

DOES SOUTH AFRICA NEED A STATUTORY BUSINESS JUDGMENT RULE?

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CHAPTER 1: INTRODUCTION

1. CORPORATE GOVERNANCE

- 1.1 Corporate governance and standards of directors' conduct have become increasingly important during the past two decades. Corporate governance generally refers to the manner in which companies are managed and controlled¹. In the light the collapse of several large national and international companies, notably Enron group of companies in the United States and the Fidentia scandal in South Africa², the public eye has increasingly fallen on directors of companies to perform their functions honestly and with high levels of integrity³. Good corporate governance has become a buzzword of the 21st century.
- 1.2 As a result of the fact that many directors do not conform to the standard of care the company's stakeholders expect of them, there has been a global drive to reinforce codes and principles of good corporate governance.
- 1.3 In South Africa this trend has also been observed and the Department of Trade and Industry has published a policy paper⁴ during 2004 with the purpose of modernizing company law and aligning it with growing international trends in order to accommodate the changing needs of business, both in South Africa and internationally⁵. It was further specifically proposed to clarify the responsibilities, duties and liabilities of directors⁶ The repeal of the Companies Act no. 61 of 1973 and the replacement thereof with the Companies Act no 71 of 2008 (hereinafter referred to as "the Companies Act"), was the upshot of the abovementioned process⁷.
- 1.4 A significant change occasioned by the Companies Act is the partial codification of director's duties. Directors' duties stand central to ensuring the promotion of good corporate governance⁸ and have traditionally been judicially developed by the courts on a case by case basis⁹. The Companies Act, 1973 did not contain clear prescriptions regarding the duties of directors and the content of these duties was mainly found in

¹ Mongalo (2003) *SALJ* 173.

² Makuta (2009) *MLJ* 58, Matsimela (2011) *Company Law Hub Journal of Student Research Vol 1 Article 5* 1.

³ Cassidy (2009) *Stell JR* 373.

⁴ South African Company Law Reform for the 21st Century – Guidelines for Company Law Reform, published under Government Gazette no. 26493 of 23 June 2004.

⁵ *Ibid*, Matsilela *supra* 1.

⁶ Cassidy *supra* 373.

⁷ *Ibid*.

⁸ *Ibid*.

⁹ Cassim (2010) *Contemporary Company Law* 1st Ed.461.

the common law, as augmented with publications such as the King Report on corporate governance¹⁰.

- 1.5 At common law, a director owes two types of duties to his company: fiduciary duties and the duty of care, skill and diligence. In terms of these duties, a director is required to exercise his powers *bona fide* and for the benefit of the company on the one hand and to show reasonable care and skill in performing the functions required by his office¹¹ on the other hand. The effect of these duties is to protect shareholders and members of the company against misconduct by the directors and to ensure that the directors do not venture beyond the scope and boundaries of their duties¹².

2. **BUSINESS JUDGMENTS**

- 2.1 Fundamentally related to, and to a certain extent overlapping, the duty of care is that which is known as the business judgment rule¹³.

- 2.2 The business judgment rule is a standard of judicial review which was developed by the American judiciary¹⁴. Essentially the business judgment rule entails that courts should exercise caution in holding directors liable for *bona fide* business decisions which result in damage or loss to the company¹⁵. Together with the duty of care, the effect of the application of the business judgment rule is that a director, who made a decision in good faith, with due care and on an informed basis which he reasonably believed to be in the best interest of the company, cannot be held liable in respect of that decision¹⁶.

- 2.3 The business judgment rule affords directors considerable deference in respect of such business decisions when these are challenged by shareholders or other stakeholders through derivative litigation or by disinterested parties as contravening the required standard of care¹⁷. The rule also applies when directors act collectively as a board or a committee of the board.

- 2.4 In South Africa, the application of the business judgment rule as developed by the American courts, has been a much debated topic. In 1994, the King Committee on

¹⁰ *Infra* Chapter 4.

¹¹ Cilliers, Benade et al (2000) *Corporate Law* 3rd Ed. 139.

¹² *Ibid.*

¹³ Kennedy-Good (2006) *Obiter* 64.

¹⁴ *Ibid.*

¹⁵ *Ibid.*

¹⁶ *Ibid.*

¹⁷ Matismela *supra* 2.

Corporate Governance recommended in the King Report that it should be considered to amend the Companies Act, 1973 to include a statutory form of the business judgment rule. This proposal has been criticised by many commentators, whose views will be set out in more detail in the chapters below.

- 2.5 It has therefore become a contraversial issue whether it would be necessary or desirable to introduce the business judgment rule into our law in order to protect directors who in good faith make certain business decisions, from incurring personal liability for mistakes that led the company to suffer losses¹⁸
- 2.6 This debate has now to a large extent been settled, as the new Companies Act introduces an American style business judgment rule into our law in section 76(4)(a). There are, however, commentators who strongly criticised the inclusion of the rule into South African law and argue that the proposals on which the rule was introduced have been founded on inadequate research.

3. **SCOPE OF THIS DISSERTATION**

- 3.1 This dissertation addresses the question of whether the legislature was correct in introducing a business judgment rule into South African law by codifying it in the Companies Act and whether it is necessary to have a statutory business judgment rule in South Africa. In exploring the topic, the origins of the rule in American law are examined, as well as the elements and requirements for its successful application in its resident jurisdiction. The American business judgment rule has been described as a “great river” which has followed a “long and winding course”¹⁹ in its inception and which is, as a result, quite advanced and well-developed.
- 3.2 Regard is also had to other jurisdictions in which the inclusion of the business judgment rule has been considered. The rule has, for instance, been accepted into Australian and German company law but was rejected in the United Kingdom.
- 3.3 The inclusion of the rule into South African company law is discussed with reference to the common law duty of care and skill, the arguments for and against its codification and the ultimate version of the rule which was enacted in the Companies Act.
- 3.4 The conclusion following the aforementioned inquiries is set out last in Chapter 5.

¹⁸ Kennedy-Good *supra* 63.

¹⁹ Du Plessis (2011) *The Company Lawyer* 347.

CHAPTER 2: DEVELOPMENT OF THE BUSINESS JUDGMENT RULE IN AMERICA

1. INTRODUCTION

- 1.1 American corporate directors owe fiduciary duties to the companies in which they are appointed as well as to their shareholders. Amongst these fiduciary obligations are the duty of care and the duty of loyalty²⁰. The duty of care requires directors to exercise that standard of care that an ordinarily cautious person would exercise in similar circumstances. The duty of loyalty, on the other hand, involves that directors may not be conflicted in their decisions and accordingly prohibits faithlessness and self-dealing²¹.
- 1.2 The business judgment rule is a tool of judicial review²² that has developed in the United States of America as a common law rule relating to directors' duty of care during the past two centuries. It has been described as one of the least understood concepts in the entire corporate law field²³ and has its origins in the state of Delaware where its existence is firmly entrenched.
- 1.3 The rule essentially serves as a "safe harbor" from liability in cases where a director has made an informed decision, not involving self-dealing, which has been made in good faith and on a rational basis²⁴. A director will accordingly not be found to be in breach of the duty of care and be personally liable to the company if he acted without self-interest, in an informed manner and with the rational belief that his decision was in the best interest of the company.
- 1.4 It has been observed that the business judgment rule was developed "because of a desire to protect honest directors and officers from the risks inherent in hindsight review of their unsuccessful decisions, and because of a desire to refrain from stifling innovation and venturesome business activity"²⁵.

²⁰ Botha (1997) *SALJ* 73.

²¹ *Ibid.*

²² *Ibid.*

²³ Lee (2003) *Columbia Law Review* 939.

²⁴ *Ibid.*

²⁵ Havenga (2000) *SA Merc LJ* 28; American Law Institute *Principles of Corporate Governance and Structure: Restatement and Recommendations* (1982).

- 1.5 The rule is fundamentally a standard of judicial review rather than a standard of conduct, and provides that courts should exercise restraint in holding directors liable for poor business decisions, subject to compliance with the above requirements²⁶.
- 1.6 This chapter examines the origin and purpose of the business judgment rule, its relationship with the duty of care, characteristics and problems. This historical analysis into the origins of the rule is important for purposes of establishing whether the statutory codification thereof in South African company law is necessary²⁷.

2. **PURPOSE OF THE BUSINESS JUDGMENT RULE**

- 2.1 The most commonly cited reasons for the existence of the rule are that it (1) promotes risk taking and allows shareholders to voluntarily take risk, (2) encourages competent persons to serve as directors; (3) prevents judicial second-guessing; (4) allows directors sufficient freedom to manage the company and (5) allows more effective market mechanisms to manage director behaviour²⁸. These five basic purposes will be briefly discussed below.

2.2 **Promotion of risk taking**

- 2.2.1 The main argument advanced by supporters of the business judgment rule is that there is a need to encourage risk-taking on the part of directors. In absence of the rule directors would have to be more cautious, perhaps excessively so, as business decisions which are subsequently evaluated to have been improper can expose them to personal liability²⁹. Shareholders will further benefit by getting better returns on their investments when directors know that they can take risky decisions without the fear that they may be successfully sued should such decisions not ultimately benefit the company or the shareholders themselves³⁰. Removal of the business judgment rule may cause honest directors to exercise excessive caution and may ultimately stifle effective leadership.
- 2.2.2 The rule therefore operates to provide directors with certain discretion and allows the company to regulate its risk levels. It has been argued³¹ that if the shareholders are not comfortable with the direction and risk taken by the directors,

²⁶ Kennedy-Good (2006) *Obiter* 64.

