

Shareholder Participation in Corporate Governance

Irene-marie Esser

*Senior Lecturer in the Department of Mercantile Law, School of Law,
College of Law and Justice, University of South Africa*

Michele Havenga

*Professor in the Department of Mercantile Law, School of Law,
College of Law and Justice, University of South Africa**

1. INTRODUCTION

Corporate governance is a wide term defined in different ways by commentators. In essence it relates to the manner in which corporations are regulated and managed.¹ Principles of good corporate governance are usually entrenched in self-regulatory codes.² It is widely recognised that shareholders can, and should, play an important, albeit limited,³ role in ensuring that companies adhere to sound and effective corporate governance standards. Institutional shareholders in particular can be a highly effective mechanism through which sound corporate governance can be ensured. In this article we focus on the codes of best practice of South Africa and Australia and on the role that institutional investors, like pension funds and unit trusts, should have in ensuring sound corporate governance practices.

The article examines the perceived difficulties relating to the involvement of institutional shareholders in company management. The *King* recommendations and *ASX's Best Practice Principles and Recommendations* on how to encourage

* This article was submitted for publication during March 2008 and is based on a paper delivered at the Corporate Law Teachers Association Conference held in Sydney, Australia during February 2008. The discussion is therefore based on the Draft Companies Bill of February 2007.

1 See du Plessis, McConville and Bagaric *Principles of Contemporary Corporate Governance* (2005) 1–3 on the meaning of “corporate governance”; and, generally, Mongalo *Corporate Law and Corporate Governance A Global Picture of Business Undertakings in South Africa* (2003).

2 See, eg, the *South African King Report on Corporate Governance* of 2002 (hereafter *King II*); the *United Kingdom Combined Code on Corporate Governance* of July 2003 available at www.fsa.gov.uk/pubs (hereafter the *Combined Code*) and the *Australian Stock Exchange (ASX) Corporate Governance Council's Principles of Good Governance and Best Practice Recommendations* of March 2003 and August 2007 (hereafter *ASX's Best Practice Principles and Recommendations*).

3 See Ramsay, Stapledon and Fong “Corporate governance: The perspective of Australian institutional shareholders” 2000 *Company and Securities Law Journal* 110 135. Institutional investors include government and corporate pension funds, labour unions, mutual funds, insurance companies and bank trusts departments.

institutional shareholders to be more actively involved are considered and evaluated. The draft South African Companies Bill of 2007 is also considered.

2. INSTITUTIONAL SHAREHOLDERS

2.1 Introduction

The potential influence of large shareholders on corporate governance was acknowledged in the 1930s by Berle and Means,⁴ who highlighted the separation of the owners (shareholders) from the control of the company, which rested with the managers or directors.⁵ They were concerned that the divergence between the managers and the shareholders was unchecked because of a lack of incentive for holders of insignificant shareholdings to monitor management in a highly diffuse ownership structure.⁶ Stapledon indicates that, although the same highly diffuse ownership structure is not prevalent in modern companies, the divergence between the interests of shareholders and managers remains an issue.⁷ This separation of ownership and management leads to the problem that the directors

4 Berle and Means *The Modern Corporation and Private Property* (1939). See also Ramsay *et al* 2000 *Company and Securities Law Journal* 112; Karmel "Should a duty to the corporation be imposed on institutional shareholders?" 2004 *The Business Lawyer* 1 14–18; Bainbridge "The case for limited shareholder voting rights" 2006 *UCLA LR* 601 620.

5 The classification of shareholders as owners has been criticised. See, eg, Roach "The paradox of the traditional justifications for exclusive shareholder governance protection: Expanding the pluralist approach" 2001 *The Company Lawyer* 9 13; Sheehy "Scrooge – The reluctant stakeholder: Theoretical problems in the shareholder-stakeholder debate" 2005 *Miami Business LR* 193 226; Millon "Theories of the corporation" 1990 *Duke LJ* 201 221. See also *King II* Introduction para 17.3. The critics argue that there are substantial differences between shareholders and traditional property owners. Shareholders own stock, which gives them claims to control and certain financial rights. They do not, however, have direct control over a company's underlying assets. Directors are also not directly controlled by their principals (as is the case with traditional agents). Directors' powers are largely statutory. The agency theory, based on the works of Coase "The nature of the firm" 1937 *Economica* 386; Alchain and Demsetz "Production, information costs, and economic organisation" 1972 *American Economic Review* 777–795; Jensen and Meckling "The theory of the firm, managerial behaviour, agency costs and ownership structure" 1976 *Journal of Financial Economics* 305–360; Fama and Jensen "Separation of ownership and control" 1983 *Journal of Law and Economics* 301–325. Proponents of this theory found it strange that the public company with its separation of ownership and control has survived for so long (see Ramsay "Law and economics as an approach to corporate law research? A commentary" 1996 *Canberra LR* 48). See also, generally, Fisch "Measuring efficiency in corporate law: The role of shareholder primacy" 2006 *The Journal of Corporation Law* 637 650.

6 See Stapledon *Institutional Shareholders and Corporate Governance* (1996) 10–11. Actions by institutional shareholders can lead to a balance between management and shareholders and serve to reduce the divergence between the interests of the shareholders and management. Other mechanisms can also be used to create a balance between management and the shareholders. Eg, executive incentive remuneration (link directors' remuneration to the creation of shareholder wealth), mandatory disclosure of financial and non-financial information by management to shareholders, the appointment of non-executive directors to monitor executive directors and by conducting independent audits. This paper only focuses on shareholder participation.

7 See Stapledon *Institutional Shareholders* 10.

do not necessarily act in the best interests of the company (being the shareholders collectively) when they manage a company.⁸

South African and Australian companies have a unitary board structure, clearly separating ownership and control.⁹ In South Africa a single board of directors is appointed by the shareholders.¹⁰ The two main organs of the modern company are the general meeting (meeting of shareholders) and the board of directors (managing body).¹¹ General meetings are usually convened by the board of directors. The board must convene such a meeting if it is in the best interest of the company as a whole.¹²

The board of directors performs certain acts of management and agency.¹³ The directors are appointed by the members in an annual general meeting.¹⁴ The general meeting may also remove directors from office by way of a general resolution.¹⁵ The board of directors acts with the general meeting concerning internal matters, but there is a clear separation of powers.¹⁶ If certain matters are assigned to the board of directors in terms of the articles of association then only the board has the power to deal with those matters. The general meeting may, however,

