

**IMPLICATIONS OF THE PARTIAL CODIFICATION OF THE DIRECTORS' DUTIES
UNDER THE NEW COMPANIES ACT**

by

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CHAPTER 1

1.1 INTRODUCTION

For many decades common law has played a critical role in the determination and assertion of the duties of directors of companies. South African courts have relied on common law principles to develop the South African company law in respect of various duties of directors. Over the years, a substantial body of literature has also been produced to assist in the interpretation and application of common law principles relating to the directors' duties.

The new Companies Act 71 2008 ("the new Act") finally came into effect in May 2011 and has brought fundamental changes that have both positive and negative effects on the operations of companies. Section 7 of the new Act lists the following as some of the objectives of the new company law regime:

- to balance the rights and obligations of shareholders and directors within companies;¹
- to encourage the efficient and responsible management of companies;²

The legislature has included section 76 in the new Act. This section deals specifically with the duties of the directors of companies, most of which are of common law origin. By way of example, section 76(3)(a) mandates directors of a company to exercise their powers and perform their functions in good faith and for a proper purpose. The inclusion of section 76 in the new Act presents a significant improvement in the application of company law in that it brings certainty to directors of companies. However, it is not clear whether common law will cease to have influence in the development of the South African company law in this area. This is the case because the new Act does not seem to incorporate all of the common law duties of directors.

1.2 The dissertation question and objective

As indicated above, the new Act only came into effect in May 2011. To date, courts have not had enough opportunity to interpret and apply section 76 of the new Act. Thus, it is still a bit

¹ Section 7(i).

² Section 7(j).

unclear how our courts will treat common law principles in light of the codification of the directors' duties.

This dissertation purports to examine the implications of the codification of the duties of directors under 76 of the new Act. It determines the extent of the codification. The study also investigates whether or not there are valid grounds to continue to rely on common law principles despite the express inclusion of the directors' duties in the new Act. In this regard, I will compare the existing common law principles relating to the duties of directors (including the duty to act with care and skill) with the provisions of section 76 of the new Act. I will determine the extent to which it would be prudent and possible to apply common law principles when dealing with the codified principles relating to the directors' duties.

Linked to the directors' duties are remedies that apply in case of a breach of the duties. Given this link, the study also examines the liability of directors for breach of their duties. In this regard, a comparison is done between common law remedies and the remedies contained in section 77 of the new Act.

1.3 Research methodology

In order to achieve the objectives of this dissertation, I propose to use a comparative research method. In this regard, I will use mainly primary sources law (i.e. South African and foreign case law, legislation) and secondary sources of law (journal articles, textbooks and other related sources).

1.4 The Structure of the dissertation

This study consists of the following chapters:

Chapter 1

The first chapter introduces the subject and highlights the objectives of the dissertation.

Chapter 2

This chapter discusses various common law duties of directors and how such duties have been applied in South Africa over the years.

Chapter 3

This chapter investigates the rationale for the codification of the directors' duties in South Africa.

Chapter 4

This chapter discusses the directors' duties under the new Act with specific reference to section 76 of the new Act.

Chapter 5

This chapter looks at the liability of directors where there is a breach of duties. The chapter considers the position under both common law and the new Act. Under the latter, reference is made to section 77.

Chapter 6

This chapter makes conclusions and recommendations.

CHAPTER 2

THE DUTIES OF DIRECTORS UNDER COMMON LAW

2.1 Introduction

The management of a company is the responsibility of its directors who act collectively as a board. In order to perform this function successfully and effectively, the directors require some level of autonomy and freedom.³ However, this autonomy and freedom cannot be open-ended because this may lead to abuse. It is for this reason that there are various duties of directors aimed at serving as mechanisms that curtail the abuse of power vested in the board of directors.

Under common law, it is a general principle that directors owe their fiduciary duties (and the duty of care and skill) to the company that they work for.⁴ In broad terms, these duties require directors to act in the best interest of the company, to act in good faith and to act for a proper purpose. Executive and non-executive directors have the same duties. As explained by Goldstone J in *Howard v Herrigel*:

“In my opinion it is unhelpful and even misleading to classify company directors as “executive” or “non-executive” for purposes of ascertaining their duties to the company or when any specific or affirmative action is required of them. No such distinction is to be found in any statute. At common law, once a person accepts an appointment as a director, he becomes a fiduciary in relation to the company and is obliged to display the utmost good faith towards the company and in his dealings on its behalf. That is the general rule and its application to any particular incumbent of the office of director must necessarily depend on the facts and circumstances of each case.”⁵

Common law also recognises that a director owes fiduciary duties to the company on whose board he serves and not to other companies, regardless of whether they belong to the same group of companies or not.⁶ However, the power that a holding company has over the

³ Automatic Self-cleansing Filter Syndicate v Cunninghame 1906 2 Ch 34. See also Pretorius & Delpont *Hahlo's South African Company Law through cases* (1999) 270.

⁴ Re Day-Nite Carries Ltd 1975 1 NZLR 172. See also *Howard v Herrigel* 1991 2 SA 660 (A), which is discussed below.

⁵ 1991 2 SA 660 (A).

⁶ Cilliers & Benade *Corporate Law* (2000) 140.

subsidiary company may result in the directors of the holding company owing fiduciary duties to the subsidiary company. A common example given in this regard is the duty not to use the controlling power of the holding company to destroy the subsidiary's ability to act in its own interest.⁷

Under common law directors' duties may be categorised as follows:

- The duty to avoid conflict of interest;
- The duty to act within powers;
- The duty to maintain an unfettered discretion;
- The duty not to exercise powers for an improper purpose;
- The duty to act in good faith; and
- The duty to act with care and skill.⁸

The sections that follow discuss each of the above duties in some detail.

2.2 The duty to avoid conflict of interest

Common law requires the directors of companies not place themselves in a situation where their personal interests conflict with those of the companies they serve.⁹ The 'no conflict' rule (as it is often called) is the most important of the directors' duties.¹⁰ It is worthwhile to note that this duty can manifest itself in different forms. For instance, a director who, without the consent of the company, seizes the corporate opportunities of the company and make profits for his own benefit acts in breach of his duty to avoid conflict of interest.¹¹ Similarly, a director who misuses the company's assets or information for his personal gain may be held to have acted in breach of the 'no conflict' rule.¹²

The discussion that follows illustrates how the 'no conflict' rule applies.

⁷ *Robinson v Randfontein Estates Gold Mining Co. Ltd* 1921 AD 168.

⁸ This classification was taken from Cilliers & Benade 139; and Pretorius & Delpont *Hahlo's South African Company Law through cases* (1999) 278.

⁹ *Industrial Development Consultants Ltd v Cooley* 1972 WLR 443; *Atlas Organic Fertilizers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd* 1981 2 SA 173. See also Havenga "Directors' exploitation of corporate opportunities and the Companies Act 71 of 2008" 2013 TSAR 257.

¹⁰ *Davies Gower and Davies' principles of modern company law* (2012) 392.

¹¹ *Robinson v Randfontein Estates Gold Mining Co. Ltd* 1921 AD 168. This case is discussed in detail below.

¹² *Magnus Diamond Mining Syndicate v Macdonald & Hawthorne* 1909 ORC 65.

2.2.1 Interference with the company's economic or corporate opportunities

In order to avoid conflict of interest, a director is obligated not to acquire the economic opportunities of the company he serves.¹³ The essence of this principle is that a director should not acquire any economic opportunity for his own benefit unless the company has consented to such action. Any profit made by a director in the course of and by means of his office must be disgorged, unless the majority of shareholders consent to the making of the profit.¹⁴

*Transvaal Cold Storage Co Ltd v Palmer*¹⁵ is the oldest South African authority on the duty not to acquire the company's economic opportunities. Although the judgment was delivered in the context of the principal and agent relationship, its principles are instructive and have governed even the relationship between a company and its directors. The court had the following to say regarding the acquisition of profit by an agent without the consent of the principal:

"Whenever an agent in the course or by means of the agency acquires any profit or benefit without the consent of the principal, such profit or benefit is deemed to be received for the principal's use, and the amount must be accounted for and paid over to the principal. In order to render the agent liable to account for such profit it is not essential that it should arise from transactions falling within the scope of the principal's business; for the agent's liability is based not on the fact that he has prevented the principal from earning the profits, but on his duty in good faith to hand over to his employer every advantage directly or indirectly connected with the agency, save the remuneration agreed upon."