²⁷ Chapter 4 below.

²⁸ Lee *supra* 945.

²⁹ *Ibid.*

³⁰ Rosenberg (2006) *Journal of Corporation Law* 2.

³¹ Kennedy-Good *supra* 65.

they can sell their shares and invest in another company with which they are more at ease. Without the business judgment rule, the courts would in fact be indirectly determining the risk level companies³².

- 2.2.3 It has been argued that this element of the business judgment rule will, instead of contributing to a higher standard of good corporate governance, in fact contribute to a higher level of corporate misconduct³³ by encouraging directors to engage in riskier behaviour than they normally would have done because they cannot be “second guessed” by the courts if they have acted within their duty of care.

2.3 Competent persons to act as directors

- 2.3.1 There is a need to persuade competent, efficient and independent persons to act as directors³⁴. Due to the fact that directors often earn relatively low remuneration for their positions (especially in the case of non profit directors), there is some concern that qualified persons will be reluctant to assume the office of director³⁵.

- 2.3.2 Lee states that the above argument has been made despite the fact that many directors are very well paid for the rather inconsequential time they spend discharging their duties³⁶. The business judgment rule affords directors, especially non profit directors, protection from personal liability.

2.4 Judicial second guessing

- 2.4.1 A further argument in favour of the business judgment rule is that courts and judges are not in the best position to evaluate business decisions as economics and business practice fall outside their scope of expertise³⁷. After the fact litigation is not a suitable tool to evaluate corporate business decisions.

- 2.4.2 It has also been suggested that, since the judiciary will have the benefit of hindsight in evaluating the conduct of a particular director, an unjustified high level of scrutiny will be applied³⁸. If judges fail to respect *bona fide* business decisions

³² Veasey (1982) 37 *The Business Lawyer* 1266.

³³ Jones (2007) SA Merc LJ 333.

³⁴ Kennedy-Good *supra*.

³⁵ Lee *supra* 949.

³⁶ *Ibid* at 950.

³⁷ *Ibid* at 951, Kennedy-Good *supra* 65.

³⁸ Lee *supra* 954.

of directors which are taken on an informed basis, it could very well have the effect that the courts would become “super directors”³⁹.

2.5 Avoiding shareholder management of company

2.5.1 The business judgment rule allows directors, rather than shareholders, to manage the company’s affairs⁴⁰. Lee contends that without the protection of the business judgment rule, shareholders would litigate more often in an attempt to influence the managerial direction of the company.

2.5.2 In presence of the rule, shareholders will think twice before instituting action against the directors, especially in light of the high costs of litigation.

2.6 Market mechanisms

2.6.1 Due to the competitiveness of the modern corporate environment, directors must ensure that the company is well managed in order to remain in the market⁴¹. Directors must further act with care as they may easily be removed from their positions if they fail to apply reasonable care.

2.6.2 Lee argues that “in the corporate context, implementing an ordinary negligence standard, by not granting the safe harbor protection of the business judgment rule, is arguably less necessary to curb director misbehavior, due to the many self-enforcing market mechanisms that control corporate conduct just as well as the threat of litigation”⁴².

2.6.3 Examples of such market mechanisms are strong competition in the market and the fact that directors are often given shares or stock in their companies as part of their remuneration package, which contribute to the directors acting with a higher level of care⁴³.

³⁹ *Brehm v Eisner* 746 A.2d 244 (Del. Supr. 2000) 266, quoted in Kennedy Good *supra* at 66.

⁴⁰ Lee *supra* 955.

⁴¹ *Ibid* at 957.

⁴² *Ibid*.

⁴³ Kennedy-Good *supra* 66.

3. COMMON FORMULATIONS OF THE RULE

3.1 There are only two formulations of the business judgment rule that have been widely adopted in the United States: the American Law Institute (“ALI”) version and the Delaware business judgment rule⁴⁴.

3.2 The ALI version of the rule has been adopted by the highest courts of several states and can be found in par. 4.01(c) of the ALI Corporate Governance Project⁴⁵, which provides:

“4.01 (c) a director or officer who makes a business judgment in good faith fulfils the [duty of care] if the director or officer:

(1) is not interested in the subject of his business judgment;

(2) is informed with respect to the subject of the business judgment to the extent that the director or officer reasonably believes to be appropriate under the circumstances;

(3) rationally believes the business judgment to be in the best interest of the corporation.”

3.3 A director will therefore escape liability for an alleged breach of the duty of care if (a) he (or an officer of the corporation) made a judgment or decision, (b) as decision maker he was free from conflict of interest, (c) he exercised reasonable care in making the decision and (d) he had a rational basis for the decision⁴⁶. It is clear that for a director to have the benefit of the business judgment rule, a decision must have been made⁴⁷, otherwise the rule does not apply.

3.4 It has been argued with regard to the above formulation of the rule that if “reasonable” care or a “reasonable” basis for a decision were required, the courts would have to “hold plenary trials”⁴⁸ as questions of reasonableness are decided in court. The business judgment rule would therefore not serve its function. A defending director will accordingly only need to show a slight standard of care and provide a rational or credible basis for his decision.

⁴⁴ Branson (2004) *Hong Kong LJ* 305.

⁴⁵ American Law Institute, ALI Corporate Governance Project (Philadelphia: American Law Institute (1994)).

⁴⁶ Branson *supra* 306.

⁴⁷ Havenga *supra* 28.

⁴⁸ Branson *supra* 306.

- 3.5 The ALI version of the rule has been described as a “safe harbour”⁴⁹. The directors carry the burden of proof to demonstrate compliance with the rule’s elements. Upon conformity with the rule’s elements, a director will not incur liability for a business decision, no matter how bad the outcome thereof may be.
- 3.6 The Delaware courts on the other hand have formulated the rule along the lines of a presumption. The rule was described in *Aronson v Lewis*⁵⁰ as “a presumption that in making a business decision the directors of the corporation acted on an informed basis, in good faith and in the honest belief that the action taken as in the best interest of the corporation”. Unless a plaintiff can rebut this presumption, directors’ decisions will be respected by the courts, therefore exonerating directors from personal liability.
- 3.7 Contrary to the ALI formulation of the rule, in Delaware a plaintiff must accordingly show that the director or the board was tainted by a conflict of interest. This reverse burden exists because of the formulation of the rule as a rebuttable presumption and the shareholder therefore has to establish non-compliance with the elements of the rule by the director in question or the board⁵¹. In so doing, a plaintiff can either challenge the substance of the director’s decision or the procedure that the director used in arriving at the decision. The plaintiff would further have to show that the decision was so irrational that no reasonable business person would have made the decision, as well as that the board was grossly negligent in failing to consider all material information when arriving at the decision⁵².
- 3.8 Nearly every formulation of the rule under Delaware law requires that the directors must act honestly or in good faith⁵³. The precise meaning of “good faith” is a much debated topic, but the principle of good faith has been equated to rationality by Chancellor Allen in *In re RJR Nabisco Inc Shareholders Litig.*⁵⁴ by stating that: “such limited substantive review as the rule contemplates (i.e. is the judgment under review “egregious” or “irrational” or so beyond reason etc) really is a way of inferring bad faith”. All commentators agree that the courts ought to be able to review a director’s decision if such decision is either irrational or made in bad faith⁵⁵.

⁴⁹ *Ibid.*

⁵⁰ 473 A 2d 805, 812 (Del 1984), cf *Warshaw v Calhoun* 221 A 2d 487, 492 – 493 (Del 1966).

⁵¹ Branson *supra* 306.

⁵² Aman (2010) *Albany Law Review* 7.

⁵³ Rosenberg (2006) *Berkeley Electronic Press* 1067.

⁵⁴ 1989 WL 7036 13 (Del. Ch. 1989), quoted by Rosenberg *supra* 15.

⁵⁵ Rosenberg *supra* 21.

4. **COMPONENTS OF THE RULE**

4.1 In order for the business judgment rule to apply, the courts will consider the business decision or judgment, whether the decision was an informed one, absence of conflict of interest, good faith and whether the directors believed that the decision would be in the best interests of the company. Each of these elements will briefly be analysed below.

4.2 **Decision or judgment**

4.2.1 For a director to benefit from the business judgment rule, he or she must have made a conscious decision. A failure to act will not be protected by the rule, unless the director made a deliberate decision not to take specific action⁵⁶. The rule does not apply if no decision has been made⁵⁷. It has also been argued⁵⁸ that “rubber-stamping the CEO’s or controlling shareholder’s wish or command will not do.”

4.2.2 In arriving at decisions, directors are expected to evaluate the various risks relating thereto, including factors influencing the assumption or avoidance of risk⁵⁹. Decisions can further be grouped into ordinary business decisions, such as the sanctioning of a dividend, and extraordinary decisions, such as a merger or acquisition of a large asset. In the context of ordinary decisions, the application of the business judgment rule has been described as “straightforward”⁶⁰, whereas extraordinary decisions require closer scrutiny.

