
Directors' Duties: Negligence and the Business Judgment Rule

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1 Introduction

The business judgment rule originated in the United States as a common-law rule relating to directors' duty of care and skill. After considerable deliberation, going as far back as 1989, a statutory version of the rule has now been adopted in Australia (as s 180(2) of the Corporations Act 2001; see A Finlay 'CLERP: Non-Executive Directors' Duty of Care, Monitoring and the Business Judgment Rule' (1999) 27 *Australian Business LR* 98).

In South Africa the King Reports in 1994 and 2002 (published by the Institute of Directors in Southern Africa) recommended that the Standing Advisory Committee on Company Law investigate the necessity for the business judgment rule in South Africa. Now, and contrary to the views of most South African legal authors, a statutory version of the rule has been included in of the Companies Bill of 2007 (as cl 91(2)).

The duty of care and skill is already a very tenuous and risky foundation on which to found a legal claim against a director, as is witnessed by the paucity

of decisions finding directors in breach of this duty. This is the case both in Australia (see Finlay op cit at 99) and in South Africa (see, eg, D Botha & R Jooste 'A Critique of the Recommendations in the King Report regarding a Director's Duty of Care and Skill (1997) 114 *SAL* 65). Only rarely do shareholders resort to relying on breach of this duty as a ground of argument, and it is rarer still for them to succeed on that ground. It is therefore submitted that the adoption of a means of further limiting this duty would effectively lower the standard of care expected of directors.

As the business judgment rule developed in importance in the United States, so the duty of care and skill diminished in importance (see, eg, RM Jones 'Rethinking Corporate Federalism in the Era of Corporate Reform' (2004) 29 *J of Corporation Law* 644, and Stuart R Cohn 'Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions through the Business Judgment Rule' (1983) 62 *Texas LR* 603) until the business judgment rule blurred the distinction between the fiduciary duty and the duty of care and skill. Until now, in South African law, a director's fiduciary duty to his or her company has been separate and distinct from his or her duty of care and skill.

The origins of the South African fiduciary duty lie in Roman-Dutch law while the duty of care originated in English tort law. The consequences of breach of a director's fiduciary duty differ from those that follow a breach of the duty of care and skill, although situations may arise where they overlap (see Jones op cit at 626).

The fact that the business judgment rule was developed by the courts, and the fact that it blurs the distinction between the fiduciary duty and the duty of care and skill, demonstrate that American law on director's duties differs radically from South African law on this point. Nevertheless, it is interesting to observe that the courts of the American state of Delaware, by tradition sympathetic to corporate directors, appear to be changing their approach by restricting the limits of the protection offered by the business judgment rule, and moving towards more vigorous enforcement of directors' duties (*idem* at 625). In support of this position it has been pointed out that since the Enron and other corporate scandals, the Delaware Supreme Court's corporate decisions 'depart dramatically from the tradition of management deference' (*ibid*).

As evidence of this trend, reference is made (*ibid*) to four decisions.

In *In re Walt Disney Co Derivative Litigation* (825 A 2nd 275 (Del Ch, 2003)) the plaintiffs brought a derivative action against Disney's directors and former directors, alleging breach of the board's duty of care. Relevant were board decisions involving the approval of Michael Ovitz's employment contract (negotiated between Ovitz and Michael Eisner, Walt Disney's CEO, chairman of the board, and close personal friend of Ovitz), and the subsequent approval (within 12 months) of his severance package worth USD140m. The Delaware Court of Chancery dismissed the plaintiffs' claims on the ground that the plaintiffs had failed to demonstrate the CEO's interest in the

employment of a close personal friend who was appointed as president and chief operating officer. However, the Delaware Supreme Court allowed the plaintiffs to amend their pleadings by alleging facts that raised a reasonable doubt that the board's decisions were entitled to the protection of the business judgment rule. The same judge who rejected the plaintiff's claim in the Court of Chancery, this time concluded that the conduct of the board raised a reasonable doubt that it was entitled to the protection offered by the business judgment rule, and that the negligence of the board in itself amounted to breach of its fiduciary duty. The friendship between Eisner and Ovitz, and the fact that Ovitz's employment contract was negotiated directly between the two of them, raised questions as to the independence of both Eisner and the board. The Court took into account, amongst other factors, that the board had taken no more than ten minutes to approve Ovitz's employment contract, and that the minutes of this meeting amounted to a compendious one and a half pages. Jones (op cit at 642) points out that this approach indicates a sharp departure from the approach that existed before the Enron case and the Sarbanes-Oxley Act of 2002 (Public Law No 107-204).

