

The Stakeholder Debate and Directors' Fiduciary Duties

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1 Introduction

It is usually said that a company is a legal entity separate from its management and shareholders and that the business and affairs of a company must be managed by or under the direction of its board. This implies various duties and responsibilities for directors.

Directors' duties traditionally include onerous fiduciary duties and obligations of care, skill and diligence in terms of the common law, various statutory provisions in the Companies Act 61 of 1973 requiring certain things of directors or preventing them from doing certain things (see, eg, ss 221-227 and 234-246 of the Act), and possible duties imposed by the articles of association or even separate agreements between directors and their companies. (For decisions concerning the duties of directors, see, eg, *Symington v Pretoria-Oos Privaat Hospitaal Bedryfs (Pty) Ltd* 2005 (5) SA 550 (SCA) at 562; *Cyberscene Ltd v i-Kiosk Internet and Information (Pty) Ltd* 2000 (3) SA 806 (C) at 813-4; *Du Plessis v Phelps* 1995 (4) SA 165 (C) at 170; *Sibex Construction (SA) (Pty) Ltd v Injectaseal CC* 1988 (2) SA 54 (T) at 64; and *Fisheries Development Corporation of SA Ltd v Jorgensen, Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd* 1980 (4) SA 156 (W) at 163.)

Until very recently, neither United Kingdom nor South African companies legislation contained any provisions dealing with the general duties of directors – directors' duties were based on case law, that is, on common law. This was also the case in Australia and New Zealand. However, Australia and New Zealand broke away from this tradition a few years ago and currently both the Australian Corporations Act of 2001 and the New Zealand Companies Act 105 of 1993 contain provisions dealing with directors' general duties (see ss 180-184 of the Australian Corporations Act; and ss 131, 133, 137 and 138 of the New Zealand Companies Act). It seems that these examples were followed and currently the United Kingdom Companies Act, 2006 (c 46) and the South African Companies Bill of 2007 (available at <<http://www.dti.gov.za/>>) contain comparable provisions on directors' general duties.

In the case of the United Kingdom Companies Act, ss 171-177 seem to contain an exhaustive codification of directors' duties (see *Modern Company Law Review for a Competitive Economy: Developing the Framework* (URN

00/656) (Mar 2000), available at <<http://www.berr.gov.uk/bbf/co-act-2006/clar-review/page25086.html>> ('*Developing the Framework*') in pars 3.20 and 3.82; *Modern Company Law Review for a Competitive Economy: Completing the Structure* (URN 00/1335) (2000), available at <<http://www.berr.gov.uk/bbf/co-act-2006/clar-review/page25080.html>> ('*Completing the Structure*') in pars 3.2, 3.6 and 3.12; and *Modernising Company Law: The White Paper* (Mar 2005), available at <<http://www.dti.gov.uk/companiesbill/whitepaper.htm>> ('*White Paper*') in par 3.3, stating that the code is exhaustive in nature and that it will replace the common law).

The South African Companies Bill of 2007, however, adopting an approach similar to s 185 of the Australian Corporations Act, specifically retains the common-law duties of directors (see cl 91(6)). In this sense, it may be appropriate to say that cl 91 only provides for a partial codification of directors' duties, but it is probably better just to state that the South African Companies Bill now contains statutory provisions dealing with directors' general duties and that these duties are comparable to directors' common-law duties. The issue as to in whose interests directors should act, is dealt with in the United Kingdom Companies Act (in s 172(1)) and in the South African Companies Bill (in cl 91(1)(b)). However, there seems to be fundamental differences between the United Kingdom and the South African approaches.

In this analysis the focus is, first, on the stakeholder debate. The discussion then deals with the way in which directors' duties are treated in the United Kingdom Companies Act and in the South African Companies Bill. As part of the general discussion on the United Kingdom and South African company-law reform programs, we consider some general approaches towards company law and, in particular but briefly, what is meant by the concept 'the best interests of the company as a whole'. We focus, more specifically, on the approach that was preferred as part of the reform processes and on whether the United Kingdom Companies Act and the South African Companies Bill have adopted the approaches they professed as part of their company-law reform programs. This analysis is concluded by making some suggestions on the most appropriate approach to be adopted in respect of directors' duties, and by proposing our own theory as well as making some recommendations to incorporate that theory into South African legislation.

2 The Stakeholder Debate: Tensions between Shareholder Primacy and Recognising Other Interests

2.1 The American Debate

In America, tensions between shareholders as potential primary stakeholders and other stakeholders were recognised several years ago. In the early 1930s, Berle and Dodd debated the issue of shareholder primacy versus the protection of other stakeholders.

Berle argued in favour of the shareholder primacy norm. He stated that directors hold the property of shareholders in trust for the sole benefit of the

Berle shareholders. The exclusive obligation of directors was therefore the maximisation of shareholders' property (see AA Berle 'For Whom Corporate Managers are Trustees: A Note' (1932) 45 *Harvard LR* 1365-72). He based his argument of trusteeship on the fact that shareholders are owners of a company. Directors' obligations to shareholders are based on their role as trustees or agents of the shareholders. He therefore classified a company in terms of the separation of ownership and control.