4.3 **Decision must have been an informed one**

4.3.1 In evaluating a particular decision, the court will firstly consider whether the directors had regard to all relevant available information at hand⁶¹. This inquiry involves an exploration of the process employed by the directors in arriving at the decision⁶², the specific methodology as well as whether the directors were assisted by books, reports or other expert opinion⁶³.

⁵⁶ Kennedy-Good *supra* 67.

⁵⁷ *Ibid.*

⁵⁸ Branson (2002) *Val U L Rev* 631.

⁵⁹ Kennedy-Good *supra* 67.

⁶⁰ *Ibid.*

⁶¹ *Thomas v Kempner* 398 A 2d. 320 (Del Ch. 1979).

⁶² Veasey (1982) *The Business Lawyer* 1252.

⁶³ *Ibid.*

4.3.2 The salient decision in this context is *Smith v Van Gorkom*⁶⁴, also referred to as “the Trans Union case”. The case was succinctly summarised by Kennedy-Good⁶⁵ as follows:

“Van Gorkum was the chairman and Chief Executive Officer of Trans Union Corporation. In August 1980 Van Gorkum met with senior management of Trans Union, at which time the sale of the company was discussed. By September 1980 Van Gorkum had found a buyer, Pritzker, who was willing to pay \$55 per share. This particular offer was disclosed to senior management. The reaction to the offer was negative and it was contended by the Chief Financial Officer of Trans Union that the price was too low. Despite the pessimistic attitude of management, Van Gorkum proceeded to present the offer to the board of directors. The members of the board had extensive knowledge concerning the characteristics of the company and were familiar with the company’s current financial standing. Van Gorkum’s presentation to the board concerning the sale lasted a mere 20 minutes and the board was not afforded an opportunity to study the merger agreement. Van Gorkum further failed to disclose the methodology that was utilised to arrive at the sale price of \$55 a share. Based on this meeting, which lasted 2 hours, the board approved the merger agreement. The agreement was subsequently executed without Van Gorkum or any other director having read the agreement.”

4.3.3 The court found that the directors did not make an informed decision under the circumstances and that they were grossly negligent in approving the sale at \$55 per share with a mere two hours’ deliberation. The court stated that: “...we think that the concept of gross negligence is the proper standard for determining whether a business judgment reached by a board of directors is an informed one”⁶⁶. The court further found that the board could not have come to an informed decision on the merger by a simple presentation by Van Gorkum⁶⁷, and resultanty the business judgment rule could not be applied.

4.3.4 The decision has been criticised by various commentators. Herzel and Katz⁶⁸ contend that the court erred in that it failed to appreciate that –

4.3.4.1 courts are not well equipped to evaluate a director’s business acumen, especially since they only review one decision at a time;

⁶⁴ 488 A 2d. 858 (Del 1985).

⁶⁵ Kennedy-Good *supra* at 68.

⁶⁶ 488 A 2d at 873.

⁶⁷ Kennedy Good *supra* 69.

⁶⁸ Herzel and Katz (1986) *The Business Lawyer* 1187.

4.3.4.2 courts need to help directors to be bold, as the threat of litigation will make them over-cautious; and

4.3.4.3 good decision making is almost impossible to describe and that courts are not able to “codify the practices of a careful board”.

4.4 **Absence of conflict of interest**

4.4.1 It is a further requirement that the director must have no self-interest or other conflict of interest in the subject matter of the decision.

4.4.2 For instance, a direct financial interest of the director, his associates or close family members will in all likelihood taint the decision for which the rule’s protection is sought⁶⁹. On the other hand, normal directors’ remuneration does not constitute a conflict of interest⁷⁰.

4.4.3 Directors are required to be disinterested in the transactions they manage and make decisions on. Therefore they may not be parties to such transactions, nor must they become entitled to any form of benefit arising therefrom⁷¹. A director may further not be unduly influenced in his decision.

4.5 **Rational basis for decision and good faith**

4.5.1 It has been pointed out in par. 3 above that the requirement of rationality and good faith go hand in hand. Put differently, good faith assumes the existence of a rational business purpose⁷². The duty to exercise good faith further comprises the qualities of honesty and integrity⁷³. It has further been argued that a director, who acts irrationally or unwisely, may not be acting in good faith⁷⁴. Similarly, if a director acts without a rational business purpose, he will be seen to act in bad faith.

⁶⁹ Branson *supra*.

⁷⁰ *Marx v Ankers* 666 N E2d 1034 (NY 1996).

⁷¹ Kennedy-Good *supra* 69.

⁷² Veasey *supra* 1251.

⁷³ Kennedy-Good *ibid*.

⁷⁴ *Ibid*.

- 4.5.2 The courts evaluate the conduct of a director by enquiring whether the director “acted as a person of sound ordinary business judgment”⁷⁵. This test has been described as being subjective, taking into account an objective element⁷⁶.

5. PROBLEMS WITH THE AMERICAN BUSINESS JUDGMENT RULE

- 5.1 The American business judgment rule has many facets and nuances, and is, at best, a complex standard due to the differences in approach in the various states. This chapter only briefly examined the ALI and Delaware versions of the rule. There exists uncertainty in the scope and the application of the rule⁷⁷, illustrated by statements such as:

“The exact relationship between the business judgment rule and the duty of care is a source of great confusion, with some seeing the business judgment rule as defining the contents of a director’s duty of care. Others, however, regard it as a tool of judicial review rather than a standard...”⁷⁸

“The exact parameters of application of the business judgment rule present problems even in its jurisdiction of origin. The failure to define parameters of the business judgment rule results in attempts to qualify the degree of care a director owes to his corporation”⁷⁹

- 5.2 Proposals have therefore been made for the codification of the business judgment rule. To date two noteworthy attempts to reduce the business judgment rule to the statute books have been made, one by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association (“ABA”) and the other by the ALI⁸⁰.
- 5.3 The ABA embarked on a revision of section 35 of the Model Business Corporation Act⁸¹ in an attempt to correctly reflect the rule as developed by the courts. Unfortunately this exercise was unsuccessful as no consensus on the formulation of the rule could be obtained and the committee could not finalise a proposal within the limited space of time afforded for the project. It was therefore decided by the ABA to leave the rule uncoded on the premise that “the rule was a doctrine that could be

⁷⁵ *Ibid.*

⁷⁶ *Ibid.*

⁷⁷ Du Plessis (2012) *Comp Lawyer* 347 – 342.

⁷⁸ *Ibid.*

⁷⁹ *Ibid.*

⁸⁰ Kennedy-Good *supra* 73.

⁸¹ *Ibid.*

applied on a case by case basis”⁸². Kennedy-Good states that, with reference to Gevurtz⁸³, that the ABA applied an incorrect premise in its attempt to codify the business judgment rule, namely that there is only one rule. This premise, it is contended, is incorrect as the business judgment rule has a number of different meanings.

5.4 As far as the second attempt at codification undertaken by the ALI is concerned, the ALI sought to set out in the elements and requirements of the business judgment rule in section 4.01(c) of the ALI Corporate Governance Project⁸⁴. The content of this formulation has been discussed in par. 3.2 hereof. Kennedy-Good states⁸⁵ that the ALI’s Corporate Governance Project also does not take cognisance of the intricacies and diversity of the American corporate structure and that the ALI draft has failed to address problematic issues relating to the classic formulation of the rule. Accordingly, it is argued, that directors can potentially be exposed to a wider scope of liability.

5.5 Section 4.01(c) has been criticised on the basis that it does not differentiate between a director’s duty of care in a “decision making and non-decision making context”⁸⁶, which would be required as the business judgment rule applies only in cases where decisions have been made.

5.6 It appears therefore that the challenges surrounding the rule arise especially when attempts are made to define the exact content of the rule. Kennedy-Good states the following in addressing the various descriptions of the rule:

“It is clear though, that the rule is practically a sensible notion, as business decisions involve taking calculated risks and it is necessary to afford a measure of protection to the decision makers in the event that the decision produces a result that is hurtful to the company”.

6. **CONCLUSION**

6.1 In summary, the business judgment rule, as developed by the judiciary in the United States of America, has many permutations. The exact content of the rule is difficult to define as the courts in different states attach different interpretations to the rule.

⁸² *Ibid*, Botha *supra* 75.

⁸³ Gevurtz (2000) *Corporation Law* 278 – 279.

⁸⁴ See note 24 *supra*.

⁸⁵ Kennedy-Good *supra* 73 – 74.

⁸⁶ *Ibid*.

- 6.2 No federal legislation has yet been enacted to give effect to the rule and it remains a tool used by the courts to review the standard of conduct of directors in their decision making.

CHAPTER 3: THE BUSINESS JUDGMENT RULE IN OTHER JURISDICTIONS

1. INTRODUCTION

- 1.1 The business judgment rule is not confined to the United States of America. Numerous jurisdictions have considered the merits and demerits of its application, with the result that it has been accepted in some legal systems but rejected in others.
- 1.2 Recent developments in Australia, where the rule was ultimately enacted in the Australian Corporations Act, are of importance to assess the effect and necessity of its inclusion in the South African Companies Act. The debate in Australia centered around the question on whether a statutory business judgment rule should be introduced and if so, how it should be phrased.
- 1.3 A statutory version of the business judgment rule has been rejected in the United Kingdom, but has been accepted in Germany. This chapter will briefly examine these developments.

