

**UNIVERSITY OF KWAZULU-NATAL**

**RECKLESS AND FRAUDULENT TRADING BY A COMPANY AND THE  
BUSINESS JUDGMENT RULE AS A DEFENCE FOR DIRECTORS**

**BY**

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## DECLARATION

I, Lunga Peter, hereby declare that:

- 1 the research reported in this dissertation is my original work, except where otherwise indicated;
- 2 this dissertation has not been submitted for any degree or examination at any other university;
- 3 this dissertation does not contain other persons' writing, unless specifically acknowledged as being sourced from other researchers. Where other written sources have been quoted, then:
  - a their words have been re-written but the general information attributed to them has been referenced; and
  - b where their exact words have been used, their writing has been placed inside quotation marks and referenced.



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Signature

04/12/2018  
..... / 2018

## DEDICATION

I dedicate this dissertation to my father and mother, Mziyanda and Nomkitha.

## **ACKNOWLEDGEMENTS**

Firstly, I thank the Almighty Lord, Jesus Christ, for giving me the strength and courage to study. I dedicate this work to my late father and mother, Mziyanda and Nomkhitha who were always supportive and encouraging me to further my studies. I would also like to express my deepest gratitude to my wife Khanyi for her support and patience throughout my studies, and to my son Lukhanyo and my daughter Elethu who had to endure my absence from home during my studies. Lastly, I thank my supervisor, Mr S.P. Phungula, for his guidance, patience and support.

## ABSTRACT

The Companies Act 71 of 2008 is the current legislation regulating the conduct of company directors in the execution of their fiduciary duties. Its broadened scope significantly impacts on directors' liability in corporate South Africa. This Act has two provisions dealing with reckless and fraudulent trading by a company, namely sections 22(1) which prohibits recklessness, gross negligence and fraudulent conduct, and section 77(3)(b) which imposes personal liability on directors for any loss incurred by the company through reckless or fraudulent conduct in the carrying on of business. The Act also holds directors and prescribed officers liable for breach of common law fiduciary duties of care and skill. On the other hand, the business judgment rule contained in section 76(4) of the Act has been used as a shield or defence by directors who acted honestly and in good faith from liability for any losses or damages sustained by the company emanating from poor decision making. The rule is premised on a rebuttable presumption that directors of a company have acted in good faith, on an informed basis, and in the honest belief that their conduct was in the best interests of the company when making business decisions. However, there is uncertainty as to when directors can use the business judgment rule and how the rule protects them from provisions relating to reckless and fraudulent trading by a company. On the other hand, strict enforcement of the provisions relating to reckless and fraudulent conduct is a necessity in the fight against unethical corporate governance. Hence, this research investigates the impact of the Companies Act on the duties of the directors and what needs to be done to either fortify or ease the relevant provisions so that the directors can have latitude in the performance of their duties. The research also discusses how holding a director personally liable affects the notion of separate corporate liability. On the other hand, the research investigates the impact of the business judgment rule and deliberates on its relevance in the South African corporate system. A thorough discussion and analysis of reckless and fraudulent trading by directors and the business judgment rule, including case law will also be done in this research.

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## CHAPTER 1: INTRODUCTION

### 1.1. Background to the study

A company is a legal entity formed by and comprising of people, either natural or legal, for the purposes of carrying on a business. In terms of section 1 of the Companies Act 71 of 2008, as amended, a company refers to a juristic person formed in terms of the Act, a domesticated company, or a juristic person that:

- a was registered in terms of the Companies Act 61 of 1973 (except an external company) or the Close Corporations Act 69 of 1984;
- b was already recognised as an “existing company” in terms of the Companies Act of 1973; or
- c had been deregistered in terms of the of the 1973 and subsequently registered in terms of the Act of 2008.

The concept of a company in law is premised on the doctrine of separate legal personality, whose principles mainly hold that a company’s existence is separate from those who comprise it; its assets and liabilities are of its own and not the shareholders, with perpetual existence.<sup>1</sup> The concept of a separate legal personality of a company can be traced back to the English case of *Salomon v Salomon and Co Ltd*<sup>2</sup> which formed the foundation of the notion that a company has a separate existence from its shareholders and directors. In this case, Lord MacNagthen of the House of Lords held that:

The company is at law a different person altogether from the [shareholders] . . . , and though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands received the profits, the company is not in law the agent of the [shareholders] or trustee for them. Nor are the [shareholders], as members, liable in any shape or form, except to the extent and in the manner provided for by the Act.<sup>3</sup>

Notwithstanding the separate legal personality of a company, directors of a company may face liability for the company’s reckless and fraudulent trading.<sup>4</sup> This is because the limited liability on directors and the company’s separate legal personality could open endless

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<sup>1</sup> Cassim (et al) *Contemporary Company Law* (2011) 29.

<sup>2</sup> [1897] AC 22.

<sup>3</sup> *Ibid* at 51.

<sup>4</sup> *Pressma Services (Pty) Ltd v Schuttler* 1990 (2) SA 411 (C) 416; Phungula S., ‘Personal Liability of a Director in Terms of Section 424 (1) of the Companies Act 61 of 1973 in relation to Default Judgment in Terms of Rule 39 of the Uniform Rules of the High Court: An Analysis of—*Minnaar v Van Rooyen NO* [2015] ZASCA 114’ 2016 37(3) *Obiter* 695, 700.

opportunities for abuse of the entity by both the directors and controlling shareholders. In South Africa, there are two laws that render directors personally liable for reckless and fraudulent trading, namely the Companies Act 71 of 2008 (hereafter Companies Act of 2008) and the Companies Act 61 of 1973 (hereafter Companies Act of 1973). The provision that deals with reckless and fraudulent trading in the Companies Act of 1973 is section 424(1). This section provides that:

When it appears, whether it be in a winding-up, judicial management or otherwise, that any business of the company was or is being carried on recklessly or with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the Court may, on the application of the Master, the liquidator, the judicial manager, any creditor or member or contributory of the company, declare that any person who was knowingly a party to the carrying on of the business in the manner aforesaid, shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court may direct.

The Companies Act of 2008 has a broadened scope which significantly impacts on directors' liability in corporate South Africa. This Act has two provisions dealing with reckless and fraudulent trading by a company. Section 22(1) of the Act proscribes a company from carrying on its business "recklessly, with gross negligence, with intent to defraud any person or for any fraudulent purposes." On the other hand section 77(3)(b), read with section 22 of the Act, imposes personal liability on directors for any loss incurred by the company through deliberate reckless or fraudulent conduct in the carrying on of business.<sup>5</sup> Section 77(2) of the Companies Act 71 of 2008 also holds directors liable for loss of damages incurred by the company as a result of a breach of common law fiduciary duties contemplated in section 75, 76(2) or 76(3)(a) or (b).

The question which arises then is when can directors use the business judgment rule and how does that rule protect them from reckless and fraudulent trading by a company.

The business judgment rule has been used as a tool or defence by directors in law. It entails a rebuttable presumption that directors of a company have acted in good faith, on an informed basis, and in the honest belief that their conduct was in the best interests of the company when making business decisions.<sup>6</sup> Emanating from the United States of America, the principle simply maintains that "...directors of a corporation... are clothed with [the] presumption, which the law accords to them, of being [motivated] in their conduct by a bona

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<sup>5</sup> In terms of section 77(3)(b), a director of a company is liable for any loss, damages or costs sustained by the company as a direct or indirect consequences of the director having acquiesced in the carrying on of the company's business despite knowing that it was being conducted in a manner prohibited by section 22(1).

<sup>6</sup> Jones E., 'Directors' duties: negligence and the business judgment rule' 2007 (19) *SA Merc LJ* 326, 329.

fide regard for the interests of the corporation whose affairs the stockholders have committed to their charge.<sup>7</sup> The rule shields directors who acted honestly and in good faith from liability for any losses or damages incurred by the company emanating from poor decision making.<sup>8</sup>

It is submitted that the business judgment rule promotes risk-taking, innovation and entrepreneurial spirit by offering directors (acting in good faith and in the best interests of the company) protection against honest errors of judgment and poor business decisions which may have negative effects on the company. It recognises the need for entrepreneurial spirit by encouraging directors to take necessary calculated business risks, whilst at the same time promoting values such as honesty, good faith and reasonableness.

The business judgment rule principle was adopted in the South African legal system in section 248 of the Companies Act of 1973. This section provided that directors who act 'honestly' and 'reasonably' would be excused from liability if the court concluded that in the circumstances they 'ought fairly to be excused'.<sup>9</sup> Honesty and reasonableness were the main factors to distinguish reckless and negligent conduct from a *bona fide* decision that turned out to be unsound. The principle was later developed in South African legal parlance through section 76(4) of the Companies Act of 2008. Section 76(4) provides that directors acting in good faith, with proper care and in the best interests of the company, may rely on performance, information or opinions of a competent employee or person delegated by the board whom the directors reasonably believe to be reliable. This creates what other academics have referred to as a 'safe harbour from liability'.<sup>10</sup>

In the present day corporate system, recurring stories and cases relating to abuse of corporate powers are cause for concern.<sup>11</sup> It makes one wonder whether shareholders and senior executives in companies are aware of the distinction between their personal status and the legal nature of the companies they are entrusted to run.<sup>12</sup> Poor corporate governance, poor

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<sup>7</sup> *Gimbel v Signal Companies Inc* 316 A.2d 599, 608 (Del. Ch. 1974).

<sup>8</sup> Naidoo R., *Corporate Governance: An essential guide for South African Companies* (2009) 171.

<sup>9</sup> Jones E., 'Directors' duties: negligence and the business judgement rule' 2007 (19) *SA Merc LJ* 326 331.

<sup>10</sup> Cassim (et al) *Contemporary Company Law* (2012) 563.

<sup>11</sup> *Passenger Rail Agency of South Africa v Gustin* [2017] ZAGPPHC 530; See 'High Court orders former Prasa finance chief to repay R8m' reported on 1 August 2017, available at <https://www.timeslive.co.za/news/south-africa/2017-08-01-high-court-orders-former-prasa-cfo-to-repay-r8m/>, accessed on 2 May 2018; *AllPay Consolidated Investment Holdings (Pty) Ltd and others v Chief Executive Officer of the South African Social Security Agency and Others* (No 2) [2014] ZACC 12; See 'Steinhoff – The largest corporate failure on the JSE' reported on 7 December 2017, available at <https://mg.co.za/article/2017-12-07-steinhoff-the-largest-corporate-failure-on-the-jse/>, accessed on 24 April 2018.

