KING II, CORPORATE GOVERNANCE AND SHAREHOLDER ACTIVISM

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1 INTRODUCTION

The many corporate failures in recent years — such as Masterbond, Tollgate, Leisurenet, Unifer, Saambou and CNA — have raised serious questions about corporate governance in South Africa. The main concern is about how to ensure good corporate governance and thus reduce the risk of company failure.

The *King Report on Corporate Governance in South Africa 2002* (published on 29 March 2002 by the King Committee on Corporate Governance, herein after 'King II') recognizes the responsibility of those people that perform the management functions of the company. This is evident from the set of principles in the report relating both to the financial and non financial management of the company, ranging from the role of the board of directors and the appraisal of directors (King II, s 1) to the development of an effective and appropriate HIV/AIDS strategy for the company (King II, s 4, chap 4, para 4).

In order to ensure that company management conform to the principles of good corporate governance, the King Committee proposes a number of enforcement mechanisms. Shareholder activism is identified as a very important component of these mechanisms (King II, s 6, chap 6), particularly because of the power that vests in the general meeting of shareholders. Most importantly, the shareholders have ultimate control over the composition of the board of directors (s 220 of the Companies Act 61 of 1973). Furthermore, the general meeting of shareholders is the place where the appointment or re appointment of auditors is dealt with, where the annual financial statements are considered and dividends are decided upon. At the general meetings shareholders may consider resolutions that grant general authority to directors to issue shares (s 221 of the Companies Act), which allow for share buy backs (s 85 of the Companies Act) and that approve of acquisitions and/or disposals of a substantial part of the undertaking or assets of the company (s 228 of the Companies Act). It serves as a platform to raise and discuss concerns about corporate governance and to oppose resolutions that would result in corporate governance failure.

Where shareholders, in order properly to exercise their voting powers, require additional information that might not be contained in documents such as the annual reports or circulars to shareholders or public announce ments, they could rely on the Promotion of Access to Information Act 2 of 2000 for assistance. This legislation provides for a prescribed form, which is available on the website of the South African Human Rights Commission, to

request information. Such information can only be requested 'for the exercise or protection of a right if it will be of assistance in the exercise or protection of the right' (*Cape Metropolitan Council v Metro Inspection Services (Western Cape) CC* 2001 (3) SA 1013 (SCA) para 28). The aforesaid was confirmed in the unreported case of *Davis v Clatcho (Pty) Ltd*, where the Cape High Court ordered a private company to open its financial records to a disgruntled shareholder for the exercise or protection of the applicant's rights qua shareholder (see Wim Mostert 'Finding out what you need to know' (2003) 3 *Without Prejudice* 25).

The King Report recommends the encouragement of corporate governance focused shareholder activism, particularly amongst institutional investors. An environment should be created for shareholders to be more than speculators, to be owners concerned with the well being of the company in which they invested, and constantly to check whether the directors of the company practise good corporate governance.

2 KING II RECOMMENDATION TO ENCOURAGE SHAREHOLDER ACTIVISM

In order to encourage shareholder activism, King II contains certain very interesting recommendations. First, it refers to the possibility of educating shareholders in corporate governance (King II, s 6, chap 6, paras 2 and 4). Raising awareness with shareholders about their rights as minority shareholders, their place within the corporate structure, their functions, the importance and advantages of scrutinizing the acts of company management and being pro active, is the first and most important step in creating shareholder activism amongst individual shareholders. Only when individual shareholders appreciate the implications of management's failure to comply with principles of good corporate governance and have the knowledge to scrutinize acts of management and to influence the corporate behaviour of directors, are we likely to find commitment to shareholder activism. Such an education drive might, however, not have a huge impact on shareholder activism in South Africa, because the majority of shares in companies listed on the JSE are held by institutional investors who should already be aware of the importance of corporate governance (King II, s 6, chap 6, para 2).

Secondly, King II points out that shareholders seldom undertake legal action against directors. King II identifies high litigation costs as one of the main reasons for the low level of legal action (King II, s 6, chap 3, para 4). In order to encourage legal action, the report suggests the introduction of class actions and a contingency fee system (King II, s 6, chap 3, paras 5 and 6). These attempts at making the legal enforcement mechanisms more accessible to shareholders would create an environment conducive to greater shareholder activism. They might also serve a preventative purpose. The existence of a legal environment that makes legal action against directors easier might just caution those directors not mindful of corporate governance to ensure that their actions are in line with good corporate governance principles.