2. DEVELOPMENTS IN AUSTRALIA

- 2.1 As a result of several company collapses during the 1980's, there have been considerable developments in Australia during that time to augment the standard of care and diligence required from directors in order to protect shareholders and creditors against the actions of negligent and dishonest directors⁸⁷.
- 2.2 The debate on the inclusion of a statutory business judgment rule started in earnest in the late 1980's and continued during the 1990's and 2000's when corporate law legislation was ultimately amended to introduce objective standards to ascertain whether directors breached their fiduciary duty of care and diligence⁸⁸.
- 2.3 **Australian common law**
 - 2.3.1 The Australian common law duty of care, skill and diligence originally imposed significantly low standards of care on company directors. Directors were not required to have special business or other skills relating to the management of the company and the test imposed by the courts was largely subjective⁸⁹ and

⁸⁷ Arsalidou (2005) *The Company Lawyer* 156; Havenga *supra* 31.

⁸⁸ Du Plessis (2011) *The Company Lawyer* 347.

⁸⁹ Havenga *supra* 31.

considered factors such as the nature of the company's business and the particular responsibilities of the director in the company. Especially decisions taken by non-executive directors were adjudicated with a very light standard⁹⁰.

2.3.2 The business judgment rule, in one of its earliest forms at common law, was described by Lord Greene M R in *Re Smith and Faucett Ltd*⁹¹ as follows:

“They [the directors] must exercise their discretion bona fide in what they consider – not what the court considers – is in the interests of the company.”

2.3.3 The above dictum has been interpreted by commentators⁹² to mean that courts are restrained from interfering with the commercial decisions of directors and that it is not the function of the courts to act as arbiter in such circumstances. Directors cannot be held liable simply because a court disagrees with their decisions.

2.3.4 Du Plessis observes⁹³ that another decision, namely that of *Overend & Gurney Co v Gibb*⁹⁴, has been used to describe the common law business judgment rule in Australia:

“It would be extremely wrong to import into the consideration of the case of a person acting as a mercantile agent in the purchase of a business concern, those principles of extreme caution which might dictate the course of one who is not at all inclined to invest his property in any venture of a hazardous character... Men were chosen by the company as their directors, to act on their behalf in the same manner as they would have acted on their own behalf as men of the world, and accustomed to business, and accustomed to speculation, and having knowledge of business of this character.”

2.3.5 The business judgment rule has, in the above case, been expressed as a standard of conduct and personal liability⁹⁵. It was held that directors were only liable for a breach of their duty of care, skill and diligence if they acted with gross negligence⁹⁶.

⁹⁰ *Ibid.*

⁹¹ [1942] Ch. 304 CA.

⁹² Du Plessis *supra* 348, McLennan (1996) SA Merc LJ 94.

⁹³ Du Plessis *ibid.*

⁹⁴ (1871-72) L. R. 5 H. L. 480 HL.

⁹⁵ Du Plessis *supra* 348.

⁹⁶ *Ibid.*

2.3.6 Du Plessis further points out⁹⁷ that the rule, as developed by the Australian courts, has never been quoted under that term in any of the cases which are traditionally cited as authority for existence of a common law business judgment rule.

2.3.7 This so-called common law business judgment rule has been described as a “safe harbor” which protects directors from liability⁹⁸. Contrary to the American business judgment rule, however, it remains a poorly developed rule which is largely based on the reluctance of the courts to interfere with directors’ decisions⁹⁹.

2.4 Codification of the business judgment rule

2.4.1 The Senate Standing Committee on Legal and Constitutional Affairs, Company Directors’ Duties, Report on the Social and Fiduciary Duties and Obligations of Company Directors (Cooney Report) recommended in 1989¹⁰⁰ that the “American business judgment rule be introduced into Australian corporations law”¹⁰¹. It was suggested that the business judgment rule be augmented with an obligation on directors to “inform themselves of matters relevant to the administration of the company” as well as that “they show that they exercised active discretion and a reasonable degree of care in the circumstances”¹⁰².

2.4.2 The recommendation of the Cooney Report was echoed by the Companies and Securities Law Review Committee¹⁰³ in 1990 and the Lavarch Report¹⁰⁴ in 1991, but the recommendations were not adopted then for several reasons. Du Plessis points out that the following arguments were advanced to counter the rule’s codification¹⁰⁵:

2.4.2.1 the development of the business judgment rule would best be left to Australian courts, as in the case of its American counterpart;

2.4.2.2 both the ABA and the ALI struggled to formulate a statutory version of the rule,

⁹⁷ *Ibid.*

⁹⁸ *Ibid.*

⁹⁹ *Ibid* at 350.

¹⁰⁰ Par 3.35 of the Cooney Report.

¹⁰¹ Du Plessis (2011) *The Company Lawyer* 377.

¹⁰² *Ibid.*

¹⁰³ Companies and Securities Law Review Committee, Company Directors and Officers: Indemnification, Relief and Insurance Report No. 10 (1990) at par. 76 -81, cited in Du Plessis *supra* 377.

¹⁰⁴ House of Representatives Standing Committee on Legal and Constitutional Affairs, Report on Corporate Governance Practices and the Rights of Shareholders (1991) at par. 5.4.29 – 5.4.30, cited in Du Plessis *supra* 377.

¹⁰⁵ Du Plessis *supra* 378.

- 2.4.2.3 there was already a common law business judgment rule in use;
- 2.4.2.4 it was uncertain whether a statutory codification of the rule was intended to achieve protection from liability for directors or a lowering of the standard of care, skill and diligence.
- 2.4.3 In 1992, the Public Exposure Draft and Explanatory Paper of the Corporate Reform Bill proposed to introduce a list of factors which a court would have to consider in deciding whether a director acted in proper discharge of his duties under section 4 of the Corporations Act¹⁰⁶ (i.e. whether the director was in breach of his duty of care, skill and diligence). These factors included:
- 2.4.3.1 an inquiry as to the information the director obtained about the company's affairs;
- 2.4.3.2 a determination as to what meetings the director attended;
- 2.4.3.3 a consideration of whether the director exercised an active discretion in the matter; and
- 2.4.3.4 an inquiry into the steps and arrangements taken by the director to ensure that the professional advisors of the company were honest, competent and reliable, that compliance with the law was upheld and monitored and that persons making decisions about the company were adequately informed about the subject matter of the decisions.
- 2.4.4 The above proposals were not included in the 1992 Corporate Law Reform Act¹⁰⁷. Pursuant to the decision of *Daniels v Anderson*¹⁰⁸, where the court indicated that it was no longer sufficient to judge directors' conduct with reference to the subjective standards applied in the older cases, it was again proposed under the Corporate Law Economic Reform Program ("CLERP") Bill of 1998 to introduce a statutory business judgment rule as part of the standard of care and diligence¹⁰⁹. Particularly, the court in *Daniels* held that ordinary negligence, and not gross negligence or recklessness, was sufficient to hold directors liable for a breach of their duty of care.

¹⁰⁶ *Ibid.*

¹⁰⁷ *Ibid.*

¹⁰⁸ (1995)16 A.C.S.R. 607 CA (NSW).

¹⁰⁹ Du Plessis *supra* 378, Havenga *supra* 32.

2.4.5 Despite criticism that a statutory business judgment rule would lower the standards against which directors' conduct would be evaluated, a codification of the business judgment rule was finally enacted through the Corporate Law Economic Reform Program ("CLERP") Act of 1999¹¹⁰.

2.4.6 The statutory business judgment rule is currently found in section 180(2) and (3) of the Australian Corporations Act, 2001 and provides as follows:

"180(2) A director or officer of a corporation who makes a business judgment is taken to meet the requirements of subsection (1), and their equivalent duties at common law and in equity, in respect of the judgment if they:

- (a) make the judgment in good faith and for a proper purpose;
- (b) do not have a material personal interest in the subject matter of the judgment;
- (c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and
- (d) rationally believe that the judgment is in the best interest of the corporation.

A director's or officer's belief that the judgment is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold."

2.4.7 The Corporations Act further defines "business judgment" to mean "any decision to take or not to take action in respect of a matter relevant to the business operations of the corporation".

2.4.8 Section 180(1) of the Corporations Act deals with the standard of care and diligence required of directors and states that a director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence a reasonable person would exercise as director or officer in the corporation's circumstances and occupying the responsibilities of the director

¹¹⁰ Du Plessis *supra* 378.

or officer. This definition of the standard of care and diligence is an objective one and does not differentiate between experienced and non-experienced directors¹¹¹.

2.4.9 Havenga points out¹¹² that two essential ironies underpin the drive to codify the business judgment rule:

2.4.9.1 firstly the *Daniels* case, which can be seen as the “impetus” for the introduction of the statutory rule, related to the directors’ failure to take a decision. The provisions of section 180(2) of the Corporations Act will therefore make no difference to the court’s finding in the above case; and

2.4.9.2 secondly, the business judgment rule originates in the United States of America where it developed in a series of judicial decisions in various states, yet the rule has not yet been codified in the United States.