<sup>12</sup> *Strut Ahead Natal (Pty) Limited v Burns* 2007 (3) All SA 190 (D).

decision making, corruption, collusion and non-compliance with legislation and relevant industry policies result in companies suffering reputational damage or losing revenue, which may ultimately result in job losses.<sup>13</sup> It is submitted that other factors such as economic uncertainty, recession, inflation, political instability and market manipulation may drive company executives to make decisions or engage in activities that may benefit or bring their corporations into disrepute. The threat of personal liability against directors for poor outcomes in the exercise of their fiduciary duties can also stifle enthusiasm and innovation in companies. In this case, the business judgment rule emerges as a vital tool to protect *bona fide* directors exercising their fiduciary duties in the best interests of the company, even in instances where their decisions can have devastating effects on the company.<sup>14</sup> The statutory business judgment rule lays down three requirements which must be met for a director to enjoy protection. First, the director must have taken reasonably thorough steps to become well-versed about the matter.<sup>15</sup> Secondly, the director must have no personal financial interest or no reasonable basis to know any related person to with a personal financial interest in the subject matter of the decision.<sup>16</sup> Thirdly, the director must have made a decision with a rational belief that it was in the best interests of the company.<sup>17</sup> It is apparent from section 76(4) that qualities such as good faith, acting in the best interests of the company, and the exercise of reasonable care, skill and diligence are vital factors in applying the business judgment rule. However, although innovation and entrepreneurial spirit are encouraged, a distinction must be drawn between recklessness (or dishonesty) and a *bona fide* error of judgement.<sup>18</sup>

The research will focus on the liability of directors when the company acts recklessly in accordance with section 77(3)(b) and section 22 of the Companies Act 71 of 2008, and the defence available for directors in terms of the business judgment rule as provided in section 76(4) of the Companies Act of 2008. The research will further discuss the business judgment rule, a defence available to directors in terms of section 76(4), and deliberate on its

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<sup>13</sup> See 'South Africa's R600 million train blunder' reported on 5 July 2015, available at <https://businesstech.co.za/news/government/92424/south-africas-r600-million-train-blunder/>, accessed on 17 August 2017; see 'SA Banks Accused Of Price-Fixing' retrieved from [http://www.huffingtonpost.co.za/2017/02/15/sa-banks-accused-of-price-fixing\\_a\\_21714786/](http://www.huffingtonpost.co.za/2017/02/15/sa-banks-accused-of-price-fixing_a_21714786/), accessed on 19 August 2017.

<sup>14</sup> Bouwman N., 'A new defence for directors' *Without Prejudice*, May 2011, 12.

<sup>15</sup> S 76(4)(a)(i).

<sup>16</sup> S 76(4)(a)(ii).

<sup>17</sup> S 76(4)(a)(iii).

<sup>18</sup> *Mafikeng Mail (Pty) Ltd v Centner (No 2)* 1996 (4) SA 607 (WLD).

relevance in the South African corporate system. The research will further discuss and analyse case law on reckless and fraudulent trading by directors and the business judgment rule; and an in-depth discussion of the interface between these two will be done. In conclusion, recommendations will be made on the way forward.

## **1.2. Statement of purpose / rationale**

The Companies Act 71 of 2008 is the current legislation regulating the conduct of directors in the execution of their duties. The King III Report on Corporate Governance for South Africa, although not a binding legislative document, is another well-recognised corporate governance manual laying out guidelines for the governance structures and operation of companies in South Africa.<sup>19</sup> The Companies Act of 2008 further evidently imposes liability for breach of fiduciary duties and the duty of care and skill to prescribed officers and to board committee members who are not directors of the company.

However, the said law is to an extent very restricting on the performance or the execution of duties of the directors in a country riddled with economic and political uncertainties. The purpose of this research is to look at the impact these laws have had on the duties of the directors and what needs to be done to either fortify or ease them so that the directors can have latitude in the performance of their duties. The purpose of this research is to further look at how holding a director personally liable affects the notion of separate corporate liability.

## **1.3. Research questions**

- a) How does personal liability affect directors in performing their functions properly?
- b) When can directors protect themselves against such liability?
- c) Is the business judgment rule enough to protect or justify the directors' actions?

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<sup>19</sup> Popularly known as the King Code or the King III. It must also be noted that compliance with the King Code or the King Report is compulsory for companies listed on the Johannesburg Stock Exchange as it is regarded as 'the most effective summary of the best international practices in corporate governance'. See Banhegyi, S., *Financial Management: Fresh Perspectives*, Cape Town, Pearson Education (2007) 317. It must also be noted that the *King IV Report on Corporate Governance* was recently published on 1 November 2016.

#### 1.4.Literature review

Directors are generally absolved from personal liability for any debts, liabilities, loss or damages incurred by the company when they act on its behalf because the doctrine of separate legal personality imposes such obligations on the company in its own capacity as a legal *persona*.<sup>20</sup> Exceptions are when the company is a personal liability company or when a court pierces the corporate veil after being satisfied that an act or conduct of a director or the whole board was reckless or fraudulent. In *Anderson v Dickson*, the court referred to reckless trading as “carrying [on business] by conduct which evinces a lack of any genuine concern for its prosperity.”<sup>21</sup> Likewise, in *Ozinsky NO v Lloyd and Others*<sup>22</sup>, Van Deventer J described recklessness as follows:

If a company continues to carry on business and to incur debts when, in the opinion of the reasonable businessman standing in the shoes of the directors there would be no reasonable prospect of the creditors receiving payment when due, it will in general be a proper inference that the business is being carried on recklessly.

In *Shawinigan v Vokins & Co Ltd*<sup>23</sup>, the court likened recklessness to gross carelessness and further iterated that it implies the following:

...the doing of something which in fact involves risk, whether the doer realises it or not, and the risk being such, having regard to all the circumstances, that the taking of that risk would be described as ‘reckless’...

In *Ex parte Lebowa Development Corporation Ltd*<sup>24</sup>, the court referred to the term ‘reckless’ as implying a departure from a standard of care thus resulting in negligence (*culpa*) or gross negligence (*culpa lata*). In *Fisheries Development Corporation of SA Ltd v Jorgensen: Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd*<sup>25</sup>, the court held that in determining whether the business of the company had been conducted recklessly, several factors including the scope of the company’s operations, the duties and powers of the directors, the debt involved, the scope of the company’s challenges and its prospects of recovery must be taken into consideration.<sup>26</sup>

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<sup>20</sup> Cassim (2012) 35.

<sup>21</sup> 1895 (1) SA 71 (T), quoted in Meskin PM (ed) *Henochnsberg on the Companies Act*, vol 1 (1994) 914.

<sup>22</sup> 1992 (3) SA 396 at 414 G-H.

<sup>23</sup> [1961] 3 All ER 396 at 403 F.

<sup>24</sup> 1989 (3) SA 71 (T) 111C.

<sup>25</sup> 1980 (4) SA 156 (W) 170B-C.

<sup>26</sup> These sentiments were also adopted by the courts in *Philotex v Snyman* 1998 (2) SA 138 (SCA) 144B; *McLuckie v Sullivan* 2011 (1) SA 365 (GSJ); *Fourie NO v Newton* [2011] 2 All SA 265 (SCA).

The test for recklessness was further expanded in ensuing cases, in which it was measured against the wording of section 424(1) of the Companies Act 61 of 1973.<sup>27</sup> However, a distinction must be drawn between recklessness (a disregard for consequences of one's actions) and innocent error of judgement.<sup>28</sup> In *Mafikeng Mail (Pty) Ltd v Centner (No 2)*<sup>29</sup>, the court held that recklessness was not an error of judgement, provided the director could show that he was confronted with a choice, the decision of which was invoked by thought and reflection.<sup>30</sup>

Fraudulent trading invokes a subjective enquiry into a director's intention or state of mind when carrying on the business,<sup>31</sup> involving the intentional making of a misrepresentation which is unlawful, thus causing actual or potential prejudice to the party relying on the misrepresentation.<sup>32</sup> Falsifying company records to reflect profits when currently in fact incurring losses or intentionally trading and taking more loans under insolvent circumstances without the hope of repaying creditors are typical examples of fraudulent trading. Also, failure to disclose certain facts may amount to fraud.<sup>33</sup>

Section 424(1) of the Companies Act of 1973 was enacted with a view to curbing acts of fraud and recklessness by company directors when the company was being wound up, undergoing judicial management or otherwise. The provision permits the Master, the liquidator, the judicial manager, any creditor or member or contributory of the company to apply to court for an order declaring a director personally liable for the debts or liabilities of the company where there appears to be an act of recklessness with intent to defraud creditors or for any other fraudulent purpose. Du Plessis regards this provision as a vital tool for creditors.<sup>34</sup> Courts have methodically and in detail unpacked this provision. In *Ozinsky NO v Lloyd and Others*, Nienaber JA held as follows:

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<sup>27</sup> Some of these cases include the following: *Ex parte Lebowa Development Trust* 1989 (3) SA 71 (T); *Strut Ahead Natal v Burns* 2007 (4) SA 600 (D); *M A Vleisagentskap CC and another v Shaw and another* 2003 (6) SA 714; *Ebrahim and another v Airport Cold Storage (Pty) Ltd* 2008 (6) SA 585 (SCA); *McLuckie v Sullivan* 2011 (1) SA 365 (GSJ); *Raflatac SA (Pty) Ltd v Bell & another* [2012] ZAECGHC 5.

<sup>28</sup> Cassim (ed) 'The Duties and liabilities of directors' in *Contemporary Company Law* (2012) 591; Kekana N.B. (2016) 'Liability for fraudulent and reckless trading: a critical analysis of *Engelbrecht NO & Others NNO v Zuma & Others* [2015] 3 All SA 590 (GP)', Master's Thesis, University of Johannesburg.

<sup>29</sup> 1995(4)SA 607 (W).

<sup>30</sup> *Ibid.* See *Levin v Feld and Tweeds Ltd* 1951 (2) SA 401 (A); *Strut Ahead Natal (Pty) Ltd v Burns* (supra).

<sup>31</sup> *Terblanche NO & Others v Damji & Another* 2003 (5) SA 589 (C).

<sup>32</sup> Snyman C.R., *Criminal Law* (2008) 531.

<sup>33</sup> Phungula S., (2013) 'Liability of directors for reckless and fraudulent trading: the continuance of s 424 (1) of the Companies Act 61 of 1973 together with the coming into force of s 22 and s 77 (3) of the Companies Act of 2008' LLM Thesis, University of KwaZulu-Natal, 27.

<sup>34</sup> Du Plessis J. (1990) 'Maastkappyregtelike Grondslae van de Regsposisie van Direkteure en Besturende Direkteure', unpublished LLD Thesis, University of the Orange Free State, 126.

There are two parts to the body of this section: (1) the business of the company must be carried on in a certain manner i.e. (i) recklessly or (ii) with intent to defraud creditors (of the company or of any other person) or (iii) for any fraudulent purpose; and (2) the person concerned must (a) be a party to the carrying on of the business . . . and (b) have knowledge of the facts from which the conclusion is properly to be drawn that the business of the company was or is being carried on (i) recklessly or (ii) with intent to defraud creditors (of the company or of any other person) or (iii) for any fraudulent purpose . . . .

Hence, factors such as knowledge of fraud and recklessness on the part of the director and intention to defraud are the key elements on which personal liability may be imputed on directors of a company in terms of section 424(1). In addition, section 424(1) is said to be far-reaching in that it does not limit the liability placed on the directors or officers of the company with regard to the debts. The director may face both civil and criminal sanctions for reckless and fraudulent trading.<sup>35</sup> Section 424(1) restricted the inquiry to insolvent circumstances. However, since the entire Chapter XIV of the Companies Act of 1973 relating to the winding-up of companies continues to apply, section 424(1) remains relevant and is applied in conjunction with sections 22(1) and 77(3) of the Companies Act 71 of 2008.<sup>36</sup>

Section 22(1) of the Companies Act of 2008, as amended, prohibits a company from carrying on its business in a reckless manner, with gross negligence, with intent to deceive any person or for any fraudulent purpose, or trade under insolvent circumstances. Such unlawful conduct of the company is occasioned by directors as individuals tasked with the responsibility to run the day-to-day affairs of the company. Section 77(3)(b) outlines the specific acts directly or indirectly occasioned by the director resulting in a company incurring loss, damages or costs and by which he or she must be held personally liable. Should a director be found to have traded recklessly or fraudulently, he or she may be declared a delinquent director in terms of section 69(8) and thereafter be disqualified from office.

