BUSINESS JUDGMENT RULE: SHOULD SOUTH AFRICAN CORPORATE LAW FOLLOW THE KING REPORT'S RECOMMENDATION?

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ABSTRACT

Like many commonwealth countries, South African company law relating to company directors is mainly found in the common law which is based predominantly on English law. Like our English counterparts, South African law adopts a dual subjective-objective test when ascertaining whether a director has breached his common law duty of care, skill and diligence. On an analysis of this test it becomes clear that the objective duty of care gets subsumed into the subjective duty of skill resulting in a more lenient subjective test and a lesser likelihood of liability ensuing for breach of this duty.

However, in a new era of corporate governance there is a greater tendency to impose stricter liability on company directors for breach of their common law duties of care, skill and diligence when such a breach causes detriment to the company and its shareholders. This raises the possibility for future courts to adopt a much stricter objective test thereby holding directors liable for almost every decision or action that falls short of the reasonable man standard irrespective of the individual's competency.

This article suggests that the correct balance between the strict objective test and the more lenient subjective test can be created by the codification of the duty of care, skill and diligence and through the enactment of a statutory business judgment rule. The business judgment rule will serve as a mechanism to protect company directors against the ramifications of honest business mistakes, provided certain conditions are met.

1. INTRODUCTION

"...We should be thinking creatively about the ways in which the law can facilitate economic development and not simply coerce, regulate and control its occasional errors and ugly manifestations."

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In March 2002, the final draft of the King Report on Corporate Governance for South Africa was published with the aim “to promote the highest standards of corporate governance in South Africa.” The Report identifies seven characteristics of good corporate governance, namely: discipline, transparency, independence, accountability, responsibility, fairness and social responsibility. These characteristics have been adopted and applied throughout the Report, which focuses predominantly on the system by which corporate entities are governed and controlled and the communications between these entities and their shareholders.

The King Report identifies the pivotal role of the board of directors as being the focal point of the corporate governance system, which must retain full and effective control over the company and who is ultimately accountable and responsible for the performance of the company. The board of directors must aim to conform to the governance constraints while simultaneously performing in an innovative and entrepreneurial way. Ultimately, the board of directors have the responsibility and authority to take calculated business risks in return for rewards while at the same time remaining accountable to the shareholders.

The King Report recommended that the Standing Advisory Committee on Company Law should investigate whether there is a need to enact a statutory business judgment rule (BJR) in South Africa.2 The King Report based its recommendation on its earlier Report,3 which defined the BJR as a rule that protects directors against being held accountable for business decisions, however unwise they subsequently turn out to be.

The recommendation came amidst a growing concern that in a new era of corporate governance there would be a greater tendency to impose stricter liability on company directors for breach of their common law duties or where their actions have caused the company to suffer financial harm.4 Within the corporate governance system directors are clothed with the authority to manage the affairs of the company and they are required to show initiative, to be enterprising and dynamic. They are required to show an entrepreneurial flair by engaging in competitive and responsible risk-taking so as to maximise returns to shareholder. Directors would fail in their responsibilities if he did not show this spirit of enterprise, which is required of any

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director operating in a modern-day competitive business economy.\(^5\)

However, corollary to this spirit of enterprise, directors need to be held accountable for their decisions and actions. Good corporate governance seeks to create a balance between these two competing values: authority and accountability. These values refer to: the need to preserve the board of directors’ decision-making discretion and the need to hold the board accountable for its decisions. The BJR operates to provide a “safe harbour” for directors and protects them from personal liability for claims made against them because of errors of judgment or business decisions that have adversely affected the company.

The need for a statutory BJR in South African law will depend predominantly on two things. Firstly, whether the existing law provides sufficient protection to directors’ business judgments and secondly, whether it is desirable to introduce a statutory version of the BJR into our law, as recommended by the King Report. The statutory defence that the BJR will provide is that the merits of a business judgment made by a director, meeting certain requirements, will not be subject to judicial scrutiny. If the requirements of the BJR are met, directors will be taken to have discharged their common law duty of care and skill.

This article will begin by examining the origins, nature and rationale of the BJR followed by an analysis of the application and effectiveness of the BJR in the foreign jurisdictions of United States, Australia, Canada and England. Thereafter, the focus will shift to the current position of company directors in South African law and whether there already exists an “implied” or “unwritten” BJR, which is evident in the courts unwillingness to review certain business decisions made by directors. Finally, it will be argued that South African law will benefit from the codification of the common law duties of company directors and the enactment of a statutory BJR. In support of this contention, a proposed amendment, codifying the common law duties will be drafted in an attempt to provide the framework and requirements of the defence in the form of the BJR.

2. THE BUSINESS JUDGMENT RULE – BJR

The BJR is a mechanism to protect company directors against the ramifications of honest business mistakes, provided certain conditions are met. The BJR will relieve directors of some of the uncertainty relating to the judgment of the rights and wrongs of business decisions, which with the benefit of hindsight, could have

led to different outcomes. An important purpose of the BJR is that it provides a structure for taking calculated business risks – any success in business involves the calculation of potential risk against reward. Business decisions characteristically take place in conditions of uncertainty and on occasions where there is no time for deliberation; a decision must be made immediately, or else an opportunity is lost. Directors know that if things go wrong they will incur a loss but they nonetheless regard the potential gain as outweighing the risk involved. In essence, this is the type of decision that the BJR seeks to protect. The BJR will therefore give greater protection to directors who make an error of judgment, but at the time of making the decision were of the view that it was in the best interests of the company.

3. THE UNITED STATES APPROACH TO THE BJR

In American corporate law, directors’ duties are owed to the company and the shareholders collectively. These fiduciary duties include the duty of care and the duty of loyalty, which serve as the platform for the law of corporate governance in America. In essence, the duty of care requires a director to act with the care that an ordinary prudent person would be expected to exercise in a like position and under similar circumstances, while the duty of loyalty simply prohibits faithlessness and self-dealing. The BJR has its origins in American corporate law and is to be found in cases over the past 160 years, and various attempts have

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7 According to the American Law Institute Principles of Corporate Governance, the BJR is designed to “stimulate risk-taking, innovation and other creative entrepreneurial activities” – American Law Institute Corporate Governance Project, Branson D.M., Corporate Governance, Cumulative Supplement, Michie Law Publisher (1997); A. Greenhow, op. cit., note 1 at p. 62.

8 In Joy v North Block 692 F.2d 880 (2d. Cir. 1982), a US court held that “business imperatives often call for quick decisions, inevitably based on less than perfect information...the entrepreneur’s function is to encounter risk and to confront uncertainty...” D. J. Block, N. E. Barton and S. A. Radin, The business judgment rule: Fiduciary duties of corporate directors, Englewood Cliffs, N.J., Prentice Hall (1991), pp. 6 - 7.


10 The position is different in South African law in that two independent, although complementary, common law duties exist: the common law fiduciary duty, which is akin to trusteeship and agency and the common law duty of care, skill and diligence. These fundamental differences between American company law and South African company have been used in support of the contention that South Africa should not adopt a statutory BJR, a rule that has its origins in American common law, which is based on an entirely different Company Law regime, as transposing only one aspect of directors duties can have unforeseen consequences. See ibid.

11 See Ibid.

12 See Percy v Millaudon 8 Mart. (n. s.) 68 (La. 1829); Godbold v Branch Bank 11 Ala. 191 (1874); Hodges v New England Screw Co. 3 R. I. (1853); Pollitz v Wabash Railroad Co. 207 N. Y. 113 (1912); Joy v North 692 F.2d 880 (2d. Cir. 1982); D. J. Block, N. E. Barton and S. A. Radin, op. cit., at pp. 4 – 6.
been made to codify the BJR.\textsuperscript{13}

Under the BJR, directors are protected from having to justify to shareholders or the courts the correctness of business decisions made in the ordinary management of the company. The BJR relates to directorial standards of conduct and the test is satisfied where, after reasonable investigation, without self-interest directors adopt a course of action, which in good faith, they honestly and reasonably believe to be in the best interests of the corporation.\textsuperscript{14} If the shareholders subsequently sue the directors because of their decisions, the courts will not second-guess the merits of the decision but will examine the decision only to the extent necessary to verify whether the requirements of the rule have been met. Where each requirement is present and has been satisfied, the BJR will shield directors' decisions from judicial second-guessing. The BJR arises in actions where parties seek to impose liability for damages upon directors or boards of directors for their decisions.\textsuperscript{15}

In essence, the BJR creates a presumption in favour of directors where they are presumed to have acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company.\textsuperscript{16} The BJR will therefore protect a director unless the presumption (which extends to each element of the rule) is rebutted, and the burden lies on the party who challenges the decision, to establish facts that will rebut the presumption. Where the party challenging the decision overcomes the presumption, the BJR will have no application, and the merits of the decision in issue will then be scrutinised by the courts to determine whether there has been a breach of the directors' common law duty of care, breach of which, carries personal liability.\textsuperscript{17}

Therefore, the BJR exists alongside the duty of care, which is a separate and distinct, although complementary, concept. The BJR will not operate to protect directors who have breached their duty of care from the consequences of negligent decisions; it will only protect them against later challenges to their decisions,

\textsuperscript{13} In the past ten years there have been two attempts to codify the BJR, one by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association ("ABA") and the other by the American Law Institute ("ALI"). The ABA, after much debate decided to leave the BJR as uncodified as it was felt that this was a doctrine which should rather be applied by the courts on a case-by-case basis; while the ALI decided to codify the BJR. See D. Botha and R. Jooste, \textit{op. cit.}, at p. 75.

