Directors' Duties and the Business Judgment Rule in South African Company Law: An Analysis

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Abstract

The business judgment rule is provided for in the South African company law as part of the statement on the duty to act in the best interest of the company and the duty to act with care, skill and diligence. In terms of the rule, a director will be protected from allegations of breach of the duty to act in the best interests of the company and with care, skill and diligence in relation to a matter where that director has taken reasonably diligent steps to become informed about the matter; either had no conflict of interest in relation to the matter or complied with the rules on conflict of interests; and had a rational basis for believing, and did believe, that his decision was in the best interest of the company. This article provides an analysis of the directors' duty to act with care, skill and diligence and the business judgment rule. It further seeks to advance the thesis that in determining compliance with the business judgment rule, not only compliance with legislation but also compliance with governance codes and good governance criteria is relevant.

1. Introduction

The business judgment rule[1] is found in section 76(4) of the South African Companies Act 71 of 2008[2] and relates to the director's duty[3] to act in the best interests of the company[4] and with care, skill and diligence.[5] In terms of the rule, a director will be protected from allegations of breach of the duty to act in the best interests of the company and with care, skill and diligence in relation to a matter where that director has (i) taken reasonably diligent steps to become informed about the matter, (ii) either had no conflict of interest in relation to the matter or complied with the rules on conflict of interests and (iii) had a rational basis for believing, and did believe, that his decision was in the best interest of the company.[6] The business judgment rule therefore becomes a shield for directors against liability imputations.[7] This article provides an analysis of the directors' duty to act with care, skill and diligence[8] and the business judgment rule.

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1 The business judgment rule was developed in the United States of America (USA) alongside the duty of care and relates to one aspect of this duty, namely that of decision-making. In the USA, the business judgment rule as a common law principle can be traced as far back as 1829 – see *Percy v Milledon* 8 Mart (NSW) 68 78 (La 1829).

2 Hereinafter, the Act. The Act was assented to by the President on 9 April 2009. It became effective on the 1st of May 2011, the date gazetted in the Government Gazette No 34239.

3 The Act introduces provisions relating to the standards of conduct of directors in the form of a partially codified regime of directors' duties, which includes a fiduciary duty and a duty of reasonable care – see section 76 (3). The provisions governing directors' duties are supplemented by other provisions addressing conflict of interest – see section 75, directors' liability – see section 77 and indemnities and insurance – see section 78. These provisions relating to the directors' duties are a partial codification of the company law. The common-law principles remain, but only to the extent that they have not been narrowed by the Act.

4 Section 76(3)(b).

5 Section 76(3)(c). The standard of care, skill and diligence expected is one that 'may reasonably be expected of a person (i) carrying out the same functions as those carried out by that director and (ii) having the general knowledge, skill and experience of that director.'

6 Section 76(4).

7 The rationale being to promote innovation by providing the right balance between the competing interests of commercial risk taking by directors and, on the other hand, their accountability.

8 It is noteworthy that the duty to act in the best interest of the company is not discussed.

It further seeks to advance the thesis that in determining compliance with the business judgment rule, not only compliance with legislation but also compliance with governance codes and good governance criteria is relevant.

2. The Duties of Directors

The business judgment rule has been incorporated into the South African company law as part of the statement on the duty to act in the best interest of the company and the duty to act with care, skill and diligence (Benade, 2010). Business decisions therefore exist alongside these duties which are entirely separate and distinct, although complementary concept. A separate analysis of whether or not a director has complied with these duties is always necessary. These duties apply whether or not a business judgment has been made. For instance, if the directors fail to monitor the affairs of the company, there could be liability under the duty of care, skill and diligence and the business judgment rule would have no application. The duty to act with care, skill and diligence is discussed briefly below.