Dodd Dodd, in contrast, argued that directors serve as trustees for the entire community rather than for shareholders only. Therefore, directors should use the company's resources to address the interests of a wider variety of stakeholders. By doing so, directors would behave in a socially responsible manner (see EM Dodd 'For Whom are Corporate Managers Trustees?' (1932) 45 *Harvard LR* 1145; see also AA Berle 'Corporate Powers as Powers in Trust' (1931) 2 *Harvard LR* 1049-74).

Later Dodd acknowledged that it was misleading to treat directors as trustees for employees, consumers and other interest groups (see EM Dodd, reviewing ME Dimock & HK Hyde *Bureaucracy and Trusteeship in Large Corporations* (1940) in (1942) 9 *University of Chicago LR* 538 at 547; see also JE Fisch 'Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy' (2006) 31 *J of Corporation Law* 637 at 647-8).

However, it should be observed that Berle never disputed the fact that there are other interests in a corporation that could not be ignored. In his work with Means (AA Berle & GC Means *The Modern Corporation and Private Property* (1932)), they made the point very clearly (at 352-3 and 356):

'[The large public corporation] involves the interrelation of a wide diversity of economic interests, - those of the "owners" who supply capital, those of the workers who "create," those of the consumers who give value to the products of enterprise, and above all those of the control who wield power.'

'It is conceivable, - indeed it seems almost essential if the corporate system is to survive, - that the "control" of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income streams on the basis of public policy rather than private cupidity.'

In actual fact, Berle's only point was that if you recognise duties of directors also towards other interest groups, the standard of the duties of managers and directors will be eroded. If they are not trustees for the stockholders alone, all that will come out of it in the long term, Berle argued, was 'massing of group after group to assert private claims by force or threat - to take what each can get, just as corporate managements do' (Berle (1932) op cit at 1368). That is why he argued that when the fiduciary obligation of the corporate management and control to stockholders is weakened or eliminated, 'the management and "control" become for all practical purposes absolute' (idem at 1367).

This argument was, with hardly any modification, relied on in the 1998 United Kingdom Hampel Report to once again justify shareholder primacy (see *The Committee on Corporate Governance* (1998) in par 1.17). The modern expression of Berle's fears is neatly summarised by the following

comments of RAG Monks (with reference to 'A Consultation Document from the Company Law Review Steering Group' (Feb 1999), available at <<http://www.lens-library.com/info/DTI0399FINAL.html>>):

'What is the question? It is not whether the various corporate constituencies have equal entitlements or whether any one of them should have preference. It is not whether the interests of each group are necessarily to be quantified in a definition of long-term value for the enterprise. It is - rather - whether corporate management is effectively accountable to any informed, motivated, independent and effective entity.'

The theory of shareholder primacy is still the dominant theory in the United States. Even in establishing the objectives and conduct of the corporation, the American Law Institute has suggested that 'a corporation should have as its objective the conduct of business activities with a view to enhance corporate profit and shareholder gain' (see American Law Institute *Student Edition: Principles of Corporate Governance: Analysis and Recommendations as Adopted and Promulgated by the American Law Institute at Washington DC on May 13, 1992* (1994) at 55-60 in par 2.01). The question, then, is who will normally be responsible for the 'conduct of business activities' of a corporation? The recommendation of the American Law Institute was that it should be done 'by or under the supervision of such principal senior executives as are designated by the board of directors' (idem at 82 in par 3.01).

The American Bar Association's Model Business Corporation Act states that 'the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors' (see American Bar Association *Model Business Corporation Act: Official Text with Official Comment and Statutory Cross-References Revised through June 2005* (2005) at 8.4 in par 8.01(b)). Under such a model it is not difficult to conclude that directors and senior executives fulfilling their duties will have enhancing corporate profit and shareholder gain uppermost in their minds (see American Law Institute op cit at 56). This view is supported by the fact that the American Law Institute recognised only limited exceptions to the general objectives of a corporation:

§ 2.01(b) Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business:

- (1) Is obliged, to the same extent as a natural person, to act within the boundaries set by law;
- (2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and
- (3) May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.'

2.2 The Intensification of the Stakeholder Debate

It is beyond dispute that the stakeholder debate became particularly prominent when the basic perception of the company changed.

At first the only real concern for a company and its directors was the maximisation of profits (see AA Berle 'The Impact of the Corporation on Classical Theory' in: Thomas Clarke (ed) *Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance* (2004) at 45, 49 et

seq; see also JJ du Plessis, J McConvil & M Bagaric *Principles of Contemporary Corporate Governance* (2005) at 4 ff. Profits for whom? The shareholders as they were seen as the 'owners of the company'; the primary stakeholders; and most important providers of capital to enable the company to conduct business (see Dodd op cit at 1146; MM Blair 'Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century' in: Thomas Clarke (ed) *Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance* (2004) at 175 and 181).

Gradually this perception changed. The company, especially the large public company, came to be seen in a different light. People started realising that there were other stakeholders in a company too; that if the only purpose of a company was 'the maximisation of profits for the shareholders', society as such could suffer tremendously – poor working conditions for workers, the exploitation and pollution of the environment, and so on (see Du Plessis, McConvill & Bagaric op cit at 4).

