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Introduction

The area of conflict of interest has long been the source of much debate both amongst board members and in the wider public domain. In the South African context conflicts often arise publicly in areas such as the awarding of tenders and the granting of jobs to relatives. However, directors are often at risk because they are unaware of the conflict or potential conflict.

The new requirements of the Companies Act, 2008 (The Act) has also brought the debate into the spotlight. Directors would be well advised to deal appropriately with conflicts of interest, given that perhaps the most significant protection for directors, the business judgement rule, requires that directors manage conflicts in accordance with the Act. Additionally, transactions entered into where a director had a conflict of interest may be voidable.

This paper focuses on identifying conflicts, either real or perceived, and also touches on conflicts from the perspective of the Companies Act, 2008. It also provides guidance to directors to assist them in assessing the appropriate manner of dealing with conflicts as they arise.

It is also important to note that whilst the paper discusses the concept of materiality in relation to conflicts, a conflict that is not material may nevertheless give rise to the perception that there is a conflict and this could result in reputational harm. There is therefore an added dimension to consider in making an assessment of whether to disclose a conflict that is not material.

A broad overview

What are conflicts?

Conflicts are defined in many ways; however, the basic elements of any of these definitions is the tension between multiple competing interests, be these personal or financial. This often manifests in the entanglement of the private and professional interests of an individual. These conflicts may be actual or perceived.

The perception of a conflict is influenced by whether an independent observer might question whether a director’s professional actions were motivated or influenced by a potential personal financial gain.

The existence of a conflict is, however, not necessarily an indication that an impropriety has occurred. As discussed below, the management of the conflict is a crucial step in dealing with these issues, and is the responsibility of the individual director. As King III states, the onus is on individual directors to assess whether he or she is free from apparent or actual conflicts.

Whilst the Act does address a limited range of conflicts, directors should bear in mind that those conflicts not covered by the Act may be covered by common law.

Common conflicts not recognised

There are many common conflicts which are often overlooked. Some argue that this is as a result of familiarity with the processes within the organisation that lead to a lackadaisical approach to conflicts. In assessing the duties of a director, the Act in Section 76 states that a director has a duty to act in good faith and for a proper purpose in the best interests of the company. The director also has a responsibility not to use the position as director to gain advantage for the director or for another person other than the company. It therefore follows that the wider definition of conflict of interest is embodied within the Act and forms part of the duties of the director.

Examples of common conflicts include:

- The CEO acting as a member of the remuneration, audit or nomination committees, rather than attending by invitation to discuss matters other than his or her own remuneration.
- A staff member or director accepting frequent or lavish entertainment or gifts from a supplier or contractor who has business dealings with the company.
- The director of a company proposing the appointment of a company that he or a close family member has a beneficial interest in.
- The director of a company whose family member is proposed for a position within the company or who is present when any aspect of that family member’s remuneration is discussed.
- Directors who are appointed by major shareholders or others who expect them to act on their behalf, and not necessarily in the best interest of the company on whose board they serve, (see also the ‘Representative Director’ position paper in this regard)
In addition, directors should consider whether they are conflicted when faced with the following situations:

- having multiple directorships – a director who sits on more than one board is obliged to notify the respective boards on which he or she serves as director;
- holding a material shareholding in a competing company or a company that is an actual or potential material customer of or supplier to the company;
- owning property adjacent to the company’s property or otherwise of value to the company that could affect, or be affected by, the company’s activities;
- having an advisory relationship (e.g., financial, accountancy, legal or consultancy) with the company or having an interest in an advisory firm that provides material services to the company;
- being a trustee of the company’s pension scheme whilst being a non-executive director of the company;
- being in a position to take up an opportunity that has been offered to the company even if the company has declined it;
- being in a position to make a profit as a result of his or her directorship; or
- being offered a role or commission by a potential bidder for the company.

**Materiality in the context of conflicts**

The materiality of the conflict remains an important area of judgment and should be assessed both from the perspective of the company and the individual. In exercising that judgment, the director considers the guidelines that are available, bearing in mind that there is no single measure of whether something is material or not.