-
- 8 This problem is referred to as “the agency cost problem”. See Fama and Jensen 1983 *Journal of Law and Economics* 304–305; Jensen “Self-interest, altruism, incentives and agency theory” 1994 *Journal of Applied Corporate Finance* 40–55; Clarke *Theories of Corporate Governance* (2004) 4 57; Anderson *Corporate Directors’ Liability to Creditors* (2007) 34; Mallin *Corporate Governance* (2006) 10–12 explaining the agency cost problem.
- 9 The company law of both jurisdictions is largely influenced by English common-law heritage. In a two-tier system like Germany, the distinction between ownership and control is less apparent, especially when employees are given board representation through co-determination.
- 10 Shandu “Shareholders’ interests versus social demands: Incongruous agendas” 2005 *Obiter* 87 89. See, generally, ss 208ff of the Companies Act 61 of 1973.
- 11 Subject thereto that the managers nowadays manage the company and the board of directors have a more supervisory role. See ss 179–192, 242–246 of the Companies Act of 1973; Beuthin “The range of a company’s interests” 1969 *SALJ* 155; Cilliers, Benade *Corporate Law* (2000) 93; Beuthin and Luiz *Basic Company Law* (2000) chs 25 26.
- 12 See Cilliers and Benade *Corporate Law* 95; Havenga *Fiduciary Duties of Company Directors with Specific Regard to Corporate Opportunities* (1998) 1.
- 13 See Cilliers and Benade *Corporate Law* 116; Beuthin 1969 *SALJ* 156; Beuthin and Luiz *Basic Company Law* 199.
- 14 The annual general meeting is a general meeting subject to a number of provisions stipulated in the Companies Act. A company should have an annual general meeting within 18 months after the company’s incorporation and subsequent annual general meetings are to be held every nine months after the end of each ensuing accounting date, but still within 15 months of the date of the previous meeting (see s 179(1) of the Companies Act). The annual general meeting should deal with the matters as stipulated in the Companies Act and in the articles of association of the company (s 179(2) of the Companies Act). These matters typically include the sanctioning of a dividend, the consideration of the financial statements, the election of directors and the appointment of an auditor. See ss 185(6) (resolutions to which members have notice by requisition), 221(3) (extension of general authority to directors to issue shares), 226(3)(b) (approval of certain loans to directors), 286 (annual financial statements to be considered). See Cilliers and Benade *Corporate Law* 93; Wixley and Everingham *Corporate Governance* (2005) 24.
- 15 S 220 of the Companies Act. The shareholders can also amend the articles of association by way of a special resolution: s 62 of the Companies Act.
- 16 Cilliers and Benade *Corporate Law* 116.

intrude upon the powers of the board in certain matters. These matters include situations when the board of directors refuses or is unable to institute action on behalf of the company;¹⁷ when the board of directors cannot or will not exercise powers reserved for it or when certain powers have been reserved for the board of directors, but the particular act is voidable because the board has exceeded or abused its powers.¹⁸ The board of directors also acts on behalf of the company in transactions with third parties, but it does not have unlimited powers to bind the company.¹⁹

In Australia there is also a separation or division of powers between the board of directors and the shareholders of a company. The directors have the responsibility to ensure that a company is properly managed.²⁰ They are accountable to the shareholders and the shareholders can resolve to remove the directors, in a general meeting of the company, if they are not satisfied that the company is managed in a proper manner.²¹ The power that the shareholders have to intervene has a preferred and beneficial impact on corporate governance.²² The general meeting should decide on certain matters, such as altering a company's constitution, reducing the company's issued share capital and altering a company's status.²³ The board also has wide powers of management. The board usually appoints and reward the chief executive officer of a company, sets goals for the company, monitors management's performance and business results and sets conformance strategies.²⁴ The board does, however, sometimes need the approval of the general meeting.²⁵

Institutional shareholding changed over the years and in countries such as South Africa, Australia and the United Kingdom institutional shareholders started to hold large portions of equity in many companies.²⁶ Individual shareholdings

17 See Naude *Die Regsposisie van die Maatskappydirekteur met Besonderse Verwysing na die Interne Maatskappyverband* (1970) 92; Davies *Gower and Davies' Principles of Modern Company Law* (2003) 187.

18 See generally Cilliers, Benade *Corporate Law* 88. See also *LSA UK Ltd (formerly Curtainz Ltd) v Impala Platinum Holdings Ltd* (28 March 2000) available at <http://www.uovs.ac.za/apps/law/appeal/files/2000/1/253Lsa.doc> (accessed 25-10-2007); *Ben-Tovim v Ben-Tovim* 2001 3 SA 1075 (C) 1085I–1086D (if the board does not want to or cannot exercise the powers vested in them, then the general meeting may do so). The powers conferred on a specific organ by the articles of association of a company are the exclusive powers of that organ (see *John Shaw and Sons (Salford) Ltd v Shaw* 1935 2 KB 113). The general meeting may not simply usurp the powers of the board (see *Automatic Self-Cleansing Filter Syndicate v Cunningham* 1906 2 Ch 34).

19 Delpont "Korporatiewe reg en werkplekforums" 1995 *De Jure* 409 410.

20 See s 198A(1) of the Corporations Act of 2001.

21 See s 203D of the Corporations Act of 2001.

22 See Bebchuk "The case for increasing shareholder power" 2005 *Harvard LR* 833 842.

23 See ss 136, 256B, 256C, part 2B.7 of the Corporations Act of 2001.

24 See Austin, Ford, Ramsay *Company Directors* (2005) 60 on the general functions of the board of directors.

25 For example when a listed company's main undertaking is being sold (see Listing Rule 11.2 of the JSE Listings Requirements in this regard). See Austin *et al Company Directors* 66.

26 Mallin *Corporate Governance* 76–80. See also Anderson and Ramsay "From the picket line to the board room: Union shareholder activism in Australia" 2006 *Company and Securities Law Journal* 279–315 where they examine the recent practice of union shareholder activism in Australia. This article confirms that unions are effectively utilising their powers

continued on next page

have therefore declined in these countries. Due to their size, institutional shareholders can potentially play a large role in ensuring good corporate governance standards. Institutional investors own large blocks of shares and have an incentive to develop specialised expertise in making and monitoring investments. Holding these large blocks of shares give them the power to hold management accountable for actions that do not promote the shareholders' welfare. Their greater access to firm information and their concentrated voting power enable them to make changes to the board of directors if performance lags.²⁷ Shareholders are, however, mostly inactive when it comes to the management of a company.²⁸ The reasons why the majority of shareholders are inactive are discussed in the next section. Some of the reasons are valid in respect of individual shareholders, but institutional shareholders cannot necessarily rely on them for their inactivity. Due to their nature, there are also some deterrents that apply specifically to institutional shareholders.

2.2 Shareholder apathy

The first reason why most shareholders are inactive is a possible lack of knowledge concerning the legal rights and powers available to them. Secondly, shareholders have the perception that their efforts will not bring about any change or compliance with corporate governance principles. Thirdly, shareholders will rather sell their shares than get involved in the management of a company and ensure good corporate governance principles. This is mainly due to the fact that shareholders do not have a fiduciary obligation towards other shareholders or to the company in which they hold shares.²⁹ Lastly, the costs involved in pursuing shareholder activism also discourages shareholder activism. Attendance of general meetings could, for example, result in travel expenses and loss of productive working hours. Monitoring the conduct of directors' actions would also result in high costs based on the time constraints when perusing and assessing annual reports and other company information.³⁰ These reasons are, however, more relevant with regard to the smaller investor. Ramsay, Stapledon and Fong distinguish various barriers to institutional shareholder activism, based on the nature of these barriers. They are, in broad terms, categorised as legal, economic and practical barriers.³¹

as shareholders to advance employee interests. On union-shareholder activism, see further Rawling "Australian trade unions as shareholder activists: The rocky path towards corporate democracy" 2006 *Sydney LR* 227–258. See also Karmel 2004 *The Business Lawyer* 1 7 who indicates that institutional investors account for over half the ownership and 75% of the trading in equities listed on the New York Stock Exchange Inc.

27 Bainbridge 2006 *UCLA LR* 828–629.

28 See recommendation 18 on p 44 of *King II* where it is stated that institutional shareowners in South Africa have been notable for their apathy towards participating actively in shareholder meetings. See also Bebchuk 2005 *Harvard LR* 876, who indicates that some American institutional investors, like mutual funds, are generally reluctant to take the initiative in corporate governance matters.

29 *Gundelfinger v African Textile Manufacturers Ltd* 1939 AD 314.

30 See Rademeyer and Holtzhausen "King II, corporate governance and shareholder activism" 2003 *SALJ* 767 769–770 on the reasons why shareholders are usually inactive when it comes to monitoring directors' actions. A possible fiduciary duty of institutional shareholders to their clients is considered in para 4 below.