Thirdly, with regard to the lack of participation at general meetings of shareholders, the report suggests statutory amendments to the current quorum requirements (King II under the heading 'Recommendations requiring statutory amendment and other actions', recommendation 7). The current legislative minimum quorum for a public company wanting to pass an ordinary resolution is three members that are entitled to vote and present at the meeting, either personally or by representation (s 190*(a)* of the Companies Act). King II suggests that the quorum requirement for ordinary resolutions be increased to the quorum requirement for the passing of special resolutions. Currently, s 199 of the Companies Act, in dealing with special resolutions, requires the presence, either in person or by proxy, of members holding at least 25 per cent of the total votes of all members.

Fourthly, it recommends the establishment of shareholder watch dog organizations that could range from groupings that look after the interests of minority shareholders to institutions that rate the corporate governance performance of companies (King II, s 6, chap 6, para 3).

Finally, King II specifically addresses the role of institutional investors. Institutional investors are recognized as an integral part of the campaign to achieve successful corporate governance in South Africa. Their commitment to shareholder activism is crucial, not only in the light of the make up of South African shareholders (King II, s 6, chap 6, para 2) but also because of the fact that they have the resource capabilities and the expertise properly to scrutinize company management. They have the know how properly to analyse and evaluate financial statements and buy back motivations. Drawing from international trends, King II recommends heightened transparency on the part of institutional investors (King II, recommendation 19 under the heading 'Recommendations requiring statutory amendment and other actions'). (See also references to international developments in regard to the role of institutional investors in King II, s 6, chap 6, paras 5 and 6.)

3 COMMENT ON THE KING RECOMMENDATIONS

Any recommendation to increase shareholder activism will only be successful if it addresses those issues that are responsible for a lack of participation. A number of reasons for a lack of shareholder activism can be identified, including, first, a lack of knowledge on the part of shareholders about the legal rights and powers that are available to them, and, second, the perception amongst shareholders that their efforts will not bring about change or compliance with corporate governance principles.

Third, shareholders might also simply find it more attractive and advantageous to sell their shares rather than to engage in actions that would ensure compliance with corporate governance. Such a decision is the prerogative of the shareholder who owes no duty to fellow shareholders or to the company in which she holds the shares (*Gundelfinger v African Textile Manufacturers Ltd* 1939 AD 314). The shareholder does not stand in a fiduciary relationship with the companies.

Finally, the costs involved in pursuing shareholder activism could also discourage such action. High shareholder activism costs would normally be experienced by shareholders of large public companies listed on the stock exchange, where the shareholders would often be widely dispersed, not only throughout South Africa, but also across the world. Attendance of general meetings could, for example, result in huge travel expenses and loss of productive work hours. Other costs would flow from the effort and time spent on monitoring the conduct of directors, assessing company information, meeting lawyers for advice on the best possible way of addressing apparent corporate governance failures and pursuing such failures. Such high costs might persuade shareholders not to be activists, especially where the shareholder has a small shareholding or where the desired outcome is not a certainty and would in any event be overshadowed by the costs.

A shareholder awareness campaign seems to be the only sensible way to address the first three concerns mentioned above. We should, however, bear in mind that shareholder education will not influence a shareholder with a negligible shareholding. It is highly unlikely that such a shareholder will be motivated to engage in shareholder activism involving sacrifices to time and money not justified by the size of their shareholding. Possible solutions to the fourth concern will be discussed later.

In the light of the abovementioned reasons for shareholder apathy we will briefly comment in more detail on the following two recommendations contained in King II.

3.1 *Quorum recommendation*

The aim of the quorum recommendation is to ensure an increase in attendance at general meetings. It is probably hoped that the increased quorum requirement would force companies actively to pursue and convince shareholders to attend the meetings or to provide proxies. The director, who might already be suspected of a failure of corporate governance, would be entrusted with the responsibility of finding ways to address the causes for shareholder apathy. The danger is of course that they might only decide to canvas shareholders that are supportive of them.

