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CORPORATE & COMMERCIAL **ALERT**

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How not to resolve a conflict of interests where the entire board of directors is conflicted

A persistent problem with the practical application of s75 of the Companies Act, No 71 of 2008 (Companies Act) relates to the conflicts of interest of common directors in the context of intra-group transactions. The objective of this article is not to cover any new ground with respect to s75, but rather to critique the argument that s75(2)(a)(i)(ii) excludes the application of s75 in such cases.

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How not to resolve a conflict of interests where the entire board of directors is conflicted

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A persistent problem with the practical application of s75 of the Companies Act, No 71 of 2008 (Companies Act) relates to the conflicts of interest of common directors in the context of intra-group transactions. The objective of this article is not to cover any new ground with respect to s75, but rather to critique the argument that s75(2)(a)(i)(ii) excludes the application of s75 in such cases.

The problem

For the purposes of our argument below, it may be useful to summarise the problem referred to above as follows –

1. Section 75, among other things, requires a director to recuse herself from a board meeting (it is general practice to apply this also to "round robin" written resolutions under s74 of the Companies Act) whenever a person "related" to her has a material personal financial interest in the matter to be considered at the meeting. In other words, the foregoing director is not permitted to vote on the applicable resolutions.
2. A "related person" for the purposes of the section, includes a second company of which that director is also a director. Therefore, if (A) a holding company (Guarantor) provides a guarantee in respect of a loan to be advanced to its subsidiary (Borrower) (i.e. financial assistance is to be provided by one group company to another group company), and (B) the same person is a director of both the Borrower and the Guarantor, that common director of both group companies is not permitted to vote in respect of any resolution to authorise the foregoing financial assistance.
3. It happens every so often that both group companies have "mirror boards". In other words, the board of directors of both group companies are identical. The practical effect of this is that the entire board of directors of the Guarantor is ruled out of being able to participate in the board resolution (in that one can accept that the Borrower has a direct and material financial interest in the Guarantor's board approving the guarantee), which would render the passing of any resolutions impossible, if not for the ability of shareholders to ratify the board resolution by way of ordinary resolution. Unlike the company statutes of a number of other jurisdictions, s75 does not contain a carve out in this regard for the group company context.

The solution

The only method to resolve this "stalemate" is therefore to (A) have all the directors of the Guarantor disclose the personal financial interest (being the Borrower's interest in the matter to be decided by the board of directors of the Guarantor), to nevertheless vote on the matter, and to then have the shareholders of the Guarantor ratify the board resolution by way of ordinary resolution. It is uncontroversial that under common law, shareholders enjoy the authority to ratify board resolutions despite a breach by the directors of, among others, this no conflict rule. Furthermore, it is arguably a logical extension of the principle in s75(3) which provides that where a company has a sole director, and that director is conflicted under s75, the director may still proceed to vote but must additionally obtain shareholder approval.

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How not to resolve a conflict of interests where the entire board of directors is conflicted...*continued*

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What not to do

In numerous transactions in which we have acted for both lenders and borrowers, the argument has been raised that s75(2)(a)(i)(ii) excludes the application of s75 and that shareholder ratification is therefore not required.

Section 75(2)(a)(i)(ii) provides, among other things, that "*this section [75] 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*". The argument in support of this interpretation appears to be that: the conflict of interests (broadly) affects all of the directors in their capacity as directors and therefore the section does not apply.

We are the view that this interpretation is incorrect for the following reasons –

1. Section 75(2)(a)(i)(ii) clearly refers to a "*decision that may generally affect all of the directors of the company in their capacity as directors*". A decision that would generally affect all of the directors in their capacity as such relates, for example, to their remuneration for their services as directors or the purchase of insurance to protect the directors.
2. For s75(2)(a)(i)(ii) to apply, it is clear that the decision must affect the director in her capacity as director (of the first company i.e. the Guarantor), and not in any other capacity (i.e. as director of the second company i.e. the Borrower). In other words, if a company is to contract with all five of its directors individually, then all the directors are conflicted and the section applies, as the conflict relates to their capacity as a party to a contract and not to their functions as directors.
3. Section 75(3) provides that where a company has a sole director and that director is conflicted, any decision by that sole director must be approved by an ordinary resolution of the shareholders. It follows then that where all the directors are conflicted, whether it is a sole director or a board of twelve directors, shareholder approval is required. There is no rational reason why the legislature would have intended to distinguish between these two situations.

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How not to resolve a conflict of interests where the entire board of directors is conflicted...*continued*

It is submitted that where all the directors of a company are conflicted, on the basis that they are all directors of a second company which has a direct and material financial interest in the matter to be considered, s75(2)(a)(i)(ii) does not exclude the need for shareholder ratification.

4. If the argument is to be accepted that s75(2)(a)(i)(ii) does exclude the application of s75 as described above, the following absurd conclusion would follow –

    4.1 **Scenario 1:** Company X has five directors, four of which are also directors of Company Y. If Company X provides financial assistance to Company Y, then the four conflicted directors are required to disclose the personal financial interest and recuse themselves, leaving the one non-conflicted director with a vote to pass the resolution.

    4.2 **Scenario 2:** Company X has five directors, all of which are also directors of Company Y. If Company X provides financial assistance to Company Y, then the directors of Company X are free to vote as they please without the need for shareholder ratification, as they are all conflicted. The strange result is that a more lenient position applies (i.e. all directors may participate and vote) where every single director is conflicted and therefore where the risk of an unobjective vote is at its greatest. Why would they have a free pass to proceed without any shareholder involvement?

Thus it is submitted that where all the directors of a company are conflicted, on the basis that they are all directors of a second company which has a direct and material financial interest in the matter to be considered, s75(2)(a)(i)(ii) does not exclude the need for shareholder ratification.

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