



**UNIVERSITY OF  
KWAZULU-NATAL**

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**INYUVESI  
YAKWAZULU-NATALI**

**A CRITICAL DISCUSSION OF THE DIRECTORS' DUTIES AND BUSINESS**

**JUDGEMENT RULE**

**SPHESIHLE BRILLIANT ZONDI**

**(213531552)**

Submitted in partial fulfilment of the academic requirements for the degree of Master of

Laws (business law) in the University of KwaZulu-Natal, Pietermaritzburg Campus.

Supervised by Darren Subramanien

November 2018

## DECLARATION

I, Sphesihle Brilliant Zondi, hereby declare that this thesis is based on my original work, and all my sources of information have been acknowledged. To my knowledge, neither the substance of this dissertation, nor any part thereof, is being submitted for a degree in any other University.

Sphesihle B Zondi (213 531 552)

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Signature



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Date

2019  
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## **ACKNOWLEDGEMENTS**

I would like to thank God for seeing me through these studies, and through all the gruelling and challenging moments of this journey. To my family, and friends, thank you for providing a pillar of support and strength and for being the encouragement that I needed. Thank you to my supervisor Advocate Darren Subramanien, for his guidance and direction. I am truly grateful for it all.

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## CHAPTER ONE: INTRODUCTION

### 1. RATIONALE/ PURPOSE OF STUDY

The concept of the duties of a director must be looked at with its focus on the ever-changing commercial landscape present in South Africa.<sup>1</sup> When a person fills in the post of being director it has been seen throughout the years that such person's interests impact on the company, whether positively or negatively. It is because of such interests that South African company law imposes certain duties on a director that he or she must exercise when executing office. Before the Companies Act 71 of 2008 directors' rights and duties were derived principally from contracts entered into with the company, the memorandum and articles of association, the Companies Act 61 of 1973 and the common law.<sup>2</sup>

At common law there are two categories of director duties, namely; fiduciary duties and the duty of care and skill. These duties existed in the common law and are now partially codified in the Companies Act of 2008 (hereinafter referred to as 'the 2008 Act'). These duties are said to be partially codified because they are not exactly the same in the context of wording, however, the meaning is still the same. The common law interpretation of these duties is still relevant because it assists us in interpreting and applying these duties accordingly.<sup>3</sup>

In terms of common law, the fiduciary duties of company directors are the duty to act in good faith, honesty and in the best interest of the company. These duties are based on the 'general principle that a person standing in a fiduciary relationship to another commits a breach of trust if he acts for his own benefit or to the prejudice of the other'.<sup>4</sup> These director's duties are of crucial importance and they have been remodelled over the years through our corporate law system. The 2008 Act brought about a significant improvement in that for the first time in our company law regime the fiduciary duties of directors and the duty to exercise reasonable care and skill has been partially codified into statute. As a partial codification of the common law duties of directors, section 76 (3) of the 2008 Act expresses the standard of conduct expected

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<sup>1</sup> FHI Cassim et al *Contemporary Company Law* 2ed (2012) 555.

<sup>2</sup> Natasha Bouwman 'An appraisal of the modification of the director's duty of care and skill' (2009) 21 *SA Merc LJ* 509-534.

<sup>3</sup> Cassim op cit note 1 at 526.

<sup>4</sup> Ibid.

of directors.<sup>5</sup> This section codifies the main fiduciary duties and the duty to exercise care, skill and diligence.<sup>6</sup>

The partial codification of the common law duties of directors as contained in section 76 (3) is followed by the enclosure of section 76 (4). Section 76 (4) covers instances where a director depends on the performance of an employee and acts on same.<sup>7</sup> This section provides for what is commonly known as the business judgment rule. The business judgment rule originated in the United States of America and is one of the Companies Act's numerous innovations imported into South African company law.<sup>8</sup> The rule provides that directors are not liable for errors where they have adopted a course of action which they honestly and in good judgment, reasonably believed will benefit the company. On the one hand, the operation of the business judgment rule promotes an interaction between fiduciary duties to act in the best interest of the company and to avoid conflict of interest of a financial nature under section 75 of the 2008 Act, and on the other hand, the composite duty of care and skill.<sup>9</sup>

The purpose of this dissertation is to critically discuss the various duties that directors owe to their companies, make a comparative evaluation of the duties at common law and in statute. This paper also aims at looking into the introduction of the business judgment rule into South African company law.

## 2. LITERATURE REVIEW

This dissertation will analyse the literature from some of the writers who have written about the duties of directors. It will look into the literature that will be used as sources of information.

The Companies Act 71 of 2008 was enacted to replace the Companies Act 61 of 1973. The 2008 Act<sup>10</sup> introduces a partial codification of directors' duties; that is both the fiduciary duties and the duty of reasonable care and skill, which will operate in addition to the existing common law duties. Section 76 of the Act is the section that entails the partial codification of the duties of directors. It requires a director to act in good faith and for a proper purpose in the best

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<sup>5</sup> Brighton M Mupangavanhu 'Fiduciary duty and duty of care under Companies Act 2008: Does South African law insist on the two duties being kept separate?' (2017) 28 (1) *Stellenbosch Law Review* 148-163.

<sup>6</sup> Ibid.

<sup>7</sup> Nithen Maharaj *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* (unpublished LLM thesis, University of KwaZulu-Natal, 2014) 8.

<sup>8</sup> Mupangavanhu op cit note 5.

<sup>9</sup> Ibid.

<sup>10</sup> Companies Act 71 of 2008.

interests of the company.<sup>11</sup> Furthermore, a director should perform his duties with the degree of care, skill and diligence that may reasonably be expected of a person carrying out such functions and having the same skill and experience of that director.<sup>12</sup> The 2008 Act also includes a section which covers instances where a director depends on the performance of an employee and acts on the same.<sup>13</sup> This is commonly known as the business judgment rule.

Prior to the Companies Act ('the 2008 Act'), directors' rights and duties were derived principally from contracts entered into with the company, the memorandum and articles of association, the Companies Act ('the 1973 Act) and the common law.<sup>14</sup> Howard Sher states that the function of the law is to supplement and add detail to responsibilities of directors as contained in a company's constitution and to deal with areas on which a company's constitution is silent. The relevant law that supplements a company's constitution may be found in statute, primarily being the Companies Act, and case law which constitute our common law.

This dissertation will look into the directors' duties in terms of both the common law and legislation. The article by Sher gives a slight overview of the position regarding the duties that directors owe to the company as a fiduciary. Sher defines a fiduciary as a person who is in a special position of trust, thus a director is a fiduciary and must act in good faith in his dealings with or on behalf of the company; and must exercise the powers and perform the duties of his office honestly.<sup>15</sup> Sher also points out the liability that directors incur for not properly executing their office. The Companies Act imposes personal liability on directors who have acted in bad faith and this fact is discovered in the course of winding-up or judicial management.<sup>16</sup> This dissertation will also slightly touch on the consequences of directors not performing in terms of their duties; which are personal liability for the company debts.

Linda Muswaka observes that a director is required to conduct the business of the corporation with the same degree of fidelity and care as an ordinary prudent person would exercise in the management of his own affairs of like magnitude and importance.<sup>17</sup> Muswaka is, however, of the opinion that general rules are not altogether helpful. He is of the notion that a director is

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<sup>11</sup> Section 76 (3) (a) and (b) of the 2008 Act.

<sup>12</sup> Section 76 (3) (c) of the 2008 Act.

<sup>13</sup> Section 76 (4) of the 2008 Act.

<sup>14</sup> Bouwman op cit note 2.

<sup>15</sup> Howard Sher 'Company directors' duties and responsibilities' (2005) 13 (3) *Juta's Business Law* 129-134.

<sup>16</sup> Ibid at 133.

<sup>17</sup> Linda Muswaka 'Directors' duties and the business judgment rule in South African company law: An analysis' (2013) 3(7) *International Journal of Humanities and Social Science* 89-95.



called upon to bestow the care and skill which the situation demands.<sup>18</sup> With regards to the enactment of the business judgment rule, Muswaka states that the rule is not a fortress for directors. He, however, has a different approach in discussing the business judgment rule. He places focus on how the rule intersects with existing corporate governance principles.<sup>19</sup> The corporate governance principles to which he refers were those recommended by the King Committee, which was formed by the Institute of Directors in Southern Africa.

The King Committee has issued reports with recommendations as to how we can improve our standard of corporate governance. Three reports have been issued by the Committee and Muswaka in his article, focuses on the third report (King III). In relation to its recommendations of the business judgment rule, he raises a concern as to ‘on what basis should the courts use the corporate governance codes as a tool to assist in the interpretation of the Act’.<sup>20</sup> Muswaka therefore calls for the broader interpretation of section 5 of the Companies Act read with section 7. Muswaka maintains that ‘reliance by the courts on King III is undeniably pivotal if the Act is to be interpreted in a manner that promotes the development of the economy by encouraging transparency and high standards of corporate governance’.<sup>21</sup>

Natasha Bouwman in her article shows how the common law moved away from the lenient approach to directors duties. Bouwman shows that the lenient approach adopted by courts was a subjective test concentrating on the specific director’s intelligence and experience, and that this approach eventually needed revision. The new approach adopted by the courts includes both subjective and objective elements; this proposed test was contained in the Companies Bill 2007 and also in the 2008 Act.<sup>22</sup> In her article, Bouwman explores the partial codification of the duty of care and skill into statute. She discusses the advantages and disadvantages of both partial and complete codification of the duty of care and skill, and the recommendations by the King Committee.<sup>23</sup> With regards to the adoption of the business judgment rule, Bouwman critically analyses the first King report reasoning for the adoption of this rule. She states that

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<sup>18</sup> Ibid at 91.

<sup>19</sup> Ibid at 92.

<sup>20</sup> Ibid at 94.

<sup>21</sup> Ibid at 94.

<sup>22</sup> Bouwman op cit note 2 at 512.

<sup>23</sup> Ibid at 521.

‘the reasoning that a higher degree of corporate governance will be achieved by the introduction of the business judgment rule (which will aid directors who are in potential breach of the duty of care and skill by providing an additional defence) also seems flawed’.<sup>24</sup>

This dissertation will look at the business judgment rule; its origin, how it became part of our law and whether its inclusion into our law was required.

