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THE DUTY OF CARE, SKILL AND DILIGENCE: THE *KING REPORT* AND THE 2008 COMPANIES ACT

1 Introduction

Corporate governance is a broad concept and includes not only the common-law and statutory duties of directors, but also refers to the codes of practice of various (usually extra judiciary) entities (see generally on corporate governance and its regulation Du Plessis, Hargovan and Bagaric *Principles of contemporary corporate governance* (2011) 156 ff and Naidoo *Corporate governance* (2009) 27ff). The difference between these two meanings is that the former includes possible liability under the law for non-compliance, while the latter implies what it says, namely, it is a recommendation and non-compliance will result in "sanctions" other than direct liability. In a recent South African case the court referred to principles of good governance and it would appear that these principles (which are not contained in legislation or which are not mere restatements of common law principles) are not always mere recommendations. Instead, directors may have to adhere to these recommendations to prevent liability for breaching their legal duties.

2 *King Reports*

King I was released in 1994 and dealt with a number of corporate governance issues. Its purpose was to create the highest standard of corporate governance in South Africa. The Report resulted in a *Code of corporate practices and conduct* ("*Code*"), being a set of principles recommended as integral to good governance. Compliance with the *Code* was, however, voluntary.

In 2002 the *King II Report on corporate governance* replaced *King I*. *King II* applied to all companies listed on the Johannesburg Stock Exchange (now the JSE Limited) as well as large public entities, banks, financial and insurance entities and large unlisted public companies. Other companies were encouraged to comply with the Code. Non-compliance with these recommendations could result in secondary liability (such as "sanctions" by the JSE), but not necessarily in direct legal liability. (See generally on the *King II Report* Botha "Confusion in the King Report" 1996 *SA Merc LJ* 26–39; Loubser "Does the King II Report solve anything?" 2001 *Juta's Business Law* 135–140; and Rademeyer and Holtzhausen "King II, corporate governance and shareholder activism" 2003 *SALJ* 767–776.)

In view of the (then) anticipated new Companies Act 71 of 2008 ("2008 Companies Act") a new *King Report on corporate governance* became necessary ("*King III*"). (See Esser "The protection of stakeholder interests in terms of the

South African *King III Report on Corporate Governance*: An improvement on King II?" 2009 *SA Merc LJ* 188–201 for a comparison of *King II* and *King III*, specifically regarding stakeholder protection. See also Havenga *et al South African corporate business administration* (2010) ch 1 on *King III*.) Additional matters not covered in previous Codes are contained in Chapter 5 (IT governance) and it also refers to business rescue proceedings (principle 2.15 and the Practice Notes) as provided for in the 2008 Companies Act (see ss 128 ff) although they are not dealt with in detail. Some principles in *King II*, such as audit committees are also found in the Companies Act 61 of 1973 ("1973 Companies Act") and in the 2008 Companies Act (see s 94). *King III* also applies to all entities regardless of the manner and form of incorporation or establishment (see para 11 of the preface).

King III operates on an "apply and explain" basis. This is a refinement of the "comply and explain" basis that *King II* operated on. The *King III* committee found the word "apply" more appropriate than "comply" for the following reasons:

> "The 'comply or explain' approach could denote a mindless response to the King Code and its recommendations whereas the 'apply or explain' regime shows an appreciation for the fact that it is often not a case of whether to comply or not, but rather to consider how the principles and recommendations can be applied" (*King III* 6).

The underlying principle of all the King Reports is that directors should act not only in accordance with the letter of the law, but also in the spirit of their fiduciary duties:

> "It is the legal duty of directors to act in the best interests of the company. In following the 'apply or explain' approach, the board of directors, in its collective decision-making, could conclude that to follow a recommendation would not, in the particular circumstances, be in the best interests of the company. The board could decide to apply the recommendation differently or apply another practice and still achieve the objective of the overarching corporate governance principles of fairness, accountability, responsibility and transparency" (*King III* 6).

The guidelines in *King III* can be used as a test to determine whether a director acted, at least, with the necessary care and skill, as explained as follows:

> "As far as the body of legislation that applies to a company is concerned, corporate governance mainly involves the establishment of structures and processes, with appropriate checks and balances that enable directors to discharge their legal responsibilities, and oversee compliance with legislation. In addition to compliance with legislation, the criteria of good governance, governance codes and guidelines will be relevant to determine what is regarded as an appropriate standard of conduct for directors. The more established certain governance practices become, the more likely a court would regard conduct that conforms with these practices as meeting the required standard of care. Corporate governance practices, codes and guidelines therefore lift the bar of what are regarded as appropriate standards of conduct. Consequently, any failure to meet a recognised standard of governance, albeit not legislated, may render a board or individual director liable at law" (*King III* 6-7).

