

THE BUSINESS JUDGMENT RULE: UNDUE EROSION OF DIRECTOR'S DUTY OF CARE, SKILL AND DILIGENCE

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CHAPTER1: INTRODUCTION

1.1. Background

The collapse of corporations due to negligence of directors and difficulties in holding them accountable has in the recent past actuated the evaluation of duty of care and skill. The outcome of this evaluation was a universal realisation that common law director's duty of care and skill was not enough for protection of interests of investing community. This weakness was attributed to subjective nature of common law duty of care and skill.

Recent times have witnessed a move in most commonwealth jurisdictions towards codification of duty of care and skill. This has been coupled with movement from subjective to objective test of the duty. Though South Africa lagged behind most comparable jurisdictions in this regard, it adopted the same approach of abandoning pure subjective test with the coming to effect of Companies Act of 2008.

With the elevation of the bar on duty of care and skill, some jurisdictions, South Africa included, adopted the business judgment rule as a measure to mitigate the heightened demands of the objective test of duty of care and skill. The jurisdictions which have always had the business judgment rule started to pay added attention to it for the same reason. The necessity of business judgment rule for the fulfilment of the aforementioned purpose remains a contested matter in the legal terrain. So much so that other commonwealth jurisdictions like UK have rejected it.

1.2. Research question

Is the business judgment rule necessary to mitigate the higher standard of director's duty of care and skill, or does it unduly erodes the duty of care and skill?

1.3. Research purpose

The research would seek to establish the following:

- The impact of Companies Act of 2008 on common law duty of care and skill.
- The effect of Companies Act of 2008 approach of conflating subjective and objective standards of evaluation of duty of care and skill.
- The assessment of the perils and advantages posed by the business judgment rule on the preservation and enforcement of the duty of care and skill.
- Evaluation of alignment of South African duty of care and skill and business judgment rule with those of comparable jurisdictions.

1.4. Research methodology

The research would entail:

- The study of South African common law and statutory law, particularly Companies Act of 2008
- Studying of comparable statutory provisions of comparable jurisdictions
- Studying of relevant articles, cases and books

1.5. Scope of the research

This paper considers the evolution of the duty of care and skill in the context of South Africa. It further looks at the nature of business judgment rule which is adopted in South Africa through Companies Act of 2008. Comparisons are also drawn with comparable jurisdictions with a view of assessing the alignment of South African approach with comparable jurisdictions on the matter related to the topic.

CHAPTER 2: COMMON LAW

2.1. Introduction

The South African duty of care and skill has its foundation in English law. This accounts for South African courts reliance on English courts decisions when seeking context and contents of this duty.¹ Therefore, the nature and outlook of South African and English versions of duty of care and skill hugely resemble each other.

Action for breach of duty of care and skill is delictual.² Meaning the five elements of delict must be proved for liability to arise. Though the South African duty of care and skill is based on English law, liability for its breach is based on Roman-Dutch law delict.

2.2. Delict as a basis for liability for breach of duty of care and skill

2.2.1 General background on delict

Delict can be defined as the act of a person that in a wrongful and culpable way causes harm to another. The law of delict is concerned with those situations where the conduct of one party causes or threatens harm to the interests of the other.

Delictual liability is governed by a generalising approach. There are general principles or requirements which regulate liability regardless of which individual interests are impaired and the way in which impairment is caused. In every case of delict, all five elements of delict must be present for delictual liability to arise. The five elements are act, wrongfulness, fault, causation and harm.

Despite the foregoing, there is a line of demarcation between delicts that causes patrimonial damage (*dammun iniuria datum*) and those that cause injury to personality. This distinction dictates which action should be preferred between *actio legis aquiliae* in terms of which damages for the wrongful and culpable causing of patrimonial damage are claimed, the *actio iniuriarum* in terms of which satisfaction for the wrongful and internal injury to personality and action for pain and suffering in terms of which compensation for injury to personality as a result of the wrongful and negligent impairment of bodily or physical-mental integrity is claimed.

The duty of care and skill is owed to the company. Since the breach of duty of care and skill will ordinarily lead to loss of money the suitable action would be *actio legis aquiliae*. It is accepted that personality rights of juristic persons such as companies can be infringed. This

¹ *Fisheries Development Corporation of SA Ltd v Jorgensen* 1980 (4) SA 156 (W).

² Ciliers & Benade ML Benade *et al Corporate Law* 3th (2000) 147.

can happen, for instance, in situation where the breach of duty of care infringes the reputation or business. In such instances *action iniuriarum* will be the suitable action.

2.2.2. Five elements of delict

2.2.2.1. Conduct

For the purpose of law of delict, conduct is defined as a voluntary human act or omission. Conduct can be in the form of commission- positive act or omission- failure to act. It is neither always easy nor important to draw a distinction between omission and commission. However, the distinction can be necessary since the duty not to cause harm is more stringent than the duty to prevent it. An omission or failure to take certain measures in the course of some activity is therefore not necessarily a form of conduct, but may well indicate that the action was negligently performed. Inaction as a part or a stage of some positive activity can therefore constitute or indicate negligence on the part of the actor. Negligence is by definition failure to take reasonable precautions. Many omissions are therefore merely indications of legal deficient positive conduct.³

Duty of care and skill is a positive duty which demands positive action. Therefore, in most instances, the conduct which constitutes breach of duty of care would be in the form of omission.⁴ The case of *Dorchester Finance Co. Ltd v Stebbing*⁵ illustrates this point. The case also lays bare how omission and commission can overlap. The brief facts of the case are as follows: the ordinary director had been left in complete control of the company's affairs; no board meetings were ever held, the other directors being content that this was, as one director suggested, in vast majority of wholly owned subsidiaries. The result was that the company made unsecured loans and irregular payments to other group companies and businesses in which the active director was interested. The other two directors – one a chartered accountant and the other with accounting experience – had facilitated this not only by their inactivity but also by signing blank cheques. The two directors were held liable for specific negligence in signing blank cheques, and more generally for failing to exercise any of their duties, let alone to exercise due care and skills.

The other case which crystallised the conduct by omission is the *Re City Equitable*⁶ case. In this case the managing director was given a free hand by his colleagues. He committed fraud and concealed the fraud by showing in the balance sheet as 'loans at call' and 'cash in

³ See J Neethling *et al Neethling-Potgieter-Visser Law of Delict* 6th ed (2010) 30 quoting Van der Walt and Midgley.

⁴ See P Loose *et al The Company Director Powers and Duties* 7th (1993) 197.

⁵ *Dorchester Finance Co. Ltd v Stebbing* [1989] BCLC 498.

⁶ *Re City Equitable Fire Insurance Co Ltd* [1925] 1 Ch 407.

hand' while in fact the loans were mainly to him and the cash included a very large sum in the firm of stockbrokers of which he was a partner. The other directors never inquired about these items and for that omission they were found to have conducted themselves in breach of duty of care and skills.

2.2.2.2. Wrongfulness

The test for wrongfulness must be objective in nature and must entail *ex post facto* inquiry aided by the wisdom of hindsight. The determination of wrongfulness essentially entails dual investigations.¹ It must be determined that legally recognised interest has been infringed. 2. If it is clear that an individual interest has been prejudiced, legal norms must be used to determine whether such prejudice occurred in a legally reprehensible or unreasonable manner.⁷

The legal convictions of the community (*boni mores*) are employed as a basic test for wrongfulness. This test is objective in that it uses the criterion of reasonableness. However, the general *boni mores* test is seldom applied directly to establish wrongfulness because more precise methods have been developed to determine the legal convictions of the community. One of such methods which can be useful in case of duty of care and skill is wrongfulness as a breach of a legal duty. The legal duty approach is more appropriate in cases where breach of duty of care lead to pure economic harm.

The existence of legal duty can be proved from common law or statutory law. In addition, it can arise from considerations of public policy which justifies the recognition of such legal duty. The breach of legal duty approach enquires if the defendant has a legal duty to prevent harm according to the *boni mores* or reasonableness criterion. The defendant is under a legal duty to act positively to prevent harm to the plaintiff if it is reasonable to expect of the defendant to have taken positive measures to prevent the harm.⁸

All directors are required by law to exercise the necessary care, skill and diligence in the performance of their duties. The effect of this trite proposition is that failure by a director to observe requisite care, skill and diligence would be considered wrongful in the context of delict.

In the case of *Dorchester Finance Co. Ltd v Stebbing* it has been held that a) a director is required to exhibit in the performance of his duties such degree of skill as may be reasonably expected from person with his knowledge and experience. b) a director is

⁷ See J Neethling *et al Neethling-Potgieter-Visser Law of Delict* 6th ed (2010) 54-55.

⁸ See J Neethling *et al Neethling-Potgieter-Visser Law of Delict* 6th ed (2010) 56.

required to take in the performance of his duties such care as an ordinary man might be expected to take on his behalf. c) a director must exercise any power vested in him as such honestly, in good faith and in the interests of the company. The effect of the foregoing legal duties of directors is that in case directors do not observe them wrongfulness as an element of delict would have been fulfilled.