Jones in his article places his focus on the business judgment rule. He says that ‘the fact that the business judgment rule was developed by the courts, and the fact that it blurs the distinction between the fiduciary duty and the duty of care and skill, demonstrates that American law on directors’ duties differs radically from South African law on this point’.<sup>25</sup> Jones points out the distinction between the fiduciary duty and the duty of care and skill. A plaintiff alleging breach of fiduciary obligations will bring an action based on breach of trust,<sup>26</sup> whilst the duty of care addresses the question of delictual conduct in the form of negligence rather than honesty.<sup>27</sup> In respect of the duty of care and skill, Jones goes on to say that ‘rather than directors’ conduct constituting a specific delict, his or her conduct must be delictual in its nature’.<sup>28</sup> Jones does not focus much on the standard of care that directors need to exercise in executing their duty of care and skill towards a company. This dissertation will expand more on the standard of care required in terms of this duty. Jones explains clearly why the business judgment rule exists and its necessity, that is, whether it is required or not.

Mupangavanhu identifies that the standard for the duty of care and skill is not clear. He points out that

‘while standards applicable to fiduciary duties are clearer, and there is a plethora of cases of successful enforcement of the duties, the same cannot be said of the duty of care, skill and diligence<sup>29</sup> ...the reason for this is that the standard according to which the degree of care and skill at common law is to be measured is by no means clear’.<sup>30</sup>

He points this out but does not suggest how the standard of care for this duty could have been made clearer and more accessible. This article’s main question is whether South African law

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<sup>24</sup> Ibid at 527.

<sup>25</sup> E Jones ‘Directors’ duties: Negligence and the business judgment rule’ (2007) 3 *SA Merc LJ* 326-336.

<sup>26</sup> Ibid at 334.

<sup>27</sup> Ibid at 334.

<sup>28</sup> Ibid at 334.

<sup>29</sup> Mupangavanhu op cit note 5 at 153.

<sup>30</sup> Ibid at 153.

still regards the fiduciary duties and the duty of care and skill as separate duties. Because of the different causes of action and remedies in respect of these duties, the duties remain separate.

Mupangavanhu points out that ‘there is a potential alternative view that the partial codification of directors' duties and adoption of the business judgment rule may change the position that case law insist on the separation of the duties’.<sup>31</sup> Furthermore, he points out that ‘the legislative intent was that the statement of directors' common law duties under the Companies Act should not operate to override the common law, but rather to apply in addition to it’.<sup>32</sup>

### 3. RESEARCH QUESTION/OBJECTIVES

The purpose of this dissertation is to critically discuss the various duties that directors owe to their companies. The discussion will be of the common law and statutory duties of directors and the business judgment rule. The dissertation will discuss whether the duties at common law overlap with the statutory duties, and whether the adoption of the business judgment rule into our company law was necessary and the effect it has on the duties of directors. The dissertation will enquire as to what are the consequences of failing to carrying out such duties are.

### 4. RESEARCH METHODOLOGY

The research methodology employed in this dissertation is desktop based. The relevant information regarding the of directors’ duties as well as the business judgment rule will be obtained from case law, statutes, journal articles and textbooks. A qualitative approach will be used in researching about the common law and statutory law duties of directors, including the business judgment rule. The substantial parts of this dissertation will place emphasis on the common law and the Companies Act 2008.

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<sup>31</sup> Ibid at 161.

<sup>32</sup> Ibid at 162.

## CHAPTER TWO: THE FIDUCIARY DUTIES OF DIRECTORS – AT COMMON LAW AND IN TERMS OF STATUTE

### 1. INTRODUCTION

The duties of directors are derived from two sources, the Act<sup>1</sup> and the common law as found in the decisions of the courts.<sup>2</sup> The common law duties of directors are the fiduciary duties of good faith, honesty and loyalty.<sup>3</sup> The fiduciary duties are generally owed by directors to the company. It is therefore, important that the directors act in a bona fide manner towards the company in what they consider to be in the best interest of the company. In *Cohen v Segal*<sup>4</sup> the court held that the directors occupy a fiduciary position towards the company and must exercise their powers bona fide solely for the benefit of a company as a whole and not for an ulterior motive.

### 2. THE DUTY TO ACT IN GOOD FAITH AND IN THE BEST INTEREST OF THE COMPANY

The common law principle is that a director must act in good faith and in the best interest of the company; and this principle is now codified into statute, that is, the 2008 Act. It is a well-established rule of common law that directors have a fiduciary duty to exercise their powers in good faith and in the best interests of the company.<sup>5</sup> From this it is apparent that there must be such a belief, and that it must be an honest belief at that; therefore it begs the question whether such belief is a subjective one.<sup>6</sup> On the other hand, at common law directors are expected to perform their duties bona fide that is, this is qualified in the sense that such duties will only be performed for the benefit and in the interest of the company.<sup>7</sup> The ‘best interests of the company’ is an indefinite phrase and possibly has different meanings in different contexts.<sup>8</sup> A breach of this duty consequently requires subjective awareness of wrongdoing.<sup>9</sup>

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<sup>1</sup> Companies Act 71 of 2008.

<sup>2</sup> FHI Cassim et al *Contemporary Company Law* 2ed (2012) 523.

<sup>3</sup> Ibid at 507.

<sup>4</sup> *Cohen v Segal* 1970 (3) SA 702 (W) 706.

<sup>5</sup> *Da Silva v CH Chemicals (Pty) Ltd* 2008 (6) SA 620 (SCA) 13, 627b.

<sup>6</sup> Cassim op cit note 2 at 524.

<sup>7</sup> O Charles Job *Common Law Duties and Section 76 of the Companies Act, 71 of 2008 Compared* (unpublished LLM thesis, University of Pretoria, 2012) 8.

<sup>8</sup> Blackman...et al *Commentary on the Companies Act* 8-67.

<sup>9</sup> Cassim op cit note 2 at 524.

In *Re Smith & Fawcett Ltd*<sup>10</sup> the court laid down the long-standing principle that the directors are bound to exercise their powers in a bona fide manner and not what the court may consider to be in the best interest of the company. This principle is based on the rationale that directors, unlike courts, have more knowledge, time and expertise to consider and evaluate what would be in the best interests of the company.<sup>11</sup> The court will not act as a supervisory board with regard to the decisions made by the directors, as long as these decisions were arrived at within the powers of their management.<sup>12</sup> In *Hogg v Cramphorn Ltd*<sup>13</sup> the court stated that it was not for the courts to review the merits of the decision that the directors arrived at in honesty.

In *Shuttleworth v Cox*<sup>14</sup> the court emphasised that the best interests of the company are not assessed by the court itself; instead, the test is whether a reasonable man would have regarded the act of the directors to be in the best interests of the company. The court held that, the absence of any reasonable ground for deciding that a certain course of action is made for the benefit of the company, may be a ground for finding lack of good faith.<sup>15</sup> The subjectivity of the test has some objective limits in that if there are no reasonable grounds upon which the director bases his subjective belief, he or she would have breached this duty.

This common law principle is now codified in section 76 (3) (b) of the Companies Act of 2008. The section provides that when acting in their capacity as directors, a director of a company must exercise their powers and perform their functions in the best interests of the company. The wording of this section and section 77 (2) (a) and (b) that '[a] director of company may be held liable ...for any loss, damages or costs sustained by the company as a consequence of any breach' confirms that directors in carrying out their duties and performing their functions, must do so with the company's best interests at heart. The duty to act in good faith and in the best interests of the company is consequently enforceable by the company only. Directors are, therefore, obliged to maximise profits for the company.

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<sup>10</sup> *Re Smith & Fawcett Ltd* [1942] Ch 304 at 306.

<sup>11</sup> Cassim op cit note 2 at 524.

<sup>12</sup> *Ibid.*

<sup>13</sup> *Hogg v Cramphorn Ltd* [1967] Ch 254 at 268.

<sup>14</sup> *Shuttleworth v Cox Brothers & Co (Maidenhead) Ltd* [1927] 2 KB 9 at 23; [1926] All ER Rep 498 (CA) 506.

<sup>15</sup> *Ibid.*

### 3. THE DUTY TO ACT FOR A PROPER PURPOSE

Directors are not only to exercise their powers and perform their functions for what they best believe to be in the best interests of the company; however, when so doing, they must have a 'proper purpose'. At common law, 'proper purpose' meant a director must exercise his or her powers for their true purpose. A directors' failure to exercise his or her powers for the purpose for which they were conferred could amount to breach of their duty. The consideration of this duty invokes an objective test rather than a subjective test which is utilised to evaluate the presence of good faith. This is because good faith involves honesty which can be assessed subjectively, and a proper purpose on the other hand may be assessed objectively. This duty is now both a common law and a statutory obligation. Section 76 (3) (a) requires directors to exercise the powers conferred upon them for a proper purpose. If a director exercises his or her powers for an ulterior purpose, then that director will be in breach of this duty.

The proper meaning of what 'proper purpose' is may be found in *Hogg v Cramphorn*,<sup>16</sup> a case which dealt with the issue of shares in a family owned company in order to prevent a hostile takeover bid by a person whom the directors honestly believed to be inexperienced and unsuitable.<sup>17</sup> The directors considered it to be in the best interests not to allow such a person to take over the company, which might have been an act of good faith in the best interests of the company on their part. However, the court held that the directors had improperly exercised their powers to issue shares, and it was irrelevant that they acted in good faith and in the best interests of the company. The court found that the primary purpose for the issue of the shares was not to raise capital, but to ensure that the directors will retain control of the company. The court stated further that the manipulation of the issue of shares and voting power was not a legitimate act on the part of the directors, and the power to issue share is a fiduciary power and in this case it was exercised for an improper purpose.

In *Howard Smith Ltd v Ampol Petroleum Ltd*<sup>18</sup> there was a similar improper exercise of the power to issue shares. The underlying principle in *Howard* as illustrated by *Darvall v North Sydney Brick & Tile*,<sup>19</sup> is that:

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<sup>16</sup> *Hogg* supra note 13.

<sup>17</sup> Cassim op cit note 2 at 526.

<sup>18</sup> *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 (PC).

<sup>19</sup> *Darvall v North Sydney Brick & Tile Co. Ltd* (1988) 15 ACLR 230 CA (NSW) at 257.

‘the purpose of the prohibition is to protect the proper interest of a company’s creditors and shareholders by ensuring that those who acquire shares in a company do so from their own resources and not from those of the company itself.’

While it was contended in this case with a measure of justification that the company was in need of further share capital, the court held that shares had been issued for the substantial purpose of diluting the shareholding of two major shareholders who held the majority shares and had been trying to take over full control of the company<sup>20</sup> and the court set aside the allotment of shares.

Section 38 of the Companies Act 2008 confers upon the board of directors of a company the power to issue shares. This is not a fiduciary duty however it relates to the exercise of a director’s powers with a proper purpose. The issuing of shares under section 38 must be exercised in a bona fide manner for a proper purpose and not for any ulterior purpose. The common law principles contained in *Hogg v Cramphorn* also apply under section 38.

