

# **THE BUSINESS JUDGMENT RULE (PART 2)**

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## **SUMMARY**

The business judgment rule entails that courts should not hold a director liable for a decision that produces poor results in the circumstances in which the director made the decision in good faith, with care and on a informed basis, which the director believed was in the best interest of the company.<sup>1</sup>

This article considers the South African position relating to the director's common law duty of care and skill. The Companies Act, recommendations of the King Committee, and the Department of Trade and Industry's report on corporate law reform are taken into account. The efficiency of the current law in South Africa is evaluated in light of the advantages and disadvantages of the importation of a foreign legal rule.

A closer examination of the characteristics of the business judgment rule and the South African law relating to director liability will reveal whether it is essential to implement the rule in South Africa. In paragraph 3 a conclusion is drawn and an assessment made of whether it is indeed desirable or necessary to import the business judgment rule into South African law.

## **1 INTRODUCTION**

The business judgment rule was developed in the United States of America alongside the duty of care. The business judgment rule entails that courts should exercise restraint in holding directors accountable for business

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<sup>1</sup> See par 1 of part 1.

decisions which produce poor results.<sup>2</sup> Coupled with the duty of care<sup>3</sup> the result is that if a director made a decision in good faith, with care and on an informed basis, which the director reasonably believed was in the interest of the company, the director cannot incur liability in respect of that decision.<sup>4</sup> An objective of the rule is to limit litigation and judicial scrutiny in respect of decisions that are taken within the private business sector.<sup>5</sup>

When the rule is utilized it essentially has two effects. Firstly, it precludes the court from examining the merits of the director's decision once it is evident that the director acted in good faith and, secondly, the rule creates a presumption in favour of the director of due care and good faith.<sup>6</sup> The rule has numerous basic purposes, which include: the encouragement of risk-taking; to persuade competent persons to undertake the office of director; the prevention of judicial second-guessing; avoiding shareholder management in the corporation; and permitting effective market mechanisms to manage director behaviour.<sup>7</sup>

A director's duty of care and skill entails that a director must carry out the functions of his or her office and exercise the powers of that office *bona fide* and for the benefit of the company and in so doing the director is required to exercise the requisite degree of care and skill.<sup>8</sup> Directors exercise a measure of judgment in their daily decision-making on behalf of companies. A possibility exists that a particular decision taken can turn sour, be it due to unexpected events or merely because the directors made an honest mistake.

The aim of this article is to investigate the South African law relating to the director's duty of care, the relevant provisions of the Companies Act, the recommendations of the King Committee<sup>9</sup> and the report concerning corporate law reform that was issued by the South African Department of Trade and Industry.<sup>10</sup> The discussion will, where applicable, take into account the effectiveness of the current South African law and evaluate this in light of the characteristics of the business judgment rule.

<sup>2</sup> Gevurtz *Corporation Law* (2000) 278-279; and Hinsey "Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine, and the Reality" 1984 52 *The George Washington Law Review* 610.

<sup>3</sup> Gevurtz 274; Schneeman *The Law of Corporations and Other Business Organizations* 3ed (2002) 251; Sniffen *The Essential Corporation Handbook* (1992) 56; and Subak "A Snapshot of the Law Being Carved in Stone" 1987 42 *The Business Lawyer* 763-764.

<sup>4</sup> For a different description of the rule see *Panter v Marshall Field & Co* 646 F.2d 271 (7<sup>th</sup> Cir. 1981) 102. (American case law will be quoted in this manner. Copies of the cases were obtained from Mr James Parker at Kane & Kane, Boca Raton, West Palm Beach, Florida.)

<sup>5</sup> The American Law Institute *Principles of Corporate Governance and Structure: Analysis and Recommendations* Vol 1 (1994) 135.

<sup>6</sup> Block and Prussin "The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?" 1981 37 *The Business Lawyer* 33.

<sup>7</sup> Lee "The Business Judgment Rule: Should it Protect Nonprofit Directors?" 2003 103 *Columbia Law Review* 945-960.

<sup>8</sup> *Ibid.*

<sup>9</sup> The Institute of Directors in South Africa 1994 November; The Institute of Directors in South Africa 2002 March.

<sup>10</sup> The Department of Trade and Industry in South Africa "South African Company Law for the 21<sup>st</sup> Century: Guidelines for Corporate Law Reform" 2004 May.

## 2 THE SOUTH AFRICAN LEGAL POSITION

In South African law directors are subject to various duties. These obligations are: obligations which arise due to the fiduciary nature of their office;<sup>11</sup> duties of care and skill; duties which arise due to provisions in the Companies Act;<sup>12</sup> or the company constitution and obligations created by contracts concluded with the company.<sup>13</sup>

The business judgment rule is not officially recognised in South African law.<sup>14</sup> The rule does, however, relate to one aspect of the duty of care, namely decision-making.

### 2.1 The common law duty of care and skill

The duty of care and skill curtails the powers of directors.<sup>15</sup> The rules governing the standard of care required of directors can be traced back to various English decisions during the nineteenth and twentieth centuries.<sup>16</sup> In *Re City Equitable Fire Insurance Company*<sup>17</sup> it was stated that a director need not exhibit a greater degree of skill than may be reasonably expected from a person with his knowledge and experience.<sup>18</sup> The test therefore contains an objective element, the criterion of “care”, and a subjective element, “skill”, which varies from person to person.<sup>19</sup>

The standards according to which the degree of care and skill are to be tested are not clear.<sup>20</sup> It is not required that a particular individual must possess any qualification to take up the office of director,<sup>21</sup> nor is it required that he or she must bring to the office any special business acumen.<sup>22</sup> The

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<sup>11</sup> For issues pertaining to the fiduciary duties of directors see in general *Atlas Organic Fertilizers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd* 1981 2 SA 173 (T); Benade, Henning, Du Plessis, Delpport, De Koker and Pretorius *Entrepreneurial Law* 3ed (2003) 125-129; Blackman “Companies” Vol 4 Part 2 *LAWSA* First Reissue (1996); and *Movie Camera Company (Pty) Ltd v Van Wyk* [2003] 2 All SA 291 (C).