Nowadays, it is fairly generally accepted that 'in future the development of loyal, inclusive stakeholder relationships will become one of the most important determinants of commercial viability and business success'. (D Wheeler & M Sillanpää *The Stakeholder Corporation* (1997) at ix; see further JE Post, LE Preston & S Sach *Redefining the Corporation* (2002) at 1-3; and MJ Roc 'Preface' in: MM Blair & MJ Roe (eds) *Employees & Corporate Governance* (1999) at v) and that 'recognition of stakeholder concern is not only good business, but politically expedient and morally and ethically just, even if in the strict legal sense they remain directly accountable only to shareholders' (DSR Leighton & DH Thain *Making Boards Work* (1997) at 23).

The fact that there has been a shift in public opinion towards the recognition of a wider variety of interests, is also clearly recognised in South African literature (see I Esser 'The Enlightened-Shareholder-Value Approach versus Plurism in the Management of Companies' (2005) 26 *Obiter* 719-25; MK Havenga 'Directors' Fiduciary Duties under Our Future Company-Law Regime' (1997) 9 *SA Merc LJ* 310 at 314; JJ Du Plessis 'Direkteure se Pligte teenoor Partye Anders as die Maatskappy' (1992) 25 *De Jure* 378; and M Larkin 'The Fiduciary Duties of the Company Director (II)' (1979) *The South African Company LJ* E1 at E11-E17). The wider variety of interests includes, inter alia, those of the following stakeholders: investors, employees, consumers, the general public, and the environment.

2.3 Summary

It should be clear from the preceding discussion that since the 1930s it has been realised that there are various interests, apart from that of shareholders, that play a role in the success of corporations. The only real issue was how to develop a workable corporate model in which all stakeholders are recognised. This debate is still continuing and there is still considerable divergence in opinion on this. However, serious attempts have been made in recent times by

both the United Kingdom and the South African governments to bring their corporate-law models in line with recognised theories of the company and its stakeholders. In what follows we deal with these attempts in the United Kingdom and in South Africa.

3 Recent Company-law Reviews in the United Kingdom and in South Africa

3.1 Overview

In both jurisdictions, company-law reform has been quite prominent in recent times. The previous United Kingdom Companies Act dated back to 1985, while the South African Companies Act is still that from 1973. Although several amendments had been made to both pieces of legislation, these amendments were passed piecemeal to reflect some international practices or to address specific issues that caused problems.

3.2 The United Kingdom

3.2.1 The Lead-up to the United Kingdom Companies Act, 2006

The United Kingdom began with a process of company-law review in 1998. The aim of the review was to develop a simple, modern, efficient and cost-effective framework to carry out business activity in Britain in the twenty-first century. A number of consultative documents were issued during the process. These dealt with the stakeholder debate in detail.

The first document issued by the Company Law Review Steering Group (*Modern Company Law for a Competitive Economy: The Strategic Framework* (URN 99/654) (Feb 1999), available at <<http://www.dti.gov.uk/files/file23279.pdf>> ('*Strategic Framework*')) dealt with the scope of company law in chapter 5. The Steering Group referred to the traditional view that directors should manage a company for the benefit of the shareholders, but subject to the safeguards for the benefit of actual and potential creditors (see in par 5.1.4). However, it was recognised that there is a view that the benefit of the community as a whole too plays a role (ibid).

'[F]or ease of reference' (*Strategic Framework* op cit at 37 in par 5.1.11), the Steering Group referred to two basic approaches as far as company interests were concerned, namely the so-called 'enlightened shareholder value' approach and the 'pluralist' approach. In order to prevent focusing on several uncertainties in determining the exact meaning of these two approaches for purposes of our current discussion (see *Strategic Framework* op cit at 37-46 in pars 5.1.12-5.1.33), we simply refer to the Steering Group's own summary (idem at vi in par 5) of the two different approaches:

'A distinction is drawn between the "enlightened shareholder value" approach, which asserts that [productive relationships] can be achieved within present principles, but ensuring that directors pursue shareholders' interests in an enlightened and inclusive way, and the

"pluralistic" approach, which asserts that co-operative and productive relationships will only be optimised where directors are permitted (or required) to balance shareholders' interests with those of others committed to the company.

It should be observed that the Steering Group acknowledged that what they called 'enlightened shareholder value' is often referred to in the literature as 'enlightened self interest' (idem at 37 in par 5.1.11, n 27) and that 'current law is not widely recognised as embracing the enlightened shareholder value approach' (idem at vi in par 6). Irrespective of these acknowledgements and the uncertainty regarding the exact meaning of the so-called 'enlightened shareholder value' approach and the 'pluralist' approach, the Steering Group seemed to strongly favour the 'enlightened shareholder value' approach (see idem at 39 in par 39, at 42 in par 5.1.23, and at 43 et seq in pars 5.1.25 et seq).

The Company Law Review Steering Group issued another Consultation Document in March 2000 (see *Developing the Framework* op cit supra). Chapters 2-4 dealt with corporate governance issues with the core issue of corporate governance, as far as directors and officers are concerned, being covered in Chapter 3. In this Consultation Document, the reference to the so-called 'enlightened shareholder value' approach was far less prominent. There was, in actual fact, just one reference to it in the main text of these chapters (at 14 in par 2.21). The 'pluralist' approach is mentioned on 21 occasions in them, but the main purpose of these references was to reject it rather than to explain it further or emphasising the variations of such an approach. The Steering Group rejected the 'pluralist' approach as one that should be followed in defining directors' duties (see, in particular, at 17 in par 3.1, and at 23 et seq in pars 3.20 et seq).

