voluntarily by board resolution or compulsorily by application to court. That is, the majority shareholder having a large loan account against the company can, as creditor, apply to court for the business rescue of the company.

Once the company is placed under business rescue it will be under the supervision and control of the Business Rescue Practitioner ("BRP"). The BRP must prepare and propose a business rescue plan for approval by creditors and shareholders (if required). Shareholders will only vote on the business rescue plan if their rights as shareholders are affected by proposals contained in the business rescue plan. This would include a proposed buyout or dilution of shareholding or the acquisition of the business. If a buyout is achieved and the plan is approved, the BRP will remain on board to ensure that the plan is properly implemented. The company will continue trading but under new ownership (and often a new board of directors) and having avoided the consequences of being forced to liquidate a viable and potentially profitable entity.

DERIVATIVE ACTIONS – ACTIVISM THROUGH COURT PROCEEDINGS

Usually derivative actions are taken in order to seek redress for the company, when those in control of it improperly fail or refuse to do so. For instance, it is generally utilised where a person who commits wrongdoings against a company controls that company and uses such control (alone or with others) to prevent the company from taking legal steps against that person. It is therefore a form of corporate activism that can be taken to the courts.

In South Africa a shareholder, director, or a trade union representing employees of a company may, in terms of section 165 of the Act, serve a demand upon a company to commence a derivative action in order to protect the company's legal interests.

When served with such a demand a company may apply to a court to set aside the demand only on the grounds that it is frivolous, vexatious or without merit. If such an application is not, however, launched by the company it must either initiate or continue legal proceedings, or take related legal steps to protect the legal interests of the company as contemplated in the demand, or serve a notice on the person who made the demand refusing to comply with the demand.

The person who has made a demand in terms of section 165 may apply to a court for leave to bring or continue proceedings in the name and on behalf of the company. The Court may then grant leave only if it is satisfied that the applicant is acting in good faith, the proposed or continuing proceedings involve the trial of a serious question of material consequence to the company, and it is in the best interests of the company that the applicant be granted leave to commence the proposed proceedings or continue the proceedings, as the case may be.

CONDUCT EXPECTED OF DIRECTORS

The English idiom 'an ounce of prevention is worth a pound of cure' rings true for directors in the face of ever evolving challenges faced by boards of companies and the growing phenomenon of corporate activism. It is therefore imperative that directors understand the standard of conduct expected from them.

Section 75 and 76 of the Companies Act 71 of 2008 addresses, to a very large extent, the standard of conduct expected from directors. Section 75 primarily deals with conflicts of interest and requires the disclosure of personal financial interests in respect of matters relating to the company.

Section 76 deals with directors' standard of conduct, specifically directors' fiduciary duties and their duty of care, skill and diligence, and provides that directors must exercise their powers and perform their functions in good faith and for a proper purpose, in the best interest of the company, and with a degree of skill, care and diligence of a person with the same functions and having the knowledge, skill and experience of that particular director. It also provides that a director of a company must not use the position of director, or any information obtained while acting in the capacity of a director to gain an advantage for the director, or for another person other than the company or a wholly-owned subsidiary of the company, or to knowingly cause harm to the company or a subsidiary of the company. This means that a director has the duty not to misappropriate corporate opportunities, to account for secret profits and not to improperly compete with the company.

Section 76(4) provides that a director will escape personal liability if that director has:

- taken reasonably diligent steps to become informed about the matter at hand;
- does not have a personal financial interest therein (or has declared such an interest to the board in terms of section 75 of the Act); and
- has a rational basis to believe that the decision was in the best interest of the company at the time.

The Act has therefore adopted the business judgment rule. The first requirement for the application of the business judgment rule is that the decision must be an informed one, and in taking reasonably diligent steps in becoming so informed, directors are entitled to rely on information prepared by the employees of the company, accountants or any other professional person retained by the company. The second requirement is self-explanatory, and insofar as the third requirement is concerned it must be noted that the test of rationality is objective. The belief must be one that a reasonable person in the position of the director would hold. An objectively irrational decision is not protected.

