

A discussion on the duty of care, skill and diligence to be exercised by a director in light of the Companies Act 71 of 2008, as well as the common law and an overview of the business judgement rule: A company law perspective

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Abstract

The duty of care, skill and diligence is a duty on a director that has been considered both internationally as well as locally. It is a duty that has come under the microscope, and is thus of importance to consider in a country such as South Africa, whom attempts to update its corporate law, to meet international standards. This duty is therefore of importance to consider, as well as to gain some insight as to exactly what the tests for negligence will be or is. This “confusion” is as a result of the development of the common law as well as the statutory law, standard of care, skill and diligence. This is because it will need to be determined whether both objective and subjective tests are to be adopted in determining a director’s negligence, and thus whether a director’s performance of such care and skill resulted in negligence. The business judgement rule is a recent addition to the South African corporate law regime, and is seen with its codification in the Company’s Act 2008¹. In essence this rule is there as a means to protect directors, as a result of having both objective and subjective elements mentioned above. It also allows for a director to defend him or herself from liability, but also safe harbour them from a possible breach of the duty of care, skill and diligence, that is expected of a director. Although the business judgement rule is one that has been applied in many foreign jurisdictions, it is a rule that has come under the microscope in South Africa, for criticism, as to whether it is really a rule that is needed in South African corporate law. The rationale of this dissertation is therefore to allow for readers to have a better understanding of the duty of care, skill and diligence in terms of both the common law as well as the statutory law, in South Africa. It will also allow for a reader to have insight on the business judgement rule, and its applicability in South African law.

¹ The Companies Act 71 of 2008.

CHAPTER ONE

Introduction

1.1 The Title

A discussion on the duty of care, skill and diligence to be exercised by a director in light of the Companies Act 71 of 2008, and an overview of the business judgement rule: A company law perspective

1.2 The topic:

As can be seen from the above title, that the area under examination is corporate law, and more specifically, the duty of care, skill and diligence to be exercised by a director in performing this duty. In order for one to do comprehensive research on the duty of care, skill and diligence to be exercised by a director, one will need to consider both the common law as well as the statutory law in this regard.

In researching this area, it is only appropriate, that a discussion be included on the business judgement rule that has now been introduced into South African corporate law. The reason for this inclusion of the discussion on the business judgement rule, is because firstly the business judgement rule is closely related to the duty of care, skill and diligence to be exercised by a director, as well as because the business judgement rule is a new inclusion, which has now been codified in South African company law. Thus it is only appropriate that a discussion into whether the business judgement rule should have been adopted or not into South African law be included.

1.3 The research design and methodology being applied:

In compiling this dissertation on the duty of care, skill and diligence to be exercised by a director, visits to various libraries both nationally and internationally have been made. As a result, it was important to also make extensive use of the interlibrary loan facility. A number of other sources have been utilized in writing this dissertation. Relevant South African and international sources have been used, such as:

- Books
- Journal articles
- Conference papers

- Policy documents and recommendations
- Bills
- Statutes
- South African and international law reports
- Articles from the internet
- Articles from local and international newspapers and magazines.

The research methodology for this paper is desk-based. As a result, various databases have been used to comprehensively research the topic. The following databases have been accessed; Juta, Lexis Nexis, Heinonline, Ebscohost, Google scholar, Sabinet, West law, SAFLII, amongst others.

In terms of the research design, this will include a qualitative as well as a descriptive approach that will consider the duty of care, skill and diligence, in terms of the common law as well as statutory law. The research will also include a discussion on the business judgement rule, and in particular whether it was necessary to include it in South African law.

With the above being built on, this will allow for the exploration of the duty of care, skill and diligence that a director must exercise, as well as considering the business judgement rule. This will allow for clarity to be obtained on the above as well as consider the application and suitability to the South African law, with use of case law and various other publications.

1.4 The background of the topic:

A director has common law duties, namely the fiduciary duties of good faith, honesty and loyalty. Directors also have to exercise the duty to exercise reasonable care and skill, which are not fiduciary duties. In terms of the Companies Act 71 of 2008², (hereinafter referred to as the 2008 Act) the fiduciary duties of directors are mandatory and prescriptive. In terms of the common law, the fiduciary duties of directors were formulated by way of case law. However this case law is of vital importance, as the 2008 Act, has used this case law and incorporated same into the 2008 Act.³

² The 2008 Act.

³ Section 66(1).

As a result of the common law and the introduction of the 2008 Act, a new innovation that has come about, is that the duty to exercise reasonable care and skill have been partially codified. This partial codification of director's duties allows for clearer law and more accessibility. As will be seen below, the partial codification can be clearly seen in terms of section 76(3)(c)⁴. There are however advantages and disadvantages to having a partial codification of directors duties. This aspect will be discussed in the following chapter.

In regards to the partial codification, and in respect of the duty of care and skill, in terms of the 2008 Act, and in terms of section 76(3)(c)⁵, which illustrates the partial codification, this section imposes a less subjective test and a slightly more demanding standard of care on directors and prescribed officers of the company than the common law. This leading to the inclusion of section 76(4) and 76(5)⁶. These sections will cover where a director relies on the performance of an employee, and acts on same. This is what has become known as the business judgement rule. It is these areas that will be considered in detail, as one will note that the subjective and objective factors in measuring negligence of a directors duty to exercise care, skill and diligence, are areas that needs considering in light of the 2008 Act, and the inclusion of the business judgement rule. In terms of the subjective test mentioned above, this subjective test indicates that a director, if he or she is unskilled and lacks the relevant business acumen, then a low standard of skill and care will be attached to that director. This is one of the two part test that is applied in terms of section 76(3)(c). The second part being the objective test, which uses the reasonable person test to determine the standard of care, skill and diligence of a director in question⁷.

In terms of the common law, the basic principle here is that directors are liable for negligence in their performance of their duties. However in the past, the courts have held that if shareholders appointed foolish directors they had only themselves to blame.⁸ Thus the courts formulated the duty of care, skill and diligence on delictual liability for negligence, and thus on subjective terms such as, skill, experience and the ability of the particular director in question. This thus created a low standard of care to test against, as the less a director knows the less is expected of him.⁹

⁴ The 2008 Act.

⁵ The 2008 Act.

⁶ See note 1: The 2008 Act.

⁷ Cassim, FHI...et al. *Contemporary Company Law* 2nded (2012) 558.

⁸ *Deloitte Haskins & Sells v Anderson* (1995) 16 ACSR 607 (NWS).

⁹ FHI Cassim 'Fraudulent or reckless trading and s424 of the Companies Act of 1973' (1981) 98 *SALJ* 162.

However in terms of section 76(3)(c) of the Companies Act 2008, this section improves the requirements to test a directors' duty of care and skill. This can be seen in that this section imposes a less subjective test and a slightly more demanding standard of care on directors than the common law. This would seem to be in keeping with modern standards, as directors these days are often skilled professionals with experience. The test in these sections seems to be that of a reasonable person as well as taking into account the skill experience and knowledge of that director. This thus implying that there is no longer a uniform standard of care of directors¹⁰.

An important aspect in this regard is the delegation of certain functions to employees in a company. The common law rules regarding delegation and a director's liability are still applicable. This is because in terms of section 76(4) and (5) of the 2008 Act, these rules have been expanded on as well as codified. This can be seen in section 76(4) and (5), which provides that directors may now rely on the performance of an employee, a professional person, an expert, or a board committee, provided that they reasonably believe that such persons are reliable and competent or merit confidence. This will therefore mean that if a director has complied with section 76(4)(b) and (5), they will not incur liability for the actions of persons on whom they have place their reliance.

This therefore leads to the business judgement rule, in terms of section 76(4). For the business judgement rule to apply the following needs to be applicable:

1. The decision must be an informed on;
2. The director must have no personal financial interest;
3. The director must have had a rational basis for believing and did believe that the decision was in the best interest of the company. The rationality test being objective.

Taking the above into consideration, this would mean that if the above are satisfied, then a director will not be liable for honest and reasonable mistakes. It will also apply where directors have acted honestly and reasonably and the above requirements have been met, they will not incur liability for honest errors of judgement.¹¹ This is a new inclusion in South African law, and therefore needs to be explored as to whether it is a good addition to South African corporate law.

¹⁰ Cassim op cit note 7 at 559.

¹¹ *Smith v Van Gorkum* 488 A2d 858 (Del. Supr. 1985).

Company law is an important area in any country, as it affects the economy, and also commercial activity. It will therefore either make the economy better and boost it or restrict the economy. It is thus an important area, and thus having the correct legislation and company law is of vital importance to the economy. It can be noted that the Companies Act 61 of 1973¹², (hereinafter referred to as the 1973 Act), was seen to be bulky, complex and full of conflict in its philosophy and policy. This can be seen in the fact that the 1973 Act was amended about 42 times in its 37 years of existence, making the Act rather complex and excessively technical. The fact that the Act was in existence for 37 years, also showed that the domestic and global economy had changed, and thus there was a need for a change. This change will result in law that is simpler, cost effective as well as to keep up to a standard of international jurisdictions. This was the thinking behind the drafting of the 2008 Act, and hence the idea behind the 2008 Act, was to have clearer legislation that was simply.

1.5 The problems that manifest in respect of this topic

With the above information, one will note that the problem area that arises is firstly whether the common law approach or statutory approach will be able to function together. This is because over the previous company law regime a wealth of cases that has been created by the common law, which is now been seen as outdated precedents, and thus raises the question, as to whether can they still apply, with the 2008 Act.

The duty of care, skill and diligence is only a partial codification, and therefore it is important to see if the partial codification will work in addition to the common law duty of care, skill and diligence. There is still to be a judgement or case law that decides if the common law will apply in conjunction with the 2008 Act, and therefore as it stands whether the common law and statutory law approach will work hand in hand remains unclear.

The second issue to look at is the business judgement rule. This is because although the business judgement rule is there to ensure that directors are protected from hindsight bias, and that it encourages innovation as well as risk taking by protecting certain business

¹²Preceded the 2008 Act.

decisions and other acts of directors, the problem arises in the fact that the business judgement rule has been heavily criticized, despite its many advantages.¹³

It is with the above two issues that lead to the question of firstly; what standard of care, skill and diligence must be exercised by a director in terms of the common law; secondly, what standard of care, skill and diligence must be exercised by a director in terms of the statutory law; and thirdly, is the business judgement rule a good addition to the South African corporate law system.

1.6 The rationale or purpose of conducting research in respect of this topic

The purpose of conducting research for this dissertation will be to examine each of the abovementioned areas, and determine the change that has been made from the 1973 Act to the 2008 Act. It will allow for a discussion on whether the common law is still applicable. At the same time it is important that the research is able to illustrate the standard of care, skill and diligence that must be exercised by a director in the performance of his or her duty, while holding office. And thus it is important to differentiate between the common law standard and the statutory law standard that is utilized to measure a director's negligence in respect of the duty of care, skill and diligence.

It is important to show the readers the rationale of this research, being also that there have been developments of the standard of care, skill and diligence that must be exercised by a director. For example and as will be illustrated in Chapters Two and Three the common law initially adopted a lenient approach to test the skill, care and diligence of a director, while later developments in the common law allowed for a more rigorous test to be adopted. This will allow for the reader to identify the changes, and developments that have been effected by the 2008 Act.

It is also important to illustrate to the readers the rationale behind the research in respect of the business judgement rule and whether the addition of this rule is of any significance in South African corporate law, as it has now been included in terms of the 2008 Act, although there has been various criticisms of having such a rule, which allows for a director to escape liability in respect of a breach of duty.

¹³ Cassim op cit note 7 at 563.

1.7 Structure of the dissertation

The most appropriate way of considering the problems and purpose of the topic at hand, is by looking at each aspect chapter by chapter. Therefore it can be noted that the next chapter, namely Chapter Two will focus on the director's duty to exercise care, skill and diligence – the common law approach. This will allow for a proper understanding for the next chapter being the statutory law, and in particular section 76(3)(c) of the Companies Act.¹⁴

Chapter Three will focus on statutory law, and in this regard, the chapter will focus on the 1973 Act and the 2008 Act. The chapter will also look at the common law approach, known commonly as the lenient approach, as well as the strict approach in terms of the statutory laws. As a result it is important to also consider the advantages and disadvantages of partial and total codification of the duty of care, skill and diligence, in terms of the 2008 Act.