2.1 The Duty to Act with Care, Skill and Diligence

Directors are liable for negligence in the performance of their duties. Not being insurers, directors are not liable for errors of judgment or for mistakes while acting with reasonable skill and prudence. It has been said that a director is required to conduct the business of the corporation with the same degree of fidelity and care as an ordinary prudent person would exercise in the management of his own affairs of like magnitude and importance. It is submitted that general rules are not altogether helpful. In the final analysis, whether or not a director has discharged his duty, whether or not he has been negligent, depends upon the facts and circumstances of a particular case, the kind of the transaction, and the immediacy of the problem presented. A director is called upon to bestow the care and skill which the situation demands.

Undoubtedly, a director of a bank is held to stricter accountability than the director of a small ordinary business corporation. However, clairvoyance is not required even of a bank director. The law recognizes that the most conservative director is not infallible and that he will make mistakes, but if he uses that degree of care ordinarily exercised by prudent bankers he will be absolved from liability although his opinion may turn out to have been mistaken and his judgment faulty. Thus, in order to determine whether transactions approved by a director would subject him to liability for negligence one must look at the facts as they exist at the time of their occurrence, not aided or enlightened by those which subsequently take place. Indeed, it will not be an overstatement to submit that a wisdom developed after an event and having it and its consequences as a source, is a standard no person should be judged by.

It is noteworthy that our courts have on numerous occasions made it quite clear that directors are not liable for mere errors of judgment (Muswaka, 2009). In *Levin v Feld and Tweeds Ltd*[9] it was held that it is not the duty of the court to usurp the functions of the directors and to consider what was best for the companies from the business point of view. In *Mafikeng Mail (Pty) Ltd v Centner (No 2)*[10] it was held that recklessness was not an error of judgment, nor even a gross error of judgment for, provided the defendant had an explanation which showed that he was confronted by a choice, and that thought and reflection went into the decision taken, the decision could not be subsequently characterized as negligence if it turned out to be wrong. It was further held that an error of judgment might not even amount to negligence, for business decisions, involving as they do the risk of an unknown future, would sometimes be wrong even when taken by the most circumspect manager.[11]

The fact that the courts will normally not enquire into the commercial wisdom of a company transaction was also considered in *Ben-Tovim v Ben-Tovim and Others*[12] in the context of a resolution taken by majority creditors.
It was stated that the court would not interfere with the views of the majority creditors on the commercial wisdom of a scheme of arrangement under section 311.[13]

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9 *Levin v Feld and Tweeds Ltd* 1951 (2) SA 401 (A) 402C-D.

10 *Mafikeng Mail (Pty) Ltd v Centner (No 2)*1996 (4) SA 607 (WLD) 613G-H.

11 This point made by Van Schalkwyk J goes on to reinforce the argument brought forward in this dissertation that there is no need for the business judgement rule.

12 *Ben-Tovim v Ben-Tovim and Others* 2001 (3) SA 1074 (CPD).

13 *Ibid*.

In *Lordon v Dusky Dawn Investments (in liquidation) (Pearmain Intervening)*,[14] the court again stated that it would not interfere with the views of the majority creditors on the commercial wisdom of a scheme of arrangement under section 311.[15] Thus, the courts have shown undoubted preparedness to allow directors to make business judgments and decisions in a spirit of enterprise and they have emphasized that they will not usurp the function of the directors and will not consider what is best for the company from a business point of view.[16]

3. The Business Judgment Rule

The business judgment rule is provided for in section 76(4) of the Act which states as follows:

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

(a) will have satisfied the obligations of subsection (3)(b) and (c)[17] if-

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

(ii) either-

(aa) the director had no material personal financial interest in the subject matter of the decision, and had no reasonable basis to know that any related person had a financial interest in the matter; or

(bb) the director complied with the requirements of section 75 with respect to any interest contemplated in subparagraph (aa); and

(iii) the director made a decision, or supported the decision of a committee or the board, with regard to that matter, and the director had a rational basis for believing, and did believe, that the decision was in the best interests of the company…