31 See Ramsay *et al* 2000 *Company and Securities Law Journal* 127. See also Ramsay and Stapledon "Institutional investors, corporate governance and the new international financial

continued on next page

The specific legal barriers identified by 12 institutional investors in respect of the Australian legal framework were takeover provisions,³² insider trading provisions,³³ the possibility of becoming a shadow director³⁴ and restrictions on the voting powers of unit trust managers.³⁵ The economic barriers include the option of doing the “Wall street walk” (in other words to sell shares when there is a crisis), collective action and “free rider problems” (in other words that those other shareholders who are not involved in actively monitoring company management get a “free ride”) and the high costs of monitoring of corporate governance issues. The practical barriers include a lack of information³⁶ and the difficulty of getting institutions to meet at short notice.

Many of the same reasons probably lie at the root of inactivity of institutional shareholders in South Africa.³⁷ We are not aware of any studies done in South Africa where institutional shareholders provided specific reasons why they are generally inactive.³⁸

2.3 The Role of Institutional Shareholders

It was stated earlier that institutional shareholders, compared to individual shareholders, can play a much bigger role in monitoring directors’ actions. As a collective unit, institutional shareholders can voice their opinions directly to management.³⁹ By using their power and influence they can also ensure that

architecture” 2002 available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=946317 (accessed 11-02-2008). The second part of the paper is of specific importance and deals with institutional investors and their role in corporate governance. It is indicated that institutional investment in a number of Asian countries has been much lower than in the United Kingdom, the United States and Australia.

32 Institutional investors are afraid that they trigger takeover provisions without intending a takeover.

33 Institutional investors are afraid that they acquire insider information and are then prohibited from trading in the specific shares until the information is available to the market.

34 A shadow director is defined as a person who is not validly appointed as a director, but accustomed to act in accordance with the instructions of a director. Institutional investors who are actively involved in the management of a company are afraid that they could be seen as shadow directors and hence be subject to the fiduciary duties of directors.

35 See Ramsay *et al* 2000 *Company and Securities Law Journal* 127–129. The former s 1069(1)(k) of the Corporations Law, regulating the voting powers of unit trust managers, has since been repealed.

36 The board of directors usually have more information than the investors.

37 In South Africa, insider trading is regulated by chapter VIII of the Securities Service Act 36 of 2004. The Companies Act does not provide for the concept of “shadow directors”, which has been regarded by some commentators as unfortunate (see Locke “Shadow directors: Lesson from abroad” 2002 *SA Merc LJ* 420). *De facto* directors can, however, incur liability as if they were properly appointed.

38 We contacted the African Institute of Corporate Citizenship to enquire whether they have conducted any research on the role of South African institutional shareholders in enhancing corporate governance principles. No such research was conducted (see also their website: <http://www.aiccafrica.org> where reports are posted on research done by them).

39 See also the *Report of the Committee on the Financial Aspects of Corporate Governance chaired by Sir Adrian Cadbury* 1992 (hereafter the *Cadbury Report*) and the *Report of the Committee on Corporate Governance Final Report* 1998 (hereafter the *Hampel Report*) in the United Kingdom which relied heavily on the powers of institutional investors within a company. It is stated in the *Combined Code* (at section 2) that institutional investors have a

continued on next page

directors comply with self-regulatory codes of best practice. Mallin⁴⁰ refers to the United Kingdom Institutional Shareholders' Committee (which consists of the ABI,⁴¹ NAPF,⁴² AITC⁴³ and IMA⁴⁴) and which issued a statement on the responsibilities of institutional investors in late 2002. In terms of this statement institutional investors should be clear on their policy on activism and how they will discharge their responsibilities. They should further monitor the performance of the directors, review company accounts, attend company meetings and be satisfied that the board structure of a specific company is effective. The committee also recommended that institutional investors should intervene with company management when necessary, for example, when they are concerned about a company's board structure. Finally, institutional investors should evaluate and report on the outcomes of their shareholder activism.⁴⁵ The *King Report* also refers to a report by NAPF and ABI providing recommendations to shareholders on how to vote at annual general meetings. *King II* recommends that similar bodies (consisting of institutional shareholders) should be established in South Africa.⁴⁶

3. CODES OF BEST PRACTICE

3 1 South Africa

3 1 1 Principles of good governance

The King Committee on corporate governance was formed under the auspices of the Institute for Directors in Southern Africa, with support from, amongst others, the Johannesburg Stock Exchange⁴⁷ and the South African Chamber for Business. The report took into account the recommendations in the *Cadbury Report* of the United Kingdom, but its ambit was wider and it considered the specific circumstances of South Africa.⁴⁸

It is stated in the introduction⁴⁹ of *King II* that there are seven characteristics of good corporate governance. These characteristics include discipline, transparency, independence, accountability, responsibility, fairness and social responsibility. These principles include that an outsider should be able to make a meaningful analysis of a company's actions, its economic fundamentals and the

responsibility to make use of their votes and should be ready to engage with a company in a dialogue concerning the objectives of a company.

40 Mallin *Corporate Governance* 80–82.

41 The Association of British Insurers.

42 The National Association of Pension Funds in the United Kingdom.

43 The Association of Investment Trust Companies in the United Kingdom.

44 The Investment Management's Association.

45 See Mallin *Corporate Governance* 82.

46 See *King II* s 6, ch 6, para 1.

47 As it then was. It is now the JSE Ltd. The first *King Report* on corporate governance was published in 1994 and the second *King Report* in 2002. It is anticipated that a third *King Report* will be published by the end of 2008.

48 See Armstrong "The King Report on Corporate Governance" 1995 *Juta's Business Law* 65–70. The *King Report* has a wider application than the *Cadbury Report*. The *Cadbury Report* mainly focuses on the financial aspects of corporate governance such as financial accounting. *King II* also considers social accounting (including stakeholder protection).

49 See para 18, p 11 of *King II*.

non-financial aspects pertinent to the business.⁵⁰ Mechanisms should be in place regulating possible conflict of interests such as dominance by a chief executive officer or a large shareholder in order to ensure that decisions are taken objectively without any undue influence. These mechanisms include the appointment of board committees and the appointment of an independent auditor. The board should further act in a responsible manner towards the company and its stakeholders.⁵¹ A company should, lastly, place a high priority on ethical standards like environmental and human rights issues and acknowledge the rights of various interest groups.⁵²

The *Code of Corporate Practices and Conduct* issued by *King II* gives effect to these principles of good governance. In terms of this *Code* all companies listed on the JSE Limited should comply with the *Code*.⁵³ Other companies are, however, encouraged to comply with the *Code* where applicable. The *Code* operates on a “comply and explain” basis – if companies do not comply with the *Code* they should explain why they did not comply.⁵⁴ The *Code* contains recommendations concerning the board and directors. These recommendations include aspects like the composition of the board, the chairperson and chief executive officer, remuneration of directors, board meetings and board committees.⁵⁵ Risk management, internal audits, integrated sustainability reporting, accounting and auditing, relations with shareowners and communication issues are also addressed in the *Code*.⁵⁶ The underlying principle of *King II* is, however, that directors should act not only in accordance with the letter of the law, but also in the spirit of their fiduciary duties.⁵⁷

The King Committee recommends that every board should have a charter setting out its responsibilities. The board should give strategic direction to the company and monitor how management carries out its functions. The board should comprise of a balance of executive and non-executive directors. It should also ensure that a company complies with all relevant laws and regulations.⁵⁸ The chairperson of the board should preferably be a non-executive director.⁵⁹ The chief executive officer and the chairperson should not be the same person.⁶⁰ Both executive and non-executive directors are subject to fiduciary duties and duties of care and skill.⁶¹ The board of directors is appointed by the shareholders. They should be assisted, where appropriate, by a nomination committee. New

50 See para 18.2, p 12 of *King II*.

51 See para 18.5, p 12 of *King II*.

52 See paras 18.6 and 18.7, p 12 of *King II*.

53 See para 1.1.1, p 21 of the *Code*. In terms of Listings rule 3.84 of the JSE Listings Requirements (dealing with corporate governance issues) listed companies have to comply with certain of the recommendations in *King II*. Eg, there has to be a separation between the roles of the chief executive officer and the chairperson.