2.4.10 The Explanatory Memorandum to the CLERP Bill 1998¹¹³ points out that the purpose of the statutory rule is to –

2.4.10.1 provide directors with a “safe harbour” from liability in relation to honest, informed and rational business judgments. It was pointed out that if it were not acknowledged that directors should not be liable for decisions made in good faith and with due care, it could lead to a reduction in risk taking¹¹⁴;

2.4.10.2 confirm the common law position that courts will rarely review bona fide business decisions¹¹⁵.

2.4.11 Du Plessis further points out that the Australian business judgment rule, as it appears in section 180(2) of the Corporations Act, only protects directors against a breach of the duty of care and diligence (i.e. section 180(1) of the Corporations Act) and not against breaches of other fiduciary duties under the Corporations Act or the common law (such as the duty to act in the best interests of the corporation and for a proper purpose)¹¹⁶.

¹¹¹ Havenga *supra* 33.

¹¹² Havenga *supra* 33.

¹¹³ Du Plessis *supra* 378.

¹¹⁴ *Ibid.*

¹¹⁵ *Ibid.*

¹¹⁶ *Ibid.*

2.5 Further development of the Australian rule: ASIC v Rich

2.5.1 There has been considerable debate about whether the directors carry the burden of proof to show that they have complied with the elements of the business judgment rule as set out in section 180(2)(a) – (d).

2.5.2 This issue has, for the moment, been settled in the 2009 decision of *Australian Securities and Investments Commission (“ASIC”) v Rich*¹¹⁷. In this case, Austin J considered the business judgment rule in the context of the collapse of a telecommunications company, One.Tel¹¹⁸. ASIC alleged that the four defendant directors committed numerous breaches of the duty of care and diligence under section 180(1) of the Corporations Act. ASIC subsequently reached settlement with two of the four directors, who made high compensation payments. The remaining two executive directors, Messrs Rich and Silberman, refused settlement and ASIC proceeded with a claim against them that they breached the duty of care and diligence by withholding certain crucial financial information from the One.Tel board¹¹⁹. Both the directors relied on the business judgment rule.

2.5.3 Austin J held that the defendant directors were not in breach of their duty of care and diligence and that ASIC failed to prove its case against them. The learned judge expressed the view that the issue of the burden of proof had to be revisited as the language was “profoundly ambiguous”¹²⁰, but held that the defendant directors carried the burden of proof to show that they acted in compliance with the requirements set out in section 180(2)(a) – (d).

2.5.4 Another important outcome of the decision is that the judge endorsed ASIC’s list of factors which were submitted to be relevant in determining the reasonableness of whether a director has taken an informed decision¹²¹. These factors include:

2.5.4.1 the importance of the decision;

2.5.4.2 the time available to obtain information;

2.5.4.3 the costs related to obtaining information;

¹¹⁷ [2009] NSWSC 1229.

¹¹⁸ Legg and Jordan (2010) *Company Law Newsletter* 269.

¹¹⁹ *Ibid.*

¹²⁰ Du Plessis *supra* 380.

¹²¹ Legg *supra* 272.

2.5.4.4 the state of the company's business at the time and the nature of competing demands on the board's attention¹²².

2.5.5 With regard to the interpretation to be attributed to the requirement that the director "must have a rational belief that the judgment is in the best interests of the corporation" Austin J found that a director's belief that a certain decision in the best interest of the company will be rational if there is some arguable reasoning to support it¹²³. Lee argues¹²⁴ that "this construction allows his Honour to reach the position that s. 180(2) has some protective work to do in cases where, in its absence, there would arguably be a contravention of s. 180(1). It also means that the 'Australian position on this matter is very close to the US position'."

2.6 The duty of care and the decision in ASIC v Healey

2.6.1 A recent decision in which the courts considered the duty of care is *ASIC v Healey*¹²⁵ where the Australian Federal Court of Appeal held that directors of a company were liable for a breach of their duty of care and diligence by not noticing that the company's financial records incorrectly classified a large number of current liabilities as non-current liabilities¹²⁶.

2.6.2 ASIC based its case against the directors on a breach of three provisions of the Corporations Act, amongst others a breach of the duty of care and skill in section 180(1). Middleton J held that ASIC was successful in its contentions and that "the directors failed to take all reasonable steps required of them, and acted in the performance of their duties as directors without exercising the degree of care and diligence the law requires from them"¹²⁷.

2.6.3 It was further found that the directors did not inform themselves about the subject matter of the decision "to the extent they reasonably believe to be appropriate" and the judge also "did not believe that the directors took all reasonable steps required of them"¹²⁸. The business judgment rule was not explicitly considered in this case. Du Plessis and Meaney that they are of the view that the business judgment rule in section 180(2) of the Corporations Act could in any event not be

¹²² *ASIC v Rich supra* at 7283.

¹²³ *Lee supra* 272.

¹²⁴ *Ibid.*

¹²⁵ [2011]FCA 717 (Fed Ct Aus) (Sgl judge).

¹²⁶ Du Plessis and Meaney (2012) *The Company Lawyer* 274.

¹²⁷ At [8].

¹²⁸ Du Plessis and Meaney *supra* 279.

applied to the directors¹²⁹ as the elements in section 180(2)(c) and (d) were clearly not met. They also argue that it is “questionable whether the court would have considered the directors’ failure to apply their ‘independent inquiring minds’ to be a ‘judgment’ that would be captured under the business judgment rule”¹³⁰.

2.6.4 The importance of the case is, however, that Australian directors were sensitised to the fact that there could be potentially serious consequences if they did not make “informed decisions”¹³¹ and that they need to apply themselves diligently and with an inquiring mind so that they can form their own opinions.

3. DEVELOPMENTS IN THE UNITED KINGDOM

3.1 English law recognises a fiduciary duty of loyalty and good faith between a director and his company¹³² as well as a duty of care, skill and diligence¹³³.

3.2 There have been several failed attempts to codify the duty of care, skill and diligence in the 1973 and 1978 Companies Bills as well as during 1998 when the English and Scottish Law Commissions proposed amendments to the then current Companies Act, 1985¹³⁴. Neither of these proposals were eventually enacted.

3.3 However, in 2006, with the introduction of a new UK Companies Act, the duty of a director to exercise reasonable care, skill and diligence was codified for the first time in section 174 of the UK Companies Act. This section now sets a dual subjective/objective standard and therefore departs from the mainly subjective standard which has traditionally been applied at common law¹³⁵ and implied generally only a low standard of care.

3.4 The English courts have however always been reluctant to review directors’ decisions which were taken in good faith with the benefit of hindsight, and have been slow to criticise the accuracy of directors’ business acumen at the time their decision was made¹³⁶. The English Law Commission’s report on the duties of company directors

¹²⁹ *Ibid.*

¹³⁰ *Ibid.*

¹³¹ *Ibid.*

¹³² Havenga (1996) *SA Merc LJ* 47.

¹³³ See chapter 4 par. 3 *infra*.

¹³⁴ Havenga (2000) *supra* 33.

¹³⁵ Chapter 4 *infra*.

¹³⁶ Matsimela *supra* 10.

further argues that a statutory business judgment rule should not be adopted in the United Kingdom, mainly on the above ground¹³⁷.

- 3.5 It is therefore not surprising that section 174 of the UK Companies Act does not provide for a statutory business judgment rule, and the American version of the rule has therefore not yet found its way into English law.

4. **DEVELOPMENTS IN GERMANY**

- 4.1 In Germany, the duty of care of company directors is contained in section 93 of the *Aktiengesetzbuch* (Stock Corporation Act). In terms of section 93(1), the directors and management of a public company must exercise the “care of a conscientious business manager”¹³⁸. The standard can be described as “that of a man in a leading and responsible position as the manager of other persons’ property” in a specific company¹³⁹. This standard is not the same as that of an ordinary (reasonable) businessman, and the duty of care expected from a director in a public company is therefore higher than that of an “ordinary businessman”¹⁴⁰.
- 4.2 Zwinge states that the “requirements of care are not static, but are determined with reference to the nature and size of the company, the number of employees, the business situation as well as the functions of the particular director”¹⁴¹.
- 4.3 The German duty of care at face value appears to be purely objective. However, Zwinge points out that the courts generally hold that, according to general principles of German law, if a director possesses special skills or knowledge, he has an obligation to apply them¹⁴².
- 4.4 In 2005, the *Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts* (“UMAG”) introduced a statutory business judgment rule to section 93 of the Stock Corporations Act. Zwinge points out that this statutory version of the business judgment rule had already been developed by the Federal Supreme Court in Germany¹⁴³. It reads as follows:

¹³⁷ Arsalidou (2003) *The Company Lawyer* 231.

¹³⁸ Zwinge (2011) *International Company and Commercial Law Review* 33.

¹³⁹ *Ibid.*

¹⁴⁰ *Ibid.*

¹⁴¹ *Ibid.*

¹⁴² *Ibid* at 34.

¹⁴³ *Ibid.*

“There is no breach of duty if the director, when making a business decision, reasonably believes to act on an appropriate informed basis and in the best interests of the company.”

- 4.5 The federal courts, however, had already developed a business judgment rule before the above enactment as was alluded to in par. 4.4 above. In the landmark decision of *ARAG v Garmenbeck*¹⁴⁴, the court concluded that there is a fine line between the violation of the duty of care and loyalty on the one hand and business mistakes made in the conduct of the business of the company on the other hand. According to the court, a director of the company would only incur a risk of liability if the management of the company conducts its business in an irresponsible manner¹⁴⁵. The court further found that non-executive or “supervisory” directors would only be to a very limited extent be protected by the business judgment rule when monitoring the management board. In other words, non-executive directors are not entitled to the protection of the business judgment rule¹⁴⁶.
- 4.6 It can therefore be seen that the business judgment rule has found its way into German jurisprudence.