<sup>12</sup> 61 of 1973 (hereinafter “the Act”).

<sup>13</sup> Benade *et al* 125; and Cilliers, Benade, Henning, Du Plessis, Delpport, De Koker and Pretorius *Corporate Law* 3ed (2000) 139.

<sup>14</sup> See The Institute of Directors in South Africa “King Report on Corporate Governance for South Africa” 2002 March 70 where it is stated that “[t]he Standing Advisory Committee should investigate whether there is a need for the business judgment rule in South Africa”.

<sup>15</sup> Mongalo *Corporate Law & Corporate Governance – A Global Picture of Business Undertakings In South Africa* (2003) 170; and Pretorius (ed), Delpport, Havenga and Vermaas *Hahlo’s South African Company Law Through the Cases* 6ed (1999) 278.

<sup>16</sup> Cilliers *et al* 147; *Fisheries Development Corporation of SA Ltd v Jorgensen* 1980 4 SA 156 (W) 165F-G; and Havenga “The Business Judgment Rule – Should We Follow the Australian Example?” 2000 12 *SA Merc LJ* 25.

<sup>17</sup> (1925) 1 Ch 407.

<sup>18</sup> *In re City Equitable Fire Insurance Company supra* 428-429.

<sup>19</sup> Benade *et al* 129; Blackman par 138; and Cilliers *et al* 147.

<sup>20</sup> Cilliers *et al* 147; Havenga 2000 12 *SA Merc LJ* 34; and Van Dorsten *The Law of Company Directors in South Africa* 2ed (1999) 217.

<sup>21</sup> Blackman par 138; and Havenga 2000 12 *SA Merc LJ* 34.

<sup>22</sup> Beuthin and Luiz *Beuthin’s Basic Company Law* 3ed (2000) 204; Blackman par 138; and Cilliers *et al* 148.

court has indicated that the extent of care exercised by directors is dependent on the nature of the company's business<sup>23</sup> and any particular obligations assumed by the director.<sup>24</sup> Where another official performs a particular duty of the director, the director is justified in trusting that the official in question will carry out the duty honestly.<sup>25</sup> The director is furthermore entitled to rely upon the advice of management, but clearly should not do so blindly and must exercise his or her own judgment.<sup>26</sup> The rules in respect of the duty of care are applied equally to executive and non-executive directors.<sup>27</sup>

It has been contended that the degree of care and skill which is found within the common law is, in fact, disappointingly low.<sup>28</sup> In light of this statement it is vital to bear in mind that two purposes of the business judgment rule as it is expounded in America are firstly, the desire to persuade competent persons to undertake directorships and, secondly, the need to encourage risk-taking activities by directors.<sup>29</sup> It is contended that these particular needs, in a South African context,<sup>30</sup> are in fact satisfied by virtue of the low degree of care and skill that is required by the common law.<sup>31</sup> The South African common law indirectly entices proficient persons to serve as directors and allows such directors ample discretion to carry out decisions that may be regarded as risk-prone.<sup>32</sup> Thus, it may be argued that it is not necessary to import the business judgment rule in order to fulfill these two purposes as these objectives are satisfied within South African law.

<sup>23</sup> *Fisheries Development Corporation of SA Ltd v Jorgensen supra* 165G-H; and *Wolpert v Uitzigt Properties (Pty) Ltd* 1961 2 SA 257 (W) 267D-E.

<sup>24</sup> Beuthin and Luiz (2000) 203; and Cilliers *et al* 147.

<sup>25</sup> Benade *et al* 130; Blackman par 139; and Cilliers *et al* 148.

<sup>26</sup> Benade *et al* 130; Blackman par 139; Cilliers *et al* 148; and Van Dorsten 218.

<sup>27</sup> Blackman par 138; *Howard v Herrigel NNO* 1991 2 SA 660 (A) 678C-D; and *Philotex (Pty) Ltd v Snyman, Braitex (Pty) Ltd v Snyman* 1998 2 SA 138 (SCA) 145B-D. See also *Dorchester Finance Co Ltd v Stebbing* (1989) BCLC 498 Ch where it was held that, in English law, there is no distinction between the duties of executive and non-executive directors.

<sup>28</sup> Botha and Jooste "A Critique of the Recommendations in the King Report Regarding a Directors Duty of Care and Skill" 1997 114 *SALJ* 76; and Cassim "Fraudulent or 'Reckless' Trading and Section 424 of The Companies Act" 1981 98 *SALJ* 171-172. Taking into account that English law is similar to South African law in respect of the duty of care and skill see Davies *Gower's Principles of Modern Company Law* 6ed (1997) 640; Finch "Company Directors: Who Cares About Skill and Care?" 1992 55 *Modern Law Review* 202; Mackenzie "A Company Director's Obligations of Care and Skill" 1982 *Journal of Business Law* 461; Sealy "Reforming the Law on Directors' Duties" 1991 12(9) *The Company Lawyer* 176; and Trebilcock "The Liability of Company Directors for Negligence" 1969 32 *Modern Law Review* 508.

<sup>29</sup> See par 2 of part 1.

<sup>30</sup> It is contended, particularly in light of the 2002 King Report, that there is an aspiration in South Africa to attract competent individuals to serve on the board of directors. In this regard see in general The Institute of Directors in South Africa 2002 March 62-64.

<sup>31</sup> Botha and Jooste 1997 114 *SALJ* 76.

<sup>32</sup> See Blackman par 138 where it is stated that "[t]he courts have recognised that directors must be allowed to make business judgments and business decisions in a spirit of enterprise untrammelled by the concerns of a conservative investment trustee; and that risks may be taken in the hope of commensurate rewards".