In *Robinson v Randfontein Estates Gold Mining Co Ltd*, the then Appellant Division emphasised the principle that a person who stands in a position of confidence to another involving a duty to protect the interest of that other, may not make secret profits at the expense of that other. Likewise, an agent who secretly purchases a property that could potentially be acquired by his principal and sells the same property to the principal acts against this principle. Any profits that accrue to the agent as a result of such a transaction are to be transferred to the principal and the acquisition is to be treated as one made in the interest of the principal. As the court explains, this principle is meant to prevent an agent from entering into transactions which would result in his interests clashing with his duties.¹⁶

When determining whether the opportunity should be considered as a corporate one, the test that should be applied is to assess whether the opportunity in question is in the line of

¹³ *Da Silva v CH Chemicals (Pty) Ltd* 2008 6 SA 620 (SCA).

¹⁴ *Havenga* 258.

¹⁵ 1904 TS 4.

¹⁶ 1921 AD 168.

business of the company and whether the company would have expected its directors to acquire the opportunity or at least to assist in its acquisition.¹⁷ It is immaterial whether at the time the opportunity become available the company would not or could not have taken it up.¹⁸ The directors' duty not to acquire the corporate or economic opportunities belonging to the companies they serve has been recognised in even more recent decisions. A good example in this regard is the decision in *Phillips v Fieldstone*.¹⁹

2.3 The duty to act within powers

The duty to act within powers entails that when a director enters into transactions on behalf of the company, he should be careful not to enter into transactions that fall beyond the capacity of the company.²⁰ Where this happens, the company would not be entitled to claim that the transaction is void. However, it may still hold the responsible director liable for any losses incurred as a result of the transaction.²¹

The logic behind the common law duty not to act *ultra vires* is the notion that directors, who act as agents of companies, cannot have authority to enter into transactions that exceed the legal capacity of their principals (i.e. the companies that they represent).²² In other words, the limitations that apply to the principal, as the holder of authority, extend to his agents who are mere instruments used to exercise the authority.

In determining whether or not a director acted in breach of the duty not to act *ultra vires*, it appears that the director's knowledge of whether or not he had authority to act is essential. According to the ruling in *R v Byrnes*, directors would be found to have acted in breach of their duty where they entered into transactions knowing that they lacked authority to

¹⁷ Canadian Aero Services Ltd v O'Malley 1973 40 DLR 371 (SCC).

¹⁸ Da Silva v CH Chemicals (Pty) Ltd 2008 6 SA 620 (SCA). See also Cassim MF "Da Silva v CH Chemicals (Pty) Ltd: Fiduciary Duties of Resigning Directors" 2009 SALJ 61; Cassim R "Post-Resignation Duties of Directors: the application of the fiduciary duty not to misappropriate corporate opportunities" 2008 SALJ 731; Havenga 260.

¹⁹ 2004 1 All SA 150 (SCA). In this case, Mr. Phillips, an employee of Fieldstone Africa ("Fieldstone"), was tasked with dealing with one of Fieldstone's clients, Safika Wireless (Pty) Ltd ("Safika"). During the course of their business dealings, Mr Phillips purchased shares from Safika and later sold them back to Safika, thereby making profit. Mr Phillips did not disclose this to Fieldstone. When it found out, Fieldstone sued Mr Phillips for breach of duties of loyalty and good faith, and failure to account for profits made while acting in the capacity as an employee/ agent of Fieldstone. The Supreme Court endorsed the decision of the court of first instance by finding that Mr Phillips stood in a fiduciary relationship with Fieldstone when the opportunity to acquire shares avail itself to him, thus the opportunity belonged to Fieldstone. The fiduciary relationship required him to place Fieldstone's interests above his own whenever a possibility of conflict arose. The court held further that Mr Phillips' duties towards Fieldstone included the promotion of Fieldstone's interests.

²⁰ Cilliers & Benade 144.

²¹ Ibid 144.

²² Ashbury Railway Carriage and Iron Co v Riche 1875 LR 7 HL 653. See also Cassim *Contemporary Company Law* (2011) 483.

transact. Alternatively, it should be shown that the director accused of acting *ultra vires* ought to have known that he had no authority to transact.²³

The founding documents of a company, in particular the memorandum of association, play a critical role in defining the scope and ambit of the company's powers.²⁴ It is important to note that where an action falls outside the powers of a company, not even the sanction of every shareholder can bring such action within the powers of the company.²⁵ Thus, the action is likely to be found to be *ultra vires*.

Directors of a company may also be found to have acted *ultra vires* where they use the company's assets, especially its funds, for their own purposes. In *S v De Jager and Another*, the court found that an action of this nature offends against principles of company law basic to the concept of limited liability, namely:

- that the company is a separate legal persona, owning its assets;
- that the directors manage the affairs of the company in a fiduciary capacity to it; and
- that the shareholders' general right of participation in the assets of the company is deferred until winding-up, and then only subject to the claims of creditors.²⁶

In a subsequent ruling, in *S v Hepker*²⁷, Hiemstra J had the following to say regarding the role of directors in execution of their duties:

"...directors are not allowed knowingly to bind their companies to transactions which are unprofitable to the company and are intended to serve the directors' own ends. That is so even when they all hold the shares and even when all the members of the board agree with full knowledge of the facts. The basis of this proposition is that the company is a person in law and that the directors stand in a fiduciary relationship towards it."

2.4 The duty to maintain an unfettered discretion

At common law, directors of a company, individually or collectively, have a fiduciary duty to exercise independent judgement and unfettered discretion in their management role of the

²³ 1995 183 CLR 501. In *R v Jona* 1961 2 SA 301 (W), the court took into account the fact that the director alleged to have committed theft had acted *bona fide* with the belief that the money he was accused to have stolen was rightfully taken by him. The court also took into account the fact that he was the only director and shareholder of the company. See also Cassim 485.

²⁴ *S v De Jager* 1965 2 SA 616 (A). Note though that this was mentioned in the dissenting judgement of Rumpff JA.

²⁵ *Exchange Banking Company*, In re *Flitcroft's case* 1882 21 ChD 519; *George Newman & Co*, In re (1895) 1 Ch 674.

²⁶ *S v De Jager* 1965 2 SA 616 (A). See also *R v Herholdt* 1957 3 SA 236 (A) where it was concluded that the unauthorized use of the company's assets, in particular its finances, constituted theft against the company.

²⁷ 1973 1 SA 472 (W).

company.²⁸ This fiduciary duty is often referred to as the “no fettering” rule and its essence is that directors are expected not to take decisions as a result of undue influence or directions from third parties even if such directions are in the best interest of the company.²⁹

Directors are required to act independently and to do what they consider to be in the best interest of the company and its shareholders.³⁰ Further, directors are expected not to contract with one another to act in a certain way. For instance, directors of a company cannot agree on how to vote at future board meetings, whether or not they stand to benefit something in consequence of such an agreement.³¹ However, this should not prevent them from concluding contracts on behalf of the company wherein they undertake to take specific actions (at board meetings) that would give effect to such contracts, provided they act *bona fide*.³²

Courts have held that where directors of a company contract to act in a specific manner and later come to a *bona fide* conclusion that it would not be in the best interest of the company and its shareholders that they should carry out their undertaking, it would not be justifiable for a court to interfere with their discretion and compel them to do what they honestly believe would be detrimental to the interest of the company. This principle was introduced into South African law through the 1903 decision delivered by Solomon J in the case of *Coronation Syndicate Limited v Lilienfeld and the New Fortuna Co. Limited*.³³

The facts of the case are as follows: Coronation Syndicate and New Fortuna Co. entered into an agreement in terms of which the latter, through its two directors, undertook to convene a meeting of shareholders wherein it would propose to increase the capital of the company from £ 70,000 to £127,000. In return, Coronation Syndicate undertook to purchase 50,000 of the new shares, provided the company adopted the proposal on the increase of shares. Lilienfeld, who held more than two-thirds of the shares in the company, undertook to

²⁸ Kregor v Hollins 1913 103 LT 225 (KB and CA).

²⁹ McLennan “No contracting out of fiduciary duty” 1991 SA *Merc LJ* 86. See also Davies 390.

³⁰ Howard v Herrigel 1991 2 SA 660. Public Investment Corporation Ltd v Bodigelo 128/2013 2013 ZASCA 156. The directors are not only expected to act independently but to do so in an unbiased and objective manner. See also Havenga “Fiduciary duties of company directors with specific regard to corporate opportunities” (29 *Tran CBL* 1998) 334 and McLennan 86.

³¹ Cassim 480.