Based on the above background, and having considered the duty or care, skill and diligence in terms of the common law as well as the statutory law, Chapter Four will examine the business judgement rule as well as its applicability in South African corporate law.

Finally, Chapter Five will aim to draw a conclusion from the above chapters. It will recap the standard of care, skill and diligence that should be exercised by a director, as well as a recap as to whether the business judgement rule is a good addition to the South African corporate law regime, and thus its incorporation in the 2008 Act.

¹⁴ The 2008 Act.

CHAPTER TWO

A director's duty to exercise care, skill and diligence – the common law approach

2.1 Introduction

It is important to consider the common law prior to the 1973 Act, as well as the 2008 Act, as this will allow for one to have a better understanding when one looks at the 2008 Act, as well as allow for one to see the changes and improvements that have come about by the 2008 Act, and the reasoning behind these changes.

The reasoning for this is that in recent times, there have been major corporate collapses, caused by board mismanagement, which have resulted in many countries to rethink whether a director meets the standard of care, skill and diligence required or expected by investors both locally or internationally. It is as a result of this that South Africa, decided to review this area of law.

The general principle is that directors are liable for negligence in the performance of their duties¹⁵. However this would mean that one would need to look at the extent to which a director, whether executive or non executive, is liable for the loss caused by his or her actions, namely his or her incompetence or carelessness. However courts have in the past have simply adopted the approach that the shareholders were ultimately responsible for the appointment of the directors of the company, and therefore if the appointment was an unwise one the shareholders had to bear the consequences of same, and therefore the directors would be the one to blame¹⁶. It will be noted though, that in recent years that the courts have now started adopting a more rigorous approach, and thus a change in the approach.

A director has common law duties, namely; the fiduciary duties of good faith, honesty and loyalty. Directors also have to exercise the duty to exercise reasonable care and skill, which are not fiduciary duties. This aspect will be discussed below in terms of the 1973 Act and the 2008 Act.

2.2 A discussion on the Directors duty to exercise care, skill and diligence in terms of the common law. Subjective or objective test?

¹⁵ Cassim op cit note 7 at 563.

¹⁶ *De Loitte Haskins* supra note 8 at 607; *Turquand v Marshall* (1869) LR 4 Ch App 376.

The duty of care, skill and diligence, is not a fiduciary duty and can rather be seen as one which is based on delictual or Aquilian liability for negligence.¹⁷ In this regard the courts have based the test for negligence on subjective factors such as; skill, experience, and the ability of the director in question. Thus a court would look at these factors in determining whether a director can be held liable for negligence. This subjective test therefore created an unreasonably low standard of care, that was required of directors, and thus directors were only required to exercise that level of care and skill that they were capable of. This therefore meant that the more inexperienced or incompetent the director was the lower the standard of care that was expected of him or her.¹⁸ Cassim has written on this aspect and is of the view that as a result of this subjective test of care and skill, it is the director's ignorance and inexperience that protects him or her from liability, since the less he or she knows the less is expected of him or her.¹⁹ This is unlike a professional person, because a director in terms of law is not required to have any qualifications to hold office.

In terms of qualifications for a director, one will note that a director does not need to have any special qualifications to hold office. Directors are also not members of any professional body and as such no objective standard of skill is thus applicable to directors. Cassim notes that it is difficult to formulate a single objective standard that can apply to all directors, as the degree required will differ from executive to non executive directors, as an executive director will be expected to know more and be more qualified than a non executive director. This thus makes it very difficult for courts or even the legislature to formulate one objective standard that can be applied.²⁰

However on consideration of the common law, one of the factors that the court looked at was, that a director was expected to exercise the care and skill that may be expected of a person with his or her knowledge and experience. This was illustrated in the case of *Re Brazilian Rubber Plantations & Estate Ltd*²¹. In this case the directors were unsuccessfully sued for losses as a result of their poor speculation in the rubber plantations in Brazil. Their decision was based on a fraudulent report, and the court held that a director's duty is to act with such care as is reasonably expected from him, having regard to his knowledge and experience.²²

¹⁷ *Ex parte Lebowa Development Corporation Ltd* 1989 (3) SA 71 (T); *Du Plessis NO v Phelps* 1995 (4) SA 165 (C).

¹⁸ Cassim op cit note 7 at 555.

¹⁹ Cassim op cit note 7 at 162.

²⁰ Cassim op cit note 7 at 555.

²¹ [1911] Ch 425 (CA) 437.

²² This principle was also laid down in the case of *Lagunas Nitrate Co v Lagunas Syndicate* [1899] 2 Ch 392.

The court further held that a director is not bound to bring any special qualifications to his office. However should he have any knowledge of the rubber industry then he would be obliged to use that knowledge to the best of his ability. The court further held that a director is not liable for damage caused by errors of judgement (imprudence)²³.

It is important to note that there is a distinction between care and skill, and although not always easy to distinguish, there is a difference. This distinction has been illustrated in the case of *Deliotte Haskins & Sell v Anderson*²⁴, in which the court stated that skill referred to the knowledge and experience that a director brings to his office. Skill therefore would mean the technical competence of a director, while care is the manner in which the skill is applied. Thus care maybe objectively considered, however skill varies from person to person.

In terms of the common law a director was required in the performance of his or her duties to exercise the care and skill that may be expected of a person with his or her knowledge and experience. This was illustrated in the case of *Re City Equitable Fire Insurance Co Ltd.*²⁵ This case dealt with a company that had suffered a short fall in its funds as a result of its managing director was convicted of fraud. The liquidator of the company wanted to hold the other directors of the company liable for their failure to detect the fraud of the managing director. The liquidator of the company was successful in this regard, as the court held that the directors were negligent in this regard. However the directors were exempted from liability with a clause from the company constitution. It can be noted in this case that, Romer J, held that directors must use the degree of care which an ordinary man might be expected to take in the circumstances.²⁶ However he went on to qualify this statement by adding that a director need only exhibit the skill of a person of his knowledge and experience. Thus while Romer J imposed some objectivity in regard to the care that directors must exercise, director's were only required to apply the skills they posses. This therefore indicated that there was a transformation of the prima facie objective test underlying the duty of care into a subjective one which took into account not only the directors particular position in the company, but also the directors intelligence and experience. The rationale for this approach was that it is the shareholders fault if they appoint an incompetent director.²⁷ This lenient

²³ Cassim op cit note 7 at 556.

²⁴ Supra note 8.

²⁵ [1925] Ch 407.

²⁶ Supra.

²⁷ Supra; *Re Forest of Dean Coal Mining Co* (1878) 10Ch D 450 453; *Re Faure Electric Accumulator Co* (1888) 40 Ch D 141.

approach of the common law, seems to have been premised on the assumption that directors were benevolent amateurs, who lacked any specialist talent, and thus they could not be expected to maintain involvement in company affairs, much less exercise the care and skill of a professional. It was also held by Romer J, that the duties of a director were intermittent, as at common law a director was not bound to give continuous attention to the company's affairs.²⁸ As a result of the above case we can note the movement from the lenient approach to a more stringent approach, and thus an objective and subjective test to be considered. Thus if a directors duty is intermittent, the duty to exercise care and diligence would only arise if the director actually attends a board meeting, and directors are not bound to attend all board meetings.

In this regard one should also take note of *Fisheries Development Corporation of SA Ltd v Jorgensen*,²⁹ where the court made a distinction between executive and non executive directors. It was noted that an executive director maybe under a duty to exercise a higher standard of care arising from the terms, whether express or implied, of his or her contract of service with the company. A non executive director is not liable for mere errors of judgement, as he or she is not required to have any special business acumen, expertise, intelligence or even experience in the business of the company. He or she must however not accept information or advice blindly even if it is given by a suitably qualified person³⁰. If this distinction is made it would suggest that an executive director who is under contract with a company, owes the company a higher duty of care, skill and diligence, as they are appointed to that position because they would have some skill or background experience that is suitable for the position. Whereas a non executive director would not have such a heavy burden placed on him or her, as he or she is not required to hold any special qualifications or skills. This is because a non executive director is not required to attend board meetings, and thus should not be held liable for errors of judgements.

The court further approved the subjective test laid down in *Re Brazilian Rubber Plantations & Estate Ltd*,³¹ and has identified three principles, which have been applied for a number of years and approved also in the case of *Fisheries Development Corporation of SA Ltd v*

²⁸ Supra at 428-429.

²⁹ 1980 (4) SA 156 (W).

³⁰ Cassim op cit note 7 at 557.

³¹ Supra at 437.

*Jorgensen; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd*³².

The three principles are as follows:

- A director need not exhibit a greater degree of skill than may reasonably be expected from a person of his or her knowledge and experience. This would therefore imply that one is expected to exercise the care that can reasonably be expected of a person with his or her knowledge or expertise.³³ It will also be noted that a director will not be held liable for mere errors of judgement.³⁴ This standard thus indicates that it is a subjective standard and not an objective standard.
- A director is not required to give a company his contentious attention to the running of the company's affairs. A director's duties are of an intermittent nature and are performed at periodical board meetings. This would therefore mean that there is a difference between full time executive director, who is engaged in the day to day management of the company, and a non executive director who has not undertaken any special obligations. This therefore would mean that, as suggested above that the latter is not bound to give continuous attention to the affairs of the company, and his duties are of an intermittent nature³⁵.
- In respect of all duties that having regard to the exigencies of business and the articles of association, may properly be left to some official. One will note that a director is in the absence of grounds for suspicion is justified in trusting an official to perform such duties honestly. The leading case in this regard *Fisheries Development Corporation of SA Ltd v Jorgensen*³⁶, which illustrated the above point. This would be in cases where a director can trust the companies accountants, auditors or attorney or other such persons to perform their functions properly and honestly. It should be noted that a director exercising reasonable care would not accept information and advice blindly, but rather he or she should accept it and rely on it provided he or she has given it due consideration and he or she has exercised his or her own judgement on the aspect in question.³⁷

³²Supra.

³³ N Bouwman 'An appraisal of the modification of the director's duty of care and skill' (2009) 21(4) *SA Merc J* 509-534.

³⁴ Supra at 437.

³⁵ MM Botha 'The role and duties of directors in the promotion of corporate governance: a South African perspective' (2009) 30(3) *Obiter* 702-715.

³⁶ Supra at 156.

³⁷ Bouwman op cit n33 at 509-534.

It should be noted that as pointed out by Cassidy³⁸, and a view which can be seen as correct, that by allowing a director to attend to their duties in an intermittent manner, there is no requirement at common law that directors actively participate in the management or inform themselves of the company's financial position. She is further of the view that the common law test fails to require of directors one of the most basic aspects of corporate duties, that being their attendance at board meetings, and it is for this reason that she is of the view that the South African common law duty of care is inappropriate in a modern commercial world. This is because as Cassidy puts it, and correctly so, that there is no reason as to why a director should not meet the standards expected of other professionals, for example accountants, lawyers and doctors all are expected to maintain a standard of a reasonable person conducting a business in that profession.

2.3 What degree of care and skill is required of a director?

Having considered the above one needs then to consider what degree of care and skill is required of a director?

Williams, has written on this aspect and is of the view that the law imposes a heavy duty on directors to act honestly, but also imposes a light burden in relation to the skill and diligence with which they must carry out their duties³⁹. The reasoning for same can be seen as follows:

- It will be noted that a director is not an employee of a company. This is because a director has no contract with a company, and therefore one cannot impose the contractual implications that he or she is to act with the skill that an ordinary employee under contract is required to possess or even the required diligence that an employee is required to exercise. This means that while a director has no contract with the company, it is insurmountable to imply that there is a contractual promise by such a director that he will act diligently or with the required skills. Thus for example if an accountant or secretary is employed for a position, then it is given as a guarantee that the skills for which they are employed will be present⁴⁰.

³⁸ J Cassidy 'Models for reform: The directors' duty of care in a modern commercial world' (2009) 20(3) *Stell L R* 373-406.

³⁹ RC Williams *Concise Corporate law and Partnership Law* 3rd ed (2013) 179.

⁴⁰ *Ibid* at 182.