#### 4. THE DUTY TO EXERCISE AN INDEPENDENT JUDGEMENT

The duty to exercise an independent judgment best qualifies the overarching duty to act bona fide, as directors are required to act bona fide and in the best interest of the company.<sup>21</sup> This is a common law principle and duty which requires directors when exercising their powers as directors and when deciding what is in the best interests of the company to exercise an independent and unfettered judgment.<sup>22</sup> Within this exercise of powers, a director must so do in an unbiased and objective manner. This duty has been seen to be an aspect of the directors’ duty to act in good faith in the best interests of the company, hence it is not specifically referred to in section 76 of the Companies Act of 2008. Nevertheless, this duty is considered as one of the fiduciary duties of directors. In *Fisheries Development Corporation of SA Ltd v Jorgensen*<sup>23</sup> the court stated that a director’s duty is to exercise an independent judgment and to take decisions according to the best interests of the company.

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<sup>20</sup> Job op cit note 7 at 11.

<sup>21</sup> Ibid at 12.

<sup>22</sup> Cassim op cit note 2 at 528.

<sup>23</sup> *Fisheries Development Corporation of SA Ltd Jorgensen; Fisheries Development Corporation of SA Ltd v AWJ Investment (Pty) Ltd* 1980 (4) SA 156 (W) 163.

## 5. THE DUTY TO ACT WITHIN THEIR POWERS

Under the common law, directors were under a distinct fiduciary duty not to exceed their authority or powers when exercising same.<sup>24</sup> This duty is well illustrated by way of the principle laid down in *Royal British Bank v Turquand*<sup>25</sup> that an outsider contracting with a company in good faith is entitled to assume that the internal requirements and procedures have been complied with. The rule suggests the placement of bounds of duty on directors to be amongst other things, dependent on certain internal requirements, for example, prior approval by the general meeting or some other company resolutions.<sup>26</sup> In *Cullerne v London and Suburban General Permanent Building Society*<sup>27</sup> the court held that if the directors exceed the powers conferred upon them by the company, they will be liable to the company for breach of their fiduciary duty. This liability for the breach of a fiduciary duty arises irrespective of the bona fides of the director in question or any fault on the director's part. Like the duty to exercise an independent judgment, this duty is also not specifically referred to in section 76 of the 2008 Act. However, the duty is a fiduciary duty of a director as it is an aspect of the fiduciary and statutory duty of directors to exercise their powers in good faith for a proper purpose, and in the best interests of the company, as contemplated in section 76 (3) (a) and (b).

## 6. THE DUTY TO AVOID CONFLICT OF INTERESTS

This duty is one of the most important duties of a director. The common law principle as far as this duty is concerned has been heavily influenced by trust law and by the decision of *Keech v Sanford*.<sup>28</sup> A person holding office of director must not have his or her personal interests' conflict with that of the company for which he or she is employed.

In *Sibex Construction (SA) (Pty) Ltd v Injectaseal CC*<sup>29</sup> the court referred to the dictum in *Canadian Aero Service Ltd v O'Malley*<sup>30</sup> of Laskin J who stated the following:

'[a]n examination of the case law in this court and in the courts of other jurisdictions on the fiduciary duties of directors and senior officers shows the pervasiveness of a

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<sup>24</sup> Cassim op cit note 2 at 532.

<sup>25</sup> *Royal British Bank v Turquand* (1856) 6E & B 327; 119 ER 886.

<sup>26</sup> Job op cit note 7 at 10.

<sup>27</sup> *Cullerne v London and Suburban General Permanent Building Society* (1890) 25 QBD 485.

<sup>28</sup> *Keech v Sanford* (1726) Sel Cas Ch 61.

<sup>29</sup> *Sibex Construction (SA) (Pty) Ltd v Injectaseal CC* 1988 (2) SA 54 (T) at 66D.

<sup>30</sup> *Canadian Aero Service Ltd v O'Malley* (1973) 40 DLR 3d0 371 (SCC).



strict ethic in this area of law. Persons in positions of trust may be less tempted to place themselves in a position where duty conflicts with interest if the court recognised and enforced the strict ethic in this area of the law’.

In *Robinson v Randfontein Estates Gold Mining Co Ltd*<sup>31</sup> the court stated that no one who has a duty to perform shall place himself in a situation where his interests conflict with his duty. Directors must be precluded from being persuaded by their personal interests.

There are two separate principles that deal with the duty to avoid conflict of interests, which are the no-profit rule and the corporate opportunity rule.

*(a) The no-profit rule*

In terms of this rule, directors may not retain any profit made by them in their capacity as directors while performing their duties as directors.<sup>32</sup> Any profits made by directors in the course and scope of their duties as director must be returned to the company, unless the majority shareholders in a general meeting have consented to a director making the profit.<sup>33</sup> This applies even if the company itself could not have made a profit. The leading case with regards to this rule is the case of *Regal (Hasting) Ltd v Gulliver*.<sup>34</sup> In this case the House of Lords held that the defendants, the four former directors of Regal (Hasting) Ltd, had to pay back the profits they had made, as the profits had been made in their capacity as directors while acting in the course and scope of their duty. The court held that the opportunity to acquire the shares in Hastings Amalgamated Cinemas Ltd had come to them only because they were directors of Regal (Hasting) Ltd which gave them access to the information they needed regarding the value of the shares in Hastings Amalgamated Cinemas Ltd. The court said that it was irrelevant that due to the lack of financial resources Regal (Hasting) Ltd was unable to take the opportunity. The liability to account arises from the mere fact of the profit having been made. No matter how honest and well intentioned the defendants may have been they remained under the duty to account for the profits made by them.<sup>35</sup>

The no-profit rule is also illustrated by the majority judgement in *Cook v Deeks*<sup>36</sup> where it was stated that:

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<sup>31</sup> *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168 at 178-9.

<sup>32</sup> Cassim op cit note 2 at 536.

<sup>33</sup> Ibid.

<sup>34</sup> *Regal (Hasting) Ltd v Gulliver* [1942] 1 All ER 378 (HL); [1967] 2 AC 134.

<sup>35</sup> Cassim op cit note 2 at 537.

<sup>36</sup> *Cook v Deeks* [1916] 1 AC 554 (PC).

‘It is quite right to point out the importance of avoiding the establishment of rules as to directors’ duties which would impose upon them burdens so heavy and responsibilities so great that men of good position would hesitate to accept the office. But on the other hand, men who assume the complete control of a company’s business must remember that they are not at liberty to sacrifice the interests which they are bound to protect, and, while ostensibly acting for the company, divert in their own favour business which should properly belong to the company they represent.’<sup>37</sup>

In *Canadian Aero Service Ltd v O’Malley*<sup>38</sup> the court held that a director must not be allowed to use his or her position as director to make a profit even if the opportunity was not available to the company.

*(b) The corporate opportunity rule*

This rule prohibits a director from taking any contract, information or opportunity that belong to the company, and that came to him or her by virtue of his or her position in the company.<sup>39</sup> Since the opportunity belongs to the company, it will constitute a breach of fiduciary if the director takes the opportunity for themselves. Before the decision of the Supreme Court of Appeal in *Da Silva v CH Chemicals (Pty) Ltd*<sup>40</sup> the courts regarded the corporate opportunity rule as an aspect of the no-profit rule.<sup>41</sup> The court in *Da Silva* acknowledged the corporate opportunity rule by stating:

‘A consequence of the rule is that a director is in certain circumstances obliged to acquire an economic opportunity for the company if it is acquired at all. Such an opportunity is said to be a ‘corporate opportunity’ or one which is the ‘property’ of the company.’<sup>42</sup>

The court said that a corporate opportunity is one that the company was actively pursuing or one that can be said to fall within the company’s ‘existing or prospective business activities’, or that is related to the operations of the company within the scope of its business or that falls within its line of business.

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<sup>37</sup> Ibid at 563.

<sup>38</sup> *Canadian Aero Service Ltd* supra note 30.

<sup>39</sup> Cassim op cit note 2 at 538.

<sup>40</sup> *Da Silva v CH Chemicals (Pty) Ltd* 2008 (6) SA 620 (SCA) 627. 72.

<sup>41</sup> Cassim op cit note 2 at 538.

<sup>42</sup> *Da Silva* supra note 40.

In *Cooks v Deeks*<sup>43</sup> there were four equal shareholders in a construction company (T Co) and were the only directors of the company. The company had in the past concluded lucrative construction contracts with Canadian Pacific Railway Co. The four directors then entered into a further similar contract with the company in their own names and used their majority voting power to pass a resolution at a general meeting to the effect that the company had no interests at the contract itself. One of the shareholders, Cooks, brought an action claiming that the construction company was entitled to the benefit of the contract and the resolution passed be deemed invalid. The court ruled that the benefit of the contract in question belonged to the construction company and that the respondent were not entitled to the profits themselves. The court held further that directors holding a majority of the votes are not permitted to make a gift to themselves. To do this is to allow the majority to oppress the minority shareholders.<sup>44</sup>

The case of *Da Silva v CH Chemical*<sup>45</sup> is the first case that dealt with the duty to avoid conflict of interest under the 2008 Act. In this case, the appellant while occupying the position of managing director of a company, exploited opportunities that should have been exploited for the company's benefits. The court held that directors are not entitled to make a profit or place themselves in a position where their fiduciary duty conflicts with their personal interests. A director must acquire an economic opportunity for the company, should the opportunity be claimed by the director personally, the company may sue for any profits that the directors has made as a result of breach of his or her fiduciary duty.<sup>46</sup> The court held that a director cannot escape liability by resigning before seeking to exploit an opportunity that a company was after, nor a director escape liability in a situation whereby the opportunity was in the company's scope of activities of which the director became aware in the performance of his or her duties as director and which he deliberately hid from the company. The opportunity still remained with the company.

## 7. THE DUTY TO AVOID CONFLICT OF INTEREST IN TERMS OF STATUTE

The duty to avoid conflict of interest is provided for in section 76 (2) (a) (i) and (ii) ; which states that a director of a company must not use the position of director or any information obtained while acting in the capacity of director:

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<sup>43</sup> *Cook* supra note 36.

<sup>44</sup> Cassim op cit note 2 at 564.

<sup>45</sup> *Da Silva* supra note 40.

<sup>46</sup> *Ibid.*

- (i) ‘to gain an advantage for the director, or for another person other than the company or a wholly owned subsidiary of the company; or
- (ii) to knowingly cause harm to the company or a subsidiary of the company;’

In subsection (2) paragraph (a) (ii), it could be said that the causing of harm to the company or a subsidiary as in paragraph (a) basically resonates with the directors common law duties.