\textsuperscript{14} See D. J. Block, N. E. Barton and S. A. Radin \textit{op. cit.}, at pp. 1 - 2.

\textsuperscript{15} See D. Botha and R. Jooste, \textit{op. cit.}, at p. 73.


\textsuperscript{17} See D. Arsalidou, \textit{ibid.} at pp. 161 – 162 and D. J. Block, N. E. Barton and S. A. Radin, \textit{op. cit.}, at pp. 8 – 12.
which were properly made but have had an unfavourable consequence.\footnote{Do we need a codified business judgment rule? www.sandpit.law.uts.edu.au/jwan/articles/corporate.html at pp. 1 - 2.}

The case of Shlensky \textit{v} Wrigley\footnote{237 N.E. 2d 776 (Ill. App. 1968). Cited in S. Bainbridge, \textquotedblright The business Judgment Rule as Abstention Doctrine\textquotedblright \ U.C.L.A. School of Law accessed, http://ssrn.com/abstract=429260\ at p. 14.} remains a classic expression of the BJR in American jurisprudence. The company involved in the dispute operated and owned a baseball franchise for the Chicago Cubs, which also operated Wrigley Field, the home venue for Cubs' games. At the time, Mr Wrigley, was a major shareholder and was on the board of directors of the company. The Cubs were the only major league baseball team that played on a home field without lights. While the Cubs' gate revenue had consistently operated at a loss, when they played away games at night, their gate revenue was substantially higher than that for home games. It was alleged by a Mr Shlensky, who was a minority shareholder, that, the low revenue could be attributed to the Cubs' poor home attendance, which in turn could be attributed to Mr Wrigley's decision not to install lights at Wrigley Field thereby precluding the scheduling of night games. The minority shareholder brought a derivative action against the directors for negligence and mismanagement, claiming damages and an order that the directors cause the installation of lights at Wrigley Field.

The court held that the director’s decision not to install lights was protected by the BJR. The court held that “it would not step in and interfere with honest business judgments of the directors unless there was a showing of fraud, illegality or conflict of interest.” The court, after analysing the facts held that the decision not to install the lights was neither irrational nor motivated by personal interests and the minority shareholder did not produce sufficient evidence to rebut the presumptions created by the BJR. The directors successfully fended off the action.\footnote{Ibid, at p. 15.}

Traditionally, the courts would rarely find that a director had been in breach of his duty of care. The main reason is that the courts were very reluctant to interfere in director’s management decisions if they acted in good faith and in furtherance of what they honestly and reasonably believed to be in the best interest of the company. The problem however, is that the fiduciary duty of care requires a director to act with the care that an ordinary prudent person would be expected to exercise in a like position and under similar circumstances. This is essentially a subjective enquiry that takes objective considerations into account; the former often resulting in a lesser likelihood of liability ensuing. These two facts combined provided...
an easy standard for directors to satisfy mainly because there was no objective standard by which the correctness of corporate decisions could be measured. However the trend in modern American corporate law, which is evident through case law, seems to impose a stricter objective standard on company directors.  

To illustrate this point, in *Graham v. Allis-Chalmers Manufacturing Co.*, directors of a manufacturing company were held not liable to indemnify the company against damages it had to pay to third parties because of illegal price-fixing agreements entered into by the company’s senior executive, when there was no evidence either that the directors knew or had reason to believe that such an arrangement had been made, or that they were negligent in appointing the senior executive. Compare this to *Francis v United Jersey Bank*, where a senior director of a company was held personally liable for negligence in failing to prevent the misappropriation of trust funds by other directors who had also been shareholders and officers of the company. The court held that the director’s inactivity in preventing the misappropriation of funds was a breach of the duty of care owed to the company and its shareholders. The court further held:

"A director is not an ornament but an essential component of the company...directors are under an obligation to keep informed about the activities of the company...when financial statements demonstrate that insiders are bleeding the corporation to death, a director should notice and try to stanch the flow of blood..."

In *Smith v Van Gorkom*, litigation arose out of a shareholder’s duty of care-based challenge to a board of directors’ decision to approve a merger. The court held that the BJR did not entitle the directors to protection because on the facts, the court found numerous procedural errors and irregularities. These irregularities amounted to gross negligence in the directors’ process of evaluating the merger proposal and then recommending the merger for the shareholders to approve. The directors were found personally liable for any damages resulting from their decision to sell the company after only a two-hour meeting, at which they failed to thoroughly read over the proposed agreement or enquire into the details of the price agreed upon. The court held that the directors could not rely on the BJR because the decision, based on the facts, was uninformed, irrational and unreasonable. The

court, in finding the directors personally liable, emphasised that the duty of care required of directors had taken on a new dimension and it would now be more difficult for directors to be protected by the BJR. The court held that under the BJR, no protection existed for directors who made an “unintelligent or unadvised decision, they are required to act in an informed and deliberate manner.”26

In Cede & Co. v Technicolor Inc,27 litigation arose when Technicolor’s board of directors approved merging Technicolor into a subsidiary of MacAndrews and Forbes Group, Inc. In the merger, Technicolor shareholders received $23 cash per share. The plaintiff, who was a minority shareholder, dissented from the merger and brought an action for damages against the directors of Technicolor for the breach of the board’s duty of care when it approved the merger in that the shares were worth more than $23 per share. Technicolor’s board of directors raised the BJR as a defence by stating that the decision to merge met the requirements of the BJR and hence could not be scrutinised by the courts.28 The court rejected the contention made by the board and found in favour of the plaintiff in that it had met its burden of proof for the purpose of rebutting the BJR’s presumptions by showing that the directors’ of Technicolor had failed to fully inform themselves concerning all the material information reasonably available prior to approving the merger agreement.29 In effect, the court evaluated the substantive merits of the board’s decision while determining whether each element of the BJR had been satisfied.30

Essentially the BJR is a tool of judicial review rather than a standard of conduct, and it seeks to protect a director’s decision from judicial second-guessing. However with the increasing tendency to hold company directors liable for breach of their common law duties, the courts seem to use the BJR as a standard of liability, which is contrary to its original purpose.31 The BJR is essentially a doctrine of

26 Ibid, at p. 10.
27 634 A.2d 345 (Del. 1993) cited in S. Bainbridge, ibid. at p.9
28 The board argued that they had taken steps to determine the fair value of Technicolor shares, which at the time of the merger were valued at $21.60 per share, while the shareholders had been offered $23. See S. Bainbridge, op. cit., at pp. 9 – 10.
29 The court identified the following five failures, which amounted to a breach of the duty of care: (1) the board had failed to make a prudent search for alternatives; (2) once the merger was signed there was no reasonable basis for believing that competing bids might have been made; (3) most directors had little information about the merger and its terms before the meeting at which they approved it; (4) MacAndrews & Forbes had locked the transaction through stock options and (5) the board was not adequately informed before approving the agreement. See S. Bainbridge, op. cit., at p. 11.
30 See S. Bainbridge, ibid., at pp. 12 – 13.
31 Ibid.
judicial abstention and the courts must simply examine the decision only to the extent necessary to verify the presence of the rule’s elements.

The courts must not treat the BJR as a substantive standard of conduct, which entails some objective review of the quality of directors’ decisions. The BJR was not designed for this purpose and its function is to set out certain elements that must be met in order for a court not to scrutinise the substantive merits of a director’s decision. Only if any of the elements are not met will the courts investigate the substantive merits of the decision. It is this misunderstanding of the BJR that has taken the law in a highly undesirable direction and is perhaps one of the main reasons why there has been no single common law definition or statutory formulation of the BJR.

4. THE AUSTRALIAN APPROACH TO THE BJR

In Australia, there has been renewed emphasis on the duty of care and diligence owed by company directors, particularly in a new era of corporate governance, which requires greater accountability. The off-shot of this was much talk of introducing a statutory BJR into Australian company law. The proposed introduction of a statutory BJR was met by mixed responses from both judges and academics that felt that the most appropriate forum for the development and application of the BJR was the courts. Another reason put forward was that there was already sufficient protection available under the discretionary relief provisions for personal liability, and courts already expressed a reluctance to second-guess business judgments made in good faith by directors.