54 See para 1.2, p 21 of the *Code*.

55 See pp 22–30 of the *Code*.

56 See pp 30–40 of the *Code*.

57 Esser and Coetzee “Codification of directors’ duties” 2004 *Juta’s Business LR* 26 27.

58 See s 1, ch 1 of *King II* on recommendations concerning the role and function of the board.

59 See s 1, ch 8 of *King II* on recommendations concerning board committees.

60 See s 1, chapters 2 and 3 of *King II* on recommendations concerning the chairperson and the chief executive officer.

61 See s 1, ch 5 of *King II* on recommendations concerning the role and function of the executive and non-executive directors

directors should be trained to inform them on their duties, responsibilities and powers.⁶² Board committees should also be appointed. As a minimum each company should have audit and remuneration committees. The remuneration of directors should be sufficient to retain and motivate executives of the quality required by a board. A remuneration committee should make recommendations to the board relating to the company's framework of executive remuneration. This committee should consist of non-executive directors only.⁶³

With regard to risk management it is stated that risk management and internal control should be practised by all staff of a company and embedded in its day-to-day activities. The board is responsible for creating a process relating to risk management as well as the implementation and effectiveness of such a process. A board committee should be appointed to assist the board to review its risk management policies and processes.⁶⁴ Companies should also have an effective internal audit function that has the respect of the board and management. An internal audit relates to an independent, objective assurance and consulting activity that should add value and improve a company's operation.⁶⁵ Integrated sustainability reporting is also important and concerns reporting on the nature and extent of a company's social, transformation, ethical, safety, health and environmental policies and practices.⁶⁶ Companies should be subject to external audits which provide an independent and objective check on the way in which the financial statements have been prepared by the directors in exercising their stewardship to the various stakeholders. An audit committee should be appointed to determine whether an internal audit report should be subject to an independent review by an auditor.⁶⁷

The King Committee proposed a number of enforcement mechanisms in order to ensure that management conforms to these recommendations. Shareholder activism is identified in *King II* as a very important component of these mechanisms. Shareholders have control over the composition of the board.⁶⁸ They appoint the auditors and directors and the annual financial statements are considered and evaluated by them at an annual general meeting.⁶⁹ *King II* suggests that an environment should be developed for shareholders, and particularly for institutional shareholders, to be more than mere spectators, and rather to be "owners" concerned with the well-being of a company by monitoring the behaviour of the company managers.⁷⁰ A number of recommendations are made in *King II* to encourage institutional shareholders to take a more active part in the management of a company. These recommendations are considered below.

62 See s 1, ch 5 of *King II* on recommendations concerning director selection and development.

63 See s 1, ch 4 of *King II* on recommendations concerning the remuneration of directors.

64 See s 2 of *King II* on recommendations relating to risk management.

65 See s 3 of *King II* on recommendations concerning internal audits.

66 See s 4 of *King II* on recommendations relating to sustainable reporting.

67 See s 5 of *King II* on recommendations concerning accounting and auditing.

68 See s 220 of the Companies Act 61 of 1973 which allows directors, by ordinary resolution, to remove a director from the board.

69 See para 2.1 above where the unitary board structure as applied in South Africa is discussed.

70 Rademeyer and Holtzhauzen 2003 *SALJ* 768.

3.1.2 Recommendations relating to shareholder activism

King II highlights the need for the education of shareholders on corporate governance issues.⁷¹ It indicates that shareholders should be aware of their rights as minority shareholders (if applicable), their place within the corporate structure, their functions, and the importance of scrutinising the acts of company management.⁷² Shareholders can only be pro-active when they have the relevant knowledge to determine whether or not directors are complying with principles of good corporate governance. When they have sufficient knowledge they are able to influence the corporate behaviour of directors. It is, however, important to note that this recommendation about informing shareholders is not necessarily relevant when dealing with institutional shareholders, but is rather aimed at individual shareholders. Due to their size and power institutional shareholders usually have the necessary knowledge and expertise to monitor directors' actions when they manage a company. Institutional shareholders will therefore usually have the necessary expertise concerning corporate governance principles. Secondly, *King II* points out that shareholders do not easily institute legal action against directors. The main reason for this is high litigation costs. To overcome this problem, class actions⁷³ and a system based on contingency fees⁷⁴ are proposed by the King Committee.⁷⁵ If legal enforcement mechanisms were more accessible to shareholders, it would create an environment that encourages greater shareholder activism.⁷⁶ It may also serve a preventative purpose, in that directors would be more mindful of principles relating to good governance and strive to achieve them in order to avoid legal action. Thirdly, the Committee made recommendations concerning quorum thresholds. It argued that it is important to ensure that the quorum threshold for company meetings is sufficient to permit access of shareholders to management through this forum. It also suggested that consideration should be given to amending the Companies Act in order to increase the quorum requirement for ordinary resolutions to the same as is

71 See s 6, ch 6, paras 2 and 4 of *King II*.

72 Rademeyer and Holtzhausen 2003 *SALJ* 768.

73 Class actions enable a large number of claimants, whose claims are based on a well-defined common question of law or fact, to have their matters heard in one proceeding (see s 6, ch 3, para 5.1 of *King II*).

74 A contingency fee is an agreement between a legal practitioner and a client to the effect that no fees are payable by the client if the case is conducted unsuccessfully (see s 6, ch 3, para 6.2 of *King II*).

75 See s 6, ch 3, paras 5 and 6 of *King II*.

76 Rademeyer and Holtzhausen 2003 *SALJ* 768. The draft Companies Bill provides for new enforcement mechanisms for shareholders. Cl 163 relates to an application to declare a director delinquent or to place a director under probation. A company, a shareholder, director, company secretary or other officer of a company, a registered trade union or other representative of the employees of a company, or the Commission or the Takeover Regulation Panel may apply to a court for an order declaring a person delinquent or under probation. Cl 164 states that a shareholder, creditor or director of a company may apply to a court for relief if directors, *inter alia*, exercised their powers in a manner that is oppressive or unfairly prejudicial to, or unfairly disregards, the interests of the specific applicant. Cl 166 relates to derivative actions. A shareholder, former shareholder, a person entitled to be registered as a shareholder, a director, a former director, a registered trade union or another representative of employees may apply to a court on behalf of the company in terms of a derivative action.

required for special resolutions.⁷⁷ These recommendations concerning quorum requirements for company meetings can be problematic as too high a quorum requirement can frustrate the convening of meetings and the proper functioning of a company. We suggest that the quorum requirement should only be increased when decisions are taken on issues that affect the shareholders and specifically when they have to vote on (and approve) actions of management.⁷⁸ Fourthly, the King Committee also proposes the establishment of watch-dog organisations to look after the interests of minority shareholders or to determine whether companies comply with good corporate governance principles.⁷⁹ With regard to this recommendation it is important to remember that watch-dog systems are only as good as their management and leaders, but it would be unwise for a company to ignore such systems completely.⁸⁰ Lastly, the King Committee specifically refers to the role of institutional shareholders when discussing shareholder activism.⁸¹ It indicates that when one considers the “make-up” of shareholders in South African companies it is clear that the majority are institutional shareholders. Focus should therefore be placed on the actions of institutional shareholders, and their conduct should be scrutinised. The Committee recommends that institutional shareholders should make their voting policies publicly available and should communicate the information to their constituencies on a regular basis.⁸² Heightened transparency on the part of institutional shareholders is recommended by *King II*.⁸³ It should be borne in mind that institutional shareholders may incur liability to their clients if they do not provide them with sufficient information.⁸⁴

Mallin⁸⁵ refers to tools of corporate governance that would encourage institutional shareholders to play an active role in company management. She refers to one-on-one meetings between the management and the institutional shareholders. She argues that it is much easier for institutional shareholders, compared to individual shareholders, to have meetings with the directors of a company on a regular basis. Issues such as the achievement of the objectives of a company and the quality of management could be discussed at these meetings. The right to vote is also a fundamental element of control by shareholders. Given the weight of the votes of institutional shareholders it is clear that their votes are of primary importance. Mallin argues that shareholders should make use of their voting rights. In order to ensure that institutional shareholders vote, voting should be as easy and convenient as possible. Electronic voting is a possible method to

77 See recommendation 7 on p 42 of *King II*. See also Rademeyer and Holtzhauzen 2003 *SALJ* 767. Cl 81(3)(a) and (b) of the draft Companies Bill of 2007 provides for a quorum of 25% of holders of shares entitled to vote.