³² Thorby v Goldberg 1964 112 C.L.R 597, Aus.HC. At 605 of this decision, the court stated “there are many kinds of transactions in which the proper time for the exercise of the director’s discretion is the time of the negotiation of a contract and not the time at which the contract is to be performed...If at the former time they are bona fide of the opinion that it is in the best interest of the company that the transaction should be entered into and carried into effect, I can see no reason in law why they should not bind themselves to do whatever under the transaction is to be done by the board” The English Court of Appeal followed this reasoning in the case of Fulham Football Club Ltd v Cabra Estates 1994 1 BCLC 363, Ch and CA. In this matter, the directors of a football club agreed to support a planning application that developers of a football club ground were intending to make in future. In exchange, the club stood to benefit a substantial amount of money. Evidence before court showed that the directors believed that the agreement was in the best interest of the company. The court found no fault in this conduct. See also Cilliers & Benade 145.

³³ 1903 TS 489.

support the proposed increase of capital by his vote at the meeting of shareholders.³⁴ When the meeting was held, Lilienfield failed to adhere to the terms of the agreement. Instead, he voted in favour of the proposal that the meeting be adjourned, conduct that was against the spirit of his contract with the Coronation Syndicate.³⁵

In response to Lilienfield's actions, Coronation Syndicate brought an application that sought to prevent Lilienfield from selling his shares in New Fortuna and also to force him (and the two directors who were signatories to the agreement) to abide by the terms of the agreement. One of the legal questions that the court had to answer was whether directors of a company could bind themselves to a contract with a third party to call a general meeting and to submit and support proposals for increasing the capital of the company. In refusing the application, Solomon J followed the English decision in *MacDougall v Gardiner*³⁶ where it was held:

*"If a general meeting is wanted for any purpose, then the directors, if they think it for the interest of the company, have power to call a general meeting; but I do not think that the court has any jurisdiction to compel the directors to call the meeting, when they may honestly think it is not for the interests of the company to do so... Now what power have we to say that a general meeting is to be called, if the directors do not think it right, and if one-fifth of the shareholders will not sign a requisition for the purpose? We have no authority, and there is, as it appears to me, no reason why we should interfere to do that which the shareholders have a right to do themselves."*³⁷

The fiduciary duty to exercise unfettered discretion extends to nominee directors.³⁸ By virtue of being nominated, a nominee director is expected to act in the interest of his nominator and to even report developments that could interfere with such interest. However, common law requires him to act independent of his nominator and to take actions that are in the best interest of the company.³⁹ The interest of the company must always prevail over the interest of his nominator, especially in instances where the company's interests are in conflict with those of the nominator. In other words, he is expected to put the interests of the company

³⁴ The agreement was also signed by two directors and the secretary of New Fortuna Co.

³⁵ One of the terms of the agreement was that the process of increasing the company's capital should take place as soon as possible, thus Lilienfield's decision to vote in favour of the adjournment of the meeting was not consistent with the agreement.

³⁶ 1875 10 Ch. App 606.

³⁷ In this case, the plaintiff in a representative action sought a declaration that certain resolutions had been validly passed at a general meeting, or alternatively an order that a meeting of members be summoned for purposes of putting the resolutions to it afresh. The court a quo held in favour of the plaintiff. However, the Appeal Court held that courts had no powers to intervene. The facts of the case and the quotation are from Sealy L and Worthington S, *Cases and Material in Company Law* (2013) 510. See also *John Crowther Group Plc v Carpets International Plc & Others* 1990 BCLC 460.

³⁸ A nominee director is a person who has been appointed by another (i.e. nominator) to represent the interest of that person at the company, especially at board level. See Cassim 481.

³⁹ *Ibid.*

first regardless of how this would affect the interests of his nominator.⁴⁰ In exercise of this duty, the nominee may consult with the nominator but must ultimately exercise independent judgment in the interest of the company.⁴¹

Directors of a company are also expected to not serve as mere ‘puppets’, ‘dummies’ or ‘stooges’. In *S v Shaban*⁴² it was emphasised that there was no place in company law for the appointment of puppets that would play the role of deceiving interested parties about the true identity of persons managing the affairs of the company.⁴³

2.5 The duty not to exercise powers for an improper purpose

A director acts in breach of his fiduciary duties if he exercises his power for a purpose other than the purpose for which the power was conferred on him.⁴⁴ As explained by Friedman, the duty to act ‘for a proper purpose’ requires a director to use the power given to him for the purpose for which it was originally granted. The proper purpose doctrine seeks to control the exercise of discretionary power conferred on the director. However, it is often hard to determine “the proper basis for the imposition of the ‘proper purpose’ standard”.⁴⁵

The duty to act for a proper purpose often applies in instances where power is conferred to directors by the company’s founding documents such as articles of association. This power may include the power to issue shares, the power to manage the business of the company, the power to recommend dividend, and the power not to register somebody as a shareholder.⁴⁶

The essence of the duty to act for a proper purpose is best illustrated in one of the English decisions: *Piercy v S Mills & Co Ltd*.⁴⁷ The case concerned the use of power to issue the company’s shares selectively. The court expressed the following view regarding proper purpose:

⁴⁰ *Boulting v Association of Cinematograph, Television and Allied Technicians* 1963 1 All ER 716, CA. See also *Davies* 391.

⁴¹ *Cassim* 482.

⁴² 1965 4 SA 646 (W). See also the English decision in *Selangor United Rubber Estates Ltd v Cradock* 1968 1 WLR 1555, 1968 2 All ER 289.

⁴³ In *Fisheries Development Corporation of SA Ltd v Jorgensen* 1980 4 156 it was held that even a person who serves as a director on the basis of a nomination has a duty to exercise independent judgment and to take decisions that are in the best interest of the company notwithstanding the wishes of his nominator or principal. While he may be representing the interests of the person who nominated him, in carrying out his duties and functions as a director, he is obliged to serve the interests of the company. As a director, a nominee cannot be subject to the control of any employer or principal other than the company he serves. See also *Selangor United Rubber Estates Ltd v Cradock (a bankrupt) & Others* 1968 2 All ER 1073 (Chd).

⁴⁴ *Whitehouse v Carlton Hotel Pty Ltd* 1987 11 ACLR 715 (HC of A).

⁴⁵ Friedman “An analysis of the proper purpose rule” 1998 *Bond Law Review* 165.

⁴⁶ Du Plessis “Directors’ duty to use their powers for proper or permissible Purposes” 2004 SA Merc LJ 308.

⁴⁷ 1920 1 Ch 77.

“...directors are not entitled to use their powers of issuing shares merely for the purpose of maintaining their control or the control of themselves and their friends over the affairs of the company, or merely for the purpose of defeating the wishes of the existing majority of shareholders. This is, however, exactly what has happened in the present case...The plaintiff and his friends held a majority of the shares of the company, and they were entitled, so long as that majority remained, to have their views prevail in accordance with the regulations of the company; and it was not, in my opinion, open to the directors, for the purpose of converting a minority into a majority, and solely for the purpose of defeating the wishes of the existing majority, to issue the shares which are in dispute in the present action.”⁴⁸

Generally, courts are reluctant to interfere with the internal affairs of companies, including decisions as taken by directors. Moreover, courts would be reluctant to interfere where decisions were taken *bona fide*. As explained in *Howard Smith Ltd v Ampol Petroleum Ltd*, courts should not “assume to act as a kind of supervisory board over decisions within the powers of the management honestly arrived at.”⁴⁹ Directors are better placed to manage companies and to take decisions that are in the best interest of their companies due to, among other things, their expertise. It is precisely for this reason that courts tend to be reluctant to interfere with the internal affairs of companies.⁵⁰

Courts would generally be willing to interfere with the internal affairs of companies where there are acts of dishonesty because such acts serve to show that power is not exercised for a proper purpose.⁵¹ The ruling in *Hogg v Cramphorn*⁵² illustrates what would constitute an act of dishonesty, thus an improper exercise of power. In this case, directors of a family business were concerned about the imminent hostile takeover of the company. The situation was exacerbated by the possibility that the takeover would result in the company being controlled by a person perceived to be inexperienced and incompetent. As a means to avoid the takeover, the directors of the company allotted unissued preference shares with special voting rights. The shares were allotted to persons who would vote against the takeover, thereby saving the company.

Although the directors acted in what they believed would be in the best interest of the company, the court found that their actions were improper and dishonest. Buckley J found

⁴⁸ A similar view was held in *Gaiman v National Association for Mental Health* 1970 2 All ER 302. In this case, it was specifically held that an issue of shares in order to distort the balance of voting power is an improper exercise of the power to issue shares.