Australian company law is modelled on English law and the propositions of Romer J in the English case of Re City Equitable Fire Insurance Corporation Ltd, have often been cited with approval by the Australian courts as reflecting their common law position. Romer J held that a director is not liable for mere errors of judgment and the duty required of directors was to use a degree of care which an ordinary man might be expected to take in the circumstances. While at first glance, this lays down an objective standard, the court further held that a

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32 See S. Bainbridge, op. cit., at pp. 7 – 8.
33 See D. Arsalidou, op. cit., at p. 119.
35 See A. Greenhow, op. cit., at p. 35.
director need not exhibit in the performance of his duties, a greater degree of skill than may reasonably be expected from a person of his knowledge or experience. This test is essentially subjective and takes into account the particular director’s intelligence and experience.37

This predominantly subjective test that takes objective considerations into account when applied by the courts imposes a relatively low burden on company directors, as they are not required to possess any special skill which often results in a lesser likelihood of liability ensuing. This approach was viewed as being out of step with modern commercial practice.38 As result, in addition to the common law duty of care, Australia is one of the few common law countries to have codified the common law duties of company directors,39 which imposes upon them a higher objective standard of care.40

Prior to its latest amendment, section 232(4) of the Australian Companies Act provided that:

“In the exercise of his or her powers and the 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 would exercise in the corporation’s circumstances”

38 See D. Arsalidou, op. cit., at p. 49.
39 The only other common law country to have codified the common law duties of company directors has been Ghana. After Professor Gower’s “Final Report into the working and administration of the company law of Ghana,” section 203 of the Ghana Company Code, 1963 (Act 179) was enacted, which provides that: (a) A director of a company stands in a fiduciary relationship towards the company and shall observe the utmost good faith towards the company in any transaction with it or on its behalf, and (b) A director shall act at all times in what he believes to be the best interest of the company as a whole so as to preserve its assets, further its business, and promote the purpose for which it was formed, and in such a manner as a faithful, diligent, careful and ordinarily skilful director would act in the circumstances. Professor Gower states that this section emphasizes the primary duty of directors to preserve the company’s assets and promote its business or objects. It further provides that a director shall act in such a manner as a faithful, diligent, careful and ordinarily skilful director would act in the circumstances. On an interpretation of this section the High Court in Republic v Ibrahim Adam and 4 Others, Suit No. FT/Misca. 2/2000 (28th April 2003)(Unreported) (www.datacenta.com/docquality_grain1.htm) held that the duties imposed by this section on directors are more onerous than the lowly standards set in In Re Equitable Fire Insurance Company Limited Case. Like many other common law countries, Ghana has taken steps to bring their company law into line with the modern trends of corporate governance. The Institute of Directors - Ghana investigated and reported on the current state of Corporate Governance in Ghana and recommended major changes to their Company Code, which included a review on the structure and conduct of Board of Directors – www.cipe.org/whats_new/events/conferences/africa/ghana, .
40 “Do we need a codified business judgment rule?” www.sandpit.law.uts.edu.au/jwan/articles/corporate.html at pp. 5.
The effect of section 232(4) was that it changed the subjective test that existed in the common law into a statutory objective "reasonable person" test but still allowed for some subjective considerations. This resulted overall in company directors being required to comply with a much higher, objective standard. With section 232(4) properly in place it was accepted that the general principles and guidelines had developed with sufficient certainty that Australian law could now easily ascertain the standard of care and diligence required of company directors. However, in a series of cases, a considerable degree of uncertainty crept into court decisions regarding the exact standard required, coupled with a piecemeal application of the BJR. This led to a revived interest in the enactment of a statutory BJR.

It is submitted that there can be no general objective standard of care required by company directors and that such a statutory enactment may result in the test becoming too objective. Directors will be held liable for almost every decision that adversely affects the company if the court is of the opinion that his conduct deviated from the standard of care required by a reasonable person. The law should strive towards creating a correct balance between the lenient subjective test and the strict objective test so that directors will not be held liable for every decision but will also not be able to rely on ignorance or simple lack of business acumen to escape liability.

A catalyst for the enactment of a statutory BJR came after the decision in AWA v Daniels. AWA was an Australian company that manufactured and imported electronic products and as a result was exposed to the effects of currency fluctuations. To minimise the risks of currency fluctuations the board of AWA decided to trade on the foreign exchange market and they appointed a Mr Koval, a foreign currency dealer to manage these operations on behalf of AWA. Mr Koval led the board to believe that the company was doing well on the foreign exchange market but in reality the company was suffering substantial losses. When the true state of affairs became apparent, AWA had lost almost $50 million through foreign exchange operations. The minority shareholders sought to claim damages from the board for their failure to properly manage the affairs of the company. The importance of this case for our purposes are the propositions made by Rogers CJ

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41 Ibid. at p. 5.

42 See for example, AWA v Daniels (1992) 7 ACSR 759; Claremont Petroleum NL v Cummings (1992) 10 ACLC 1685; Hurley v National Companies and Securities Commission (1993) 11 ACLC 443 – ibid at pp. 7 – 8; Vrisakis v Australian Securities Commission (1995) 13 ACLC 1635 where the court held that "...the duties of care, skill and diligence are becoming more demanding, and that the standards were to be determined objectively...". See further, D. Arsalidou, op. cit., at p. 125.

with regard to the standard of care, skill and diligence expected of executive and non-executive directors. 44

Rogers CJ held that traditionally, the standard of care, skill and diligence required of company directors was always measured by subjective standards, which depended on the actual knowledge and experience of the individual director. However, the court did acknowledge that this traditional approach had been modified by legislation and case law which now required directors to take reasonable steps to place themselves in a position to guide and monitor the companies' affairs. This imposed upon directors a higher, objective standard. The court did however acknowledge that section 232(4) gave the court considerable flexibility to distinguish between “executive” and “non-executive” directors. The latter normally being held to a lower standard. The court held that the “executive” directors are held to a strict objective standard while “non-executive” are held to a more lenient subjective standard. The court came to the conclusion that on the facts the “executive” directors were to be held personally liable for breach of their duty of care and diligence, while the “non-executive” directors were not liable. 45

The AWA Case went on appeal, 46 where the Appeal Court reversed Rogers CJ’s decision. The court came to the conclusion that all directors, “executive” and “non-executive;” are to be judged according to the same standard and that standard was an objective one. The court found that both the “executive” and “non-executive” directors were liable for breach of their duty of care and diligence. The court said:

“All directors are expected to inform themselves about the affairs of the company, they must become familiar with the business of the company and they must ensure that the board has available means to supervise the management of the company.” 47

In 1999, the Corporate Law Economic Reform Program Bill (CLERP) implemented a number of changes to Australian company law, relating particularly to directors’ duties and corporate governance. The CLERP was passed by Parliament in 1999 and became law in 2000. The changes introduced by the CLERP, were to amend the duty of care required by company directors and to introduce a statutory BJR. 48

44 Ibid. at pp. 134 – 135.
45 See D. Arsalidou, op. cit., at p. 135.
46 Daniels v Anderson [1995] 37 NSWLR 439 and also see D. Arsiladou, ibid. at pp. 137 – 140.
47 Ibid.
Section 180\textsuperscript{49} of the Companies Act dealing with, Care and diligence — directors and other officers, provides:

(1) A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:

a. Were a director or officer of a corporation in the corporation’s circumstances; and

b. Occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.

(2) A director or other officer of a corporation who makes a business judgment is taken to meet the requirements of subsection (1) and their equivalent duties at common law and in equity, in respect of the judgment if they

a. Make the judgment in good faith and for a proper purpose; and

b. Do not have a material personal interest in the subject matter of the judgment; and

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 interest of the corporation (the judgment is a rational one unless the belief is one that no reasonable person in their position would hold).

The effect of this section is that section 180(1) seems to create a desirable balance between the objective and subjective considerations that need to be taken into account when ascertaining the liability of company directors for breach of the duty of care and diligence. Section 180(2) provides directors and officers with a presumption that they have met the requirements of “care and diligence” if the four requirements are met. A business judgment is any decision to take or not to take action in respect of a matter relevant to the business operations of the corporation. The BJR will protect those directors who make business judgments in good faith, and for a proper purpose, have acted on an informed basis without material personal interests and who have a rational belief that the decision is in the best interests of the corporation but will not protect them in cases of negligence, ill-informed or fraudulent decisions. If one of these requirements is not met, the rule will not operate.\textsuperscript{50}

\textsuperscript{49} Amended s 232(4) and also see A. Greenhow, \textit{op. cit.}, at p. 37.