78 A duty to be actively involved in company management (and specifically on voting) is discussed below.

79 See s 6, ch 6, para 3 of *King II*.

80 Rademeyer and Holtzhauzen 2003 *SALJ* 773.

81 See s 6, ch 6, para 2 of *King II*.

82 See recommendation 19 on p 44 of *King II*.

83 See also Rademeyer and Holtzhauzen 2003 *SALJ* 769.

84 Eg, the Collective Investment Schemes Act 45 of 2002 contains a duty to act in the best interests of the investor/client (see s 71).

85 Mallin *Corporate Governance* 84.

increase voting by shareholders.⁸⁶ Information can also be provided to shareholders electronically and cost-effectively.

We suggest that shareholder activism can be improved in various ways. First, institutional shareholders should complete service level agreements with their clients in which their expectations should be clearly defined. The agreement should set out what the clients expect of the institutional shareholders regarding voting at general meetings and how much information they want to receive from the investors concerning the affairs of the company. Voting and other procedures at meetings should be kept as simple as possible. Institutional shareholders should also ensure that amendments to the company charter or founding documents reflect current corporate governance principles, particularly in older companies.

3 2 Australia

Ramsay *et al* indicate that the growth in institutional shareholding in Australia mirrors even greater growth elsewhere. The lower percentage of institutional investors in Australia reflects the prevalence of large founding family and intercorporate stakes in almost half of Australia's large- and medium-sized listed companies. The increase in institutional investors is, however, set to continue in Australia.⁸⁷ The Australian Institutional Managers' Association (AIMA) established in 1991 reflects increasing institutional shareholder activism.⁸⁸ Representative groups, such as AIMA, play an active role concerning corporate governance issues in the companies in which they invest.⁸⁹

3 2 1 Principles of good governance

ASX listed companies are compelled to comply with *ASX's Best Practice Principles and Recommendations*.⁹⁰ Non-compliance must be explained in their annual reports.⁹¹ These principles of good corporate governance were established by the ASX Corporate Governance Council, established on 15 August 2002. The Council developed ten principles on corporate governance and approved the *ASX's Best Practice Principles and Recommendations* in March 2003. The *ASX's Best Practice Principles and Recommendations* consist of various parts, namely: corporate governance in Australia; the essential corporate governance principles; and best practice recommendations. There are 28 recommendations⁹²

86 Mallin 84; Rademeyer and Holtzhauzen 2003 *SALJ* 771. See also s 5, ch 4, para 4.2 in *King II* on information technology. See cl 81(2)(a) of the draft Companies Bill of 2007 stating that a meeting of shareholders may be conducted by way of electronic communication.

87 See Ramsay *et al* 2000 *Company and Securities Law Journal* 111.

88 Today it is known as IFSA (Investment and Financial Services Association Ltd).

89 See the *Corporate Law Economic Reform Programme: Paper 3 Directors' Duties and Corporate Governance* (hereafter *CLERP 3*) at 69.

90 Most of the recommendations only apply to companies wef 1 July 2004. For non-listed companies there are comparable guidelines, see *Standards Australia* (June 2003) available at www.standards.org.au (accessed 20-10-2007).

91 These principles and recommendations are therefore not mandatory rules, nor are they entirely voluntary since they operate on a comply-or-explain basis or "if not why not" approach. This is similar to the approach followed in terms of *King II*, discussed in para 3.1.1 of this article above.

92 These recommendations include that the majority of the board should be independent directors (2.1), that the board should establish a remuneration committee (9.2) and, very

continued on next page

representing implementation guidance for listed companies to satisfy the ten principles of good corporate governance. The ten chapters each explain one of the ten corporate governance principles.

ASX's Best Practice Recommendations and Principles were reviewed during 2007 and new revised recommendations and principles were issued in August 2007. The aim of the revision was to reduce the number of principles and to simplify them. The principles have now been reduced to eight.

Institutional investors and their role in promoting good corporate governance principles are not referred to in *ASX's Best Practice Principles and Recommendations*. No recommendations are provided on how institutional shareholders can ensure that companies adhere to sound corporate governance principles. The recommendations focus more on the role of non-executive directors and the structure of the board.⁹³

Principle 1 states that solid foundations should be laid down for management and for oversight. A board charter should be established for this purpose. Principle 2 concerns the structure of the board and that it should add value. A nomination committee is important in this regard. Principle 3 relates to the recognition of stakeholders' interests and specifically the promotion of ethical and responsible decision-making. Principle 4 concerns the safeguarding of integrity in financial reporting. A formal audit committee charter is relevant in this regard. Principle 5 requires timely and balanced disclosure. Written policies should be established to ensure listing and statutory disclosures. Principle 6 states that the rights of shareholders should be respected; this can be achieved by way of a communication policy. Principle 7 states that risk should be recognised and managed. Companies should therefore have a risk management policy in place.

importantly, that a code of conduct should be established. Compliance with legal and other obligations to legitimate stakeholders should also be disclosed (10.1). See du Plessis *et al Principles of Contemporary Corporate Governance* 134–137. See also Blackmore “Evaluating New Zealand’s evolving corporate governance regime in a comparative context” 2006 *The Canterbury LR* 34 47–49; Havenga “Duties of the company chairman” 2005 *SA Merc LJ* 137 145; Von Nessen “Corporate governance in Australia: Converging with international developments” 2003 *Australian Journal of Corporate Law* 189 199–200 and 205–206. See also Grantham “Corporate Governance Codes in Australia and New Zealand: Propriety and prosperity” 2004 *Queensland LJ* 218–225 where he discusses the *ASX's Best Practice Recommendations and Principles* as well as the New Zealand version, *Corporate Governance in New Zealand: Principles and Guidelines* (2004). He asked whether these two codes address the agency-cost problem. The agency-cost problem concerns senior management who act self-interestedly. According to him the codes do address this problem, especially due to the principles dealing with independent boards and financial reporting. He also deals with the question whether or not the codes improve governance. He states that the solution does not necessarily lie in independent directors, they do not have detailed knowledge of the nature of the company’s business and should therefore rely on senior management. Independent directors are also only part-time and they do not always give enough time to the affairs of the specific company. He states furthermore that the codes are overly concerned with corporate scandals and corruption. Accountability is only one aspect of corporate governance; the quality of decision-making and the realisation of wealth is also important. Propriety in management is a prerequisite for wealth maximisation, but it is not an end in itself. It is therefore a pity that the codes did not pay more attention to the creation of wealth. We suggest that institutional shareholders can play an active role relating to the agency-cost problem.