⁴⁹ 1975 AC 821 (CA), 832E-F.

⁵⁰ This point is well articulated in *Darvall v North Sydney Brick & Tiles* 1989 15 ACLR 230 (CA, NSW), 247: “Courts properly refrain from assuming the management of corporations and substituting their decisions and assessments for those of directors. They do so, *inter alia*, because directors can be expected to have much greater knowledge and more time and expertise at their disposal to evaluate the best interests of corporation than judges”.

⁵¹ *Automatic Self-cleansing Filter Syndicate v Cuninghame* 1906 2 Ch 34; *British Equitable Co v Baily* 1906 AC 35 (ChD). See also *Du Plessis* 315.

⁵² 1976 Ch 254.

that the primary purpose for exercising power in this instance (i.e. the allotment of shares) was not to raise capital for the company but rather to ensure that the takeover bid was unsuccessful. Thus, the Hogg decision demonstrates that the 'primary purpose' is to be considered when determining whether or not a court should intervene.⁵³

According to the ruling in *Extrasure Travel Insurance Ltd v Scattergood*,⁵⁴ the law relating to improper purpose does not require evidence that a director was dishonest or that he knew that he was pursuing a collateral purpose. Rather, a four-step approach should be followed:

- the power being challenged should be identified;
- the proper purpose for which the power was given to the director should be identified;
- the substantial purpose for which the power was in fact exercised should be investigated; and
- decide whether the purpose was proper.⁵⁵

2.6 The duty to act in good faith

Common law requires the board of directors to act in what they *bona fide* consider to be in the best interest of the company and not for an improper purpose or collateral purpose.⁵⁶ The duty to act in good faith requires the directors to have reasonable grounds for holding a specific belief and for acting in accordance with that belief. For instance, if they believe there will be substantial damage to the company's interest as a result of certain actions or

⁵³ Further discussions and examples of improper purpose are to be found in the following cases: *Punt v Symons & Co Ltd* 1903 2 Ch 506. In this case directors had issued shares with the object of creating majority to enable them to pass a special resolution depriving other shareholders of special rights conferred on them by the company's articles. Having considered the merits of the case, Byrne J stated that "I am quite satisfied that the meaning, object, and intention of the issue of these shares was to enable the shareholders holding the smaller amount of share to control the holders of a very considerable majority. A power of this kind exercised by the directors in this case, is one which must be exercised for the benefit of the company: primarily it is given them for the purpose of enabling them to raise capital when required for the purposes of the company...I find as I do that shares have been issued under the general and fiduciary power of the directors for the express purpose of acquiring an unfair majority for the purpose of altering the rights of the parties under the articles. I think I ought to interfere." In *Piercy v Mills* 1920 1 Ch 77, the directors had issued shares with the object of creating a sufficient majority to enable them to resist the election of three additional directors, whose appointment would have put the two existing directors in a minority on the board. The court found that the allotment of shares in this instance was invalid as it was done for an improper purpose. See also *Mears v African Platinum Mines* 1922 WLD 57. See also Pretorius & Delpont 292.

⁵⁴ 2003 1 BCLC 598.

⁵⁵ See also Cassim 479.

⁵⁶ *Visser Sitrus (Pty) Ltd v Goede Hoop Sitrus (Pty) Ltd and Others* 2014 5 SA 179 (WCC).

decisions, there must be substantial grounds for that belief.⁵⁷ Furthermore, the belief held by the directors must have 'a rational basis'.⁵⁸

In the case of *Minister of Water Affairs and Forestry v Stilfontein Gold Mining Co Ltd*,⁵⁹ it was held that the directors of a company cannot resign from the company in order to avoid their fiduciary duties, in particular the duty to act in good faith. In this case, a court order had been obtained against, among others, Stilfontein Gold Mining. The order related to its conduct of causing pollution. In an effort to escape liability, the whole board of the company resigned and this made it difficult for the company to comply with the order.

In arriving at its decision, the court highlighted that the directors of Stilfontein Gold Mining were "the directing minds" of the company at all material times and were under a duty to act *bona fide* in the interests of the company. The court concluded that the directors did not act in good faith when they decided to resign from the company. Instead, they incapacitated themselves from discharging their duties to the company.

When determining whether or not directors have acted in breach of their duty to act in good faith, courts are cautioned to have regard to the fact that companies are ran by directors with expertise and that these directors have the responsibility to act in the best interest of the companies that they serve. This point is well-articulated in the Austrian decision of *Wayde & Another v New South Wales Rugby League Ltd*:

"The question here is whether the resolutions which were manifestly prejudicial to and discriminatory against Wests, were also unfair - that is, so unfair that reasonable directors who considered the disability the decision placed on Wests would not have thought it fair to impose it. The decision by the League's directors to reduce the number of competitors to 12 and to exclude Wests was in fact taken with full knowledge of the disability that that decision would place on Wests. But the directors also knew that the larger competition was burdensome to, and perhaps dangerous for, players and that a shorter season was conducive to better organization of the Premiership Competition. The directors had to make a difficult decision in which it was necessary to draw upon the skills, knowledge and understanding of experienced administrators of the game of rugby league. The Court, in determining whether the decision was unfair, is bound to have regard to the fact that the decision was admittedly made by experienced administrators to further the interests of the game. There is nothing to suggest unfairness save the inevitable prejudice to and discrimination against Wests, but that is insufficient by itself to show that reasonable directors with the special qualities possessed

⁵⁷ Teck Corporation Ltd v Millar 1973 33 DLR 288.

⁵⁸ Visser Citrus (Pty) Ltd v Goede Hoop Citrus (Pty) Ltd and Others 2014 5 SA 179 (WCC).

⁵⁹ 2006 (5) SA 333 (W).

*by experienced administrators would have decided that it was unfair to exercise their power in the way the League's directors did.*⁶⁰

Generally, the directors of a company are not required to give reasons for their actions. The least they are required to do is to provide full disclosure of what they have done. However, they are still expected to act in good faith and in the best interest of the company.⁶¹ Similarly, the board of directors may refuse to transfer or register shares provided they act *bona fide* in the interest of the company.⁶²

2.7 The duty to act with care and skill

When performing his functions and duties, a director of a company is required to exercise some degree of care and skill. In other words, the duty of care and skill requires a director to manage the affairs of the company as a reasonable prudent person would manage his own affairs.⁶³ This is particularly important because any damage suffered by the company as a result of the director's incompetency or carelessness may attract liability for the director concerned. It is important to note that the duty of care and skill is not a fiduciary duty. According to Cassim, this duty is based on delictual or Aquilian liability for negligence.⁶⁴

Furthermore, it is worthwhile to note that care and skill denote two different things. Skill denotes the knowledge and experience that a director poses.⁶⁵ Directors' skills would therefore often be different. On the other hand, care appears to be objective as it relates to the manner in which a skill is applied. As discussed below, while skills may be subjectively determined, the level of care to be exercised by a director in a particular situation should be assessed objectively.

*Fisheries Development Corporation of SA Ltd v Jorgensen*⁶⁶ appears to be the leading case in South Africa on the duty of care and skill. Based on this decision, the key features of the duty of care and skill can be summarised as follows:

⁶⁰ 1985 HCA 68; 1985 180 CLR 453.

⁶¹ *Visser Citrus (Pty) Ltd v Goede Hoop Citrus (Pty) Ltd and Others* 2014 5 SA 179 (WCC).

⁶² *Re Smith & Fawcett Ltd* 1942 Ch 304 (CA); *Ex parte Bennett: In re Cameron's Coalbrook Steam Coal & Swansea & Lougher Railway Co* 1854 24 LJ Ch 130; *Charles Forte Investments Ltd v Amanda* 1964 Ch 240 (CA). See also Delpont *Henochsberg on the Companies Act 71 of 2008* (2014) 297.

⁶³ *Fisheries Development Corporation of SA Ltd v Jorgensen* 1980 4 156 (W); *Brazilian Rubber Plantations and Estates, In re* [1911] 1 Ch 425, 436. See also Botha "The role and duties of directors in the promotion of corporate governance: A South African perspective" 2009 *Obiter* 702; *The Third King Report on Corporate Governance* (2009) 11.

⁶⁴ Cassim 505. *Du Plessis NO v Phelps* 1995 4 SA 165 (C); *Ex parte Lebowa Development Corporation Ltd* 1989 3 SA 71 (T).

⁶⁵ *Daniels v Anderson* 1995 13 ACLC 614 (CA (NSW)) 665.

⁶⁶ 1980 4 SA 156 (W).