During November 2000, the Company Law Review Steering Group issued yet another Consultation Document (see *Completing the Structure* op cit supra). In this document, references to the 'enlightened shareholder value' approach disappeared completely in the chapter that dealt with directors' duties. The 'pluralist' approach was only mentioned once in the main text and only to observe that the Steering Group saw it as a key objection that the supporters of that approach did not suggest 'a practical means of dealing with the crucial question of how such a duty could be enforced' (idem at 34 in par 3.5).

Both the *Final Report* (URN 01/942 and URN 01/943) of July 2001 and the Government's *White Paper* of 2005 (available at <<http://www.dti.gov.uk/companiesbill/whitepaper.htm>>) also supported the 'enlightened shareholder value' approach. It was stated in the *White Paper* that the duties of directors are owed to the company and that only the company can enforce them. The United Kingdom Government was also in favour of the 'enlightened shareholder value' approach as it would drive long-term company performance and maximise wealth and welfare (see in par 3.3).

On 4 November 2005, the Company Law Reform Bill was introduced in the House of Lords and in November 2006 the Companies Act received royal assent. A few of the sections in the Act have already come into force, and the

other provisions will come into force during 2007 and 2008. All of its provisions should be effective by October 2008.

3.2.2 The Duty to Promote the Success of the Company

Corporate governance is probably the most prominent feature of the United Kingdom Companies Act, 2006 (see A Keay 'Section 172(1) of the Companies Act 2006: An Interpretation and Assessment' (2007) 28 *The Company Lawyer* 106-10). As stated earlier, the United Kingdom Companies Act, 2006 provides for an exhaustive statement of directors' duties.

Section 172(1) of the Act provides as follows:

172 Duty to promote the success of the company

(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to –

- (a) the likely consequences of any decision in the long term,
- (b) the interests of the company's employees,
- (c) the need to foster the company's business relationships with suppliers, customers and others,
- (d) the impact of the company's operations on the community and the environment,
- (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
- (f) the need to act fairly as between members of the company.

(2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.

(3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

It should be clear that the primary expectation from directors under this duty is to act in good faith to promote the success of the company for the benefit of its members as a whole; in other words, shareholder primacy has been retained. However, apart from this duty, the directors may have regard to the other matters, primarily those listed in subs (1)(a)-(f), but this list is specifically not made exhaustive. The listed matters that directors may also consider are probably the most comprehensive list of matters contained in any modern company-law legislation and probably also the clearest recognition in such legislation of the importance of interests other than those of shareholders, namely the interests of other stakeholders such as employees, suppliers, and customers.

However, the practical application of this section is unclear. First, directors are provided with an unfettered discretion in terms of this provision. They should manage a company in a way they consider would promote the success of the company, for the benefit of its members. But there is no objective criteria indicating how they should exercise this important discretion. Secondly, the list of issues directors need to have regard to is also not exhaustive, seeing that it is stated that directors need to consider these issues 'amongst other matters'. There is no indication of what these 'other matters' entail. Thirdly, there is no definition of 'the success of the company' (see Keay op cit at 109). Finally, none of the other stakeholders will have standing to compel directors to take their interest into consideration, unless it could be

established that the interest of the company itself had been contravened, and that will have to be done by way of a shareholder derivative action (in terms of the derivative action in ss 260-264 of the United Kingdom Companies Act, 2006). This was one of the dilemmas employees faced under s 309 of the United Kingdom Companies Act, 1985 (see JJ du Plessis & J Dine 'The Fate of the Draft Fifth Directive on Company Law: Accommodation Instead of Harmonisation?' 1997 *J of Business Law* 23 at 46; *Gower's Principles of Modern Company Law* 6 ed (1997) by PL Davies at 68; L Roach 'The Paradox of the Traditional Justification for Exclusive Shareholder Governance Protection: Expanding the Pluralist Approach' (2001) 22 *The Company Lawyer* 9 at 15, who refers to the 'highly suspicious drafting of section 309 of the Companies Act 1985'). Section 309 read as follows:

'309 Directors to have regard to interests of employees

(1) The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members.

(2) Accordingly, the duty imposed by this section on the directors is owed to by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors.'

However, the dilemma for the other interests mentioned seems more acute as the basic duty of the directors is no longer a general common-law duty, but is now expressed very clearly in s 172: the directors must in the first instance 'promote the success of the company for the benefit of its members as a whole'. It is only 'in doing so' that they may 'have regard (amongst other matters) to' other interests.

One can hardly imagine a more vague and elusive way of recognising other interests and it is not difficult to predict that challenging times lie ahead for the other stakeholders before a clearer picture will emerge in the United Kingdom as far as the substance of these 'other interests' is concerned. In actual fact, it seems to suggest that the only practical consequence of legislatively recognising these other interests is that the actions of directors would not be open for any challenge if they have *not only* taken the interests of the company as a whole (defined as the collective interest of the current and future shareholders) into consideration in making decisions, *but also* other interests. The embarrassment for the directors, before s 309 of the United Kingdom Companies Act, 1985 formed part of the United Kingdom legislation, in putting the interest of the employees above that of the company (current and future shareholders) will not be forgotten easily (see *Parke v Daily News Ltd* [1962] 2 All ER 929). That is why it has been said that one effect of s 309 was to dilute directors' accountability to shareholders rather than to strengthen their accountability to employees (see Davies op cit at 603.) Under the common law, other interests, like employees' interests, were considered to be pertinent only when they coincided with the company's best interests (see *Hampson v Prices Patent Candle Co* (1876) 24 WR 754; *Huton v West Cork Railway Co* (1883) 23 ChD 654; and see also L Klein & JJ du Plessis 'Corporate Donations, the Best Interest of the Company and the

Proper Purpose Doctrine' (2005) 28 *University of New South Wales LR* 69 at 70, 81-2, and 97).