One of the publicly available guidelines is issued by the ASX corporate governance council which suggests, in the publication “Principles of Good Corporate Governance and Best Practice Recommendations” that the determination of materiality requires consideration of both quantitative and qualitative elements. An item is presumed to be immaterial if it is equal to or less than 5% of the base amount. It is presumed to be material (unless there is evidence to the contrary) if it is equal to or greater than 10% of the appropriate base amount. This would seem a reasonable starting position for consideration by the board in determining thresholds for the company and its directors. The Board’s assessment should also factor in qualitative factors which may influence whether a relationship is considered material such as its strategic importance, the competitive landscape, the nature of the relationship and the contractual or other arrangements governing it and other factors which point to the actual ability of the director in question to shape the direction of the company’s loyalty.

The assessment must also consider materiality from the perspective of the director, in that whilst a holding may be immaterial to the company, it may well be material to the directors’ personal wealth.

The responsibility for declaring the interest and assessing whether this interest is material ultimately rests with the director.

However, good practice suggests that the director in all cases disclose the conflict and obtain advice from the board on the materiality of the matter. The assessment of whether the matter is material will remain that of the director. However, if challenged, the court will ultimately decide whether the transaction or interest in the matter was considered to be material.

The Companies Act also defines materiality. It states that material, when used as an adjective, means significant in the circumstances of a particular matter, to a degree that is:

a) Of consequence in determining the matter; or
b) Might reasonably affect a person’s judgement or decision making in the matter.

The Companies Act does not go into further detail regarding materiality.
When can conflicts be managed and when not?

King III states that certain conflicts of interest are fundamental and should be avoided. Other conflicts (whether real or perceived) should be disclosed in good time and in full detail to the board and then appropriately managed.

In assessing whether the conflict is fundamental and therefore must be avoided, the director considers the pervasiveness of the conflict and the period of time over which the conflict will occur. This will often involve judgement. However, an indicator to consider would be whether the director can continue in his or her current position whilst the conflict still exists. An example of such a conflict would be the appointment onto the board of a direct competitor. In such a situation, the competing director may find it impossible to avoid or manage the actual conflict, as well as the appearance of conflict. In this instance, the director should resign from the board of one of the companies.

However, there may be circumstances where the conflict can be managed. This may be the case where the conflict is not as pervasive, or relates to a decision that is taken only once. For example, where the conflict relates to the decision to make a donation to the soccer club of which the director’s child is a member, the director need not resign from the board of the company but will recuse himself from the decision relating to the donation.

In referring to the matter, King III states that it is not sufficient merely to table a register of interests. All internal and external legal requirements must be met. It is therefore clear that disclosure is not the cure for all conflicts.

It is also important to distinguish between actual conflicts and other perceived conflicts. An example of this may be where a director of a charitable organisation is also employed by one of the donors. In this case, though there may not be an actual conflict, there may be a perception that the company’s donations are made to entities which are represented by employees.

Where the conflict is one that is defined in the Act, it is imperative that the requirements of the Act are adhered to. However, where the conflict is not one defined in the Act, the requirements may no longer apply and the director must consider the manner in which the conflict may be managed. It will still be good practice to follow the suggested practices in the Act; however, directors should obtain legal advice in these situations.

Whether the conflict is considered to be one that may be managed or not, the relevant disclosures as required in the Act must at all times be adhered to. The reference to management of the conflict relates to whether the director may continue to operate in his or her current capacity or whether the director should consider terminating the appointment.

A Companies Act and King III perspective

Section 75 of the Act deals with directors’ personal financial interests. The term director here includes alternate directors, prescribed officers and members of committees of the board. It also applies to persons (individual and juristic) related to the director.

What is a personal financial interest?

The Act defines personal financial interest, when used with respect to any person to mean:

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

Since the concept of materiality is an important part of the definition of personal financial interest, it is important that the director is aware not only of what the Act defines as material but is also aware of the broader discussions around materiality, as discussed on page 4.

Exemptions from Section 75

Section 75 discussed above does not apply to a director of a company in respect of a decision that may generally affect all of the directors of the company in their capacity as directors; or a class of persons, despite the fact that the director is one member of that class of persons, unless the only members of the class are the director or persons related or inter-related to the director.

Section 75 also does not apply to a company or its director, if one person holds all of the beneficial interests of all of the issued securities of the company, and is the only director of that company.
Who are related persons as it relates to personal financial interest?

Furthermore, the requirements of s75 (5) also extend to persons, related to the director, who have a personal financial interest in the matter. This extends the circle of influence that the director must consider in making the assessment of whether he or she is conflicted.