Of importance in section 22 are elements such as recklessness, gross negligence and intent to defraud or having a fraudulent purpose. The imposition of personal liability on directors engaging in reckless and fraudulent trading arises when the company, or any other person in terms of section 218(2), suffers loss, damages or incurs costs sustained by the company.<sup>37</sup> In

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<sup>35</sup> Havenga M., 'Creditors, Directors and Personal Liability under S 424 of the Companies Act' (1992) 4 *SAMerLJ* 63, 64.

<sup>36</sup> In terms of item 9 of schedule 5 to the Companies Act 71 of 2008, 'Despite the repeal of the previous Act, until the date determined by the [Minister] Chapter 14 of the Act continues to apply with respect to winding up and liquidation of companies under this Act, as if that Act had not been repealed.'

<sup>37</sup> S 77 (3) of the Companies Act of 2008.

terms of section 77(3)(b), directors can be personally held liable under the following circumstances:

- a) when they trade recklessly;
- b) when they carry on business with gross negligence; and
- c) when they intentionally act (or fail to act) fraudulently or for any fraudulent purpose.

Hence, it can be seen that the scope of reckless and fraudulent trading is wider in the 2008 Act. The new Act creates boundaries that directors must not cross in order to maintain the separate personality and dignity of a company. Section 22 of the new Act not only applies under insolvent circumstances as prescribed by section 424 of the old Act, it also applies even when the company is operating under solvent circumstances.<sup>38</sup>

It must be noted that reckless and fraudulent trading is interpreted in contrast with section 76(3) of the Companies Act of 2008 which promotes qualities such as good faith, acting in the best interests of the company and exercise of care, skill and diligence as core factors which directors should abide by in the exercise of their powers and carrying out of their fiduciary duties.

On the other hand, it must be noted that commercial risks are a necessity in driving innovation and promoting growth in a company. Directors are at times required to make hasty business decisions without carefully investigating the uncertainty.<sup>39</sup> Considering the unpredictable political and socio-economic circumstances in South Africa and around the globe, the business judgment rule may be ideal for protecting directors against risky, but *bona fide*, business decisions. The business judgment rule has been regarded as a defence which absolves directors from liability for any losses incurred by the company or its shareholders as a result of poor decision-making or error of judgement.<sup>40</sup> The rule denotes that directors are presumed to have acted with reasonable knowledge, in good faith, and with an honest belief that the decision taken was in the best interests of the company.<sup>41</sup>

Section 76(4) of the new Act encompasses the common law business judgment rule and it restrains courts from easily interfering with honest and reasonable decisions of the

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<sup>38</sup> Phungula (LLM thesis) 7.

<sup>39</sup> Leach, J. (2014) 'The Correct Understanding of the Business Judgment Rule in Section 76(4) of the Companies Act 71 of 2008: Avoiding the American Mistakes' LLM thesis, University of Cape Town 32.

<sup>40</sup> Jones E., 'Directors' duties: negligence and the business judgment rule' 2007 (19) *SA Merc LJ* 326, 329.

<sup>41</sup> *Ibid.*

directors.<sup>42</sup> Section 76(4) provides that directors acting in good faith, with proper care and in the best interests of the company, may rely on performance, information or opinions of a competent employee or person delegated by the board, whom the directors reasonably believe to be reliable. Legal counsel, accountants, board committee members and competent employees retained by the company or its board for specific functions are some of the professionals a director may rely on.<sup>43</sup>

In short, the following requirements must be satisfied for a director to be protected by the business judgment rule in terms of section 76(4)(a):

- a) He or she must have taken steps to make an informed decision;
- b) There must be no material financial interest on the part of the director; and
- c) It must be reasonably believed that the director was acting in the best interests of the company.<sup>44</sup>

Jones opines that the business judgment rule recognises that business decisions are often occasioned with risk and uncertainty, and thus encourages directors to engage in business transactions with greater potential for profit regardless of the risks they may entail.<sup>45</sup> For a director to be protected by the rule, his or her actions must have been honest, made in good faith and in the best interests of the company, even if the disastrous result thereof is indicative of poor decision-making or error of judgement.<sup>46</sup> A distinction should however be drawn between a foreseeable risk and uncertainty which is unforeseeable. A director cannot rely on the business judgment rule if he or she acted in bad faith, without the company's best interest, lacked independence, had a material or financial interest in the transaction and thus engaged in conduct for self-gain, or failed to exercise oversight over a continuous period of time.<sup>47</sup>

It must be acknowledged that the rule is not without challenges of its own. The standard of reasonability plays a crucial role in determining whether a director should not be personally held liable for poor decision-making. However, the Act does not provide guidance as to what constitutes taking 'reasonable' effort on the part of the director in making an informed decisions or 'reasonable' reliance on the information of the employees or professionals

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<sup>42</sup> Cassim et al (2012) 563.

<sup>43</sup> S 76 (5).

<sup>44</sup> Cassim et al (2012) 565.

<sup>45</sup> Jones (2007) 333.

<sup>46</sup> Cassim et al (2012) 566.

<sup>47</sup> Leach (LLM thesis) 31.

specified in section 76(5) of the Act.<sup>48</sup> Questions are also raised on the ability of the courts to appropriately determine whether a director, at the time of making a decision, was reasonable and correct.<sup>49</sup> While innovation and entrepreneurship are encouraged, a distinction should also be drawn between a skilled director taking *bona fide* calculated risks based on experience and an unskilled one acting honestly but based on assumptions and blind faith. One may also question the extent of the rule in distinguishing foreseeable risks from unforeseeable uncertainties in business. Hence, while the rule offers protection to honest directors, it also seems to suppress innovation and venturesome business activity<sup>50</sup>, and acts to the disadvantage of the company itself which suffers loss and damages.

### **1.5. Research outline**

This is an introductory chapter in which a background to the study has been undertaken in order to provide an understanding on the research topic as well as the dichotomy between the provisions relating to reckless and fraudulent trading, and the defence afforded to directors acting in good faith albeit to the detriment of the company.

Chapter 2 will discuss the defences afforded to directors of a company to avoid personal liability in cases of reckless and fraudulent trading. The business judgment rule will be the main point of discussion in the chapter.

Chapter 3 will critically analyse both aspects of the research: namely reckless and fraudulent trading, and the business judgment rule as a defence. This chapter will also analyse case law on reckless and fraudulent trading by a company. A critical discussion on the practical effects of the application of both principles and the possible shortcomings thereof will also be undertaken in this chapter.

Chapter 4 concludes the whole study and contains recommendations regarding the future of the business judgment rule in South African law.

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<sup>48</sup> Muswaka, L. 'Shielding Directors against Liability Imputations: The Business Judgment Rule and Good Corporate Governance' 2013 (1) *Speculum Juris* 25, 40.

<sup>49</sup> Leach (LLM thesis) 31.

<sup>50</sup> Note 48 above, 26.

## **CHAPTER 2: THE STATUTORY BUSINESS JUDGMENT RULE EXPLAINED**

### **2.1. Introduction**

Conducting or running a business is premised on a myriad of factors. One of them is the need to take commercial risks in order to ensure productivity and growth. However, in most instances, even after careful investigations have been undertaken and due diligence has been done before taking a calculated business risk, decisions that follow are masked in uncertainty. One is never completely certain that a calculated commercial risk will yield maximum results without a possibility of any failure. Sound decisions may sometimes have catastrophic effects on the company. In such circumstances, the law absolves a director from liability for unforeseeable harm while acting in the best interests of the company. Hence, the business judgment rule protects a director who acted with due care, skill and diligence from liability for decisions which yield undesirable results.<sup>51</sup> The rule promotes entrepreneurial innovation by providing equilibrium between the directors' competing interests of commercial risk on one hand, and their accountability on the other. It has been argued that the rule can be used as a standard of conduct, a standard of liability, a standard of review and a standard of immunity.<sup>52</sup> In this chapter, the business judgment rule, as provided for, in the Companies Act of 2008 will be discussed, particularly the requirements that must be satisfied for a director to be protected, the significance of the rule, its shortcomings, and its future in South African law.

### **2.2. Requirements of the business judgment rule**

As outlined in chapter 1 above, the business judgment rule draws its roots from American law. In terms of common law, there are four conditions that must be satisfied in order to ascertain whether a director's decision as well as the decision-making process was of such a standard warranting protection under the rule. First, a judgment must have been made.<sup>53</sup> Secondly, the director must have educated himself to the extent that he believes that the decision taken and the decision-making process thereof were reasonable under the

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<sup>51</sup> Truter A., 'The Business Judgement Rule – what directors need to know' available at [www.schoemanlaw.co.za/business-judgement-rule/](http://www.schoemanlaw.co.za/business-judgement-rule/), accessed on 09 October 2017.

<sup>52</sup> Eisenberg M.A., 'The Divergence of Standards of Conduct and Standards of Review in Corporate Law' (1993) 62 *Fordham LR* 437; Leach (Masters thesis) 30. However, a detailed discussion of the above standards will not be done in this thesis.

<sup>53</sup> Eisenberg (supra) 441.

circumstances.<sup>54</sup> Thirdly, the director must have acted in good faith and, fourthly, he or she must have had no personal financial interest in the matter.<sup>55</sup>

In South Africa, section 76 of the Companies Act of 2008 lays out standards of directors' conduct when exercising their powers and performing their respective functions. Directors are obliged to act in good faith, in the best interests of the company and with the degree of care, skill and diligence.<sup>56</sup> On the one hand, failure to comply with the standards may render a director personally liable to the company or any person who suffered loss or damage as a consequence thereof.<sup>57</sup> On the other hand, compliance with the standards entitles a director to rely on the business judgment rule as a defence for decisions made in good faith, albeit with catastrophic effects on the company.<sup>58</sup> Section 76(4) of the Act, the statutory business judgment rule, encompasses the aspects raised in section 76(3). In terms of section 76(4), the requirements discussed below must be met for a director to enjoy protection.

### **2.2.1. The director must take “reasonably diligent steps”**

The Act requires that the director must have taken reasonable steps to become well-versed with the matter.<sup>59</sup> The Act neither defines nor explains what is meant by ‘reasonably diligent steps’. Jones opines that this requirement should be considered in the context of the common law *Lex Aquilia*.<sup>60</sup> The conduct of the director will be juxtaposed with the legal convictions of society (*boni mores*).<sup>61</sup> The test is objective and the reasonable man test will apply. In other words, the conduct of the director will be measured against what would be expected from a reasonable person in the same situation. Several factors will be considered, for instance, whether the director is employed on a full-time basis or not, his or her access to company information, his or her skills and experience and the nature of the company.<sup>62</sup> In addition, section 76(4)(b), read with section 76(5) entitles a director to rely on the performance of any employee of the company whom the director believes to be dependable and competent including legal counsel, accountants or other professionals retained by the company for their

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<sup>54</sup> Ibid.