In the second case, *Telxon Corp v Meyerson* (802 A 2nd 257 (Del 2002)), the directors were alleged to have breached their fiduciary duty by allowing the chairman of the board, Robert Meyerson, to take an opportunity open to the company of developing a product within the company's line of business, and then to sell the technology back to the company. The other directors were also alleged to be in breach of their fiduciary duty by agreeing to the transaction. It was alleged that Meyerson dominated the board to such an extent that the transaction could not be said to have been approved by independent directors, and that therefore the directors were not entitled to the protection offered by the business judgment rule. The Court of Chancery dismissed the plaintiff's argument, and on appeal, the Supreme Court held that not enough facts were available to decide whether or not the directors were independent. Jones (op cit at 657) observes that this means that Court therefore adopted a stricter test for director independence.

In *Krasner v Moffat* (826 A 2nd 277 (Del 2003)), two companies, with several communal board members, entered into merger negotiations, each having formed a special committee of independent directors to assess the transaction. Company A's shareholders alleged that their directors had breached their fiduciary duties by approving a transaction that was unfair to A's shareholders, in that company B's shareholders received a greater percentage interest in the merged body than did A company's shareholders. The Delaware Court of Chancery held that the special committee process rendered the decision of company A's board subject to the business judgment rule. However, on appeal, the Supreme Court held that the directors bore the burden of proving that the committee was actually independent, and that independence depended upon the special facts of each case.

Finally, in *In re Oracle Corp Derivative Litig* (824 A 2nd 917 (Del Ch 2003)), Oracle had formed a special litigation committee to decide whether

the plaintiff's claim (that four of Oracle's directors had breached their fiduciary duty to the company by engaging in insider trading) was in the interests of the company. The committee concluded that pursuing the plaintiffs' claim in court was not in the interests of the company. The Court of Chancery decided that the committee was not sufficiently independent to decide the question of continuing the litigation objectively, due to the extensive social and professional connections between the directors and the committee members, which centred around their connection to Stanford University.

Jones (op cit at 661) is of the view that these decisions demonstrate 'a new reluctance to credit defendants' arguments which are premised on the assertion that the directors charged with making the challenged decision were independent'. However, this shift in perspective may merely be incidental to a real or perceived encroachment of federal legislative power over state courts due to the enactment of the Sarbanes-Oxley Act (idem 644). However, it may also be due to a judicial recognition that derivative litigation by shareholders is one way to curb errant board members, and to prevent the kinds of corporate scandals mentioned earlier.

2 What Is the Business Judgment Rule?

The business judgment 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 interests of the company (idem at 625). It addresses the issues of both the honesty of directors and, to a limited extent (ie, whether they have properly informed themselves as to the circumstances surrounding the particular decision), 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 (see M Havenga 'The Business Judgment Rule – Should We Follow the Australian Example?' (2000) 12 *SA Merc LJ* 28). It also means that the rule does not apply to questions of negligence in the context of directors' passivity or inactivity, at least where no actual decision has been taken (idem at 30).

In the Companies Bill of 2007, the intended operation of the rule appears to be as follows.

Clause 91(1)(a) provides for the director's duty of care and skill, and appears to have given it both the objective and subjective elements that it possesses at common law. It does not appear to add anything new to the position, especially since cl 91(6) provides that cl 91 operates in addition to the director's common-law duties.