The possible effect of *Stilfontein Minister of Water Affairs and Forestry* v *Stilfontein Gold Mining Co Ltd* 2006 5 SA 333 (W) (*Stilfontein*) on the duties of company directors will be evaluated, especially where principles of good governance were discussed and references were made to the predecessors of *King III* and its application to company directors, also in light of the 2008 Companies Act. This case may have far-reaching consequences, not only for directors of

listed companies, but most probably for directors of all companies, profit and non-profit, as *King III* is applicable to all companies. The aim of this analysis is not to provide a detailed discussion of directors' duties in terms of the 2008 Companies Act and the common law and also not to discuss the interaction between the 2008 Companies Act and the common law, but rather to indicate the possible implications if courts test directors' conduct against the *King Report*, in view of the 2008 Companies Act. (For a detailed discussion of directors' duties see Cassim *et al Contemporary company law* (2011) ch 12; Davis *et al Companies and other business structures* (2010) 102 ff.)

3 *Stilfontein* and the *King Report*

Stilfontein Gold Mining Co Ltd was a listed company involved in gold mining that resulted in underground water being polluted if not raised to the surface and treated properly. The Minister of Water Affairs and Forestry issued directives against the company which required the company to supply the Minister with certain information and to make interim contributions regarding the costs of pumping and treating of water. The company failed to comply with these directives and the Minister subsequently obtained a court order after which all the company's directors resigned simultaneously (see Luiz and Taljaard "Mass resignation of the board and social responsibility of the company: *Minister of Water Affairs and Forestry v Stilfontein Gold Mining Co Ltd*" 2009 *SA Merc LJ* 420–425 and Cassim *et al* 416 for a discussion of the facts and the judgment).

Stilfontein deals basically with two issues: firstly, whether or not the directors breached their duties to the company by resigning simultaneously; and secondly, with the issue of social responsibility and to whom directors owe their duties. The reference by the court to the *King Report* in this regard is important. Hussain J does not, however, link these two issues as there is no link in the judgment between the directors' breach of their fiduciary duties and the application of the *King Report*.

With regard to the first issue it was held that the directors breached their fiduciary duty to act *bona fide* in the best interests of the company by resigning simultaneously. Their mass resignation resulted in them being unable to fulfil their duties to the company and its members (para 16.6). Luiz and Taljaard 423 argued that *Stilfontein* could be seen as authority that the right of directors to resign is tempered by the fiduciary obligation owed to the company. We will for purposes of this analysis not deal with this issue but focus on the second issue, namely, that directors must act in a corporate socially responsible manner. The object of the directive was to prevent pollution of water resources. A mining company cannot simply walk away from their obligations towards the environment. Directors of such a company therefore have a duty and obligation to protect the environment. It is clear from this judgment that directors have to act in terms of the triple bottom line approach, therefore not only in the best interests of the shareholders collectively with profit maximisation in mind, but by also bearing in mind, at least, environmental concerns. The court specifically referred to the *King Report* and held that:

> "The conduct of the second to the firth respondents flies in the face of everything recommended in the code of corporate practices and conduct recommended by the King Committee. In my view, the second to fifth respondents acted irresponsibly in merely abandoning the first respondent, a listed company of which they were the directors" (para 16.7).

Although the court based its judgment on the breach of the fiduciary duties of the directors by resigning simultaneously, Hussain J also made the following comment (para 16.9) when discussing the application of the *King Report* and that directors must adhere thereto:

> "*For this reason too*, the second to firth respondents cannot be permitted to merely walk away from the company . . . I am persuaded that the second to the firth respondents, *notwithstanding their sudden resignation*, must be held responsible" (our emphasis).

It therefore seems that even if the directors did not resign simultaneously, but only acted without regard to the environment the court would still have found that they have breached their duties. This is mainly based on the court's interpretation of the recommendations in the *King Report*. It is, however, not clear from the judgment whether the court would have based such a breach on the duty of care and skill or on fiduciary duties. While a simultaneous resignation, and thereby leaving the company "rudderless", is clearly not acting in the interest of the company, it would also be a breach of care and skill by not complying with *King*. The court used the word "irresponsibly", which implies fault (para 16.7). Fault is a *sine qua non* for liability for breach of care and skill, but the absence thereof would not necessarily mean absence of breach of fiduciary duties (see below).

Hussain J refers (para 16.7) to the *King II Report* (2002) (*King* II 22, para 2.1.1.) and specifically to the part dealing with the board of directors:

> "The Board is the focal point of the corporate governance system. It is ultimately accountable and responsible for the performance and affairs of the company. Delegating authority to board committees or management does not, in any way, mitigate or dissipate the discharge by the board and its directors of their duties and responsibility."