<sup>55</sup> Ibid.

<sup>56</sup> S 76(3).

<sup>57</sup> Muswaka (2013) 36.

<sup>58</sup> Ibid.

<sup>59</sup> S 76(4)(a)(i).

<sup>60</sup> Muswaka (2013) 29.

<sup>61</sup> Muswaka (2013) 30.

<sup>62</sup> Ibid.

specialised skill and expertise, or a board committee where the director is not a member. It is submitted that a director relying on any information or statements of the above professionals would be deemed to have taken 'reasonably diligent steps' to educate himself about the matter, as opposed to a director who acts compulsively without conducting due diligence in matters or decisions which require specialised skill.<sup>63</sup> For instance, a director in a company faced with a potential legal problem may rely on the legal opinion of an in-house legal expert, an attorney or an advocate and, should he act on the basis of the opinion, he or she may use the business judgment rule as a defence if the results cause harm or loss to the company.

### **2.2.2. The director must have no 'material personal financial interest'**

The Act requires that a director must have no personal financial interest or any reasonable basis to know that any related person had a personal financial interest in the subject matter.<sup>64</sup> The interest could be of the director in his or her personal capacity or of any person related to him or her such as a family member, friend or business associate. For instance, a director may be said to have a personal financial interest if he exerts pressure or influences the board of the company to authorise the purchase of property or materials belonging to him or her above the market price. It is therefore required that directors make a disclosure when they are faced with matters that could amount to either a conflict of interest or self-dealing in order to avoid suspicions of fraud, collusion or unjustified enrichment on their part.<sup>65</sup>

It must also be noted that the interest does not only have to be financial, but also material in nature.<sup>66</sup> A typical example would be where a director uses his influence for an invalid decision to be rubber-stamped while causing the company financial prejudice in the process. A further example would be where a director uses his influence to employ an under-qualified individual related to him without following due process.

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<sup>63</sup> Kennedy-Good S., Coetzee L., 'The business judgment rule (part 1)' (2006) 27(1) *Obiter* 62, 67.

<sup>64</sup> S 76(4)(a)(ii).

<sup>65</sup> Staff Reporter (2017) 'Ex-Eskom Boss Koko To Be Disciplined Over Conflict Of Interest' *The Huffpost Online* 11 July 2017, available at [http://www.huffingtonpost.co.za/2017/07/11/former-eskom-boss-to-be-disciplined-over-conflict-of-interest\\_a\\_23024420/](http://www.huffingtonpost.co.za/2017/07/11/former-eskom-boss-to-be-disciplined-over-conflict-of-interest_a_23024420/) [accessed on 10 October 2017].

<sup>66</sup> Muswaka (2013) 31.

### 2.2.3. The director must have rationally believed that the decision was in the best interest of the company

A director must have made a decision with a reasonable belief that it was in the best interests of the company.<sup>67</sup> A few aspects must be noted in respect of this requirement. First, since the phrase ‘rational belief’ is not explained in the Act; the test for rationality is thus objective.<sup>68</sup> The belief must be of such a nature that a reasonable director would have taken the same decision in the given circumstances.<sup>69</sup> Should the decision be so irrational that a reasonable person in the director’s position would not have taken it, then one cannot enjoy the protection of the business judgment rule, as such conduct indicates lack of reasonable care, skill and diligence. This correlates with section 76(4)(a)(i) which requires the director to follow proper procedure throughout the decision making process.<sup>70</sup>

Secondly, the decision of the director must have been a reasonable one, premised on the merits of the issue before him or her rather than external influences.<sup>71</sup> Eisenberg states that since business decisions are usually made in hindsight or based on incomplete information and with moderate provision of obvious risks, a prejudicial decision made after a reasonable assessment does not necessarily mean that the director made a bad decision.<sup>72</sup> Cassim further states that an irrational decision is a sign of bad faith and is thus not reasonable and the business judgment rule cannot be used to protect the *mala fide* director.

If the requirements set out in section 76(4) are satisfied, the director will be deemed to have exercised the duty of reasonable care, skill and diligence, and acted in the best interests of the company. Hence, he or she will not be held liable for innocent errors of judgement or decisions made in hindsight but in good faith. The Act does not specify who bears the *onus* to prove compliance with the provisions of section 76(4)(a) for a director to enjoy protection under the rule. It is submitted that the wording of the provision implies that the *onus* rests on the director to prove on a balance of probabilities that he or she complied with the standards set out in the Act in order for the business judgment rule to apply. If the director fails to prove such compliance, the company or any of its stakeholders may hold him or her personally liable in terms of section 77 for any loss, damage or costs incurred by the company as a director of consequence of his or her reckless and fraudulent conduct.

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<sup>67</sup> S 76(4)(a)(iii).

<sup>68</sup> Cassim (2012) 564.

<sup>69</sup> Ibid.

<sup>70</sup> Muswaka (2013) 31.

<sup>71</sup> Cassim (2012) 564.

<sup>72</sup> Eisenberg (1993) 444.

### 2.3. Significance of the business judgment rule

The presence of the business judgment rule is met with mixed feelings. It is submitted that while the rule acts as a safe harbour for directors against liability from shareholders and third parties dealing with the company, it also limits the rights of the same shareholders and third parties to recover their losses caused by the director's poor decision-making. However, the rule creates equilibrium between the exercise of directors' discretionary powers in pursuit of economic growth and their accountability.<sup>73</sup>

The King III Report on corporate governance recognises that business decisions often involve risk and uncertainty, and thus encourages directors to engage in risky but innovative transactions with greater potential for profit.<sup>74</sup> In this light, the business judgment rule encourages directors to take the necessary risks associated with running a business without fear of taking risks which in hindsight might prove to be unsuccessful.<sup>75</sup> The absence of the rule would create an exceptional level of caution among directors who would carry out their functions in fear of bad decision-making and risk of being personally liable.<sup>76</sup> The fear of risk-taking would in turn suppress the company's competitive edge in the marketplace.

It is also worth noting that section 76(4)(a)(i) to (iii) precludes courts from being too quick to second-guess business decisions taken by directors where there is compliance with the statutory standards.<sup>77</sup> The provisions place a standard of review which courts must apply in order to separate fraudulent or dishonest directors from honest directors who make poor decisions or errors of judgement. Leach argues that section 76(4)(a) dictates respect of 'corporate independence' and the role of directors within companies.<sup>78</sup> The statutory rule thus promotes corporate innovation by offering directors the leeway to take necessary business risks without the fear of being penalised.<sup>79</sup>

McMillan refers to the business judgment rule as a form of legal immunity insulating *bona fide* directors from any judicial review or adjudication.<sup>80</sup> Reliance on opinions and reports from designated employees and company experts lift the burden off a director to account for

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<sup>73</sup> Bainbridge S.M., 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 *Vanderbilt Law Review* 84, 84.

<sup>74</sup> Principle 4.1.

<sup>75</sup> Muswaka (2013) 39.

<sup>76</sup> Kennedy-Good S., Coetzee L., 'The business judgment rule (part 1)' (2006) 27(1) *Obiter* 62, 65.

<sup>77</sup> Cassim et al (2012) 565.

<sup>78</sup> Leach (Masters thesis) 41.

<sup>79</sup> Muswaka (2013) 26.

<sup>80</sup> McMillan L., 'The Business Judgment Rule as an Immunity Doctrine' (2012) 4 *William & Mary Business Law Review* 521, 569.

certain areas beyond his or her scope of knowledge. It is, however, not necessarily a fortress for all directors. Dishonest and irrational directors will not escape liability for breach of their fiduciary duties.<sup>81</sup>

The current economic realities dictate that companies take commercial risks in the anticipation these risks would yield great returns for the company. However, some decisions, even after proper investigations are done, may cost the company dearly and subject the conduct of the directors who made the decisions to scrutiny. The fear of personal liability may hinder competent individuals from taking up directorship positions.<sup>82</sup> Hence, the presence of protection through section 76(4)(a) affords some form of incentive for competent directors to take up positions in companies and make meaningful contributions in the process.<sup>83</sup>

It has also be argued that the statutory business judgment rule as espoused in section 76(4)(a) promotes higher standards of corporate governance among company directors.<sup>84</sup> However, Jones disagrees with that notion and argues that it is not possible to comprehend how the rule which limits the duty of care and skill could promote higher standards of corporate governance.<sup>85</sup> Instead, Jones argues that the relaxation of the standards of care, skill and diligence will most probably 'contribute to a higher degree of corporate misconduct'.<sup>86</sup> Naidoo further argues that section 76(4)(a) may operate inversely by encouraging directors to engage in even more risky conduct than before with the defence that their conduct cannot be second-guessed by courts if they comply with the fiduciary and statutory duties.<sup>87</sup> It is submitted that Muswaka's view above is more convincing as section 76(4)(a) encourages innovation and risk-taking while at the same time prescribing reasonable standards of accountability among directors.

It must also be noted that a director who fails to comply with the principles and standards set out in the Act will not be protected by the business judgment rule. While the rule protects directors who make honest business decisions in compliance with the requirements contained in section 76(4)(a), it does not necessarily afford protection to a director where no actual

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<sup>81</sup> Muswaka (2013) 27.

<sup>82</sup> Block, Paton and Radin 'The Business Judgment Rule: Fiduciary Duties of Corporate Directors and Officers' (1987) 42 *The Business Lawyer* 995.

<sup>83</sup> Kennedy-Good & Coetzee (2006) 65.

<sup>84</sup> Muswaka (2013) 39.

<sup>85</sup> Jones (2007) 333.

<sup>86</sup> *Ibid.*

<sup>87</sup> Naidoo (2009) 171.

decision has been taken.<sup>88</sup> An inability to perform or apply the requisite skills does not guarantee protection of the business judgment rule.<sup>89</sup> It must also be noted that section 76(4)(a) has not yet been scrutinised in a court of law. Hence, the rule will probably need to be applied and developed on a case-by-case basis, taking into the account the circumstances of each case, the unique corporate governance provisions and principles of the company and the socio-economic factors.<sup>90</sup> It is also unclear whether section 76(4)(a) trumps liability arising from the failure to perform common law fiduciary duties. Naidoo argues that section 76(4) only applies to a director's statutory duties.<sup>91</sup> Therefore, it is still possible for a director to be held liable in terms of common law. In addition, since the wording of section 76(4) connotes protection to a director in an individual capacity, it is not clear how the Act deals with a case where directors are being charged jointly and severally. However, recent case law has always been clear in protecting innocent directors against joint and several liability in instances where it is proved that they acted in good faith.

## 2.4. Conclusion

The business judgment rule has been regarded as a safe harbour which protects a director who acts with due care, skill and diligence from liability for decisions which yield undesirable results.<sup>92</sup> The rule promotes entrepreneurial innovation by providing equilibrium between the competing interests of commercial risks taken by directors on the one hand, and their accountability on the other. However, for one to enjoy protection of the business judgment rule, the requirements espoused in section 76(4)(a) of the Companies Act of 2008 must be satisfied. First, the director must have taken reasonably diligent steps to become informed about the matter. In this regard the conduct of the director will be measured against what would be expected from a reasonable person in the same situation. It must also be noted that the director's reliance on an opinion or report from a designated employee or expert outlined in the Act constitutes a diligent step to become informed about a subject matter. Secondly, neither the director nor any person related to him or her must have a personal financial interest in the subject matter. The interest could be of a financial nature or one that

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<sup>88</sup> Havenga M., 'The Business Judgment Rule – Should we follow the Australian example?' (2000) 12 *SA Merc LJ* 28, 30.