\textsuperscript{50} See A. Greenhow, \textit{op. cit.}, at p. 33.
5. THE CANADIAN AND ENGLISH APPROACH TO THE BJR

5.1 The Canadian Approach

Canada has codified the common law duties of care, skill and diligence in section 134(1)(b) of the Ontario Business Corporations Act and section 122(1)(b) of the Canadian Business Corporations Act, which requires directors to exercise the "care, diligence and skill that a reasonably prudent person would exercise in a comparable circumstance." Canada has not, however, adopted a statutory BJR, but seems to implicitly apply it in court decisions. The Canadian courts have adopted the well-established principle that courts will not usurp the functions of the board of directors as the managing body of the corporation, and in particular will not substitute their own decisions for those legitimately made by the board.51

In CW Shareholdings Inc. v. WIC Western International Communications Ltd.,52 Justice Blair said:

"When assessing whether or not directors have met their fiduciary and statutory obligations of care, skill and diligence, the court generally approaches the issue on the basis of what has become known as the 'business judgment rule'. This rule is an extension of the fundamental principle that the business and affairs of a corporation are managed by or under the direction of its board of directors. It operates to shield directors from court intervention where business decisions have been made honestly, prudently, in good faith and on reasonable grounds. In such cases the director's decision will not be subject to examination and the court will be reluctant to interfere and usurp the director's function in managing the corporation."53

This proposition was followed in a subsequent case, decided later in the same year, where the court added that "the mandate of the directors is to manage the company according to their best judgment; that judgment must be an informed judgment; it must have a reasonable basis. The court ensures that the directors make a reasonable decision not a perfect decision."54

53 Ibid.
The position in Canadian law seems very attractive: codify the common law duty of care, skill and diligence and not the BJR as such. This rule is left to be developed and applied by the courts on a case by case basis. Furthermore, it seems that the approach taken in the CW Shareholdings and the Maple Leaf Food cases is correct, and the courts seemed to expound the rule with certainty and clarity.

However, it is submitted that the problem is that if such a rule is left to the courts to be developed on a case by case basis, an ad hoc application of the rule might ensue. For example, in the Repap case,\textsuperscript{55} the Canadian Supreme Court confirmed the earlier enunciations of the BJR as a "rule that protects directors' decisions from those that might second-guess their decision. Directors are however only protected to the extent that their actions actually evidence their business judgment." This case strongly suggests an element of judicial deference for directors' business decisions. However, further on in the judgment, the court went on to say that they are "entitled to consider the content of the director's decision and the extent of the information on which it was based".\textsuperscript{56}

It is submitted that this statement confuses the purpose of the BJR. The BJR is not a standard of conduct but rather a tool of judicial review. The courts must simply examine the decision only to the extent necessary to verify the presence of the rule's elements. Then and only then, if any of the elements of the rule are absent, can the court investigate the content or merits of the decision to see whether the director breached his duty of care, skill and diligence. Therefore, a clear statutory formulation of the BJR may help eliminate future misapplication of the rule by the courts.

2.2. The English Approach

In English law, directors owe a fiduciary duty in equity to their companies and also a common law duty to exercise their powers and functions with the proper care and skill so as not to cause the company loss by their failure to do so.\textsuperscript{57} The courts have generally taken a lax view with regards to the duty of care and skill owed by directors to their companies mainly because at common law it was impossible to apply a professional standard of skill and care that could be assigned to other recognised categories of professionals – directorship as such is still not regarded as a profession.\textsuperscript{58}

\textsuperscript{55} UPM-Kymmene Corp. v. UPM-KymmenMirachichi Inc., [2002] O.J. No. 2412 Ont. Court of Justice and see the Repap case and also see N. Dietrich, \textit{ibid} at p. 8.

\textsuperscript{56} \textit{Ibid}. at p. 8.

\textsuperscript{57} See R. Pennington, \textit{op. cit.}, at p. 81.

\textsuperscript{58} \textit{Ibid}. at pp. 81 – 82.
The reason for this is that English company law saw the position of directors as akin to that of a trustee and hence the law set strict standards in relation to directors by virtue of the fiduciary relationship they had with their company. Moreover, when assessing the duty of care and skill, a director was required to exhibit no higher level of foresight or attentiveness in managing the affairs of the company than they would be expected to show in dealing with their own personal affairs. No legal framework exists for directors which is remotely equivalent to the objective standards of performance of duties expected from other professionals.59

Where allegations of negligence have been made against directors, the position in English law seems to be that, when ascertaining whether the directors have breached their duty of care and skill, the courts will assess each case on its own merits by measuring the conduct against that directors own personal abilities and qualifications and not against some general objective standard of care and skill: a subjective analysis. The reasons advanced for the lack of an objective professional standard for company directors is that they are required to show different degrees of care and skill depending on the size and nature of the company they serve.60 This lenient approach that exists in English law can be illustrated through the following cases.

In Overend and Gurney Co. v Gibb,61 the court held that directors were not guilty of negligence when they permitted their company to purchase the assets and undertakings of a private bank even though they failed to investigate the value of the bank’s assets and the extent of its liabilities. Moreover, the directors knew that the bank had insufficient realisable assets to meet its obligations and that it was on the brink of insolvency. The court held that the directors could only be held liable if they acted beyond the powers conferred upon them by the company’s constitution. In Lagunas Nitrate Co. v Lagunas Syndicate,62 the court held that “the amount of care required by company directors is difficult to define; but it is plain that directors are not liable for all the mistakes they may make, although if they had taken more care they might have avoided them...” A similar approach was adopted in Brazilian Rubber Plantations and Estates Ltd,63 where a director contracted on behalf of a company to purchase a plantation on the basis of a false report. Despite the directors’ awareness of the discrepancies and his failure

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60 See R. Pennington, op. cit, at p. 83.
61 [1872] LR 5 HL 480 and also see R. Pennington, op. cit., at pp. 82 and 86.
62 [1899] 2 Ch 392 (CA) and also see R. Pennington ibid. at pp. 82 , 83 and 86.
63 [1911] 1 Ch 425 (CA) and also see R. Pennington ibid. at p. 86.
to make proper inquiries to correct and expose the discrepancy, he was held not to be liable to the company for breach of his duty of care and skill. Neville J remarked:

“A director’s duty has been laid down as requiring him to act with such care as is reasonable to be expected from him, having regard to his own knowledge and experience...He is not, I think, bound to take any definitive part in the conduct of the company’s business...” 64

Finally, in *Re City Equitable Fire Insurance Co.*, 65 which is often referred to as containing the roots of the common law duty of care, the directors of an insurance company were found not to have been negligent in failing to supervise the company’s managing director who had perpetrated fraud against the company by falsifying periodical financial reports. The court held that a director is not liable for mere errors of judgment and the duty required of directors was to use a degree of care, which an ordinary man might be expected to take in the circumstances. The court further added that a director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge or experience. 66

It is interesting to note that the first attempts to codify the common law duty of care in England, both in 1973 and 1978, were never actually enacted. 67 It is only recently that the English and Scottish Law Commission suggested a codification of the duty of care, skill and diligence by the insertion of a new section 309A of the Companies Act 1985. 68 The proposed provision imposes a much stricter objective test than the more lenient subjective test previously applied by the courts. Moreover, while the English courts seem to implicitly apply the BJR insofar as they would prefer not to review commercial business judgments or decisions made by company directors, 69 they expressly rejected any attempt to codify the BJR. The report concludes that there is no need to codify the BJR and that this

64 Ibid.
65 [1925] Ch 407 - A chairman of an insurance Company had defrauded the company of approximately one million pounds. At the time he was a one of the most respected managing directors of the company and his co-directors trusted him implicitly even to the extent that they never checked over anything he did. When the company was finally put into liquidation, the question arose whether the other directors were to be held personally liable for negligence or breach of the duty of care and skill in failing to ensure the proper management of the company. See P. L.R. Mitchell, op. cit., at pp. 104 – 109.
67 See, Havenga, op.cit. at p.20
68 See ibid. at p. 30.
69 *Howard Smith Ltd v Ampol Petroleum Ltd and others* [1974] 1 All ER 1126 (PC) held: “Their Lordships accepts...that it would be wrong for the courts to substitute its opinion for that of the management or indeed
"rule" is best left to be developed by the courts.\textsuperscript{70}

The approach by the Law Commission is particularly interesting because recent court decisions have held that a more objective test is to be applied when ascertaining the duties of care, skill and diligence of company directors.\textsuperscript{71} What is striking from these cases is the proposition that section 214(4) of the English Insolvency Act\textsuperscript{72} should represent the current law on the duties of care, skill and diligence of company directors as a more demanding standard was required of them than those previously imposed.\textsuperscript{73} The test contained in subsection (4) is based on an objective test that takes subjective considerations into account.\textsuperscript{74} In adopting this approach, the court appears to have struck the correct balance between holding directors to a threshold that is neither too stringent nor too lenient. It can be argued that in an era of corporate governance, the corporate communities' attitudes and expectations concerning company directors have changed and that they should be held to a higher objective standard but the actual position of each individual director in relation to the company and his or her personal skills and experience should be taken into account.