He then states, and this is the important part of the judgment, that the respondents acted against everything recommended in the *King Report* and that they acted irresponsibly by merely abandoning the first respondent (the company). He refers (para 16.9) to the relevant recommendation in the *King II* (12 para 18.7) that deals with social responsibility and quotes from the *Report* that:

> "A well-managed company will be aware of, and respond to, social issues, placing a high priority on ethical standards. A good corporate citizen is increasingly seen as one that is non-discriminatory, non-exploitative, and responsible with regard to environmental and human rights issues. A company is likely to experience indirect economic benefits, such as improved productivity and corporate reputation, by taking those factors into consideration."

It is therefore clear that Hussain J referred to the *King Report* and used it to determine whether a director breached his duties, fiduciary and care and skill, to the company or not. The *King Report* as a test for breach of duties can have far-reaching consequences in view of the 2008 Companies Act, although it was not as important in terms of the 1973 Companies Act because directors' duties are partially codified and in addition to specific liability towards the company, non-compliance can also lead to liability in terms of section 218(2).

4 Duty of care, skill and diligence: 2008 Companies Act

The business and affairs of a company must be managed by or under the direction of its board (s 66 of the 2008 Companies Act). This implies various duties

and responsibilities for directors and prescribed officers. A prescribed officer is somebody who is part of the management of a company, although not a director (s 66(10) and reg 38 of the regulations: R351 in *GG* 34239 of 2011-04-26). The statutory fiduciary and other duties are now applicable to the management level, and maybe even lower levels.

Directors' duties traditionally included onerous fiduciary duties and obligations of care, skill and diligence in terms of the common law, various statutory provisions in the 1973 Companies Act and possible duties imposed by the articles of association or even separate agreements between directors and their companies.

Directors' duties are now (at least partially) codified in the 2008 Companies Act (Esser and Coetzee "Codification of directors' duties" 2004 *Juta's Business Law* 26–31). The common law duties of directors are not abolished and it may be correct to say that the Act only provides for a partial codification of directors' duties.

The duty of care, skill and diligence is now also contained in section 76(3) which provides that a director of a company, when acting in that capacity, must exercise the powers and perform the functions of director in good faith and for a proper purpose, in the best interests of the company and with the degree of care, skill and diligence that may reasonably be expected of a person carrying out the same functions in relation to the company as those carried out by that director and having the general knowledge, skill and experience of that director. This is the statutory equivalent of the common law duty of care and skill, but goes beyond the common law, not only in respect of the content of the duties, but also as to the level of compliance. Common law duties were determined with a subjective/objective test, but the minimum standard was always the lower of the two (see Cilliers *et al Cilliers & Benade Corporate law* (2000) 147 and authorities cited).

In respect of the statutory duty, an objective test is applied to determine what may reasonably be expected of a person carrying out the same functions as well as a subjective test which takes into account the general knowledge, skill and experience of the specific director. It would appear that, in contrast with the present common law position, the requirement would be that there is a minimum objective standard, in addition to the subjective standard. This could raise the standards of care and skill required from the director (see eg s 60(1A) of the Banks Act 94 of 1990 for a similar provision and De Jager "Comments on the effect of section 40 of the Banks Amendment Act 19 of 2003 on section 60 of the Banks Act 94 of 1990" 2005 *SA Merc LJ* 170; see also Cassidy "Models for reform: The directors' duty of care in a modern commercial world" 2009 *Stell LR* 373).

The importance of a distinction between the fiduciary duties and the duties of care, skill and diligence lies in the basis of liability. While the former is, at common law, *sui generis* and not based on fault (see eg *Phillips v Fieldstone* [2004] 1 All SA 150 (SCA)), the liability for breach of care and skill is purely delictual and based on fault (see Cilliers *et al Cilliers & Benade Corporate law* (2000) 141 and 147 and authorities cited). Liability for breach of fiduciary duties will also be determined based on the loss or damage to the company or the

benefit to the director, with the two bases being totally separate (*Symington v Pretoria-Oos Privaat Hospitaal Bedryfs (Pty) Ltd* [2005] 4 All SA 403 (SCA)). The common law distinction in respect of the basis of liability above was attempted in the 2008 Companies Act in section 77(2), but while the care and skill liability is similar to that of the common law, the liability for breach of fiduciary duties differs extensively from that of the common law.