93 See Principles 1 and 2 of *ASX's Best Practice Principles and Recommendations*.

Principle 8 encourages sound principles of corporate governance in Australia. The extent to which companies comply with the recommendations of ASX and the approach towards monitoring and enforcing compliance of the recommendations by listed companies will determine the extent of involvement of ASX in corporate governance regulation. Du Plessis and others⁹⁴ argue that ASX should assume a dual role, namely that of both educator and regulator. The ASX recommendations and how they operate should be explained. The intention of the drafters was that the recommendations would give companies flexibility in implementing specific aspects that they find useful. ASX has therefore not yet assumed a strong role as enforcer. The recommendations are, however, supported by the Listing Rules.⁹⁵

These recommendations are similar to those of the South African *King Report*. They are also mainly suggestions and encourage flexibility when directors manage a company. In both instances the recommendations are supported by the Listing Rules of the respective countries.

3.2.2 Recommendations relating to shareholder activism

The Investment and Financial Services Association Ltd's (IFSA's) Guide for Investment Managers and Statement of Recommended Corporate Practice⁹⁶ is of specific importance with regard to the role of institutional shareholders in Australian company management.⁹⁷ They provide a guide as to what is considered best practice in certain areas of the industry. Guidance Note 2 concerns guidelines on corporate governance for fund managers and corporations.⁹⁸

In 1999 the *Guide* was divided in two parts. The first part concerns specific recommendations for fund managers regarding their approach to corporate governance, and the second part contains general principles on corporate governance for corporations generally.⁹⁹ With regard to institutional shareholders (or fund managers as referred to in the *Guide*) it is recommended that they should establish direct contact with companies, including constructive communication with senior management and board members, especially about the performance of these managers.¹⁰⁰ It is also recommended that fund managers should vote on all Australian company resolutions where they have the voting authority and responsibility to do so.¹⁰¹ Fund managers should further have a written policy on

94 *ASX's Best Practice Principles and Recommendations* 136–137.

95 See rule 4.10.3 stating that listed companies should comply with the recommendations or state why they did not comply.

96 Available at www.ifsa.com.au (accessed 20-10-2007).

97 Codes were published in 1995, 1997 and 1999, and republished in December 2002. The latter version of the code is referred to as the *IFSA Blue Book*. In October 2004 another version was published, but changes were made to this version after the release of the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act of 2004 and *ASX's Best Practice Recommendations and Principles*. See du Plessis *et al Principles of Contemporary Corporate Governance* 101 on the *IFSA Blue Book*.

98 See www.ifsa.com.au/public/content (accessed 26-10-2007) for the Guidance Notes.

99 The largest part of the *Guide* deals with recommendations to corporations, including guidelines regarding the composition of the board, that the chairperson should be an independent director and guidelines on board committees and company meetings. These guidelines do not deal with institutional investors specifically and are not discussed in this article. See du Plessis *et al Principles of Contemporary Corporate Governance* 103–106.

100 Guideline 1.

101 Guideline 2.

corporate governance. This policy should include the articulation of internal measures to ensure that the policy is applied consistently.¹⁰² Fund managers should report to their clients, especially if a proxy was awarded to the particular fund manager.¹⁰³

No practical methods are provided to encourage or assist institutional shareholders to comply with these guidelines as was the case in the recommendations of the South African King Committee. A body like IFSA can, however, play an important role in assisting institutional shareholders and their members to play an active role in monitoring corporate governance. We suggest that such a body should also be formed in South Africa to assist South African institutional shareholders to play an active role in company management.

4. INSTITUTIONAL INVESTORS AND THE DUTY TO ACT IN THE BEST INTERESTS OF THEIR CLIENTS

4.1 Introduction

It was mentioned above that institutional investors have a duty to act in the best interests of their clients. It is important to consider whether or not active institutional shareholders should only consider the interests of their clients or whether they should also have regard to the interests of the stakeholders of the company. In other words, should institutional shareholders only consider profit maximisation for their clients, or should they also take the wider interests of other stakeholders of the company and broader corporate social responsibility issues that might have long-term benefits for the company into account? Clients usually have short-term goals in mind; they want profit maximisation or the best return on their investment. By only acting with profit maximisation as goal institutional shareholders might act in the best interests of their clients, but act against the interests of the company and the other stakeholders.¹⁰⁴

The duties of institutional shareholders towards their clients are, in some respects, similar to those of directors to the company. In addition to their duties arising from contract or other common-law and statutory obligations, institutional shareholders and their clients are in a fiduciary relationship.¹⁰⁵ Directors'

102 Guideline 3.

103 Guideline 4. These guidelines remained basically the same since 1999. See du Plessis *et al Principles of Contemporary Corporate Governance* 102.

104 See paras 5.3–5.14 of the *Report on Corporate Responsibility: Managing Risk and Creating Value* by the Australian Parliamentary Joint Committee on Corporations and Financial Services (June 2006) (hereafter the *Corporate Responsibility Report*) on the fact that superannuation funds usually have long-term interests which place them in an excellent position to consider the interests of other stakeholders. It is stated in para 5.6: "If anyone has a long-term interest, it is surely the superannuation funds." This does not mean that these investors do not take advantage of short-term speculative investments, but they usually have the funds to do both (para 5.11). See also Pozen "Institutional Investors: The Reluctant Activists" 1994 *Harvard Business Review* 140 141, who states that institutional investors have a fiduciary duty to try to achieve their clients' objectives. Profit maximisation is usually the main objective of a client. Institutional investors should justify their activism in company management in terms of achieving this objective.

105 This article focuses on this fiduciary relationship. A director's common-law duties include his obligations as a fiduciary. The term "fiduciary" is applied to a large number of persons in diverse capacities, including commercial relationships. The relationship

continued on next page

duties towards the company's shareholders provide some guidance to institutional shareholders on the fiduciary duties offered to their clients, although it is generally accepted that directors owe their fiduciary duties to the company and not to individual shareholders. Due to the specific nature of their position, directors nominated by institutional shareholders may incur additional responsibilities and liabilities.

Shareholders' interests are traditionally granted primacy in the management of a company in South Africa and Australia. The traditional function of directors is that of profit maximisation for the shareholders. There has, however, been a shift in public opinion towards recognition of a wider variety of interests which should be considered than only those of the shareholders.¹⁰⁶ The wider variety of interests includes, *inter alia*, those of investors, employees, consumers, the general public and the environment.¹⁰⁷ The Constitution and other legislation also compel consideration of wider interests than those of the shareholders.¹⁰⁸ Increasingly, social, safety, health and environmental factors have been advanced as issues to be considered by company management. The so-called "triple bottom line" approach¹⁰⁹ embraces not only financial performance but also imposes social responsibility on companies.¹¹⁰

Two important schools of thought relating to the question in whose interests the company should be managed are the enlightened-shareholder-value and pluralist approaches.¹¹¹ In the enlightened-shareholder-value approach the primary role of the directors is seen as being to promote the success of the company for the benefit of the company as a whole and to generate maximum value for

between a company and a director of that company is an example of a commercial fiduciary relationship. A director can be seen as an agent, due to the fact that the director does not act on his or her own behalf, but on behalf of the company. A director can also be regarded as a trustee since he does not own company assets, but controls the assets and exercises powers for the company's and not for his own benefit, but the relationship between a director and a company remains unique. Categorising directors as agents or trustees is intended to prove the existence of a fiduciary duty rather than to equate directors with those particular positions. See Dawson "Acting in the best interest of the company – for whom are directors 'trustees'?" 1984 *New Zealand Universities LR* 68–81 in this regard. The relationship between institutional investors and their clients is also a commercial fiduciary relationship: Pozen 1994 *Harvard Business Review* 141; Karmel 2004 *The Business Lawyer* 13.