In conclusion, it can be said that the standard of care encapsulated in section 214(4) of the English Insolvency Act 1986, should be the standard of care required by South African company directors in carrying out their duties.\textsuperscript{75} With

to question the correctness of the management's decision..." and see further, D. Botha and R. Jooste, op. cit., at p. 74.

\textsuperscript{70} See D. Arsalidou, o.p cit., at pp. 174 – 175.


\textsuperscript{72} Insolvency Act, 1986 and the discussion of this by D. Arsalidou, op. cit., at p. 176.

\textsuperscript{73} Section 214(4) provides that "...the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, 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) the general knowledge, skill and experience that that director has. " See D. Arsalidou, op. cit. at pp. 178 – 179.

\textsuperscript{74} See J.S. McLennan, op. cit., at p. 101.

\textsuperscript{75} See J.S. McLennan, ibid, points out that there is no material difference between the English law and our common law on this issue and that the s 214(4) test also reflects our law. Moreover see Wolhuter Steel (Welkom) Pty Ltd v Jatu Construction Pty Ltd (In Provisional Liquidation) 1983 (3) SA 815 (O) where the court held: "Although English Law is not binding on South African Courts, it has, when it is in pari materia, decidedly persuasive authority..." See further, J.L. Van Dorsten, Rights, powers and duties of directors, 1st ed., Meridian Press CC (1992), at p. 10.
the imminent amendment in 30 years to the Companies Act, and the increased focus on corporate governance and ensuring that company directors are to be held more accountable, it is submitted that South African law would benefit from the codification of the directors' duties of care, skill and diligence based on a similar provision to section 214(4). In addition, we should also incorporate into our Companies Act, a statutory BJR along similar lines to the one adopted in Australia.

6. THE DUTIES OF COMPANY DIRECTORS IN SOUTH AFRICAN LAW

A company is owned by its shareholders and managed by its directors, a term that is generally used not only to indicate the plural of an individual director but also the board of directors as a whole. The meaning of management was considered in *Ex parte Screen Media Ltd* where Leveson J remarked:

"I understand the concept of management to deal primarily with the discretion and control of a company's business with a view to produce profits from its assets...Of course, losses may be incurred in the course of managing the business, but essentially management postulates the continuation in existence of the business..."

The rights, powers and duties of company directors is regulated and provided for in the Companies Act, the common law and the company's constitution. For our purposes here, we shall focus on the common law duty of care, skill and diligence of company directors.

When a person is appointed as a director, he assumes a position which involves the imposition of various duties imposed by statute and common law. These duties can be seen as the legal consequences of assuming the position of director and are owed to the company, which has a corresponding right to enforce the duties. It is important to take cognisance of the fact that the term “company” usually means the general body of shareholders and therefore the directors’ duties are owed not

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77 *Lipschitz and Another v Wolpert and Abrahams* 1977 (2) SA 732 (A) held “…the general body of shareholders put up and risk their money (to extent of their shares), yet they have no control over or knowledge of the day-to-day administration of a company…” and see J.L. Van Dorsten, *op. cit.* pp. 1 - 2.

78 1991 (3) SA 462 (W) and see the discussion by J.L. Van Dorsten, *op. cit.,* at p. 116.

to individual shareholders but to all the shareholders of a company, both past and present.80

In South African company law, directors are classified as either executive or non-executive directors. A “non-executive” director is a director whose duties are often of an intermittent nature in that they do not take part in the day-to-day management of a company and their involvement with the company consists of attendance at periodical meetings of the board of directors. Generally, they have no contract with the company and hence are not employed by the company. The “executive” director is a director who is elected and employed by the company. The “executive” director is involved in the day-to-day management of the company and is usually the person who directs the affairs of the company. 81 However, it must be borne in mind that the common law duty of care, skill and diligence owed by directors applies equally to both. In Howard v Herrigel,82 Goldstone JA said:

“In my opinion it is unhelpful and even misleading to classify company directors as ‘executive’ and ‘non-executive’ for the purposes of ascertaining their duties to the company or when any specific or affirmative action is required.”83

Most boards of directors consist of a combination of “executive” and “non-executive” directors. The reason for this is mainly because the full-time director may become so consumed with the day-to-day activities of the company that an outsider’s wider perspective, fresh stimuli and wider strategic horizons may be invaluable in maintaining a competitive and successful company. It also has the effect of creating an enhanced sense of general responsibility.84

It is submitted that the distinct position of “non-executive” directors should be taken into consideration when determining their potential liability for breach of the duty of care, skill and diligence, and a higher standard of care, may in particular circumstances, be expected of an “executive” director. While this is not a general rule it seems to conform to the approach taken by the courts,85 and will have to be taken into account when codifying the duties of directors and the BJR.

80 See J.L. Van Dorsten, op. cit., at p. 170
81 See R.C. Williams, Concise corporate law, Durban, Butterworths (1994), at p. 88.
82 1991 (2) SA 660 (A) at 661.
83 Ibid
84 See J.L. Van Dorsten, op. cit., at pp. 20 – 21.
85 Fisheries Development Corporation of SA Ltd v Jorgensen 1980 (4) SA 156 (W) at 165 – 166.
All directors, both individually and as a board, stand in a special relationship towards the company and its members and the courts have insisted that directors observe two fundamental principles, namely (a) their fiduciary duties and (b) the duty of care, skill and diligence, the latter being of particular importance.

In terms of the common law, all directors are required to exercise the necessary care, skill and diligence in performance of their duties and, if they fail to do so, they may be held liable to the company for any loss suffered as a result. A director’s duty in this regard is not a fiduciary duty, in other words, it does not flow from his fiduciary relationship with the company but is an independent common law duty owed to the company. The problem is that the standard according to which the degree of care and skill is to be measured is by no means clear. Margo J in *Fisheries Development Corporation of SA Ltd v Jorgensen*, summarised the principles governing the duty of care and skill required by company directors as follows:

“To determine whether there was negligence in any of the conduct alleged, it is necessary to have regard to relevant aspects of a director’s duty of care and skill...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 obligation assumed by or assigned to him...In that regard there is a difference between the so-called full-time or executive director and the non-executive director...neither is 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 reasonably be expected of a person with his knowledge and experience...A director is not liable for mere errors of judgment...”

The duty of care requires that a director exercises the necessary caution and show the necessary concern when exercising the company’s powers and safeguarding the company’s assets. However, the precise standard of care required is not entirely clear; if the director is required to exercise reasonable care, the test is an objective one – the standard of the reasonable man. The courts have, however, stated that it must be a reasonable man with the director’s knowledge, skill and experience.

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87 See J.L. Van Dorsten, *op. cit.*, at pp. 216 – 220.
88 1980 (4) SA 156 (W) at 157 – 158.
89 Ibid.
90 See J.L. Van Dorsten, *op. cit.*, at p. 217.
Does this mean that the courts are lowering the standard of care required by taking into account the abilities and experience of that particular director or does it mean that the courts place more emphasis on the skill element when assessing liability for breach of such a duty? It is submitted that the terms "care" and "skill" should not be used interchangeably because they refer to different standards of liability. For the standard of care, an objective test is set, namely that to be expected of a reasonable man. The duty of skill is a duty for the individual to do his subjective best in particular circumstances, having regard to his own abilities and experience. It appears that the law seems to merge these two concepts when having to assess the liability of directors for breach of the duty of care and skill which appears to focus more on the subjective element of skill thereby exonerating the honest but incompetent person on the basis that he can do no better.

The issue becomes even more blurred by the proposition in the *Fisheries* case that the degree of care expected of an executive director differs from that expected of a non-executive director. As more obligations are assumed by, or assigned to, the former they must exercise more care. This will be an important consideration to be taken into account when assigning liability for breach of the duty of care but should not be considered as a general principle.

Directors must exercise skill in the performance of their duties and they must show the degree of skill that may reasonably be expected from persons of their particular knowledge and experience. The test is clearly a subjective one. There is no objective standard of skill and a director is not required to bring any special qualifications to his office. Skill is that special competence that is not part of the ordinary equipment of a reasonable man. Furthermore, the courts have often stated that directors are not expected to have special business acumen or expertise and will not be liable for mere errors of judgment and the courts have recognised that directors must be allowed to make business decisions in a spirit of enterprise untrammelled by judicial interference.

