The Personal Financial Interests of Directors.
A look at the implications of section 75 of the Companies Act 71 of 2008
By
Ian Cox

The international law firm Eversheds was unsuccessfully sued for negligence recently. It was alleged that the firm should not have drafted a service agreement on the instructions of a director who stood in line to receive the very substantial bonus that would be earned if its terms were fulfilled. The court held that the director had apparent authority from the board on the facts of this case and that Eversheds was not obliged to make any further enquiry notwithstanding the director's interest.

I was asked what would happen if a similar claim was brought against a South African firm under the Companies Act 71 of 2008. Hence this article.

I think the short answer is that the firm would have been in trouble if the 2008 Companies Act applied. The 2008 Companies Act goes much further than is the case in other jurisdictions or indeed the common law in prescribing what a director must do when conflicted by a personal interest in a matter before the board.

Directors owe a common law fiduciary duty:
1. to prevent conflict of interests;
2. to act within the limits of their powers;
3. to maintain an unfettered discretion; and
4. to exercise their powers for a proper purpose.

These common law duties gave rise to the rule contained in Section 234 of the 1973 Companies Act that directors must disclose their interest in contracts to the board, and the rules set out in sections 235 to 241 regarding the manner of that disclosure.

This approach was criticised for not going far enough. There was a concern that boards left unchecked would in time become oligarchies and plunder value that should accrue to the company and thus ultimately to shareholders. In South Africa there is the additional all too prevalent risk of what are often inexperienced shareholders being deprived of the windfall that is BBBEE. Hence the need to deal decisively with conflicts of interests that arise from personal financial interests reflected in the 2008 Companies Act.

The problems that arise from conflicts of interest caused by the personal financial interest of directors is not unique to South Africa. Most if not all company legislation contains rules designed to manage these conflicts. Thus in the United Kingdom directors must disclose any direct or indirect interest in a proposed transaction or arrangement. However the extent of that interest is restrictively defined. For example transactions concerning a director's remuneration are excluded. Directors who are conflicted by these transactions must recuse themselves from deliberations or dealings concerning those transactions unless their continued participation is condoned by a general resolution of shareholders passed after a full disclosure. The position is the much the same in Canada save that a special resolution is required before a conflicted director can participate . Australia on the other hand is satisfied

with a simple disclosure to the board of directors.

The 2008 Companies Act takes a much harder line. In terms of section 75 the obligation to disclose:

1. arises in respect of any matter before the board where a personal financial interest exists rather than just in the case of transactions;
2. extends to any personal financial interest that arises after the board has considered the matter; and
3. includes the personal financial interest of so called related persons to the director;

This becomes a problem when, as is the case in the 2008 Companies Act, the obligation to disclose personal financial interests is coupled with an obligation to recuse oneself from deliberations of the board on the matter when a personal financial interest arises.

The problem starts with the term "personal financial interest". This ill conceived definition is couched in very broad and in subjective terms to include:

> *a direct material interest of that person, of a financial, monetary or economic nature, or to which a monetary value may be attributed but does not include any interest held by a person in a unit trust or collective investment scheme in terms of the Collective Investment Schemes Act, 2002 (Act No. 45 of 2002), unless that person has direct control over the investment decisions of that fund or investment.*

Apart from the obvious difficulty ascribing a finite meaning to an interest of a *financial, monetary or economic nature,* the use of the phrase *direct material interest* is problematic. Our law understands the meaning of the term, "direct and substantial" which is perhaps why it wasn't used. The definition of the word "material" in section 1 to include *interests that might reasonably affect a persons judgment or decision making* suggests that the intention is to achieve something between a direct and substantial interest and any interest. This has important consequences. Ordinarily the mere fact of director's shareholding in the company or a related company will not give rise a direct and substantial interest. However that shareholding may be material in the sense the word is defined. So was the intention to make a director's shareholding a personal financial interest? This will explain the otherwise inexplicable disclaimer in respect of unit trusts and collective schemes? It is bizarre, but I think that this was the intention.

Not all personal financial interests need be disclosed. However the list of exceptions is surprisingly short given the breadth of the definition of a personal financial interest. Section 75(2) lists four exceptions.