Directors may not utilise information that has come to them as directors of the company for their personal advantage, or for any other person except the company or a wholly owned subsidiary of the company. Section 76 (2) (a) does not explicitly require the use of the position of director or any information obtained as director to be improper, but it is submitted that the whole tenor and intention of the section is that it is improper to use that office of director, or information obtained as a director to gain an advantage for him/herself, or to knowingly cause harm to the company or its subsidiary.<sup>47</sup>

While section 76 (2) (a) may have encapsulated the common law no-profit rule, what is left implicit is the corporate opportunity rule. However, it is submitted that the section is wide enough to apply to both the no-profit rule and the corporate opportunity rule.<sup>48</sup>

Section 76 (2) (b) provides for the duty to communicate information to the company; which state that a director of a company must:

‘(b) communicate to the board at the earliest practicable opportunity any information that comes to the director’s attention, unless the director –

(i) reasonably believes that the information is-

(aa) immaterial to the company; or

(bb) generally available to the public, or known to the other directors; or

(ii) is bound not to disclose that information by a legal or ethical obligation of confidentiality’.

This section requires a director to communicate any information to the board of directors as soon as possible, unless the director reasonably believes that the information is irrelevant to the company, which is generally available to the public or known to the other directors.<sup>49</sup> Directors are exempt from disclosure if they are bound by a legal or ethical confidentiality

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<sup>47</sup> Cassim op cit note 2 at 551.

<sup>48</sup> Ibid.

<sup>49</sup> Ibid at 552.

obligation that prohibits them from disclosing such information or if they have signed a non - disclosure or confidentiality agreement with a third party.<sup>50</sup>

The purpose of section 76 (2) (b) is that information is the property of the company, and that, as custodians of corporate information, directors may not misuse it for their own benefit.<sup>51</sup> The duty to communicate relevant information goes hand in hand with the fiduciary duties of good faith, loyalty and avoiding conflict of interest.

## 8. CONCLUSION

At common law, as fiduciaries, directors were required to act in a bona fide manner and for the best interests of the company. The common law fiduciary duties of directors were later codified into statute as there was a need for such.

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<sup>50</sup> Ibid at 553.

<sup>51</sup> Ibid at 554.

## CHAPTER THREE: THE DUTY OF CARE, SKILL AND DILIGENCE – COMMON LAW APPROACH

### 1. INTRODUCTION

In South African company law, the common law fiduciary duties of directors and the duty of care, skill and diligence are treated differently to each other. On the one hand, fiduciary duties are preventative in nature and are said to impose on directors a largely negative obligation to do nothing which conflicts with the company's interests.<sup>1</sup> On the other hand, the duty of care and skill can be said to impose on directors a positive duty to be careful and an obligation to be competent by paying attention to their duties while applying the skills or abilities such as they have to the advantage of their companies.<sup>2</sup>

In executing their duties, directors will be held responsible for negligent conduct.<sup>3</sup> However, directors are not responsible for errors of judgment or for mistakes they make while acting with reasonable skill and prudence.<sup>4</sup> A director is required to direct the business of the company with the same level of devotion and care as a standard reasonable person would exercise in the management of his own affairs of like magnitude and significance.<sup>5</sup> A director is called upon to bestow the care and skill which the situation demands.<sup>6</sup> It is important to set out and understand the traditional common law approach which was adopted in South Africa which will be dealt with in this chapter; and the statutory approach of the duty of care and skill and as such will be explained in chapter four.

### 2. THE DUTY OF CARE, SKILL AND DILIGENCE AT COMMON LAW

Prior to the 2008 Act, the duties of directors' were derived from many sources such as the agreements concluded by companies, companies' memoranda and articles of association, the 1973 Companies Act and most importantly the common law.<sup>7</sup> The general rule is that in

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<sup>1</sup> Mildred Bekink 'An historical overview of the director's duty of care and skill: From the nineteenth century to the Companies Bill of 2007' (2008) 20 *SA Merc LJ* 95.

<sup>2</sup> Cilliers et al *Cilliers & Benade Corporate Law* (2000) 147.

<sup>3</sup> FHI Cassim et al *Contemporary Company Law* 2ed (2012) 554.

<sup>4</sup> Linda Muswaka 'Directors' duties and the business judgment rule in South African company law: An analysis' (2013) 3(7) *International Journal of Humanities and Social Science* 93.

<sup>5</sup> Ibid.

<sup>6</sup> Ibid.

<sup>7</sup> Natasha Bouwman 'An appraisal of the modification of the director's duty of care and skill' (2009) 21 *SA Merc LJ* 513.

carrying out their fiduciary duties, directors are required to act with the required degree of care and skill. The notion of care and skill and the rules governing the standards required of directors were rooted and heavily influenced by English precedent.<sup>8</sup>

The duty of care, skill and diligence, is not linked to the fiduciary duties and can rather be seen as one which is based on delictual or Aquilian liability for negligence.<sup>9</sup> The courts do not place a heavy burden on directors to exercise their duties with care and skill as they do with exercising the fiduciary duties. This is because there is no specified test to be used to compare the directors' conduct. Being a company director is not a trade or profession, thus there is no reasonable man test. In this regard the courts have based the test for negligence on subjective factors such as; skill, experience, and the ability of the particular director in question.<sup>10</sup> A director is expected to exercise the care and skill that may be expected of a person with his or her knowledge and experience. It is important to note that the common law's relaxed approach was originally rooted from two principles.<sup>11</sup> The first principle was that shareholders were ultimately liable for and responsible for the competence of the persons appointed by them to manage the affairs of the company, and secondly; early directors were mostly appointed for the sake of title and reputation and did not possess any particular skill or business acumen which would be beneficial to the company.<sup>12</sup>

At 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.<sup>13</sup> In the case of *Re Brazilian Rubber Plantations & Estates Ltd*<sup>14</sup> the directors were unsuccessfully sued for losses as a result of their disastrous business decisions in the rubber plantations in Brazil. The directors based their decision to invest in rubber plantations on a fraudulent report on rubber plantations. Neville J stated the following:

'It has been laid down that so long as they act honestly, Directors cannot be made responsible in damages unless they are guilty of gross negligence. A Director's duty requires him to act

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<sup>8</sup> *Sheffield and South Yorkshire Permanent Building Society v Aislewood* [1889] 44 ChD 412; *Lagunas Nitrate Co v Lagunas Syndicate* [1899] 2 Ch 392 (CA); and *Re National Bank of Wales Ltd* [1899] 2 Ch 626 (CA).<sup>100</sup>

<sup>9</sup> *Ex parte Lebowa Development Corporation Ltd* 1989 (3) SA 71 (T); *Du Plessis NO v Phelps* 1995 (4) SA 165 (C).

<sup>10</sup> Cassim op cit note 3 at 555.

<sup>11</sup> Michele Havenga 'The business judgment rule- Should we follow the Australian example?' (2000) 12 *SA Merc LJ* 28.

<sup>12</sup> *Ibid.*

<sup>13</sup> Cassim op cit note 3 at 555.

<sup>14</sup> *Re Brazilian Rubber Plantations & Estates Ltd* [1911] Ch 425 (CA) 437.

with such care as is reasonably expected from his having regard to his knowledge and experience. He is not bound to bring any special qualifications to his office...'<sup>15</sup>

It was further held that a director will not be liable for the losses or damages caused as a result of mere errors of judgment. In the *Re Brazilian Rubber Plantations & Estates Ltd*<sup>16</sup> case there is regard to a contention of these directors being favoured as a result of their inexperience and incompetence.<sup>17</sup> Even though the directors of the said company were sued they were not held liable, as the court stated that the duty of a director to exercise care must be one that is reasonably expected of such a director, taking into account both that specific directors experience as well as his knowledge.<sup>18</sup>

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 difference was pointed out in the case of *Daniels (formerly practicing as Deloitte Haskins & Sells) v Anderson*,<sup>19</sup> in which the court stated that skill refers 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.

Despite the importance of the distinction between care and skill the court in *Re Equitable Fire Insurance Co Ltd*<sup>20</sup> cited with much approval the subjective test applied in *Re Brazilian Rubber Plantations & Estates Ltd*<sup>21</sup> which was subsequently adopted in the case of *Fisheries Development Corporation of South Africa Ltd v Jorgensen; Fisheries Development Corporation of South Africa Ltd v AWJ Investments (Pty) Ltd*<sup>22</sup> after over 50 years.

The court in *Re Equitable Fire Insurance Co Ltd* adopted three basic legal propositions in approving the subjective test laid down in *Re Brazilian Rubber Plantations & Estates Ltd*; the propositions are as follows:

First, a director need not exhibit in the performance of his or her duties a greater degree of skill than may reasonably be expected from a person of his or her knowledge and experience. This

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<sup>15</sup> Ibid 439.

<sup>16</sup> *Re Brazilian Rubber Plantations & Estates Ltd* supra note 14.

<sup>17</sup> Luthfiya Essop *A Focus on Directors' Duties of Care, Skill and Diligence in terms of the Common Law and the Companies Act 71 of 2008* (unpublished LLM thesis, University of KwaZulu-Natal, 2015) 16.

<sup>18</sup> R C Williams *Concise Corporate and Partnership Law* 3ed (2013) 179.

<sup>19</sup> *Daniels (formerly practicing as Deloitte Haskins & Sells) v Anderson* (1996) 16 ASCR 607 (NSW); (1995) 37 NSWLR 438.

<sup>20</sup> *Re Equitable Fire Insurance Co Ltd* (1925) Ch 407.

<sup>21</sup> *Re Brazilian Rubber Plantations & Estates Ltd* supra note 14.

<sup>22</sup> *Fisheries Development Corporation of South Africa Ltd v Jorgensen; Fisheries Development Corporation of South Africa Ltd v AWJ Investments (Pty) Ltd* (1980) 4 SA 156 (W).



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.<sup>23</sup> This legal principle leaves no doubt that the standard is not that of a reasonable director.<sup>24</sup> This is thus indicative of the fact that it is a subjective standard not an objective one.