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92 See J.L. Van Dorsten, *op. cit.*, at p. 217.
Closely related to the concept of care is the notion of diligence – diligence has been defined as “careful attention, heedfulness, caution.”96 Directors must show the necessary diligence in the performance of their duties, which will depend to a large extent on the duties assigned to them. It is in this duty that protection is afforded to non-executive directors. More is expected of executive directors, who must give continuous attention to the company’s affairs, as opposed to non-executive directors whose duties are of an intermittent nature.97 While all directors will be required to exercise the same degree of diligence as may be expected from reasonable business men, account must be taken of the specific position held by that particular director when assigning liability for breach of such duty. It is on this basis that a different standard’s can be expected from the executive director than the non-executive director as more obligations are assumed by the former, and not on the basis of care, as all directors will be required to show the same amount of care.

It seems clear that the courts are attempting to apply a dual objective-subjective test of liability for breach of the duty of care, skill and diligence. This common law approach, while taking into account the standard of a reasonable person when measuring the element of care required, seems to be more influenced by the overarching subjective element of skill. In essence the objective reasonable man test is subsumed in a subjective enquiry regarding the skill of the particular director in question. A predominantly subjective inquiry imposes a relatively low burden on company directors’ as they are not required to possess any special skills or even experience in the business of the company. It is therefore evident that this result in a more lenient subjective test being invoked and lesser likelihood of liability ensuing.98

Jooste99 points out that the law as it currently stands in the context of the present tests for breach of the duty of care, skill and diligence is not very onerous and there has only been one decided case in which directors of a company were held liable

96 J.L. Van Dorsten, op. cit., at pp. 221 – 222.
97 Ibid. at pp. 221.
98 The problem surrounding the hybrid objective-subjective test is not unique to South African law. Fisher identified a similar problem in Australian law in that the courts often fused the dual objective-subjective test into a single comprehensive duty that allowed the subjective degree of skill to overshadow the objective duty of care. He illustrates this point by reference to Re Denham & Co (1884) 25 Ch D 752, where a directors was excused from liability at the suit of some of the company’s creditors after he was deceived by other directors to pay dividends out of capital which resulted in the company getting liquidated. See Fisher, “Reform of the duty of care and diligence of directors in Australia,” 4 The Company Lawyer (1993) at p. 146.
99 See D. Botha and R. Jooste, op.cit. at p.68
for breach of the duty of care and skill. Up until now directors have not been inundated with legal action for failing to act with due care and skill. However, it is submitted that this "comfortable common law position that directors find themselves in relation to their common law duty of care and skill" is out of step with the fundamentals of modern corporate governance, which requires directors to be held more accountable for their decisions and will no doubt influence the court in finding more directors liable for the breach of such duty.

If, however, the test for breach of the duty of care and skill is seen as objective, which takes into account subjective considerations, the potential exists that with a greater tendency to impose stricter liability on company directors for breach of their common law duties or where their actions have caused the company to suffer financial harm, the courts may invoke a very strict objective test thereby holding directors liable for almost every decision or action which falls short of a reasonable man standard irrespective of their individual competency. If a lenient subjective test or a strict objective test is adopted, either way, the law as it currently stands is highly undesirable. The law should strive towards creating a balance between these two tests and it is submitted that the way forward is the codification of the duty of care, skill and diligence, and the adoption of a statutory BJR.

7. SECTION 424 OF THE COMPANIES ACT: A NEW BASIS FOR LIABILITY?

As a supplement to the common law remedies for breach of the duty of care, skill and diligence, section 424 of the Companies Act provides instances when a director can be held personally liable for his conduct in carrying on any business of the company either recklessly or fraudulently. If a party is unable to hold a

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100 See Niagara Ltd (in liquidation) v Langerman and others 1913 WLD 188: company liquidators sued its directors for recovery of amounts paid out of the company’s funds as commissions in terms of an improvident contract which the directors were held to have been grossly negligent in concluding and had breached the duty of care owed to the company. See also J.L. Van Dorsten, op. cit., at p. 350.

101 See D. Botha and R. Jooste, op. cit. at p. 68.

102 Finch points out that in an era of full time directors and rising standards of commercial education, the standard of skill required of directors could very well be raised. He points out further that the responsible nature of the modern directors’ position and responsibility has been emphasised in calls for an objective test. He believes that an objective test should be applied but that it should not be so onerous as to chill enterprise and discourage director’s from seeking to improve their own level of skill. See his paper, “Company directors: Who cares about skill and care?” The Modern Law Review (1992), at p.202. The author respectfully agrees with this proposition and hence in a new era of modern corporate governance a balance needs to be achieved between a too strict objective test and a too lenient subjective test.

103 See H.S. Cilliers and M.L. Benade, Corporate law 3rd ed., Durban, Butterworths (2000), pp. 160 – 161; and also Pressma Services Pty Ltd v Schuttler and Another 1990 (2) SA (C) where it was held that: “...the clear purpose of s 424(1) is to render personally liable all persons who knowingly participate in the fraudulent or reckless conduct of the business of a company...to this end the section is phrased in very wide terms...” and J.L. Van Dorsten, op. cit., at p. 295.
director personally liable under the common law for breach of the duty of care and skill they may invoke section 424 as an alternative. The only safeguard available to the director in terms of the Companies Act is section 248, which provides that in any such proceedings if the court is of the opinion that the person concerned has acted honestly and reasonably, and in all the circumstances ought fairly to be excused, it may relieve him in whole or in part, from any liability on such terms as it thinks fit.

Section 424 applies where the company is “in a winding-up, judicial management or otherwise” and can therefore be invoked where the director’s conduct is reckless in respect of operating the company as a going concern. It is submitted that this would entitle a party to invoke section 424 in instances where it is alleged that the director, during the management of the company, has breached his duty of care and skill by adopting a course of action or making a business decision that has caused the company financial prejudice.

“Recklessness” in terms of section 424 is a relatively broad concept and conduct will be regarded as reckless if it involves gross negligence and unjustifiable risk. The test for recklessness has two elements, an objective and subjective element, but the enquiry is predominantly an objective one. According to Hyman, the test for recklessness will vary greatly from case to case and it is submitted that given the nature of the special relationship that a director owes to his company, a breach of any of the common law duties (especially now in an era of corporate governance) would be tantamount to gross negligence. The Courts would therefore be justified in invoking their wide discretionary powers under section 424(1) thereby holding directors personally liable by measuring

104 In *Ex Parte Lebowa Development Corporations (supra)*, the court held that section 424(1) does not replace any of the common law remedies available to an innocent third party. See also J.L. Van Dorsten, *op. cit.*, at p. 296.


106 See *Philotex case, supra*, defined “recklessly” as “not connoting mere negligence but at the very least gross negligence”. Gross negligence has been defined as “a degree of negligence which indicates a complete obtuseness of mind and conduct” or “a failure to show any reasonable care”. In *Transnet Limited t/a Portnet v The Owners of the mv “Stella Tingas” & Another 2003 (2) SA 473 (SCA)*, the court held that for conduct to qualify as gross negligence is “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 conscious risk-taking, a total failure to take care.” See Deneys Reitz Attorneys, Insurance Report No 8, September 1993 at www.deneysreitz.co.za


109 As quoted by Margo J in the *Fisheries Case, supra*, at p. 170.
their actions and decisions against a stricter, objective test.\textsuperscript{110}

In \textit{Mafikeng Mail (Pty) Ltd v Centner Mail (No 2)},\textsuperscript{111} the court said:

"Recklessness is not an error of judgment, nor even a gross error of judgment...provided the defendant has an explanation which shows that he was confronted by a choice, and that thought and reflection went into the decision...the decision cannot be subsequently characterised as reckless if it turns out to be wrong. An error of judgment may not even involve negligence for business decisions, involving as they do the risk of an unknown future, will sometimes be wrong...generally, it may be said that business conduct is reckless where there is no \textit{plausible explanation} for the conduct complained of."\textsuperscript{112} (emphasis added).

It is submitted that this statement is contradictory because while the judge seems to imply that an error of judgment, which is a subjective enquiry will not constitute reckless conduct for the purposes of section 424, such conduct will be regarded as reckless where \textit{no plausible explanation} can be given, that is, no reasonable explanation as to why that course of action or decision was made hence making section 424 applicable. A reasonable explanation could only be given if objective considerations were taken into account so as to justify the subjective belief. This makes the test more objective than subjective.

