PRACTICE NOTES

Retirement by rotation of executive directors

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Retirement by rotation of executive directors

Introduction

The purpose of this document is to provide guidance on the requirement for directors to retire by rotation and to explain why, for rotation purposes, a differentiation is being made by the King Committee between executive and non-executive directors.

This Practice Note follows the following format:

- Provision of background information relevant to the discussion, including:
  - King Report and Code on Governance 2009 (King III) and Companies Act, 2008 (the Act) on election of directors and rotation
  - Categories of directors and their respective governance function
  - Role of the board vis-a-vis the role of shareholders
- The unintended consequences of executive retirement by rotation taking into account the background information
- Conclusion and recommendations

BACKGROUND INFORMATION

King III and Companies Act on election and rotation of directors

The relevant paragraphs from Chapter 2 in King III read as follows:

"73. As a minimum, two executive directors should be appointed to the board, being the chief executive officer (CEO) and the director responsible for the finance function. This will ensure that there is more than one point of contact between the board and the management. From June 2009, listed companies must appoint a financial director to the board.

74. A programme ensuring a staggered rotation of non-executive directors should be put in place by the board to the extent that it is not already regulated by the company's memorandum of incorporation or relevant regulation. Rotation of board members should be structured so as to retain valuable skills, maintain continuity of knowledge and experience and introduce people with new ideas and expertise.

75. At least one-third of non-executive directors should retire by rotation yearly, usually at the company's AGM or other general meetings, unless otherwise prescribed through any applicable legislation. These retiring board members may be re-elected, provided they are eligible. The board, through the nomination committee, should recommend eligibility, considering past performance, contribution and the objectivity of business judgement calls."

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Schedule 10.16(b) of the JSE Listings Requirements (the Requirements) provides that all directors’ appointments (both executive and non-executive) are subject to shareholders’ approval. However, schedule 10.16(g) of the Requirements supports King III in that it requires only non-executive directors to rotate. This is obviously only a minimum standard, but was introduced as such by the JSE as the potential problems associated with retirement of executive directors by rotation were recognised. Similar provisions were also in the previous version of the Requirements that dealt with the Articles of Association.

The Companies Act, 2008 (the Act) allows for *"the direct appointment and removal of one or more directors by any person named in or determined in terms of the Memorandum or Incorporation"* (the MoI) subject thereto that in the case of a for profit company the MoI *"must provide for the election by shareholders of at least 50% of the directors".* (Refer to section 66(4)(a)(i) and (b)). It further allows that the MoI may provide for *"a person to be an ex officio director of the company as a consequence of that person holding some other office, title, designation..."* (Refer to section 66(4)(a)(ii)).

Therefore, in terms of the Act:

- directors may be elected and removed by shareholders,
- directors may be directly appointed by persons other than shareholders as provided for in the MoI, or
- a person may become a director by virtue of holding a specific position in relation to the company.

It also needs to be noted that for listed companies the Requirements do not allow the appointment of directors other than by shareholders.

The Act does not provide for, nor require, retirement of directors by rotation. Staggered rotation of directors is recommended as a good corporate governance practice.

Categories of directors

Whilst there is in law no distinction between executive and non-executive directors in terms of directors' duties and liability for breaching those duties, it needs to be acknowledged that there are differences in the respective functions/roles from a governance perspective. The terminology "executive directors", "non-executive directors" and "independent non-executive directors" are purposely distinct in order to practically differentiate amongst these various governance roles.

The executive director participates in the board room wearing two hats. On the one hand executives are full time employees of the company and in this capacity they will usually have a contract of employment with the company. On the other hand, executive directors are also office bearers of the company who need to act and bear responsibility within the scope of statutory and common law duties and liabilities of directors. A major part

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of executive directors' participation in board meetings involves reporting to non-executive directors on behalf of the management of the company.

Non-executive directors bring to bear a broader perspective, a wider background and range of skills. Their role is to balance the power of the executive and to serve as a counterfoil to management serving self-interest. The objectivity of independent non-executive directors further strengthens this function and hence the shift in corporate governance in recent time towards greater independence on boards.

The power within the board should be carefully balanced and much of the board's effectiveness as a governance structure hinges on the dynamics of the relationship between executives and non-executive directors.

Role of the board vis-a-vis the role of shareholders

Shareholders invest their money to provide risk capital for the company and shareholders' rights are enshrined in law and the incorporation documents of the company. These rights include to set the objectives of the company and to appoint the directors. Shareholders do not have the right to be involved in the day-to-day business of the company.

The board's role includes to direct and control the company and to appoint and remove management.