There are few cases which lay bare wrongfulness through the method of breach of legal duty. Some of such cases do so without necessarily textually expressing it. In the case of *Dorchester Finance Co. Ltd v Stebbing* the directors breached their legal duty to prevent harm by their inactivity and signing blank cheque and they were therefore wrongful in failing to discharge their legal duty to guard against that. In the case of *Re City Equitable* the giving of a managing director a free hand and not questioning his conspicuous fraudulent activities was treated as a wrongful conduct in that it constituted breach of legal duty.

It is important to note that in most instances of wrongfulness in the context of breach of duty of care and skill there will be loss of money and that would constitute pure economic loss. Wrongfulness in the case of pure economic loss has been dealt with in the case of *Telexmax (Pty) Ltd v Advertising Standards Authority SA*⁹ in which the court observed that *when dealing with the causation of pure economic loss it is well to remember that the act or omission is not prima facie wrongful ... and that more is needed. Policy considerations must dictate that the plaintiff should be entitled to be recompensed by the defendant for the loss suffered (...unless it is a case of prima facie wrongfulness, such as where the loss was due to damage caused to the person or property of the plaintiff). In other words, conduct is wrongful if public policy considerations demand that in the circumstances the plaintiff has to be compensated for the loss caused negligence act or omission of the defendant. It is then that it can be said that the legal convictions of the society regard the conduct as wrongful ...*

2.2.2.3. Fault

Fault requires that the law holds a person responsible for harm caused by his wrongful conduct. Fault, as an element of delict, refers to the blameworthy attitude or conduct of someone who has acted wrongfully. There are two forms of fault, namely intention and negligence. Most cases, if not all, of contravention of duty of care and skill would involve fault in the form of negligence. The foregoing view seems cogent despite the fact that, *actio legis Aquiliae* requires either intention or negligence as a form of fault. Fault in the form of intention in case of breach of duty of care and skill will imply that the director was *mala fide* and that will constitute breach of fiduciary duty. Therefore, emphasis will be devoted to

⁹ *Telexmax (Pty) Ltd v Advertising Standards Authority SA* 2006 (1) (SCA) par 14.

negligence. In the case of negligence, a person is blamed for an attitude or conduct of carelessness, thoughtlessness or impudence because, by giving insufficient attention to his actions, he failed to adhere to the standard of care legally required of him.¹⁰

The paradox of fault in a form of negligence is that though fault is a subjective element of delict the test for negligence is objective. A person is negligent if-¹¹

- (a) A reasonable person in position of the defendant-
 - i. Would foresee the reasonable possibility of his conduct injuring another in his person or property and causing him patrimonial loss; and
 - ii. Would have taken reasonable steps to guard against such occurrence; and
- (b) The he (defendant) failed to take such steps.

Using the case of *Dorchester Finance Co. Ltd v Stebbing* to demonstrate operation of this test it can be said a reasonable person in the position of the directors should have foreseen the reasonable possibility of signing of black cheques causing financial loss for the company and should have put measures to guard against that or alter their conduct but the directors failed to do so. The other case which can be employed to illustrate this point is the *Re D'Jan of London Ltd* case¹² in which a director signed the insurance form filled by the broker with incorrect information which leads to loss of money. The director should have foreseen that the broker can provide incorrect information that can lead to insurance being invalid and he should have proof read the information in the form to ensure its accuracy and he failed to do so.

2.2.2.3.1. Duty of care and negligence

The alternative of the test elucidated above is the duty of care doctrine. This approach which has its roots in English law entails the following two questions which must both be answered in affirmation in order to establish negligence. a) Whether the defendant owed the plaintiff duty of care. In answering this question, and departing from traditional approach which used to consider whether the reasonable person in the position of the defendant would have foreseen that his conduct might cause damage to the plaintiff, it is emphasised that the issue is a policy-based value judgement in which foreseeability plays no role as to whether interests should be protected against negligent conduct. b) Whether there has been breach

¹⁰ See J Neethling *et al Neethling-Potgieter-Visser Law of Delict* 6th ed (2010) 131.

¹¹ *Kruger v Coetzee* 1966 2 SA 428 (A) 430.

¹² *Re D'Jan of London Ltd* [1994] 1 BCLC 561.

of duty. In answering this question the consideration is whether the respondent exercised the standard of care that the reasonable person would exercise in order to prevent damage.¹³

In the *Fisheries Development Corporation*¹⁴ case it was held that a director is not required to have special business acumen or expertise, or singular ability or intelligence, or even experience in the business of the company...he is nevertheless expected to exercise the care which can be reasonably expected of a person with his knowledge and experience. The effect of this assertion by the court is that it posed a subjective duty of care on a director. If a director breaches that duty to the detriment of a company he will be held liable irrespective of whether he foresaw the possibility of damage to the company or not.

2.2.2.3.2. Expert and reasonable person test

In case the person in position of the respondent possess proficiency or expertise in respect of the alleged misconduct, the hypothetical reasonable person against whom the respondent must be evaluated must be considered to be a reasonable expert.¹⁵ The court in the case of *Re Brazilian Rubber Plantations & Estates Ltd*¹⁶ held that director's duty is to act with such care as is reasonably to be expected from him, having regard to his knowledge and experience. Meaning a director who is a chartered accountant, for instance, will be evaluated against the standard of a reasonable chartered accountant.

It has always been expected that directors, particularly executive directors, who are appointed on the basis of particular skill or who are members of a particular profession may be expected to display care and skill expected of a reasonable person in that profession.

2.2.2.3.3 Ordinary negligence and gross negligence

In *Mv Stella Tingas Transnet t/a Portnet v Owners of the MV Stella Tingas*¹⁷ it was held that to qualify as gross negligence the conduct in question although falling short of *dolus eventualis*, must involve a departure from the standard of the reasonable person to such an extent that it may properly be categorised as extreme, it must demonstrate, where there is found to be conscious risk taking, a complete obtuseness of mind or, where there is no

¹³ See J Neethling *et al Neethling-Potgieter-Visser Law of Delict* 6th ed (2010) 152.

¹⁴ See *Fisheries Development Corporation of SA Ltd v Jorgensen* 1980 (4) SA 156 (W).

¹⁵ See J Neethling *et al Neethling-Potgieter-Visser Law of Delict* 6th ed (2010) 139.

¹⁶ *Re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425.

¹⁷ *Mv Stella Tingas Transnet t/a Portnet v Owners of the MV Stella Tingas* 2003 2 SA 473 (SCA).

conscious risk-taking no risk-taking, a total failure to take care. If something less were required, the distinction between ordinary and gross negligence would lose its validity.

For the purpose of delict, it is not necessary to draw distinction between ordinary and gross negligence since prove of ordinary negligence is sufficient. The implication of this is that South African approach is in contrast with a suggestion that gross negligence is required for a director to be found liable for breach of duty of care and kill.¹⁸

2.2.2.4. Causation

The defendant can only be held delictially liable if it has been established that there is causal nexus between his conduct and the harm suffered by the plaintiff. Causation as an element of delict consists of two elements, namely, factual causation and legal causation.

2.2.2.4.1. Factual causation

The widely accepted test of establishing factual link is *conditio sine qua non* test, which is known as 'but-for' test. This test accepts that an act is the cause of a result if the act cannot be thought away without the result disappearing simultaneously.

This test requires that in the case of positive conduct or *commisio* on the part of the defendant, the conduct must be removed from the mind to determine whether the relevant consequence would still have resulted; in the case of an omission the hypothetical positive act must be inserted into the particular set of facts.¹⁹

If this test were to be applied in *Dorchester Finance Co. Ltd v Stebbing* case the signing of a blank cheque, which is a positive conduct, would have to be eliminated and thereafter determination be made if loss would still have ensued. If loss disappears with the elimination, factual causation is not proven. If the test were to be applied to *Re D'Jan of London Ltd* case the omission to read the insurance form before signing would be mentally eliminated, meaning the director would be, for the purpose of the test, considered to have read the information in the form before signing. If the loss would still have ensued had the director proof read the form, factual causation is not proven.

¹⁸ See N Bouwman 'An Appraisal of Modification of the Director's Duty of Care and Skill' (2009) 21 SA *Merc LJ* 509-534 at 512 which refers to *Re Denham* to canvass the point that the required standard is gross negligence.

¹⁹ See M Loubser *et al The Law of Delict in South Africa* 2 ed (2012) 71 for examples of how the approach applies.

2.2.2.4.2. Legal causation

No legal system will hold people responsible for all the harmful consequences of their conduct since a person is only liable for the consequences that are strongly linked to his conduct. Defendant cannot be held liable for the damage which is too remote from the conduct. Legal causation serves the purpose of limiting the liability of the defendant to harm which can be imputed to him.