- A considerable degree of the nature of the company's business and of any particular obligations assumed by or assigned to a director must be taken into account when dealing with a director's duty of care and skill. A distinction must also be drawn between the so-called full-time or executive director, and the non-executive director. An executive director participates in the day-to-day management of the company's affairs or a portion thereof whereas a non-executive director has not undertaken any special obligation and is not bound to give constant consideration to the affairs of the company. The latter's duties are of an irregular nature in that he can be required to attend periodic board meetings, and any other meetings which may require his attention. He is not, however, bound to attend all such meetings, though he ought to wherever he is reasonably able to do so. He can also call for further meetings if he believes that they are reasonably necessary.
- A director's duties and qualifications are not listed as being equal to those of an auditor or accountant nor is he required to have special business acumen or expertise, or ability or intelligence, or experience in the business of the company. He is nevertheless expected to exercise the care which can reasonably be expected of a person with his knowledge and experience. He is not liable for mere errors of judgement.
- A director can delegate any duty that may properly be left to some other official. When doing so a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly. He is entitled to rely upon and accept the judgment, information and advice of the management, unless he has proper reasons for querying it. He is also not bound to examine entries in the company's books, however, he should not accept information and advice blindly. When he accepts information and advice, he is entitled to rely on it, but he should give due consideration and exercise his own judgment in the light thereof.⁶⁷

There is no single or uniform objective standard that has been prescribed for purposes of determining whether a director has acted within the scope of the duty of care and skill. This is because there are different types of directors with different skills, qualifications and knowledge. As explained by Romer J in *City Equitable Fire Insurance Ltd*:

⁶⁷ Fisheries Development Corporation of SA Ltd v Jorgensen 1980 4 SA 156 (W), 165g-166e; Brazilian Rubber Plantations and Estates, In re 1911 1 Ch 425, 436. See also Du Plessis "A comparative analysis of directors' duty of care, skill and diligence in South Africa and in Australia" (201) *Acta Juridica* 263; Cilliers & Benad 147; Botha 709.

*“...It is indeed impossible to describe the duty of directors in general terms...The position of a director of a company carrying on a small retail business is very different from that of a director of a railway company. The duties of a bank director may differ widely from those of an insurance director, and the duties of a director of one insurance company may differ from those of a director of another.”*⁶⁸

Thus, the duty of care and skill depends on, among other things, the type of company, the type of director, the skills and knowledge of the director, and his position and his key responsibilities in the company.⁶⁹ The more experienced and knowledgeable the director is, the higher the risk of liability as such a director is generally expected to use his knowledge and skills for the benefit of the company. In contrast, the less experienced and knowledgeable director can easily avoid liability on the basis of lack of knowledge and inexperience.⁷⁰ It therefore remains the responsibility of shareholders to appoint competent directors to avoid this eventuality. Nonetheless, as Botha puts it, directors are still expected to always take reasonably diligent steps to become informed about the matter at hand despite their level of skills or experience. While they may take risks, this ought not to be done in a reckless fashion.⁷¹

Despite the above observations, the general test that is often used to determine whether a director has acted in breach of the duty of care and skill has both an objective element and a subjective element. In the *City Equitable* case, it was held that a director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience.⁷² Davies’ interpretation of this ruling is that it contains an objective element in that the director may be held liable for failing on a particular occasion to live up to the standard of which he is in fact capable of reaching. Davies further submits that the ruling also contains a subjective element in that the director cannot be required to achieve a standard higher than that which he is capable of reaching.⁷³

2.7.1 The business judgment rule

⁶⁸ 1925 1 Ch 407, 426.

⁶⁹ Cassim 505.

⁷⁰ Ibid 506.

⁷¹ Botha 711.

⁷² *City Equitable Fire Insurance Ltd, In re* 1925 1 Ch 407, 428.

⁷³ Davies 433.

A critical aspect of the duty of care is what is commonly known as the business judgement rule. This rule originates from the United States of America and deals largely with directors' decision-making processes. E Jones describes the rule as follows:

“The business judgement rule applies to the process of directors’ decision-making, and consists of a rebuttable presumption that in making business decisions, the directors of a company have acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interest of the company...It addresses the issues of both the honesty of directors and, to a limited extent...whether the director has breached the duty of care. This means that the rule usually serves to protect directors from liability to the company or to its shareholders for losses resulting from poor decision-making...”⁷⁴

There has been an academic debate on whether or not the business judgment rule is necessary. This debate intensified just before the adoption of the new Act. In this regard, the question was whether or not the codification process should include the business judgment rule. Although most of the prominent scholars and academics argued against the codification of the business judgement rule⁷⁵, the legislature saw it prudent to incorporate the rule in the new Act. I discuss this further later on in this dissertation.

According to Havenga, the business judgment rule requires that a decision be made on an informed basis, in good faith, and without financial interest. The decision maker must reasonably believe that the decision is in the best interest of the company. If all these requirements are met, the decision maker may be exempted from liability regardless of the outcomes of the decision.⁷⁶

A policy justification for the business judgment rule is that directors of companies should not be constrained unnecessarily from taking risks which could potentially benefit the companies they serve. Furthermore, directors need not spend money on expert opinions so as to be certain about decisions to be taken.⁷⁷

⁷⁴ Jones “Directors’ duties: negligence and the business judgment rule” 2007 SA Merc LJ 326.

⁷⁵These include Kennedy-Good & Coetzee “The business judgement rule” 2006 *Obiter* 277; Bouwman “An appraisal of the modification of the director’s duty of care and skill” 2009 SA Merc LJ 509; Jones 326.

⁷⁶ Havenga “The business judgement rule- Should we follow the Austrian example?” 2000 Merc LJ 25.

⁷⁷ *Ibid.*

CHAPTER 3

THE RATIONALE FOR CODIFICATION

3.1 Introduction

The codification of laws is not a new phenomenon. This process dates back to many decades ago and has been done for various reasons. For instance, in 6th century AD the Romans, through Emperor Justinian, embarked on a process aimed at codifying Roman laws. This process led to the production of what became famously known as the *corpus juris civilis* or Justinian's codification. Some of the key objectives behind the process of codifying Roman laws were to make these laws easily accessible to Roman citizens and to bring legal certainty.⁷⁸ As will be demonstrated below, these objectives remain valid to date and have served as the basis for the codification of the duties of directors in various countries.

In a study conducted by the United Kingdom Institute of Directors, it has been proven that directors of companies generally do not understand their fiduciary duties and to whom these duties are owed.⁷⁹ In consequence, this impairs their ability to effectively comply and execute their duties. Therefore, the codification of the duties of directors seeks to address this concern. In Europe, the United Kingdom has taken a lead in the codification of the duties of directors, with countries such as Australia and New Zealand following suit. In Africa, jurisdictions such as Ghana and Singapore have taken the lead.

3.2 The rationale for the codification of directors' duties in South Africa

As explained earlier, some of the academics in South Africa have argued against the codification of directors' duties, and the duty of care and skill. For instance, Havenga contests that the codification of the duty of care and skill was unnecessary because this was already covered in King I.⁸⁰ This argument appears to hold water, especially when one

⁷⁸ Van Niekerk & Wildenboer *The origins of South African Law* (2009) 63.

⁷⁹ Cassim 462.

⁸⁰ Havenga 257. McLennan submits that there should not be an over-legislation of issues, especially if such issues are governed satisfactorily by the common law. The more legislation there is, the more interpretation will be necessary. See McLennan "Directors' fiduciary duties and the 2008 Companies Bill" 2009 TSAR 184. Havenga 257.

considers King II, which was published after the publication of Havenga's article.⁸¹ King II provides guidelines on how the duty of care and skill should be exercised:

"Some general guidelines require that directors:

...must, in line with modern trends worldwide, not only exhibit the degree of skill and care as may be reasonably expected from persons of their skill and experience (which is the traditional legal formulation), but must also:

- *exercise both the care and skill any reasonable persons would be expected to show in looking after their own affairs as well as having regard to their actual knowledge and experience; and*
- *qualify themselves on a continuous basis with a sufficient (at least a general) understanding of the company's business and the effect of the economy so as to discharge their duties properly, including where necessary relying on expert advice.*⁸²

In essence, King II presents the codification of the duty of care and skill. Thus, Havenga is quite right to question the need to codify the duty of care and skill under the new Act. It may be argued that the King reports are mere instruments of self-regulation and do not have legal force. Further, King II only applies to listed companies to the exclusion of non-listed companies. However, it is imperative to note that courts have demonstrated their willingness to apply the King reports where appropriate. As submitted by Delpont & Esser, the King reports are not mere self-regulatory and voluntary codes that operate on a comply-or-explain basis. King reports are law that directors are expected to follow failing which there may be consequences.⁸³ In support of this contention, Delpont & Esser rely on the ruling in *Stilfontein Minister of Water Affairs and Forestry v Stilfontein Gold Mining Ltd*⁸⁴ as an example. In this case Hussain J referred to one of the King's reports and used it as the basis for his determination on whether or not a director breached his fiduciary duties, and the duty of care and skill.