In addition to this, it is clear that the South African courts are wary of second-guessing decisions that were taken by the directors.<sup>33</sup> Directors cannot be held liable for an error of judgment merely due to the fact that the court disagrees with the decision taken by the director concerned.<sup>34</sup> Thus, it is questionable whether it is indeed essential to include the business judgment rule in South Africa, as it is apparent that South African courts strive towards the prevention of judicial second-guessing, which is a further purpose which the rule fulfils in America.<sup>35</sup>

Directors will, however, always be held liable for gross negligence.<sup>36</sup> This liability may be founded within the law of delict or, if a contract existed between the director and the company, the director may be guilty of breach of contract.<sup>37</sup>

### 2 1 1 *Delictual liability*

A director who fails to observe the duties of care and skill to the company can be held liable in delict for damages.<sup>38</sup> In order to incur liability, which is Aquilian in nature,<sup>39</sup> the general elements of the law of delict will have to be satisfied. These elements will now be briefly analysed.

The first of these is that of conduct, which may be in the form of a positive act or an omission.<sup>40</sup> The second requirement, wrongfulness, entails that an act is unlawful if it is done in breach of a legal duty and results in infringement of another individual's interests.<sup>41</sup> Wrongfulness consists of a twofold investigation.<sup>42</sup> Firstly, it must be established that an interest has been infringed.<sup>43</sup> Secondly, it must be determined whether such prejudice occurred in an unreasonable manner taking into account the *boni mores* of the community.<sup>44</sup> The *boni mores* test is an objective test based on the criterion of reasonableness.<sup>45</sup>

<sup>33</sup> *Howard v Herrigel NNO supra* 676B-C; *Mongalo* 170; *Levin v Feld and Tweeds Ltd* 1951 2 SA 401 (A) 414G-H; *Ozinsky NO v Lloyd* 1992 3 SA 396 (C) 414D-E; and *Triptomania Twee (Pty) Ltd v Connolly* 2003 3 SA 558 (C) 563A-B.

<sup>34</sup> *Blackman* par 138; *Fisheries Development Corporation of SA Ltd v Jorgensen supra* 166B-C; *Mongalo* 170; and *Van Dorsten* 220.

<sup>35</sup> See par 2 of part 1.

<sup>36</sup> *Beuthin and Luiz* (2000) 204.

<sup>37</sup> *Benade et al* 130; *Cilliers et al* 148; and *Van Dorsten* 221.

<sup>38</sup> *Benade et al* 130; *Blackman* par 163; *Cilliers et al* 148; and *Havenga* 2000 12 SA Merc LJ 35.

<sup>39</sup> *Du Plessis NO v Phelps* 1995 4 SA 165 (C) 170B-C; *Ex parte Lebowa Development Corporation Ltd* 1989 3 SA 71 (T) 106I-J; and *Havenga* 2000 12 SA Merc LJ 35.

<sup>40</sup> Midgley "Delict" Vol 8 Part 1 LAWSA First Reissue (1996) par 49; and Neethling, Potgieter and Visser *Law of Delict* 4ed (2001) 27.

<sup>41</sup> *International Shipping Co (Pty) Ltd v Bentley* 1990 1 SA 680 (A) 694D-E; and *Van Dorsten* 428.

<sup>42</sup> *Neethling et al* 35.

<sup>43</sup> *Ibid.*

<sup>44</sup> *Midgley* par 51; and *Neethling et al* 35.

<sup>45</sup> *Midgley* par 51; and *Neethling et al* 38.

In *Coronation Brick (Pty) Ltd v Strachan Construction Co (Pty) Ltd*<sup>46</sup> it was held that “in any given situation the question is asked whether the defendant’s conduct was reasonable according to the legal convictions or feelings of the community”.<sup>47</sup>

Therefore, a director will only incur liability in the event that his or her conduct meets the requirement of wrongfulness. The criterion of wrongfulness may serve to limit the liability of the director due to the fact that the decision of the director may have indeed caused a loss but such a decision is not regarded as unreasonable according to the convictions of the community.<sup>48</sup>

Generally, an individual does not act wrongfully in the event that he or she fails to act positively to prevent harm to another.<sup>49</sup> However, in circumstances in which the common law places an obligation upon an individual to perform certain positive acts, such as the director’s duty of care and skill, the failure to perform this duty will be regarded as wrongful.<sup>50</sup> Furthermore, the occupation of a particular office may also place a legal duty upon the bearer to act in a certain manner.<sup>51</sup> In order to determine whether the director owed a legal duty by virtue of the occupation of office, one will merely have to apply the *boni mores* test.<sup>52</sup> It is contended that the occupation of the office of a director may require the holder to act in a certain manner and failure to do so may constitute a breach of that duty.<sup>53</sup>

The third delictual requirement is fault.<sup>54</sup> Two forms of fault are recognised, namely, intention and negligence.<sup>55</sup> Intention consists of direction of the will and knowledge of wrongfulness.<sup>56</sup> Negligence, on the other hand, is established if a reasonable person in the position of the defendant would foresee the reasonable possibility of his conduct injuring another and would take reasonable steps to guard against such occurrence, and the defendant failed to take such steps.<sup>57</sup> This general test for negligence may, however, be adapted in respect of directors as a director may be regarded as an “expert”. If this is so, the court will have regard to the general level of skill exercised by that particular profession to which the director belongs and thus a higher standard of care may be required of a

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<sup>46</sup> 1982 4 SA 371 (D).

<sup>47</sup> *Coronation Brick (Pty) Ltd v Strachan Construction Co (Pty) Ltd supra* 380E-F.

<sup>48</sup> Havenga 2000 12 SA Merc LJ 35.

<sup>49</sup> Neethling *et al* 57.

<sup>50</sup> Midgley par 54; and Neethling *et al* 66.

<sup>51</sup> *Macademia Finance Ltd v De Wet NNO* 1991 4 SA 273 (TPA) 278I-J; and Neethling *et al* 70.

<sup>52</sup> *Jowell v Bramwell-Jones* 1998 1 SA 836 (W) 878C-D; and Van Dorsten 428-429.