1. It does not apply if the sole director is also the company's only shareholder.
2. It does not apply to decisions that may generally affect all of the directors in their capacity as such. This is in terms of section 75(2)(a)(i)(aa). It is difficult to decipher precisely what this means but it seems that deliberations regarding the remuneration of directors as such won't be affected but those regarding their remuneration as employees will. This is unlike other jurisdictions which exempt matters concerning remuneration on account of employment from disclosure.
3. Section 75 will not affect a director where the decision relates to a class of persons even if that director belongs to that class. Save for section 75(2)(a)(i)(bb) which states that related persons cannot define a class one is left to guess at what is meant by a class of persons.
4. It also does not apply in respect of a proposal to remove a fellow director from office.

Directors may elect to disclose their personal financial interests in advance of any conflict

arising in terms of section 75(5). A disclosure must be made to the board or, if section 75(3) applies (where there is single board member), to the shareholders. A disclosure in terms of section 75(3) obviates the need to disclose in terms of section 75(5) or (6).

Though the section is concerned with members of the board of directors the term director is defined to include prescribed officers, alternate directors and members of board sub committees other than the audit committee. It is not clear why this is necessary.

The failure of a director to disclose properly a personal financial interest in a matter before the board of directors renders any decision on that matter invalid unless the decision:

1. was subsequently ratified by an ordinary resolution of the shareholders following a disclosure of that interest; or
2. is subsequently declared valid by a court on application by any interested person in terms of section 75(8).

It does not seem to matter that the director was unaware of the need to disclose or that the board was unaware of the non disclosure.

It is also not clear if section 75(7) overrides section 20(7) or the Turquand Rule. My view is that it does. If I am right third parties who enters into an agreement with a company in the bona fide but erroneous belief that section 75(5) has been complied with will have to apply to court in terms of section 75(8) for an order declaring the agreement to be valid.

Directors who fail to make proper disclosure face possible claims from:

1. the shareholders in terms of section 20(6);
2. the company in terms of section 77(3); and
3. third parties in terms of section 218(2).

Thus the duty to disclose is no longer owed only to the company. It is now owed to everyone and given what is stated above the risk of such a claim is very considerable.

It is worth noting that the obligation to maintain a register of disclosures has not survived the 2008 Companies Act though section 73(6) states that these disclosures must be properly minuted. Directors will do well to ensure that this is strictly complied with.

So section 75 casts the disclosure net very wide indeed. The risk of a failure to disclose properly must inevitably weigh heavily upon directors given the consequences of nondisclosure. Indeed the risks are so severe that one can't help wondering if this the section was deliberately drafted with this in mind. There are other signs in the 2008 Companies Act that suggest that the legislature intend fear to be the engine that drives corporate governance.

And that is it. Directors who fail to navigate the uncertainties of Section 75 will have to trust their luck to the mercies of the shareholders or failing them the courts. This is not a happy place to be especially since the issue non disclosure is only likely to arise when there is already a problem with the outcome of the decision under attack.

The heavy obligation placed on directors to disclose their personal financial interests is clearly intended to encourage directors to err on the side of caution when deciding what they must disclose. That by itself is no bad thing but unfortunately there is more. Disclosure is a rock that traps directors against the hard place that is sections 75(5)(d) and (e). These sections state:

> *If a director of a company, other than a company contemplated in subsection (2) (b) or (3), has a personal financial interest in respect of a matter to be considered at a meeting of the board, or knows that a related person has a personal financial interest in the matter, the director—*
>
> *(d) if present at the meeting, must leave the meeting immediately after making*

any disclosure contemplated in paragraph (b) or (c);

(e) *must not take part in the consideration of the matter, except to the extent contemplated in paragraphs (b) and (c);*

What is more the director's absence does not impact on the required quorum or the number of votes required to pass a resolution. Section 75(5)(f) requires the board to treat the director as present for the purposes of determining a quorum but absent for the purposes of deciding if the resolution carries sufficient votes to be adopted.

Again directors who recuse themselves should ensure that this is properly minuted in terms of section 73(6).

Outside section 75(3) the shareholders cannot condone non compliance with section 75(5)(d) or section 75(5)(e). This is because the 2008 Companies Act contains no equivalent to the British or Canadian companies acts that permit the shareholders to authorise a conflicted director to continue to participate notwithstanding the personal financial interest.