However, the drafters of s 172 may be applauded for stating in direct terms which approach they preferred when it came to the stakeholder debate. The Act seems to provide a theoretical answer to the stakeholder debate, but its practical application is far from clear. It may well be that over time guidelines on its practical application will be provided in the form of codes of best practice.

3.2.3 An Evaluation of the Approach Adopted in the United Kingdom Companies Act, 2006

In the light of the prominent way in which the so-called 'enlightened shareholder value' approach was promoted and of the clear rejection of the so-called 'pluralist' approach in all consultation documents leading up to s 172 of the Companies Act, 2006, it is hardly possible not to conclude that the Legislature intended to implement the so-called 'enlightened shareholder value' approach as far as directors' duty to promote the success of the company is concerned.

However, one should bear a few important matters in mind in evaluating the 'enlightened shareholder value' and the 'pluralist' approaches as discussed in the consultation documents. It should be mentioned that the labels of the two approaches should not be seen as sacrosanct. The Steering Group made it clear that the terms were used 'for ease of reference' (see *Strategic Framework* op cit at 37 in par 5.1.11). Even a superficial analysis of academic material on the theories of the company and of the different approaches of company law regarding to whom directors owe their duties, will reveal that this is an immensely complex area (see, eg, D Millon, 'New Directions in Corporate Law: Communitarians, Contractarians, and the Crisis in Corporate Law' (1993) 50 *Washington & Lee LR* 1373; Wheeler & Sillanpää op cit supra; Post, Preston & Sachs op cit supra; Clarke op cit supra; JN Gordon & MJ Roe *Convergence and Persistence in Corporate Governance* (2004); R Kraakman, DP Davies, H Hansmann, G Hertig, K Hopt, H Kanda & E Rocco (eds) *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2004)).

Not only do the theories of the corporation and approaches to company law vary considerably, but there are also so many nuances and variations on the various theories and approaches to company law that it is definitely an oversimplification to state that all these theories and approaches boil down to a simple choice between an 'enlightened shareholder value' approach and a 'pluralist' approach. Many other labels could be used – such as the constituency theory; the shareholder primacy theory; the associative theory; or the inclusive stakeholder theory – to explain different approaches to company law as far as directors' duties are concerned.

It should further be appreciated that the Steering Group defined the 'enlightened shareholder value' approach and 'pluralist' approach in such a

way that it seems as if they are completely competing approaches. None of the variations to these approaches was analysed in the discussion papers, nor do we find in them any in-dept discussion of the recent developments regarding perceptions of social and other responsibilities of large corporations. There was also no analysis of the importance of the entity theory and the associated, but very important, legal principle that directors owe their duties towards 'the company as a separate legal entity'.

3.3 South Africa

The Corporate Regulation Division of the Department of Trade and Industry commenced with the reform of national corporate laws by issuing a policy document on the guidelines for corporate-law review in 2004 (see *The Guidelines for Corporate Law Reform, South African Company Law Reform for a 21st Century, Department of Trade and Industry* (May 2004) ('*Policy Document*'), available at <www.polity.org.za/pdf/notice>). It envisaged an overall review of corporate laws in South Africa, comprising of the Companies Act 61 of 1973, the Close Corporations Act 69 of 1984, and the common law relating to these corporate entities. The review did not include the law relating to partnerships.

The objective with the review process was to ensure that company law in South Africa was in line with social, economic and legal developments. The *Policy Document* stated that company law should promote competitiveness and the development of the South African economy. The new company law should do the following: encourage entrepreneurship and enterprise diversity by simplifying the formation of companies and reducing the associated costs; promote innovation and investment in South African markets by providing a predictable and regulatory environment and flexibility in the formation of the management of companies; promote the efficiency of companies and their management; encourage transparency and high standards of corporate governance; recognise the broader social role of enterprises; and ensure compatibility and harmonisation with international standards (see *Policy Document* op cit in ch 1, par 2).

In February 2007, a Draft Companies Bill was issued. The Bill contains provisions regarding directors' duties but, as mentioned before, it is no complete codification of these duties. For purposes of this discussion, cl 91(1) is of particular importance. It provides as follows:

'91 Standards of director's conduct

- (1) Each director of a company, when acting in that capacity, or as a member of a committee of directors, or when gathering information or similarly preparing to act in either of those capacities, is subject to –
- (a) a duty to exercise the degree of care, skill and diligence that would be exercised by a reasonably diligent individual who had both –
 - (i) the general knowledge, skill and experience that may reasonably be expected of an individual carrying out the same functions as are carried out by that director in relation to the company; and
 - (ii) the general knowledge, skill and experience of that director; and
 - (b) a second, fiduciary, 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.'