<sup>53</sup> See *Pinshaw v Nexus Securities (Pty) Ltd* 2002 2 SA 510 (C) 535I-J where it was held that the director concerned had, on the facts of the case, attracted a legal duty of care.

<sup>54</sup> Midgley par 85; and Neethling *et al* 119.

<sup>55</sup> *Du Plessis NO v Phelps supra* 170C-D.

<sup>56</sup> Midgley par 87; and Neethling *et al* 123.

<sup>57</sup> *Kruger v Coetzee* 1966 2 SA 428 (A) 430E-F; Midgley par 91; *Mukheiber v Raath* 1999 3 SA 1065 (SCA) 1077E-F; and Neethling *et al* 129.

director.<sup>58</sup> It is clear that the requirement of fault, particularly in the form of negligence, may limit the liability of directors.<sup>59</sup>

Causation, which comprises factual and legal causation, is the fourth requirement that must be present.<sup>60</sup> Factual causation entails that a factual causal nexus must exist between the act and the harmful consequence.<sup>61</sup> Legal causation is established if there is a sufficiently close connection between an act and a consequence, taking into account policy considerations.<sup>62</sup> Causation is utilized to limit legal responsibility for the consequences of a wrongful act.<sup>63</sup> Legal causation may, although not as readily as the requirement of wrongfulness and negligence, also impose a limitation on director liability.

The last requirement is that of damage, which is the diminution, as a result of a damage-causing event, in the utility of a patrimonial or personality interest.<sup>64</sup> It is clear that in the context of delictual liability of directors this requirement does not pose any difficulty.

In light of the test for wrongfulness, fault in the form of negligence and legal causation, it is argued that the current law of delict is in fact effective, due to the fact that the law of delict achieves a balance between the incurrance of liability and the prevention of limitless liability.<sup>65</sup> It is apparent that a director will not easily be held liable in terms of delict for a mere error of judgment and that this therefore indicates that it is needless for the business judgment rule to be imported into South African law in order to shield directors from delictual liability.

## 2.2 The Companies Act 61 of 1973

The Companies Act contains two notable provisions that pertain to director liability and that are relevant to the inquiry into whether it is necessary to introduce the business judgment rule into South African law. These provisions are in sections 248 and 424.<sup>66</sup>

<sup>58</sup> *Durr v ABSA Bank Ltd* 1997 3 SA 448 (SCA); and Midgley par 98.

<sup>59</sup> Havenga 2000 12 SA Merc LJ 35.

<sup>60</sup> *Minister of Police v Skosana* 1977 1 SA 31 (A); and Midgley par 102.

<sup>61</sup> Midgley par 103; Neethling *et al* 173; and Van Dorsten 432.

<sup>62</sup> Midgley par 105; Neethling *et al* 186-188; and *S v Mokgethi* 1990 1 SA 32 (A). For a detailed discussion of *S v Mokgethi* see Neethling, Potgieter and Scott *Case Book on the Law of Delict* 3ed (2000) 385-395.

<sup>63</sup> Midgley par 105; and Van Dorsten 432-433.

<sup>64</sup> *Kellerman v South African Transport Services* 1993 4 SA 872 (C); Neethling *et al* (2001) 211-212; *Santam Versekeringsmaatskappy Bpk v Byleveldt* 1973 2 SA 146 (A); and Van Dorsten 431-432.

<sup>65</sup> See *Body Corporate of Greenwood Scheme v 75/2 Sandown (Pty) Ltd* 1999 3 SA 480 (W) 488I-J where it was stated that "[t]he purpose of s 424(1) was to supplement the common law and to simplify the evidential requirements of a delictual claim which might be difficult if not impossible to prove".

<sup>66</sup> A detailed discussion of these sections falls beyond the scope of this article. For such an analysis see Blackman par 158 and 164-171.

## 2 2 1 Section 248

Section 248 provides that the court may relieve a director from liability in circumstances in which the director has acted honestly and reasonably.<sup>67</sup> It is, however, contended that special circumstances will have to exist before a director is granted the relief envisaged by the section and that the court will take into account all the circumstances of the particular case.<sup>68</sup> In *Ex parte Lebowa Development Corporation Ltd*<sup>69</sup> it was held that the requirement of “honestly” means that a court cannot relieve a director from liability that was incurred due to fraudulent conduct on the part of the director.<sup>70</sup> It was further stated that section 248 does not find application in circumstances in which a creditor of the company lodges a claim against the director for damages that were suffered by the creditor as a result of the negligence of the director.<sup>71</sup> Therefore, the only relief that the section permits is relief from liability to the company in question and from criminal liability.<sup>72</sup> In order for a person to successfully invoke the section, he or she will have to show, on a balance of probabilities, that he or she acted honestly, reasonably and ought to be excused.<sup>73</sup>

Due to the fact that section 248 cannot be invoked against a claim that is instituted by a third party, it is clear that section 248 finds application only in certain circumstances. It may therefore be argued that the business judgment rule should be incorporated into South African law in order to provide for the specific circumstance in which a third party lodges a claim against a director. However, it is contended that, where a director is sought to be held accountable by a third party on the basis of the law of delict, the principles of delict, including the test for wrongfulness, fault in the form of negligence and legal causation, will impose sufficient limitations that will provide directors with adequate protection.<sup>74</sup>

Section 248 is an efficient mechanism that can be employed by a director who has acted honestly in order to be excused from liability towards the company and from criminal responsibility. In the event that a third party seeks to hold a director liable, on the basis of delict, the general principles of delict will shield the director from liability in the event that he or she has acted honestly. Consequently, it is argued that it is not essential to include the business judgment rule in South African law.

<sup>67</sup> Blackman par 158; and Visser *et al* 352.

<sup>68</sup> Benade *et al* 134; and Cilliers *et al* 160.

<sup>69</sup> *Supra*.

<sup>70</sup> *Ex parte Lebowa Development Corporation Ltd supra* 107D-E.