106 Havenga "Directors' fiduciary duties under our future company-law regime" 1997 *SA Merc LJ* 310 314.

107 Shareholders have a permanent stake in the profits of the business, whereas creditors provide loan capital to the company. They usually have a fixed income and invest for a limited period. Their interests are often secured. The interests of employees lie in job security. Consumers and the general public are concerned with the company as a source of products and services. Suppliers (as a special type of creditor) are concerned about timely payment of their services and that the company should keep to the contract concluded between them.

108 See the Constitution of the Republic of South Africa, 1996 (hereafter the Constitution). See, eg, the Labour Relations Act 66 of 1995 and the Broad-based Black Economic Empowerment Act 53 of 2003.

109 The "triple-bottom line" refers to economic, social and environmental factors. Directors should consider all three of these factors when they manage a company.

110 Crook "The good company" 2005 *The Economist* 1–18.

111 These were the terms used during the company law reform process in South Africa and the United Kingdom.

shareholders.¹¹² The second school is that of plurism, which sees shareholders as one constituency among many and recognises the interests of various groups.¹¹³ Thus, a company's existence and success are seen as inextricably intertwined with the consideration of the interests of its employees and other potentially qualifying stakeholders in the business, such as suppliers and customers.¹¹⁴ Scholars in South Africa and Australia have debated on the interpretation that should be given to "the company" in the interpretation of directors' fiduciary duties. This is briefly dealt with below to indicate that it is uncertain in whose interests directors should manage a company.

4.2 South Africa

In May 2004 the Corporate Regulation Division of the Department of Trade and Industry issued a policy document with guidelines for a comprehensive review of South African corporate law.¹¹⁵ It envisaged a review of South African corporate laws, including the Companies Act, the Close Corporations Act¹¹⁶ and the common law relating to these corporate entities.¹¹⁷ In February 2007 the draft Companies Bill was published, and which stated in clause 91(1)(b) that directors should 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.

The draft Companies Bill of 2007 provides for a partial codification of directors' duties.¹¹⁸ One of the advantages of such a codification is the clarity that it should provide to directors concerning their duties. It seems, however, if clause 91(1)(b) has not been drafted in sufficiently clear terms. First, it seems as if acting "honestly" and "good faith" are treated as two separate issues. It is unclear

112 This conclusion is based on the "too many masters" argument; namely if more stakeholders were recognised in whose favour the duties of directors had to be exercised, the various stakeholder groups would have to be identified and the nature and the extent of directors' duties and responsibilities to each of them would need to be determined. The result would be that directors would not effectively be held accountable to anyone, since there would be no clear yardstick for judging their actions: Proctor and Miles "Duty, accountability and the company law review" 1999 *The Company Lawyer* 21. See also Dawson 1984 *New Zealand Universities LR* 68 81; Havenga "The company, the Constitution and the stakeholders" 1997 *Juta's Business LR* 134 135 where she refers to the Berle-Dodd debate as summarised in Hodes "The social responsibility of a company" 1983 *SALJ* 468 485. See also Cheffins "Teaching corporate governance" 1999 *Legal Studies* 515-525; the *Policy Document* ch 3 para 3.2.2.

113 Sealy "Directors' wider responsibilities – Problems conceptual, practical and procedural" 1989 *Monash University LR* 164 173; Dean "Stakeholding and the company law" 2001 *The Company Lawyer* 66; the *Policy Document* ch 3 para 3.2.2.

114 See also Havenga 1997 *SA Merc LJ* 173; the *Policy Document* ch 3 paras 3.2.1-3.2.2; Roach 2001 *The Company Lawyer* 9.

115 See generally, the *Policy Document*.

116 69 of 1984.

117 The review does not include partnership law. The review process aims to identify the fundamental rules regarding procedures for company formation, corporate finance law, corporate governance, mergers and acquisitions, the cessation of the existence of a company and the administration and enforcement of the law.

118 See ch 2 of the draft Companies Bill concerning directors' duties and cl 91(6) stating that the common law is still applicable.

what the difference is between these two concepts.¹¹⁹ Secondly, the clause provides that directors should act in the best interests of and for the benefit of the company. The meaning of “benefit” has not been explained and it is uncertain if this term only relates to a financial benefit or whether any benefit is relevant. Since the term is unqualified it seems that all benefits will be considered.¹²⁰ Thirdly, it is unclear what is meant by “the company”. This last aspect is discussed in more detail below.

By stating in clause 91(1)(b) 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*,¹²¹ it seems if the drafters of the draft Companies Bill opted for the enlightened-shareholder value approach. This is, however, by no means clear as will be seen from the discussion below.

The meaning of “the company” is not clear in terms of the common law and various academics have debated its exact meaning.¹²² The new Companies Act should have been the ideal vehicle to clarify this issue. With the current drafting in the draft Companies Bill, it is still unclear whether directors should manage a company for the sole benefit of the shareholders or whether they should also consider the interests of other stakeholders. It can be argued that the traditional viewpoint is still applicable due to the wording of the clause in the Bill (“the company” has always been interpreted as meaning the shareholders collectively) and the fact that a preference for the enlightened-shareholder value approach was expressed in the *Policy Document*. The proposed new Companies Act should promote clarity on the meaning of this phrase and eliminate further uncertainty and debate on its definition.¹²³

4.3 Australia

In Australia directors should act in the best interests of the shareholders collectively and only take the interests of other stakeholders into account when shareholders will benefit. The general law duty of directors to act in good faith in the best interests of the company has been incorporated into legislation. S 181(1) of the Corporations Act of 2001 states that directors should act in good faith and in the best interests of the company for a proper purpose.¹²⁴

119 As indicated by Mervyn King SC at the Department of Trade and Industry (the DTI) Conference, Velmore Estate, Pretoria, South Africa, 19 and 20 March 2007, where the draft Companies Bill of 2007 was discussed.

120 These issues were discussed at the DTI Conference by various speakers.

121 Our emphasis.

122 On South African authority, see for example, Fourie “Die plig van direkteure teenoor maatskappyskuldeisers” 1992 *SALJ* 25–52; Havenga 1997 *SALJ* 134–139; Mongalo “Self-regulation versus statutory codification: Should the new regime of corporate governance be accorded with statutory backing” 2004 *THRHR* 264–273.

123 See Esser and du Plessis “The stakeholder debate and directors’ fiduciary duties” 2007 *SA Merc LJ* 346 where suggestions are provided on providing clarity regarding the definition of “the company”.

124 Although s 181(1) refers to directors acting in good faith and for a proper purpose, these are two separate duties imposed on directors. This is confirmed by ss 184(1) and 187 of the Corporations Act 2001 which treat them as two separate duties. See Austin *et al Company Directors* 266 and 271; Baxt, Fletcher and Friedman *Corporations and Associations Cases and Materials* (2003) 337–361. See for instance, *Mills v Mills* 1938 60 CLR 150 162–163 concerning the duty of directors to act in good faith, especially when the directors are also shareholders (see further Baxt *et al Corporations and Associations Cases*

continued on next page

It is necessary to understand what is meant by “the company” to determine in whose interests directors should manage a company.¹²⁵ In some cases it has been stated that directors should act in the best interests of the company, whereas other cases indicate that they should act in the best interests of the company “as a whole”.¹²⁶ The Corporations Act of 2001 only refers to “the company”. The general or traditional viewpoint is that directors owe their duties to the company and that no independent duties are owed to any third parties.¹²⁷ It seems that owing their duty to “the company” does not imply that directors should act in the best interests of the company as a separate legal entity, but rather that they should act in the best interests of the members collectively.¹²⁸