Secondly, a director is not required to give a company his continuous 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. In the case of an executive director, such director is a full time director and applies his or her duties to the everyday management of such company, such director participates in his occupation in terms of normal working hours from 'nine to five'. A non-executive director on the other hand does not at any stage give his or her attention to the company or the affairs of that company instead he merely attends monthly or quarterly meetings.<sup>25</sup> Despite the distinction between the two types of directors, it has been said that in modern company law this legal principle is somewhat redundant due to the fact that this very principle no longer reflects what is expected even of a non-executive director.<sup>26</sup>

Thirdly, 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. In the case of *Dovey v Cory*<sup>27</sup> the court stated that 'the business of life could not go on if people could not trust those who are put in a position of trust for the express purpose of attending to the details of management'. This principle was approved and accepted in the case of *Fisheries Development Corporation of South Africa Ltd v Jorgensen*<sup>28</sup> where the court cited with approval the following –

'in respect of all the duties that 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 is entitled to accept and rely on the judgement, information and advice of the manager unless

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<sup>23</sup> Bouwman op cit note 7 at 511.

<sup>24</sup> Cassim op cit note 3 at 557.

<sup>25</sup> Bouwman op cit note 7 at 511.

<sup>26</sup> Cassim op cit note 3 at 557.

<sup>27</sup> *Dovey v Cory* 1901 AC 477 (HL) 485-6.

<sup>28</sup> *Fisheries Development Corporation of SA Ltd Jorgensen* supra note 22.

there are proper reasons for querying such. Similarly, he is not bound to exam entries in the company's books ... obviously, a director exercising reasonable care will not accept information and advice blindly'

It is clear that directors may delegate some of their functions, duties and tasks to certain officials or employees who are experts in certain fields of the company, only if the director does not have any reason for distrusting or doubting such official or employee's honesty.<sup>29</sup>

While the above developments are clear and emphasise the low standard attached to directors who are in breach of their duty to exercise care and skill in the performance of their appropriate duties, the propositions are still subject to several criticisms by many authoritative sources and commentators.<sup>30</sup>

Cassim infers that the propositions examined and adopted by the courts in both the case of *Re City Equitable Fire Insurance Co Ltd* and *Fisheries Development Corporation of South Africa Ltd v Jorgensen* had been examined and adopted at such a time when directors were appointed as directors due to their title and status, despite the lack of business acumen that they were prone to or did in fact possess.<sup>31</sup> Thus the above developments have been criticised.

### 3. THE SHIFT FROM THE LENIENT APPROACH (SUBJECTIVE TEST) TO A MORE STRICT APPROACH (OBJECTIVE TEST)

South African corporate law, in particular the duty of care and skill was heavily reliant on the findings of English law and as such our common law was shaped by the findings illustrated by the common law of England. The English courts have traditionally adopted a lenient approach to the standard of the duty of care and skill.<sup>32</sup> This is seen from the subjective formula as noted above which was used in testing a director's intelligence and experience. The reasoning behind this lenient approach was based on certain assumptions: First, the conviction that shareholders are responsible for the competence of the managers appointed by them; and, second, the fact that, in earlier days, companies were few and directors were mostly part-time, non-executive persons appointed for their title or reputation within society, not for their business expertise or skill.<sup>33</sup> This standard therefore meant that nothing less than the utmost gross or culpable

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<sup>29</sup> Essop op cit note 17 at 17.

<sup>30</sup> Manashya Maharaj *A Thorough Examination Regarding the Standard of Skill and Care to be Exercised by a Director in terms of the Common and Statutory Laws and an Overview of the Business Judgement Rule: A Company Law Perspective* (unpublished LLM thesis, University of KwaZulu-Natal, 2015) 22.

<sup>31</sup> Cassim op cit note 3 at 556.

<sup>32</sup> Bouwman op cit note 7 at 511.

<sup>33</sup> Ibid at 512.

negligence would lead to a finding that a director was in breach of his or her duties.<sup>34</sup> At the outset, English law embraced the lenient approach as can be seen by the approach adopted by the court in *Re Denham & co*<sup>35</sup> where the court held that despite the director not performing his duties at all during the period of four years that this was not sufficient to hold that director to be in breach of his duty of skill and care.

With the passage of time, the expectations about the duty of care, skill and diligence changed and the common law approach had change. In the case of *Re D'Jan of London Ltd*<sup>36</sup> the court applied a new test based on a section in the Insolvency Act,<sup>37</sup> which included both subjective and objective elements, reflecting a more rigorous approach.

The new test laid down in *Re D'Jan of London Ltd*<sup>38</sup> comprised of a twofold test that had subjective and objective elements which was once again adopted in South African corporate law. In this regard it is important to note the case of *Deloitte Haskins*<sup>39</sup> which held that the concept of both skill and care are not the same. The court held that it is no longer appropriate to judge directors conduct by the subjective tests that were applied in outdated precedents.<sup>40</sup> The implication of the *Deloitte Haskins* case is that an objective test should be applied, in that there be a test in terms of which the standard of care and skill be tested in respect of a reasonable person.<sup>41</sup> This proposition is not only supported by English law, but due to the more rigorous approach that they have adopted it is also supported by various international jurisdictions.<sup>42</sup>

The United States of America and Canada are amongst the international jurisdictions that followed the more rigorous approach. In the United States the US Model Corporation Act<sup>43</sup> adopted an objective standard which is to be followed by the directors of a company. Such standard requires looking at the circumstances, nature, extent and responsibilities of the duties which are imposed on a particular director.<sup>44</sup> The US Model Business Corporation Act extends that when performing or carrying out their duty of care and skill, directors shall do so with the appropriate care that a person in such position would believe to be reasonably suitable in such

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<sup>34</sup> Ibid.

<sup>35</sup> *Re Denham & co* 1884 LR 25 Ch D 752.

<sup>36</sup> *Re D'Jan of London Ltd* [1993] BCC 646 (Ch D (Companies Court)).

<sup>37</sup> Section 214(4) of the Insolvency Act 1986.

<sup>38</sup> *Re D'Jan of London Ltd* supra note 36.

<sup>39</sup> Cassim op cit note 3 at 555.

<sup>40</sup> Ibid.

<sup>41</sup> Jean J Du Plessis 'A comparative analysis of directors' duty of care, skill and diligence in South Africa and in Australia' 2010 *Acta Juridica* 263.

<sup>42</sup> Maharaj op cit note 30 at 24.

<sup>43</sup> US Model Corporation Act 1984.

<sup>44</sup> Essop op cit note 17 at 22.

situation.<sup>45</sup> In Canada a similar inference as in the US Model Corporation Act was drawn from the Canada Business Corporations Act<sup>46</sup> that an objective standard needs to be used by directors in the midst of carrying out their duties. Section 122 (1) (b) of the Canada Business Corporation Act adopts an objective approach by providing that ‘every director and officer of a corporation in exercising their powers and discharging their duties shall exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.’

From the above advancements in English, American and Canadian law it is safe to state that South Africa has closely followed the findings of the above jurisdictions in an attempt to eliminate the common law lenient approach which attached very little liability to the negligence of directors which left huge voids and scope for unscrupulous conduct.<sup>47</sup> This is evident from statutes that adopted a more rigorous approach, firstly being section 43 (1) of the Close Corporation Act<sup>48</sup> which states that a member of a corporation shall be liable to the corporation for loss caused by his failure in the carrying on of the business of the corporation to act with the degree of care and skill that may reasonably be expected from a person of his knowledge and experience.

Secondly, section 60 (1) of the Banks Act<sup>49</sup> provides that a director of a bank owes a fiduciary duty and a duty of care and skill to the bank; and to exercise such care in the carrying out of his or her functions in relation to that bank as may reasonably be expected of a diligent person who holds the same appointment under similar circumstances. Thirdly section 40 (c) and (d) of the Bank Amendment Act,<sup>50</sup> which actually made way for South Africa to enforce such rigorous approach, states that a director should act in a bona fide manner for the best interest of the company, possess the required knowledge and skill of a prudent person and should carry out their duties in a manner in which a reasonable person of a similar situation would do so. Lastly it is evident from the partial codification of the duty in terms of section 76 of the Companies Act 2008<sup>51</sup> which will be explained in detail in chapter

#### 4. CONCLUSION

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<sup>45</sup> Cassim op cit note 3 at 558.

<sup>46</sup> Canada Business Corporations Act of 1985.

<sup>47</sup> Cassim op cite note 3 at 558.

<sup>48</sup> Close Corporation Act 69 of 1984.

<sup>49</sup> Banks Act 94 of 1990.

<sup>50</sup> Bank Amendment Act 19 of 2003.

<sup>51</sup> Act 71 of 2008.

It is clear from the above discussion that South African common law in terms of the duty of care and skill was greatly influenced by English law. The common law placed little liability on directors for the carrying out of the duty of care, skill and diligence as opposed to the carrying out of the fiduciary duties of good faith. Due to the controversial nature of the duty, the traditional lenient approach conveyed in the principles of the common law needed to be reconstructed due to the vagueness and uncertainty which hovered around this area.<sup>52</sup> As a result of the Companies Act 2008, the traditional lenient approach was reconstructed by means of the partial codification of the duty to include both subjective and objective elements.

The reconstructed approach in respect of the duty of care, skill and diligence is incorporated in the provisions of section 76 (3) (c) of the Companies Act 2008 which consists of a stricter approach than that of the common law. It must be noted that even though the Companies Act 2008 contains a much stricter approach, the common law has not been completely excluded from being applied.

The provisions of the duty of care, skill and diligence in terms of section 76 (3) (c) work hand in hand with the provisions of section 76(4), which comprises of the business judgment rule which places a limitation on how directors may curb out their liability as a result of performing their duties in good faith despite concluding with disastrous results.<sup>53</sup> The statutory duty of care, skill and diligence will be dealt with in dealt in chapter four below.

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<sup>52</sup> Essop op cit note 17 at 59.

<sup>53</sup> Ibid.

## CHAPTER FOUR: THE DUTY OF CARE, SKILL AND DILIGENCE – STATUTORY APPROACH (SECTION 76 (3) (c))

### 1. INTRODUCTION

Before the enactment of the Companies Act 2008 the director's duty of care, skill and diligence was primarily derived from common law. The nature of the duty at common law was surrounded with controversy as the common law placed little liability on directors and there was no uniform standard of care to be exercised by a director. However, due to extensive judicial scrutiny as to what the appropriate standard of care, skill and diligence a company director was to carry out, the common law was then modified by means of the partial codification of the duty of care and skill into statute.

The common law duty of care and skill stepped its way into statute with particular reference to Section 76 (3) (c) of the Companies Act 2008. This section places a more onerous and demanding standard of care and skill than that which was traditionally expected of in the common law. In the carrying out of his or her duties the common law required a director to exercise the care and skill that may be expected of a person with that particular director's knowledge and experience. The initiation of the statutory duty of care and skill mirrors modernised commercial and business factors while incorporating corporate governance which will in turn reflect the promotion of the best interests of the company to operate in the most profitable and successful manner to include the involvement of international trade.<sup>1</sup>

While at common law the test for the standard of care that was to be applied by directors was of a subjective nature, the statutory provisions of the Companies Act 2008 incorporated both subjective and objective elements which form the partial codification of the duties of directors.