The quorum requirement does not address any of the abovementioned causes of shareholder apathy. The causes, such as the high activism cost factor, coupled with a large quorum requirement, would, in all probability, prove disastrous to the smooth operation of companies. It is therefore not surprising that the main objection to the recommendation was aimed at the high threshold that would make it unrealistically difficult and impractical to convene general meetings, and in the process frustrate the functioning of the company (King II at 43n14 acknowledges considerable public objection to the quorum requirement that suggests that the recommendation is impractical and unduly onerous on companies). We suggest that, if the quorum requirement is altered, any increase should be limited to shareholder decisions needed to approve management actions and to grant powers to

management (e g authority to issue shares, buy back shares or sell a substantial part of the company business). It is submitted that the current quorum requirement should at least be maintained where shareholders meet to curtail the powers of directors (e g the removal of a director or the withdrawal of a general authority to issue shares).

Meeting the proposed quorum requirement does not, of course, guarantee the scrutiny of the acts of management on an ongoing basis, a willingness to investigate matters on the general meeting agenda, and the active participation in deliberations. Such apathy would be more evident where the shareholder is of the opinion that the size of the shareholding does not warrant any activism.

The concern of high costs involved with shareholder activism could rather be addressed in one or more of the following ways, all of which should be carefully considered as they might have their own flaws.

(a) *Utilising information technology*

King II refers to the possible future role of information technology in the area of corporate governance. It acknowledges information technology as an important tool in distributing corporate information to all stakeholders, in cluding the shareholder (King II, s 5, chap 4, para 4.2). Company information would be available to shareholders at the mere press of a button and at a very low cost. Although this would not ensure that shareholders take up their role as corporate activists, it would make activism much more effective.

Information technology could also be used to reduce the high activism costs that impede shareholder activism. This could be done in one of the following two ways.

(i) Internet shareholder voting

The company could create a corporate web site that would provide for the online publication of corporate information and reports, the posting of proposals that would be up for discussion at meetings. It could contain devices that would allow for posting of shareholder messages, responses to information, and communication between shareholders inter se as well as between shareholders and management (see George P Kobler 'Shareholder voting over the Internet: A proposal for increasing shareholder participation in corporate governance' (1998) 49 *Alabama LR* 673 at 681–2). The website could also provide for actual Internet voting by shareholders (King II, recommendation 10 under the heading 'Recommendations requiring statutory amendment and other actions'). Access to such corporate websites should be restricted to registered shareholders (Kobler op cit at 682). Such developments would make general meetings more accessible to shareholders.

The Internet voting option should, however, be made available to South African companies only if it is clear that the computer voting system meets important criteria such as voter confidentiality, verification of voting and the reliability of the data (see Peter Neuman 'Security criteria for electronic

voting' paper delivered at the 16th National Computer Security Conference, Maryland, USA (1993), accessed at *www.csl.sri.com/users/neumann/ncs93.html*).

The unfortunate experience of Vivendi Universal at its shareholders' meeting of 24 April 2002 does call for a careful evaluation of available electronic systems and devices. Vivendi Universal shareholders present at the general meeting used electronic voting machine control panels to vote. A large number of the electronic votes cast by the shareholders were recorded as abstentions. Some of the shareholders indicated that the abstentions were not a true reflection of the way in which they voted. Even though this was not an example of Internet voting it illustrates the dangers inherent in electronic voting systems.

(ii) Linked video conferencing

Linked video conferencing makes it possible to have real time cyber meetings between shareholders irrespective of their location (Kobler op cit at 681). The most important limitation of this option seems to be the inaccessibility of such video conferencing facilities (ibid).

As in the case of Internet voting, this option would enhance the accessibility of the shareholders' meeting by reducing the high activism cost caused by the logistical difficulties particularly common to large listed companies. It has the added feature that members would be able to participate in the discussions during the meeting.

(iii) Enhancing the proxy system

The aim of a proxy system is to provide shareholders, who are denied participation in the company's affairs owing to logistical difficulties, with an opportunity to have their say at shareholders' meetings by instructing the proxy holder on how to vote (Kobler op cit at 674). The proxy system thus has a vital part to play in addressing the high activism costs that underlie shareholder apathy.