Notwithstanding the arguments that have been made against the codification of directors' duties in South Africa, there are good grounds to justify the codification. These include the following:

- legal principles set through case law are often complicated, inaccessible, and sometimes confusing. Many directors are not clear on what their duties are and what

⁸¹ King II was published in 2002 whereas Havenga's article was published in 2000.

⁸² King II, 54.

⁸³ Esser & Delpont "The duty of Care, skill and diligence: The King Report and the 2008 Companies Act" (2011) THRHR 449.

⁸⁴ 2006 5 SA 333 (W).

is expected of them, and most need legal advice in order to understand what they should do;⁸⁵

- codification seeks to make the law accessible;
- codification provides clear and efficient guidelines for directors. Commercial decisions are usually made at speed, so if there is a statement telling the directors what to do, it will make their position much easier. Such a statement of duties may help to save time, effort, and money spent in ascertaining the law, advising on it, and complying with it;⁸⁶
- through legislative interference, common law principles are clarified where necessary;
- legislative interference also helps to resolve some of the conflicting judicial decisions that often lead to confusion;⁸⁷
- codification reflects a step away from the traditionalist approach⁸⁸ which was historically followed in South Africa, to a modernistic approach⁸⁹ which is being followed internationally.⁹⁰ Thus, codification provides South Africa with the opportunity to conform to international best practices.

Further to the above, the policy paper of the Department of Trade and Industry (the “DTI”) sets out, among other things, policy objectives that form the basis of the codification of the duties of directors. According to the DTI:

“Current company law also does not contain clear rules regarding corporate governance and the duties and liabilities of directors. These matters have been largely left to common law and Codes of Corporate Practice. Thus, there is no extensive statutory scheme covering the duties and obligations of directors and their accountability in cases of violations. It will be an important part of the review of company law to ensure that directors are made as accountable to shareholders as is practicable...Perhaps the most significant deficiency in the current law is

⁸⁵ Esser & Coetzee “Codification of directors’ duties” 2004 JBL 26.

⁸⁶ *Ibid.* See also Botha 712.

⁸⁷ Cassim 462.

⁸⁸ The traditionalist school of thought is against the codification of directors’ duties and holds that codification would result in the duties becoming superfluous. Traditionalists believe that common law duties and liabilities have been adequately dealt with. See Botha 713.

⁸⁹ The modernistic school of thought holds that the common law standards are too modest and reflect outdated economic and social philosophies. See Botha 713.

⁹⁰ Botha 713.

*that it does not provide effective mechanisms for the enforcement of even those duties prescribed under the present law.*⁹¹

The DTI believes that the new company law should be simple and accessible to business people and their advisors. Furthermore, important principles of law should not be left to common law as some of the sources of common law, in particular English cases, do not always provide the content of fiduciary duties with sufficient precision. Some of the cases are irreconcilable and make it difficult to point to the existing legal position with certainty.⁹² Lastly, the DTI notes that:

*“In South Africa, research has established that management and directors are not clear about their duties. A statutory standard for conduct and a clear statement of duties would assist in capturing case law set out in other jurisdictions and would give directors a degree of certainty about their duties, the standard for their conduct and associated liabilities.”*⁹³

⁹¹ South African Company Law for the 21st Century- Guidelines for Corporate Law Reform (GG 26493, 2004), 19.

⁹² *Ibid*, 29 & 38.

⁹³ *Ibid*, 38.

CHAPTER 4

THE DUTIES OF DIRECTORS UNDER THE NEW ACT

4.1 Introduction

As explained in previous chapters, the reform of company law in South African has brought a number of important changes. These changes include the partial codification of the directors' fiduciary duties, and the duty of care and skill. Overall, the changes that have been made by the legislature seek to reinforce and encourage good corporate governance. The changes have put measures in place to prevent the abuse of power by directors. As one of these mechanisms, the new Act contains the general statement of the minimum duties of directors in a statutory form.⁹⁴

This chapter discusses all the common law duties of directors that have been codified and incorporated in the new Act, including the duty of care and skill, and the business judgment rule. The relevant section of the new Act in this regard is section 76 which reads as follows⁹⁵:

"76. Standards of directors conduct.-

(2) A director of a company must-

(a) not use the position of director, or any information obtained while acting in the capacity of a director-

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

(ii) to knowingly cause harm to the company or a subsidiary of the company; and

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

(i) reasonably believes that the information is-

(aa) immaterial to the company; or

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

⁹⁴ See Mongalo "An overview of company law reform in South Africa: from the guidelines to the Companies Act 2008", in Mongalo (ed) *Modern Company Law for a Competitive Economy* (2010) xiii-xxv.

⁹⁵ These sections are unpacked below.

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

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

(a) in good faith and for a proper purpose;

(b) in the best interest of the company;

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

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

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

4.2 Meaning of director

The obvious starting point in the analysis of the relevant provisions of the new Act is to consider some of the terminology used. Of great relevance to the discussion at hand is the meaning of a “director”. In terms of section 76 (1), a director⁹⁶ includes a prescribe officer or a person who is a member of a committee of a board of a company, or of the audit committee of a company. This person need not sit on the board of the company.

Regulation 38 of the Companies Regulations (2011) defines a prescribe officer as a person who, despite not being a director of a particular company, exercises general executive control over and management of the whole, or a significant portion, of the business and activities of the company; or regularly participates to a material degree in the exercise of the general executive control over and management of the whole, or a significant portion, of the business and activities of the company.⁹⁷

There is no doubt that the meaning of “director” in terms of the new Act is broad enough to include both executive and non-executive directors, which are the two important types of directors under common law.⁹⁸ It is important to note that at common law there is no distinction between executive and non-executive directors when it comes to the application

⁹⁶ Section 1 defines a director as member of the board of a company or an alternate director of a company and includes any person occupying the position of a director or alternate director, by whatever name designated. An alternate director is defined as a person elected or appointed to serve, as the occasion requires, as a member of the board of a company in substitution for a particular director of that company.

⁹⁷ It has been submitted that this definition limits the participation of such a person to that of a direct nature and such participation may be equated to that of a director in terms of authority and control. See Delpont *Henochsberg on the Companies Act 71 of 2008* (2014).

⁹⁸ *Howard v Herrigel* 1991 2 SA 660.

of the duties of directors. There is no reason to suspect that this position has changed since the enactment of the new Act. Instead, it appears that the new Act has opened the net even wider.

4.3 The duty to avoid conflict of interest

The duty to avoid conflict of interest is one of the most important fiduciary duties at common law. Cassim describes this duty as “the core duty of a fiduciary”.⁹⁹ It is therefore not surprising that the legislature has incorporated the duty to avoid conflict of interest in section 76(2)(a)(i) and (ii) of the new Act.

Firstly, the new Act requires a director, as defined above, not to use his position, or any information obtained while acting in the capacity of director, to gain an advantage for himself or any other person, other than the company that he serves or its wholly-owned subsidiary. An important observation that should be made here is that common law has been modified in that the duty to avoid conflict of interest is no longer limited to the company that the director serves, but now extends to wholly-owned subsidiaries of that company. It should be recalled that under common law a director owes fiduciary duties to the company on whose board he serves and not to other companies, regardless of whether they belong to the same group of companies or not.¹⁰⁰

Secondly, the new Act requires a director of a company to refrain from knowingly causing harm to the company or a subsidiary of the company. It would seem to me that the element of intention will play a critical role in the application of this section and in the determination of liability. Thus, if a director of a company can demonstrate that he did not cause harm to the company deliberately (i.e. knowingly), he may not be held liable even though the company may have suffered harm. The test that seems to apply here is subjective in nature.

In terms of section 1 of the new Act the word “knowingly”, as used in section 76(2)(a), means that the person either had actual knowledge of the matter or was in a position in which the person reasonably ought to have had actual knowledge or reasonably ought to have investigated the matter to an extent that would have provided the person with actual knowledge or reasonably ought to have taken other measures which, if taken, would reasonably be expected to have provided the person with actual knowledge of the matter.¹⁰¹ Based on this interpretation, I submit that it is not only the subjective test that applies in the determination of liability under section 76 (2)(a), as explained above, but the objective test also finds application.