It should be clear that cl 91(1)(b) is of particular interest for purposes of our current discussion. The fundamental question is what is in actual fact meant by 'the company'. Since there is, otherwise than in the United Kingdom Companies Act, 2006, no mention of the shareholders in particular or of any other interests, cl 91(1)(b) will have to be interpreted in accordance with the common law. In several cases it has been stated that directors owe their fiduciary duties to 'the company' and not to individual shareholders (see, eg, *Percival v Wright* [1902] 2 Ch 421). Following this, it has been stated that directors must act in good faith and 'in the interests of the company as a whole'. It is at this point that considerable confusion arises as it is no easy task to determine exactly what is meant by the concept of 'the best interests of the company as a whole' (see *Hahlo's South African Company Law through the Cases – A Source Book* 6 ed (1999) by JT Pretorius, PA Delpont, M Havenga & M Vermaas at 293). Several years ago, Parsons pointed out that 'the concept remains miserably indeterminate' (see R Parsons, 'The Director's Duty of Good Faith' (1967) 5 *Melbourne University LR* 395 at 396) and it is suggested that that is still the case (see *Kirwan v Cresvale Far East Ltd (in liq)* (2002) 44 *ACSR* 21 at 56). Also, for purposes of this analysis '[i]t is of no real use to regurgitate the numerous utterances of past courts on this topic' (idem at 21; see also *Ex parte Glossop* [1988] 1 *WLR* 1068 at 1076; and LS Sealy 'Bona Fides and Proper Purposes in Corporate Decisions' (1989) 15 *Monash University LR* 265 at 269-71).

However, the point remains that, irrespective of excellent research by South African academics, there is still considerable uncertainty as far as the meaning of the concept 'the best interests of the company as a whole' is concerned (see T Mongalo 'Self-Regulation versus Statutory Codification' (2004) 67 *Tydskrif vir Hedendaagse Romeins-Hollandse Reg* 264-73; MK Havenga 'The Company, the Constitution and the Stakeholders' (1997) 5 *Juribus Business Law* 134-139; OJS Fourie 'Die Plig van Direkteure teenoor Maatskappyskuldeisers' (1992) 4 *SA Merc LJ* 25-52.)

It is possible that South African courts, as they have done on several occasions in the past, will conclude that a duty owed towards 'the company' in actual fact means a duty towards the shareholders collectively, but the proposed new company legislation creates the ideal opportunity to clarify this issue and to eliminate the existing confusion regarding the definition of 'the company'.

With the current Bill, it is still unclear whether directors should provide the shareholders with primacy when they manage a company, or whether they should, or even could (see again *Parke v Daily News Ltd* supra), consider the interests of other stakeholders. It may be argued that the traditional viewpoint is still applicable due to the wording of the clause: 'the company' has always been interpreted as meaning the shareholders collectively. Then again, it is unclear whether the inclusion of the word 'reasonably' in cl 91(1)(b) would not make it possible for directors to consider other interests as well in fulfilling this duty towards 'the company'. In this sense it could be argued that

the Companies Bill is wider than the traditional position when it comes to in whose interests directors should manage a company.

3.4 The United Kingdom and South African Approaches Compared

The United Kingdom Companies Act, 2006 is clear on the approach preferred, namely the 'enlightened shareholder value' approach. Despite this clarity, one has to ask whether it is indeed the best approach to follow and how it will be applied practically. The South African Bill is not clear at all and contains elements of both a shareholder primacy and stakeholder approach. This confusion must be eliminated.

4 A Proposed Approach: The Merry-go-round Approach

4.1 Arguments for and against a Shareholder Primacy Approach

The literature on, and reasons for and against, shareholder primacy are almost endless. Here we can only list a few reasons advanced in favour of shareholder primacy. Shareholders own the company and its assets and accordingly have a legitimate claim to have the company managed in their own best interest. It is also argued that as the shareholders bear the risk of poor corporate performance, they should have the right to the company's residual income. It has even been said that shareholder should get exclusive protection due to the fact that they cannot protect themselves contractually. A final argument in favour of shareholder dominance is that unlike the interests of employees, consumers, the community and the environment that are protected in separate measures such as labour laws, liquidation (insolvency) laws, consumer protection laws and environmental laws, the interests of shareholders are not protected in any legislation other than company laws.

However, there are several flaws with these justifications of shareholder primacy. First, the classification of shareholders as 'owners' is flawed in that there are substantial differences between shareholders and the traditional owners of property. Shareholders own stock, which gives them claims to control and certain financial rights. But they do not 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 (see Roach *op cit* at 9-19). Secondly, from the date of incorporation, the company is a separate legal person with a separate legal personality and thus cannot be owned. Thirdly, the shareholders can substantially reduce their overall risk via a policy of diversification. Apart from private companies, where the articles of association or shareholder agreements can occasionally lock shareholders in, shareholders in public companies can predict risk and avoid sustaining losses by simply selling their shares. Over time there is virtually no financial risk at

all for the original providers of share capital. A good rise in the share price would soon reduce the risk for a shareholder to zero. If shares were originally issued at R1 per share, and the shareholder holds 1,000,000 shares, he could sell 500,000 of the shares when the price reaches R2 per share to recover his original investment. This may sometimes take a while, but shareholders are not excluded from returns on their original investments as they will normally receive dividends when profits are made. Shareholder risks are nowadays also reduced considerably by way of large professional investment funds and by the rapid rise of institutional shareholders over the last 30 years or so. Fourthly, the company's constitution forms a contract between the company and its shareholders and between the shareholders themselves. This is indeed a special contract that may be amended only by special resolution, but the shareholders have exclusive powers to amend it and this provides for considerable contractual protection. There is also ample scope for contractual protection of shareholders by way of shareholder agreements. Fifthly, although it is generally true that shareholders do not have any protection under separate laws, there are formidable protections imbedded in most modern economies. Apart from a very rapid growth of financial services legislation in recent times, one can think of the considerable protection of shareholders under company law in terms of statutory derivative actions, continuous disclosure provisions, actions aimed at oppressive and unfairly prejudicial conduct, insolvent trading provisions, reckless trading provisions, and insider trading provisions, to name but a few.