The circumstances where such conflicts may arise are very wide ranging. For example:

1. As I have already pointed out a shareholding in any company can give rise a personal financial interest if the fact of that shareholding might reasonably affect the director's judgement. The only exception to this are those set out in sections 75(2) and section 75(3)
2. The potential for conflict extends beyond mere shareholding. A director who serves on the board of a holding company or another subsidiary could also be conflicted by virtue of the extended definition of a related person in section 75(1)(b) to include a another company where that director, or a related person, is also a director.
3. An executive director enjoying the benefits of an incentive scheme will be conflicted on almost every matter before the board. This is because that interest invariably influences the directors' decision making.

But here is the rub. The fact that a director conflicted by a personal financial interest nonetheless remains in the meeting or deliberates on the matter in contravention of section 75(5)(d) and (e) does not render the meeting or the subsequent decision invalid provided of course there is a proper disclosure of the personal financial interest. The tortuous language of section 75(7) only refers to disclosure. It does not mention recusal. Section 75(7)(a) states:

> *A decision by the board, or a transaction or agreement approved by the board, or by a company as contemplated in subsection (3), is valid despite any personal financial interest of a director or person related to the director, only if it was approved following disclosure of that interest in the manner contemplated in this section.*

The mechanisms set out in sections 75(7) and (8) do not therefore apply. The principles set out in section 20(7) and in the case of British Royal Bank vs. Turquand will have a bearing on the question whether a court can nonetheless invalidate a decision of the board on account of a failure of a director to recuse himself. The risk of liability of a director and the board who allowed the director to participate in the meeting in contravention of section 75(5)(d) and (e) is very considerable. Not only will the board face a risk of claims from the shareholders, the company and anyone else who can show a loss, they do so without the benefit of the indemnity or liability insurance contemplated in section 77. That safe harbour is closed to directors who knowingly contravene the Act. Boards will do well to err on the side of safety and require directors compromised by a potential conflict to recuse themselves.

There does not seem to be any remedy available to a director who having disclosed a personal financial interest, nonetheless remains at the meeting of the board and deliberates on the

matter. This also applies to members of the board who knowingly permit the director to do so. It may be an oversight induced perhaps by the tortuous language of section 75(7) but, it does not seem that the shareholders can condone or even ratify such participation. The provisions of section 75(5)(d) and (e) are peremptory.

It seems to me that the only way past this impasse is to invoke section 30(1) and amend the MOI to reserve to the shareholders all decisions where these conflicts exist.

One must question whether it was necessary to frame section 75 in such harsh terms. No other country has done so as far as I am aware. Are shareholders not adequately protected given that Section 163 extends the protection against oppressive conduct that existed under section 252 of the 1973 Companies Act? Is section 76 and its codification of the standard of conduct expected of a director insufficient?

The requirements of section 75 are counter intuitive to normal business practice and to company law as it practiced in other jurisdictions which variously allow such conflicts after a disclosure to the board sometimes with the approval of the shareholders.

The idea that directors represent the company to the exclusion of the interests of shareholders who put them there or indeed their own interests is more of a theoretical construct than a practical reality. The reality is that save for the professional independent non executive directors found in publicly held companies, directors generally have a personal financial interest of one sort or another in the decisions they take in that capacity. This is particularly so in the case of small companies operating as so called quasi partnerships. Section 75 is inimical to the practical reality that exists in these companies. They do not have large boards that can fill the breach when a director is conflicted. The contribution of that director is often essential to the success of the company.

Stopping a director doing his job merely because a conflict exists is impractical. Frightening directors is counterproductive. I suggest that these conflicts are better managed in advance by a process of disclosure and condonation backed, where transactions are involved, by a resolution from the shareholders approving such transactions.

I don't think that Section 75 works. That is not to say it won't be made to work. The power given to the courts in section 75(8) to validate contracts where there has been a non disclosure is an invitation that they do so. It is an unfortunate fact that parliament is increasingly leaving it to the courts to tidy up after them.

None of this alters the fact that section 75 exposes directors to considerable risk.

One hopes that the legislature will amend the section using plain language and on terms that are compatible with the purposes of the 2008 Companies Act.

And Eversheds? Why do I think the point might have been decided differently in South Africa? Section 75(5)(g) prohibits a conflicted director from executing any document on behalf of the company that relates to the matter unless specifically requested to do so by a resolution of the board. Thus a South African law firm faced with that situation should have called for the resolution before proceeding any further.

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