- One will note that members of a company can elect a director who has no knowledge or experience in the running of a company. This thus makes it difficult for a court to measure against what a reasonable director is. This is because a director is not a member of any association, and thus a court cannot measure the degree of negligence against a 'reasonable' director. Further a director is appointed by a majority vote and does not require any experience or skill to be appointed to that position. In this regard Williams illustrates his point by way of example, of a medical practitioner, in the medical profession and who is a doctor, then in those circumstances a court when judging, a medical doctor and determining whether same was negligent would look at whether there was negligence whilst in the midst of his or her profession. By looking at this a court will be able to enquire whether the medical doctor was negligent in the midst of his or her profession. Again in this regard Williams has pointed out that while it is easier to measure a doctor's negligence, although it entails entrance examinations and practical experience, a director is not subjected to such requirements⁴¹.
- Further it will be noted that judges can assess whether a director has acted honestly or not, but judges are reluctant to determine whether a director's judgement on a business related idea was negligent or not. This was noted in the leading case on director's duty to exercise care and skill in *Re City Equitable Fire Insurance Co Ltd*.⁴² As discussed earlier the principles laid down in this case were adopted in the *Fisheries Development Corp of SA Ltd v Jorgensen*⁴³. These principles laid down have become known as the common law principles,⁴⁴ and include the objective and subjective tests.

Having considered the above it will also be noted that a director has an affirmative duty to safeguard and protect the affairs of a company.⁴⁵ This is because a director has a duty to act in the best interest of a company, therefore a director is under the duty to ensure the best is carried out for the company, and thus acts in the best interest of the company. This is a view that Williams also maintains, while at the same time noted that both executive and non

⁴¹ Ibid at 182.

⁴² Supra.

⁴³ Supra.

⁴⁴ Williams op cit n39 at 183.

⁴⁵ *Howard v Herrigel* 1991 (2) SA 660 (A).

executive directors are subject to the same line of duties in respect of negligence. It can also be noted that the 1973 Act,⁴⁶ provides that where a director's negligence results in a company carrying on business recklessly, the director may incur personal liability, in terms of s 424 of the 1973 Act.

The standard of care has been illustrated above to be a mixture between objective and subjective factors.⁴⁷ This being because it is seen that the minimum standard is that of a reasonably prudent person, but a director who has greater skills, knowledge or experience than the reasonable person must give to the company the benefit of those skills, knowledge and experience.⁴⁸ This would mean that a director with 20 years experience as a director will be judged according to a director with 20 years experience, and thus consider subjective factors as well. But in this regard it is important to take note of the view of Havenga, which states that no clear borderline exists between the fiduciary duty and the duty of care and skill and that overlapping can exist. This is because a director is under the duty to act in the best interest of the company. This will be explored in more detail later in the chapter. If this overlapping exists then this will become known as what is now known as the business judgement rule.⁴⁹ It is important to note that the director's duty of care, skill and diligence is very closely related to the business judgement rule.⁵⁰

It can also be noted as illustrated above that a director's duty to exercise care and skill does not flow from the fiduciary relationship that exist with the company. The common law imposes both a fiduciary duty as well as a duty of care and skill.

2.4 The Remedies for a breach of Fiduciary Duties and the Duty of Care and Skill

It is of vital importance that one considers the remedies available. Thus one will note that when one considers the fiduciary duties that a director owes a company, one will note that, a director is required to act in good faith and to act for the benefit of the company. This therefore means that a person in a fiduciary relationship will be held liable for a breach of trust if he or she acts for his or her own benefit or to the prejudice of another. Thus one will

⁴⁶ The Companies Act 51 of 1973.

⁴⁷ Botha op cit note 35 at 702.

⁴⁸ *The King Report on Corporate Governance for South Africa* (Institute of Directors in Southern Africa) (2009).King III 11-12

⁴⁹ M Havenga "The business judgement rule – Should we follow the Australian example?" (2000) 21 SA Merc LJ 25.

⁵⁰ JJ Du Plessis 'A comparative analysis of directors' duty of care, skill and diligence in South Africa and in Australia: Corporate governance and mergers & take over's: part II' 2010 *Acta Juridica* 263-289.

be entitled to claim restitution to the company, as the remedy for the breach of a fiduciary duty, for any loss that a company has suffered or the benefit that a director may have gained.⁵¹ It is to be noted that the cause of action for the breach of the duty of care is based on delict and requires that the following elements be established⁵²:

- Conduct;
- Wrongfulness;
- Fault (either intent or negligence);
- Loss suffered;
- Causation.

However one will note that the standard of care in our law is derived from English common law, and in that instance the remedy for breach of the duty of care is delictual damages recoverably by the company, and not restitution.⁵³

If a contract exists between the director and the company then he or she is guilty of breach of contract.⁵⁴

2.5 The movement in the common law

It must be pointed out that South African law has long recognised the need for directors to delegate, and have adopted the English common law in this regard. In terms of the common law a director is allowed to delegate their responsibilities to and rely on the advice of third parties without the additional requirement that the delegate be supervised.⁵⁵ The leading South African case on this issue is, *Fisheries Development Corporation of SA Ltd v Jorgensen*⁵⁶, which held that a director is entitled to rely on another in the absence of grounds for suspicion and to assume that the delegate is properly and honestly performing their duties.

It is important to note that the English courts have followed a “lenient approach” in holding directors accountable for their breach of duty of care and skill. This is because as noted above that a subjective formula was used in testing a director’s intelligence and experience. Both English and South African law have adopted the attitude that directors need not have

⁵¹ E Jones ‘Directors’ duties: Negligence and the business judgement rule’ (2007) 19 *SA Merc LJ* 326 at 334.

⁵² Ibid at 330.

⁵³ Ibid at 329.

⁵⁴ Botha op cit note 35 at 710.

⁵⁵ Supra note 25.

⁵⁶ Supra note 29.

any special qualifications for their office. This would be seen as a correct approach, as this would encourage people to take up positions as directors, in South Africa, where there has been a history of previously disadvantaged people. One will note that South African law has been based on the English law, and thus our common law has been derived from same. However unlike South African law, English law has imposed a more rigorous duty of care on directors of a company, in that the English have included both a dual objective and subjective standard according to which the skill and care performed by a director could be measured. However this position was not adopted in South African common law. The reasoning for this “lenient approach” was based on the following⁵⁷:

- Shareholders are responsible for the competence of managers appointed by them; this is because they are the ones that decide who is to be appointed, and thus if they appoint incompetent people, it is them who should bear the consequences as such, as a result of their failure to appoint competently.
- In earlier days companies were few and directors were mostly part time, non executive persons appointed for their title or reputation within society, and not for their business expertise or skill. This standard therefore meant that nothing less than the uttermost gross or culpable negligence would lead to a finding that a director was in breach of his or her duties.

The above has been well illustrated in case law namely ; *In Re Denham & Co*,⁵⁸ where the court held that the director not to be in breach of his duty of care after having found him guilty of negligence in the performance of his duties and for not executing the duties of his office at all for four years. However at some point this lenient approach needed to change as it no longer suited society’s needs and the expectations relating to the standard of care that directors should adhere to. In the case of *Re D’Jan of London Ltd*⁵⁹ the court applied a new test based on a section in the Insolvency Act⁶⁰, which included both a subjective and objective elements, mirroring a more rigorous approach. However the comments of Bouwman should be considered in that the wording of the test stated in *Re D’Jan of London*

⁵⁷ Bouwman op cit note 33 at 515.

⁵⁸ *In Re Denham & Co* (1884) LR 25 Ch D 752.

⁵⁹ *In Re D’ Jan of London Ltd* [1993] BCC 646 (Ch D (Companies Court)).

⁶⁰ Section 214(4) of Insolvency Act 1986.

Ltd corresponded largely with the proposed test for the degree of care and skill contained in the Companies Act 2008.⁶¹

The question that arose was whether South Africa should adopt a rigorous approach. In this regard the case of *Deloitte Haskins*,⁶² is of importance, as it illustrated that the concept of both skill and care are not the same. It was correctly held that it is no longer appropriate to judge directors conduct by the subjective tests that were applied in outdated precedents and that a more objective test must be applied to a director's duty of care and skill. Thus the implications of the *Deloitte* case is that an objective test should be applied, in that a test in terms of which a standard be tested in respect of a reasonable person. This is a standard that has been adopted by various international economies. In this regard, this should be the approach that South Africa adopts, which includes an objective as well as subjective approach, and as will be seen in the next chapter this is the approach adopted as the common law has a more rigorous approach of objective and subjective tests, the 2008 Act, has retained a rigorous approach.

It can also be noted that as pointed out above that a director can delegate certain functions, it however must be pointed out that such delegation in terms of the common law is far too lenient. The common view in this regard seems to be that the mere requirement of "absence of grounds for suspicion" is insufficient.⁶³ This is because this approach does not consider ones competence and trustworthiness in respect of the delegation, or the monitoring of the delegation. Thus the common law allows for a director to pass off their responsibilities to another without any regard to the reasonableness of that delegation. These elements are of importance, as if a director is giving someone work to complete the director must be satisfied that the person is able to deal with it in a manner that is appropriate, as well as competently. This would thus allow for a director to be able to over look and merely monitor the work passed onto that person and be able to rely on the information provided by that person, and thus trust same.

2.6 Conclusion

It is important to note that this chapter has illustrated that it is important to look at the common law, in order to look at a director's duty of care and skill, in terms of the 1973 Act

⁶¹ Bouwman op cit n33 at 522.

⁶² Supra note 8.

⁶³ Cassidy op cit note 38 at 381.

as well as the 2008 Act, so that one is able to identify the changes that have come about. In this regard and in terms of the duty of care and skill, the general principle is that directors are liable for negligence in the performance of their duties. However this needed to be discussed in more detail, and was looked at in more detail in the above chapter, as one needs to determine the extent to which a director can be held liable for the loss suffered as a result of the negligence. It has been noted that in the past that courts have adopted the approach that the shareholders were responsible for the appointment of the directors of the company and thus if the appointment was an unwise one, the shareholders would be the ones to have to bear the consequences of the appointment. The courts in recent years have however moved to a more rigorous approach, and thus the courts have based the tests for negligence on subjective factors such as skill, experience and the ability of the director in question. It is as a result of this subjective test that has resulted in problems with such test being applied, as it would mean that an unreasonably low standard of care would be required of directors, and thus directors would only be required to exercise that level of skill and care that they were capable of.

Objective factors would be difficult for a court to formulate and use a single objective factor, because a court would not be able to apply a single objective standard to all directors, as the degree required will differ from executive to non executive directors, as the former would be expected to know more than the latter.

In terms of the common law however a director was expected to exercise the care and skill that maybe expected of a person with his/her knowledge and experience.⁶⁴ In this regard the element of care and skill when considered illustrated that care maybe objectively considered, however skill varies from person to person.⁶⁵ This principle was endorsed in the case of *Fisheries Development Corporation of SA Ltd v Jorgensen; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd*,⁶⁶ as it was correctly noted that a director was expected to exercise the care and skill that can be reasonably be expected of a person with his or her knowledge or expertise. It was in this case that the courts distinguished between care and skill. This indicates a subjective standard that will be required to be applied, and correctly so as each person should be judged on the circumstances surrounding them, and in that regard their qualifications and work experience. As was noted in the

⁶⁴ Supra note 21.

⁶⁵ Supra note 8.

⁶⁶ Supra note 29.

Fisheries Development Corporation of SA Ltd v Jorgensen; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd,⁶⁷ that the court correctly distinguished between an executive director and a non-executive director, and that an executive director would be under a duty to exercise a higher standard of care, as this type of director would be employed by a company because they see him or her as having the required skill, intelligence and experience to be in that position, whereas a non-executive director, is not required to have any special business acumen, expertise, intelligence or even experience in the business of the company. An executive director would be required to have these elements, as they are appointed as executive directors as a result of their experience, skill, intelligence, and business acumen.