There are few methods which are widely accepted as useful in establishing legal causation. Those methods are flexible approach, adequate causation, direct consequences, fault reasonable foreseeability, novus actus interveniens and talem qualem rule.²⁰

2.2.2.5. Damage

Damage as an element of delict can be defined as the detrimental impact upon any patrimonial or personality interest deemed worthy of protection by law. Damage can be patrimonial or non-patrimonial. There are several approaches through which patrimonial damages can be computed.

It is a trite proposition that directors' duty of care and skill is owed to the company and not individual shareholders or company's creditors. This means that for director to be held liable the damage must have ensued on the company. The effect of the foregoing is that no matter how extremely negligent the conduct of a director might be, the errant director cannot be held liable for breach of duty of care and skill. If facts in *Re City Equitable* case were to be employed to demonstrate the working of this element it would mean that if the giving of free hand to a managing director by other directors didn't lead to losses on the part of the company, this element would not have been satisfied.

²⁰ See J Neethling *et al Neethling-Potgieter-Visser Law of Delict* 6th ed (2010) 190-210 for detail discussion of these methods.

CHAPTER 3: STATUTORY LAW

3.1. Duty of Care, Skill and Diligence

3.1.1. Standard of conduct: section 76(3) (c)

Section 76(3) (c) of Companies Act 71 of 2008 (hereinafter referred to as the Act) provides that:

Subject to subsection (4) and (5), a director of a company, when acting in that capacity, must exercise the powers and perform the functions of a director with degree of care, skill and diligence that may reasonably expected of a person.

- i. *Carrying out the same functions in relation to the company as those carried by that director; and*
- ii. *Having the general knowledge, skills and experience of that director.*

The purpose of this section is to set the standard of director's conduct in relation to duty of care, skill and diligence. The standard has two limbs, one of which objective and the other subjective. The first limb set the standard which is objective in that its effect is that all the directors carrying out the same functions in relation to the company must adhere to the same standards. This limb has no regard for particular director's abilities. The words "carry out the same functions in relation to the company as those carried by that director" in limb (1) refers to particular circumstances of director's office rather than directors personal qualities, and therefore do not detract anything from its objectivity. The second limb brings the subjective considers - particular director's general knowledge, skills and experience - into play.

The cumulative effect of the two limbs is that there is a minimum standard that all directors must adhere to irrespective of their particular skills, knowledge skills and experience. However, if the director has higher degree of general knowledge, skills and experience the standard would be elevated accordingly.²¹

The proponents of the two limbs approach in South Africa argue that it allows for apples to be compared with apples. They further argue that it is suitable for South Africa on the basis that the pool of skilled directors is limited and setting the standard too high might serve as a

²¹ See FHI Cassim 'The Duties and The Liabilities of Directors' In FHI Cassim (Managing ed) *Contemporary Company Law* 2ed (2012) 505-594 at 559 for discussion of two limbs.

barrier for people from all walks of life to accept directorship.²² This line of reasoning should be treated with caution since it is the same reasoning which underpinned the common law subjective standard. Put differently, if this reasoning is overemphasised the danger of the second limb rendering the whole standard subjective might arise.

The view that a higher standard than the one objectively expected of every director should be demanded from the director with higher skills is consistent with the view expressed in the case of *Re Brazilian Rubber Plantations*²³ that a director who is knowledgeable must give the company the benefit of his knowledge when transacting the company's business.

The effect of the foregoing discussion is that though the section establishes minimum objective standard in the first limb, it retains common law biasness against more skilled directors. To that extent judgments like *Dorchester Finance Co Ltd v Stebbing*²⁴ in which two of the three directors were held liable for negligence since they possessed high skills while the third one was exonerated on the basis of having lower skills remains relevant.

The two limbs approach adopted in the Act marks a departure from common law heavily subjective approach. In the *Fisheries Development Corporation* case, which reflects common law as adopted in *Re City Equitable*²⁵ case, the court held that a director is expected to exercise care that can be reasonably expected of a person of his knowledge and experience.²⁶

The departure from common law subjective standard to objective-subjective established by this section was necessitated by the view that the community attitudes and expectations concerning director's duties have changed and the early English decisions no longer correctly reflect the standard of care expected from the directors.²⁷ Moreover, the dearth of court decisions finding directors in breach of common law duty of care and skill gives credence to the view that the common law test made it extremely difficult to find a director liable.

There is no unanimity on the interpretation of section 76(3) (c) which has been elucidated above. The dissenting interpretation is that the wording of the second limb which is subjective transforms the first limb which is objective into subjective test. Put differently, the

²² See JJ Du Plessis 'A Comparative analysis of a directors' duty of care, skill and diligence in South Africa and in Australia' in TH Mongalo (ed) *Modern Company Law for a Competitive South African Economy* 1 ed (2010) 263-289 at 287 for details of this argument.

²³ *Re Brazilian Rubber Plantations & Estate Ltd* [1911] 1 Ch 425.

²⁴ *Dorchester Finance Co Ltd v Stebbing* [1989] BCLC 498 (Ch).

²⁵ *Re City Fire Insurance Co Ltd* [1925] 1 Ch 407.

²⁶ *Fisheries Development Corporation of SA Ltd v Jorgensen* 1980(4) SA 156 (W).

²⁷ M Havenga 'The Business Judgment Rule- Should We Follow the Australian Example?' (2000) 12 SA Merc LJ 25-37 at 27.

second limb renders the standard established by section 76(3) (c) totally subjective. The basis of this argument is that as in common law, the section does not impose minimum standard of care, skills and diligence which is required of all directors since directors are only required to meet the standard that could be expected of someone with the same skill and intelligence as a particular director, even if this happens to be a very low standard. The effect of this interpretation is that there is no difference between section 76(3) (c) and common law.²⁸

The historical evolution of duty of care and skill accords with the earlier interpretation of the section, not with the latter. Given the paucity of cases in South Africa which deal with duty of care and skill, it is compelling to look at comparative jurisdiction, particularly English law, for the evolution of duty of care and skill.²⁹

The brief history of duty of care and skill is as follows: The test for duty of care and skill has been subjective as crystallized by the old English cases.³⁰ With the passage of time and alterations in directors' roles and expectations of them, the English courts accepted that the purely subjective test was no longer a correct reflection of care expected from directors. In the case of *Norman v Theodore Goddard*³¹ the court was willing to assume that the test of directors duty of care, in considering what he ought to have known or inferred, empowered the court to consider the knowledge, skill and experience which he actually had, in addition to that which the person carrying his functions should be expected to have. In adopting this objective-subjective test as "new" common law stand, the courts were influenced by section 214 of the Insolvency Act³² which in part provides that ... *by a reasonably diligent person having both (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and (b) general knowledge, skill and experience that that director has.*³³ It has always been accepted that this section demands objective-subjective standard in the same way as the earlier interpretation of section 76(3) (c). It must be noted that the provisions of 2007 Companies Bill were verbatim modelled after the above quoted provisions of insolvency Act. Section 76(3) (c) of Companies Act 2008 is also materially alike. It is therefore logical to interpret section 76(3)(c) in the context of its own history.

²⁸ See J Cassidy 'Models for reform: the directors duty of care in a modern commercial world' (2009). 20 *Stell LR* 373-406 at 385 for this interpretation.

²⁹ *Fisheries Development Corporation of SA Ltd v Jorgensen* 1980(4) SA 156 (W).

³⁰ *Re City Fire Insurance Co Ltd* [1925] 1 Ch 407 is the leading case.

³¹ *Norman v Theodore Goddard* [1994] 1 All ER 261.

³² UK Insolvency Act.

³³ See Paul L. Davies et al *Gower and Davies Principles of Modern Company law* 9 ed (2012) 519 for detail discussion of how the quoted provisions of Insolvency Act influenced company law approach of duty of care and skill.

3.1.2. Impact of Section 76(3) (c) on Fisheries Development Corporation case

The standard of conduct for duty of care and skill in South African common law has been laid down in *Fisheries Development Corporation* case which establishes three broad propositions.³⁴To date, this case remains the prominent case in South Africa in relation to duty of care and skill. What follows is an evaluation of how section 76(3)(c) impacts on the three propositions.

The first proposition is that the extent of a director's duty of care and skill depends to a considerable degree on the nature of the company's business and on any particular obligations assumed by or assigned to him. There is a difference between a full-time or executive director, who participates in the day-to-day management of the company's affairs, and the non-executive director who has not undertaken any special obligation. The latter is not bound to give continuous attention to the affairs of the company. His duties are of an intermittent nature, to be performed at periodic board meetings and at any other meetings which may require his attention. He is not, however, bound to attend all such meetings, though he ought to whenever he is reasonably able to do so.

Section 76(3)(c) varies expected standards in accordance with directors responsibilities.³⁵The Australian court in *ASIC v Rich*³⁶ when interpreting the equivalent section held that the responsibility of a director includes arrangements flowing from the experience and skills that the director brought to his or her office, and also any arrangements within the board or between the director and executive management affecting the work that the director would be expected to carry out. The implication of the above is, inter alia, that a high standard will still be expected from executive directors in comparison to non-executive directors.