<sup>89</sup> Muswaka (2013) 37; Kennedy-Good & Coetzee (2006) 67.

<sup>90</sup> Leach (Masters thesis) 36.

<sup>91</sup> Naidoo (2009) 173.

<sup>92</sup> Truter A., 'The Business Judgment Rule – what directors need to know' available at [www.schoemanlaw.co.za/business-judgement-rule/](http://www.schoemanlaw.co.za/business-judgement-rule/), accessed on 09 October 2017.

in which the director exerts his influence to draw a material benefit for himself or anyone related to him. Thirdly, the director must have made a decision with a rational belief that the decision was in the best interests of the company. If a director fails to prove compliance with the above requirements, then he or she cannot enjoy the protection of the business judgment rule and may instead be personally held liable for reckless and fraudulent conduct in terms of section 77. Consequently, the company or any aggrieved third party may initiate proceedings against the director to recover any loss, damages or costs occasioned by the conduct of the director.<sup>93</sup> It has been argued that the business judgment rule can be used as a standard of conduct, a standard of liability, a standard of review and a standard of immunity.<sup>94</sup>

In this chapter, the significance of the business judgment rule has also been discussed. It has been noted that the statutory rule invokes mixed feelings, in that while the rule protects directors from liability against shareholders and third parties dealing with the company, it also limits the rights of the same shareholders and third parties to recover their losses caused by the director's poor decision-making. It has also been argued that the rule strikes a balance between the exercise of directors' discretionary powers in pursuit of economic growth and their accountability. It is only unfortunate that, at the time of this research, section 76(4) has not been scrutinised by the courts in order to assess its effectiveness in the current corporate system. However, it has been acknowledged that the statutory business judgment rule is significant in that it promotes innovation by offering directors a platform to take necessary business risks without the fear of being penalised. It must also be noted that the business judgment rule has a significant effect on the statutory provisions relating to reckless and fraudulent conduct by directors. While the rule protects directors from *bona fide* errors of judgement, it may also be seen as a barrier to shareholders and aggrieved third parties who may wish to recover their loss, damage or costs occasioned by poor decision-making. The effects of the business judgment rule on personal liability occasioned by reckless and fraudulent trading will be fully discussed in chapter 3.

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<sup>93</sup> S 77 (7) of the Companies Act 71 of 2008.

<sup>94</sup> Eisenberg M.A., 'The Divergence of Standards of Conduct and Standards of Review in Corporate Law' (1993) 62 *Fordham LR* 437; Leach (Masters thesis) 30. However, a detailed discussion of the above standards will not be done in this thesis.

## CHAPTER 3: PERSONAL LIABILITY OF DIRECTORS AND THE BUSINESS JUDGMENT RULE

### 3.1. Introduction

It is a general rule that directors who act in good faith on behalf of the company will not be personally held liable for any loss or damages incurred by the company because the doctrine of separate legal personality protects directors from the company's obligations, except when the company is a personal liability entity or when the corporate veil is pierced on account of reckless or fraudulent conduct by the board of directors.<sup>95</sup> When the corporate veil is lifted, the directors (not the company) will be held jointly and severally liable (usually with one paying the other to be absolved) for any losses or damages suffered by the company occasioned by their reckless or fraudulent conduct.<sup>96</sup> It must be noted that a criminal sanction may also be imposed on the directors if their conduct was of a fraudulent nature.

Section 424 of the old Companies Act as well as section 77(3)(b), read with section 22 of the new Act, impute director liability for reckless, grossly negligent and fraudulent conduct by the company. In *Philotex (Pty) Ltd v Snyman*, the court held that such elements (in this case, recklessness) must not be taken lightly.<sup>97</sup> As such, the party alleging recklessness or fraud on the part of the directors must prove such elements on a balance of probabilities and a court must be satisfied that such elements have been proven before rendering a director personally liable. On the other hand, the three fundamental requirements that must be met by a director in order to enjoy protection of the business judgment rule have been outlined in chapter 2 above.<sup>98</sup> However, it is anticipated that both aspects may present a practical challenge to a court when it is faced with a claim for reckless and fraudulent conduct against directors pleading the business judgment rule as their defence in the same subject matter.

Hence, both aspects will be discussed in this chapter. An analysis of case law on reckless and fraudulent trading by directors will be undertaken. A critical discussion of the practical effects of application of both principles and the possible shortcomings thereof will also be done in this chapter. This chapter will also highlight how the threat of personal liability affects directors of companies in carrying out their functions, how the business judgment rule

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<sup>95</sup> Cassim et al (2012) 43,564.

<sup>96</sup> S 77 (6) of the Companies Act 71 of 2008; Cassim et al (2012) 583.

<sup>97</sup> 1998 (2) SA 138 (SCA).

<sup>98</sup> These include the following: that he or she must have made an informed decision; he or she, or any person related to him or her, must have no material personal financial interest in the subject matter or transaction; and there must be a rational basis that he or she acted in the best interests of the company.

counters that threat and whether the rule is enough to protect or justify directors' *bona fide* functions.

### **3.2. Liability for reckless, grossly negligent and fraudulent trading: the applicable provisions**

In terms of section 424 of the Companies Act of 1973, fraud (or intention to defraud) and recklessness must be proved in order to impute liability on a director.<sup>99</sup> It must also be noted that the wording of the provision expressly ascribes personal liability on the individual director and not the company or the whole board of directors if it is made up of more than one director. In addition, the phrase 'without limitation of liability' denotes that the director may face either civil or criminal (or both) sanctions for reckless and fraudulent trading. Section 424 of the old Act is a vital tool and it is still used a yardstick in many cases because the provision is still applicable in the current dispensation.<sup>100</sup>

Section 424(1) of the Companies Act of 1973 is still operational in line with section 22(1) of the Companies Act of 2008. However, these provisions rather deal with the conduct of the company than the directors in their personal capacity. The conduct of directors is dealt with by sections 76 and 77 of the new Act.<sup>101</sup> This raises questions on the intention of the courts when dealing with matters relating to section 424 of the old Act in ascribing personal liability on directors when they should actually be directing liability on the company. One might however argue that, since the directors dictate the daily activities of the company, personal liability could be a necessary measure to prohibit abuse of the corporate entity.<sup>102</sup> In *McLuckie v Sullivan*, Blieden J held that section 424 was passed to avoid the injustices caused by abuse of a corporate entity by directors who used the company as an alter ego to make undertakings that are impossible to fulfil.<sup>103</sup>

Section 22(1) of the Companies Act of 2008, as amended, prohibits a company from carrying on its business recklessly, with gross negligence, with fraudulent intent or trade under insolvent circumstances. Elements such as recklessness, gross negligence and intent to defraud or having a fraudulent purpose are vital in determining liability. It must also be noted

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<sup>99</sup> These elements will be fully discussed in 3.3 below.

<sup>100</sup> In terms of item 9 of Schedule 5 to the Companies Act of 2008, Chapter 14 of Act 61 of 1973 (dealing with the winding-up and liquidation of companies) continues to apply as if the Act had not been repealed.

<sup>101</sup> Kekana (LLM Thesis) 5.

<sup>102</sup> *Ebrahim and Another v Airport Cold Storage (Pty) Ltd* 2008 (6) SA 585 (SCA) para 15.

<sup>103</sup> 2011 (1) SA 365 (GSJ) at 373C.

that such personal liability is imposed on a director when the company suffers loss, damage or incurs costs.<sup>104</sup>

On the other hand, section 77(3)(b) provides as follows:

A director of a company is liable for any loss, damages or costs sustained by the company as a direct result or indirect consequence of the director having acquiesced in the carrying on of the company's business despite knowing that it was being conducted in a manner prohibited by section 22(1).

It must be noted that the scope of reckless and fraudulent trading in the 2008 Act is not just limited to trading under insolvent circumstances, as evinced in section 424 of the 1973 Act. The Companies Act of 2008 extends liability even when the company is operating under solvent circumstances.<sup>105</sup> In terms of section 77(3)(b), directors can be personally held liable under the following circumstances:

- a) when they trade recklessly;
- b) when they carry on business with gross negligence;
- c) when they intentionally act (or fail to act) fraudulently or for any fraudulent purpose;
- or
- d) when they trade under insolvent circumstances.

However, it has been questioned whether section 77(3) is a remedy readily available to creditors or just confined to the company alone. In *Gihwala and Others v Grancy Property Ltd and Others*,<sup>106</sup> Wallis JA upheld the order of Fourie J in the *court a quo* that section 77(3), unlike section 424 of the old Act, enables the company to institute a statutory claim against a director for liability for loss, damages or costs incurred by the company including in circumstances where the director knowingly participates in reckless trading. The court added that the provision cannot be applied as a remedy by a creditor or shareholder in respect of their claim against the company or the *mala fide* director.<sup>107</sup> This contention was however disputed in *Rabinowitz v Van Graan and Others*<sup>108</sup> where the court held that, in terms of section 77(3):

... [a] third party can hold a director personally liable in terms of the Act for acquiescing in or knowing about conduct that falls within the ambit of section 22(1) thereof.

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<sup>104</sup> S 77 (3) of the Companies Act 71 of 2008.

<sup>105</sup> Phungula (LLM thesis) 7.

<sup>106</sup> 2017 (2) SA 337 (SCA) para 120.

<sup>107</sup> *Ibid.*

<sup>108</sup> 2013 (5) SA 315 (GSJ) para 22.

The same sentiments were echoed in *Blue Farm Fashion Limited v Rapitrade 6 (Pty) Ltd and Others* in which the court held that since a company as a juristic person relies on the acts of its directors, such directors cannot escape liability when they act recklessly with the possibility of intent to defraud the plaintiff.<sup>109</sup> The court further iterated that if the version of the court *a quo* in *Gihwala* was to be followed, it would be contrary to the intentions of the legislature, impracticable and thus produce ‘absurd results’.<sup>110</sup> However, it would seem that the decision of the Supreme Court in *Gihwala* stands. The creditor or third party in turn would only have to rely on section 22 or 218, or recover such losses in terms of common law.

### 3.3. Requirements for personal liability

#### 3.3.1. Recklessness

Neither the Companies Act of 1973 nor the new Act of 2008 define the term ‘recklessness’ in the corporate context. Hence, much has been left to courts to explain the term. In *Anderson v Dickson*, the court referred to reckless trading as “‘carrying [on business] by conduct which evinces a lack of any genuine concern for its prosperity.’”<sup>111</sup> It consists of elements of gross carelessness and little or no concern for the success of the company.<sup>112</sup> In *Ex parte Lebowa Development Corporation Ltd*<sup>113</sup>, the term ‘reckless’ was described as implying a departure from a standard of care thus resulting in negligence (*culpa*) or gross negligence (*culpa lata*). According to Cassim, the test for recklessness entails a disregard of “‘the objective standard of care that would be observed by the reasonable man in the conduct of the business of the company’”.<sup>114</sup> In *Fisheries Development Corporation of SA Ltd v Jorgensen: Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd*<sup>115</sup>, the court held that in determining whether the business of the company had been conducted recklessly several factors such as the scope of the company’s operations, the functions and powers of the

<sup>109</sup> [2016] ZAWCHC 35 paras 20.