It is as a result of the above that one can note that the standard of care and skill, is therefore a mixture between objective and subjective factors. This is because, in terms of the common law, the subjective test being that directors were only expected to exercise the care and skill that they were capable of, which was seen as a very low standard to measure against, and hence the move away and incorporation of an objective test, of measuring the directors' conduct against that of a reasonable person. This can be seen as the correct approach as in a country such as South Africa, where directors are still learning or gaining experience, and people are being encouraged to take on positions as directors, this subjective and objective standard would be suitable. This standard allows for one to be measured against a reasonably prudent person, but a director who has greater skill, knowledge or experience than a reasonable person must give to the company the benefit of those skills, knowledge and experience.

The common law standard of care imposed by the courts in South African law under the previous company law regime is manifestly inadequate in modern times to protect shareholders from the carelessness and negligence of the directors of a company. This was a point that was well illustrated in the case of *Deloitte Haskins & Sells v Anderson*,⁶⁸ which held that it is no longer appropriate to judge directors' conduct by the subjective tests that were applied in the past. It was suggested that a more objective approach to the director's duty of care and skill be applied. As a result South African law has moved towards a more rigorous and less subjective duty of care and skill, and thus keeping it both objective with some subjective factors being looked at in the circumstances. However whether the common

⁶⁷ Supra note 29.

⁶⁸ Supra note 8.

law applies with the duties of care and skill in terms of the 2008 Act, is yet to be seen. But it can be noted that the subjective and objective approach can be seen as a correct approach, for a country like South Africa, which has a history of previously disadvantage people, who are now taking up positions as directors. It is an approach that would encourage directors to take up the position, rather than them being afraid of the consequences of them being held liable. However a double standard of an approach may be problematic as one would not be sure in terms of which standard to be measured against and which standard to hold one accountable and liable. It should be noted and considered that one should consider our common law as well as the relevant legislation, as this allows for both objective and subjective test to be applied. This is because it allows for one to use the common law, and at the same time to be take into account the persons qualifications, skill and experience and thus considering subjective factors.

CHAPTER THREE

A Directors duty to exercise care, skill and diligence in a company- a statutory law approach

3.1 Introduction

In considering the 2008 Act, it is worth while mentioning that the 1973 Act, does not make statutory provision for the duties of directors, other than the duty to disclose material interest, whether direct or indirect, in which a director has or may have in any contracts which have been proposed or entered into by the company.⁶⁹ One will note that the remaining duties which directors are obliged to comply with are to be found in our common law, which has been discussed in the previous chapter.

Prior to the 2008 Act, director's rights and duties were derived principally from contracts entered into with the company, the memorandum and articles of association, the 1973 Act, and the common law. In terms of the 1973 Act, a director's duty to act in good faith and for a proper purpose was based on common law principles and was to a certain extent tested objectively.⁷⁰ However one can note that there was a subjective element, because a director with his/her specific qualifications was expected to act with care and in the best interest of the company. This was measured by the guidelines contained in *Fisheries Development Corporation of SA Ltd v Jorgensen*,⁷¹ which was in turn influenced by the English cases of *In re Brazilian Rubber Plantation and Estates Ltd*⁷² and *In re City Equitable Fire Insurance Co Ltd*⁷³.

These guidelines established in the above cases, were an objective evaluation of the conduct of a reasonable person who held a director's position, and had the director's specific abilities⁷⁴. As mentioned above in the case of *In re City Equitable Fire Insurance Company*⁷⁵

⁶⁹ The 1973 Act, ss 234 to 241.

⁷⁰ N Schoeman 'How the Companies Act impacts on directors: Company law' (2013) 13(5) *Without Prejudice* 10-13.

⁷¹ Supra note 29.

⁷² Supra note 21.

⁷³ Supra note 25.

⁷⁴ Schoeman op cit note 70 at 12.

⁷⁵ Supra note 25.

, it was stated that a director need not exhibit a greater degree of skill than maybe reasonably expected from a person with his knowledge and experience. From this one will note that there is both an objective standard, being the care element, and the subjective standard being the element of skill, which will vary from person to person.

In terms of the *King III report*,⁷⁶ which will be discussed below, the duty of care, skill and diligence requires that a director manage the business of the company as a reasonably prudent person would manage his own affairs.

Therefore the issue that remains is the standard of care, skill and diligence that is required of a director in terms of the statutory law.

In this regard it can be noted that, despite the fact that both the common law and statutory law co-exists, to the extent that the common law is not substituted by the statutory law, the statutory law, however allows for a more stringent approach as opposed to the rigorous common law approach, which was discussed in the previous chapter. In this regard, the common law as was discussed previously, adopts both an objective as well as a subjective test to determine the care, skill and diligence required of a director, while the statutory law adopts the same objective and subjective tests, but as will be discussed later is different to that of the common law. This difference is due to the fact that the test applied in the statutory law, included the situation whereby there is a less subjective test that is applied and a more demanding criterion for the duty of care, skill and diligence, than that is imposed on directors, thus making the approach more stringent. This area therefore will need to be considered.

3.2 The duty of care and skill to be exercised by a director in terms of the statutory law:

3.2.1 The now stringent statutory law approach: the codification of the common law duty of care, skill and diligence to be exercised by a director.

The 2008 Act now contains provisions dealing with director's general duties that are comparable to the common law duties of directors.

In terms of the 2008 Act, section 76(3) requires that a director of a company must exercise the powers and perform the functions of a director⁷⁷:

⁷⁶ Supra note 48.

⁷⁷ The 2008 Act.

- i. In good faith and for proper purpose;
- ii. In the best interest of the company;
- iii. 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 the director; and
 - ii. Having the general knowledge, skill and experience of that director.
- iv. A director must not use his position as a director, or any information obtained as a director, to gain personal advantage or to cause harm to the company or a subsidiary of the company.
- v. A director must communicate to the board any information that comes to the director's attention, other than information which the director reasonably believes is immaterial to the company or is generally available to the public or known to the other directors or information which the director is bound not to disclose by a legal or ethical obligation of confidentiality.
- vi. Directors have an obligation to disclose interests and conflicts of interest.
- vii. A director of a company can demonstrate that he/she acted in the best interest of the company and with the required care, skill and diligence if:
 - The director has taken reasonably diligent steps to become informed about the matter;
 - The director either did not have any interest in the matter being considered or declared such an interest as required by section 75; and
 - The director made, or supported a decision made by a committee of the board, with a rational basis for believing and did believe that the decision was in the best interest of the company.

In light of the above, it is thus of importance that section 76(3)(c)⁷⁸, be considered in detail, as it deals with the duty of care and skill, as well as the partial codification, and thus this section needs to be examined. It is evident that the above section welcomes the statutory regimes and criteria according to which the skill and care of a director must be measured. Williams,⁷⁹ however states that despite the statutory law being reformed so as to include section 76(3)(c), there is yet to be case law that surfaces and applies the codified laws relating

⁷⁸ The 2008 Act..

⁷⁹ Williams op cit note 39 at 181.

to the duty of care and skill that is required of a director. Despite the lack of case law, Cassim⁸⁰, has considered the statutory law, in terms of what it means and how such law in respect of section 76(3)(c), should be considered.

In terms of section 76(3)(c), one will note that this section imposes a less subjective test and thus a more demanding standard of care on directors and prescribed officers of the company, than the common law imposed⁸¹. This is because this section imposes a more demanding standard of care, as one will be measured against a director that has the same knowledge and experience of that director. Thus, subsection 76(3)(c) prima facie imposes a “reasonable person/director test”.⁸² This will be further discussed in the chapter. It will be noted from the partial codification of the duty of care and skill that is contained in s 76(3)(c) of the 2008 Act⁸³, which determines that a director of a company when acting in that capacity, must exercise the powers and perform the functions of a director, with the degree of care, skill and diligence that may reasonably be expected of a person, carrying out the same functions in relation to the company as those carried out by the director and has the knowledge, skill and experience of that director.⁸⁴ In terms of the common law, one will note that the requirement was that a director should exercise the care which can reasonably be expected of a person with his knowledge and experience.⁸⁵ It is thus clear from the wording of this section that the 2008 Act’s codification of the common law duty preserved both the objective and subjective elements that are contained in the common law. This is noted in the section, as one will note that it contains the elements of care and skill which are elements that have been kept from the common law, while at the same time it measures the conduct of a director, with that of a reasonable person who has knowledge and experience and thereafter determine the negligence of the director.

This being a view held by Cassim⁸⁶, who notes that there is a twofold standard. This twofold standard, according to McLennan⁸⁷, the objective and subjective test can be found in section 76(3)(c)(i) and (ii) of the Companies Act. The objective standard being the minimum standard that all directors have to meet, and the subjective standard being the standard for

⁸⁰ Cassim op cit note 7 at 558.

⁸¹ Ibid at 554.

⁸² Cassidy op cit note 38 at 392.

⁸³ The 2008 Act.

⁸⁴ Bouwman op cit note 33 at 526.

⁸⁵ Du Plessis op cit note 50 at 272.

⁸⁶ Cassim op cit note 7 at 558.

⁸⁷ L McClennan “Directors’ fiduciary duties and the 2008 Companies Bill” 2009 *TSAR* 186.

directors who have more skill or experience than expected in terms of the objective standard. This would therefore mean that the directors would need to meet both the objective and subjective requirements. This is because subsection 76(3)(c) potentially transforms the objective test into a subjective test by taking into account the directors intelligence and experience.⁸⁸ It can be seen from section 76(3)(c) that this section limits the “reasonable directors” test to that of a person “having the general knowledge, skill and experience of that director.”⁸⁹

Cassidy⁹⁰, is of the view that as with the common law, subsection 76(3)(c), does not impose any minimum standard of care, skill and diligence by which all directors are required to abide, and thus directors only have to meet the standard of that could be expected of someone with the same skill and intelligence as that particular director, even if this happens to be a very low standard.

A director will be seen to have fulfilled the above requirements namely; section 76(3)(c), if the following are met in terms of section 76(4)(a).⁹¹:

- i. the director has taken reasonably diligent steps to become informed about the matter;
- ii. 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 the director complied with section 75 of the companies Act 71 of 2008;
- iii. the director complied with the requirements of section 75 with respect to any interest contemplated in the above paragraph;
- iv. The director made a decision, or supported the decision of a committee or the board, with regard to that matter and the director had a rational basis for believing and did believe that the decision was in the best interest of the company.

It must be noted that the 2008 Act, does not expressly provide that the statutory provisions relating to directors duties do not substitute the common law provisions in relation to those duties of the directors. This would therefore seem to suggest that Parliaments intention with the 2008 Act, was that the common law would not be modified, and therefore the statutory provisions do not substitute the common law.

⁸⁸ Cassim op cit note 7 at 559.

⁸⁹ Cassidy op cit note 38 at 392.

⁹⁰ Ibid at 394.

⁹¹ The 2008 Act.

Cassim is of the view that the changes to the common law duty correctly reflect the modern commercial fact, that nowadays, a director is a skilled professional with considerable business experience.⁹² Section 76(3)(c) also illustrates a more closely contemporary attitude towards the management of the company and corporate governance best practices.

If one considers section 76(3)(c), one will note that this section imposes a mandatory duty which is owed not to the shareholders, but rather to the company.⁹³ This is unlike the other fiduciary duties that a director owes. Section 76(3)(c)(i) and (ii) requires that a director exercise reasonable care, skill and diligence that would be exercised by a person carrying out the same functions as a director and with the same general knowledge, skill and diligence that the director has or had. It is thus important to consider this section, as one would note that subsection 76(3)(c)(i) refers to in particular, circumstances of the director's office, rather than the directors personal qualities⁹⁴. This would therefore mean that this section in particular would not consider a directors subjective experience or expertise, unless this is a requirement to hold office.

Although one will note that the standard that is required is not completely objective, as the standard will be influenced by the size and the nature of the company and the position and responsibilities of the director.⁹⁵ However the subjective standard from the common law remains part of the test of care and skill.⁹⁶

In terms of the subjective test, which can be seen in terms of section 76(3)(c)(ii), which requires that the knowledge, skill and experience of the director in question must also be taken into account. This subjective test thus means that if a director has any special skill or is more experienced or knowledgeable, this will all be taken into account when one measures his or her conduct against the higher subjective standard.⁹⁷ The converse will also apply, namely that the more inexperienced he or she is, the less the level of care and skill expected of him or her, provided that he or she does at the very least exercise reasonable care and skill.