If South African corporations believe that proxies are underutilized by members, it is necessary to re evaluate the proxy solicitation process, the proxy format, and the method of submitting the proxy with the view of making it more user friendly. One specific aspect that might be worthwhile investigating is the introduction of a system that allows for the electronic submission of a proxy (Kobler op cit at 680 and King II, recommendation 8). This might result in an increase in the use of proxies, because the mere press of a button would provide the proxy.

Apart from making the proxy system user friendly, there should also be an investigation into the ways in which corporate management might currently be able to abuse the proxy process in order to secure outcomes favourable to directors at shareholder meetings.

(b) *Encouraging an effective shareholder watchdog system*

King II encourages the formation of organisations acting as shareholder watchdogs (King II, s 6, chap 6, para 3 and recommendation 20). Such organizations may be suitable vehicles for minority shareholders to have some impact, even though in an indirect way, within the companies that they invested in. Shareholder watchdogs are the ideal platforms for minority shareholders to forge united fronts, which the company's management might find difficult and unwise to ignore.

Apart from the possible positive impact that the watchdogs might have on corporate governance, such a system could also reduce the activism costs that shareholders have to bear, because a number of shareholders would share the costs incurred by one organization. An added advantage is that these watchdogs might also have the necessary knowledge and expertise, generally lacking with the average shareholder, properly to inspect and interpret financial and technical company information.

The watchdog systems, however, are not the sole answer to shareholder activism focused on enhancing good corporate governance. We should be realistic and admit that these organisations will only be as strong and effective as their leaders. There is also the possibility that watchdogs might aim to further personal agendas hidden behind a veil of minority shareholder protection.

3.2 *Recommendations regarding institutional investors*

King II suggests that institutional investors be required to provide information regularly to their clients about their voting policies (King II, recom mendations 18 and 19). It is hoped that such transparency would result in greater shareholder activism. This transparency recommendation also makes practical sense in a legal system that allows for the possible liability of institutional investors to their clients. Transparency would make it easier for clients to establish whether or not such breach did in fact occur.

King II picked up on the international move to include shareholder activism as a fiduciary duty owed by the institutional investors to their clients. It referred to draft United Kingdom legislation that will make shareholder activism a fiduciary duty of UK investment funds, closely resembling USA legislation that establishes the right to vote at general meeting as a trust asset that must be exercised with the necessary care and skill (King II, s 6, chap 6, paras 5 and 6). The report recommends that consideration be given to the possible application of these international developments in South Africa. King II then refers to a specific aspect of shareholder activism, namely voting, and recommends that consideration be given to the implementation of legislative amendments that would place a duty on trustees of pension funds to exercise the voting rights attached to the shares in which they invested (King II, recommendation 22).

South African common law recognizes the existence of a fiduciary duty in relationships of trust, where one person takes responsibility to act in the best

interests of the other person in the relationship (*Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168 at 177–8). The trustees of a trust stand in such a relationship to their trust beneficiaries (*Sackville West v Nurse* 1925 AD 516). Where the investment scheme is structured in the form of a trust (e g a unit trust investment scheme), the trustees of such investment trusts would owe common law fiduciary duties to the clients who have made investments in a portfolio of the investment scheme. Our common law also recognizes the trustee's duty to act with skill and care (*Sackville West* (supra)).

The fiduciary duties of the institutional investor are confirmed in legislation. Section 71 of the Collective Investment Schemes Act 45 of 2002, which replaced the Unit Trust Control Act 54 of 1981, contains a duty to act in the best interests of the investors. This duty is placed on trustees, custodians and investment managers. Section 4 of the same Act prescribes that the investment manager must avoid a conflict between the interests of the manager, his directors and management and the interests of the investor. Section 2 of the Financial Institutions (Protection of Funds) Act 28 of 2001 places a duty on persons dealing with the funds and property of the financial institution (which would include the shares invested in) to observe utmost good faith. In particular, the Financial Institutions Act places such duties on any director, member, partner, official, employee or agent of a financial institution or of a nominee who invests, holds, controls or administers any funds or trust property held by the financial institution.