5. **CONCLUSION**

- 5.1 The business judgment rule, as it was developed by the judiciary in the United States of America, has had a significant influence on numerous jurisdictions, and recommendations relating to its statutory codification have been widely and sometimes heatedly debated. The rule has been codified in Australia and Germany, but was rejected in the United Kingdom.
- 5.2 The exact content of the rule is difficult to define and law makers in Australia grappled with an acceptable formulation of the rule before it was ultimately enacted in the Australian Corporations Act in 2001. Nonetheless, directors in Australia now have the benefit of “safe harbor” provisions which afford them with a greater degree of protection against personal liability for poor business decisions than was the case before the introduction of the codified version of the business judgment rule.

¹⁴⁴ [1997] BGHZ 175/95.

¹⁴⁵ Zwinge *supra* 35.

¹⁴⁶ *Ibid* at 36.

- 5.3 Although the UK Companies Act was overhauled in 2006, a statutory business judgment rule was not introduced in the United Kingdom. The duty of care, skill and diligence was, however, codified for the first time.

CHAPTER 4: SOUTH AFRICAN BUSINESS JUDGMENT RULE

1. INTRODUCTION

- 1.1 There has been a debate since the mid-1990's as to whether an American style business judgment rule should be introduced into South African law in order to protect honest directors from personal liability for decisions or mistakes that caused the company to incur losses¹⁴⁷.
- 1.2 This chapter examines the historical background relating to the proposals advocating the inclusion of a statutory business judgment rule into our law, the content of the duty of care and skill at common law and pursuant to the enactment of the Companies Act and analyses the codified business judgment rule as it appears in section 76(4) of the Companies Act.

2. HISTORICAL DEVELOPMENT

2.1 Recommendations of the King Committee

2.1.1 The King Committee, under the chairmanship of Mervyn E King SC, recommended as far back as in 1994 in the King Report on Corporate Governance¹⁴⁸ that the Companies Act¹⁴⁹ be amended to provide for a statutory limitation on a director's duty of care and skill. The reasoning behind the recommendation was that there was a need to encourage entrepreneurship and to attract persons with skill to accept appointments in enterprises¹⁵⁰.

2.1.2 It was argued that the common law test relating to a breach of the duty of care and skill made the appointment of directors, particularly non-executive directors, onerous¹⁵¹. The King Report therefore recommended that directors should not be liable for breach of the duty of care and skill if they exercised a business judgment in good faith and subject thereto that –

2.1.2.1 the decision was an informed one based on all the facts of the case;

¹⁴⁷ Kennedy-Good *supra* 63.

¹⁴⁸ The King Report on Corporate Governance, published by the Institute of Directors on 9 November 1994, hereinafter referred to as "the King Report".

¹⁴⁹ Companies Act 61 of 1973, hereinafter referred to as the "Companies Act, 1973".

¹⁵⁰ Par. 3.2 of the King Report.

¹⁵¹ Par. 3.3 of the King Report.

- 2.1.2.2 the decision was a rational one; and
- 2.1.2.3 there was no self-interest¹⁵².
- 2.1.3 The business judgment rule was also briefly analysed in the King Report of March 2002¹⁵³. This time the report recommended that the Standing Advisory Committee on Company Law should investigate the desirability of the integration of the rule into South African law¹⁵⁴.
- 2.1.4 The above recommendations of the two King Reports have been met with considerable criticism. It has been argued¹⁵⁵ that the statement that the Companies Act should be amended to provide for a statutory limitation on the duty of care and skill, as the appointment of directors in the context of the test for breach of the duty of care and skill being onerous, is incorrect.
- 2.1.5 At common law, the standard of care and skill has been described as being “disappointingly” or “deplorably”¹⁵⁶ low. Kennedy-Good is of the view that “contrary to the King Report, the duty should in fact be enhanced”¹⁵⁷. Botha argues convincingly¹⁵⁸ with reference to numerous commentators that the impression created by the King Report, namely that directors are being flooded with actions for failing to act with care and skill, is simply not true. The common law standard of care and skill is discussed in more detail in par. 3 below.

2.2 DTI Guidelines for corporate law reform

- 2.2.1 In 2004, the Department of Trade and Industry (“DTI”) issued a report¹⁵⁹ stating that the then current company law was in dire need of reform as the environment within which enterprises operate had changed considerably since the inception of the Companies Act, 1973 and needed to be aligned with South Africa’s new constitutional dispensation.

¹⁵² Par 24.6 of the King Report.

¹⁵³ The King Report on Corporate Governance, published by the Institute of Directors in March 2002, hereinafter referred to as “King II”.

¹⁵⁴ King II, 70.

¹⁵⁵ Kennedy-Good *supra* 287; Botha *supra* 67.

¹⁵⁶ *Ibid.*

¹⁵⁷ *Ibid.*

¹⁵⁸ Botha *supra* 68.

¹⁵⁹ The Department of Trade and Industry in South Africa May 2004.

- 2.2.2 The report postulates that the law on the duties of directors does not provide effective mechanisms for the enforcement of director's duties and that the duties of directors are somewhat vague¹⁶⁰. The report, however, acknowledges that the principles governing directors' duties are mainly found in case law and that the precise content of such duties remains subject to numerous different views¹⁶¹. In order to create certainty in the law relating to the duties of directors, it is suggested to consider a statutory codification of director's duties¹⁶². Although the aforementioned proposal does not specifically deal with the introduction of a statutory business judgment rule, the report acknowledges that such codification of director's duties would have to take place within the restrictions it will inevitably place on the development of the common law¹⁶³.
- 2.2.3 The report further recognises that South African society is not litigious in nature and that it is therefore not necessary to exonerate directors against liability for breach of their duties. By implication, therefore, the report suggests that it is not necessary to introduce a statutory business judgment rule into South African law¹⁶⁴.
- 2.2.4 The report has been criticised for its contradictory views¹⁶⁵, as on the one hand it advocates the introduction of provisions into our statute books which can be used in litigation to hold directors liable for misconduct and on the other hand it suggests that there is no need for the enactment of provisions which will pardon directors for their conduct. It is submitted that this contradiction reduces the credibility one can attribute to the findings of the report.

3. COMMON LAW DUTY OF CARE AND SKILL

- 3.1 The rules governing the duties and standards of care required from directors originate in a number of English decisions in the late nineteenth and early twentieth centuries¹⁶⁶. The salient decision, which has been described as "containing the roots of the common-law duty of care"¹⁶⁷, is *In re City Equitable Fire Insurance Co Ltd*¹⁶⁸ in which it was decided by Romer J that directors must apply that duty of care which an ordinary

¹⁶⁰ *Ibid*, at 18.

¹⁶¹ *Ibid*, at 39.

¹⁶² *Ibid*, at 40; Kennedy-Good *supra* 289.

¹⁶³ *Ibid*.

¹⁶⁴ *Ibid*.

¹⁶⁵ Kennedy-Good *supra* at 290.

¹⁶⁶ *Havenga supra* 25; *Marquis of Bute's Case* [1892] 2 Ch 100; *Lagunas Nitrate Co v Lagunas Syndicate* [1899] 2 Ch 392; *Prefontaine v Grenier* [1907] AC 101.

¹⁶⁷ *Havenga supra* at 26.

¹⁶⁸ [1925] Ch 407.

man might be expected to take in the circumstances¹⁶⁹. This seemingly objective test is qualified to the extent that his Lordship added that a director need not apply a greater degree of skill in the performance of his or her duties than may reasonably be expected from a person with his or her experience¹⁷⁰.

- 3.2 The above decision was approved and introduced into our law by Margo J in *Fisheries Development Corporation of SA Ltd v Jorgensen and Another; Fisheries Development Corporation v AWJ Investments*¹⁷¹, where the court held that the extent of a director's duty of care and skill depends to a considerable degree on the nature of the company's business and on any particular obligations assumed by or assigned to him or her. In this regard a distinction can be drawn between a full-time or executive director, who participates in the day to day management of the company and a non-executive director who has not undertaken any special obligation. The latter is not bound to give continuous attention to the affairs of the company, and only has duties of an intermittent nature, to be performed at periodical board meetings and at other meetings which require his attention¹⁷². The result is that the courts have adopted a very lenient attitude towards the duty of directors to exercise reasonable care and skill in the performance of their functions¹⁷³
- 3.3 In the recent decision of the Appellate Division in *Howard v Herrigel*¹⁷⁴, the court concluded that it was unhelpful and ambiguous to categorize company directors as "executive" and "non-executive" in relation to the determination of their duties to the company, as the duties apply to all directors equally.
- 3.4 A director is further not required to have special business acumen or expertise or singular ability or intelligence, or even experience in the business of the company. He is, however, required to exercise that degree of care which can be reasonably be expected of a person of his knowledge and experience¹⁷⁵. A director will not be liable for mere errors of judgment¹⁷⁶. The test therefore becomes subjective and is based on the particular director's knowledge and experience.
- 3.5 A director is further entitled, in the absence of grounds for suspicion, to rely in the performance of his functions on the advice, information and judgment of the

¹⁶⁹ *Ibid* at 428.