However again it is worth noting that Cassidy,⁹⁸ is of the view that, subsection 76(3)(c)(ii) undermines the objectivity of the skills test by asserting that the directors need only meet the

⁹² Cassim op cit note 7 at 559.

⁹³ Ibid at 558.

⁹⁴ Ibid at 559.

⁹⁵ Ibid at 559.

⁹⁶ Ibid at 559.

⁹⁷ Ibid at 560.

⁹⁸ Cassidy op cit note 38 at 393.

standard of a person having the skill and experience of that director, and thus transforms the objective standard of skill into a subjective standard and as such is inappropriate in the modern commercial world. Cassidy⁹⁹, suggest that in light of the ambiguity of subsection 76(3)(c)(ii), it is possible that the courts will read down the legislative duty of care, to the subjective common law standard, and thus subsection 76(3) should have clearly and explicitly imposed an objective standard of conduct that is not qualified by the particular directors personal skill and knowledge.

Cassim¹⁰⁰, states that section 76(3)(c)(i), is the approach that is adopted as it is both one that is equitable and fair in the circumstances. In justifying his point, he is of the view that such contention can be supported by the fact that the test that is applied is measured against the standard that maybe reasonably expected of a person in a like position.¹⁰¹

This section namely section 76(3)(c)(i) and (ii), thus now illustrates that the objective standard is thus the minimum standard with which all directors will be measured against and expected to comply with. This however does not mean that since the standard is objective, that it is not limited by the lack of knowledge or experience or the ignorance of the particular director. As mentioned earlier Cassidy¹⁰², is of the view that although subsection 76(3)(c)(i), has a qualification of its own, as mentioned above, this does not transform the basically objective standard in subsection 76(3)(c) into a subjective standard, and thus the key to determining whether a breach has occurred will still be the objective standard of a reasonable person in that position of that company.

3.2.2 The *King reports* - the crux of the stringent approach:

Section 76(3)(c), also indicates that, there is a distinction between an executive director and a non executive director, and thus a different standard of care and skill maybe expected of a non-executive director. This distinction came about by the *King Report on Corporate Governance*,¹⁰³ which contained a code of good practice that accentuated director's responsibilities regarding corporate governance. The *King reports*, are not prescribed by law, but are rather a means of a guide line on how to achieve good corporate governance.

⁹⁹ Ibid at 398.

¹⁰⁰ Cassim op cit note7 at 559.

¹⁰¹ Ibid at 559.

¹⁰² Cassidy op cit note 38 at 401.

¹⁰³ *The King Report on Corporate Governance for South Africa* (1994); *The King Report on Corporate Governance for South Africa* (2002) (King II).

In terms of *King II*,¹⁰⁴ a distinction is drawn between the role of executive directors and the role of non executive directors. It can be noted that both kinds of directors are bound by the duty of care and skill. In terms of non executive directors, they perform their duty intermittently and have less regular access to the books and records than executive directors do.¹⁰⁵ However in terms of executive directors, they are required to always manage the conflict between their management responsibilities and their fiduciary duties as directors in the best interests of the company.¹⁰⁶ As mentioned above, *King II*, is to be used as a guideline, in line with modern economies, and suggest that directors must not only exhibit the degree of care and skill that may reasonably be expected from persons of their skill and experience, which has become known as the traditional formulation, but directors must also exercise care and skill that any reasonable person would be expected to show in looking after their own affairs, as well as having regard to their actual knowledge and experience, and qualify themselves on a continuous basis with a sufficient, or at least general, understanding of the company's business and the effect of the economy so as to discharge their duties properly, including where necessary relying on expert evidence.¹⁰⁷

On 1 March 2010, *King III*, was released, and this is worth noting as it refers to statements of the common law duties in the 2008 Act and confirms that the standard of director's duties described in the 2008 Act by reference to common law principles. This would seem to indicate that the common law principles are still applicable. This is because although director's duties have now been specifically included into legislation, it should not result in any significant additional duties which the director did not previously have under the common law.¹⁰⁸ *King III*, seems to suggest that courts will also consider good governance, in determining the standards of directors. It further gives guidance on the standard of care and skill that should be required from directors. In this regard, and in terms of the duty of care and skill, the *King III*, suggest that directors should attempt to resolve disputes expeditiously, efficiently and effectively, and ensure that prudent and reasonable steps have been taken in respect of governance. This would therefore suggest that directors are required to acquaint themselves adequately with the content of applicable laws, rules, codes and standards, in

¹⁰⁴ Ibid.

¹⁰⁵ King II op cit note 103 at 54.

¹⁰⁶ Ibid at 54.

¹⁰⁷ Ibid at 54.

¹⁰⁸ E Retief 'Directors duties and obligations' 2011 *Professional Accountant* 10-11.

order to discharge their fiduciary duties and duty of care, skill and diligence adequately.¹⁰⁹ It must be noted that *King* reports, was used as a guide to draft the 2008 Act.

In respect of none executive directors, they should honestly apply their minds to their workloads and abilities to discharge their duties, that are required to avoid holding offices of directorship in excess of those reasonable in order to exercise due care, skill and diligence.

It can however be noted that the subjective standard of skill, knowledge and experience is only taken into account when it increases or improves the objective standard of care or skill expected of a reasonable director¹¹⁰. This would therefore mean that if a director has a higher level of skill and knowledge, than that of a reasonable person, then that higher level of skill and knowledge must be taken into account in deciding whether that particular director has exercised reasonable care and skill and has complied with the requirements in section 76(3)(c). By way of example, if one is a director of a company, and is qualified as an attorney, therefore he/she has a higher level of skill and expertise in legal matters, then this skill will be taken into account when measuring his duty of skill and care, when holding such office.

As indicated above, a higher standard is expected of experienced or professional persons. This was well illustrated in the case of *Dorchester Finance Co Ltd v Stebbing*,¹¹¹ which helps one to understand the flexible approach of the subjective test. In this case, two out of the three directors of the company were qualified accountants with business experience. They were held liable for their negligence in signing blank cheques without enquiry, which resulted in the managing director to misappropriate funds of the company. The court held that as professional persons, a higher standard of care was expected of them.

Therefore this means that in terms of the statutory law section 76(3)(c)(i), will apply to all directors, however section 76(3)(c)(ii), will only come into play when a director has a higher level of skill at his disposal. In this event both legs of the test will be applied. If in the event of the director not having any special business acumen, then only the first leg will apply.

In determining the degree of care, skill and diligence, that maybe reasonably expected of a director, the courts will in all likelihood take into account the nature of the company, the nature of the decision in question, the position of the director, the nature of the

¹⁰⁹ Supra note 48.

¹¹⁰ Cassim op cit note 7 at 559.

¹¹¹ *Dorchester Finance Co Ltd v Stebbing* [1989] BCLC 498 (Ch).

responsibilities undertaken by him or her¹¹². It can be further noted that directors will make mistakes, however a distinction is drawn between a mistake or error of judgement and negligence. Thus if a director makes a mistake, and provided there was reasonable care and skill, they are unlikely to incur liability for negligence. As a general principle though, directors will not incur liability for a mere mistake. It must however be noted that the basis of liability for a breach of the directors duty of care, skill and diligence is an extension of the aquilian action.¹¹³

In terms of section 76(3)(c), it is assumed that the meaning of ‘diligence’, means that one will attend to ones duties. This would therefore include one devoting attention to the company’s affairs and the proper supervision and mentoring of other company officers and employers. This thus would also include regular attendances at board meetings. This is something that has changed from the past, as in the past one could miss board meetings, now failure to attend a board meeting without a reasonable excuse, will now likely be seen as a failure to exercise reasonable care and diligence. It has also been held that a director must at least have a rudimentary understanding of the company’s business.¹¹⁴

3.3 Advantages and Disadvantages of Total Codification versus Partial Codification

3.3.1. Total Codification

It is important to consider the advantages of statutory codification of director’s duties replacing the common law, as the 2008 Act has to some extent retained the common law. The following can be noted as advantages of total codification:¹¹⁵

- Improving clarity, simplicity and legal certainty, which will make the law more accessible to directors. The view on the common law director’s duties is that it is complicated, inaccessible and confusing and that legal advice is usually sought in this regard.¹¹⁶ This would mean that money, time and effort will be saved if directors could extract efficient guidance from the statute.
- The law needs to be accessible to other. By this it is meant that the law on director’s duty of care and skill should be more accessible to all persons including shareholders

¹¹² Cassim op cit note 7 at 560.

¹¹³ *Benson v De Beer Consolidated Mines Ltd* 1988 (1) 834 (NC) at 863; Supra note 16.

¹¹⁴ *Francis v United Jersey Bank* 432 A 2d 814 (1981); *Re Barings plc (No 5)* [1999] 1 BCLC 433 (ChD).

¹¹⁵ Bouwman op cit note 33 at 521-522.

¹¹⁶ IM Esser & J Coetzee ‘Codification of directors duties: An option for South Africa’ (2004) 12 *Juta’s Business Law* 26 at 29.

and other stakeholders, such as employees, creditors, customers and other interested groups. If these people are better informed, they through the correct channels could prevent directors from being in breach of their duty of care and skill, as this would serve as a deterrent, if directors knew that they will be easily detected.

- Director's duties need to be aligned with modern economies. This is because the common law has been developed over many years and thus some of the rules are outdated, and thus needs to be aligned with modern requirements.
- The law can be improved in so far as areas that have been identified now as being problematic areas.
- It is important to have a statement, which clearly states director's duties, then directors know what is expected of them.

However it must also be noted that there are disadvantages to the statutory codification of director's duties replacing the common law. The following will be noted as disadvantages:¹¹⁷

- Codification of a mass of developed common law is impractical. This is a very difficult task as the common law duty of care and skill has been developed through case law over a considerable period. Inattentiveness on the part of the drafters of the codification could lead to results that are unwanted. There is also the possibility of losing a wealth of common law, if one attempts to codify same.
- Oversimplified principles in the codification would not be appropriate to assist in the decisions of complex cases.
- There will also be an incentive for people to find loopholes, once it has been codified, as people will attempt to avoid compliance in order to avoid costs of compliance. In this regard it can be noted that the common law has been tried and tested over many years and has been developed accordingly.
- Flexibility will be tested. This is because in the modern economy, the common law provides the necessary flexibility.

¹¹⁷ Bouwman op cit note 28 at 522.

3.3.2 Partial Codification

It is important to also consider the partial codification, of director's duty of care and skill that coexists with the common law. It must be noted however that in terms of section 76(3) as mentioned above that in terms of this section, it can be seen as a partial codification.¹¹⁸ The semi codification is welcomed in the sense that directors will have a better understanding of what their duties are, and where the Companies Act is silent on certain issues, the common law will apply and thus ensure that director's duties remain flexible and capable of development. The South African approach of partial codification of director's duties is similar to that of the United Kingdom, as was illustrated in the United Kingdom case of *Towers v Premier Waste Management Limited*.¹¹⁹ In this case it illustrated that a court should and will consider the principles and precedents relating to the common law, although the directors duties have been partially codified, it will allow for a court to make a decision using the codified law as well as the common law principles and precedents. The following can be noted as advantages:¹²⁰

- Partial codification does not stunt the common law growth of the duty of care and skill. It however can be noted that this allows for the principles that have been developed through various cases to be applied. It thus prevents the issues of having to reduce all the common law to a single principle, and allows for the common law principles to govern the situations for which parliament has not made provision in the statute.
- Most of the disadvantages of total codification are avoided. This would therefore mean that flexibility is not compromised, as there is no incentive to find any loopholes and the common law can be consulted in complex cases.

The disadvantages of partial codification are that the coexisting principles will not resolve issues regarding:¹²¹

- Uncertainty of the legal position experienced by directors, shareholders and other stakeholders;
- Clarity, simplicity and accessibility and;

¹¹⁸ DM Davis 'Contemporary company law, Farouk H.I Cassim (Ed): book review' (2011) 128(4) *SALJ* 793.

¹¹⁹ [2011] EWCA Civ 923.

¹²⁰ Bouwman op cit note 33 at 522-523.

¹²¹ Ibid at 523.

- Reducing time, effort and legal fees in deciphering the law to extract the applicable legal principles.