### 2. SECTION 76 (3) (c) OF THE COMPANIES ACT 71 OF 2008

The Companies Act 2008 now contains provisions dealing with director's general duties that are comparable to the common law duties of directors. The provisions for the duty of care, skill and diligence are contained in section 76 (3) (c) of the Act, which states that:

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

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<sup>1</sup> Luthfiya Essop *A Focus on Directors' Duties of Care, Skill and Diligence in terms of the Common Law and the Companies Act 71 of 2008* (unpublished LLM thesis, University of KwaZulu-Natal, 2015) 29.

- (c) with the degree of care, skill and diligence that may reasonably be expected of a person—
- (i) carrying out the same functions in relation to the company as those carried out by that director; and
  - (ii) having the general knowledge, skill and experience of that director.’

It is clear from the wording of the above section that the 2008 Act’s codification of the common-law duty preserved both the objective and subjective elements that were later contained in the common law. It should be noted that the statutory approach of the duty of care and skill is less subjective and thus imposes a more demanding standard of care on directors and prescribed officers of the company, than that which was imposed by the common law. Section 76 (3) (c) prima facie imposes a ‘reasonable person/director test’.<sup>2</sup> This stringent approach incorporated in our statute aims to instil modernised commercial and business factors and incorporates the best practices of corporate governance applicable to a director which may eventually lead to a more successful and profitable company.<sup>3</sup>

The statutory dual objective and subjective standard is hybrid in nature and is not entirely uneven to either being an objective or subjective test. Different factors are considered under the use of this test which will amplify the minimum objective standard of the common law to a higher subjective standard.<sup>4</sup> These factors consist of the size of the company, position and responsibilities of a director and the nature of the circumstances under which the decision was made.<sup>5</sup> The rationale behind this consolidation into the test guarantees adaptability when there is a factual scenario which should be resolved.<sup>6</sup>

It is evident that section 76 (3) (c) welcomes the statutory regimes and criteria according to which the standard of care and skill of a director must be measured. Williams states that despite the statutory law being reformed so as to include the above section, there is yet to be case law that surfaces and applies the codified laws relating to the duty of a director to exercise skill and care in the midst of carrying out his office.<sup>7</sup> Despite this lack of case law authority, Cassim considered the statutory law, disintegrating the complicated interpretation and emphasising

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<sup>2</sup> J Cassidy ‘Models for reform: The directors’ duty of care in a modern commercial world’ (2009) 20(3) *Stell LR* 392.138

<sup>3</sup> Essop op cit note 1 at 31.

<sup>4</sup> FHI Cassim et al *Contemporary Company Law* 2ed (2012) 60.

<sup>5</sup> Ibid.

<sup>6</sup> Ibid.

<sup>7</sup> R C Williams *Concise Corporate and Partnership Law* 3ed (2013) 181.

what is actually meant by it and how such laws in respect of section 76 (3) (c) should be considered in light of any circumstances that may arise.<sup>8</sup>

The statutory provisions of director's duty of care, skill and diligence have absorbed a twofold test for directors. The first part of the test, which is objective, is set out in subsection (i) of section 76 (3) (c) which states that all directors carrying out the same function should meet a requisite threshold as that director to avoid liability for negligent conduct in the performance of their duties.<sup>9</sup> The objective test involves measuring the conduct of the director against the conduct reasonably expected from a person exercising the same powers and performing the same duties as he or she possesses. It is not clear too whether there is a notional reasonable person in this standard, or whether the reasonableness is on the expectation upon such a person and from whose perspective is the expectation measured.<sup>10</sup>

The second part of the test, which is subjective, is set out in subsection (ii) of section 76 (3) (c) which provides that that if a director is found to have a higher standard of knowledge, skill and business acumen that could be reasonably be expected of a person carrying out the same function in relation to a company, then such a director will be liable to a higher standard.<sup>11</sup> The approach here is that if the director in question has any special knowledge or skill at his disposal or if he is in fact more knowledgeable and experienced in respect of such business acumen then the standard to which that particular director's skill and care is measured will be against that of a higher standard.<sup>12</sup>

Cassim states that what can be interpreted from the above twofold test is that the objective part incorporated in section 76 (3) (c) (i)<sup>13</sup> is the minimum requirement that all directors are subjected to and must comply with and that due to the fact that the test which is being applied is an objective one, there need not be an inquiry as to the personal skill, experience or expertise that the director actually has at his disposal.<sup>14</sup> Cassidy expresses a 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

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<sup>8</sup> Cassim op cit note 4 at 558.

<sup>9</sup> S McLennan 'Duties of care and skill of company directors and their liability for negligence' (1996) 8 *SA Merc LJ* 101 as cited in Essop op cit note 1 at 31.

<sup>10</sup> Nosihle Pearl Gumbi *The Evolution of the Directors' Duty of Care, Skill and Diligence: A Comparative look at Common Law and Statute* (unpublished LLM thesis, University of KwaZulu-Natal, 2016) 18.

<sup>11</sup> Section 76 (3) (c) (ii) of Act 71 of 2008.

<sup>12</sup> Cassim op cit note 4 at 559.

<sup>13</sup> Section 76 (3) (c) (i) of Act 71 of 2008.

<sup>14</sup> Cassim op cit note 4 at 559.



standard 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.<sup>15</sup>

A director will have satisfied the requirements of section 76 (3) (c) if the provisions of section 76 (4) (a)<sup>16</sup> are complied with, namely that:

- 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
- iii. the director complied with the requirements of section 75 with respect to any interest contemplated in the paragraph above;
- 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 interests of the company'.

It must be noted that the Companies Act 2008, 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.<sup>17</sup> The statutory duty of care, skill and diligence is partially codified, meaning that the common law duties still exist. The common law interpretation of the duty is still relevant because it helps with the interpretation and application of the statutory duty.

### 3. ADVANTAGES AND DISADVANTAGES OF TOTAL CODIFICATION VERSUS PARTIAL CODIFICATION

Since the duty is partially codified, Bouwman<sup>18</sup> compares the advantages and disadvantages of the total and partial codification of the duty of care, skill and diligence. The following, amongst others, are listed as advantages for total codification of the duty:

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<sup>15</sup> Cassidy op cit note 2 at 392.

<sup>16</sup> Section 76 (4) (a) of Companies Act 71 of 2008.

<sup>17</sup> Manashya Maharaj *A Thorough Examination Regarding the Standard of Skill and Care to be Exercised by a Director in terms of the Common and Statutory Laws and an Overview of the Business Judgement Rule: A Company Law Perspective* (unpublished LLM thesis, University of KwaZulu-Natal, 2015) 31.

<sup>18</sup> Natasha Bouwman 'An appraisal of the modification of the director's duty of care and skill' (2009) 21 *SA Merc LJ* 522.

- ‘Improving clarity, simplicity and legal certainty, to make the law more accessible to directors. This will aid directors in knowing what is precisely required of them when carrying out their duties.
- Making the law accessible to all stake holders (shareholders, employees, creditors, customers and other interest groups). This will enhance good corporate governance as shareholders will know what to expect from directors and the directors will also know what is expected of them and act accordingly.
- Aligning the regulation of directors’ duties to fit contemporary needs better. 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.
- Reducing time, effort and legal fees to ascertain what the law requires on directors’ duties.’

The disadvantages are listed by Bouwman<sup>19</sup> as follows:

- ‘Common law has developed overtime, and a perfect codification of a mass of developed common law is not possible overnight. The codification could oversimplify the common-law principles, and there is a danger that the sophistication provided by the common law could be abandoned in favour of applying the new codification.
- Complete codification will constrain development of the aspect of law that has been codified.
- Common law allows for continual development and flexibility, whereas statute is not that flexible. With times constantly changing, globalisation as well as a competitive business environment, rigidity of the law is not ideal.’

With respect to the partial codification, Bouwman<sup>20</sup> discovers the advantages as follows:

- ‘Partial codification does not stunt the common-law growth of the duty of care and skill. Common law may continue to develop in respect of the duty of care, skill and diligence.
- Most of the disadvantages of total codification are avoided, such as inflexibility and oversimplification.’

The disadvantages of partial codification are that the coexisting principles will not resolve issues regarding:<sup>21</sup>

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

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<sup>19</sup> Ibid.

<sup>20</sup> Ibid at 522-523.

<sup>21</sup> Ibid at 523.

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

#### 4. CONCLUSION

It is clear that the duty of care, skill and diligence has evolved from the time of its development and that it seemingly has not developed at the same pace as fiduciary duties due to a scarcity of cases which dealt with this duty.<sup>22</sup> This is evident from the standard according to which a director exercises his duty of care, skill and diligence which contains a stringent evaluation as opposed to that the common law.

The development of common law principles is achieved through courts having to deal with the questions of law in cases. The lack of case law in respect of the duty of care, skill and diligence seems to indicate that this duty was not a 'favourite' duty to invoke in so far as holding directors liable for lack of care; and this may have been due to the history of the standard by which the directors were measured at common law being, what some considered too low.<sup>23</sup>

Consequently, the partial codification of the common law duty of care, skill and diligence and the standard or measurement which is attached to such is of a more stringent premise. The reason for this gathering is that the partial codification does in fact retain the common law duty of skill and care as well as the objective and subjective test used to measure a directors performance of such skill and care, the difference however is that such partial codification gives life and adds content to the common law approach.<sup>24</sup>

Despite the criticisms that exist many authors embrace the partial codification with open arms, holding that despite such partial codification, both the common law as well as the statutory law coexist with each other and that courts are, as a result privileged to have access to both common and statutory laws in the mist of applying such to various circumstances that they may be faced with.<sup>25</sup>

It must be noted that a spill over from the section 76(3), is that of section 76(4), which is well known as the business judgement rule. This area will be dealt with in the next chapter, namely chapter five.

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<sup>22</sup> Cassim op cit note 4 at 534.

<sup>23</sup> Bouwman op cit note 18 at 510.

<sup>24</sup> Maharaj op cit note 17 at 40.

<sup>25</sup> Ibid at 41.