¹⁷⁰ *Ibid* at 428 – 429, Havenga *supra* at 26.

¹⁷¹ 1980 (4) SA 156 (W) at 165F – 166D.

¹⁷² *Ibid* at 165H.

¹⁷³ See Cassim *supra* 505 ff.

¹⁷⁴ 1991 (2) SA 660 (A) at 678.

¹⁷⁵ *In re City Equitable Fire Insurance Co* at 428; *Lagunas Nitrate Co* at 435.

¹⁷⁶ *In re City Equitable Fire Insurance Co supra* at 429; *Fisheries Development Corporation supra* at 166.

management, advisors or other competent personnel of the company¹⁷⁷, unless there are proper reasons for querying such advice. Obviously, a director exercising reasonable care would not accept information and advice blindly and will, after giving it due consideration, exercise his own judgment accordingly.

- 3.6 The rather relaxed approach to the standards of care required from directors has its roots in two principles¹⁷⁸:
- 3.6.1 the idea that shareholders should be responsible for the competence of the persons appointed by them to the management of the company¹⁷⁹; and
- 3.6.2 the fact that early directors were largely appointed because of title or reputation and did not possess particular skill or business acumen.
- 3.7 If a director breaches his duty of care and skill to the company, he is liable in delict to the company for any loss or damage it may have suffered as a consequence of the breach¹⁸⁰. If there is a contract between the particular director and the company, he or she may be guilty of breach of contract in addition to the delictual liability incurred¹⁸¹.
- 3.8 It must further be noted that there is only one South African decision where a director was held liable for breach of the duty of care and skill, namely *Niagara Ltd (in liquidation) v Langerman and Others*¹⁸².
- 3.9 Common law courts required gross negligence before a director would be found liable for breach of his duty of care¹⁸³, and even extreme misconduct did in certain circumstances not amount to gross negligence. In the English decision of *Re Brazilian Rubber Plantations & Estates Ltd*¹⁸⁴ Neville J held that where the directors contracted to buy a plantation on behalf of the company on the basis of a fraudulent report, the failure of the directors to make proper inquiries into the report and to correct certain exposed discrepancies, could not be classified as gross negligence and merely amounted to an error of judgment¹⁸⁵ for which no liability was incurred.

¹⁷⁷ *Fisheries Development Corporation supra* at 166.

¹⁷⁸ *Havenga supra* at 26 – 27.

¹⁷⁹ Also see *Turquand v Marshall* (1869) LR 4 Ch App 379).

¹⁸⁰ *Cilliers Benade et al* (2007) 148.

¹⁸¹ *Ibid.*

¹⁸² 1913 WLD 188.

¹⁸³ *Havenga supra* at 26.

¹⁸⁴ [1911] 1 Ch 425.

¹⁸⁵ *Havenga supra* at 27.

3.10 There has been a gradual move towards a more rigorous duty of care, as is evident from more recent decisions such as *Norman v Theodore Goddard (a firm)*¹⁸⁶ and *Re D'Jan of London Ltd*¹⁸⁷ where the common law duty of care was extended to the conduct required of –

“a reasonably diligent person having both (a) the general knowledge, skill and experience that may be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and (b) the general knowledge, skill and experience that that director has.”

3.11 This trend was however not adopted in South African common law¹⁸⁸, and the common law standard of care imposed by South African courts has been described by Cassim as being “manifestly inadequate in modern times to protect shareholders from the carelessness and negligence of directors of the company”¹⁸⁹. A more objective standard to the director’s duty of care and skill is required. In *Daniels t/a Deloitte Haskins & Sells v AWA Ltd*¹⁹⁰, for example, it was held that it was no longer appropriate to judge directors’ conduct by applying the subjective tests in outdated precedents.

4. DUTY OF CARE AND SKILL UNDER THE COMPANIES ACT

4.1 The standards of directors’ conduct have been partially codified in section 76 of the Companies Act, 2008. The Guidelines for Corporate Law Reform¹⁹¹ provide the rationale for the codification as the need of directors to know what their duties are, and to be aware of what is expected of them. The Guidelines further state that the standards of a director’s conduct can ultimately influence the profitability of the company. The Act therefore imposes a considerably more rigorous duty of care and skill on directors in section 76(3)(c), and introduces a hybrid standard of care that is partly objective and partly subjective.

4.2 Section 76(3)(c), which deals with the duty of care, skill and diligence provides:

¹⁸⁶ [1991] BCLC 1028 (CLD), *Havenga supra* at 27.

¹⁸⁷ [1994] 1 BCLC 561 (Ch).

¹⁸⁸ Cassim *supra* at 507.

¹⁸⁹ *Ibid* at 508.

¹⁹⁰ (1995) 37 NSWLR 438, Cassim *supra* at 508.

¹⁹¹ P 103.

“76(3) Subject to subsections (4) and (5), a director of a company, when acting in that capacity, must exercise the powers and perform the functions of director

–

(c) with the degree of care, skill and diligence that may reasonably be expected of a person –

(i) carrying out the same functions in relation to the company as those carried out by that director; and

(ii) having the general knowledge, skill and experience of that director.”

4.3 The first part of the test in section 76(3)(c)(i) requires a director to exercise the degree of care, skill and diligence that may reasonably be expected of a person carrying out the same functions of that director. This test is objective and the standard is that of the reasonable person and not that of the reasonable director. The second limb of the test, however, in section 76(3)(c)(ii) provides that the general knowledge, skill and experience of the director in question also have to be considered. This subjective element ensures that if the director has more experience or is more knowledgeable, his conduct will be measured against this higher standard¹⁹².

4.4 Cassim argues that directors are not expected to take all possible care, and that reasonable care is sufficient¹⁹³ to avoid incurring liability for negligence. It is therefore clear that directors are allowed to make mistakes, provided that they must exercise a reasonable degree of care and skill.

4.5 The duty of diligence implies that a director must properly attend to his duties, amongst others be informed about the issues to be decided at meetings and have studied and understood the information availed to him.

4.6 Section 76(4)(b) permits a director to rely on the advice of a professional person, expert, employee or a board committee, provided that the director reasonably believes such a person to be reliable and competent.

4.7 The liability of a director in relation to the duty of care, skill and diligence is contained in section 77(2)(a). The section holds that a director may be held liable in accordance

¹⁹² Cassim *supra* at 509.

¹⁹³ *Ibid.*

with the common law principles relating to the breach of a fiduciary duty (i.e. in delict) for any loss, damages or costs sustained by the company as a consequence of any breach by the director of the duty of care, skill and diligence.

4.8 The common law principles discussed above have therefore been modernised and augmented in the Companies Act.

5. **DEBATE SURROUNDING A STATUTORY BUSINESS JUDGMENT RULE**

5.1 The reasons advanced by the King Committee in the King Report that the duty of care and skill should be curtailed by the business judgment rule were, amongst others, the following ¹⁹⁴:

5.1.1 the standard of the duty of care and skill expected from directors was “onerous”, particularly with regard to non-executive directors;

5.1.2 there was a need to attract persons of “skill and reputation” to accept appointment as directors;

5.1.3 there was a need to promote higher standards of corporate governance.

5.2 These statements have come under cross-fire from various commentators. Jones¹⁹⁵ and Botha and Jooste¹⁹⁶, for instance, argue that with reference to relevant standard of care in South African common law as encapsulated in *Fisheries Development Corporation v Jorgensen*¹⁹⁷, there can be no mention of an “onerous standard”. The standard of care required of a director is both objective and subjective and requires “the care which can reasonably be expected of a person with the director’s knowledge and experience”.

5.3 Jones further points out in relation to the second point that the King Report states that the business judgment rule “recognizes that business decisions frequently entail risk and uncertainty and thus encourages directors to engage in ventures which have a

¹⁹⁴ Jones (2007) SA Merc LJ 332.

¹⁹⁵ *Ibid.*

¹⁹⁶ Botha *supra* 67.

¹⁹⁷ *Supra.*

greater potential for profit but entail some risk”¹⁹⁸. It must be noted in this regard that director have never been found accountable for mere errors of judgment.¹⁹⁹

- 5.4 Regarding the third point, Jones is of the view that “it is not possible to see how the introduction of a rule limiting the directors’ duty of care and skill could contribute to a higher standard of corporate governance.”²⁰⁰ It is postulated that it will rather have the effect of increasing corporate misconduct.
- 5.5 Jones submits²⁰¹ that the South African law adequately protects directors who have acted honestly and reasonably and that there is consequently no need to introduce a statutory business judgment rule. It is further argued that the law on the duty of care and skill owed by a director is clear and if the business judgment rule were to be adopted, it could make it easier for “negligent directors to escape liability”²⁰².
- 5.6 Most legal commentators agree that there is no need for a codification of the business judgment rule²⁰³ and that the recommendations of the King Committee were based on inadequate research.
- 5.7 On the other hand, it has been submitted²⁰⁴, that there is a need to have a wider form of protection for directors, or a business judgment rule, in modern company legislation as the standards embodied in the old English cases no longer reflect modern expectations. In other words, there is a need to move away from the mostly subjective standards which, coupled with gross negligence as standard for directors liability, made it almost impossible to hold directors accountable²⁰⁵. Du Plessis views the proposed introduction of the business judgment rule into South African law as “perfectly justifiable”²⁰⁶.