Despite the disadvantages stated above, Bouwman,¹²² is of the view, and correctly so that despite the disadvantages, there are also a number of advantages for the partial codification, as mentioned above, and this has been adopted and thus does not stop the growth of the common law, and thus one can use the common law for guidance.

3.4 Conclusion

As was noted in this chapter that the 1973 Act, does not make statutory provisions for the duties of directors, other than the duty to disclose material interest, whether direct or indirect, in which a director may have in any contracts which have been proposed or entered into by the company. It was also noted that the remaining duties of directors could be found in the common law.

In terms of the 1973 Act, it was illustrated that a directors duty to exercise care and skill was determined using the common law principles and was to some extent objectively based. However this is not truly correct, as there is also an element of subjectiveness, in the test, in that a director, with his or her specific qualifications is expected to act with the care and best interest of a company. This was therefore seen as a subjective element as it took into account ones qualifications. As illustrated in the chapter above, this subjective test was approved in case law.¹²³ It was in terms of this case law that formulated objective guidelines to be followed, and measure against the conduct of a reasonable person who held a director's position, and had the director's specific abilities.

As discussed in this chapter, it was illustrated through case law,¹²⁴ that a director need not exhibit a greater degree of skill than maybe reasonably expected from a person with his knowledge or experience. It is because of this that one will note that there is both an objective and subjective element, the objective element being the care element, and the subjective element being that of skill, which will vary from person to person.

¹²² Ibid at 523.

¹²³ Supra note 29; supra note 21; supra note 25.

¹²⁴ Supra note 25.

In terms of the 2008 Act, and the applicable section for the duty of care, skill and diligence, being section 76(3)(c), in terms of this section it was noted that the section imposed a less subjective test and thus a more demanding standard of care on director than the common law did. It was noted that in terms of the abovementioned section, that a director when acting in that capacity will be measured against a person who maybe reasonably expected to perform the functions of a director, who has the knowledge, skill and experience of that director. It is thus noted that in terms of the 2008 Act, and its wording that one can note that the objective as well as subjective element has been preserved in the 2008 Act. Thus a two step approach is adopted. This is seen in terms of section 76(3)(c)(i) and 76(3)(c)(ii) of the 2008 Act. If one looks at this section it can be noted that one would see that the objective standard is then transformed into the subjective standard, as the subjective standard takes into account the intelligence and experience of a director. As a result, a director's intelligence and experience is taken into account, and the tests thus seem to be the standard that is expected of someone with the same skill and intelligence as that particular director. This seems to be the correct approach, as this judges each director on their knowledge, skill and experience, which would therefore encourage more directors to be appointed or take up appointments of directors. Therefore section 76(3) would be a reflection of the modern commercial world, namely that directors nowadays are skilled professionals with considerable business experience. An important issue that can be further noted is that the subjective element from the common law is still part of our law in terms of the 2008 Act, however it is a factor that one will look at when considering a directors duty. It is the objective elements that one will be judged on to determine whether one is in breach of their duties, but the subjective elements will be looked at as well. One will note that the 2008 Act retains the objective and subjective elements that have been contained in the common law, and therefore this would closely resemble the common law.

The *King* report, is important to create the foundation for the 2008 Act. It also helps clarify the difference that exists between executive directors and non executive directors and their role as such. It is to be noted that the *King reports*, are to be used as a guide only and are not law as such. Parliament used this to attempt to formulate the 2008 Act, as we can note that parliament went towards a partial codification, and thus to some extent followed the *King* report.

As one will see from the above chapter, the discussion on total codification versus partial codification, in which it can be noted that there is argument for and against total codification

as well as partial codification. It can be noted however that in terms of the 2008 Act, as well as section 76(3), that partial codification seems to be the way forward. This is because with the partial codification, directors would have a better understanding of what their duties are, and if the Act is silent on any issue, the common law will apply. This approach that has been adopted in South Africa, is an approach that has been used in the United Kingdom, and is seen as an approach that will help develop the law in South Africa in this regard. This is because with this approach one will have a wealth of common law decisions to consider and use. However with such wealth of common law available this could lead to a lower standard being expected of a director. However this has not been seen as a hindrance to the application of the 2008 Act, in the sense that, if one looks at South Africa, and if the standard expected of directors are too high then this would be a barrier and people would not want to take up positions as directors. And thus less experience people would be less prepared to take up positions as well. If this were to be the case then this would impact on South Africa's economy very negatively.

It must be noted that a spill over from the section 76(3), is that of section 76(4), what has become known as the business judgement rule. This is a section that is seen to be in keeping with modern economies and countries, in which directors are able to rely on a delegate to carry out a certain function. This area will be dealt with in the next chapter, namely chapter four.

CHAPTER FOUR:

The business judgement rule: a safe harbour from liability for directors and its inclusion in the 2008 Act.

4.1 Introduction

The business judgement rule is very closely related to the director's duty of care, skill and diligence, as explained in the previous chapter. The business judgement rule was developed in the United States of America, as far back as 1829, as a means to protect honest directors and officers from the risks inherent in hindsight reviews of their unsuccessful decisions and because of the desire to refrain from stifling innovation and venturesome business activity.¹²⁵ It can be noted that duty of care and skill, works in conjunction with the business judgement rule, and as will be discussed later in this chapter, with the application of these two principles, and provided a director made a decision in good faith, with care and on an informed basis, which the director reasonably believed was in the interest of the company, the director cannot incur liability. The objective of having this rule as suggested by Coetzee,¹²⁶ is that it will limit litigation and judicial scrutiny in respect of decisions that are taken within the private business sector.

Before one considers the business judgement rule and the applicable principles, it is worthwhile to consider, the common law principles in respect of delegation. But before discussing same it is worth noting the purpose of the business judgement rule. This is because in the current economic times, and especially in large companies, directors will delegate certain functions and tasks to employees of the company, and rely on the advice of experts employed by the company. This can be seen for example in the delegation to auditors, accountants and managers, which are essentially part of the way in which business of large companies are conducted. This would thus ensure that the purpose of the business judgement rule is that it will encourage directors to take part in activities that entail risk. This

¹²⁵ Bouwman op cit note 33 at 529.

¹²⁶ L Coetzee 'The business judgement rule (Part 2)' (2006) 27(2) *Obiter* 277.

is because if there is a greater potential for personal liability on a director, a director would be more risk conscious, and thus as a result a director would not engage in decisions that could possibly be beneficial to the company. With the application of the business judgement rule, it allows for competent persons to take office as a director. It also allows for the avoidance of judicial second guessing. This is because judges are experts in law, and not experts in making business decisions. And thus judges will have the benefit of hindsight of a business problem, which a director lacked when taking a decision. It can be noted that without the business judgement rule, shareholders would litigate more often, as they would want to interfere or influence the decision taken by the director. This would mean that with the business judgement rule in place, and knowing that it would be difficult to succeed in a claim against a director, shareholders will be mindful of bringing an action against a director, in light of the difficulty of getting a judge to change a directors decision as well as the cost associated with litigation.

It must be noted that directors do make mistakes while holding office, however if a reasonable amount of skill and care is utilized by such director, the director will be protected from being liable for negligence.¹²⁷ As a result of this, a distinction between a director being negligent to that of a director making a mere mistake or error of judgement in the course of holding office, needs to be made.¹²⁸ With this results in the introduction of the business judgement rule, which allows for a director to escape liability, where he has exercised reasonable care and skill.¹²⁹

4.2 The Common law and Delegation

It is important to take note of the common law and the principle of delegation, in light of the business judgement rule. It is important to note that the English common law, as adopted in South Africa, as it allows for delegation by directors as well as the need for same.¹³⁰ In the past, the principle of delegation was illustrated by way of case law. For instance, one would note that in the case of *In Re City Equitable Fire Insurance Co Ltd*,¹³¹ it was held that:

¹²⁷ Cassim op cit note 7 at 560.

¹²⁸ Ibid at 560.

¹²⁹ Ibid at 560.

¹³⁰ Cassidy op cit note 38 at 382.

¹³¹ Supra note 25 at 429.

In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.

It must be further noted from the above case.¹³² that in terms of the common law that directors are allowed to delegate their responsibilities, and rely on the advice of third parties without the additional requirement that the delegate be supervised.

This principle was further endorsed in the leading South African case of *Fisheries Development Corporation of SA Ltd v Jorgensen; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd*,¹³³ where the court stated:

In respect of all duties that may be properly left to some official, a director is in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly. He is entitled to accept and rely on the judgement, information and advice of the management unless there are proper reasons for querying such. Similarly, he is not bound to examine entries in the company's books.... Obviously, a director exercising reasonable care would not accept information and advice blindly.

The above case law illustrates that one would be allowed to delegate ones duties and trust the person to attend to it appropriately. As a result of the above case¹³⁴, the ability to delegate has been interpreted broadly, and has only been denied in cases where for example the directors have signed blank cheques without making proper inquiries as to their use.¹³⁵ It will be further noted that even though a director may rely on and delegate some of their functions and duties, they remain legally responsible for the proper performance of these tasks.¹³⁶ This would therefore mean that a director will still be responsible in terms of accountability even though he or she has delegated the task. Thus it has been argued by writers, that while the necessity of delegation is acknowledged, the common law is too lenient, because all that it requires is that there is an absence of grounds for suspicion, and this should be seen as insufficient.¹³⁷ Thus it is vitally important that a director carry out a supervisory role and monitor all delegation tasks given.

¹³² Supra note 25 at 429.

¹³³ Supra note 29.

¹³⁴ Supra note 29.

¹³⁵ *Dorchester Finance Co Ltd v Stebbing* (1927) Ch 407.

¹³⁶ *Re Barings plc (No5)* [1999] 1 BCLC 433 (ChD).

¹³⁷ Cassidy op cit note 38 at 401.

4.3 Recommendations of *King* in respect of the inclusion of the Business Judgement Rule

It is important to take note of the recommendations of *King* in respect of the business judgement rule as the *King* report, as discussed in the previous chapter, was used in the drafting of the 2008 Act. The *King* report¹³⁸ recommended that a limitation on the directors duty of care and skill by statute. In this regard what was suggested was that, a director should not be liable for a breach of duty of care and skill if he or she has exercised a business judgement in good faith, the decision was an informed one based on all facts of the case, the decision was rational and there was no self interest.¹³⁹ The reasoning for this recommendation was that a director's position, in particular that of a non executive director, was an onerous appointment, because of the test used to determine a breach of duty of care and skill (which was discussed in the previous chapter). It was also believed by the King Committee that a limitation of the duty of care and skill would encourage competitiveness of companies in South Africa, as King encouraged entrepreneurship and persons with skill and reputation to accept appointments as directors.

However it must be noted that *King I* was criticised, for the assertion that the appointment of directors are onerous in the context of the test for breach of duty of care and skill. This is because it creates the impression that directors are easily found to be in breach of their duty of care and skill. The *King I* also created the impression that directors will be immersed in litigation for breach of the duty of care and skill. This impression is also incorrect as it can be noted that only one South African case has been reported in which a director has actually been held liable for breach of the duty of care and skill.¹⁴⁰ This case being the case of *Niagara (in liquidation) v Langerman & Others*.¹⁴¹ As stated above, this is the only case in which a director has been held liable, illustrating that South Africa is not a country that is litigious in this area. This argument was raised by Coetzee¹⁴², in which she states that it is not necessary to incorporate the business judgement rule into South African law, as the business judgement rule is one that should only be applicable in a country which is litigious.

¹³⁸ See note 109.

¹³⁹ Bouwman op cit note 33 at 528.

¹⁴⁰ Ibid at 529.

¹⁴¹ *Niagara (in liquidation) v Langerman & Others* 1913 WLD 188.

¹⁴² Coetzee op cit note 126 at 277.

The *King II report*¹⁴³ however considers the origins and content of the business judgement rule, and notes that this rule and the duty of care and skill remain two distinct concepts. It does however question whether it is necessary for the business judgement rule to be applicable in South Africa.¹⁴⁴

In terms of the *King III Report*,¹⁴⁵ the only reference to the business judgement rule is limited to the statement that the 2008 Act, has introduced a new defence for the advantage of directors who are in breach of their duty of care and skill.¹⁴⁶ *King III*, makes no further recommendation as to whether the 2008 Act should include the business judgement rule, nor does it advise on any guidance on the application of the business judgement as a defence. Nevertheless after much decision making the business judgement rule was incorporated into the 2008 Act, even though many did not welcome it.