⁹⁹ Cassim 485.

¹⁰⁰ Adams v Cape Industries plc 1990 Ch 433. See also Cilliers & Benade 140.

¹⁰¹ See also Delpont 290.

It has been observed that while section 76(2)(a) explicitly codifies the common law no-profit rule, it does not explicitly codify the corporate opportunity rule. However, section 76(a)(i) and (ii) is seen as being wide enough to apply to both the non-profit rule and the corporate opportunity rule.¹⁰² I pause to mention that Havenga does not agree with this observation. In this regard, Havenga contends that the corporate opportunity rule is only partially covered in that section 76(2)(a) is specific in curbing the gaining of an advantage or knowing cause of harm to the use of the position of director, and to information gained while acting in the capacity of director. According to Havenga, these limitations do not apply under common law. Further, it is submitted that the stipulation that harm must be caused “knowingly” may also exclude some of the corporate opportunity situations.¹⁰³

4.4 The duty to act in good faith and for a proper purpose

Section 76(3)(a) mirrors two distinct yet interlinked common law duties: the duty to act in good faith and the duty to act for a proper purpose. The new Act does not provide details regarding these duties other than to state that directors of companies are expected to exercise their powers and to perform their functions in good faith and for a proper purpose. For instance, the new Act does not explain what does proper purpose mean, and what is the standard for assessing whether a director has acted for a proper purpose. Similarly, the new Act does not explain what is meant by good faith.

The significance of the above-mentioned omissions is that they leave scope for the application of common law. In other words, common law remains relevant for purposes of determining the meaning and scope of the duty to act in good faith and the duty to act for a proper purpose. As explained by the DTI, the motive behind the enactment of the new Act was not to unreasonably jettison the body of jurisprudence built up over more than a century.¹⁰⁴ Thus, such jurisprudence continues to be relevant provided it is consistent with the spirit of the new Act. The net effect of this is that the test for good faith is still subjective and is applied with reference to the belief of the director of a company at the time of engaging in conduct that brings to question his *bona fides*.

According to Cassim, the importance of section 76(3)(a) is that it removes doubt relating to the existence of the fiduciary duty to act for a proper purpose. Some authorities have seen and considered this duty as an aspect of the duty to act in good faith.¹⁰⁵ Another important aspect of the enactment of section 76(3)(a) is that it creates both a statutory and common law obligation for directors of companies.

¹⁰² Cassim 501.

¹⁰³ Havenga 257.

¹⁰⁴ South African Company Law for the 21st Century- Guidelines for Corporate Law Reform (GG 26493, 2004) 7.

¹⁰⁵ Cassim 477.

Du Plessis notes that section 76(3) applies in situations where a director acts ‘in the capacity of director’ and when acting in that capacity he ‘must exercise the powers and perform the functions of director’. The relevance of this observation is that a director may avoid liability by contending that he did not act in his capacity as a director or was not exercising the powers and performing the functions of director when the alleged conduct occurred.¹⁰⁶ It remains to be seen how courts are going to deal with such defences.

Section 76(3)(a) was recently tested in the case of *Visser Sitrus (Pty) Ltd v Goede Hoop Sitrus (Pty) Ltd and Others* where the court had to determine, among other things, whether the board of directors had exercised the power to refuse to register a transfer of shares for a proper purpose and in good faith. With regards to proper purpose, Rogers J had the following to say:

“As to proper purpose (s 76(3)(a)), the test is objective, in the sense that, once one has ascertained the actual purpose for which the power was exercised, one must determine whether the actual purpose falls within the purpose for which the power was conferred, the latter being a matter of interpretation of the empowering provision in the context of the instrument as a whole. In the context of decisions by directors, there will often be, in my view, a close relationship between the requirement that the power should be exercised for a proper purpose and the requirement that the directors should act in what they consider to be the best interests of the company. Put differently, the overarching purpose for which directors must exercise their powers is the purpose of promoting the best interests of the company.”¹⁰⁷

4.5 The duty to act in the best interest of the company

Section 76(3)(b) also gives a statutory basis for the common law duty to act in the best interest of the company. This section obligates a director, when acting in that capacity, to exercise his powers and perform his functions in the best interest of the company. The section does not amend or modify common law but reinforces the duty to act in the best interest of the company. Thus, the common law test for assessing this fiduciary duty still applies.

In *Visser Sitrus*, the court stated that the duty imposed by section 76(3)(b) to act in the best interest of the company is subjective. It requires the directors, having taken reasonably diligent steps to become informed, to have subjectively believed that their decision was in the best interest of the company and that this belief must have had a rational basis. According to Rogers J, the test is not an objective one and does not entitle the court, if the

¹⁰⁶ Du Plessis 263.

¹⁰⁷ 2014 5 SA 179 (WCC).

board's decision is challenged, to determine what is objectively speaking in the best interests of the company.

4.6 The duty to act with care, skill and diligence

Section 76(3)(c) requires a director, when acting in that capacity, to exercise his powers and perform his functions with the degree of care, skill and diligence that may reasonably be expected of a person carrying out the same functions in relation to the company as those carried out by that director; and having the general knowledge, skill and experience of that director. Although this section is a statutory equivalent of the common law duty of care and skill, it goes beyond common law with regards to the content of the duties and the expected level of compliance.¹⁰⁸

Cassim's interpretation of section 76(3)(c) is that it creates a dual standard for the duty of care and skill. This standard is partly objective and subjective.¹⁰⁹ It is objective in a sense that a director is expected to carry out his functions the same way that a reasonable person may be expected to perform similar functions. This is a minimum standard that all directors are expected to meet regardless of their skills, knowledge and experience. Furthermore, the fact that the section makes reference to "a reasonable person" also confirms the objective aspect of the standard.

The subjective aspect of section 76(3)(c) relates to the general knowledge, skill and experience of the director in question. Given that different directors have different skills, knowledge and experience, it goes without saying that the new Act prescribes a subjective standard in this regard. Thus, the application of the standard in this instance will differ from one case to another. It would seem to me that this subjective standard would have minimal application to those directors who lack experience, skills and Knowledge. For instance, if a family owned business, through its board of directors, decides to appoint one of the family members as a director. If the appointed person lacks education, experience and skills, the subjective standard would apply very minimally. On the other hand, if the appointed director has previously held positions of directorship and has extensive knowledge of the industry in which the company operates, these factors would be taken into account when assessing whether or not he acted with care and skill. Cassim sums up the standards that apply under section 76(3)(c) as follows:

"Section 76(3)(c)(i) imposes a standard of care that is fair and equitable insofar as it is assessed against the standard that may reasonably be expected to be exercised by a person

¹⁰⁸ Esser & Delport 449.

¹⁰⁹ Ibid 508. Bouwman also gives the same interpretation to section 76(3)(c). See Bouwman 509.

in a like position under like circumstances. The effect of section 76(3)(c)(ii) is that the more skilled, knowledgeable and experienced the director is, the higher the level of care and skill he or she must exercise. On the other hand, the more inexperienced he or she is, the less the level of care and skill is expected of him or her, provided that he or she does exercise reasonable care and skill...this is the minimum standard of care, skill and diligence with which every director must comply.

The subjective standard of skill, knowledge and experience is taken into account only when it increases or improves the objective standard of care or skill expected of a reasonable director. If the skill or knowledge of the particular director exceeds that of a reasonable diligent person, the higher level of knowledge, skill and experience must be taken into account in deciding whether the particular director has exercised reasonable care and skill and has complied with the requirements of s 76(3)(c) ”¹¹⁰

In is interesting to observe that section 76(3)(c) makes reference to the word “diligence”. This word has never been used by South African courts in the context of the duty of care and skill, and, according to Du Plessis, the word is derived from section 180 of the Australian Corporations Act of 2001 (“the Australian Corporations Act”).¹¹¹ Du Plessis submits that “care” and “diligence” should not be read separately but should rather be seen as a single term.¹¹²In the context of section 76(3)(c), diligence may mean attending properly to one’s duties.¹¹³For instance, a director is expected to attend board meetings and to pay attention to the affairs of the company.

4.7 The business judgement rule under the new Act

Section 76(4) of the new Act gives recognition to the business judgment rule. This section states as follows:

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

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

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

(ii) either-

¹¹⁰ Cassim 509.

¹¹¹ Du Plessis 263. Section 180 (1) of the Australian Corporations Act states that “a director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they: (a) were a director or officer of a corporation in the corporation’s circumstances; and (b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer”.

