



DAUDS ADVISORY

Corporate Governance

“When boards of directors spectacularly fail themselves and the shareholders”

Cornwell Dauds

1. There was a time, starting in the 19th century, that the law formally recognised shareholders as proprietors (owners) of the firm. The notion of ownership was understood to mean conferring on the shareholders:
 - (a) the right to manage the firm, or to have it managed for their exclusive benefit;
 - (b) the right to direct management of the firm;
 - (c) the right to override decisions of the firm’s management; and
 - (d) the right to ownership of the firm’s assets.

2. As time progressed, shareholders witnessed a gradual weakening of their position and influence as proprietors of the firm. The law started to limit many of the earlier rights of shareholders. For instance, shareholders were denied any proprietary rights in the assets of the firm, and by the 20th century, the law had embraced the long-standing commercial belief that it was not appropriate for shareholders to have direct control over the day-to-

day management of the firm. While it might have been the commercial practice not to allow shareholder direct control over management, it was only during the 20th century that the practice that management was vested in the board of directors was enshrined in the law. This meant that a shareholder, not even a majority of shareholders, could no longer legally assert control over the management of the company.

3. The right of management, as represented by the board, was made exclusive and the board was no longer subject to the direction of the general meeting of shareholders. This secured day-to-day autonomy for the board and management, and thus limited the rights of shareholders as legal owners of the company. It has since become unconstitutional for the shareholders of a firm to interfere with the right of the board. The institution of the firm thus became characterised by the separation of ownership from control. While it is now firmly recognised that ownership is vested in the shareholders, control is vested in the managers — the agents — who run the firm. While this separation is considered both legally and commercially necessary, it also creates agency and moral hazard problems. We need to look no further than the serious corporate governance lapses at LeisureNet Group (a sports company), Fidentia Group (a financial services company), Regal Treasury Private Bank Ltd, African Bank Ltd, Steinhoff (a South African global company), VBS Mutual Bank and Tongaat Hulett (a sugar and property company).
4. It is for this very reason, namely, the limitation of the rights of shareholders as well as the agency and moral hazard problems posed by the separation of ownership of the firm from control, that corporate governance has assumed such great importance.
5. Corporate governance is concerned with the implementation of monitoring and disciplining devices that will ensure the efficient use of a company's available resources. The Anglo-Saxon model, followed by South Africa, advocates governance structures which should pursue the protection of shareholder value. As a way of dealing with agency problems, this model proposes the development of good governance structures

which will serve as a mechanism to select the best managers to run firms and who will do so in the interest of investors. In this regard, the following become particularly relevant:

- (a) the role of the board of directors — more specifically:
 - that non-executive directors should serve on the board;
 - that they should operate at arm's length from management;
 - that the directors have a responsibility to carry out their duties effectively
- (b) the institution of good reporting standards which comply with a securities exchange's listing requirements and accounting standards, as well as external audit which performs a policing function;
- (c) good compensation schemes for managers to ensure that they run the firm effectively and in the interest of the shareholders.

6. The rights that shareholders have managed to retain as proprietors of the firm include:
- (a) the right to appoint directors;
 - (b) the right to change the constitution (articles of association) of the company;
 - (c) the right to approve major transactions such as, for example, a merger or acquisition;
 - (d) the right to ratify defective transactions or breaches by directors; and
 - (e) the right to have the company wound up.

Enter the Old Mutual saga

7. Old Mutual Limited is a 174-year old financial services company, which offers life and savings, property and casualty, asset management and banking services to individuals, businesses, corporations and institutions across 17 countries. It is a very established firm. NMT Capital (Pty) Ltd is an investment company founded in 2004 by three individuals — “NMT” representing the letter each of the 3 co-founders' last name starts with. In 2005, Old Mutual made the decision to fund NMT Capital by way of subscribing for 20% of the investment company's ordinary shares. Old Mutual also subscribed for the company's preference shares. The apparent motivation for Old Mutual's funding of NMT Capital was

that it wished to redress racial inequality brought on by the country's past laws which discriminated against its citizens on the ground of race. At the time, the co-founder whose last name starts with the letter "M" was, in total, a 26.66% shareholder of NMT Capital (20% held in his own name and a further 6.66% held via a company held by a family trust).