5 Testing directors' conduct against *King*: The effect of section 218(2)

It was indicated before that judgments such as *Stilfontein*, where the conduct of directors were tested against the *King Report*, can have the effect of directors being held liable to third parties. It was, however, not clear from the judgment whether the court based the breach of conduct by the directors (by not complying with *King*) on the duty of care and skill or on fiduciary duties in general. This distinction is important with regard to the basis of liability which is different if it concerns the duty of care and skill compared to the fiduciary duty. As indicated above, *King III* can be used as an instrument to test whether a director complied with the duty of care and skill. In respect of other (fiduciary and statutory) duties, the existence of "structures and processes, with appropriate checks and balances" as required by *King III* will, at least, ensure compliance with these duties.

Currently it is only the company that can have recourse against the specific director for breach of fiduciary duties and duties of care and skill but, due to section 218(2) of the 2008 Companies Act, this may change. In terms of section 218(2) a person will also have a claim against, for example, the directors, as any person who contravenes any provision of the 2008 Companies Act is liable to any other person (which could also include the company itself) for any loss or damage suffered by that person as a result of that contravention. Directors' duties are codified in the 2008 Companies Act and a director who breaches these duties can therefore be accountable, in addition to the liability in section 77, to the company, even to third parties, as it is surely a contravention of a provision of the 2008 Companies Act. In addition, these statutory duties also extend to certain "management positions" and the prescribed officers.

King III could be used as a test to determine whether a director acted with the necessary care and skill. This can lead to the situation where a director can be held accountable by a third party in terms of the 2008 Companies Act for not complying with *King III* should one follow the court's argument in *Stilfontein* that, by not complying with *King III* the director does not act with the necessary care and skill.

This could, for example, happen if the board decides not to implement the recommendations of *King III* in respect of IT integrity and safety (see ch 5 of *King III* dealing with IT governance). The company's computer system is breached and it suffers a direct loss due to the loss of client information, but also indirectly as it can be held liable by the clients for loss of their private information under the Protection of Personal Information Bill (Act) (B 9—2009). With clear objective guidelines as to what the objective care and skill standard should be, it would be impossible to escape liability for breach of care and skill. Also, to state that by ignoring guidelines to protect information as "recommended" by *King III* or any other acceptable code, the director genuinely believed that she was acting in the best interest of the company, would be very difficult, if not impossible.

The director would therefore also be liable to the company for breach of her (statutory) fiduciary duty to act in the best interests of the company. The business judgment rule (s 76(4)) should not apply as the belief that she acted in the best interests of the company must be reasonable, which it is clearly not under these circumstances. The client, as third party, will be able to claim damages from the director for loss suffered by him as a result of the breach of the duty of the director to the company (s 218(2)). This liability is in addition to any other liability in terms of any Act or the common law. Whether the ordinary common law principles in respect of liability (delictual or otherwise) will be made applicable to section 218(2) remains to be seen, but in the absence of a clear indication by the legislature (such as in s 77(2)) it seems illogical. Liability should be on the basis of section 424 of the 1973 Companies Act, otherwise the application of section 22 of the 2008 Companies Act would be ineffective (see Kunst, Delport and Vorster *Henochsberg on the Companies Act* (1994) 958).

A third party may obviously also claim directly from the directors on a delictual basis, but then the elements of the common law delict must be proved. As the primary duty of the directors is to the company, proving a duty to a third party (or even a shareholder) may not always be possible (see eg *McLelland v Hulett* 1992 1 SA 456 (D) 464B–D).

6 Conclusion

It was stated in *Stilfontein* that a director acted negligently (irresponsibly, see para 16.7) by not complying with *King II*. It therefore seems, in terms of this case, that *King II* is not a mere self-regulatory, voluntary code that operates on a comply or explain basis. Instead, it actually is law that directors have to follow otherwise they can be held accountable for not acting with the necessary care and skill. This case was, however, based on *King II* which applies only to listed companies. Considering the wide application of *King III*, all companies will be affected. If anything, the "apply or explain" principle in *King III* could extend – rather than restrict - the obligations of directors.

Section 218(2) of the 2008 Companies Act is also of relevance should *King III* be more than of a mere voluntary nature as indicated by the case law. In terms of section 218(2), a director can be held liable by any person should he act against the provisions of the Act and the third party suffers damages based on the breach. Directors' duties are now partially codified in the Act and section 218(2) will therefore apply if a director acts in breach of his "codified" duties. Therefore, before the 2008 Companies Act a director would be liable, at least in respect of breach of duties of care and skill, if she did not comply with the provisions of *King III* and the liability would be in respect of the company. The same principle also applied, although more restricted, in respect of fiduciary duties. In terms of the 2008 Companies Act, the director will be liable to any person, including shareholders, third parties and also the company on the basis of section 218(2) without the necessity to prove the elements of the particular liability, fiduciary or otherwise.

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