## CHAPTER FIVE: THE BUSINESS JUDGMENT RULE – REFERRED TO AS THE RULE OF SAFE HARBOUR FROM LIABILITY

### 1. INTRODUCTION

As a consequence of South African company law adopting a more stringent and rigorous test to which directors' duties of care and skill are to be measured, our statute had to strike a balance between this stringent test by easing the burden of liability to those directors who conducted the company and its decisions in good faith, hence the adoption of the business judgment rule into our company law. The main aim of the business judgment rule is to provide a 'safe haven' for directors who carried out their duties in a bona fide (good faith) manner even if such decisions led to disastrous results.<sup>1</sup> This does not mean that directors will be protected blindly irrespective of their mala fide (bad faith) conduct, this protection is only afforded to those directors who honestly, reasonably and rationally believed such decisions would be for the best interests of the company.<sup>2</sup>

A director must exercise his or her powers and carry out his or her duties in good faith, for the best interests of the company and with reasonable care, skill, diligence and honesty. In the application of the business judgment rule it is important that the conduct or decisions of a director amount to mere errors of judgments or mistakes and not negligence.<sup>3</sup> Therefore, if a director neglects to act in such a manner such conduct will be tantamount to negligence and the business judgment rule cannot be used to disguise the director's negligent conduct. This chapter aims at considering the origin of the business judgment rule, the reason for its development and the reception of the rule into South African company law.

### 2. THE ORIGIN AND PRUPOSE OF THE BUSINESS JUDGEMENT RULE

The business judgment rule was developed in the United States of America 'because of a desire 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'.<sup>4</sup> The business judgment rule was developed alongside the duty

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<sup>1</sup> FHI Cassim et al *Contemporary Company Law* 2ed (2012) 563.

<sup>2</sup> Ibid.

<sup>3</sup> Ibid at 560.

<sup>4</sup> Michele Havenga 'The business judgment rule- Should we follow the Australian example?' (2000) 12 *SA Merc LJ* 31.

of care and skill and dates back as far as 1829.<sup>5</sup> The rule was founded more than 170 years ago and it is apparent that an objective of the rule is to limit litigation and judicial scrutiny in respect of decisions that are taken within the private business sector.<sup>6</sup> The result is that if 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 in respect of that decision.<sup>7</sup> Ultimately the rule entails that if a decision was made in good faith, lacking fraud, the director cannot be held liable for the loss suffered.<sup>8</sup>

While it is evident that the purpose of the business judgment rule acts as a safe harbour from liability of honest directors, there are a number of other purposes that are established and that which effectively come to light.<sup>9</sup> Bouwman<sup>10</sup> lists the following five purposes in support of the business judgment rule:

- ‘First, the principal purpose is that the rule encourages directors to take part in activities that entail risk which is the core of entrepreneurship.’<sup>11</sup>
- Secondly, the rule encourages the taking up of appointment as directors by competent people. There is already a great need for competent persons to serve as directors, especially in South Africa, where no qualifications are required to undertake the office of director and the requirements Black Economic Empowerment (BEE) could force BEE candidates into directors’ positions that they might not yet be equipped to deal with.
- Thirdly, to avoid judges, who are experts in law, from second guessing business decisions made by directors. The evaluation of business decisions by judges after the event is problematic because those judges have the benefit of hindsight that the directors lacked when taking the decisions. The Supreme Court of Delaware in *Brehm v Eisner*<sup>12</sup> stated that if the judges failed to respect the decisions of the directors that were made in good faith it would have the effect that the courts would become super-directors.
- Fourthly, to avoid shareholders managing the company, which should rather be managed by directors. With a rule in place that protects certain decisions made by directors, shareholders

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<sup>5</sup> Natasha Bouwman ‘An appraisal of the modification of the director’s duty of care and skill’ (2009) 21 *SA Merc LJ* 523.

<sup>6</sup> The American Law Institute Principles of Corporate Governance and Structure: Analysis and Recommendations (1994) 135.

<sup>7</sup> Stephen Kennedy-Good, Lindi Coetzee ‘The business judgment rule (Part 1)’ (2006) *Obiter* 64.

<sup>8</sup> *Ibid* at 64.

<sup>9</sup> Cassim *op cit* note 1 at 559.

<sup>10</sup> Bouwman *op cit* note 5 at 523-524.

<sup>11</sup> Kennedy-Good, Coetzee *op cit* note 7 at 65.

<sup>12</sup> *Brehm v Eisner* 746 A.2d 244 (Del. Supr. 2000) 266.

will be wary of bringing actions against directors in the light of the difficulty in succeeding with their claim and the legal costs involved.

- Lastly, there are mechanisms already in place in the market which control the directors' conduct. The corporate environment or the business market is a competitive one in order to remain in the market the directors need to ensure sound management of the corporation or company'.<sup>13</sup>

Despite its origin and purpose being applied both at home and internationally, the business judgment rule has, as a result been liable to various criticisms, making its application prone to skepticism.<sup>14</sup>

### 3. THE APPLICATION OF THE BUSINESS JUDGMENT RULE IN THE USA

In applying the business judgment rule the courts will consider the following factors: the business decision; due care; good faith; and whether the director believed that the decision would be in the best interest of the company.<sup>15</sup>

#### *(a) Business decision*

For a director to benefit from the rule a decision must have been made. In terms of this factor or element, a decision to do something and is parallel to a conscious decision not to act.<sup>16</sup> The business judgment rule will therefore not be applicable if at all no decision was made or taken. A distinction is also made with regards to the type of decision that was made. The application of the business judgment rule is straightforward if a routine business decision was taken, however, if the decision made is extraordinary in nature, the application of the rule requires closer examination by the courts.<sup>17</sup>

#### *(b) Due care*

This factor involves an inquiry made by the court as to whether all the relevant information was considered prior to making the decision and an inquiry as to the process followed by the

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<sup>13</sup> Kennedy-Good, Coetzee op cit note 7 at 66.

<sup>14</sup> Manashya Maharaj *A Thorough Examination Regarding the Standard of Skill and Care to be Exercised by a Director in terms of the Common and Statutory Laws and an Overview of the Business Judgement Rule: A Company Law Perspective* (unpublished LLM thesis, University of KwaZulu-Natal, 2015) 4.

<sup>15</sup> Kennedy-Good, Coetzee op cit note 7 at 67.

<sup>16</sup> Ibid.

<sup>17</sup> Ibid.

directors in making the decision.<sup>18</sup> The case of *Smith v Van Gorkom*<sup>19</sup> is of importance with regards to the element of due care. Van Gorkom as the chairman and Chief Executive Officer presented to the board of directors a proposal of the sale of the company despite the senior management of the company having regarded the offer presented as being too low. In presenting the offer to the board of directors, Van Gorkom did not disclose the methodology used in reaching the figure, the board also did not study the sale agreement. The board decided to accept the proposal. The court held, under these circumstances, that the board did not come to an informed business judgment by approving the sale agreement and found that the directors were grossly negligent in approving the sale of the company. The business judgment rule could not be of assistance to the directors in this case.

*(c) Good faith and the best interest of the company*

Good faith presupposes the existence of a rational business purpose.<sup>20</sup> If the decision of a director does not have rational business purpose, it would not count that he or she exercised due care, the decision would be considered not to be in good faith.<sup>21</sup> A director is required not to have an interest in the transaction, so he or she can apply his or her independent judgment. The court will enquire whether the director acted as a person of sound ordinary business judgment.<sup>22</sup>

With regards to the best interest of the company, the director must have believed the decision that was made with due care and in good faith, to be in the best interests of the company. The best interest requirement is equivalent to the good faith test.<sup>23</sup>

It is clear that the business judgment rule only applies once a decision has been made on an informed basis, in good faith and without conflicting financial interest.<sup>24</sup>

#### 4. THE RECEPTION OF THE BUSINESS JUDGEMENT RULE INTO SOUTH AFRICAN COMPANY LAW

The argument for the statutory incorporation of the business judgment rule into the South African company law framework stems back to the recommendation made by King Report on

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<sup>18</sup> Ibid at 68.

<sup>19</sup> *Smith v Van Gorkom* 488 A.2d 858 (Del. 1985) as cited in Kennedy-Good S, Coetzee op cit note 168 at 68.

<sup>20</sup> Veasey 1982 37 *The Business Lawyer* 1251 as cited in in Kennedy-Good S, Coetzee op cit note 7 at 69.

<sup>21</sup> Kennedy-Good, Coetzee op cit note 7 at 69.

<sup>22</sup> Ibid.

<sup>23</sup> Ibid.

<sup>24</sup> Havenga op cit note 4 at 28.

Corporate Governance.<sup>25</sup> However, the development of the business judgement rule was the work of the American courts and the American common law is the cornerstone of the rule. The American common law principle embraces a situation in which a director, who acted reasonably, in good faith and for the benefit of that particular company, will not be liable for mere errors of judgement.<sup>26</sup>

The American common law principle is illustrated in *Foss v Harbottle*<sup>27</sup> which provides four requirements that must be met by a director in order to escape liability where he or she acted in good faith and in the best interests of the company in the decision making process. The court stated that the decision made by the director of that company related to business related matter; that the directors, in making their decision were not interested in the transaction, in this sense meaning that they did not have any personal gain from making such decision; that in the process of making their decision they did in fact apply due care; and that the directors acted in good faith in making that decision.<sup>28</sup> Subsequent to America including in their common law a business judgement rule there was further discussions and suggestions in South Africa that such business rule be incorporated into South African law, in particular the Companies Act 2008.<sup>29</sup>

Before the introduction of the Companies Act 2008, the Institute of Directors in Southern Africa created a report known as the King Report on Corporate Governance which aimed and focused on the review, improvement and recommendations of corporate governance.<sup>30</sup> The first suggestion to incorporate the business judgment rule in to South African company law was the work of the King committee. The King I Report on Corporate Governance<sup>31</sup> was published in 1994 and it recommended that the duty of care, skill and diligence as it stood at common law had a high standard, and that to encourage entrepreneurship and the assumption of directorship positions, the liability for the breach thereof should be limited by the statute.

The King I Report had purported to defend the potential implementation of the business judgement rule in South Africa due to the fact that the adoption of such rule would encourage

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<sup>25</sup> Khathutshelo Nethavhani *The Business Judgment Rule: Undue erosion of director's duty of care, skill and diligence* (unpublished LLM thesis, University of Pretoria, 2015) 13.

<sup>26</sup> R C Williams 'Concise Corporate and Partnership Law' 3ed (2013) 180.

<sup>27</sup> *Foss v Harbottle* (1843) 2 Hare 461, 67 ER 189.

<sup>28</sup> Ibid.

<sup>29</sup> Maharaj op cit note 14 at 41.

<sup>30</sup> Linda Muswaka 'Directors' duties and the business judgment rule in South African company law: An analysis' (2013) 3(7) *International Journal of Humanities and Social Science* 94.