Section 76(3)(c) does not only talk of care and skill, it also covers diligence. Diligence can be defined as attending properly to one's duties. There are few Australian cases which would be of great persuasive force in interpreting diligence which buttress the view that diligence demands that directors attend meetings. In *Daniels v Anderson*³⁷ the court observed that "in our opinion the responsibilities of directors require that they take reasonable steps to put themselves in a position to guide [and] monitor the management of the company". In adopting this view, the court was influenced by Supreme Court of New Jersey in *Fancies v*

³⁴ See ML Benade *et al Entrepreneurial law* 4th (2008) 135 for summary of the three propositions.

³⁵ FHI Cassim 'The Duties and The Liabilities of Directors' In FHI Cassim (Managing ed) *Contemporary Company Law* 2ed (2012) 505-594 at 560.

³⁶ *Australian Security and Investment Commission v Rich* (2009) 75 ACSR 1.

³⁷ *Daniels v Anderson* (1995) 37 NSWLR 438; 16 ACSR 607.

*United Jersey Bank*³⁸ in which it was expressly held that directors are advised to attend board meetings regularly.

The second proposition is that a director is not required to have special business acumen or expertise, or singular ability or intelligence or even experience in the business of the company. He is, however, expected to exercise care which can reasonably be expected of a person with his knowledge and experience. A director is not liable for mere errors of judgement.

It has been accepted in the presiding paragraphs that the correct interpretation of section 76(3) (c) is that it establishes objective-subjective standard. The implication of this is that a director can be expected to have special business acumen or expertise, or singular ability or intelligence or even experience in the business of the company if that can seasonably be expected of a person carrying the same functions in relation to the company as those carried out by that director. The directors cannot be held liable for errors in terms of standard required by section 76(3) (c).

The last proposition is that, in respect of all duties that may properly be left to some other official, a director is, in the absence of specific grounds of suspicion, justified in trusting that official to perform duties honestly. He is entitled to accept and rely on the judgement, information and advice of the management, unless there are proper reasons for questioning such. Obviously, a director exercising reasonable care would not accept information and advice blindly. He would accept it, and he would be entitled to rely on it, but he would give it due consideration and exercise his own judgement accordingly.

This proposition is essentially covered by section 76(4) and (5) of the Act and its discussion is beyond the scope of this work. Therefore, suffice it to mention that though section 76(4) (b) and (5) codifies the common law doctrine of reliance and delegation, the two differ in that in common law the test is “absence of ground of suspicion” while the Act demands “reasonable delegation”.

3.1.3. Section 76(3)(c) and the Banks Act of 1990

The adoption of objective standard of directors’ conduct in the Act can be regarded as an expansion to all directors of what has been applicable to directors of the banks in terms of

³⁸ *Fancies v United Jersey Bank* 423A 2d (1981) at 821-3.

the Banks Act.³⁹ Section 60(1A) (d) of the Banks Act provides that each director, chief executive officer of a bank owes a duty towards the bank to exercise such care in the carrying out of his or her functions in relation to that as maybe reasonably be expected of a diligent person who holds the same appointment under similar circumstances, and who possesses both the knowledge and skills as the director, chief executive officer in question may have.

In interpreting this provision J De Jager held that “a subjective test will apply only if the manager in question holds a higher level of skill than the minimum level that may be required in terms of the objective test. In such a case, the higher level of skill must be taken into account in determining whether a reasonable manager, possessing such additional skill, would have acted in the same manner as the manager in question had under the same circumstances.

Though the wording of section 76(3) (c) is not verbatim same as section 60(1A)(d), it is clear that the two have exactly the same effect in relation to directors.

The Banks Act further moves to expressly compel directors to possess and maintain the knowledge and skills that may reasonably be expected of a person holding a similar appointment and carrying out the same functions as are carried out by the director of the bank.⁴⁰ The Act has no express equivalence of this demand but it can be argued that it is implied in the setting of objective minimum standard of conduct which is expected of all the directors.

3.1.4. Liability for breach of duty of care, skill and diligence

Section 77(2) (b) (i) provides that a director of a company may be held liable in accordance with the principles of the common law relating to delict for any loss, damage or cost sustained by the company as a consequence of any breach by the director of a duty contemplated in section 76(3)(c). Section 77 which comprehensively deals with liability of directors and prescribed officers does not provide for any other method through which liability can be established except for the foregoing. The implication of this is that for the establishment of liability in case of breach of section 76(3)(c) the Act relies on common law rule of delict.

³⁹ See J De Jager ‘Comments on the effect of section 40 of the Banks Act 19 of 2003 on section 60 of the Banks Act of 1990’ (2005) 17 *SA Merc LJ* 170-182 at 175 for the discussion of standard required for directors of banks.

⁴⁰ Section 60 (A1) (C) of the Banks Act of 1990.

It is clear that for a director to be held liable for breach of section 76(3) (c) all five elements of delict must be proven- conduct, wrongfulness, fault, damages and causation.⁴¹

3.1.5. Comparison of Statutory law and Common law liability

It has been discussed earlier in this dissertation that section 76(3) (c) establishes objective-subjective standard of director conduct while common law demand heavily subjective standard. It has been outlined as well that for liability to be established in case of breach of both common and statutory law standard, five elements of delict must be proven. The question which arises is where lies the difference, if any, between common law and statutory law liability establishment standards.

On the strength of the above observations it can be said that for liability to arise in terms of section 77(2) (b) (i) for breach of section 76(3)(c), four of the five elements of delict must be proven in exactly the way as in common law. Those elements are conduct, wrongfulness, damage and causation.

The difference will come with the content of fault as an element of delict. As discussed in chapter 2, a person can only be at fault if he/she can be legally blamed for his/her conduct. In common law the test for fault, negligence in particular, is that a director is expected to exercise care which can reasonably be expected of a person with his knowledge and experience.⁴² Meaning fault can only be proven if it is proven that a director acted with inferior care than can be expected from him. The implication of this is that for incompetent directors the standard of wrongfulness is low.

In statutory law the test is that the director must meet objective minimum standard of care which must be met but all directors and this standard cannot be reduced to accommodate unskilled directors. The standard can however be elevated in case of directors who are highly skilled.⁴³ This means that for a director to be blameworthy in the context of delict it must be proven that he acted with inferior degree of care than objectively required of all the directors. In case of highly skilled director, fault can be proven if the director acted with inferior care than expected of a director highly skilled.

The net effect of the above is that it is relatively easy to establish fault in statutory law than in common law.

⁴¹ See chapter 2 for discussion of elements of delict.

⁴² *Fisheries Development Corporation of SA Ltd v Jorgensen* 1980(4) SA 156 (W).

⁴³ See section 76(3)(c) of the Act and earlier discussion on it.

3.2. Section 76(4)(a): the business judgment rule

Section 76(3) bears the words “subject to (4) and (5)”. The implication of those words is that in case the director meets the requirements of the said subsections he does not need to meet the standard of conduct in section 76(3)(c). Meaning since liability in terms of section 77(2) (b) (i) can only arise in case of breach of section 76(3) (c), a director can escape liability by complying with those subsections.

Section 76(4) (a) deals with the business judgment rule while section 76(4) (b) and (5) codifies the doctrine of delegation and reliance. The doctrine of delegation and reliance falls beyond the scope of this work and therefore it won't be discussed.

Section 76(4) (a) provides that

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

- i. The director has taken reasonably diligence steps to become informed about the matter*
- ii. Either-*
 - (aa) the director had no material personal financial interest in the subject matter of the decision, and had no reasonable basis to know that any related person had a personal financial interest in the matter; or*
 - (bb) the director complied with the requirements of section 75 with respect to any interest contemplated in subparagraph(aa); and*
- iii. The director made a decision, or supported the decision of the committee or the board, with regard to that matter, and the director had a rational basis for believing, and did believe, that the decision was in the best interests of the company.*

This subsection introduces the business judgment rule to our statutory law. The business judgment rule serves the following universally accepted purposes: Firstly, it encourages director to engage in risky endeavours which can be of benefit to the company. Secondly, the buffer that it confers on directors encourages suitable candidates for directorship to take

director positions. Thirdly, the decisions of the directors are not subjected to judicial second guessing. Meaning courts are prohibited from reviewing the directors' business decisions in hindsight. Fourthly, linked to the foregoing point, it prevents shareholders from taking over the management of companies through courts.⁴⁴

The generally accepted downside of the business judgment rule is that it can result in lowering of the required standard of directors' duty of care and skill. Given the dearth of cases, not only in South Africa, in which directors were held liable for breach of duty of care and skill, questions arise on its desirability. This accounts for the rejection of the rule in countries like UK and New Zealand. The introduction of business judgment rule in South Africa coincided with the elevation of the required standard of directors' conduct on duty of care and skill. Therefore, it can be said that the introduction of business judgment rule was meant to counteract and moderate the new objective standard of conduct introduced by the Act.⁴⁵

The intention of codifying the rule was to create a safe harbour from liability for directors who have made a rational and informed decision in the best interests of the company without any undisclosed self-dealing on their part or on the part of people related to them. The subsection however goes beyond applying in business decisions to apply in any particular matter arising in the exercise of the power and performance of the director.