Clause 91(1)(b) provides that a director has a fiduciary duty to act honestly and in good faith in what he or she reasonably believes to be in the company's best interests. Sub-clause (2) provides that the reasonableness of this belief

depends upon whether the director has informed himself or herself about the subject matter of the belief, whether he or she has a 'personal financial interest' (as defined in cl 1) in the subject-matter of the belief, and whether the belief is one that a reasonable person in a similar position could hold. The application of sub-cl (2) will therefore determine whether or not a director's belief that he or she was acting in the company's best interests, was 'reasonable' in accordance with sub-cl (1)(b), that is, the business judgment rule will determine whether the director has breached the fiduciary duty to act in what he or she honestly believes to be in the best interests of the company.

3 How Does the Rule Work?

The extent of protection offered by the rule depends on the context of its application. For example, in near insolvent circumstances a director must take many more factors into account than he or she need do in a takeover situation (see WK McLeod 'Potential Mergers or Acquisitions: Issues to be Considered' (1996) 113 *Banking LJ* 301).

It has been argued (see VM Rosenzweig & M Orens 'Tipping the Scales – The Business Judgment Rule in the Antitakeover Context' (1983) 14 *Securities LJ* 295) that in hostile takeover threat situations in the United States, the courts only hold target directors liable when their defensive response is disproportionate to the nature of the threat and clearly shows an improper motive (ie, the desire to maintain control regardless of the cost to the company) or when the tactics included blatantly deceptive communications to shareholders. According to this view, American courts place too much value on the business judgment rule, the application of the rule to target company directors is inappropriate, and target company directors should be subject to more stringent scrutiny. It has further been pointed out (*idem* at 293-5) that American decisions differ slightly with regard to the extent of the presumption of sound business judgment and the imposition of the burden of proof in the context of hostile takeover bids. For example, in *Panter v Marshall Field & Co* (646 F 2d 271 (7th Cir 1981)), the plaintiff had to prove sufficiently that the directors had not acted in good faith (ie, in this particular case, that they had acted for an improper purpose), before the burden moved to the defendant 'to prove that the transaction also had a valid purpose' (at 293). Most American courts follow this approach with slight variations in the point at which the burden shifts to the defendant, that is, there is conformity in the standard of proof required of the plaintiff. They generally agree on the minimum standard of proof, which is that a plaintiff must prove more than that control was merely a motive. All the courts refrain from probing too deeply into the directors' business judgment if their decisions can 'be attributed to any rational business purpose' (Rosenzweig & Orens *op cit* at 295).

In the context of takeover threats, then, once the plaintiff proves sufficient facts, the directors must prove that their decision was taken in the reasonable

belief that the company's 'policy and effectiveness' were under threat, and that their response was proportionate and reasonable in relation to the threat (see *Havenga op cit* at 30).

Where there has been an unsolicited offer, the rule will normally protect directors who decide not to respond to the offer (see *McLeod op cit* at 176). Where there has been impartial director approval of a controlling shareholder, American courts have sometimes held that this merely shifts the burden to the plaintiffs to show that the transaction is unfair. According to *Jones (op cit* at 649), this burden-shifting rule has been applied consistently only in the context of cash-out mergers, where shareholders are forced to sell their shares to the acquirer at a price dictated to them.

4 Why Does the Rule Exist?

It has been observed that policies underlying the business judgment rule include the protection of honest directors from liability where a decision turns out to have been an unsound one, and the prevention of the 'stifling of innovation and venturesome business activity' (*Havenga op cit* 28). Under s 248 of the Companies Act 61 of 1973, directors who act 'honestly' and 'reasonably' may be excused from liability if the court concludes that in the circumstances they 'ought fairly to be excused'. However, as will be set out shortly, this will no longer be the case as the power of a court to excuse errant directors will be severely curtailed by the enactment of cl 93(4) of the Companies Bill of 2007.