The business judgment rule protects honest directors from liability where a decision turns out to have been an unsound one, (Havenga, 2000) and prevents the stifling of innovation and venturesome business activity.[18] The rule is a 'standard of non-review of the merits of a business decision corporate officials have made' (Branson, 2002; Ian, 1995; Larelle, 1997).[19] However, the enactment of the business judgment rule is not a fortress for directors as dishonest and irrational directors will still face the sanction of the court for breach of the duty to act in the best interest of the company[20] and the duty to act with care, skill and diligence.[21] In terms of section 77(2)(a), a director may be held liable in accordance with the principles of the common law relating to breach of a fiduciary duty, for any loss or damages sustained by the company as a result of a breach of *inter alia*, the duty to act in the best interest of the company.

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[14] *Lordon v Dusky Dawn Investments (in liquidation) (Pearmain Intervening)* 1998 (4) SA 519 (SECLD) 521B-D.

[15] *Ibid.*

[16] Blackman MS "Companies" in WA Joubert (ed) *The Law of South Africa* First Reissue volume 4 II (1996) paragraph 124.

[17] Subsection 3(b) provides that a director must act in the best interest of the company while subsection 3(c) provides that a director must exercise reasonable care, skill and diligence.

[18] American Law Institute *Principles of Corporate Governance and Structure:Restatement and Recommendations* (1982), quoted by Lipton P & Herzberg A *Understanding Company Law* 6th ed 1995 393. On the historical development of the rule see Gordon CJ "Corporate Mismanagement as Malpractice: A Critical Re-analysis of Corporate Managers' Duties of Care and Loyalty" (1984) 1 *Houston LR* 105 118.

[19] See also *Harold Co v Seawell* 472 F 2d 1081 (10th Cir 1972); *Financial Industrial Fund Inc v Donnell Douglas Corp* 474 F 2d 514 (10th Cir 1973); *Wolf v Fried* 473 Pa 26 373 A. 2d 734 (1977); *Shlensky v Wrigley* 95 Ill App 2d 173 237 NE 2d 776 (1968), in which the court correctly declined to interfere with the business judgment of a board of directors of Chicago Club, a Delaware corporation, against night home games; *Olson Brothers v Engelehart* 42 Del Ch 348 211 A. 2d 610 (CH 1965); *John Hancock Capital Growth Management Inc v Aris Corporation NO* 9920 (Del Ch 1990); *Credit Men's Adjustment Burea Inc v Weiss* 305 NY 1 110 NE 2d 397 (1953); *Glossberg v Boyd* 35 Del Ch 293 116 A 2d 711 (Ch 1955), where a director was held not liable for good faith payment of out-of-state taxes subsequently invalidated as unconstitutional; *Conviser v Simpson* 122 F Supp 205 (D.Md 1954); *Hornstein v Paramount Pictures Inc* 292 NY 468 55 NE 2d 740 (1944).

[20] Section 76(3)(b).

[21] Section 76(3)(c).

Similarly, in terms of section 77(2)(b), a director may be held liable in accordance with the principles of the common law relating to delict for any loss or damages suffered by the company as a result of a breach of the duty to act with care, skill and diligence.

3.1 Purpose of the Business Judgment Rule

The business judgment rule is intended to further the objective of the Act, succinctly described by Davis *et al*, 2011 as follows:

> Read as a whole, the 2008 Act promotes the objective that there should not be an over-regulation of company business. The Act grants directors the legal authority to run companies as they deem fit, provided that they act within the legislative framework. In other words, the Act tries to ensure that it is the board of directors, duly appointed, who run the business rather than regulators and judges, who are never best placed to balance the interests of shareholders, the firm and the larger society within the context of running a business.