<sup>110</sup> Para 32.

<sup>111</sup> 1895 (1) SA 71 (T), quoted in Meskin PM (ed) *Henochsberg on the Companies Act*, vol 1 (1994) at 914.

<sup>112</sup> *Shaviningan v Vokins & Co Ltd* [1961] 3 All ER 396 at 403 F; *Anderson v Dickinson* 1985 (1) SA 93 (N); *Ozinsky NO v Lloyd and Others* 1992 (3) SA 396 at 414 G-H; *Strut Ahead Natal v Burns* 2007 (4) SA 600 (D). In *Engelbrecht NO and Others v Zuma and Others* [2015] 3 All SA 590 (GP) para 19, recklessness was attributed to A director’s ‘lack of care in the management of the company and disregard for standards observed by honest and diligent directors’.

<sup>113</sup> 1989 (3) SA 71 (T) 111C.

<sup>114</sup> *Philotex v Snyman* 1998 (2) SA 138 (SCA).

<sup>115</sup> 1980 (4) SA 156 (W) 170B-C.

directors, the debt involved, the extent of the company's challenges and the prospects of recovery must be taken into consideration.<sup>116</sup>

It must also be noted that courts have been careful to distinguish recklessness (a disregard for consequences of one's actions) from a *bona fide* act of a director or an innocent error of judgement on the director's part.<sup>117</sup> In *Philotex*, the court iterated that recklessness must not be lightly construed.<sup>118</sup> In *Mafikeng Mail (Pty) Ltd v Centner (No 2)*<sup>119</sup>, the court held that gross error of judgement did not constitute recklessness, provided the director could show that he was confronted with a choice, the decision of which was invoked by thought and reflection.<sup>120</sup>

The test for recklessness was further expanded in ensuing cases, the test of which was measured against the wording of section 424(1) of the Companies Act 61 of 1973.<sup>121</sup> In *Fourie NO v Newton*, recklessness was described as an "entire failure to give consideration to the consequences of one's actions".<sup>122</sup> In *Strut Ahead Natal v Burns*, Swain J indicated that in order to establish recklessness, it must be proven that a company continued to operate while incurring debt when, in the opinion of a reasonable director, there would be no prospect of paying the creditors' debt as it fell due.<sup>123</sup> In *Raflatac SA (Pty) Ltd v Bell & Another*<sup>124</sup>, the court held that an honest attempt by directors to continue trading by making arrangements with creditors to resuscitate the company did not amount to reckless or grossly negligent conduct.

The *onus* to prove recklessness on the part of the director lies on the party alleging such conduct.<sup>125</sup> In *Philotex*, it was also held that the test for proving recklessness was evidential,

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<sup>116</sup> These sentiments were also adopted by the courts in *Philotex v Snyman* 1998 (2) SA 138 (SCA) 144B; *McLuckie v Sullivan* 2011 (1) SA 365 (GSJ); *Fourie NO v Newton* [2011] 2 All SA 265 (SCA).

<sup>117</sup> Cassim (ed) 'The Duties and liabilities of directors' in *Contemporary Company Law* (2012) 505, 591; Kekana N.B. (2016) 'Liability for fraudulent and reckless trading: a critical analysis of *Engelbrecht NO & Others NNO v Zuma & Others* [2015] 3 All SA 590 (GP)', Master's Thesis, University of Johannesburg.

<sup>118</sup> The same sentiments were echoed in *Strut Ahead Natal v Burns* 2007 (4) SA 600 (D) at 608F.

<sup>119</sup> 1995 (4) SA 607 (W).

<sup>120</sup> Para 613G-H. See *Levin v Feld and Tweeds Ltd* 1951 (2) SA 401 (A); *Strut Ahead Natal (Pty) Ltd v Burns* 2007 [3] All SA 190 (D).

<sup>121</sup> Some of these cases include the following: *Ex parte Lebowa Development Trust* 1989 (3) SA 71 (T); *Strut Ahead Natal v Burns* 2007 (4) SA 600 (D); *M A Vleisageniskap CC and Another v Shaw and Another* 2003 (6) SA 714; *Ebrahim and Another v Airport Cold Storage (Pty) Ltd* 2008 (6) SA 585 (SCA); *McLuckie v Sullivan* 2011 (1) SA 365 (GSJ); *Raflatac SA (Pty) LTD v Bell & Another* [2012] ZAECGHC 5.

<sup>122</sup> [2011] 2 All SA 265 (SCA).

<sup>123</sup> 2007 (4) SA 600 (D) at 607.

<sup>124</sup> [2012] ZAECGHC 5.

<sup>125</sup> McLennan J.S. 'Recklessness or fraudulent trading of corporate business' (1998) 115(4) *SALJ* 597; Sigwadi M. 'Personal liability for the debts of close corporations' (2013) 15(2) *SAMercLJ* 303; see *Henways Freight Services v Grogor* 2007 (2) 561 (SCA) para 4-5.

not a statement of substantive law.<sup>126</sup> A claim based on mere allegations and unsubstantiated facts may not warrant a director being held personally liable for reckless trading.<sup>127</sup> In *Strut Ahead Natal*, the court held that where the plaintiff did not have enough means to investigate the alleged reckless conduct and the defendant deliberately frustrated these efforts or failed to give an explanation of evidence, then less evidence would suffice to establish a *prima facie* case.<sup>128</sup> The burden would thereafter be shifted to the defendant (the director) to provide proof to rebut the plaintiff's case.

With respect to ascribing personal liability on directors, questions may be raised as to whether all directors will be jointly and severally liable for reckless conduct occasioned by one director or whether an innocent director may also be held liable for conduct he or she was not party to. Courts have, however, been consistent in requiring proof of recklessness on one or all directors before either making a finding on joint liability or absolving innocent directors. However, a director's lesser involvement in the affairs of the company or the mere fact the he or she was a non-executive director does not necessarily protect him or her from facing personal liability.<sup>129</sup>

In addition to the above, consideration must also be given to instances where a director fails or refrains from acting against reckless conduct taking place in the company.<sup>130</sup> Whether such failure to act constitutes reckless conduct hinges on the director's knowledge and intentions. Regard must also be given to an instance where a director fails or elects not to disclose dishonest or reckless conduct on the part of a fellow director. In the *Engelbrecht* matter, the court held that a director's failure to manage the company's business or failure to avert foreseeable harm when a reasonable director would have taken preventative measures represents a degree of recklessness on the part of the inactive director.<sup>131</sup>

### 3.3.2. Fraud or intention to commit fraud

Fraudulent conduct works hand in glove with recklessness. Hunt defines fraud as "unlawfully making, with intent to defraud, a misrepresentation which causes actual prejudice or which is

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<sup>126</sup> Para 146G.

<sup>127</sup> *MA Vleisagentskap CC and Another v Shaw and another* 2003 (6) SA 714 (W).

<sup>128</sup> At 609E-F.

<sup>129</sup> *Howard v Herrigel NO* 1991 (2) SA 660 (A).

<sup>130</sup> Kekana (2016) 12; Van der Linde K., 'The personal liability of directors for corporate fault – An exploration' (2008) 20 *SAMercLJ* 439, 442.

<sup>131</sup> Paras 19 and 45.

potentially prejudicial to another”.<sup>132</sup> Snyman views fraud as intentionally making a misrepresentation which is unlawful, thus causing actual or possible prejudice to the party relying on the misrepresentation.<sup>133</sup> In *Terblanche*, Knoll J held that fraudulent trading involves a subjective inquiry into a director’s state of mind when carrying on the business.<sup>134</sup>

Van der Linde also states that, with regards to intention, the director need not necessarily be mindful of the legal ramifications of the way in which the business was conducted. In *Howard v Herrigel*, the court held that the director must at least have actually familiarized himself with the facts from which he could draw the conclusion that the affairs of the company were being carried on fraudulently or recklessly and did not rectify the situation. In *Philotex*, the court held that if the director either actively participated in or supported the carrying on of the business of the company in a fraudulent manner, such director would be held liable.

In relation to section 22(1) of the Companies Act of 2008, it must be established whether the fraudulent conduct of the director was for his or her personal benefit or for any other purpose detrimental to the person dealing with company. In the *Mafikeng Mail* case,<sup>135</sup> Van Schalkwyk J held that, although by no means conclusive, a good indication of commercial fraud was the concomitant attempt at self-enrichment, and that the conduct of the defendant must be compatible with an intention to defraud the plaintiff.<sup>136</sup>

The Companies Act of 2008 does not regulate the frequency of the fraudulent transactions. It is immaterial whether the fraudulent conduct was committed once or was recurring or habitual. In *Gordon NO and Rennie NO v Standard Merchant Bank Ltd and Others*<sup>137</sup> it was held that it does not matter whether the fraudulent act is done once or as part of a series of acts. In either case, the guilty party will be rendered personally liable in terms of section 424 of the old Act and section 77 (3) of the new Act.

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<sup>132</sup> Hunt, P.M.A., *South African Criminal Law and Procedure* (2011) 755.

<sup>133</sup> Snyman C.R., *Criminal Law* (2008) 531.

<sup>134</sup> *Terblanche NO & Others v Damji & Another* 2003 (5) SA 589 (C).

<sup>135</sup> 1995 (4) SA 607 (W).

<sup>136</sup> At 612 I-613A.

<sup>137</sup> 1984 (2) SA 519 (C) at 528.

### 3.4. The effects of personal liability on directors

In the event of a director being personally held liable for reckless and fraudulent trading, a litany of challenges may arise against the director. In *Terblanche NO and Others v Damji and Another*, the court alluded to the *Philotex* case where it was held that the remedy created by section 424 is punitive and a director can face liability for the debts of the company in the absence of proof of any causal link between his conduct and those debts.<sup>138</sup> First, the director will be vulnerable to civil litigation by either other directors or the shareholders of the company in pursuit of recovery of damages or losses suffered by either the company or the third parties concerned. In terms of section 77(6) of the Companies Act of 2008, proceedings to recover such losses, damages or costs for which the director is or may be liable must be commenced within three years from the date on which the reckless or fraudulent act was committed. The director may also be sued in terms of common law principles relating to breach of trust.<sup>139</sup>

Secondly, the director may also face criminal prosecution if the conduct was of a fraudulent nature. The offence might include, but not be limited to, disclosing confidential information,<sup>140</sup> insider trading, falsification of accounting records,<sup>141</sup> defrauding a creditor, or an employee of the company or a holder of the company's securities,<sup>142</sup> and preparing and publishing a prospectus or written statement containing misleading statements,<sup>143</sup> concealing or destroying books or assets,<sup>144</sup> concealment of liabilities or pretence as to existence of assets,<sup>145</sup> failure to keep proper records,<sup>146</sup> giving undue preferences to creditors,<sup>147</sup> contracting debts without expectation of ability to pay,<sup>148</sup> or alienating business assets under insolvent circumstances without the prescribed notice.

It must also be noted that the phrase 'without limitation of liability' connotes that the director can face both civil and criminal sanctions, and any other sanction that the court may deem just. Where the court is satisfied, or has reasonable suspicion, that the conduct of the director was fraudulent, it may refer the matter to other relevant bodies for further action to be taken

<sup>138</sup> *Terblanche NO and Others v Damji and Another* [2001] ZAWCHC 3.