In the South African context, directors must now also make decisions relating to black economic empowerment partnerships. Considering the expense and potential risk to companies taking on empowerment partners, there is greater potential for decisions which are harmful to the company, that is, to the shareholders, in that such deals expose the company to financial risk, especially where a company assists its partner to acquire its shares – in normal circumstances a contravention of s 38 of the Companies Act 61 of 1973, which itself is to be amended by cl 40 of the Companies Bill, 2007. The prohibition has effectively ceased to exist, and in its place are mechanisms designed to protect companies from ill-considered decisions. Sub-clause 40(1)(iii)(cc) will allow closely-held companies (as defined in cl 1 and 8) to give financial assistance for the purchase of shares or options, providing that specific authorization has been granted to do that in the memorandum of association, and that the board is satisfied of the matters listed in sub-cl (1)(b)(i), namely that that the company would, immediately after the financial assistance, be in compliance with the solvency and liquidity test (as set out in cl 4) and that any terms regarding the proposed assistance are fair and reasonable to the company. The boards of public-interest and widely-held companies (defined in cl 8 and 9 respectively) must also be satisfied as to these matters, and these types of companies must be authorised pursuant to a special resolution of shareholders which must approve assistance for a specific recipient or for a category of recipients. The liability of

directors is no longer criminal, and is limited to the directors who approve transactions that are inconsistent with the Act or the memorandum.

This is an apparent loosening of one of the last remaining vestiges of the common-law maintenance of capital principle in the companies legislation after the 1999 amendments to the Companies Act. These amendments were made for the purpose of modernizing the methods of protection of creditors and shareholders, which purpose is not mentioned in cl 6 of the 2007 Bill. Clause 6(b), however, does make specific provision for the promotion of the development of companies ‘in particular, among those South Africans who have historically been excluded from active participation in economic organization, management and productivity’.

Social and corporate responsibility in this context means that directors’ decisions must necessarily be based firstly on racial, and secondly, on economic considerations. One of the implications of companies being pressured into such arrangements appears to be that there is greater potential in this country for negligence on the part of directors, who, in making decisions about empowerment partnerships, are required to implement policies which give precedence to corporate responsibility in the wider community rather than to the profitability of the company. On this view, decisions taken by South African directors should be subjected to a higher standard of scrutiny, rather than a lower one.

5 Is the Rule Necessary?

The reasons for the recommendation contained in the 1994 King Report on Corporate Governance (op cit in par 3.3), namely that the duty of care and skill be limited by the business judgment rule, included the following:

- the ‘onerous’ standard of the duty of care and skill, especially in relation to non- executive directors;
- the encouragement of commercial ventures and the appointment of persons of ‘skill and reputation’; and
- the promotion of higher standards of corporate governance.

With regard to the first point, the relevant standard of care in South Africa has been described in *Fisheries Development Corporation v Jorgensen* (1980 (4) SA 156 (W) at 165) as ‘the care which can reasonably be expected of a person with his knowledge and experience’. The test is usually described as objective but is in fact also, to a large degree, subjective because the reasonable director is imbued with the knowledge and experience of the director whose decision is in question. As pointed out by Botha and Jooste (op cit at 67), this can hardly be described as an ‘onerous standard’. They also note (idem at 68) that there has only been one case in South African law (*Niagara Ltd (in liquidation) v Langerman & Others* 1913 WLD 188) where a director has been held liable for breach of his duty of care. It is interesting to observe that a recent media report on the annual business conference of the Institute of Directors in Southern Africa refers to the ‘huge’ responsibilities of

non-executive directors and the 'onerous' demands on their time (G Vaida 'The Perils of being Unethical' 12 Jun 2005 *Sunday Times*).

In relation to the second point, the King Report states (ibid) that the business judgment rule 'recognizes that business decisions frequently entail risk and uncertainty, and thus encourages directors to engage in ventures which have potential for greater profit but which may entail some risk'. However, directors have never been held accountable for mere errors of judgment.

In relation to the third point it is not possible to see how the introduction of a rule limiting directors' duty of care and skill could contribute to a higher standard of corporate governance. It is far more likely that it will contribute to a higher degree of corporate misconduct.

It is this author's submission that the existing law adequately covers the business judgment rule limits to the duty of care and skill, or, in other words, that the law sufficiently protects directors in South Africa who have acted honestly and reasonably.