Also, in terms of section 77(9), in any proceedings against a director, other than for wilful misconduct or wilful breach of trust, the court may relieve the director, either wholly or partly, from any liability set out in section 77, on any terms the court considers just if it appears to the court that the director is or may be liable, but has acted honestly and reasonably, or having regard to all the circumstances of the case, including those connected with the appointment of the director, it would be fair to excuse the director.

This is supplemented by section 77(10), which enables a director, who has reason to apprehend that a claim may be made against him or her personally, to lodge an anticipatory application to a court for relief. Section 77(10), like section 77(9), does not apply to wilful misconduct or wilful breach of trust.

LIABILITY OF DIRECTORS

In this age where information is accessible to all who cares, directors will be under close scrutiny by all stakeholders of the company. With such close scrutiny the risk of personal liability has increased exponentially.

Even though directors are generally not liable for the obligations or liabilities of their company, section 77(3)(b) of the Act, as read with section 22, penalises and holds directors personally liable to the company for any loss incurred through knowingly carrying on the business of the company recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose. In this context, it was found in *Howard v Herrigel 1991 (2) SA 660 (A)* that "knowingly" means, and a potential litigant must be able to prove, that:

> *'on a balance of probabilities, that the person sought to be held liable had knowledge of the facts from which the conclusion is properly to be drawn that the business of the company was or is being carried on [in any of such ways]. It would not be necessary to go further and prove that the person also had actual knowledge of the legal consequences of those facts.'*

There has been several court decisions prior to the commencement of the Act in which the meaning of "recklessly" has been interpreted. In the case of *Philotex (Proprietary) Limited & Others v Snyman & Others 1998 (2) SA 138 (SCA)* the Supreme Court of Appeal held that, "recklessly" must be given its ordinary meaning. It therefore does not mean mere negligence, but at the very least, gross negligence. In Fourie v Newton 2010 JDR 1437 (SCA) the Court stated that:

> *'[a]cting 'recklessly' consists of 'an entire failure to give consideration to the consequences of one's actions, in other words, an attitude of reckless disregard of such consequences.'*

Further, in the case *Ex parte Lebowa Development Corporation Ltd 1989 (3) SA 71 (T)* it was found that carrying on any business of the company recklessly means carrying it on by conduct which evidences a lack of any genuine concern for its prosperity. While in the case of *Ozinsky NO v Lloyd & Others 1992 (4) All SA 414 (C)* the court held that:

> *'If a company continues to carry on business and to incur debts when, in the opinion of reasonable businessmen, standing in the shoes of the directors, there would be no reasonable prospect of the creditors receiving payment when due, it will in general be a proper inference that the business is being carried on recklessly.'*

Recently, in the as yet unreported case of *Engelbrecht N.O and Others v Zuma and Others (25965/2012) [2015] ZAGPPHC 403; Bertelsmann J (25 June 2015)* the court described recklessness as consisting of:

> *'blameworthy conduct characterised by a failure to take any due care in the management of a company that results in detriment to the company and others and exhibits a high degree of disregard for the standards observed by honest and diligent men of affairs. The Court held that recklessness could, however, also be demonstrated by a similarly uncaring and careless failure to attend to the company's business or to prevent foreseeable harm from being caused by failing to take reasonable preventative measures against such eventualities.'*

However, in *Saincic v Industro-Clean (Pty) Ltd 2009 (1) SA 538 (SCA)* the Supreme Court of Appeal held that in order to hold directors personally liable for the debts of a company there must be evidence of the company's inability to pay. This judgment accordingly approved of the conclusion previously reached by it in the case of *L&P Plant Hire BK v Bosch 2002 (2) SA 662 (SCA)* where the court held that notwithstanding any reckless or grossly negligent conduct, if the company is nevertheless able to meet a creditor's claim, that creditor is not entitled to proceed against the directors in terms of section 424 of the previous Companies Act (which section is comparable to section 77(3)(b) of the Act, as read with section 22).

In addition, section 218(2) of the Act 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'*. A causal link is accordingly required between the offending conduct on the one hand and the loss suffered on the other hand. Therefore, this section 218, read together with sections 77 and 22, will allow a creditor to hold the directors personally liable for the debts or losses of the company if the business of that company was knowingly carried on recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purpose.