<sup>139</sup> Van der Linde (2008) 447.

<sup>140</sup> S 213 (1) (a).

<sup>141</sup> S 214 (1) (b).

<sup>142</sup> S 214 (1) (c).

<sup>143</sup> S 214 (1) (d).

<sup>144</sup> S 132 of the Insolvency Act.

<sup>145</sup> S 133 of the Insolvency Act.

<sup>146</sup> S 134 of the Insolvency Act.

<sup>147</sup> S 135 (1) of the Insolvency Act.

<sup>148</sup> S 135 (3) (a) of the Insolvency Act.

against the director. For instance, where the fraudulent conduct pertained to the concealment of funds, the matter may be referred to the South African Revenue Service for determination of charges for possible tax evasion.

It must also be noted that if the recklessness and fraudulent conduct was a collective effort of the two or more directors, then both or all of the directors concerned will be held jointly and severally liable for the loss, damages or costs incurred by the company or the third parties concerned.<sup>149</sup> This was the position of both the High Court and the Supreme Court of Appeal in the matter of *Ebrahim and Another v Airport Cold Storage (Pty)*.<sup>150</sup>

After a careful examination of the above, the importance of good corporate governance and ethics among directors in the daily exercise of their fiduciary duties must be emphasised. A digression from the norms may have catastrophic effects for the individual director. Hence, there is need for constant education and awareness among directors on the legal implications attached to the office they occupy. Though such effects may appear harsh, they are necessary in fostering corporate compliance.

On the other hand, the threat of civil or criminal liability stifles commercial adventure and risk-taking, thus ultimately disadvantaging the company which may suffer losses as a result. Directors will tread carefully and avoid taking risks that could be profitable for the company purely on account of fear of incurring liability. Although tools such as the business judgment rule are in place to offer *bona fide* directors a safe harbour, not all directors with good intentions ultimately enjoy its protection, partly due to lack of knowledge of the defence, failure to successfully satisfy the requirements of the rule, and even poor legal representation.

### **3.5. The effectiveness of the business judgment rule against personal liability**

As has been outlined in chapter 2 above, the business judgment rule protects honest directors for *bona fide* errors of judgement, subject to compliance with section 76(4)(a). However, it would seem that the rule requires the directors to individually prove compliance on their part, hence discounting any possibility of guilty directors hiding under the umbrella of joint absolution.

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<sup>149</sup> S 77 (6) of the Companies Act, 2008.

<sup>150</sup> 2008 (6) SA 585 (SCA) para 45.

The business judgment rule does not apply to questions of negligence arising from the director's inactivity or failure to make a decision, as such will not constitute compliance with the principle or standards set out in the Act.<sup>151</sup> An inability to perform or apply the requisite skills does not guarantee protection of the business judgment rule.<sup>152</sup>

At the time of this research, no court case had been heard in which a declaration was sought against a director in terms of section 424 of the old Act or section 22(1) and 77(3) of the new Act with the same director using section 76(4) as his or her defence. It is anticipated that in the near future a court may be required to decide which principle takes precedence.

It has been highlighted in 3.4 above that a director may also be held liable in terms of common law for a breach of his or her fiduciary duties of trust. It is, however, not clear whether the directors can plead the business judgment rule under such circumstances. A discussion of the relationship between personal liability occasioned by reckless or negligent trading and the business judgment rule will be conducted below.

### **3.5.1 The effects of the business judgment rule and personal liability on directors**

As highlighted in the chapter 2, three statutory requirements must be met before a director enjoys the protection of the business judgment rule.<sup>153</sup> First, the director must have taken reasonable steps to become informed about the subject matter.<sup>154</sup> Secondly, the director must have had no material or financial interest in the subject matter or had not reasonably known that any person related to him or her had a personal financial interest.<sup>155</sup> Thirdly, the director must have had a rational belief that the decision was in the best interests of the company.<sup>156</sup> It must be noted that the rule also gives effect to section 76(3) which requires directors to act in good faith, in the best interests of the company and with a degree of care, skill and diligence in the day-to-day execution of their fiduciary duties. However, a distinction must be drawn between uncertainty which is unforeseeable and a foreseeable risk. A director cannot rely on the rule if or she acted in bad faith, did not reasonably act in the best interests of the company, lacked independence and

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<sup>151</sup> Havenga (2000) 30.

<sup>152</sup> Muswaka (2013) 37; Kennedy-Good & Coetzee (2006) 67.

<sup>153</sup> Page 12.

<sup>154</sup> S 76 (4) (a) (i).

<sup>155</sup> S 76 (4) (a) (ii).

<sup>156</sup> S 76 (4) (a) (iii).

informed thought, or had a personal financial interest.<sup>157</sup> Hence, by protecting *bona fide* directors, the rule recognises the doctrine of separate legal personality.<sup>158</sup>

In essence, the rule creates a safe harbour for innovative directors by encouraging competitive risk-taking, considering the current economic climate filled with social and political uncertainty. It enables directors to make ‘hindsight’ decisions without fully investigating the uncertainty of such decisions.<sup>159</sup> The risk-taking may in return promote growth in the company.<sup>160</sup> The rule also prevents judicial interference in honest business decisions that were made in good faith.<sup>161</sup>

On the other hand, the business judgment rule limits the rights of aggrieved shareholders and third parties to recover their losses, damages or costs occasioned by poor decision-making of the directors in terms of section 77(2) and (3). Although the rule seems to create a balance between the pursuit of economic growth and accountability, scholars are of the view that the rule limits the duty of care, skill and diligence provided for in section 76(3).<sup>162</sup> In *Mafikeng Mail*<sup>163</sup> the court held that a gross error of judgement did not constitute recklessness if the director could prove that he made a decision based on thought and reflection. The standard of proof of compliance with the business judgment rule seems to be simply premised on speculation or presumption as compared to personal liability, where non-compliance with the requirements must be evidential. While holding directors personally liable for reckless and fraudulent trading is essential in promoting good corporate governance and accountability, it is submitted that the fear of liability creates exceptional caution among directors and in return stifles the company’s competitiveness in the market. On the other hand, the business judgment rule can easily be used as a scapegoat for corporate misconduct by directors.<sup>164</sup> It is therefore submitted that a conflict may arise when both principles are applied in one case involving shareholders claiming damages against poor decision-making by directors who acted in good faith.

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<sup>157</sup> Leach (LLM thesis) 31.

<sup>158</sup> Cassim et al (2012) 35.

<sup>159</sup> Leach (LLM thesis) 32.

<sup>160</sup> Cassim et al (2012) 565.

<sup>161</sup> Cassim et al (2012) 563.

<sup>162</sup> Jones (2007) 333.

<sup>163</sup> Para 613G-H.

<sup>164</sup> Jones (2007) 333; Naidoo (2009) 173.

### 3.5.2 Whether the business judgment rule is enough to justify directors' actions

While it is undoubted that the business judgment rule provides protection to directors, the rule is also fraught with challenges. While the rule is premised on the reasonableness of a director's actions, the wording of section 76(4) leaves one questioning what constitutes taking 'reasonable' effort in making an informed decision or 'reasonable' reliance on information or performance by employees and professionals specified in the provision.<sup>165</sup> It is submitted that, since the Act does not specify the test, the reasonable man test may be relied on to define or weigh the standard of reasonability on a case by case basis. In this instance, the 'reasonable' actions of the director relying on the business judgment rule will be weighed against what a reasonable competent director would have done in the circumstances.<sup>166</sup> However, it is submitted that, in companies requiring directors to have extensive skills and knowledge, 'reasonable' effort should not be enough to guarantee protection of the business judgment rule. The standard should be higher; poor decision-making, failure to make a decision or a gross error of judgement must attract personal liability as they imply recklessness and incompetence on the part of the director.<sup>167</sup>

In addition to the above, judicial interference in the determination of compliance with the business judgment rule may be a cause for concern. The outcome of hindsight decisions of directors vary with the political, economic and social challenges the company may seek to address at the time. At times, some of the decisions may result in catastrophic outcomes even after thorough research, deliberations and consultations. In some instances, market and industry related conditions may force a company to take necessary risks. The interference of courts in reviewing the reasonableness of actions of directors, especially in areas requiring specific skills, expertise and knowledge of the context in which the decision was taken may present a challenge.<sup>168</sup> For instance, what may have been a necessary risk in the eyes of the directors may not pass the judicial test and directors may as a result incur liability for the loss, damages and costs suffered by the company.

It is common cause that liability imputed to directors by section 77(2) and (3) is imposed when the company suffers loss, damages or incurs costs as a result of the directors' reckless or fraudulent conduct. However, the business judgment rule offers protection to directors when the company suffers the same loss, damages or costs. However, it is not clear whether

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<sup>165</sup> Muswaka (2013) 40.

<sup>166</sup> Phungula (LLM thesis) 23.

<sup>167</sup> Muswaka (2013) 37; Kennedy Good & Coetzee (2006) 67.

<sup>168</sup> Leach (LLM thesis) 31.

the statutory business judgment rule trumps common law delictual liability for breach of fiduciary duties including good faith, care, skill and diligence. The wording of section 76(4) does not seem to make provision for common law liability. As such, it is submitted that should a director succeed in invoking the business judgment defence, he or she may also incur personal liability in terms of common law as provided in section 77(2)(b).

### 3.6. Conclusion

The doctrine of separate legal personality protects directors from facing liability against any debts or liabilities incurred by the company during their term of office, except when the company is a personal liability entity or when the corporate veil is pierced due to reckless or fraudulent conduct by the board of directors. The same doctrine prohibits directors from using the company as an alter ego for self-enrichment. When the corporate veil is lifted, the directors will be held liable for any losses or damages suffered by the company occasioned by their reckless or fraudulent conduct. Such liability may be civil or criminal. Section 424 of the old Companies Act as well as section 77(3)(b), read with section 22, of the new Act impute liability for reckless, grossly negligent and fraudulent conduct by the company. On the other hand, it has been highlighted that a problem may exist where a director is faced with a claim for reckless and fraudulent conduct where he or she has satisfied the requirements set out in section 76(4) of the Act in the same subject matter.

Both aspects have been discussed in this chapter. An analysis of case law on reckless and fraudulent trading by directors has been undertaken. It has been argued that since directors dictate the daily activities of the company, personal liability is a necessary measure to prohibit abuse of the corporate entity. The requirements of personal liability, namely recklessness and fraud (or intent to commit fraud) have fully been discussed in this chapter, with reference to recent cases. Reckless trading has been defined by courts as carrying on business through conduct which demonstrates a lack of any honest concern for the company's prosperity. It consists of elements of gross carelessness and lack of concern for the prosperity of the company. However courts have been careful to distinguish recklessness from a *bona fide* or innocent error of judgement on the director's part. As such, the onus is placed on the party alleging recklessness to prove its case. However, in the *Strut Ahead Natal* the court laid an exception that where the plaintiff does not have sufficient means to investigate the alleged reckless conduct and the defendant deliberately frustrates the plaintiff's efforts, then less

evidence will suffice to establish a *prima facie* case, and the burden will thereafter shift to the defendant (the director) to provide proof to rebut the plaintiff's claim.