The discretionary powers under section 424 are likely to be used far more often than in the past for holding company directors liable for breach of the duty of care and skill. If the courts are to continue to invoke a more subjective-objective test in terms of the common law for holding company directors personally liable for breach of the duty of care and skill thereby allowing a director to escape liability more easily he may nonetheless be faced with a much stricter objective-subjective test in terms of s 424, which gives the court a wide discretion to impose personal liability for reckless conduct for carrying on any business of the company. It is suggested that an equitable solution can be achieved by codifying the duty of care and skill, because not only will it \textit{create clarity as to the exact standard owed by company directors} but will also provide a defence to company directors for breach of this duty in the form of a BJR.

\textsuperscript{110} \textit{S v Goetz}; 1980 (1) SA 269 (C) Fagan J held that "what was required was that the appellant acted recklessly judged by the standards of reasonable businessmen...the test is an objective one, not a subjective one..." and also see J.L. Van Dorsten, \textit{op. cit.}, at p. 298.

\textsuperscript{111} 1995 (4) SA 607 (W) at 613-614.

\textsuperscript{112} \textit{Ibid.}
8. SHOULD SOUTH AFRICAN CORPORATE LAW CODIFY THE COMMON LAW DUTIES OF COMPANY DIRECTORS AND ADOPT A STATUTORY BJR?

The courts have made it clear that directors are not liable for mere errors of judgment. In Levin v Felt and Tweeds Ltd, the court said:

"In the absence of any allegations that the directors acted *mala fide* this amounts to asking the court to usurp the functions of the directors and to consider what is in the best interest for the company from a business point of view...this is not the function of a court of law...the court is not concerned with the commercial wisdom of the scheme."

The court appears to acknowledge that directors must be allowed to make business judgments and business decisions in a spirit of enterprise and have emphasised that they will not usurp the function of directors by substituting their own decisions for that of the directors from a business point of view. Is this indicative of an "implied" or "unwritten" BJR, which although not explicitly provided for, seems to be implicitly applied by the courts? If this be the case, then why should there be a need to codify a rule that is already applied by the courts?

While the King Report's recommendation that a statutory BJR should be adopted has been met with much criticism, it is submitted that the advantages of codifying the BJR far outweigh its potential disadvantages and should, along with the codification of the common law duty of care, skill and diligence, be enacted into our Companies Act.

The benefits that the enactment of a BJR will provide can be summarised as follows. Firstly, the BJR will provide certainty and clarity to the laws relating to directors' duties as it will clarify the steps that directors ought to take in making a business judgment in order to be protected against claims that they have breached their duty of care if their decisions turn out unfavourably, while simultaneously providing the courts with some guidance as to the standard required by directors.

113 1951 (2) SA 401 (A) at 414 – 415.
as to when the BJR might be invoked.\textsuperscript{116}

Secondly, judges are not business experts and are often ill equipped to evaluate directors' decisions in a corporate context. Business decisions are frequently complex and made under conditions of uncertainty and judges do not necessarily have the skills or experience to understand the complex entrepreneurial situations directors find themselves in on a day-to-day basis.\textsuperscript{117} Moreover, it has been accepted that the courts must be careful to take into account that after the event, the knowledge of hindsight can be misleading and give rise to unfair criticism.\textsuperscript{118} With the enactment of a statutory BJR, the courts will be in a better position to apply existing legal principle within a framework of rules and criteria that are familiar to them, such as, the notions of 'good faith', 'conflict of interest', 'reasonableness' and 'rationality'.

Finally, strong policy considerations exist for the enactment a statutory BJR. If a very stringent standard is placed on company directors in carrying out their functions and duties there exists the possibility that competent directors will either resign from their positions or be too cautious in their business decisions, which may stifle innovation and growth.\textsuperscript{119} A balance needs to be struck between what the law expects from a reasonable person under similar circumstances to that which the particular directors finds himself in from a degree of precision not required by the ordinary reasonable person. A balanced objective-subjective approach and not a predominantly subjective or objective test is the desired position that the law needs to strive towards. The codification of the common law duties and the enactment of the statutory BJR that will be proposed may create this balance.

The BJR will encourage responsible risk-taking by providing directors with the comfort of knowing that their decisions will not be second-guessed by the courts if the requirements are met. The benefits of responsible risk-taking, is that it stimulates a company's economic growth and welfare by increasing returns on investments, thereby maximising the returns to shareholders and encouraging further investment.\textsuperscript{120} One of the fundamental aims of corporate governance is to

\textsuperscript{116}"Do we need a codified business judgment rule?" www.sandpit.law.uts.edu.au/jwan/articles/corporate.html at p. 9.

\textsuperscript{117} Ibid at p. 9.

\textsuperscript{118} 4 The law of South Africa (1992), op. cit. at p. 232 ; and also see Joy v North, supra, at pp. 6 - 7.

\textsuperscript{119}"Do we need a codified business judgment rule?" www.sandpit.law.uts.edu.au/jwan/articles/corporate.html at p. 9.

\textsuperscript{120} Ibid at pp. 9 – 10 and also A. Greenhow, op. cit. at pp. 58 – 59.
balance the rights of the shareholders on the one hand, with the commercial reality of risk-taking on the other.121 The BJR has the effect of creating the right balance by regulating the enforcement of directors' duties, which should not be so invasive as to stifle directors' decision-making authority and innovation, and the rights of the company and shareholders to enforce those duties.122

A statutory BJR will create an awareness of the duties owed by company directors in that its codification will render the law more accessible and more easily understandable if a framework is provided within which directors and the courts can operate. The BJR is a tool of judicial scrutiny and if the requirements of the rule are met the inquiry ends. If not, only then, will courts review the decision based on the merits to determine whether there has been a breach of the duties owed by directors. It will therefore also have the effect of saving the courts time and resources as the BJR will provide a guide as to whether complex and unmeritorious cases can be cut off at an early juncture, thereby freeing up the courts to handle other matters.123 The BJR also recognises the different roles and responsibilities assumed by executive and non-executive directors within the company structure thereby affording due protection to those directors that are not involved in the day-to-day running of the company.124

The adoption of a statutory form of the BJR is not free from disadvantages, some of which can briefly be summarised as follows: Firstly, the BJR is a creature of foreign legal systems and it is undesirable to transplant such a legal doctrine directly into South African law, which is based on an entirely different system of company law.125 This argument can be refuted on the basis that aspects of the BJR have already appeared in court decisions and the fundamental principles of the rule do not differ significantly from our own company law. Moreover, American, Australian, Canadian and South African company law are closely modelled on English law and consequently many of the basic common law rules relating to duties of company directors are the same in all five jurisdictions. The proposed codification of the common law duties and the statutory BJR will be modelled on English and Australian company law, which according to Havenga, is proving to be of considerable comparative value for South African company law.126

121 Ibid at pp. 9 – 10 and also A. Greenhaw, op. cit., at pp. 58 – 59.
122 See M. Havenga, op. cit., at p. 722.
123 "Do we need a codified business judgment rule?" www.sandpit.law.uts.edu.au/jwan/articles/corporate.html at pp. 9 – 10 and also see A. Greenhaw, op. cit., at pp. 58 – 59.
124 See A. Greenhaw, ibid., at p. 59.
125 See D. Botha and R. Jooste, op. cit., at p. 73.
126 See M. Havenga, op. cit., at p. 25.
Secondly, the King Report recommended that we adopt a statutory BJR along similar lines to the one that exists in the U.S. The problem that arises is that in U.S., there has only been one attempted codification of the BJR and there seems to be no single definition of the rule and no uniformity in its application by the courts.\textsuperscript{127} The recommendations by the King Report came before the rule had been adopted in Australia and it is submitted that the Australian version of the rule is much more reflective of modern corporate law and should be used as the basis for the South African statutory BJR.

Finally, and perhaps the strongest argument against the enactment of a statutory BJR, is the fact that the courts already apply an “implied” or “unwritten” BJR, which is evident in the courts unwillingness to review certain business decisions made by directors and that any evolution in this area of law is best left to be developed by the courts on a case by case basis.\textsuperscript{128} Furthermore, those who advocate the adoption of a statutory BJR have seemed to overlook section 248 of the Companies Act, which provides that in any such proceedings if the court is of the opinion that the person concerned has acted honestly and reasonably, and in all the circumstances ought fairly to be excused, it may relieve him in whole or in part from any liability on such terms as it thinks fit.\textsuperscript{129}

It is submitted that section 248 is too broad in its scope and application and provides the court with too much discretion. Moreover, the court, to relieve a director from liability imposed upon him in terms of section 424(1) cannot invoke this section.\textsuperscript{130} This may result in \textit{ad hoc} decision-making as each case will turn on its own facts and involve a value judgment on those facts. There is a need for uniformity when holding and/or excusing company directors from personal liability for honest business judgments which retrospectively turn out to cause financial prejudice. If the wide discretionary powers the court has under section 248 are to be maintained, there will be the risk of the lack of uniformity and the potential misapplication of the common law and the “implied” BJR which is already invoked by the courts. It is submitted that the codification of the common law duties and the BJR will eliminate this possibility before it materialises.