It is noteworthy that a number of South African authors have discussed the business judgment rule. In particular, authors such as Bouwman, 2009; Botha and Jooste, 1997; Havenga, 2000; Jones, 2007; McLennan, 1996; Kennedy-Good and Coetzee, 2006 provide interesting studies on the business judgment rule. These authors, among others, contributed to the debate around the business judgment rule prior to its adoption in the Act. The issue then, was whether or not the business judgment rule should be introduced into our South African law. In general, these authors argued against the introduction of the business judgment rule.[22] It is therefore important to note that while a number of prior studies in South Africa have discussed the business judgment rule, the focus has been on the issue whether or not the rule should be adopted. Now that the rule is now entrenched in the Act, this article, moving beyond prior literature, squarely considers how the business judgment rule intersects with existing corporate governance principles.

4. The Concept of Corporate Governance

There is no universal definition for 'corporate governance.' Bottomley, 1997 observes that 'corporate governance' is a slippery term, used both in discussions about the role of companies in society and also in discussions about the organization of affairs within companies. Generally, 'corporate governance' is understood to mean the way in which companies are directed and controlled.[23] When issues of corporate governance are considered, the emphasis is usually on the role played by directors in running their companies and the interests to be considered in corporate decision-making. Indeed, the theory is that better managed companies will yield benefits for all, hence the focus on the role of directors in, *inter alia,* managing companies. This is the main reason why corporate governance is undeniably pivotal in the modern world.

According to the Organization for Economic Co-operation and Development:[24]

> Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined.[25]

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[22] See for example Bouwman N, "An Appraisal of the Modification of the Dierector's Duty of Care and Skill" (2009) 21 SA Merc LJ 509 529-531; Jones E, "Directors' Duties: Negligence and the Business Judgment Rule" (2007) 19 *SA Merc LJ* 326 332-333; Jones E, "Directors' Duties: Negligence and the Business Judgment Rule" (2007) 19 *SA Merc LJ* 326; Kennedy-Good S & Coetzee L, "The Business Judgment Rule (Part II)" (2006) *Obiter* 277-291.

[23] See, among others, Report of the Committee on the Financial Aspects of Corporate Governance (Cadbury Report) (1992). The King Committee used this formulation as their working definition – see *King I* chapter 1 para 2 1.

[24] Hereafter the OECD.

[25] Preamble to the '*OECD Principles of Corporate Governance,'* 2004. Accessed on 26 July 2011, available at http://www.oecd.org/daf/corporateaffairs/corporategovernance. The '*OECD Principles of Corporate Governance,'* 2004 is a revised version of the '*OECD Principles of Corporate Governance,'* 1999 which was the brainchild of the OECD Council that met at Ministerial level during April 1998 in order to request that the OECD, together with national governments, relevant international organizations and the private sector; create a set of corporate governance standards and guidelines.

The OECD however, acknowledges that there is no single model of good corporate governance.[26] It is noteworthy that the OECD Principles are non-binding and are not prescriptive.[27] Their rationale is to operate as a basic reference point.[28] The OECD Principles were created in order to support member and non-member states[29] in the evaluation and improvement of the legal, institutional and regulatory structure for corporate governance in their countries.

4.1 Corporate Governance in South Africa

In 1992, the Institute of Directors in Southern Africa[30] formed the King Committee to review corporate governance and make recommendations to the corporate world, in order to improve the standard of corporate governance. In 1994, the King Committee issued a *Report*[31] and a *Code of Corporate Practices and Conduct*. Since it was the duty of the King Committee to review corporate governance on an ongoing basis, it issued, on 26 March 2002, the second *Report on Corporate Governance in South Africa*.[32] In view of the (then) anticipated new Companies Act[33] a new *King Report* became necessary. *King II* was therefore, replaced by the revised *King Report on Corporate Governance for South Africa* 2009[34] which was launched on 1 September 2009 and came into effect on 1 March 2010.[35] *King III*, like *King I* and *King II,* promotes good corporate governance in South Africa alongside compliance with the law. *King III* applies to all entities incorporated and resident in South Africa regardless of the manner and form of incorporation or establishment and whether in the public, private sectors or non-profit sectors.[36] *King III* operates on an "apply or explain" basis.[37] This is a refinement of the "comply or explain" basis that *King I* and *King II* operated on.[38]