Policy documents issued by various committees in Australia dealing with corporate governance issues and specifically the protection of stakeholders’ interests also indicate that directors should manage a company in the best interests of the shareholders collectively, but that they should not ignore the interests of other stakeholders. In the *Corporate Responsibility Report* it is stated that directors should act in the best interests of the shareholders collectively. Directors should consider the interests of other stakeholders when it enhances profit maximisation for the shareholders. The committee therefore supports the enlightened shareholder value approach (or enlightened self-interest approach) and states that an effective director will realise that it is in the best interests of the corporation to consider the interests of other stakeholders.¹²⁹ According to the committee,

and Materials 339–342 who discusses to what extent directors should consider the interests of the company rather than their own interests); *Hospital Products Ltd v United States Surgical Corp* 1984 156 CLR 41 69 and *News Ltd v Australian Rugby League Ltd* 1996 21 ACSR 635 where it is stated, *inter alia*, that directors are under certain legal discretions and they should use those discretions honestly. There is some uncertainty on the interpretation of “best” in s 181(1); see Austin and Ramsay *Ford’s Principles on Corporations Law* (2005) para 8.065. In some cases judges used the two phrases interchangeably, indicating that there is no significant difference between the two phrases: *Whitehouse v Carlton Hotel Pty Ltd* 1987 162 CLR 285 293 (for a discussion of this case, see Baxt *et al Corporations and Associations Cases and Materials* 378–382). This issue of the inclusion of the word “best” was also considered by Klein, du Plessis “Corporate Donations, the Best Interest of the Company and the Proper Purpose Doctrine” 2005 *The University of New South Wales LJ* 69 85.

125 Eg, *Re Smith & Fawcett Ltd* 1942 Ch 304 306.

126 See *Greenhalgh v Arderne Cinemas LD* 1951 Ch 286 at 291. Directors should not just consider existing shareholders when managing a company, but also future shareholders.

127 See Berkahn “Directors’ duties to the ‘company’ and creditors” 2001 *Deakin LR* 360 367 referring to the traditional viewpoint when discussing directors’ duties to creditors. See also Austin *et al Company Directors* 274–276 on this issue; Du Plessis *et al Principles of Contemporary Corporate Governance* ch 2 and Baxt *et al Corporations and Associations Cases and Materials* 343–344.

128 See *Greenhalgh v Arderne Cinemas LD* 291; *Ngurli v McCann* (1953) 90 CLR 425 438. See also Austin *et al Ford’s Principles on Corporations Law* para 8.095; Dawson 1984 *New Zealand Universities LR* 78. See *Teck Corporation Ltd v Millar* (1973) 33 DLR 288 where it was held that a directors’ duty is to the company, the company’s shareholders are the company and therefore no interests outside of those of the shareholders can be considered by the directors. See, however, *People’s Department Stores Inc v Wise* (2004) 244 DLR 564 where the court found that in determining whether directors did act in the best interests of the corporation it may be legitimate to consider the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment.

129 Chapter 4 para 4.76.

mandatory approaches to corporate responsibility are not appropriate, because nothing in the Corporations Act of 2001 restrains directors from considering the interests of stakeholders.

Principle 3 of *ASX's Principles and Recommendations* concerns the promotion of ethical and responsible decision-making. The council recommendation states: "[I]nvestor confidence can be enhanced if the company clearly articulates the practices by which it intends directors and key executives to abide."¹³⁰ Recommendation 3.1 requires companies to: "Establish a code of conduct to guide directors, the chief executive officer (or equivalent), the chief financial officer (or equivalent) and any key executives as to the practices necessary to maintain confidence in the company's integrity;¹³¹ the responsibility and accountability of individuals for reporting and investigating reports of unethical practices".¹³² Such a code is an effective way to guide the behaviour of directors and demonstrate the commitment of a company to its ethical practices and responsible decision-making.¹³³

In the *CLERP 3* paper it seems clear that the drafters favour the enlightened-shareholder value approach to be followed. It provides that directors should be clear on their duties and they should know that they must maximise shareholder value, but should also consider the interests of other stakeholders.¹³⁴

4.4 Conclusions on the beneficiary of directors' duties

To the extent that an analogy can be drawn between the duties of directors to the company and those of institutional investors to their clients, it could be argued that institutional shareholders should mainly act in the best interests of their clients, thus enhancing profit maximisation.¹³⁵ This could conflict with good corporate governance principles. They can, however, consider the interests of stakeholders and pay attention to the other principles of good governance when they manage the funds of their clients if it also serves the best interests of their clients. If the clients feel that their interests are not sufficiently protected by institutional shareholders then they can always sell their shares and invest in another company.¹³⁶ This approach is similar to the enlightened-shareholder

¹³⁰ *ASX's Best Practice Recommendations and Principles* p 25.

¹³¹ See para 3.1.1.

¹³² See para 3.1.2.

¹³³ See du Plessis *et al Principles of Contemporary Corporate Governance* 204.

¹³⁴ See *CLERP 3* part 4 para 4.1.

¹³⁵ See Berns and Baron *Company Law and Governance An Australian Perspective* (1998) 127, where it is argued that institutional investors can play an important role in ensuring that good governance principles are adhered to, but in the end profit maximisation is their main goal. "After all, institutional investors are themselves profit-driven corporate persons."

¹³⁶ See also the United Nation's Principles for Responsible Investments of 2005 available at www.unpri.org (accessed 2007-10-20). The UN considered the role of institutional investors in corporate social responsibility and issued relevant principles. The principles include that institutional investors should be active owners, seek appropriate disclosure and promote implementation of the principles in the industry. Institutional investors are signatories of these principles and it is recommended in para 5.55 of the *Social Responsibility Report* that Australian institutional investors became signatories to this UN report. See also Pozen 1994 *Harvard Business Review* 147, who states that if institutional investors are dissatisfied with decisions taken by company management, they should sell their shares in the company.

value approach discussed above and is in line with the current view that directors should act in the best interests of the shareholders collectively.

5. CONCLUSIONS

Institutional shareholders can clearly play an important role in enhancing corporate governance principles, in view of the size of their shareholdings in South African and Australian companies, and the fact that their influence is likely to increase. Empirical research in the United States of America on the effect of institutional investor activism has not found strong evidence that company performance is necessarily improved by such involvement. But in an emerging economy like that of South Africa, it can be expected that participation by institutional shareholders will be influential and will be to the advantage of smaller and sometimes less sophisticated shareholders. Due to their size and power, institutional investors can have one-on-one discussions with senior management, ensure that self-regulatory codes of best practices are adhered to and vote in a responsible manner on the basis of their involvement with the company. In this article we considered the (potential) role of institutional investors in Australia and South Africa. Some recommendations were provided on how to encourage institutional shareholders to be more active in the management of a company. It was suggested that the clients of institutional shareholders should clearly express what they expect from them. Electronic voting and the electronic distribution of information to shareholders will enable institutional shareholders to be more active.

The question in whose interests institutional investors should act when they monitor the management of companies in which they invest was also considered. In addition to their specific contractual obligations, institutional investors also incur fiduciary duties. Their duties to their clients were therefore compared with those of directors towards a company. It was seen that in Australian and South African company law directors should manage a company in the best interests of the shareholders collectively, subject to the consideration of the interests of other stakeholders. The consideration of the interests of all, in accordance with good corporate governance principles will, in any event, be in the best interests of shareholders, especially over the long term. The primary obligation of institutional investors when they monitor a company's management is to ensure that the interests of their clients are protected. In their exercise of this duty they should consider to what extent the company takes the interests of its shareholders and other stakeholders into account. Directors sometimes have to consider the interests of stakeholders other than the shareholders, because their duty to the company as a whole entails considering specific stakeholders in certain circumstances, for example when the company is insolvent. Institutional investors should also consider other stakeholders' interests, but their primary obligation is towards their clients. Directors nominated by institutional shareholders should be aware that they may have additional responsibilities and liabilities.