8. In 2017, Old Mutual appointed this shareholder and non-executive director of NMT Capital as CEO and said that he "brings a collegiate leadership style and is a highly skilled relationship-builder, which is critical for Old Mutual and its culture". Old Mutual ended up with a situation where both itself and its CEO had a financial interest in the same company at the same time, a clear recipe for disaster however much Old Mutual later contended that they were under the impression that the CEO would be mature enough to handle any conflict of interest between Old Mutual's financial interests in NMT Capital and the CEO's own financial interests in the company. Old Mutual had no business, or grounds for that matter, to form such an impression.

9. According to the 2005 preference share subscription agreement entered into between NMT Capital and Old Mutual, should dividends on the Old Mutual preference shares not be declared or paid on the due date, those shares will become redeemable. Under the subscription agreement, NMT Capital was required to declare and pay a dividend on the preference shares on a six-monthly basis — end of June and end of December. In 2010, 2013 and 2017 Old Mutual agreed to the extension of the redemption dates of the preference shares. In January 2018, a further extension to 30 June 2018 was agreed by way of an addendum signed by the Old Mutual CEO. In all this time Old Mutual had therefore not been paid any dividend on its preference shares. During 2018, the dividend arrears on the Old Mutual preference shares amounted to R65.9 million. Around February/March 2018, the NMT Capital board, on which Old Mutual's CEO served, declared a R10 million ordinary dividend to shareholders — in spite of the preference

share dividend arrears. The shareholders of NMT Capital, which included the two founders, the Old Mutual CEO (the third founder of NMT Capital) as well as Old Mutual, were paid a dividend on their ordinary shares. NMT Capital then sold its BEE equity stake in the listed property company Growthpoint. By 30 June 2018, the full dividend on the Old Mutual preference shares became due and payable. Four days later, on 04 July 2018, the Old Mutual CEO chaired an NMT Capital board meeting where the CEO — as shareholder and non-executive director of NMT Capital — proposed that a further R105 million ordinary dividend be declared, once more in spite of the R65.9 million dividend arrears on the Old Mutual preference shares. Apparently, the minutes of the NMT Capital board meeting reflected that it was noted that all the directors at the meeting were conflicted insofar as the dividend matter was concerned. Disregarding this conflict, an ordinary dividend of R28 million was paid the Old Mutual CEO (R21 million in his personal capacity and a further R7 million to a company owned by his family trust).

10. It took almost a year later for the wheels to come off. In May 2019, Old Mutual suspended its CEO on the grounds of conflict of interest and failing to protect Old Mutual shareholder value. Three weeks later, in June 2019, Old Mutual fired its CEO. This resulted in protracted litigation as the CEO challenged Old Mutual's right to fire him. The public spat saw a 17% drop in the Old Mutual share price and wiped out R16 billion of the firm's market capitalisation. The saga also caused the firm reputational damage.
11. The conflict of interest which Old Mutual fired its CEO for was very wittingly created by the firm itself when it made the appointment. The firm had no right to claim, quite after the fact and after the damage to shareholder value and its reputation, that it had laboured under the (mis)apprehension that the CEO would be mature enough to manage the conflict of interest. In this regard, the Old Mutual board of directors failed itself and its shareholders spectacularly. The protracted litigation that ensued had many of Old Mutual's institutional investors so exasperated that they urged the firm to settle the legal dispute between itself and its CEO soonest — even if it meant paying the CEO an amount

of money as a way to resolve the dispute. The litigation was, no doubt, destructive as it caused a loss in shareholder value and reputational harm to Old Mutual.

12. It remains surprising that firms — even very established ones — would become entangled in such serious corporate governance lapses when one would expect them to heed the lessons from many previous corporate scandals. No doubt, despite the Old Mutual saga, and the corporate scandals before the firm, we shouldn't be surprised to witness many more lapses in corporate governance.