King III recognizes the responsibility of those persons that perform the management functions of the company. This is *inter alia* evident from the set of principles in the report relating to the role of the board of directors.[39] The *King III* recommendations are not prescriptions. They are guidelines designed to produce an outcome of efficiency. *King III* does not adopt a "one size fits all" approach to corporate governance. Instead, it formulates guidelines of best practice for optimising corporate performance and accountability in the interests of shareholders and the broader economy. The general approach is one of flexibility. If a company considers that a recommendation is inappropriate to its particular circumstances, it is free not to adopt it.[40]

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[26] Preamble to the '*OECD Principles of Corporate Governance,'* 2004. Accessed on 26 July 2011. Available at http://www.oecd.org/daf/corporateaffairs/corporategovernance.

[27] *Ibid.*

[28] Preamble to the '*OECD Principles of Corporate Governance,'* 2004. Accessed on 26 July 2011. Available at http://www.oecd.org/daf/corporateaffairs/corporategovernance.

[29] It is worth noting that South Africa is one of the many non-member economies with which the OECD has working relations in addition to its member states. On 16 May 2007, the OECD Council at Ministerial level adopted a *Resolution on Enlargement and Enhanced Engagement* to strengthen the co-operation with South Africa, as well as with Brazil, China, India and Indonesia through a programme of enhanced engagement. The OECD Council *Resolution on Enlargement and Enhanced Engagement,* accessed on 14 May 2012 is available at http://www.oecd.org/brazil/oecdcouncilresolutiononenlargementandenhancedengagement.htm.

[30] Hereinafter, IoDSA.

[31] *The King Report on Corporate Governance 1994.* Hereinafter, *King I.*

[32] *The King Report on Corporate Governance for South Africa 2002*. Hereinafter *King II.*

[33] Companies Act 71 of 2008.

[34] Hereinafter, *King III.*

[35] Both the Companies Act 71 of 2008 and changes in international governance trends necessitated the publication of *King III*. *King III* is not law, and failure to comply therewith will not result in direct liability for directors

[36] *King III* 17. This may have the effect that entities and stakeholders will require a deeper understanding of governance in order to decide how governance principles and practices should be adopted and implemented in their particular entity – 'the one size does not fit all' consequence.

[37] *King III* 7. *King III* has opted for the more flexible 'apply or explain' approach to its principles and recommended practices.

[38] The King Committee found the word "apply" more appropriate than "comply" for the following reasons: "The 'comply or explain' approach could denote a mindless response to the King Code and its recommendations whereas the 'apply or explain' regime shows an appreciation for the fact that it is often not a case of whether to comply or not, but rather to consider how the principles and recommendations can be applied" – *King III* 7.

[39] For example, *King III* Chapter 1 'Ethical Leadership and Corporate Citizenship' and Chapter 2 'Board and Directors.'

[40] Companies are encouraged to use the guidelines provided in King III as a focus for re-examining their corporate governance practices and to determine whether and to what extent the company may benefit from a change in approach, having regard to the company's particular circumstances.

5. King III and the Companies Act

While *King III* is not law, and failure to comply therewith will not result in direct liability for directors, it is submitted that in determining compliance with the business judgment rule, not only compliance with legislation but also compliance with governance codes and good governance criteria is relevant. Corporate governance practices will raise perceptions of what can be regarded as conduct justifying exoneration form liability. *King III* for example recommends that a director should (i) act with intellectual honesty and independence of mind in the best interests of the company and all its stakeholders, avoiding conflict of interest;[41] (ii) have the knowledge and skills required for governing a company effectively;[42] (iii) be diligent in performing his duties and devote sufficient time to company affairs;[43] and (iv) have the courage to take the risks associated with directing and controlling a successful, sustainable enterprise, and also the courage to act with integrity in all board decisions and activities.[44] It is vital that directors apply these principles and in situations where these and other relevant principles have not been applied, a director should not be exonerated from liability. Courts, should therefore, when determining whether a particular director meets the requirements of the business judgment rule, consider whether such director has also applied the corporate governance principles.