<sup>71</sup> Blackman par 158; and *Ex parte Lebowa Development Corporation Ltd supra* 107H-I.

<sup>72</sup> Blackman par 158; and *Ex parte Lebowa Development Corporation Ltd supra* 107H-J.

<sup>73</sup> Meskin (ed), Blackman, Glaser, Konyn and Mullins *Henochsberg on the Companies Act* 4ed Vol 1 (1985) 386. For a general discussion of the standard of proof in a civil trial see Schwikkard “The Standard and Burden of Proof and Evidential Duties in Civil Trials” in Schwikkard and Van der Merwe *Principles of Evidence* 2ed (2002) 544-545.

<sup>74</sup> See 2 1 1 above.

## 2 2 2 Section 424

Section 424 of the Act, which is punitive in nature,<sup>75</sup> provides that when it appears that the business of the company was carried on recklessly, or with intent to defraud creditors of the company, or any other person, or for any fraudulent purpose, the court may declare any person who was knowingly a party to such conduct personally responsible for all or any of the debts of the company.

At the outset it must be made clear that the section does not replace the remedies that are available in terms of the common law, it rather plays a supplementary function.<sup>76</sup> The purpose of this section, which is encapsulated in wide terms, is to hold fraudulent and reckless persons accountable for their conduct.<sup>77</sup> The crucial distinction between section 424 and the common law remedy is that the common law requires a causal connection between the wrongful conduct in question and the damages claimed, whereas in terms of section 424, an individual may be held liable without proof of a causal connection between the fraudulent conduct of the business affairs and the liabilities for which he may be declared liable.<sup>78</sup>

In order to obtain an order in terms of the section, the applicant must prove on a balance of probabilities that the person who is sought to be held accountable, had knowledge of the facts from which a conclusion can be drawn that the business was being carried on recklessly or with intent to defraud creditors of the company.<sup>79</sup> It is not necessary to prove that the individual had actual knowledge of the consequences of those facts.<sup>80</sup> Cognisance must be taken of the fact that mere knowledge of facts is not sufficient to be held liable under section 424.<sup>81</sup> It is also required that the person concerned was a “party” to the carrying on of the business in such a manner.<sup>82</sup> It has been held that in order to be a “party” to the conduct in question, positive conduct on the part of the person in question is not required.<sup>83</sup> In the event that the person in question is found liable in terms of

<sup>75</sup> Blackman par 164; *Terblanche NO v Damji* 2003 5 SA 489 (C) 511A-B; *Philotex (Pty) Ltd v Snyman*; and *Braitex (Pty) Ltd v Snyman supra* 142H-I.

<sup>76</sup> *Body Corporate of Greenwood Scheme v 75/2 Sandown (Pty) Ltd supra* 488I-J; *Ex parte Lebowa Development Corporation Ltd supra* 109D-E; and *Kalinko v Nisbet* 2002 5 SA 766 (W) 774A-B.

<sup>77</sup> Benade *et al* 135; Blackman par 164; Cassim 1981 98 SALJ 163; Cilliers *et al* 161; and *Pressma Services (Pty) Ltd v Schuttler* 1990 2 SA 411 (C) 415F-G.

<sup>78</sup> Blackman par 164; *Kalinko v Nisbet supra* 774C-D; and *Terblanche NO v Damji supra* 511A-B.

<sup>79</sup> Beuthin and Luiz (2000) 17; and *Howard v Herrigel NNO supra* 673I-J.

<sup>80</sup> Beuthin and Luiz *Beuthin's Basic Company Law* 2ed (1992) 18; and *Howard v Herrigel NNO supra* 674A-B.

<sup>81</sup> *Howard v Herrigel NNO supra* 674A-B.

<sup>82</sup> *Cooper NO v South African Mutual Life Assurance Society* [2001] 1 All SA 355 (A) 361H-363I; *Howard v Herrigel NNO supra* 674A-B; and *Powertech Industries Ltd v Mayberry* 1996 2 SA 742 (W) 749D-I.

<sup>83</sup> *Howard v Herrigel NNO supra* 674G-H; *Nel NNO v McArthur* 2003 4 SA 142 (T) 157D-E.

the section, such person could also be charged in the criminal courts for contravention of section 424(3) of the Companies Act.<sup>84</sup>

In the case of *Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman*<sup>85</sup> the Supreme Court of Appeal found the directors concerned liable under section 424. With regards to the test of “recklessness” it was held that the test is objective to the extent that the defendant’s actions are measured against the standard of conduct of the reasonable person and is subjective to the extent that the knowledge of the defendant will be imputed to the reasonable person.<sup>86</sup> In the event that a company continues to incur debts, when in the opinion of a reasonable business person, there would be no reasonable prospect of payment when the debt fell due, it will be inferred that the business is being carried on recklessly.<sup>87</sup>

In the event that the business judgment rule was to be imported into South African law it is submitted that the rule could not be invoked in relation to section 424 where the director concerned was fraudulent. This is primarily due to the fact that the business judgment rule protects honest directors from being held liable for errors of judgment and that the rule could therefore not be used as a shield against liability.

It is, however, submitted that the rule could possibly be invoked in order to escape liability which may be imposed in terms of section 424, where the director is charged with recklessness. However, it is contended that such protection from section 424 is superfluous. The concept of “recklessness” within the section is an objective test, which entails a comparison between the conduct of the defendant and that of the reasonable person. Therefore, the section imposes a limitation on its operation. It is apparent that this limitation can effectively shield the director concerned from liability, thereby fulfilling the exact role that the business judgment rule seeks to satisfy.

It is also crucial to consider, particularly in light of corporate governance, that section 424 is in fact an effective tool to control the actions of

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<sup>84</sup> Beuthin and Luiz (2000) 17; Blackman par 172; Cassim 1981 98 SALJ 166-167; *Ex parte Lebowa Development Corporation Ltd supra* 113B-C; Havenga “Creditors, Directors, and Personal Liability under Section 424 of the Companies Act 61 of 1973” 1992 4 SA Merc LJ 65; and Van Dorsten 216. See *S v Harper* 1981 2 SA 638 (D) for a general exposition on what the State must prove in order to secure a conviction on the basis on s 424(3).