With regard to fraud, it has been defined as unlawfully and intentionally making a fraudulent misrepresentation which causes actual prejudice or has the potential to prejudice another.<sup>169</sup> It involves the intentional making of a misrepresentation which is unlawful and for self-enrichment, thus causing actual or possible prejudice to the party relying on the misrepresentation.<sup>170</sup>

This chapter has also highlighted the effects of personal liability on directors of companies and the threat it poses to carrying out their functions. It must also be noted that while the risk of personal liability may affect growth of the company and stifle commercial risk taking, it is also essential in prohibiting abuse of the corporate identity by unscrupulous directors.

A discussion of the practical effects of application of both the business judgment rule and section 77 of the Companies Act and their possible shortcomings has been done in this chapter. It has been highlighted that although the business judgment rule seems to foster balance between the pursuit of economic growth and accountability, it also seems to limit the duty of care, skill and diligence provided in section 76(3) and thereby limiting the rights of aggrieved shareholders and third parties to recover their losses, damages or costs occasioned by poor decision-making of the directors. It was also revealed that while holding directors personally liable for reckless and fraudulent trading is essential in fostering good corporate governance, the fear of personal liability may hold directors back from taking necessary risks required in ensuring the company's growth. On the other hand, the business judgment rule can easily be used as a scapegoat for corporate misconduct by directors.<sup>171</sup> It must, however, be noted that it is anticipated that a court may be put to task to decide as to which principle takes precedence, should both concepts be argued in the same case.

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<sup>169</sup> Hunt (2011) 755.

<sup>170</sup> Snyman (2008) 531.

<sup>171</sup> Jones (2007) 333; Naidoo (2009) 173.

## CHAPTER 4: CONCLUSION AND RECOMMENDATIONS

### 4.1. Conclusion

The Companies Act of 2008 significantly impacts on directors' liability in corporate South Africa. Section 22(1) of the Act prohibits a company from carrying on its business recklessly, with gross negligence, with fraudulent intent or trading under insolvent circumstances. On the other hand section 77(3)(b), read with section 22(1) of the Act, imputes personal liability on directors for any loss incurred by the company and its stakeholders as a result of their deliberate recklessness or fraudulent intent in the carrying on their functions. Further to this, section 77(2) of the Companies Act of 2008 also provides that a director of a company may be held liable for breach of common law duties envisaged in sections 75, 76(2) or 76(3)(a) or (b).

On the other hand, the business judgment rule protects directors who act honestly and in good faith from liability for any losses or damages sustained by the company resulting from poor decision-making.<sup>172</sup> The rule is necessary as it promotes risk-taking, innovation and protects directors against honest errors of judgement and poor business decisions which may have negative effects on the company. In terms of section 76(4), directors acting in good faith, with proper care and in the best interests of the company, may rely on performance, information or opinions of a competent employee or person delegated by the board whom the directors reasonably believe to be reliable. Hence, Cassim views it as a 'safe harbour from liability'.<sup>173</sup> Considering the current economic circumstances in South Africa, the rule has been regarded as a crucial tool to protect directors against a myriad of factors such as inflation and economic or political uncertainty. However, a distinction must be drawn between recklessness (or dishonesty) and a *bona fide* error of judgement.<sup>174</sup> Hence, this research set out to focus on the provisions dealing with reckless and fraudulent trading in order to investigate their interface with the business judgment rule. An introduction of the research was done in chapter one.

Conducting or running a business is premised on a myriad of factors. One of them is the need to take commercial risks in order to ensure productivity and growth. However, in most instances, even after careful investigations have been undertaken and due diligence has been done before taking a calculated business risk, decisions that follow are masked in uncertainty.

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<sup>172</sup> Naidoo (2009) 171.

<sup>173</sup> Cassim et al (2012) 563.

<sup>174</sup> *Mafikeng Mail (Pty) Ltd v Centner (No 2)* 1996 (4) SA 607 (WLD).

Sound decisions may sometimes result in catastrophic effects on the company. In such circumstances, the business judgment rule absolves a director from liability for unforeseeable harm while acting in the best interests of the company. It protects a director who acts with due care, skill and diligence from liability for decisions which yield undesirable results.<sup>175</sup> In chapter two, the business judgment rule was discussed, particularly the requirements that must be satisfied for a director to be protected, the significance of the rule, its shortcomings, and its future in South African law.

It has been highlighted that the rule is met with mixed feelings in that, while it acts as a safe harbour for directors against liability from shareholders and third parties dealing with the company, it also limits the rights of the same shareholders and third parties to recover their losses caused by the director's poor decision-making. However, the rule creates equilibrium between the exercise of directors' discretionary powers in pursuit of economic growth and their accountability.<sup>176</sup> The absence of the rule would create an exceptional level of caution among directors who would carry out their functions in fear of bad decision-making and the risk of being personally liable.<sup>177</sup> It must also be noted that section 76(4)(a) has not yet been scrutinised in a court of law. Hence, the rule will probably need to be applied and developed on a case-by-case basis, taking into the account the circumstances of each case, the unique corporate governance provisions and principles of the company and the socio-economic factors.<sup>178</sup> It has also been highlighted that since section 76(4) only applies to a director's statutory duties, it is unclear whether the provision trumps liability arising from the failure to perform common law fiduciary duties. Hence, there lies a possibility that a director may still be held liable in terms of common law.

Both aspects of the research; namely reckless and fraudulent trading, and the business judgment rule as a defence, were discussed in chapter three. An analysis of case law on reckless and fraudulent trading by directors was undertaken. A critical discussion of the practical effects of application of both principles and the possible shortcomings thereof was also done in this chapter. Elements such as recklessness, gross negligence and intent to defraud or having a fraudulent purpose are vital in determining liability. It must also be noted that such personal liability is imposed on a director when the company suffers loss, damages

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<sup>175</sup> Truter A., 'The Business Judgement Rule – what directors need to know' available at [www.schoemanlaw.co.za/business-judgement-rule/](http://www.schoemanlaw.co.za/business-judgement-rule/), accessed on 09 October 2017.

<sup>176</sup> Bainbridge (2004) 84.

<sup>177</sup> Kennedy-Good S., Coetzee L., 'The business judgment rule (part 1)' (2006) 27(1) *Obiter* 62, 65.

<sup>178</sup> Leach (Masters thesis) 36.

or incurs costs.<sup>179</sup> The requirements or features of personal liability, namely recklessness and harbouring fraudulent intentions were discussed.

The courts have maintained in cases such as *Philotex* and *Strut Ahead* that recklessness must not be lightly construed and a distinction must be made between recklessness (a disregard for consequences of one's actions) from a *bona fide* act of a director or an innocent error of judgement on the director's part. In *Mafikeng Mail (Pty) Ltd v Centner (No 2)*<sup>180</sup>, the court held that gross error of judgement did not constitute recklessness, provided the director could show that he was confronted with a choice, the decision of which was invoked by thought and reflection. On the other hand, fraud was viewed as the intentional making of a misrepresentation which is unlawful, thus causing actual or potential prejudice to the party relying on the misrepresentation.<sup>181</sup>

The effects of liability on directors have also been discussed in chapter three. It has been noted that the remedy against directors can be punitive and the sanctions can either be civil or criminal in nature. First, the director will be vulnerable to civil litigation against either the company itself or the shareholders of the company in pursuit of recovery of damages or losses suffered by either the company or the third parties concerned. The director may also be sued in terms of the principles of common law relating to breach of trust.<sup>182</sup> Secondly, the director may also face criminal prosecution if the conduct was of a fraudulent nature. It has also been highlighted that the threat of civil or criminal liability stifles commercial adventure and risk-taking, thus ultimately disadvantaging the company which may suffer losses as a result.

#### **4.2. Recommendations**

After a careful consideration of all factors raised in this research, it is clear that holding directors of a company liable for recklessness and fraudulent trading is a necessity. However, at the same time, the business judgment rule must be emphasised in order to create a balance of convenience for the company and its stakeholders. However, it has already been highlighted that since the statutory business judgment rule has not been properly tested in courts, there seems to be difficulty in measuring its effectiveness in the current corporate system. However, it is anticipated that application of both aspects will present a challenge to

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<sup>179</sup> S 77 (3) of the Companies Act 71 of 2008.

<sup>180</sup> 1995 (4) SA 607 (WLD).

<sup>181</sup> Snyman (2008) 531.

<sup>182</sup> Van der Linde (2008) at 447.

courts when they are faced with cases in which a director charged for reckless or fraudulent conduct pleads the business judgment rule as his or her defence. In light of the above, the following recommendations are proposed:

- a) It has been noted that there seems to be lack of knowledge of the business judgment rule within the business environment. There are a myriad of cases and news reports of directors facing lawsuits or criminal acts for reckless and fraudulent trading. Some of the directors, although innocent, fail to make use of the business judgment rule mainly due to lack of knowledge of the rule as a defence for catastrophic business decisions. Hence, it is recommended that directors be properly trained on the rule, as well as provisions relating to reckless and fraudulent trading, so as to encourage sound business decisions based on informed knowledge. Proper training on the Companies Act of 2008 and the applicable provisions of the old Act of 1973, along with the King Code on Corporate Governance and other relevant legislation must be compulsory before one is appointed as a director or during the term of one's service. Institutions such as the Institute of Directors South Africa may play a significant role in ensuring that current and prospective directors are trained and registered in this regard.
- b) In terms of section 77(2)(a) of the Companies Act 71 of 2008, a director may still be held liable in terms of common law for loss, damages or costs occasioned by a breach of a fiduciary duty. A director may also be held liable in terms of the common law of delict.<sup>183</sup> There seems to be contention whether common law trumps the statutory business judgment rule which is assumed to only protect a director for a breach of statutory duties as provided in section 76(4) of the Act. At the same time, one must be mindful of sections 8(3) and 39(2) of the Constitution<sup>184</sup> which call for the application and development of common law in line with legislative principles. However, since the common law business judgment rule is narrower than the statutory rule, it is recommended that section 76(4) be amended or developed to also extend its reach to absolve a director from common law breaches of fiduciary duties or delict, save where the three crucial requirements are not satisfied.

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<sup>183</sup> S 77 (2) (b).

<sup>184</sup> The Constitution of the Republic of South Africa 108 of 1996.

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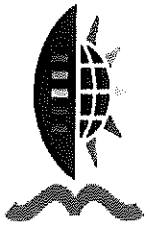
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12 March 2019

Mr Lunga Cosmo Peter (952042388)  
School of Law  
Howard College Campus

Dear Mr Peter,

Protocol reference number: HSS/1034/017M

New project title: Reckless and fraudulent trading by a company and the business judgment rule as a defence for directors

**Approval Notification – Amendment Application**

This letter serves to notify you that your application and request for an amendment received on 12 March 2019 has now been approved as follows:

- Change in Title

Any alterations to the approved research protocol i.e. Questionnaire/Interview Schedule, Informed Consent Form; Title of the Project, Location of the Study must be reviewed and approved through an 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 period of 3 years from the date of original issue. Thereafter Recertification must be applied for on an annual basis.

Best wishes for the successful completion of your research protocol.

Yours faithfully

.....  
Dr Rosemary Sibanda (Chair)

/ms

cc Supervisor: Mr S Phungula  
cc Academic Leader Research: Dr Freddy Mnyongani  
cc Post Graduate Administrator: Mr Pradeep Ramsewak

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Humanities & Social Sciences Research Ethics Committee

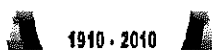
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