An interesting question is whether the duty of the institutional investor to act with care and skill includes the duty to be a shareholder activist responsible for ensuring good corporate governance. Although the Financial Investments Act contains the duty to act with proper care and skill, the legislation does not refer to any duty of shareholder activism, let alone activism driven by good corporate governance motives. Section 4 of the Collective Investment Scheme Act only refers to duties such as the duty to organize and control the scheme in a responsible manner, to keep proper records and to promote investor education. Section 91 of the Collective Investment Scheme Act deals with the voting rights conferred by securities held in a portfolio. However, it merely places a duty on the investment manager, when and if he decides to exercise his voting rights, to use them in the best interests of the investor. Although the institutional investor thus has a fiduciary duty to exercise its voting rights in the best interests of its clients, the Act does not explicitly state that it should exercise these rights. It also does not require voting rights to be exercised in favour of good corporate governance.

It remains to be seen whether South African courts or the legislature will in future extend the duty of the institutional investor to act with care and skill to include attendance at general meetings, rational voting and the scrutiny of compliance with corporate governance principles.

If the duty of the institutional investor to act with care and skill is extended to include shareholder activist behaviour, the next interesting consideration would be whether shareholder activism in pursuit of good

corporate governance will always be in the best interests of the client of the institutional investor.

The clients of the institutional investor expect the maximum financial return on their financial investments. It is this financial expectation that determines the actions of the institutional investor and the degree of shareholder activism it engages in. The institutional investor is under pressure from clients to provide excellent short term returns. Often the institutional investor will just vote with its feet by selling off shares, rather than becoming an activist attempting to ensure good corporate governance. Shareholder activism aimed at good corporate governance will involve costs and bring more long term financial return.

In certain situations the institutional investor will be involved in shareholder activism, but the motive will be to create short term wealth for its clients and not to ensure good corporate governance. You might, for example, have shareholder activism aimed at asset stripping (Marc Hasenfuss 'Cracking the whip to get better value' *Finance Week* (28 June 2002) 10). The institutional investor will be acting in accordance with its fiduciary duty to act in the best interest of its clients. The best interest of its clients might be short term profit and an abandonment of any good corporate governance goals. The clients' interests may even require shareholder activism on the part of the institutional investor that would impede good corporate governance. It might, for example, be that the clients of the institutional investor have short term goals. This might result in the institutional investor's having to vote in favour of a board of directors with business strategies that will have an appealing positive short term impact on the value of the shares, despite its being evident that these same directors do not see the need for the development of an HIV/AIDS strategy that will secure the long term sustainability of the company. The institutional investor would be acting in the immediate best interest of its clients, but contrary to the interests of the company or other stakeholders that would demand good corporate governance

Even if, in future, shareholder activism is included as part of the duty of the institutional investor to act with care and skill, it is doubtful whether the fear of possible legal action will prompt these institutional investors to take up a corporate governance watch dog role. Although a breach of such duty might lead to the corporate failure of a company in their portfolio and subsequently some loss of value in their funds, other investments might create great profits, with the fund still performing well overall. Proving damage and causality might be a huge problem for a client wanting to sue its institutional investor.

Although these recommendations are a step in the right direction, they are not sufficient. A change of heart is required. Institutional investors should be made aware of the long term social and economic importance of good corporate governance and the way in which they and their clients will benefit from good corporate governance.

4 CONCLUSION

It is crucial that any attempt to secure greater shareholder activism addresses the real reasons that underpin shareholder apathy. A wide range of problems such as a lack of access to company information, a lack of expertise and knowledge to process company information, a lack of recognition of the importance of shareholder activism and the disparity between the high costs involved in taking shareholder activism seriously and the size of many shareholders' stakes in the company must be considered. A combination of different steps, referred to earlier in this note, should be taken to enhance shareholder activism.

It is, however, important to keep two very sobering realities in mind. First, very little can be done to persuade a shareholder who is unwilling to buy into shareholder activism, but prefers a commercial solution to corporate governance failures, namely that of voting with his feet.

Secondly, shareholder activism is not necessarily aimed at ensuring good corporate governance. A shareholder's participation would naturally be aimed at enhancing his own interests. The shareholder is entitled to act and vote in his own best interests. These interests might not necessarily be served by actions in pursuit of good corporate governance. In such cases shareholder activism might actually be found to hamper good corporate governance.