3.2.1. Discussion of the requirements of business judgement test

3.2.1.1. The director has taken reasonable diligent steps to become informed about the matter

The test for this requirement is objective in that the director is required to have taken "reasonable diligent steps". Meaning the director would be expected to take steps that a reasonable person in his position would have taken. This requirement does not put emphasis on the result but on the effort to achieve result. This is based on the fact that it accentuates the taking of steps to be informed and not whether the efforts led to a desired result, namely, being informed. The upshot of this is that the director can meet this requirement even if he is ultimately not informed about the matter as long as he has taken reasonably diligent steps to be informed.

⁴⁴ See N Bouwman 'An Appraisal of Modification of the Director's Duty of Care and Skill' (2009) 21 *SA Merc LJ* 509-534 at 524 for some detail discussion of purposes of business judgment rule.

⁴⁵ See FHI Cassim 'The Duties and The Liabilities of Directors' In FHI Cassim (Managing ed) *Contemporary Company Law* 2ed (2012) 505-594 at 563.

3.2.1.2. No conflict of interests

The words “personal financial interests” in the second requirement makes it clear that it targets only financial interests. It would have been desirable to have the requirement stretching to cover other categories of conflict of interests which might debilitate the honesty of directors in making decisions. The alternative requirement that even where there is conflict of interest the director would have met the test as long as the director has met the requirements of section 75 has a potential to weaken this requirement. This is so because section 75 allows for disclosure in advance and for such disclosure to remain valid forever unless there has been changes in the nature of financial interests.⁴⁶

The commendable aspect of this requirement is that it goes beyond the personal financial interest of a director to cover those of related persons. However, the interests of related persons are limited to those that a director had reasonable basis to know. The implication of this is that the director must objectively have a basis to know. If the basis to know is objectively there and the director did not know the requirement is not met and the business judgment rule cannot be invoked.

3.2.1.3. The director made the a decision, or supported the decision of a committee or the board, with regard to that matter, and the director had a rational basis for believing, and did believe, that the decision was In the best interests of the company.

In the *Visser Sitrus v Goede Hoop Sitrus*⁴⁷ case it was held in relation to this requirement that the directors should subjectively have believed that their decision was in the best interests of the company and this believe must have a rational basis. The corollary of this is that the test is subjective in that it looks at what a particular director believed. However, in so believing the director must have had a rational basis. It is therefore imperative in the quest of understanding this requirement to gain clear appreciation of the concept of rationality.

The concept of rationality has received some attention in cases which pertain to exercise of public power. The court in *Visser Sitrus v Goede Hoop Sitrus* has accepted that the interpretation of the concept in cases relating to exercise of public power can be adopted with necessary adoption when dealing with section 76(4) (a).Rationality is concerned with the relationship between the decision and the purpose for which the powers was given.

⁴⁶ See J Cassidy ‘Models for reform: the directors duty of care in a modern commercial world’ (2009) 20 Stell LR 373-406 at 399 for some detail of this weakness.

⁴⁷ *Visser Sitrus v Goede Hoop Sitrus* 2014 (5) SA 179.

In the case of *ASIC v Rich*, when dealing with Australian equivalent provisions of section 76(4)(a), the court held that rational belief requirements are satisfied “if the defendant believed that his or her judgement was in the best interests of the corporation, and that belief was supported by a reasoning process sufficient to warrant describing it as a rational belief, as defined, whether or not the reasoning process is objectively a convincing one”.⁴⁸

The implication of finding the decision to be rational is that the court cannot interfere with the decision simply because it disagrees with it or considers that the power was exercised inappropriately.

The imperative question is whether the test for rationality is lower or equal to that of reasonableness. There are divergent views on this subject. J Cassidy is of the view that the test for rationality is lower than that of reasonableness.⁴⁹ She quoted authorities suggesting that it is possible for a decision to be unreasonable but not wholly irrational. On the other hand, FHI Cassim seems to hold that the tests for the two are exactly the same.⁵⁰

Melvin Aron Eistenberg argues that rationality standard of review is intended to be easy for a director to satisfy, and particularly much easier to satisfy than a reasonable standard. In substantiating his view he refers to the case of *Selheimer v Manganese Corp. of America*⁵¹ in which the managers poured the corporation’s funds into a single plant even though they knew the plant could not be operated profitably because of a lack of railroad siding, a lack of storage areas and other factors. The court imposed liability on the ground that the defendants conduct defies explanation, in fact, the defendants have failed to give any satisfactory explanation or advance any justification for the expenditure.⁵²

The court in the case of *ASIC v Rich* rejected an argument that the test for rationality is the same as reasonableness. The basis for the rejection was that acceptance of that argument would have rendered the equivalent provisions of section 76(4)(a) superfluous.

In the case of *Visser Sitrus v Goede Hoop Sitrus* it was held that the rationality criterion as laid down in section 76 is an objective one but its threshold is quite different from and more easily met than, a determination as to whether the decision was objectively in the interest of the company.

⁴⁸ *Australian Security and Investment Commission v Rich* (2009) 75 ACSR 1.

⁴⁹ See J Cassidy ‘Models for reform: the directors duty of care in a modern commercial world’ (2009) 20 *Stell LR* 373 406 at 400 which quotes some authorities in support of this view.

⁵⁰ See FHI Cassim ‘The Duties and The Liabilities of Directors’ In FHI Cassim (Managing ed) *Contemporary Company Law* 2ed (2012) 505-594 at 564 for this view.

⁵¹ *Selheimer v Manganese Corp. of America* 224 A 2d 634 (Pa.1966).

⁵² MA Eistenberg ‘An Overview of the Principles of Corporate Governance’ *Bus.Law.*1271 (1993) 48 1271-1296 at 1282.

The other case which attended to this question is *Minister of Defence and Military Veterans v Motau and others*⁵³ in which the court held that it is also well-established that the test for rationality is objective and is distinct from that of reasonableness. The case seems to suggest that the test for rationality doesn't assess whether the best decision was made, or whether a different decision could have been made.

From the foregoing, it is clear that there is convergence of authorities on the point that the test for both rationality and reasonableness is objective. However, though the dominant view is that the tests for the two are different, there seem to be some lingering controversy on whether the test for rationality and reasonableness are exactly the same or different.

The trite rule of statutory interpretation is that statutory provisions must be interpreted in a manner that make them operational and avoid making them superfluous.⁵⁴ Accepting that rationality and reasonableness tests are the same would expunge the difference between section 76(3)(c) and 76(4)(a) and thereby rendering section 76(4)(a) superfluous. The rule of interpretation cited above is consistent with the view that the tests for both are objective, but that of reasonableness is high and more demanding than that of rationality.

The rational basis must be for believing that "the decision was in the best interests of the company". The duty to act in the best interests of the company, which exists in common law and statutory law, is part and parcel of fiduciary duty. However, as part of the third requirement of business judgment rule it becomes a factor in determining the fulfilment of duty of care and skill. An observation can therefore be made that the business judgment rule blurs the lines between the fiduciary duty and the duty of care and skills. Moreover, the business judgment rule applies in the same way in fiduciary duty as it does in duty of care and skill.

Section 76(4) (a) has no indication as to who should bear the onus of proving the three requirements. Meaning there is no indication whatsoever in the Act or explanatory notes as to whether the burden of proof rests with the plaintiff or the defendant.⁵⁵

The concern that has been raised in certain quarters of academia about section 76(4)(a) is that it does not have the requirement that the decision must have been made for proper purpose. Proper purpose means that directors must exercise their powers for the objective purpose for which the power was given to them and not for a collateral or ulterior

⁵³ *Minister of Defence and Military Veterans v Motau* 2014 (5) 69(CC)([2014] ZACC18) which deals with rationality in the context of exercise of public power.

⁵⁴ See C Botha *Statutory Interpretation an introduction for students* 4ed (2005) 73 for discussion of this rule.

⁵⁵ See chapter 4 on how other jurisdictions deal with the onus of proof for business judgment rule requirements.

purpose. However, there is another view which seeks to invalidate this concern by suggesting that part of the last requirement which demands that a director should have acted in the interest of the company covers, by extension, this requirement.

In support of the latter view the court in *In the case of Visser Citrus v Goede Hoop Citrus* observed that “in my view, a close relationship between the requirement that the power should be exercised for 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”.