\textsuperscript{127} See A. Greenhow, \textit{op. cit.}, at p. 56.

\textsuperscript{128} See M. Havenga, \textit{op. cit.}, at pp. 36 – 37 and J.S. McLennan, \textit{op. cit.}, at pp. 100 and 102.

\textsuperscript{129} See D. Botha and R. Jooste, \textit{op. cit.}, at p. 68 criticises the King Report's failure to take account of section 248 of the Companies Act 61 of 1973.

9. TOWARDS CODIFYING THE COMMON LAW DUTIES AND THE ADOPTION OF A BJR

A recent statement by the Department of Trade and Industry, which is responsible for company law reform, stated that there is merit in considering the statutory enactment of the common law duties of company directors. A statutory standard of conduct and a clear statement of their duties would assist in encapsulating the existing common law duties that are applied by the courts and would give directors a degree of certainty about their duties, standard of conduct and associated liabilities. It is submitted that South African law should codify the common law duty of care, skill and diligence of company directors based on a similar provision to section 214 of the English Insolvency Act. Furthermore, South Africa should also incorporate into its Companies Act a statutory BJR along similar lines to the one adopted in Australia.

McLennan submits that South African law would be fully justified in applying the dual objective-subjective test in section 214 of the English Insolvency Act as the test also reflects the common law position. The test in section 214 is a clear departure from the traditional subjective approach and imposes a higher objective test on directors in that the courts will consider the knowledge, skill and experience that directors have, in addition to that which a reasonable person carrying out his functions should be expected to have.

The amendment proposed below codifies the duty of care, skill and diligence based on the objective-subjective approach similar to section 214 of the English Insolvency Act while the statutory BJR, which will create a presumption in favour of directors in that they will be regarded as having met this duty if the requirements are present. In essence, the provision envisages that if a director can show that he has not breached his common law fiduciary duties then a presumption is created that he has complied with his common law duty of care, skill and diligence unless the contrary can be proven. This is a novel attempt at creating a workable framework towards codifying the common law duties of company directors and the enactment of the BJR which will provide a safety net for directors who are alleged to have breached their common law duties and where parties seek to impose personal liability upon directors for breach of such duties.

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The proposed amendment to the Companies Act is a new section 216A, which would deal with the duties of directors and other officers of a company and should read as follows:

(1) A director or officer133 of a company must exercise his/her powers and discharge his/her duties with the degree of care and skill that a reasonably diligent person would exercise 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 or officer in relation to the company and in the company's circumstances; and

b. The general knowledge, skill and experience that the particular director or officer has in carrying out his or her responsibilities within the company.

The concept of business judgment can be defined as any decision to take or not to take action in respect of a matter relevant to the business operations of the corporation. The second part of the provision should read as follows:

(2) A director or officer of a company who makes a business judgment is taken to meet the requirements in subsection (1) and their equivalent duties at common law, in respect of the judgment if they:

a. Make the judgment in good faith for a proper purpose and within the powers conferred upon them; and

b. Do not have a material personal interest in the subject matter of the judgment; and

c. Maintain and exercise an independent and unfettered discretion about the subject matter of the judgment to the extent that the director or officer reasonably believe the judgment to be appropriate in the circumstances; and

d. Rationally believes that the judgment is in the best interest of the corporation; the judgment is a rational one unless the belief is one that no reasonable person in their position would hold.

(3) This section will only apply to a business judgment made by a director or officer in relation to the duties under this section and does not operate in relation to any other duties under any other provisions of this Act, common law or any other statutory law.

Section 216A (1) creates a desirable balance between the objective and subjective considerations that need to be taken into account when ascertaining the liability of company directors for breach of the duty of care, skill and diligence. It will require

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the courts to consider the knowledge, skill and experience that a director has, but will test it against that which a reasonable person carrying out his functions should be expected to have. Moreover, the wording "...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 or officer in relation to the company and in the company's circumstances ..." gives the court discretion to distinguish between "executive" and "non-executive" directors when having to assess the extent of their liability for breach of such a duty. It is accepted in our law that "executive" and "non-executive" directors have separate and distinct, although complementary, role to play within the company's structure. It is submitted that this does not mean that they should be held to a different standard of care, skill and diligence but simply that due regard must be taken to their respective unique positions. This section seeks to impose a general objective standard on all company directors while simultaneously taking into account the nature and responsibilities that each director has in relation to the company. 134

Subsection (2) provides for the BJR and defines a business judgment as "any decision to take or not to take in respect of a matter relevant to the business operations of the corporation." This wider meaning adopted in Australian law is preferable because it includes an actual decision or the failure to take a decision, which would cover instances where a director abdicates his responsibilities and fails to exercise any judgment thereon or fails to take reasonable action or make a reasonable judgment where a reasonable person in the same position would have. A potential problem that arises with this definition is the meaning of "...business operations of the corporation?" It is submitted that this should be left to the courts to determine on a case by case basis by looking at the nature, purpose and function of a company, which can be ascertained from the company's constitution (particularly its memorandum of association).

The BJR will protect those directors who make business judgments in good faith, for a proper purpose and within the powers conferred upon them, and have acted on a reasonably informed basis without material personal interests and who have a rational belief that the decision is in the best interests of the corporation. To be a reasonable business judgment, the decision need not be the most reasonable decision that a person might have reached; it will be sufficient if it is a rational decision made with the view towards furthering the best interests of the

134 See Cronje NO v Stone en 'n ander 1985 (3) SA 597 (T) where the court held a non executive director to be personally liable for a portion of the company debts because she acted reckless in that she had blind faith in the proposals of the executive director which were in many respects incorrect and hence had not exercised the degree of care and skill required of her in ensuring that the information was correct. Also see J.L. Van Dorsten, op. cit., at p. 299.
corporation. A reasonable decision is rational in the sense that it is supported by reliable evidence and information before the decision-maker and the reasons given for it are rationally connected to its purpose or objectively capable of furthering that purpose. Therefore, if the decision-maker takes irrelevant considerations into account or fails to take relevant considerations into account then it would not be reasonable. To require conduct less than reasonable would be to allow erratic or impulsive decision-making. To require more, would mean correctness or perfection. No business judgment can ever be completely correct or perfect. 135

10. CONCLUSION

It is submitted that South African corporate law would benefit greatly from the enactment of the common law duties of company directors and a statutory BJR, as it will provide the certainty that is needed to take companies into a new era of corporate governance. In South Africa, like in most common law countries, virtually all the legal rules relating to the duties, standards and liabilities of company directors are to be found in the common law. South African company law has its roots in English company law, which seems to impose a relatively low standard on company directors in carrying out their common law duties. This is predominantly because the courts focus more on subjective criteria than objective criteria, namely, that particular director’s skill, intelligence and experience. In the *Fisheries Case*, Margo J noted that there is a striking contrast between the director’s heavy fiduciary duties and their very light obligations of skill, care and diligence and it is submitted that it is precisely for this reason that a statutory standard for conduct and a clear statement of a director’s common law duties is required. The traditional subjective-objective test no longer represents modern corporate practice and the trend seems to impose a more demanding objective standard on directors.

Directors play a fundamental role in ensuring good corporate governance and there is a renewed focus on directors being more accountable to the company, which may see a higher objective test being imposed on directors for breach of their common law duties. If this area of law is left too be developed by the courts on a case by case basis and the courts are allowed to invoke their wide discretionary powers under section 424 and section 248, then it is submitted that more directors will be held personally liable for company debts when they ought not to be. The BJR will operate to provide a “safe harbour” for directors and


protect them from the ramifications of personal liability for claims made against them for errors of judgment or business decisions, which have adversely affected the company. Strong policy considerations exist for enacting a statutory BJR, which far outweigh its potential disadvantages.

The concept of good corporate governance practices has become paramount to large corporations which focus on controlling management and balancing the interests of all shareholders and other parties who can be affected by the corporation's conduct in order to ensure responsible behaviour by corporations and to achieve the maximum level of efficiency and profitability for a corporation. South African corporate law should not allow for the emergence of a generation of risk-averse directors' whose caution and conservatism stifle growth and innovation because of a fear of personal liability. The aim of the company and its directors should be to maximise returns to shareholders by taking calculated business risks. Success in business involves weighing up the calculated potential risk against the rewards. The enactment of the BJR would provide a structure for taking business risks, as it would balance out the interests involved for a director who faces a legal minefield of personal liability, thereby encouraging directors to engage in risks for profit.

137 See H.S. Cilliers and M.L. Benade, op. cit., at pp. 163 – 164.