<sup>85</sup> *Supra*.

<sup>86</sup> Blackman par 167; *Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman supra* 139F-H. For a comprehensive discussion of the *Philotex* case see Havenga “Director’s Personal Liability for Reckless Trading” 1998 61 THRHR 719-722; and Pretorius *et al* 605-609.

<sup>87</sup> Blackman par 167; *Ozinsky NO v Lloyd supra* 414G-H. See *Mafikeng Mail (Pty) Ltd v Centner (No 2)* 1995 4 SA 607 (W) 613H-I where it was held that business conduct will generally be regarded as reckless if no reasonable explanation for the conduct complained of exists. For a comprehensive discussion of the *Mafikeng Mail* case see De Koker “Roekelose of Bedrieglike Dryf van Besigheid – ’n Verdere Hoofstuk” 1995 20 TRW 101-118. It must however be noted that in *Ex parte De Villiers NNO: In re Carbon Developments (Pty) Ltd (in liquidation)* 1993 1 SA 493 (A) 505D-E it was held that the mere “fact that the liabilities of a company exceed its assets does not necessarily mean that the incurrance of further debts would amount to fraudulent or reckless conduct”.

directors.<sup>88</sup> Therefore, it may not be entirely desirable to import the business judgment rule, which will then act as an additional measure that reckless directors may seek to invoke when the provisions of section 424 are implemented against the director concerned.

### 2.3 The Recommendations of the King Committee

In 1994 the King Committee recommended in The King Report on Corporate Governance<sup>89</sup> that the Companies Act be amended in order to provide for a statutory limitation on a director's duty of care and skill.<sup>90</sup> It was identified that there is a need to encourage entrepreneurship and entice persons of skill to accept appointments in enterprises.<sup>91</sup> Furthermore, particularly in respect of non-executive directors, it was contended that the appointment of directors is onerous in light of the present tests of a breach of the duty of care and skill.<sup>92</sup> It was also recommended that directors should not be liable for breach of the duty of care and skill if they have exercised business judgment in good faith in a manner in which the decision is informed, is based on all the relevant facts, is rational, and there is no self-interest.<sup>93</sup>

In 2002 the King Report on Corporate Governance for South Africa<sup>94</sup> briefly analysed the business judgment rule.<sup>95</sup> It was concluded by the committee that the Standing Advisory Committee on Company Law should investigate the desirability and necessity of the integration of the rule into South African law.<sup>96</sup>

It is interesting to note that in the press release of the 1994 King Report<sup>97</sup> it was stated that, currently, if one director breaches the duty of care and skill, the other directors incur collective responsibility.<sup>98</sup> This remark is clearly false, due to the fact that in South African law there is no strict vicarious liability in this particular context.<sup>99</sup> If this was the position it is apparent that virtually no persons would assume the office of director.<sup>100</sup>

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<sup>88</sup> Cassim 1981 98 *SALJ* 163; Havenga 1992 4 *SA Merc LJ* 68; Havenga 1998 61 *THRHR* 719; and Havenga 2000 12 *SA Merc LJ* 36.

<sup>89</sup> The Institute of Directors in South Africa 1994 Nov.

<sup>90</sup> The Institute of Directors in South Africa 1994 Nov 9 par 3.5.

<sup>91</sup> The Institute of Directors in South Africa 1994 Nov 9 par 3.2.

<sup>92</sup> The Institute of Directors in South Africa 1994 Nov 9 par 3.3.

<sup>93</sup> The Institute of Directors in South Africa 1994 Nov 31 par 24.6.

<sup>94</sup> The Institute of Directors in South Africa 2002 March.

<sup>95</sup> The Institute of Directors in South Africa 2002 March 70. For a general discussion of the differences and similarities between traditional corporate governance and modern corporate governance see Mongalo "Convergence of Traditional Corporate Governance and Modern Corporate Governance Reforms: Is King II déjà vu for Boards of Directors or is it a set of New Principles?" 2004 *Obiter* 79-90.

<sup>96</sup> The Institute of Directors in South Africa 2002 March 70.

<sup>97</sup> The Institute of Directors in South Africa 1994 Nov.

<sup>98</sup> Botha and Jooste 1997 114 *SALJ* 68; McLennan "Duties of Care and Skill of Company Directors and Their Liability for Negligence" 1996 8 *SA Merc LJ* 100.

<sup>99</sup> McLennan 1996 8 *SA Merc LJ* 100.

<sup>100</sup> *Ibid.*

In respect of the recommendation that the Companies Act be amended in order to provide for a statutory limitation on the duty of care and skill, as the appointment of directors is onerous in the context of the present tests of breach of the duty of care and skill,<sup>101</sup> it is submitted that this statement, in respect of the appointment of directors being onerous, is simply not correct. This is based upon the fact that the common law duty of care and skill, as mentioned previously, is in fact disappointingly low and that, contrary to the King Report,<sup>102</sup> the duty should in fact be enhanced.<sup>103</sup>

McLennan is of the opinion that there is no need for the legislation that has been recommended by the King Report<sup>104</sup> due to the fact that under the circumstances assumed by the report, the director would have discharged both his fiduciary duty and his duty of care.<sup>105</sup> Therefore, it is contended that the current law is effective in this respect and that such additions to the South African law are not popular. It is deplorable to note that the King Report<sup>106</sup> failed to mention the provisions encapsulated within section 248 of the Companies Act.<sup>107</sup>

In consideration of the press statement, the reasoning for the recommendation in relation to the duty of care and skill and the fact that the report failed to mention the provisions within section 248 of the Companies Act, it is submitted that the research process surrounding the King committee's recommendations is dubious.<sup>108</sup>

## 2 4 The Department of Trade and Industry's Guidelines for Corporate Law Reform

It is necessary to consider the impact of the report that was issued by the South African Department of Trade and Industry (DTI).<sup>109</sup> It is contended within the report that there is a dire need for the review of company law as the domestic and global environment for enterprises has changed strikingly since the promulgation of the 1973 Companies Act.<sup>110</sup> The aim of the review is to ensure that the new legislation is appropriate for South Africa, taking into account South Africa's constitutional dispensation. It is stated that where

<sup>101</sup> The Institute of Directors in South Africa 1994 Nov 9 par 3.3.