Section 7(i) of the Act states as one of its objectives the balancing of the rights and obligations of shareholders and directors within companies. Various legal mechanisms have been created in the Act for this purpose. The board must for instance call a shareholder meeting in the event that a written demand compliant with section 63(1) is received. Section 65(3) furthermore provides that any two shareholders of a company may propose for submission for consideration by shareholders a resolution concerning any matter in respect of which they are each entitled to exercise voting rights. Shareholders are also in terms of section 71 entitled to remove a director by means of an ordinary resolution.

UNINTENDED CONSEQUENCES OF EXECUTIVE RETIREMENT BY ROTATION

Staggered director rotation is a necessary and beneficial corporate governance practice. It balances retention of experience and knowledge about the company's operations and business affairs with bringing new thinking and fresh perspectives to board decision-making. It is also necessary to maintain independence on the board. Retirement by rotation normally happens at time intervals of 3 years in respect of each director and as such, this mechanism is not intended to address matters of performance which require immediate intervention.

The premise that this Practice Note is drafted on is that an executive director would in all probability resign if not re-elected as a director because there is a perceived loss of status and an explicit loss of confidence in the ability of the executive director. Alternatively, chances are that the board may want to relieve him/her of his/her duties as an

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employee. If this premise is correct, it follows that shareholders effectively have a say on the appointment of the executive.

There are reasons why shareholders may potentially not re-elect an executive employee as a director. These may include dissatisfaction with the employment contract, the executive exerting too much power on the board or a lack of skills as an executive employee. All of these point to the relationship between the board and management and are directly related to the board's governance role as having to oversee management. From a governance perspective allowing the shareholder to intervene through the mechanism of re-election by rotation disturbs the balance of power between shareholders and the board vis-a-vis the company.

This is not to deny shareholders the opportunity to provide input in these matters, but rather to facilitate the maintenance of a sound governance system of checks and balances. Not approving the executive employee's re-election as director will not solve any of these matters. In any event, if any of these circumstances are present, it would be questionable of shareholders to wait for the executive to rotate before they raise these concerns.

The following unintended adverse consequences may follow from a practice to subject executive directors to retirement by rotation:

- Subjecting executive directors to the process may erode the relationship between management and the board and inadvertently lead to a situation where the executive is perceived to be primarily accountable to the shareholders.
- Indirect "control" over operations through the appointment of executive directors may put shareholders in a position to direct the company to their own advantage to the detriment of other stakeholders and long-term sustainability. Although the assumption is not that investors will necessarily act in a mala fide manner, it should also be acknowledged that one of the tenets of sound governance is the existence of checks and balances and an appropriate balance of power amongst the role players. Also it is poor governance to split authority and responsibility.
- Should the executive be subjected to this process and not be re-elected by the shareholders as director, neither the board nor that executive can ignore the consequence even if the employee contract remains intact. This may also expose the company to the consequences of losing a key employee at short notice and in addition may be contrary to the terms of the employment contract.
- Companies may attempt to avoid the adverse consequences of executive directors not being re-elected on rotation by not having any member of management serving as a director. This will work against the King III recommendations of a balance of executive and non-executive directors, with the CEO and director responsible for finance as a minimum being appointed as executive directors.
- Retirement by rotation is generally applied on a three-year rolling basis; which, if applied in respect of executive directors, could aggravate these unintended consequences.

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CONCLUSIONS AND RECOMMENDATIONS

The insistence by some shareholders that MoI's that are tabled for adoption at the AGM include the requirement that executive directors are subjected to retirement by rotation is not a reflection of South African legal or regulatory requirements, nor of King III.

It is also acknowledged that shareholders are not legally prohibited to follow this course of action in the event that there may be legitimate concerns regarding executive performance and succession of senior executives.

Some of the principles that director rotation seeks to address (i.e. bringing in fresh perspectives, ensuring a smooth transition, retain knowledge) could also be applicable to executive directors on fixed term contracts. However, director rotation as contemplated for non-executive directors is inappropriate and serves no purpose insofar as executives are concerned. The succession of executive directors should therefore be dealt with by the board through difference processes.

As a matter of sound governance, executive rotation is a matter for the board. The board is in the best position to judge the performance of executive directors, both as members of management and in how they fulfil the role as directors. If there are therefore concerns or dissatisfaction about the performance or the role of an executive director, a more constructive approach would be for shareholders to engage with the board on the performance measures set for the executive and how these are monitored and enforced. The board can then deal with the matter in terms of the contract of employment and even consider staggered periods for fixed term contracts.

The Act furthermore affords shareholders the right to call for meetings, to table resolutions to be considered at those meetings and to remove directors. The above recommendations do not in any way affect a shareholders unfettered right (subject to following the appropriate process) to remove any director.

It is submitted that where there is dissatisfaction with executive employment matters, the board should be held accountable in this regard and not only the executive director. By choosing retirement by rotation, shareholders may be opting for a blunt instrument whereas there are more appropriate alternatives available in the interest of all concerned.

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