A director may also be held liable to the company in terms of section 77 for any loss, damage or costs arising as a direct or indirect consequence of that director—

- breaching a fiduciary duty, or any other duty contemplated in section 76 or any other section of the Act or the company's memorandum of incorporation;
- acting for and on behalf of the company despite knowing that he/she lacked authority to do so;
- being a party to an act or omission by the company despite knowing that it was calculated to defraud a creditor, employee or shareholder of the company, or had another fraudulent purpose;
- having signed, or consented to the publication of a financial statement that was false or misleading in a material respect whilst knowing that, or acting with reckless disregard as to whether the statement was false, misleading or untrue;
- taking part in a meeting (formal or informal) and failing to vote against a resolution in respect of—
    - the issuing of any shares or options on those shares, despite knowing that those shares had not been legally authorised;
    - the issuing of any authorised shares without shareholder approval;
- the provision of financial assistance knowing that the financial assistance is in contravention of sections 44 and 45 of the Act, or the company's memorandum of incorporation;
- approving a distribution, despite knowing that the distribution was contrary to section 46;
- the acquisition by the company of any of its shares, or the shares of its holding company, despite knowing that the acquisition was contrary to section 46 or 48; or
- an allotment by the company despite knowing that the allotment was contrary to any provision of Chapter 4 of the Act.

The Act does not, however, limit the application of section 77 only to directors. It applies to a director, an alternate director, de facto directors, a prescribed officer, and to committee members irrespective of whether or not they are also directors on the company's board.

Notwithstanding a director's or other party's default however, the onus rests on the applicant/plaintiff to lead adequate evidence to show, on a balance of probabilities, that a director or such other party should be declared liable under section 77. This was recently confirmed in the as yet unreported case of *Minnaar v Van Rooyen NO (SCA case no. 20407/2014)*, which considered the comparable section of the repealed Companies Act 63 of 1971, namely section 424.

It should also be noted that section 162 of the Act states that a director may be declared 'delinquent' if such director grossly abused the position of director or intentionally or by gross negligence inflicted harm upon the company or a subsidiary of the company contrary to section 76 or acted in a manner that amounted to gross negligence, wilful misconduct, or breach of trust in relation to the performance of the director's functions within, and duties to, the company or as contemplated in section 77 of the Act.

CONCLUSION

With the proliferation of corporate activism across the world directors are being held to a much higher standard than in times past.

In the information age boards of companies cannot discount the impact which corporate activism may have on accountability, transparency and the business strategies of companies.

Directors must be aware of shareholder activism and understand the expectations of stakeholders, whilst also ensuring that those expectations are realistic and aligned with the company's strategies and projects – this can only be achieved through clear communication with stakeholders.

Directors must understand what standard of conduct are of expected of them or face the very real possibility of being held accountable to stakeholders and personally liable for losses incurred whether by their companies or stakeholders of those companies.

Boards will, in addition to the conduct prescribed in the Act and King III, also have to face the challenge or recruiting and retaining highly qualified directors who are willing to face escalating scrutiny and work load, including the need to:

- cultivate a social conscience and behave like responsible corporate citizens;
- encourage appropriate risk taking and investments by management to promote the long-term success of the company, together with short-term performance;
- monitor the performance of their companies and review corporate strategies, then report back in clear and transparent manner to shareholders and if appropriate to other stakeholders as well;
- evaluate the demands of corporate activists, and make (or resist) changes where appropriate and in the interest of the company;
- strike a delicate balance between enabling the company to recruit, retain and incentivize the most talented executives, whilst also avoiding criticism of excessive compensation;
- recognize that shareholder litigation is the new normal, and should not deter a board making decisions within the business judgment of the board.

Directors are thus seen in South Africa as having significant and important responsibilities. Clearly, appointment to company boards in South Africa today must be taken with great circumspection and with full knowledge of what the expectations of such duties will be in the context of South Africa law. Such appointments are, after all, not "for the faint hearted", but for persons fully appraised and knowledgeable of required expectations.

Download



Eric Levenstein

Head of Insolvency & Business Rescue

View Profile