6. **CODIFICATION OF THE BUSINESS JUDGMENT RULE**

- 6.1 The business judgment rule has, despite the above controversy, been adopted by the drafters of the Companies Act. The rule is modelled on the American business

¹⁹⁸ Jones *supra* 333.

¹⁹⁹ *Ibid.*

²⁰⁰ *Ibid.*

²⁰¹ *Ibid.*

²⁰² *Ibid* at 336.

²⁰³ Havenga (2000) *supra* 36; McLennan *supra* 100; Botha *supra* 78; Kennedy-Good *supra* 292.

²⁰⁴ Du Plessis (2011) *supra* 380.

²⁰⁵ *Ibid.*

²⁰⁶ *Ibid* at 381.

judgment rule and will have the effect of reducing the blow of the more objective duty of directors to exercise reasonable care, skill and diligence in their decisions²⁰⁷

6.2 Section 76(4)(a) embodies the statutory codification of the business judgment rule as follows:

“76(4) In respect of any particular matter arising in the exercise of the powers or the performance of the functions of a director, a particular director of a company –

(a) will have satisfied the obligations of subsection 3(b) and (c) if –

(i) the director has taken reasonably diligent steps to become informed about the matter;

(ii) either –

(aa) the director had no material personal financial interest in the subject matter of the decision, and had no reasonable basis to know that any related person had a personal financial interest in the matter; or

(bb) the director complied with the requirements of section 75 with respect to any interest contemplated in sub-paragraph (aa); and

(iii) the director made a decision, or supported the decision of a committee or the board, with regard to the matter, and the director had a rational basis for believing, and did believe that the decision was in the best interest of the company;”

6.3 In other words a director, who has no personal financial interest in a matter and has taken reasonable steps to become informed about it, subsequently and in good faith makes an incorrect decision relating to the company, cannot be held liable for contravening sections 76(3)(b) or (c) if there was a rational basis for his decision.

6.4 The test in section 76(4)(a)(i) is an objective one, and there is no additional subjective element required as in section 76(3)(c)(ii)²⁰⁸, which would lower the director’s standard of conduct.

²⁰⁷ Cassim *supra* 153.

- 6.5 The director in question may further have no material personal financial interest²⁰⁹ in the subject matter of the decision, and must similarly have no reasonable basis for knowing that any related person has a financial interest in the matter. Alternatively, he must have disclosed any personal financial interest to the board in compliance with section 75.
- 6.6 Section 76(4)(a)(iii) makes it clear that the director is required to actually take a decision, or he must have supported the decision of a committee or the board. Passive actions such as abstention from voting are not included²¹⁰.
- 6.7 The salient test is that the director must have had a rational basis for believing and that he ultimately did believe that the decision was in the best interests of the company. Stein submits²¹¹ that this requirement constitutes a defence against a claim that a director has breached his duty of care and skill, but not his duty of diligence. He indicates that it effectively lowers the standard of care and skill required of a director at common law from “reasonableness” to “rationality”. The test for rationality is objective. An objectively irrational decision will therefore not be protected by the rule²¹². A further noteworthy aspect is that the decision of the director in question must be reasonable. If it is, a court will not interfere with the decision and substitute it with its own ruling with the benefit of hindsight. Cassim states that the reasoning behind this requirement is that an irrational decision points to bad faith on the part of the director²¹³.
- 6.8 From the above it can be seen that the business judgment rule in section 76(4)(a) only protects informed and reasonable business decisions. It is noteworthy that good faith is not a requirement, as is required in its American counterpart. The business judgment rule creates a “safe harbor” from liability for directors who exercise their functions reasonably and on an informed basis.

²⁰⁸ Stein (2011) 245.

²⁰⁹ Section 1 of the Act defines a personal financial interest as a “direct material interest of that person, of a financial, monetary or economic nature.”

²¹⁰ Stein *supra* 245.

²¹¹ *Ibid.*

²¹² Cassim *supra* 513.

²¹³ *Ibid* at 514.

CHAPTER 5: COMPARISON AND CONCLUSION

1. COMPARISONS

- 1.1 The business judgment rule was developed by the American jurisprudence²¹⁴ and is essentially a tool of judicial review rather than a standard of conduct for directors. Due to the fact that the courts in different American states attach slightly different interpretations to the rule²¹⁵, the exact content and parameters of application thereof are hard to define. To date, two significant attempts have been made to codify the business judgment rule²¹⁶ in America which attempts can be described as unsuccessful. Accordingly, no federal legislation has been enacted to give effect to the business judgment rule.
- 1.2 The “common law business judgment rule”²¹⁷ which was developed by the Australian and South African courts, has been described²¹⁸ as a very poorly developed rule. It has its origins in the law of delict and is largely based on the courts’ unwillingness to interfere with internal company decisions of directors. Du Plessis argues that this “very worthy reluctance tends to inhibit the development of fully articulated rules”²¹⁹ and that the common law has therefore not sufficiently developed to be of any “significant utility to practitioners, judges or even directors themselves”²²⁰.
- 1.3 In comparing the statutory versions of the business judgment rule and duty of care and skill in Australia on the one hand and South Africa on the other hand, the following can be observed:
- 1.3.1 in Australia, objective standards apply in evaluating a breach of a director’s statutory duty of care and diligence²²¹;
- 1.3.2 in terms of the provisions of section 76(3)(c)(ii) an element of subjectivity is retained, and a director will be judged against the standard of a director “having the general knowledge, skill and experience of that director”;

²¹⁴ Chapter 2 *supra*.

²¹⁵ Havenga *supra* 36.

²¹⁶ Chapter 2 par. 5 *supra*.

²¹⁷ Du Plessis *supra* 382.

²¹⁸ *Ibid.*

²¹⁹ *Ibid.*

²²⁰ *Ibid.*

²²¹ *Ibid* at 383.

1.3.3 the protection afforded to directors under the Australian business judgment rule is narrower than its South African counterpart²²². Section 76(4)(a) extends beyond pure business judgments and provides directors with protection for the exercise of any powers or the performance of any function related to the office of director.

1.4 Du Plessis submits²²³ that the extended protection afforded to directors in terms of our Companies Act is “perfectly justifiable” and improves on the provisions of the Australian business judgment rule in section 180(2) of the Australian Corporations Act.

2. DIFFERENCES IN OPINION

2.1 Based on the uncertainty of application of the American business judgment rule, it has been observed²²⁴ that, if there is a need to protect directors from liability for honest business mistakes, legislation should be introduced to “limit the scope of the rule” and to balance the standards of care, skill and diligence expected from directors with the high risk of personal liability²²⁵. The business judgment rule encourages directors to take risks and they should not incur personal liability for mere errors of judgment.

2.2 Be that as it may, the introduction of a statutory business judgment rule in South Africa has been rejected by most commentators²²⁶. Because the content of the rule is difficult to define, coupled therewith that the American courts attach different interpretations to the rule, it has been described as “absurd to attempt to introduce the rule into South Africa in a rigid format, particularly in light of the failure of the American authorities to codify the rule”²²⁷.

2.3 Leading commentators on the subject have further formed the view that the business judgment rule should not be codified as the South African courts generally do not second-guess decisions of directors. The degree of care and skill required at common law is further not “onerous” as postulated by the King Report and it has been argued that the recommendations of the King Report were based on inadequate research²²⁸. This group of commentators agrees that the common law provides sufficient protection to directors.

²²² *Ibid.*

²²³ *Ibid* at 383.

²²⁴ *Ibid.*

²²⁵ *Ibid.*

²²⁶ Chapter 4 *supra*.

²²⁷ Kennedy-Good *supra* 291.

²²⁸ *Ibid.*

2.4 Contrary to the above arguments, the business judgment rule is now entrenched in our Companies Act. This development has been welcomed by writers like Du Plessis, who submits that it takes a long time to develop the common law and “many trials and errors before clear patterns can be extracted from court cases”²²⁹. It is therefore advisable to codify the directors’ duty of care and skill in order to provide legal certainty and adequate protection for directors.

3. **CONCLUSION**

3.1 There are compelling arguments²³⁰ to be made that the South Africa legislature has managed to improve the so-called “safe harbour” provisions for directors and that section 76(4)(a) of the Companies Act affords directors with better protection than both the American and Australian business judgment rules. The question whether South Africa needs a statutory business judgment rule can therefore be answered in the affirmative.

3.2 The question, however, remains to be answered whether our law makers have managed to “strike the right balance”²³¹ in the codified version of the rule in the Companies Act between the fiduciary duties of directors and the accompanying standards of care, skill and diligence required of them vis-à-vis the risk of personal liability for directors²³².

3.3 It is submitted that it is now up to the judiciary to apply the aforementioned statutory provisions to future cases and to continue to develop the interpretation and scope of the rule in a similar manner as the Australian courts in matters such as *ASIC v Rich* and *ASIC v Healey* which were discussed above.

²²⁹ Du Plessis *supra* 382.

²³⁰ *Ibid* at 383.

²³¹ *Ibid*.

²³² *Ibid*.

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