<sup>31</sup> The Institute of Directors in South Africa, 1994.



and motivate various companies to be engaged in clean competition.<sup>32</sup> The King I Report created the impression that directors were immersed in litigation for breach of the duty of care and skill, which is incorrect.<sup>33</sup> This is supported by the fact that in South Africa, in *Niagara (in liquidation) v Langerman & Others*<sup>34</sup> is the only reported case in which a director has actually been held liable for breach of the duty of care and skill.<sup>35</sup> The King Report recommended that directors should not be held liable for breach of the duty of care and skill if they exercised a business judgment in good faith, the decision was an informed one, and the decision was a rational one not based on self-interest.<sup>36</sup>

The King I Report was later replaced by the King II Report which emphasised that the Standing Advisory Committee on Company Law should investigate whether or not it was desirable and necessary to introduce the business judgment rule in South African company law.<sup>37</sup> However, the King II report did not place any valued argument as to whether the business judgement rule should be implemented in South Africa and it has been criticised for this reason.<sup>38</sup>

The King III was formed after the Companies Act 2008 with the aim to promote corporate governance and to reinforce responsibility to the class of people who partake in the management and functioning of a company and is seen as the backbone to corporate governance existent in South Africa incorporating the provisions laid down in statute.<sup>39</sup> The King III focused on measuring the appropriate standard of care and skill required of a director which was in line with the statutory provisions of the Companies Act 2008.

## 5. THE STATUTORY BUSINESS JUDGEMENT RULE

The business judgment rule was incorporated into South African company law through the provisions of section 76 (4) of the Companies Act 2008, which reads:

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<sup>32</sup> Cassim op cit note 1 at 525.

<sup>33</sup> Bouwman op cit note 5 at 526.

<sup>34</sup> *Niagara (in liquidation) v Langerman & Others* 1913 WLD 188.

<sup>35</sup> Bouwman op cit note 5 at 526.

<sup>36</sup> Deon Ernst Joubert *Duty of Care: A legal analysis of the Business Judgment Rule and the Liability of Directors for Environmental Damage in the South African Mining Industry* (unpublished LLM thesis, University of Pretoria, 2017) 45.

<sup>37</sup> Bouwman op cit note 5 at 527.

<sup>38</sup> *Ibid.*

<sup>39</sup> Luthfiya Essop *A Focus on Directors' Duties of Care, Skill and Diligence in terms of the Common Law and the Companies Act 71 of 2008* (unpublished LLM thesis, University of KwaZulu-Natal, 2015) 38.

‘In respect of any particular matter arising in the exercise of the powers or the performance of the functions of director, a particular director of a company—

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

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

(ii) either—

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

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

(b) is entitled to rely on—

(i) the performance by any of the persons—

(aa) referred to in subsection (5); or

(bb) to whom the board may reasonably have delegated, formally or informally by course of conduct, the authority or duty to perform one or more of the board’s functions that are delegable under applicable law; and

(ii) any information, opinions, recommendations, reports or statements, including financial statements and other financial data, prepared or presented by any of the persons specified in subsection (5).’

Section 76 (4) is clear in its requirements that where a director has no personal financial interest in a matter and has taken reasonable diligent steps to become informed about the matter or relied on a relevant person, continues to make a decision in good faith, for a proper purpose and in the best interest of the company, that director cannot be held liable for the results thereof.<sup>40</sup> The aim of the business judgment rule is to encourage risk taking, innovation and entrepreneurial activities by shielding directors from liability for negligence where directors make an informed rational and reasonable business decision in good faith.<sup>41</sup> Therefore, it is safe to say that the business judgment rule prevents the courts from interfering in a situation

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<sup>40</sup> James Leach *The Correct Understanding of the Business Judgment Rule in Section 76(4) of the Companies Act 71 of 2008: Avoiding the American Mistakes* (unpublished LLM thesis, University of Cape Town, 2014) 17.

<sup>41</sup> Kennedy-Good, Coetzee *op cit* note 7 at 63.

where a director has made a business decision in honesty and good faith despite the consequence of the business decision.<sup>42</sup>

Section 76 (4)<sup>43</sup> initiated a partly subjective and objective test. The first part of the test being objective in nature, is contained in the provision of section 76 (4) (a) (i) which requires that the director must take 'reasonable diligent steps' for him or her to be informed. For a director to be 'reasonably informed', he or she must have a clear understanding about the business of the company and the environment in which the company operates.<sup>44</sup> The second part of the test objective in nature, however containing a subjective element, is contained in section 76 (4) i (iii); which provides that in making a decision a director must have rationally believed that the decision was in the best interests of the company. The requirement of rationality appears to be included to objectify the belief that a director had with regards to the best interests of the company.

It is clear that a director will be assisted to avoid a finding of breach of the duty to act in the best interests of the company and the duty of care and skill against himself or herself if the criterion provided in section 76 (4) is satisfied.<sup>45</sup>

## 6. CONCLUSION

It is evident that the business judgment rule is closely related to the duty of care and skill, as the statutory business judgment rule appears to limit its application to the statutory duty of care, skill and diligence. Therefore, it is not every conduct by a director that may be protected by the application of the business judgment rule. Thus, the enactment of the business judgment rule is not a fortress for directors as dishonest and irrational directors will still face the sanction of the court for breach of the duty to act in the best interest of the company and the duty to act with care, skill and diligence.<sup>46</sup>

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<sup>42</sup> Ibid.

<sup>43</sup> Companies Act 71 of 2008.

<sup>44</sup> Joubert op cit note 36 at 49.

<sup>45</sup> Bouwman op cit note 5 at 529.

<sup>46</sup> Muswaka op cit note 30 at 91.

## CHAPTER SIX: CONCLUSION

The acceptance of the office of director places wide - ranging responsibilities on individuals in that office. This is evident from the dictum in the case of *Daniels v Anderson*,<sup>208</sup> where the court stated that a person who accepts the office of director in a company undertakes the responsibility of ensuring that he or she understands the nature of the duty a director is called upon to perform.<sup>209</sup> At common law, directors are under fiduciary duties in which when exercising their powers and carrying out their duties, are expected to do such in good faith and in the best interest of the company and to avoid conflict of interests. The common law fiduciary duties are now codified in statute.

In performing their fiduciary duties, directors are required to exercise care, skill and diligence. In regards to the duty of care, skill and diligence, the degree or standard of care that directors need to exhibit has not been clear; and such has been subject to scrutiny. It has been held that 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; and he or she is not bound to give continuous attention to the affairs of the company.<sup>210</sup> This approach at common law was considered to be lenient and was in need of development. The development of the lenient approach came about by the partial codification of the duty of care and skill into the Companies Act 2008.<sup>211</sup>

The provisions of the 2008 Act incorporated a much stricter approach than the traditional lenient approach at common law, which approach is encompassed in section 76 (3) (c). It should be noted that, despite the modification of the common law provisions, the common law has not been cast off in the statutory provisions, but the statute has changed the duty of care, skill and diligence of directors by adopting a more taxing and burdensome approach.<sup>212</sup> The duty of care, skill and diligence works hand in hand with the provisions of section 76(4), which comprises the business judgment rule, which limits or restricts the managers ' liability for performing their duties in good faith, despite the disastrous results achieved.<sup>213</sup>

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<sup>208</sup> *Daniels v Anderson* [1995] 13 ACLC 614.

<sup>209</sup> *Ibid* at 665.

<sup>210</sup> *In re Equitable Fire Insurance Co Ltd* [1925] Ch 407.

<sup>211</sup> Companies Act 71 of 2008.

<sup>212</sup> Luthfiya Essop *A Focus on Directors' Duties of Care, Skill and Diligence in terms of the Common Law and the Companies Act 71 of 2008* (unpublished LLM thesis, University of KwaZulu-Natal, 2015) 60.

<sup>213</sup> *Ibid*.

The business judgment rule states that if a manager makes a mistake in his judgment, he can hide behind the statutory business judgment rule in order to avoid liability. However, with regards to the business judgment rule, there is not much case law to assist with the application of the rule. Until we understand the exact interpretation of the business judgment rule in the South African context, companies should choose directors wisely and attorneys should work to carefully regulate the positions of their clients and their parameters through the company's memorandum of incorporation.<sup>214</sup>

Not only has the Companies Act 2008 changed the entire corporate landscape of South Africa, but it has also changed the roles and responsibilities of the directors and their associated liability.<sup>215</sup>

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<sup>214</sup> Nicolene Schoeman-Louw 'The business judgment rule: how the Companies Act of 2008 is impacting on directors' duties' available at <http://www.polity.org.za/article/the-business-judgment-rule-how-the-companies-act-of-2008-is-impacting-on-directors-duties-2013-08-07> accessed on 05 November 2018.

<sup>215</sup> Ibid.

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18 March 2019

Ms Sphesihle Brilliant Zondi (213531552)  
School of Law  
Pietermaritzburg Campus

Dear Ms Zondi,

Protocol reference number: HSS/0130/019M

Project title: Critical discussion of directors' duties and the business judgment rule

**Full Approval – No Risk / Exempt Application**

In response to your application received on 18 February 2019, the Humanities & Social Sciences Research Ethics Committee has considered the abovementioned application and the protocol has been granted **FULL APPROVAL**.

Any alteration/s to the approved research protocol i.e. Title of the Project, Research Approach and Methods must be reviewed and approved through the amendment/modification prior to its implementation. In case you have further queries, please quote the above reference number.

**PLEASE NOTE:** Research data should be securely stored in the discipline/department for a period of 5 years.

The ethical clearance certificate is only valid for a period of 1 years from the date of issue. Thereafter Recertification must be applied for on an annual basis.

I take this opportunity of wishing you everything of the best with your study.

Yours faithfully

.....  
Dr Rosemary Sibanda (Chair)

/ms

Cc Supervisor: DC Subramanien  
cc Academic leader Research: Dr Freddy Mnyongani  
cc School Administrator: Ms Robynne Louw

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Humanities & Social Sciences Research Ethics Committee

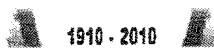
Dr Rosemary Sibanda (Chair)

Westville Campus, Govan Mbeki Building

Postal Address: Private Bag X54001, Durban 4000

Telephone: +27 (0) 31 260 3587/8350/4557 Facsimile: +27 (0) 31 260 4609 Email: [ximbap@ukzn.ac.za](mailto:ximbap@ukzn.ac.za) / [snymam@ukzn.ac.za](mailto:snymam@ukzn.ac.za) / [mohung@ukzn.ac.za](mailto:mohung@ukzn.ac.za)

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