After exposing the flaws in some of 'the most convincing' reasons for retaining shareholder primacy as the norm, one would have expected that any company-law model should immediately move away from that model to one recognising all internal and external interests equally. Unfortunately it is exactly the attempt at achieving that equal recognition that has kept company lawyers and economists busy since at least the early 1930s and still we have no clear answer.

4.2 The Theory of Simple Juridical Reality as Basis of Our Merry-go-round Approach

We should like to propose that the starting point should be a very fundamental legal one: directors owe their fiduciary duties to the company and to the company alone as the company is a separate legal entity from the moment it is registered until it is deregistered. The company may be a creature of statute, but there is hardly any other creature as real as this. One need look only at how the legal status of companies are defined in cl 12 of the Companies Bill 2007 to realise how serious the Legislature is that this creature of statute be recognised and that it should be allowed to blend into the day-to-day activities of society as seamlessly as possible:

¹² Legal status of companies

(1) From the date and time that the incorporation of a company is registered, as stated in its Registration Certificate, the company –

- (a) is a juristic person, which exists continuously until its name is removed from the Companies Register in accordance with this Act; and
 (b) has all of the legal powers and capacity of an individual, except to the extent that a juristic person is incapable of exercising any such powers, or having any such capacity.'

The company is represented by several interests and these include the interests of shareholders, employees, consumers, the community and the environment. Thus, requiring of directors to act in good faith in the interest of 'the company' cannot nowadays mean anything other than a blend of all these interests, but first and foremost they must act in the best interest of the company as a separate legal entity. The courts will thus be in a position to give different weight to the degree of interests. It will also be appropriate for a court to consider any other remedies under other legislation before it allows a particular interest to rely on particular company-law remedies. Such an approach may well reveal that a particular interest is already well catered for under separate legislation.

An interest that may be primary at one particular point of time in the company's existence, may well become secondary at a later stage. This is a continuing process which could be compared to a merry-go-round, the company; many interests are represented in this merry-go-round at any particular time. Just like a merry-go-round, there are sometimes brief stops to let some participants get off and to take other participants on board, but then the motion continues with the participants (interests) constantly moving up and down without any real finishing line. The speed of rotation may even vary, until it comes to a permanent standstill when the company is liquidated. But even then it will require of the court to weigh up the various interests of at least creditors, shareholders and employees. During the existence of the company, the directors will focus on the interests of 'the company' (the merry-go-round), but they are not only allowed, but are in actual fact required, to observe the various other interests, moving up and down just like those who are enjoying the ride on the merry-go-round, very carefully when they act. After all, it is required of them to act in good faith and in the best interest of the company as represented by the various interests in the company.

It should be remembered that the meaning of 'the company' only becomes obscure if that term is, for historic reasons (see SJ Naudé *Die Regsposisie van die Maatskappydirekteur met Besondere Verwysing na die Interne Maatskappyverband* (1970) at 113, relying on LS Sealy 'The Director as Trustee' (1967) *Cambridge LJ* 83 at 90), equated with the shareholders collectively and that, currently, is what the legal position is under the common law. Thus, the only solution is indeed for the Legislature to step in and change the common law, for otherwise this fallacy will be perpetuated.

In our view it is unnecessary to give any particular or well-resounding tag to this view of the company, other than just stating that it is based on a simple juridical reality (a 'teorie van eenvoudige juridiese realiteit') as Naudé already pointed out in 1970 (op cit at 18-9). The natural entity theory states that directors are the agents of a corporate entity. Directors could therefore act in a manner that is to the shareholder's detriment if it is to the advantage of the

company as a separate legal entity. Management works for the company and its obligations to the shareholders are therefore only secondary (see D Millon 'Theories of the Corporation' (1990) *Duke LJ* 201-262), but need not be secondary depending on what is required to act bona fide in the best interest of the company.

How will this be reflected in legislation? We propose the following provisions.

First, expand the definition of 'company' to read as follows:

'"company" means a juristic person to the extent that it is, or its activities are, regulated by this Act in terms of section 7 and includes, from time to time, any or all the interests of -

- (a) the company's members as a whole;
- (b) the company's employees;
- (c) the company's suppliers, customers and others;
- (d) the community and the environment to the extent that it could be affected by the company's business activities.'

Next, replace the existing cl 91 of the South African Companies Bill of 2007 with the following provision:

'91 Directors' duty of care, skill and diligence

A director of a company must exercise his powers and discharge his duties with a degree of care, skill and diligence that a reasonable person would exercise if -

- (a) he is a director of the company; and
- (b) had the same responsibilities within the company as that director.