<sup>102</sup> The Institute of Directors in South Africa 1994 Nov.

<sup>103</sup> Botha and Jooste 1997 114 *SALJ* 76.

<sup>104</sup> The Institute of Directors in South Africa 1994 Nov.

<sup>105</sup> McLennan 1996 8 *SA Merc LJ* 100.

<sup>106</sup> *Ibid.*

<sup>107</sup> Botha and Jooste 1997 114 *SALJ* 68.

<sup>108</sup> Botha and Jooste 1997 114 *SALJ* 76; and see also Botha "Confusion in the King Report" 1996 8 *SA Merc LJ* 27 where it is argued that the report, in addition, fails to indicate the model of the limited liability corporation upon which the report is based.

<sup>109</sup> The Department of Trade and Industry in South Africa 2004 May.

<sup>110</sup> The Department of Trade and Industry in South Africa 2004 May 14; and Hendricks "Second Reading Debate, Companies Amendment Bill by Deputy Minister of Trade and Industry, Lindiwe Hendricks" <http://www.info.gov.za/speeches/2004/04082515151002.html> (27 Aug 2004).

the current law meets this objective, it should remain part of South African law.<sup>111</sup>

The report states that whilst new company law should be comprehensive, it should not encumber companies with unnecessary rules.<sup>112</sup> Furthermore, it is contended that current company law, in relation to the duties of directors, is somewhat vague and that the current law does not provide effective machinery for the enforcement of directors' duties.<sup>113</sup> The report acknowledges that the majority of principles governing the duties of directors are to be found within case law and that there is little consensus as to the precise content of such duties.<sup>114</sup> It is believed that the statement within the report that South African law does not provide for the effective enforcement of the duties of directors is not entirely correct. This is based upon the argument that section 424 of the Companies Act is in fact a valuable instrument that can be used in order to restrain directors' conduct<sup>115</sup> and is furthermore, as was previously concluded, an effective provision within South African law.<sup>116</sup>

Although the report does not expressly address the introduction of the business judgment rule, it does state that in order to create certainty within the law relating to the duties of directors, there is merit in considering a statutory standard for directors' duties.<sup>117</sup> However, it is acknowledged by the drafters of the report that the benefits of such a standard will need to be assessed against the constraints it will place on the development of the common law.<sup>118</sup> The report does not indicate the exact content of the statutory standard that is proposed. It is therefore a difficult task to determine at this stage whether such a standard will place undue restriction upon the development of the common law.

It is suggested that in order to introduce clarity into the sphere of directors' duties, without restricting the development of the common law, a general statutory statement of the directors' fiduciary duties and their obligation of care and skill could be seriously considered and possibly introduced, but without incorporating a business judgment rule.<sup>119</sup>

The report further pronounces that due to the fact that South Africa is not a litigious society, it is not necessary to exonerate directors against liability.<sup>120</sup> This comment is supported by taking into account that it appears that there has been only one reported case in South Africa in which a

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<sup>111</sup> The Department of Trade and Industry in South Africa 2004 May 8.

<sup>112</sup> The Department of Trade and Industry in South Africa 2004 May 29.

<sup>113</sup> The Department of Trade and Industry in South Africa 2004 May 18.

<sup>114</sup> The Department of Trade and Industry in South Africa 2004 May 39.

<sup>115</sup> Cassim 1981 98 *SALJ* 163; Havenga 2000 12 *SA Merc LJ* 36; and Havenga 1998 61 *THRHR* 719.

<sup>116</sup> See par 2 2 2 above.

<sup>117</sup> The Department of Trade and Industry in South Africa 2004 May 40.

<sup>118</sup> *Ibid.*

<sup>119</sup> Havenga 2000 12 *SA Merc LJ* 37.

<sup>120</sup> The Department of Trade and Industry in South Africa 2004 May 40.

director was held liable for breach of the duty of care and skill.<sup>121</sup> Due to the fact that the report acknowledges that South Africa is not litigious in nature, it is argued that the report indicates, by implication, that it is not necessary to incorporate the business judgment rule into South African law. Furthermore, it is submitted that the South African authorities, when considering the implementation of the rule, must be continually conscious of the fact that the business judgment rule stems from a society where litigation is frequently employed, whereas in South Africa the position is quite the opposite. Thus, in America the business judgment rule is required on the basis of this fact, whereas in South Africa the courts are not approached with such enthusiasm and therefore the current South African law, which is effective, suffices for the position in this country.

The DTI's report is somewhat contradictory. This is founded upon the fact that the report initially states that the current law is deficient in that it does not provide effective means for the enforcement of the duties of directors.<sup>122</sup> However, in addition to this, it is stated that due to the fact that South Africa is not litigious in nature, it is not necessary to exculpate directors against liability.<sup>123</sup> Thus the credibility of the report is questionable as it seems to indicate that, on the one hand, there is a need for provisions within the law which can be readily used through litigation to hold directors liable for misconduct, but on the other hand, the report contends that due to the fact that South Africa is not a litigious society it is not necessary to enact provisions that will pardon directors for their conduct.

The duties of directors, within South African law, stem from various sources. The common law duty of care and skill, although the content thereof is not always entirely clear, forms an integral basis of the law relating to companies. The general principles of delict and contract, where applicable, lend support to the duty of care and skill. It is apparent that the Companies Act, in particular section 424, supplements the common law principles that have been developed by the courts.<sup>124</sup> In light of the analysis of the existing company law it is contended that the current provisions are effective indeed and that the proposals relating to the integration of the business judgment rule that have been put forth should be approached with care.