Section 248 of the Companies Act provides that in proceedings against a director for negligence, breach of duty or trust, or where a director has reason to fear that such allegations may be made against him, the director concerned may apply to the court for relief. If the court is of the opinion that the director is or may be liable, but that he has acted honestly and reasonably and that he ought fairly to be excused, then it has the power to excuse him from liability. However the Companies Bill of 2007 will change this position as it provides in cl 93(4) and (5) that, if in proceedings against a director, '*other than for gross negligence, willful misconduct or breach of trust*', it appears to the court that the director is or may be liable, but has acted honestly and reasonably, and in the circumstances of the case it would be fair to excuse the director, the court may wholly or partly relieve the person. Where a director has reason to apprehend that a claim alleging the director's liability, on the grounds mentioned in italics above, he or she may apply to the court for relief. It seems, then, that under the new dispensation courts will no longer have the power to relieve directors from breach of their fiduciary duties or from breaches of their duty of care and skill which constitute gross negligence (although it seems highly unlikely that a court would have excused the latter type of conduct under s 248).

A director who exercises his or her powers for an improper purpose, or who has an interest in the decision, is in breach of the fiduciary duty. Where a director makes an irrational business decision or has not adequately informed himself or herself of all factors or circumstances relevant to the decision, the duty of care and skill may or may not have been breached, depending on whether or not the conduct falls below the relevant standard of care.

6 The Distinction between the Fiduciary Duty and the Duty of Care and Skill

The fiduciary duty is encountered when a person is in control of the assets of another. In general it entails acting in good faith, that is, honestly and in the

best interests of that other person or, in the present context, the company as a whole (Cilliers & Benade *Corporate Law* 3 ed (2000) by HS Cilliers, ML Benade, JJ Henning, PA Delport, L de Koker & JT Pretorius at 139). Types of conduct which have been held to breach this duty include making a profit at the company's expense, exceeding the limits of authority, acting for an improper purpose, and fettering the director's discretion. The cause of action for breach of this duty is one for breach of trust. It is sui generis, and is not based on either contract or delict (see M Havenga 'Directors in Competition with Their Companies' (2004) 16 *SA Merc LJ* 275 at 286), and in South Africa its origins lie in Roman-Dutch rather than English law (MS Blackman 'Companies' in: WA Joubert (ed) *The Law of South Africa* vol 4 part 2 (1996) in par 116n2).

In South African law, a plaintiff alleging breach of fiduciary obligations will bring an action based on breach of trust. One of the consequences of breach of the fiduciary duty is that a contract entered into in breach of the fiduciary duty will usually be voidable at the company's option. Section 36 of the Companies Act (and also cl 17 of the Companies Bill of 2007) creates an exception in the case of a director who causes his company to act beyond its capacity. It provides that where a company enters a contract that is beyond its capacity, the contract is not void only for that reason. However, any loss to the company or benefit to the director is recoverable by the company. In other circumstances involving breach of the fiduciary duty, the contract will be voidable at the option of the company, for example where a director has not disclosed his interest in a contract as required by both the Companies Act (ss 234-238, and see also cl 92(4) of the Bill) and the common law. The other consequence of breach of the fiduciary duty is that the director makes restitution to the company, either for loss suffered by the company, or for a benefit gained by the director.

In contrast, the duty of care addresses the question of delictual conduct in the form of negligence rather than honesty. The standard of care in South African law is derived from the English common law, and it has now been codified in the Companies Bill of 2007 (in cl 91(1)(a)).

However, up to now, in South African law, the cause of action for breach of this duty lies in delict. This means that, rather than the director's conduct constituting a specific delict, his or her conduct must be delictual in its nature. For conduct to be delictual, the following elements must be proved: conduct, defined as 'a voluntary human act or omission' (see J Neethling, JM Potgieter & PJ Visser *Law of Delict* 4 ed (2001) at 27); the wrongfulness of such conduct, defined as 'legally reprehensible or unreasonable' (see *idem* at 35); fault, in the form of intent or negligence (*idem* at 119); causation; as well as damage caused by such conduct. Where a director breaches this duty, the consequence is that delictual damages are recoverable by the company. Whether there is any effect on a contract entered into in breach of such duty, depends on whether or not there was also a negligent misrepresentation by the company (the directors) before the contract was entered into. The remedy for the company is delictual damages, not restitution.