4.4 The 2008 statutory business judgement rule

It is with the above common law principles and guidance from the King reports, that the 2008 Act, and section 76(4) and (5), have been modernised, expanded on and codified. These sections contain provisions relevant to a director's ability to delegate and rely on the advice of third parties. Even though many did not like the idea of having included the business judgement rule, it has been included and in terms of section 76(4) and (5), this is the area that deals with where a director may now rely on the performance of an employee, a professional person, an expert, or a board committee, provided that they reasonably believe that such persons are reliable and competent or merit confidence. This would therefore mean that, in discharging any board or committee duty, a director is entitled to rely on the performance of any of the following persons:¹⁴⁷

- One or more employees of the company whom the director reasonably believe to be reliable and competent in the functions performed or the information, opinions, reports or statements provided;
- Legal counsel, accountants, or other professional persons retained by the company, the board or a committee as to matters involving skills or expertise that the director

¹⁴³ *The King Report on Corporate Governance for South Africa* (Institute of Directors in Southern Africa)(2002).

¹⁴⁴ Ibid.

¹⁴⁵ Cassidy op cit note 34 at 393.

¹⁴⁶ Ibid.

¹⁴⁷ Bouwman op cit note 33 at 529.

reasonably believes are matters within the particular persons profession or expert competence; or as to which the particular persons merits confidence; or

- A committee of the board of which the director is not a member, unless the director has reason to believe that the actions of the committee do not merit confidence;
- Any of the persons to whom the board may have delegated, formally or informally by course of conduct, the authority or duty to perform one or more of the boards functions that are delegable.

The above provisions being in terms of section 76(5), thus indicate that a director would be permitted to rely on any information, opinions, recommendations, reports or statements, including financial statements and other financial data, as long as it is prepared or presented by any persons specified in the first three items above.¹⁴⁸ This is because a director will be held liable for failing in his or her duties and obligations, which extends to the failure of a director to make a decision or apply their own mind.¹⁴⁹

Section 76(5) on reading indicates that a director is required to take reasonably diligent steps to become informed about the matter at hand, had no personal financial interest or dealt with the financial interest as required by section 75 and rationally believed that the decision was in the best interest of the company.¹⁵⁰

The effect of section 76(4) and (5), is that, provided the requirements of the section are complied with, directors are entitled to rely on the performance of such persons, as well as information, opinions, recommendations, reports or statements prepared by them.¹⁵¹ It should however be noted that there should not be any red flags that warn a director of the incompetence of the person or the committee to whom some task or function has been delegated to.

With the above information, it is therefore important to consider section 76(4) and (5). This section states that, 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 is entitled to rely on:¹⁵²

¹⁴⁸ The 2008 Act, section 76(4)(b)(ii), read together with s 76(5).

¹⁴⁹ Retief op cit note 108 at 10-11.

¹⁵⁰ Schoeman op cit note 70 at 11.

¹⁵¹ Cassim op cit note 7 at 563.

¹⁵² Ibid at 563.

- a) The performance by one or more of the employees of the company whom the director reasonably believes to be reliable and competent in the functions performed or in the information, opinions, reports or statements provided by them. It can however be noted that section 76(5)(a) does imply that a director must at least have read the report or statement in question or must in some way be familiar with it.
- b) Legal counsel, accountants and other professional persons retained by the company, the board, or a committee as to matters involving skills or expertise that the director reasonably believes (i) fall within that persons professional or expert competence; or (ii) are matters as to which the particular person merits confidence, in terms of section 76(5)(b).
- c) A committee of the board of which the director is not a member, unless he or she has reason to believe that the actions of the committee do not merit confidence. This would clearly include, but would not be restricted only to, the audit committee.

Before discussing the above items, it is worth noting that the 2008 Act, doesn't expressly provide that the statutory provisions relating to directors duties do not substitute the common law provisions in relation to those duties of the directors.¹⁵³

In each of the instances set out in section 76(5)(a) – (c) there is a strong emphasis on the requirement that there must be a reasonable belief in the reliability and competence of those who have been assigned the particular task or duty. This thus means that two requirements need to be met, namely competence and reliability. Therefore this would mean that section 76(4)(b) and (5), would seem to indicate that since directors must always act in good faith and in the interest of the company, they must not have had any knowledge that makes their reliance on employees, professional persons and board committees unwarranted or unreasonable.

In terms of section 76(4)(b)(ii), a director is also entitled to rely on the information, opinions, recommendations, reports or statements, including financial statements and financial data, prepared or presented by the persons referred to in section 76(5)(a) to (c). This would therefore include a report of an auditor of the company, an engineer or a valuator. It should also be noted that in terms of section 76(4)(b)(i)(bb), a director may rely on persons to whom the board may reasonably have delegated, whether formally or informally by course of

¹⁵³ Bouwman op cit note 33 at 530.

conduct, the authority or duty to perform one or more of the functions of the board that are delegable under the applicable law.

This would therefore mean that if a director has complied with the requirements of section 76(4)(b), which is primarily concerned with the related issue as to when a director may delegate and section 76(5), mentioned above, deals with, were a director will then not incur liability for the actions of persons on whom they have placed their reliance. This would further indicate that a director would not be liable if he or she relied on a delegate to whom the board had reasonably delegated the authority to perform a delegable board function. Therefore this would also mean that a legal counsel who incorrectly states that a company is solvent and liquid, the director will not incur liability for the error or the loss caused to the company.

Considering the above, and considering subsection 76(4)(i)(bb), it can be seen that it incorporates a “reasonable delegation” test.¹⁵⁴ This test allows for a director to assess the competence and trustworthiness of the person receiving the delegation and that the required monitoring systems are in place to ensure that one is competent and trustworthy to carry out the duties to the best of their ability. In this regard it is the view of Cassidy,¹⁵⁵ that the “reasonable delegation” test is clearly preferable to the common law’s excessively lenient “absence of grounds for suspicion” test.

Subsection 76(5) also enforces the reasonableness of the reliance and the competence of the person providing the advice.¹⁵⁶ Cassidy is of the view that a statement that the delegation and subsequent reliance needs to be reasonable, and that this would suffice to characterise the ability to delegate and rely on third party advice, while maintaining an objective standard of care.¹⁵⁷

However as stated above if a directors knows a delegate is incompetent or dishonest, then his or her reliance on that person will be unreasonable, with the result that he or she may incur liability for the wrongdoing of the delegate. This would therefore mean that reliance on the delegate must be in good faith and in the reasonable belief that the delegate or employee in question is competent and reliable. This does however not mean that a director must make proper enquiries, before relying on an employee, professional person or board committee, he

¹⁵⁴ Cassidy op cit note 38 at 398.

¹⁵⁵ Ibid at 403.

¹⁵⁶ The 2008 Act.

¹⁵⁷ Cassidy op cit note 38 at 402.

or she must not act blindly, and thus if the circumstances require it the director must make the necessary enquires.¹⁵⁸

One will note that the business judgement rule is one that has been applied in the USA for over 160 years. It is regarded as a rule of restraint that prevents a court from interfering with the benefit of hindsight, in honest and reasonable business decisions of the directors of the company.¹⁵⁹ It can be noted that under the 2008 Act, the business judgement rule is meant to have the effect of countering the new less subjective and more rigorous duty of directors, who are required to exercise reasonable care, skill and diligence in the performance of their duties. This was discussed in detail in the previous chapter.

Thus it is important to examine section 76(4) and in particular section 76(4)(a), as it sets out a presumption of compliance if certain factors are met. In this regard one will note that in respect of any particular matter arising in the exercise of the power or performance of the functions of director, it is presumed that a director exercised his or her powers or performed his or her functions in the best interests of the company and with reasonable care, skill and diligence if:¹⁶⁰

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

Looking at the above section one will note that there are therefore 3 requirements for the application of the business judgement rule namely;¹⁶¹

- That the decision must be an informed one;
- The director must have no personal financial interest, that is he or she must not be self dealing or that he or she must make proper disclosure as per section 75;

¹⁵⁸ Cassim op cit note 7 at 563.

¹⁵⁹ Ibid at 563.

¹⁶⁰ The 2008 Act; section 76(4)(a).

¹⁶¹ Cassim op cit note 7 at 563.

- The director must have had a rational basis for believing and did believe that the decision was in the best interest of the company. This requirement would therefore seem to suggest that there is a point of safety, in that directors will not be held liable, where they have made a rational and informed decision in the best interests of the company without any undisclosed self dealing on their part or on the part of a person related to them.

According to Schoeman¹⁶², she is of the view that in terms to the above, it would mean that the business judgement rule is a legal defence for directors challenged with exercising their duties of care and skill, but at the sametime it creates a rebuttable presumption that directors acted on a rational basis, in good faith and in an honest belief that the action taken was in the best interests of the company. The theory of the rebuttable presumption was illustrated in the case of *Aronson v Lewis*,¹⁶³ in which the court held that the onus is placed on a plaintiff to produce evidence of fraud, bad faith or conflict of interest on the part of the directors. The court also held that without this evidence a court will not interfere with the decisions made by a director.

It is thus important to look at the 3rd requirement closer. This is because one will note from the 3rd requirement that there is a test of rationality. It can be noted that this test is based on an objective test, as the belief must not be one that no unreasonable person in the position of the director would hold. Therefore an objectively irrational decision is not protected by section 76(4). One will therefore note that the requirement of rationality is a vital component in the application of the business judgement rule, in that if the decision made by the directors are a reasonable one, then the courts would not substitute its own decision for that of the board, as courts are not business experts, as they do not have expertise to review the commercial merits of business decisions. If it is not a reasonable decision, section 76(4) and the business judgement rule cannot apply to protect a director.

The principle that one can note from this requirement is that an irrational decision is indicative of bad faith. This was illustrated in the case of *Shuttleworth v Cox Brothers & Co (Maidenhead) Ltd*,¹⁶⁴ in which the court held that, while it is not the business of the court to manage the affairs of the company, the absence of any reasonable ground for deciding that a certain course of action is for the benefit of the company maybe a ground for finding lack of

¹⁶² Schoeman op cit note 70 at 12.

¹⁶³ 473 A2d 805, 812 (Del. 1984).

¹⁶⁴ [1927] 2 KB 9 (CA) 23.

good faith. It is thus clear that directors cannot be held liable for mere errors in judgement, and this principle was illustrated in the case of *Fisheries Development*.¹⁶⁵

The above thus indicates that section 76(4)(a) will only protect informed and reasonable business decisions. This would mean therefore if the requirements of section 76(4)(a) are satisfied, a director will not be liable for honest and reasonable mistakes or honest errors of judgement that he or she may have made in managing the business of the company. This is because a director would be seen to have complied with his or her duty to act in the best interests of the company, as required in terms of section 76(3)(b) and the duty of reasonable care, skill and diligence, in terms of section 76(3)(c). Subsection 76(4)(a)(ii)(aa) of the 2008 Act, requires an absence of a financial interest on the part of the director, as well as any related person. On reading of this section, one would understand that it requires that there be no reasonable basis to know that any person had a personal financial interest in the matter. This thus extends the principle to ensure that any director cannot simply declare that they don't have any conflict of interest. This section is however satisfied when there is no reasonable basis for the directors to know that a related person has a financial interest.

Therefore after considering the above, one will note that when the business judgement rule is applicable, the courts will not impose its own judgement regarding the merits of the matter on the directors. This is because the business judgement rule is there to protect directors from the risk of hindsight bias.¹⁶⁶ This is because in business there may be a case where business decisions are taken by a director, that turn out to be unsuccessful and are then seen to be unreasonable, only because information has become available after the decision has been taken. It is in this situation that the business judgement rule protects a director from liability, provided the requirements mentioned above namely section 76(4)(a)(i) to (iii) are met.

As Cassim¹⁶⁷, correctly indicates that the business judgement rule encourages innovation, entrepreneurial activities and risk taking by protecting business decisions and other acts of the directors, as directors are bound to take decisions that have risks.