Thirdly, add new cll 92 and 93:

'92 Directors' fiduciary duties towards the company

(1) A director of a company must discharge his duties in good faith in the best interests of the company and for a proper purpose.

(2) A director of a company must not improperly use his position to gain an advantage for himself or another person or to cause harm to the company.

(3) A person who obtains information in his capacity as a director of a company must not use the information improperly to gain advantage for himself or another person or to cause harm to the company.'

'93 Presumption in favour of directors

It is presumed that a director fulfilled his duty of care, skill and diligence under section 91 or his fiduciary duties under section 92 if the director -

- (a) (i) has taken reasonably diligent steps to become informed about the subject matter; and
- (ii) does not have a personal financial interest in the subject matter; and
- (b) fulfilled the duty in the same way as a reasonable person in a similar position would do in comparable circumstances.'

It is, of course, particularly important to consider who will enforce these duties. We are of the opinion that any of the parties than may be affected by the conduct of directors, should have standing to enforce these duties, but only on the basis of a statutory derivative action. This will require some amendments to cl 166 of the Companies Bill of 2007.

Although our recommendations may seem radical and although the proponents of the so-called 'enlightened shareholder value' approach may argue that it will make life impossible for directors or even that it will open the floodgates of litigation, we do not agree. First and foremost, the party alleging a breach will bear the burden of proof after the directors have made out a prima facie case that they had acted as required in cl 93. In considering whether a derivative action should be allowed, the court will then have to

apply all the excellent safeguards already imbedded in cl 166, including the important right of the company to apply to the court to set aside the demand under cl 166(2) on the ground that it is frivolous, vexatious or wholly without merit. It means that there is not only considerable protection for the directors under the suggested cl 93, but the plaintiff will also have to convince the court that there is indeed an action that the plaintive derived from an action the company would have had if the directors or shareholders were prepared to institute the action on behalf of the company.

5 Conclusion

In this analysis we considered the stakeholder debate. We focused specifically on reform developments in the United Kingdom and South Africa. Both referred to two approaches when discussing the protection of different stakeholders, namely the 'enlightened shareholder value' approach and the 'pluralist' approaches. However, it is important to be aware that these two approaches are not the only relevant approaches regarding corporate governance models and specifically not as far as the protection of stakeholders are concerned. To analyse the different theories of, and approaches to, company law is a complex area and commentators hold widely divergent views on these theories and approaches. However, it was argued that the theories of company law usually have a shareholder primacy or a stakeholder emphasis. Both the Steering Group in the United Kingdom and the reform committee in South Africa treated the 'enlightened shareholder value' and the 'pluralist' approaches as opposites. After considering the reform documents in the two jurisdictions, it was clear that both opted for the 'enlightened shareholder value' approach, although they were applied differently.

In the United Kingdom legislation, different interests (stakeholders) are listed specifically in s 172 of the Companies Act, 2007. It is clear from s 172(1) that the 'enlightened shareholder value' approach was the preferred approach, and this is also confirmed by several consultative documents of the Company Law Review Steering Group. How this will apply in practice, however, remains unclear.

The South African Companies Bill of 2007 is unclear on the preferred approach and has elements of both shareholder primacy and stakeholder protection. We suggested that this confusion must be eliminated. In view of this confusion, we recommended draft clauses to be incorporated in a revised Companies Bill. These clauses are based on the theory that describes the company as separate legal entity as a simple juridical reality. We have expanded on this theory by arguing that the company is akin to a merry-go-round, and thus suggested that this merry-go-round approach of the company is currently the best way of recognising the various interests of a company without neglecting the important role of the shareholders or the members as a whole. It cannot be denied that a company is a separate legal entity,

represented by several interests, including those of shareholders, employees, investors, consumers, the community, and the environment. One therefore cannot require directors to act only in the best interests of the shareholders collectively when acting in 'the best interests of the company'. The courts will have to give different weight to the degree of interests represented in a company. These interests, and the amount of weight attached to them, may differ during the various stages of a company. The protection that these stakeholders receive in other legislation may also play a role when a court decides on the competing interests of different stakeholders.

Intellectual Property Rights from Publicly Financed Research: The Way to Research Hell Is Paved with Good Intentions

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Introduction

The Intellectual Property Rights from Publicly Financed Research Bill ('the Bill') proposes to define the rights of the 'State in Intellectual Property derived from Publicly Financed Research' (the long title of the Bill). In particular, the Bill proposes (a) to introduce a first ownership rule in respect of Publicly Financed Research; (b) to create a new government bureaucracy headed by the centralized National Intellectual Property Management Office; (c) to impose wide-ranging disclosure obligations on Publicly Financed Institutions; (d) to provide for benefit sharing between inventors and Publicly Financed Institutions; and (e) to create 'walk-in' rights for the State.

The Bill is the brainchild of the well-meaning Department of Science and Technology ('dst'), and follows on its *Intellectual Property Rights and Publicly Financed Research Policy Document* ('Policy Document'), published in July 2006. In the background to the *Policy Document*, one can hear the mantra being repeated that the strongest form of intellectual property protection (patents) is good for the economy (and by extension, society). Added to that, the *Policy Document* proceeds from the premiss that '[p]atenting reflects a nation's R[esearch] & D[evelopment] and industrial