### 3 CONCLUSION

The South African economy and legislative framework has undergone numerous changes since the introduction of the constitutional dispensation and it is subsequently necessary to amend the law relating to companies in order to acknowledge these developments.<sup>125</sup> Company law provides the

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<sup>121</sup> Botha and Jooste 1997 114 SALJ 68; and *Niagara Ltd (in liquidation) v Langerman* 1913 WLD 188.

<sup>122</sup> The Department of Trade and Industry in South Africa 2004 May 18.

<sup>123</sup> The Department of Trade and Industry in South Africa 2004 May 40.

<sup>124</sup> Blackman par 164.

<sup>125</sup> The Department of Trade and Industry in South Africa 2004 May 4.

legal basis for one of the most significant institutions that governs the economy, namely, corporate entities.<sup>126</sup> It is for this very reason that tremendous caution should be exercised when tampering with the rules that govern the corporate sector.

A further fact that must be considered is that the American judiciary developed the business judgment rule.<sup>127</sup> It is contended that the adoption of a foreign legal rule that was developed by the judiciary is in itself risky. This is founded upon the fact that America in two instances attempted unsuccessfully to codify the rule.<sup>128</sup> There has also been no legislation implemented in any federal state in America that imposes the rule.<sup>129</sup> The possibility exists that American statutory corporate law may differ considerably from South African company legislation and that relocating only one aspect may have unforeseen consequences which may be negative in nature.<sup>130</sup>

The exact content of the rule is difficult to define,<sup>131</sup> to the extent that South African authorities have reiterated that the rule is controversial.<sup>132</sup> In addition, this aspect is aggravated due to the fact that the American courts attach different interpretations to the rule.<sup>133</sup> With this in mind, it seems absurd to attempt to introduce the rule into South Africa in a rigid format particularly in light of the failure of the American authorities to codify the rule,<sup>134</sup> the different interpretations of the rule by the American judiciary.

Hippert states that South African courts do in fact analyze the underlying process of decision-making and that subsequently the business judgment rule adds nothing beneficial to South African law.<sup>135</sup> Cognisance must also be taken of the fact that if director liability is sought on the basis of the law of delict, wrongfulness, fault in the form of negligence and legal causation will impose their own limitations on the director being held accountable for his or her conduct.<sup>136</sup>

It is contended that section 424 of the Companies Act is an effective tool to control the actions of directors.<sup>137</sup> This section, coupled with section 248 of the Act and the common law principles of care and skill, appear to achieve a balance between holding directors liable for their conduct and ensuring

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<sup>126</sup> *Ibid.*

<sup>127</sup> See par 2 of part 1.

<sup>128</sup> See par 3 of part 1.

<sup>129</sup> Botha and Jooste 1997 114 *SALJ* 75-76; and Havenga 2000 12 *SA Merc LJ* 33. However see Eisenberg 1995 at <http://www.clrc.ca.gov/bkstudies.html> (27 August 2004) where it was recommended that it would be desirable to codify the business judgment rule in California.

<sup>130</sup> Havenga 2000 12 *SA Merc LJ* 36.

<sup>131</sup> Gevurtz 279.

<sup>132</sup> The Institute of Directors in South Africa 2002 March 70.

<sup>133</sup> Havenga 2000 12 *SA Merc LJ* 36.

<sup>134</sup> See par 3 of part 1.

<sup>135</sup> Hippert "The King Report's recommended 'business judgment test'" 1997 5(1) *Juta's Business Law* 19.

<sup>136</sup> See par 2 above.

<sup>137</sup> Cassim 1981 98 *SALJ* 163; Havenga 1998 61 *THRHR* 719; and Havenga 2000 12 *SA Merc LJ* 36.

that directors are not excessively protected. Furthermore, it must also be borne in mind that it appears that America does not have provisions similar to that of section 424 and section 248 of the South African Companies Act.<sup>138</sup>

It is felt that the findings of the King Report<sup>139</sup> and that of the Department of Trade and Industry<sup>140</sup> are an indication of inadequate research.<sup>141</sup> It is clear that the degree of skill and care required of directors in South Africa is by no means excessive<sup>142</sup> and that directors may avoid liability on the basis of section 248 of the Companies Act.<sup>143</sup> It is contended that the inclusion of the business judgment rule in South African law would in fact burden company law with unnecessary rules, which is the exact situation that the Department of Trade and Industry is attempting to avoid.<sup>144</sup>

The introduction of the business judgment rule into South African law is not a path that ought to be followed,<sup>145</sup> as it is clear that the South African courts do not second-guess the merits of corporate decisions, and in fact approach business judgments in a similar manner to the American regime.<sup>146</sup> The most suitable compromise that can be utilized is a general statutory statement of the directors' fiduciary duties and their obligation of care and skill but without incorporating a business judgment rule.<sup>147</sup>

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<sup>138</sup> Havenga 2000 12 *SA Merc LJ* 36.

<sup>139</sup> The Institute of Directors in South Africa 1994 Nov; and The Institute of Directors in South Africa 2002 March.

<sup>140</sup> The Department of Trade and Industry in South Africa 2004 May.

<sup>141</sup> Botha and Jooste 1997 114 *SALJ* 76.

<sup>142</sup> See par 2 above.

<sup>143</sup> See par 2 above.

<sup>144</sup> The Department of Trade and Industry in South Africa 2004 May 29.

<sup>145</sup> Botha and Jooste 1997 114 *SALJ* 76; Havenga 2000 12 *SA Merc LJ* 36-37; and McLennan 1996 8 *SA Merc LJ* 100.

<sup>146</sup> Botha and Jooste 1997 114 *SALJ* 76.

<sup>147</sup> Havenga 2000 12 *SA Merc LJ* 37.