It can be noted that section 76(4)(a), is not confined to business decisions and business judgements only. This is because the section is much wider, and to the extent that it applies to the exercise by directors of any power or the performance by them of any of their

¹⁶⁵ Supra note 29.

¹⁶⁶ Cassim op cit note 7 at 563.

¹⁶⁷ Ibid at 563.

functions. This would therefore mean that if a director has acted honestly and reasonably and the requirements of section 76(4)(a) have been met, they will not incur liability for honest errors of judgement or for poor business decisions.

This is illustrated in the case of *Smith v Van Gorkum*¹⁶⁸ which dealt with the shareholders of Trans Union Corporation, instituting a class action, in which they sought an order to rescind the cash out merger of the company, alternatively damages against the directors of the company in agreeing to sell the shares of the company without considering their intrinsic value. The court held that on the facts, that the directors had failed to adequately inform themselves of the value of the company's business. The court held that this approval was not an informed decision, on which the business judgement was based on diligence and reasonable care. In the case at hand it was noted that the directors had approved of the sale of the business in a meeting that lasted a mere 2 hours, of which the CEO had made 20 minute presentation, which did not disclose the basis at how the amount was arrived at. The court held a decision to sell a business is a fundamentally important decision for directors to make, and in this case the directors were happy to accept the recommendations of senior management without even questioning or seeking an independent valuation of the shares.

It should also be noted that a court will not interfere with a director's decision in the absence of fraud, bad faith or lack of care is absent. In South Africa there has not been much litigation in this regard, and therefore one should look at foreign jurisdiction. In this regard the leading case, which illustrates this point is that of *In re Walt Disney Derivative Litigation*.¹⁶⁹ In this case a group of shareholders brought an action against the directors on the ground of breach of fiduciary duty and taking due care. The facts of the case were as follows; the board of directors hired and then dismissed the Chief operating officer 14 months into his contract, and paid him a termination package of \$140 million. The court held that the board had been properly authorised and appointed the Chief operating office correctly. The court also held that the board had operated and exercised sound business judgements despite the loss and as a result the court held that the shareholders action was to fail.

The above cases illustrates that the business judgement rule, will apply where a director has acted honestly and reasonably and the requirements of section 76(4)(a) have been met, then they will not incur liability for honest errors of judgement or for poor business decisions.

¹⁶⁸ Supra note 11.

¹⁶⁹ Case No. 411, 2005 (Del. June 8, 2006).

However despite all the inroads that has been made by the business judgement rule, *King III* has criticised the implementation of the business judgement rule into the 2008 Act, in doing so it was held in the *King III* report that “the 2008 Act has introduced a new defence for the advantage of directors who are purportedly in breach of their duty of care and skill”.¹⁷⁰ Writers such as Bouwman, Botha and Jooste, Havelange, McLennan and Coetzee have explored the area of company law relating to the statutory business judgement rule in South Africa, and in doing so Muswaka holds the view that in general, the above authors do not favour or welcome the introduction of the statutory business judgement rule.¹⁷¹

4.5 Conclusion

This chapter sets out the business judgement rule that has now been introduced into South African law. As was suggested in the previous chapter it must be noted that the business judgement rule is very closely related to the director’s duty of care, skill and diligence. It also sets out what the business judgement rule is, how it was formulated and its application in South African law.

It can be noted from the discussion above that a director, as a result of the business judgement rule, and provided that a director made a decision in good faith, with care and on an informed basis, which a director reasonably believed was in the interest of the company, then a director cannot incur liability. This can be noted to be a proper approach to adopt in terms of the business judgement rule, as it sets out an objective standard, in which it will limit the amount of litigation, as courts will then have to decide on whether a directors decision was proper, knowing well that a judge is an expert in law and not an expert in business decisions, to which he or she has the advantage of hindsight to see if the decision was worth it or not. This was a view that was adopted by Coetzee.¹⁷²

The common law, which is important to set out the foundation of how the business judgement rule had been formulated is to be noted. This is because the business judgement rule deals with the aspect of delegation, and this area is allowed for by the common law in South Africa. It was in terms of case law, that illustrated, that a director can leave to some official to carry out certain duties, provided that the director had no reason to suspect any ground for

¹⁷⁰ Bouwman op cit n33 at 528.

¹⁷¹ L Muswaka “Director’s duties and the business judgement rule in South African company law: An analysis” (2013) 3(7) *International Journal of Humanities and Social Science* 92.

¹⁷² Coetzee op cit note 126 at 277.

suspicion, the official can be trusted to carry out the duties.¹⁷³ If this is done then a director is entitled to accept and rely on the judgement, information and advice of management unless there are proper reasons for any query. However it can be noted and correctly so, that a director should carry out a supervisory role and monitor all delegation task given. This will allow a director to therefore have some control over the official, and at the same time to be kept up to date with what is happening, so when he is relying on the information given by the official, he fully understands all the information.

In terms of the *King report*, it is important to note that the report of *King*, has acted as a guideline for the formulation of the 2008 Act. It has also allowed for guidance in terms of whether the business judgement rule should have been included in the 2008 Act.

It was with this background obtained from the *King report*, and the common law, that the 2008 Act, was able to use in formulating the business judgement rule. As was noted, section 76(4) and (5) have been modernised, expanded and codified, in which it allows for a director to delegate and rely on advice of third parties. This means that provided the requirements of section 76(4) and (5) are met, a director is entitled to rely on the performance of such delegated person, as well as information, opinions, recommendations, reports or statements prepared by such delegated person. In terms of section 76(5), it was noted that two further requirements need to be met in this regard, and that being competence and reliability. This is because there is emphasis on the requirement that there must be a reasonable belief in the reliability and competence of the person who the task has been assigned to. This is what has become known as the “reasonable delegation test”. This test allows for a director to assess the competence and trustworthiness of the person receiving the delegation and that the required monitoring systems are in place to ensure that one is competent and trustworthy to carry out their duties to the best of their ability. Section 76(5) also reinforces the reasonableness of the reliance and the competence of the person providing the advice, allowing for some method of monitoring to be kept by a director. This should therefore be seen as a preferable to the excessively lenient absence of grounds for suspicion test that was adopted in terms of the common law.

It is to be noted that a court will now not interfere with a director’s decision with hindsight information, because the onus is on the plaintiff to show that there is fraud, bad faith or conflict of interest, and without this information a court will not interfere with a director’s

¹⁷³ Supra note 25; Supra note 29.

decision. This is correct, as a court is an expert of law and not an expert in making business decisions, with the advantage of hindsight. If a court were allowed to make business decisions, and with hindsight, a lot of entrepreneurs and directors would be scared to take up a position as a director as their decisions will come under scrutiny by courts. It is for this reason that academics and commentators have stated that the business judgement rule should not be incorporated and applicable in South Africa.¹⁷⁴ It should also be noted that as mentioned above, that the business judgement rule was first seen in the USA, and the application of the business judgement rule in the USA maybe very different to its application in South Africa. This is because the application of rules depend on the characteristics of the jurisdiction, as one needs to look at the policy choices of the jurisdiction, as well as it needs are to be in line with what the society needs are at that particular time. This is because each economy is different to the next.

It has been stated by various commentators, that the business judgement rule should not be applied in South Africa, as it is over protecting directors and should one want to hold a director liable, that can be done by procedure through the common law, delict as well as the 2008 Act.¹⁷⁵

It can be noted that as discussed in the previous chapter that directors will be judged and held to a higher standard of conduct and responsible and will be measured by both objective and subjective tests, but in terms of the business judgement rule, it seems to suggest that directors will be allowed a certain amount of freedom, in respect of the business judgement rule. This freedom that directors are allowed by the business judgement rule will only be determined once determined by a court, and thus until then, companies should choose their directors wisely.

¹⁷⁴ Bouwman op cit note 33 at 532.

¹⁷⁵ Muswaka op cit note 171 at 92.

CHAPTER FIVE

Conclusion

After considering the information put forward, in chapter two, three, and four above, it is important to consider the main points that have arisen as a result.

In this regard, considering the common law approach, in regards to the duty of care, skill and diligence, that is required of a director to be exercised, one will note that this has been an area that has come under scrutiny. This is mainly because one needs to determine the extent to which a director maybe held liable for a breach of his or her duty of care, skill and diligence. Authorities have attempted to explain this, and commentators such as Williams and Cassim, have stated that the fact that the extent to which a director is liable for breach of his or her duty of care, skill and diligence is as a result of a low standard. This low standard being the subjective test for negligence, which was seen to be a rather low standard to test against.

As a result, this approach needed to be developed into an approach that would consider and take into account certain factors. This became known as the move from the lenient common law approach, which was initially followed by South Africa, to the more rigorous approach. This approach would therefore take into account not only subjective factors but also objective factors. This was a move in the right direction, as it was an approach that was being followed in other international jurisdictions, such as the United Kingdom as well as America. The approach was also consider appropriate, as South Africa was in need of development and found the rigorous approach worthy in this regard. In this regard one can note that the standard of care, skill and diligence in terms of the common law, is of a more rigorous test, as it has implemented in it both a subjective as well as an objective test. Thus if the common law is to apply, both an objective and subjective test will apply, in terms of the common law. This is seen to be a move in the right direction, as it has now moved from a lenient approach to a more rigorous approach, to test the negligence of a director in terms of the duty of care, skill and diligence.

However the common law test was not left to stand alone, and in this regard, South Africa moved to have the duty of care, skill and diligence partially codified. This complicated the

area, as it asked the question whether the common law will apply in conjunction with the partially codified duty of care and skill. It has been held that it seems that the legislature intended for the common law to apply in conjunction with the partially codified duty, as there is a wealth of common law available in this regard.

In terms of the statutory law, in partially codifying the common law duty of care, skill and diligence, one will note that this retains the objective as well as subjective elements, which is similar to the common law. However this objective and subjective test are of a more stringent nature. This can be seen in that directors, under the statutory law, have a mandatory duty to meet the requirements in terms of section 76(3)(c)(i) of the 2008 Act. However section 76(3)(c)(ii) of the 2008 Act, which will only come into operation, in the event of the director in question having a higher level of skill or expertise. This would therefore look at the director's qualifications as well as experience. Thus if the director has such skills or expertise, then the director would be required to meet both requirements in terms of section 76(3)(c)(i) and (ii).

This is what has become known as the more stringent approach. It is worthwhile to note that the partial codification, although criticised, has been seen by many as a step in the right direction as there is a vast amount of knowledge in terms of the common law, which can be used in terms of the statutory law.

Another addition to the 2008 Act, is the business judgement rule, which has been codified. This rule, as discussed earlier is closely related to the duty of care, skill and diligence. It is also there for a director who has made a decision in good faith, with care and which he believed was in the interest of the company, then he cannot incur liability. Again one will note that the business judgement rule uses objective factors to determine if a director should be liable, but at the same time as a result of the close relation with the duty of care and skill, the subjective factors also come into consideration. It is because of this close relation, and the objective and subjective tests, in terms of the duty of care and skill, that many have questioned the inclusion of the business judgement rule in South African law. Many authorities have emphasised that the business judgement rule should not be included in South African law, because it can be seen as a means of a director being over protected, and if one wants to hold a director liable, then one can in terms of the common law, or alternatively in terms of delict, or in terms of the 2008 Act.

Although with the business judgement rule, it encourages a director to take up position and not be afraid to take risks, and in a country like South Africa, where we have number of people who do not have the required experience to hold office, they are encouraged to take up office.

With that being said, one must take note that there has been considerable development, in terms of the 2008 Act, and thus raises the question as to whether the business judgement rule is really necessary in the South African system, which already has other means of holding a director liable. This may have been a more cautious approach by the legislature in this regard. The purpose of having developed South African corporate law over the years, is meant to have been for better economic stability, but many see this as a step in the wrong direction. This is because even though the business judgement rule is applicable in America, the economy is different to that in South African, and thus we shouldn't merely adopt principles without looking at the context and the applicability in South Africa. In South Africa we already have a subject and objective test, which will determine whether a director is liable, and thus questions the applicability of the business judgement rule in South Africa. This furthers the point of the applicability of the business judgement rule in South Africa, and thus it would seem that as a result South Africa is taking a step in the wrong direction by including the business judgement rule.

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