It has been suggested (see Cohn *op cit* at 617) that one of the reasons judges dislike holding directors liable for negligence is their potentially limitless liability for vast sums of money, but that the problem may be overcome by the equitable jurisdiction of American courts, meaning that they are able to apply remedies other than damages (a common-law remedy). South African courts do not have the same type of jurisdiction, but why should not jurisdiction to make orders other than damages be conferred by legislation? In some cases the court already has such jurisdiction conferred on it by statute. For example, s 252 of the Companies Act (and now also cl 164 of the Companies Bill) allows the court to make 'such order as it thinks fit' where breach of the duty of care also amounts to 'unfairly prejudicial, unjust or inequitable' conduct.

7 The Standard of Care

An action based on a director's breach of the duty of care and skill must necessarily involve an inquiry into the relevant standard of care. In South Africa and the United Kingdom, the standard is based on dicta in *Re City Equitable Fire Insurance Co Ltd* ([1925] Ch 407 at 428). Firstly, 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', and secondly, a director is 'not bound to give continuous attention to the affairs of his company'.

Most authors agree that this is a lenient approach to the duty of care (see, eg, Havenga (2000) *op cit* at 26). However, it has also been argued (see D Arsalidou 'To Be Active or Inactive': Is This a "New" Question for Company Directors?' (2003) 17 *Deakin LR* 6) that, in the context of directors' inactivity rather than where an actual decision has been taken, when the facts of the *City Equitable Fire Insurance Co* case are taken into account, it can be seen that it represented a strict approach to directors' duty of care. Liability was not imposed on the directors in that case only because the articles of association contained an 'exculpatory' clause of the kind now outlawed by s 247 of the Companies Act (and see cl 93(1) of the Companies Bill). Further, in *Fisheries Development Corporation of SA Ltd v Jorgensen* (1980 (4) SA 156 (W) at 165), the Court made it clear that the Court in the *City Equitable Fire Insurance Co* decision was referring to non-executive directors, not directors who are full-time employees of a company.

8 Conclusions

In America, the two major categories of directors' duties are lumped together under the fiduciary duty (see WO Hanewicz 'When Silence Is Golden: Why the Business Judgment Rule Should Apply to No-Shops in Stock-for-Stock Merger Agreements' (2003) 28 *J of Corporation Law* 213, TJ Lasfer 'Exposing a False Dichotomy' (2000) 3 *Delaware LR N* 94, Botha &

Jooste op cit at 70). This was not always the case (see Cohn op cit at 591). American law is generally more directly derived from English law than is South African law, and corporate law is no exception. However, the development of the business judgment rule in American corporate law means that at present there is a wide divergence between the law on directors' duties in the two jurisdictions.

South African corporate law too is largely derived from English law, and still resembles it more closely than does the American law on directors' duties. It may be that the tendency to give short thrift to the duty of care in the United States influenced the King Reports of 1994 and 2002 (see Botha & Jooste op cit at 70).

The differences between the fiduciary duty and the duty of care and skill have practical implications, as outlined above. In South Africa, the law on the duty of care and skill owed by a director to his company is relatively clear, and adopting the business judgment rule is likely to confuse the issue for the courts and ultimately make it easier for errant or negligent directors to escape liability.

Most commentators agree that there is no need for South African law to adopt the business judgment rule (see *idem* at 78; Havenga (2000) op cit at 36; and JS McLennan 'Duties of Care and Skill of Company Directors and Their Liability for Negligence' (1996) 8 *SA Merc LJ* 100). The Companies Act already protects honest and reasonable company directors, although to a lesser degree than will the Companies Bill of 2007. Added to that is the fact that there are hardly any cases in South African law (see Botha & Jooste op cit at 68) where directors have been sued for negligence. There could well be hidden pitfalls should Parliament decide to legislate on a matter which originated at common law. An 'unwritten' law is in its nature more flexible than one which is contained in legislation (see Havenga (2000) op cit at 37).

South African jurisprudence on the issue of directors' duties is at present closer to that of the United Kingdom than it is to that of the United States. In any event, it appears that even in America, the courts in Delaware are taking a different attitude towards the business judgment rule, in that they are restricting the limits of its protection.