3.3. Section 77(9) : Review by Courts

Section 77(9) provides that-

In any proceedings against a director, other than wilful misconduct or wilful breach of trust, the court may relieve the director, either wholly or partially, from liability set out in this section, on any terms the court consider just if it appears to the court that-

- a. *The director is or may be liable, but has acted honestly and reasonably; or*
- b. *Having regard to all the circumstances of the case, including those connected with the appointment of the director, it would be fair to excuse the director.*

The conditions stipulated in (a) do not really provide a director with additional cushion because it is required for a director to have acted honestly and reasonably and this is not any lower standard than the one demanded by section 76(3)(c). In *Re D'Jan of London Ltd*⁵⁶ it was held that it may seem odd that a person who has been found guilty to be negligent, which entailed, failing to exercise reasonable care, could ever satisfy a court that he had acted reasonably.

The condition stipulated in (b) demands “fairness” as a required standard. Like “reasonable” and “rational” the Act does not provide a definition of “fairness”. However, the courts in others spheres of law, particularly in labour law, have attached meaning to the word which can be adopted in interpreting this subsection. In the case of *Branford v Metrorail and others*⁵⁷ the court held that “fairness” means taking interests of both parties into

⁵⁶ *Re D'Jan of London Ltd* [1994] 1 BCLC 561.

⁵⁷ *Branford v Metrorail and others*(2003)24 ILJ 2269 (LCA).

consideration. The dictionary meaning of the word is “just”. Accordingly, the standard test of “fairness” is lower than “rationality” and “reasonableness”.

The implication of this is that even if a director has breached section 76(3)(c) and liability has been established in terms of section 77(2)(b)(i), meaning all elements of delict have been proven, the director can still escape liability in terms of section 77(9)(b). It further means that even if the director never meets the provisions of section 76(4)(a) – the business judgment rule - and (b) and subsection (5) – doctrine of delegation and reliance, a director can still escape liability in terms of section 77(9)(b).

It is difficult to conceive the circumstances within which section 79(9) (b) can be invoked in practice. In the case of *Ex parte Lebowa Development Corporation Ltd*⁵⁸, which was decided on the basis of the predecessor of section 77(9) – section 248 of Companies Act of 1973, it was held that the section does not empower the court to relieve a director in case of fraudulent conduct on his part. This case is not very helpful in this regard since it only provides what should not be done rather than what should be done. Moreover, as evidenced by discussions in this chapter, the context in which section 77(9) is operating is totally different to the one that section 248.

The net effect of the foregoing discussion is that there are three different standards which are as follows: “reasonableness” in terms of section 76(3)(c), “rational” in terms of section 76(4)(a) - the business judgment rule and “fairness” in terms of section 77(9)(b).

⁵⁸ *Ex parte Lebowa Development Corporation Ltd* 1989 (3) SA 71 (T) 107.

CHAPTER 4: COMPARATIVE LAW

4.1. Australian law

4.1.1. Duty of care

4.1.1.1. Background⁵⁹

The duty of care and diligence is codified in section 180(1) of the Australian Corporate Act of 2001 which provides that-

a director or other officer of a corporation must exercise 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*

Before dissecting the provisions of the section quoted above, it is compelling to reflect briefly on the evolution of the duty of care and diligence in Australia for the proper appreciation of background and context of the section.

The duty of care, skill and diligence in Australia, like in South Africa, was influenced by English precedence of the late 1800s and early 1900s, particularly the *Re City Equitable*⁶⁰ case. The leading illustration of this case in recent times is the New South Wales Supreme Court decision in *AWA Ltd v Daniels*.⁶¹ The implication of this adoption was that Australia adopted a subjective test in evaluating the standard of director's conduct. However, Australian courts departed from subjective to objective standard in the case of *Daniels v Anderson*⁶² which observed that a director owes to his company a duty to take reasonable care in the performance of their office. It is important to note that South Africa has no case in common law which departs from the subjective standard adopted in *Fisheries Development Corporation* case. Beyond the English influence, Australia and South Africa are similar in that both base liability for breach of duty of care, skills and diligence on law of delict/torts.

Australia is one of the first countries to codify the duty of care, skills and diligence in its statutory books. It has had few legislations which deals with duty of care, skill and diligent before the Corporations Act of 2001. Section 107(1) of Victorian Companies Act of 1958,

⁵⁹ See JJ Du Plessis 'A Comparative analysis of a directors' duty of care, skill and diligence in South Africa and in Australia' in TH Mongalo (ed) *Modern Company Law for a Competitive South African Economy* 1 ed (2010) 263-289 at 276 for discussion of relevant Australian law history.

⁶⁰ *Re City Fire Insurance Co Ltd* [1925] 1 Ch 407.

⁶¹ *AWA Ltd v Daniels* (1992) 7 ACSR 759.

⁶² *Daniels v Anderson* (1995) 37 NSWLR 438; 16 ACSR 607.

which is the first one, provides that a director shall at all-time act honestly and use reasonable diligence in the discharge of the duties of his office. Despite the interpretation of this provision in the case of *Byrne v Baker*⁶³ which suggests that the provision set the standard too low, it is explicit in the use of the words “reasonable diligence” that the legislature wanted to set an objective standard.

Section 107(1) of Victorian Companies Act of 1958 was succeeded by section 124 of the Australian Uniform Companies Act 1961. Section 124 of the Australian Uniform Companies Act 1961 was in turn succeeded by section 229(2) of the Companies Act of 1981 which provides that an officer of a corporation shall at all times exercise a reasonable degree of care and diligence in the exercise of his powers and discharge of his duties. section 229(2) of the Companies Act of 1981 was succeeded by section 232(4) of Corporations Act of 1989 which provides that an officer of a relevant body corporation shall at all times exercise a reasonable degree of care and diligence in the exercise of his powers and discharge of his or her duties.

The Corporate Law Reform Act of 1992 provides that in the exercise of his or her powers and discharge of his or her duties, an officer of a corporation must exercise the degree of care and diligence that a reasonable person in a like position in a corporation would exercise in the corporation’s circumstances. The explanatory memorandum to the Corporate Reform bill of 1992 noted that the changed language was intended “to reinforce that the duty of care is objective”.

It is clear from the foregoing discussion that Australian legislature has consistently intended to adopt objective test of director’s duty of care and diligence from Victorian Companies Act to Corporations Act of 2001. The implication of this is that the body of case law and academic writings developed over a period of time is almost fully relevant. This marks a convergent point to the South African situation in which the legislative codification of duty of care, skill and diligence was effected for the first time in Companies Act of 2008. The Act also marks a departure from subjective to objective-subjective test of director’s conduct in terms of duty of care, skills and diligence while its Australian counterpart⁶⁴ affirms common law position, as indicated above.

⁶³ *Byrne v Baker* [1964] VR 443.

⁶⁴ Australian Corporations Act of 2001 in section 185.

4.1.1.2. Section 180(1): standard of conduct

Unlike its South African counterpart, section 76(3) (c), which establishes objective-subjective standard, section 180(1) establishes a purely objective standard. This distinction comes with the fact that section 180(1) has no regard for subjective elements like general knowledge, skills and experience of a director.

However, the court in *ASIC v Maxwell*⁶⁵ when dissecting the meaning of “company’s circumstances” held that it includes the experience or skills of a particular director. The effect of this is that the subjective considerations may find their way in to the test though the “company’s circumstances” consideration.

When considering the predecessor of section 180(1), section 229(2), the court have read in knowledge and experience of a director as a consideration. In the case of *Vrisakis v ASC*⁶⁶ the court held that the test is basically an objective one in the sense that the question is what an ordinary person, with the knowledge and experience of the defendant might be expected to have done in the circumstances if he was acting on his behalf.⁶⁷ Given the similarities in provisions of section 180(1) and 229(2), it wouldn’t be surprising to see section 180(1) interpreted in the same way.

Consistent with its predecessors, section 180(1) refers to duty of care and diligence and not duty of skill. This marks a difference with its South African equivalence, section 76(3)(c), which refers to duty of care, skill and diligence. The Australian statutes have been consistent in omitting the duty of skill even though the courts have highlighted the negative impact of this omission. In the case of *Byrne v Baker* which considers section 107(1), the court noted the omission of duty skill and observed that “what the legislature by the sub-section is demanding is what is reasonable in the circumstances and no more. This obviously caused considerable concern as it was surely not intended by the legislature to lower the already low standard of care, skill and diligence expected of directors under the English-influenced common law. The weakness of section 107 (1) as interpreted in *Byrne v Baker* has been retained in section 180(1) in that it too omits the duty of skill.”⁶⁸

⁶⁵ *Australian Security and Investments Commission v Maxwell* (2006) 59 ACSR 373.

⁶⁶ *Vrisakis v ASC* (1993) 11 ACSR 162.

⁶⁷ RP Austin & IM Ramsay *Ford's Principles of Corporate Law* 15 ed (2013) 468.