Related persons means persons who are connected to one another in any manner contemplated in section 2(i) (a) to (c) which states that:

- An individual is related to another individual if they:
  1. Are married, or live together in a relationship similar to marriage, or
  2. Are separated by no more than two degrees of natural consanguinity or affinity
- An individual is related to a juristic person if the individual directly or indirectly controls the juristic person as determined in subsection 2

Additionally, Section 75(1) (b) includes in the definition of a related person any company or close corporation of which the director (or a related person) is also a director or member respectively.

In practice the director may or may not be aware of the interests of related persons in matters that are before the board. The director should take every reasonable step to obtain this information.

Actions required where a personal financial interest is present

Section 75 (5) of the Act states that if a director of a company has a personal financial interest in respect of a matter to be considered at a meeting of the board, or knows that a related person has a personal financial interest in the matter, the director—

- must disclose the interest and its general nature before the matter is considered at the meeting;
- must disclose to the meeting any material information relating to the matter, and known to the director;
- may disclose any observations or pertinent insights relating to the matter if requested to do so by the other directors;
- if present at the meeting, must leave the meeting immediately after making any disclosure contemplated in paragraph (b) or (c);
- must not take part in the consideration of the matter, except to the extent contemplated in paragraphs (b) and (c).

It is important to note that the ability of the director to disclose material information that he or she is aware of relating to the matter does not imply that the director should lobby the remainder of the board on the position that is of benefit to that director. The director in this situation should only provide the pertinent facts relevant to his or her fiduciary duty.

A King III perspective

King III goes on to state that a director who is appointed to the board as the representative of a party with a substantial interest in the company, such as a major shareholder or a substantial creditor, should recognise the potential for conflict. However, that director must understand that the duty to act in the best interests of the company remains paramount.

What is clear from the above is that both the Act and King III require appropriate disclosure of the conflict in a timely manner that allows other parties to the decision to make an informed decision. However, individuals may only make this disclosure when they are aware that they are conflicted. This is discussed below.

Acting independently and being independent

There are objective criteria that are indicative of whether a director is considered to be independent. These are discussed in King III. However, King III also states that ‘an independent director should be independent in character and judgement and there should be no relationships or circumstances which are likely to affect, or could appear to affect this independence. Independence is the absence of undue influence and bias which can be affected by the intensity of the relationship between the director and the company rather than any particular fact such as length of service or age.

Disclosure of personal financial interest

Previously, under the Companies Act of 1973, directors declared their interests on an annual basis. Under section 75(4) of the current Act it would appear that directors may, in advance, disclose their personal financial interests, which would then be considered to be disclosed until such time as this was changed or withdrawn by the director. It would appear therefore that the disclosure need only be made once; however, the director must still comply with the remaining requirements of the Act insofar as recusing him or herself from the meeting, etc. However, it would still be good practice to request directors to disclose their
interests on a periodic basis. It is also good practice to include disclosure of conflicts of interest as a standing item to the board agenda.

To the extent that a director or a related person acquires a personal financial interest in a matter in which the company already has a material interest which has been approved by the board, the director has a responsibility to disclose the nature and extent of the interest and the material circumstances relating to the acquisition of the interest. Such an event may occur, for example, the director inheriting shares in a company with which the company on whose board he or she sits having material transactions.

Where a conflict arises for the first time during a board discussion, the director should immediately consider whether the matter is material, both from his and the company’s perspective, and request additional time to consider the matter if so required. Where the director then assesses that a conflict does exist, he or she must declare the interest and take the necessary steps as envisaged in the Act.

Conclusion

Directors have a fiduciary responsibility to disclose conflicts of interest and to act with unfettered discretion. The good governance practices in this regard extend beyond what is contained in the Act and should be considered in all instances where a conflict of interest is considered. Where directors breach this duty they stand to attract civil and criminal sanction. Conflicts of interest have the potential to damage the company as any board decision taken in which a director has an undisclosed personal financial interest is void.

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INSTITUTE OF DIRECTORS IN SOUTHERN AFRICA

PO Box 908,
Parklands, 2121
144 Katherine Ave,
Grayston Ridge Office Park,
Sandown, Sandton

Tel +27 11 430 9900
Fax +27 11 444 7907