¹¹² *Ibid.*

¹¹³ Cassim 510.

- (aa) the director had no material personal financial interest in the subject matter of the decision, and had no reasonable basis to know that any related person had a personal financial interest in the matter; or
 - (bb) the director complied with the requirements of section 75 with respect to any interest contemplated in subparagraph (aa); and
 - (iii) the director made a decision, or supported the decision of a committee or the board, with regard to that matter, and the director had a rational basis for believing, and did believe, that the decision was in the best interest of the company; and
- (b) is entitled to rely on-
- (i) the performance by any of the persons-
 - (aa) referred to in subsection (5); or
 - (bb) to whom the board may reasonably have delegated, formally or informally by course of conduct, the authority or duty to perform one or more of the board's functions that are delegable under applicable law; and
 - (ii) any information, opinions, recommendations, reports or statements, including financial statements and other financial data, prepared or presented by any of the persons specified in subsection (5)"

As stated above, the purpose of this rule is to protect honest directors from liability in cases where the decisions they take give rise to outcomes that may be harmful to the company. The rule also seeks to limit the interference of courts in the affairs of companies while giving directors the latitude of running companies to the best of their abilities, without fear of taking well-informed risks. Furthermore, the business judgment rule purports to ensure that directors are not reprimanded for errors of judgment. The rule also prevents shareholders from usurping the functions of the board.¹¹⁴

The most important element under section 76(4) is that the director must have taken a decision that is well informed. Where he supports a decision, he is expected to have honestly believed that the decision in question is in the best interest of the company.

A director of a company is also expected not to be conflicted financially when making the decision. It is important to note that section 76(4)(ii) makes reference to "material" financial interest in the subject matter of the decision. It appears that this section acknowledges that

¹¹⁴ Ncube "Transparency and accountability under the new company law" 2010 Acta Juridica 43.

there would be instances where directors would be required to take decisions pertaining to matters where they may have financial interest. However, the interest may not be significant enough to influence directors to take irrational decisions. For instance, X who is a director in company A may have a financial interest in company B, a company that competes with company A. However, X's interest in company B may be so insignificant that he may not even consider company B when deciding on competitive strategies as a director in company A. Nonetheless, he would still be expected to declare his interest in company B in accordance with the provisions of section 75 of the new Act.¹¹⁵

The director's duty to disclose financial interest is not limited to his own interest but extends to the financial interest of a related person. Section 2 of the new Act provides guidance in terms of who can be considered as a "related person". The section stipulates that an individual is related to another individual if they are married, or live together in a relationship similar to a marriage; or are separated by no more than two degrees of natural or adopted consanguinity or affinity.¹¹⁶

In short, the three requirements that should be met in order for a director to benefit from the application of the business judgment rule are as follows:

- the director must have made an informed decision;
- there must have been no self-dealing or, alternatively, there must have been proper disclosure of any material personal financial interest of the director or a related person; and
- there must be a rational basis for believing that the director was acting in the best interest of the company.¹¹⁷

In arriving at the decision, the director may rely on other sources or third parties. In this regard, he may rely on information supplied by employees of the company who are believed to be reliable and competent in the performance of their functions. He may also rely on the company's legal counsel, accountants, or other professional persons retained by the

¹¹⁵ Section 75 of the new Act provides a list of instances where a director would be required to disclose personal financial interest. In terms of section 75 (4), a director may disclose financial interest by submitting a notice in writing setting out the nature and extent of the interest.

¹¹⁶Note that the term "related" can also be used to describe the relationship between an individual person and a juristic person, as well as a relationship between juristic persons. For purposes of this dissertation it is not necessary to discuss this further.

¹¹⁷ This summary was taken from Cassim, 514.

company or a committee of the board of which the director is not a member. In all these instances, reliability and competency are key requirements.¹¹⁸

¹¹⁸ Ncube 43. See also Kennedy-Good & Coetzee 62.

CHAPTER 5

CONCLUSION

One of the objectives of the new company law regime is to encourage the efficient and responsible management of companies.¹¹⁹ There are numerous benefits that come with efficiency in the management of companies. For instance, efficiently managed companies yield positive results for shareholders and encourage them to invest more in their companies. In turn, this benefits the economy at large as more jobs are created and more revenue is generated through tax. Efficiently managed companies play a significant role in giving effect to government policies such as the National Development Plan and the Industrial Policy Action Plan.

The partial codification of the duties of directors is one of the most important changes brought by the new company law regime. There have been debates on whether this change is necessary and essential. Most of the prominent South African academics and scholars have argued against the codification. For instance, Havenga submits that the codification of the duty of care and skill was unnecessary because this was already covered in King I.¹²⁰ McLennan submits that there should not be an over-legislation of issues, especially if such issues are governed satisfactorily by the common law. The more legislation there is, the more interpretation will be necessary.¹²¹

Despite the above submissions, this study has shown that there are benefits that are derived from the codification of the duties of directors. One of these benefits is that codification makes the law easily accessible. Studies undertaken by different organisations have shown that many directors do not know what their duties are. This makes it essential for the duties to be codified and encourages good corporate governance. Codification also affords South Africa the opportunity to conform to international best practices.

Common law has laid a good foundation for the duties of directors. It explains the meaning of these duties and defines their parameters. Common law also holds that fiduciary duties and the duty of care and skill apply to both executive and non-executive directors.

¹¹⁹ See Section 7(i).

¹²⁰ Havenga 257.

¹²¹ McLennan 184.

Furthermore, in terms of common law, a director owes fiduciary duties to the company on whose board he serves and not to other companies, regardless of whether they belong to the same group of companies or not. The study has shown that common law recognises the following duties of directors:

- The duty to avoid conflict of interest;
- The duty to act within powers;
- The duty to maintain an unfettered discretion;
- The duty not to exercise powers for an improper purpose; and
- The duty to act with care and skill.

Further, common law gives recognition to the so-called business judgment rule. The purpose of this rule is to protect honest directors from liability in cases where the decisions they take give rise to outcomes that may be harmful to the company. The rule also seeks to limit the interference of courts in the affairs of companies while giving directors the latitude to run companies to the best of their abilities, without fear of taking well-informed risks. The business judgment rule also purports to ensure that directors are not reprimanded for errors of judgment. Lastly, the rule prevents shareholders from usurping the functions of the board.

Under the new company law regime, the duties of directors are contained in section 76. This section deals specifically with the duty to act in good faith and for a proper purpose, the duty to act in the best interest of the company, and the duty of care, skill and diligence. Although the new Act has largely retained common law principles, it has also brought important changes that are noteworthy. These changes can be summarised as follows:

- the meaning of “director” has been broadened to include a prescribe officer or a person who is a member of a committee of a board of a company, or of the audit committee of a company. This person does not have to sit on the board of the company;
- the duties of a director are no longer limited to the company that the director serves, but now extend to wholly-owned subsidiaries of that company; and

- the duty of care and skill now includes “diligence”. This word has never been used by South African courts in the context of the duty of care and skill.

The new Act also incorporates the business judgment rule. There are three essential elements of this rule, namely the director must have made an informed decision; there must have been no self-dealing or, alternatively, there must have been proper disclosure of any material personal financial interest of the director or a related person; and there must be a rational basis for believing that the director was acting in the best interest of the company.

Section 77(2) codifies common law remedies that apply when fiduciary duties, and the duty of care and skill, have been breached. In this regard, the section states that where a director has breached his fiduciary duty to act in good faith and for a proper purpose, or the duty to act in the best interest of the company, he shall be held liable in accordance with the principles of common law relating to a breach of fiduciary duties, for any loss, damages or costs sustained by the company. For a breach relating to the duty of care, skill and diligence, section 77(2) states that the principles of common law relating to delict shall apply. The essence of section 77 is that common law tests and standards will continue to apply when directors have breached their duties.

Overall, the partial codification of the duties of directors should be seen as a step in the right direction. It is hoped that this move will assist companies, in particular their directors, to be more compliant. Corporate governance should also improve. However, it remains to be seen how courts will interpret and apply the newly adopted principles and concepts, such as “diligence”.

The fact that the codification is partial means that not all common law principles have been incorporated into the new Act. For this reason, common law shall continue to apply in this area of law. As explained by the DTI, the motive behind the enactment of the new Act was not to unreasonably jettison the body of jurisprudence built up over more than a century.¹²² Thus, such jurisprudence continues to be in force provided it is consistent with the spirit of the new Act.

¹²² South African Company Law for the 21st Century- Guidelines for Corporate Law Reform (GG 26493, 2004), 7.

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