⁶⁸ See JJ Du Plessis ‘A Comparative analysis of a directors’ duty of care, skill and diligence in South Africa and in Australia’ in TH Mongalo (ed) *Modern Company Law for a Competitive South African Economy* 1 ed (2012) 263-289 at 281 for brief discussion of *Byrne v Baker* case.

Section 180(1) considers the circumstances of the company while section 76(3) (c) has no equivalent provision. When considering what “circumstances of the company” entail, the court in the case of *ASIC v Maxwell* held considered the following to be relevant: the type of company, the provision of its constitution, the size and nature of the company’s business, the composition of the board, the director’s position and responsibilities within the company , the particular function the director is performing, the experience or skill of a particular director, the terms on which he or she has undertaken to act as director, the manner in which the responsibility for the business of the company is distributed between director and employees, and the circumstances of a particular case

Section 180(1) also considers the responsibilities of a director within the company. This consideration is essentially alike the provisions of the first limb of section 76(3) (c).

4.1.1.3. Impact of section 180(1) on common law

Section 185(a) provides that section 180 to 184 have effect in addition to, and not in derogation of, any rule of law relating to the duty or liability of a person because of their office or employment in relation to a corporation. Meaning section 180(1) is not a statutory codification of duty of care and diligence. The clarity of section 185(a) on the impact of section 180(a) to the status of common law is commendable. It must be mentioned that the Act has no equivalent clarity. Unlike the Companies Bill 2007 which expressly stated the new directors’ duties operates in addition to existing common law duties, section 76(3) does not have an express provision to that effect. However, the Companies Act of 2008 expiratory guide provides that it introduces partial codification of duties.⁶⁹

Given the fact that common law standard of directors conduct has been elevated by *Daniel v Anderson* from subjective to objective, section 180(1) and common law demand similar standard. The implication of this is that Australia has two different systems, namely, common law and statutory law, both of which demand objective standard.

4.1.2. Business judgment rule

4.1.2.1. Section 180(3): Definition of business judgment rule

The business judgment rule is defined in section 180(3) as any decision to take or not to take action in respect of a matter relevant to the business operations of the corporation. From the definition it is clear that business judgment rule applies only to matters relevant to the business operations of the corporation. Therefore, the precise meaning and scope of that

⁶⁹ DTI Companies Act Explanatory Guide 32.

should be ascertained. In the case of *ASIC v Rich*⁷⁰ when attending to what is meant by business operations the court held that it is broad and that a matter may be relevant to the business operations even if it is not itself a business operational matter. The court also held that the decisions to enter into transactions for financial purposes are business judgment, as are matters of planning, budgeting and forecasting.

In explaining the meaning of business operations of the corporation, the Explanatory Memorandum to the Corporate Law Economic Reform Program Bill 1998 provides that the operation of the business judgment rule will be confined to the cases involving decision making about the ordinary business operations of the company. For example, the decision to undertake a particular kind of business activity promoted in a prospectus would be the kind of business to which the proposed rule may apply. However, compliance (or otherwise) with the prospectus requirements imposed by the Law would not be a decision to which the proposed rule could apply.⁷¹

The foregoing is clearly different with section 76(4) of the Act which contains the South African version of Business Judgment rule. For starters, section 76(4) (a) has no definition of business judgment. This omission is clearly due to the fact that the application of the section is not limited to business decisions since it extends to any matter arising in the exercise of the power and performance of the director. The liberal scope of section 76(4)(a) comes with the advantage that, unlike section 180(2) and (3), the need to appreciate the meaning and parameters of “business operations of the company” does not arise. However, the downside is that it casts the net wide enough to be an undue safe harbour in certain cases. The example of this is that while the scope of section 180(2) excludes oversight duties like monitoring the company’s affairs and policies, it appears those are covered by section 76(4)(a).

The other aspect of the definition worth attention is “take or not take action”. This means that the director must have turned his mind to the matter and make a conscious decision. Section 76(4) provides that “... matter arising in the exercise power or performance of function of director”. It is clear that section 76(4) cannot cover cases in which no power was exercised or where there has been non-performance. Meaning section 76 (4), unlike section 180, does not cover “not take action”.

⁷⁰ *Australian Securities and Investments Commission v Rich* (2009) 75 ACSR 1.

⁷¹ RP Austin & IM Ramsay *Ford's Principles of Corporate Law* 15 ed (2013) 486.

4.1.2.2. Section 180(2): Requirement of business judgment rule

Section 180(2) provides that

A director or other officer of a corporation who makes a business judgment is taken to meet the requirements of the statutory duty of care and diligence in s 180(1), and the equivalent duties at common law and in equity, in respect of the judgment if they:

- a. Make the judgment in good faith for proper purpose;*
- b. Do not have a material personal interest in the subject matter of the judgment;*
- c. Inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and*
- d. Rationally believe that the judgment is in the best interests of the corporation*

Discussion of the requirements in turn

4.1.2.2.1. An informed decision

This requirement is objective in that it requires the directors to inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate. The implication of this is that in assessing whether the defendant was appropriately informed, the court would use the reasonable person test and not what he subjectively believed.

In the case of *ASIC v Rich* the court adopted the following considerations in respect of reasonableness of the belief for purposes of section 180(2):

- The importance of the business judgment to be made;
- The time available for obtaining information;
- The directors or officer's confidence in those exploring the matter;
- The state of the company's business at that time and the nature of competing demands on the board's attention;
- Whether or not material information is reasonably available to the director.

Section 76(4) of the Act has a requirement comparable to this. However, the two are different in that section 180(2) requires the directors to inform themselves while section 76(4) requires directors to take steps to be informed. Put differently section 180(2) put emphasis on the result while section 76(4) emphasise the efforts without saying much about results.

4.1.2.2.2. No material personal interests

This requirement precludes all material personal interests in totality. This means that it goes beyond section 76(4) which precludes only material personal financial interests. The other point of divergent is that the South African version has an alternative in the form of compliance with section 75 of the Act while section 180(2) does not have. This point renders section 180(2) more demanding in this regard. Section 76(4) has a preferable feature in that it excludes even the personal financial interests of related persons while section 180(2) lacks equivalent feature.

4.1.2.2.3. Rational belief that the judgment is in the best interest of the corporation

In the case of *ASIC v Rich* it was held that if evidence shows that the defendant believed that his or her judgment was in the best interests of the corporation, and the belief was supported by a reasoning process sufficient to warrant describing it as rational belief, as defined, whether or not the reasoning process is objectively convincing one. It is clear as demonstrated by the foregoing that this requirement is exactly the same as its South African equivalence.

4.1.2.2.4. The judgment to be made in good faith for a proper purpose

This requirement has two distinct parts which are also independent fiduciary duties, namely, good faith and proper purpose. Good faith is subjective in that it is largely dependent on honesty. Meaning a breach of this duty requires subjective awareness of wrongdoing.

Proper propose means exercise power for the objective purpose for which the power is given and not for a collateral or interior purpose. The two parts operate in tandem in that even if a director acted honestly he could be objectively in breach of duty to exercise power for a proper purpose.⁷²

The single biggest criticism of section 76(4) (a) is that it does not have the equivalence of this requirement. The results of this omission is that section 76(4) (a) can be invoked even if the director acted dishonestly and/or for improper purpose.

4.1.2.3. Burden of proof

⁷² FHI Cassim 'The Duties and The Liabilities of Directors' In FHI Cassim (Managing ed) *Contemporary Company Law* 2ed (2012) 505-594 at 523 for discussion of "good faith and proper purpose" as fiduciary duties.

The next question is that who bears the onus proofing those requirements. The Explanatory Memorandum provides that a presumption in favour of the director. Though this provision provides more confusion than clarity, the fact that efforts were made to address the question of burden of proof remain commendable. It is important to note that there is nothing in South Africa which seeks to provide any guidance on this issue.

The view that the presumption is in favour of the directors has been rejected with cogent reasons. In the case of *ASIC v Adler* the court lamented the logic of expecting the plaintiff to bear the proof burden. In *ASIC v Rich* the court observes that the burden lies with the defendant. The court further held that expecting the plaintiff to bear the burden would be tantamount to adding to the elements of contravention to be proven by the plaintiff. The court in *ASIC v Fortescue Metals Group Ltd*⁷³ went against the Explanatory Memorandum by holding that the onus of establishing the requirements is on the defendant.

4.2. United states of America

4.2.1. Background

Owing to the disparities in structures of their legal systems, the comparison of South Africa and United States of America (hereinafter referred to as USA) can be a convoluted exercise. South Africa has a unitary system in which the same rules apply across the whole country while the USA has a federal system in which different states have different laws. The Delaware is the USA's most influential in terms of corporate law.

The net effect of the foregoing is that the best approach to dissect the USA jurisdiction is to aggregate the legal positions of various states while allowing Delaware to preponderate. The American Law Institute Principles of Corporate Governance of 1992 (hereinafter referred to as ALI Principles) provides useful insight of principles which are observed across USA. In addition, USA has a Model Business Corporation Act which provides a model that various states should, as far as possible, align with. The justification for navigating the intricacies of contrasting South Africa and USA is that USA, Delaware to be precise, is credited for developing the business judgment rule, and therefore for one to comprehend the nature of the rule is it logical to look at USA.