A matter of concern that arises with regard to the above submission is, on what basis should the courts use the corporate governance codes as a tool to assist in the interpretation of the Act (Muswaka, 2013). It is noted that section 5 of the Act, which deals with the rules regarding the general interpretation of the Act does not expressly provide for the use of corporate governance codes such as *King III* when interpreting the Act. It is however, argued that section 5 of the Act must be interpreted within a broader context. In this light, it is submitted that section 5(1) read together with section 7,[45] in particular, section 7(b)(iii) provides a ground of justification for reliance on the corporate governance codes by the courts. Section 5(1) provides that the Act must be interpreted and applied in a manner that gives effect to the purposes set out in section 7. Section 7(b)(iii) provides as one of the purposes of the Act, 'to promote the development of the South African economy by encouraging transparency and high standards of corporate governance as appropriate, given the significant role of enterprises within the social and economic life of the nation.' It is argued in light of section 5(1) read together with section 7(b)(iii) that the starting point for the courts should, without any doubt, be *King III*.

Reliance by the courts on *King III* is undeniably pivotal if the Act is to be interpreted in a manner that promotes the development of the economy by encouraging transparency and high standards of corporate governance. Indeed, corporate governance in South Africa has changed from being a 'soft' mainly ethical issue, to a 'hard' issue, recognized as pivotal to the success and revitalization of the country's capital markets and ultimately, the prospects of the corporate economy. The corporate governance codes serve a crucial role in promoting good corporate governance in South Africa alongside compliance with the law as highlighted in *King III*:

> In addition to compliance with legislation, the criteria of good governance, governance codes and guidelines will be relevant to determine what is regarded as an appropriate standard of conduct for directors. The more established certain governance practices become, the more likely a court would regard conduct that conforms with these practices as meeting the required standard of care. Corporate governance practices, codes and guidelines therefore lift the bar of what are regarded as appropriate standards of conduct. Consequently, any failure to meet a recognized standard of governance, albeit not legislated, may render a board or individual director liable at law.[46]

Thus, 'there is always a link between good governance and compliance with the law.'[47] Good governance is therefore, not something that exists separately from the law and it is entirely inappropriate to unhinge governance from the law.[48]

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[41] *King III* para 15.1 21.
[42] *King III* para 15.3 22.
[43] *King III* para 15.4 22.
[44] *King III* para 15.5 22.
[45] Section 7 sets out an impressive list of legislative purposes.
[46] *King III* 8.
[47] *King III* 7.
[48] *King III* 7.

In this regard, it would therefore, not be an overstatement that the Act and *King III* should work in tandem to promote the development of the South African economy by *inter alia* encouraging high standards of corporate governance.

6. Conclusion

In the foregoing discussion, directors' duty of care, skill and diligence and the relationship between the business judgment rule and good corporate governance has been highlighted. It has been recommended that the courts, when determining whether or not a director meets the requirements of the business judgment rule, should also consider compliance with good corporate governance practice.[49] While section 5 does not expressly provide for the use of corporate governance reports and codes of practice, it has been argued that section 5(1)[50] read together with section 7(b)(iii)[51] provides a justification for such use. The Act and *King III* should therefore, work in tandem to promote the development of the South African economy by *inter alia* encouraging high standards of corporate governance.

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[49] Focus has however been on *King III* Chapter 1 Principle 1.1 para 15 21-22.

[50] Section 5(1) provides that the Act must be interpreted and applied in a manner that gives effect to the purposes set out in section 7.

[51] Section 7(b)(iii) provides as one of the purposes of the Act, 'to promote the development of the South African economy by encouraging transparency and high standards of corporate governance as appropriate, given the significant role of enterprises within the social and economic life of the nation