⁷³ *Australian Securities and Investments Commission v Fortescue Metals Group Ltd* (2011) 81 ACSR 563.

4.2.2. Duty of care

Section 4.01(a) of the ALI Principles states that

a director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believe to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances. This subsection (a) is subject to the provisions of subsection(c) (the business judgement rule) where applicable.

1. *The duty in subsection (a) includes the obligation to make, cause to be made, an inquiry when, but only when, the circumstances would alert a reasonable director or officer to the need therefor. The extent of such inquiry shall be such as the director or officer reasonably believes to be necessary*

Section 8.30(a) of the Revised Model Business Corporation Act of 1984(the Model Act) provides that a director shall discharge his duties as a director with the care an ordinary prudent person in a like position would exercise under similar circumstances.

USA has a history of encapsulating the duty of care to fiduciary duty; hence the duty of care is referred to as fiduciary duty of care. The ALI Principles, like the Model Act, refers only to “care”. This is consistent with common law approach which also refers only to “care”. This marks a departure from section 76(3)(c) approach which refers to “care, skills and diligence. However, too much should not be read into this difference since exploration of USA cases and academic writings which deal with the duty of care stretches the scope of the duty too wide, perhaps wide enough to cover skill and diligence. The duty of care has been defined as duty to act with certain degree of skill, prudence and attention when managing a business.⁷⁴ In the case of *Fancis v United Jersey Bank* it was held that a director should acquire at least a rudimentary understanding of the business of the corporation, this includes attending the meetings of the board.

The Model Act and ALI principles converge in that both set objective standard of director's conduct. This is because both gauge the conduct of a director against an ordinary prudent person. The objective test is consistent with the demand of section 76(3)(c)

Section 4.01(a) of the ALI principles built in flexibility in providing that “in a like position and similar circumstances”. The phrase “in a like position” recognises that the nature and extent

⁷⁴ See L Johnson ‘Unsettledness in Delaware Corporate Law: business judgment rule purpose’ *Delaware Journal of Corporate Law* 2013 for how “skill” meaning can be stretched

of the functions to be performed by a director varies with the tasks that have been imposed on the director or by corporation. The implication of this is that the section differentiates between executive and non-executive directors. This approach is consistent with section 76(3)(c) which considers the function carried out by a particular director.⁷⁵

The phrase is also intended to recognise that the special skills, background or expertise of a director may entail greater responsibility. A director's length of service on the board may also be relevant in evaluating the director's conduct. The meaning of this is that though section 4.01(a) does not explicitly provides for subjective considerations in the same way as section 76(3)(c), they find their way through this phase.

The phrase "under similar circumstances" is meant to recognise that the nature and extent of the functions and obligations of a director will vary depending upon such factors as the nature of the business, the urgency and the magnitude of a problem, and the corporation's size and complexity. This is comparable to the Australian "company's circumstances". From the wording of section 76(3)(c) there is nothing which suggest that the circumstances of the company should be a consideration.

What is clear from the above is that while in USA and Australia the court must consider both the position of a director and circumstances of the company, in South Africa the court should only consider the position of the director. Meaning in South Africa a financial director of a big company and very small company are treated alike.

Stemming from common law, ALI Principles burdens directors with duty to enquire as part of duty of care. In South Africa this only arise in case of delegation and reliance, not generally as part of duty of care.

4.2.3. Business judgment rule

USA is widely credited for being the originator of the business judgment rule. The earliest the history of the rule goes is 1919 in the Delaware case of *Dodge v Ford Motor Co.*

Section 4.01(c) of ALI Principles provides that

A director or officer who makes business judgment in faith fulfils the duty under this section if the director or officer;

⁷⁵ See Principles of Corporate Governance: analysis and recommendations: current thought April 2012 for meaning of "in a like position and similar circumstances".

1. *Is not interested in the subject of business judgment;*
2. *Is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances;*
and
3. *Rationally believes that the business judgment is in the best interests of the corporation*

Section 4.01(c) and accompanying Commentary makes it clear that the business judgment rule effectively consist of the following four conditions.

1. A decision (business judgment) must have been made,
2. The decision must have been made in good faith
3. The director or officer must not be self-interested in the decision,
4. The director or officer must have been informed with respect to the decision to the extent he or she actually and reasonably believed to be appropriate under the circumstances.
5. Rationally believes that the business judgment is in the best interests of the corporation

Brief discussion of those factors in turn

4.2.3.1. A decision (business judgment) must have been made

This requirement demands a conscious decision. To this extent it is similar to its equivalence in South Africa and Australia. For this requirement to be met there must have been a decision, meaning it does not cover failure to take decision. It is not clear whether deciding not to take business decision would qualify as a decision. Section 76(4) provides that "... matter arising in the exercise of power or performance of function of director". It is clear that section 76(4) cannot cover cases in which no power was exercised or where there has been non-performance. This means that this requirement makes similar demands to section 76(4) in that both do not cover failure to take decision.

The requirement also demands that there must have been business judgment while section 76(4) is not limited to business judgment since it extends to cover "any particular matter".

4.2.3.2. The decision must have been made in good faith

Good faith is subjective in that it is largely dependent on honesty. Meaning a breach of this duty requires subjective awareness of wrongdoing. For this requirement to be fulfilled the

defendant must have acted with good intention irrespective of whether he acted with proper purpose or not, and it does not matter how illogical, irrational or unreasonable the decision can be. Section 76(4) has no equivalence of this provision.

4.2.3.3. The director must not be self-interested in a decision

The requirement prohibits all kinds of interests. This is in contrast with its South African equivalence which prohibits only financial interests. Unlike section 76(4)(a) which provides for alternative in the form of compliance with section 75 of the Act, this requirement has no such alternative. However, section 76(4) compares favourably to the extent that it also prohibits the financial interests of related persons.

4.2.3.4. The director or officer must have been informed with respect to the decision to the extent he or she actually and reasonably believed to be appropriate under the circumstances.

This requirement demands of a director to be informed with respect to a decision. The test for whether the director was is informed is the reasonable man test, meaning the test is objective. this requirement differs with its South African equivalence in that section 76(4)(a)(i) puts emphasis on the steps taken to be informed, not on being informed.

4.2.3.5 Rationally believes that the business judgment is in the best interests of the corporation

This requirement is exactly alike as its South African equivalence. For discussion see chapter 3

4.2.4. Burden of proof

The duty of care provisions in subsection 4.01(a) and the business judgment rule in subsection 4.01(c) interact in the following way: if a director has complied with the business judgment criteria set forth in section 4.01(a) he will be free of liability under 4.01(a). This is the same interaction that section 76(4)(a) has on section 76(3)(c). However, if the challenging party can discharge the burden of proof in demonstrating a failure to meet these requirements, the safe harbour of the business judgement rule is unavailable. From the foregoing it is clear that the director is presumed to have complied with the business judgment requirements until the challenging party can proof non-compliance.⁷⁶

⁷⁶ MF Knowles and C Flannery 'The ALI Principles of Corporate Governance Compared with Georgia Law' *Mercer law Review* (1995) 47 1-39 at 18.

CHAPTER 5: CONCLUSION

The companies Act of 2008 does not make an express statement as to whether it totally or partially codifies the duty of care and skill. Though the explanatory guide of the Act states that the Act partially codifies the duty, there is lingering uncertainties on this matter. An express statement in the Act, as it is the case in Australia, would have averted this ambiguity.

The popular view espoused by the explanatory guide which declares that the Act partially codifies common law is also problematic in that it allows for coexistence of two systems which set different standards, one purely subjective and the other objective- subjective.

The Companies Act conflates the subjective with the objective standard. Though this arrangement is understandable given the skills pool of eligible directors in South Africa, it must be treated with care to avert the risk of the subjective element dominating the objective element. In other words, there is a risk of subjective element rendering the whole standard subjective.

The business judgement rule is desirable as far as it protects business decisions and promotes efficient business decision making. Therefore, the adoption of the business judgment rule by the Act is commendable.

However, there are challenges with the form of the rule that has been adopted in that It goes beyond covering business decision to cover matter arising in the exercise power or performance of function of director. This renders the scope of South African version of business judgment rule too liberal and, therefore, it can provide an undue safe harbour for directors who have breached their duty of care and skill. For this reason, the South African version of the rule is not aligned with comparable jurisdictions in that they constrain their scope to business decision.

Beyond the above weakness, the South African version of business judgment rule has weaknesses in terms of its requirements in that it can be invoked upon fulfilment of not so stringent requirement. This also marks a departure from the comparable jurisdiction requirements in that they are relatively more rigorous. The departures cited above from other jurisdiction would also make it limiting for South African courts to tap into the jurisprudence of such jurisdictions developed through the years.

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