

The Correct Understanding of the Business Judgment Rule in Section 76(4) of the Companies Act 71 of 2008: Avoiding the American Mistakes

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WORDS: 25 424

SUBMITTED TO THE UNIVERSITY OF CAPE TOWN

in fulfilment of the requirements for the degree LLM Commercial Law Specialisation

Faculty of Law

UNIVERSITY OF CAPE TOWN

14 February 2014

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1. INTRODUCTION

The importance of having an effective corporate governance regime has been a central issue throughout the development of corporate law.¹ The recent economic downturn has once again brought the laws of director's liability and corporate governance into the public view. A company can only function through human actors. Corporate officers and directors² act as the central hub of the conduct of a company who make decisions and direct the company in a particular course. Directors are accordingly at the core of many business scandals and failures in recent years with which the public has become so engrossed.³

The common thread which runs through many spectacular corporate meltdowns of recent times is poor directorial decisions and corporate governance.⁴ Despite being more well-known in South Africa compared to other countries; it would be a mistake to think of corporate scandal and failure being isolated to America.⁵ Given the current context, it is unsurprising that legal regimes governing corporate governance and directorial liability have been the subject of much review and analysis by national legislatures, academics and the corporate communities globally.⁶

Company law in general has a profound impact on economies for companies play a vital role within any economy. Companies potentially provide massive social benefit. Simultaneously there is the possibility that the separate legal personality that

¹ R Naidoo *Corporate Governance: An Essential Guide for South African Companies* 2nd Ed. (2009) at 2.

² The term 'directors' will be used to refer generally to corporate officers and directors throughout this dissertation despite the uncertainty as to whether this is the case: L Johnson 'Corporate Officers and the Business Judgment Rule' (2005) 60 *Business Lawyer* 439 and the sources cited therein; Lawrence A. Hamermesh & A. Gilchrist Sparks III 'Corporate Officers And The Business Judgment Rule: A Reply To Professor Johnson' (2005) 60 *Business Lawyer* 865; JB Hardin & SR Tellies 'California's Business Judgment Rule is not a Defence for Corporate Officers' (June 2013) *Orange County Lawyer* 32. Viewed at <http://ocbusinesslawyerblog.com/secure/wp-content/uploads/2013/09/201306061437-2.pdf> [last viewed on 3 February 2014]. It should suffice to say that in my opinion the business judgment rule in South African law will apply to corporate officers.

³ J Mayanja 'Promoting Enhanced Enforcement of Directors' Fiduciary Obligations: The Promise of Public Law Sanctions' (2007) *Australian Journal of Corporate Law* 20(2) 157. See also: *The Failure of HIH Insurance: A corporate collapse and its lessons* Vol.1 (2003) viewed at <http://www.publicaccountants.org.au/media/76396/a00009280.pdf> [last viewed 30 January 2014]; and R Monem 'The One-Tel Collapse: Lessons for Corporate Governance' viewed at http://www98.griffith.edu.au/dspace/bitstream/handle/10072/42673/74746_1.pdf;jsessionid=C7819CA25660076F1B7D3E546655FBB9?sequence=1 [last viewed 30 January 2014].

⁴ *Australian Securities and Investments Commission, In the Matter of Richstar Enterprises Pty Ltd (ACN 099 071 968) v Carey (No.3)* [2006] FCA 433; (2006) 24 ACLC 581 at 583-4.

⁵ Ibid.

⁶ TM Aman 'Cost-benefit Analysis of the Business Judgment Rule: A Critique in Light of the Financial Meltdown' (2010) 74(1) *Albany Law Review* 1.

companies provide may be exploited, which may in turn negatively impact society on a grand scale. The previous legislation that governed company law in South Africa was in existence for 37 years and was amended 42 times during that period.⁷ Much of the law governing the duties and liability of corporate directors was found within the King II Code and the common law.⁸ The laws governing directors' duties and responsibilities were inaccessible to most corporate actors and the public, archaic, outdated, and at times even wholly inappropriate for a modern developing country such as South Africa.

The South African Companies Act 71 of 2008⁹ which became effective on 1 May 2011 has introduced a multitude of changes within South African company law and is aimed at making the law more readily accessible to society in general. It has consequently been drafted in 'plain language'. Throughout the legislative process the Department of Trade and Industry made it clear that the aim of the Act would be to modernise company law in order to align with international trends and accommodate for the needs of modern corporations conducting business in South Africa's unique commercial and societal context.¹⁰ The Act consequently introduces a number of new rules and legal principles, changes existing common law and even alters the policies and philosophy of corporate law in general.

The legislature saw fit to partially codify the law regarding director's duties and liabilities in the attempt at making the law more accessible.¹¹ In many respects the Companies Act has created a wider base of potential liability for directors, whilst simultaneously it has introduced the business judgment rule into South African corporate law. The business judgment rule is an American common law device which limits director liability in cases where the directors are accused of contravening the duty of care and skill when making business decisions. There is thus both the widening of potential director liability which is tempered by the introduction of a liability limiting device in the form of the business judgment rule.

⁷ Companies Act 61 of 1973 as amended.

⁸ MM Botha 'The Role and Duties of Directors in the Promotion of Corporate Governance: A South African Perspective' (2009) 3 *Obiter* 702 at 706.

⁹ Companies Act 71 of 2008. From here on referred to as 'the Companies Act'.

¹⁰ South African Company Law for the 21st Century – Guidelines for Corporate Law Reform (GG 26493 of 23 June 2004) (referred to as *Guidelines for Corporate Law Reform*).

¹¹ D Ahern 'Directors' Duties, dry ink and the accessibility agenda' (2012) 128 (January) *Law Quarterly Review* 114.

Further - the common law remains relevant which doesn't fully match the relevant sections of the Companies Act. Clearly then – there is much uncertainty which must be clarified.

Section 76(4)(a) of the Companies Act codifies the business judgment rule into South African law. This is an interesting addition given the relative upheaval and uncertainty in this area of the law in America. In Delaware (arguably the state with not only the most thoroughly developed business judgment rule but arguably also the state most sympathetic or deferential to director conduct) it would appear as though the protection afforded by the business judgment rule is being eroded. This is most likely a reaction to the recent corporate scandals such as that of Enron, which has led one commentator to conclude that the recent Delaware Supreme Court's decisions “depart dramatically from the tradition of management deference”.¹² This recent shift adds even more complexity to the already confusing and largely contested law pertaining to the common law business judgment rule in America. The underlying cause of concern seems to be finding the correct balance between directors' authority to steer the company in a particular direction and the shareholders' right to hold the directors accountable for their decisions.¹³ The business judgment rule has acted as the primary judicial mechanism which has been adopted by the judiciary as a means of balancing this tension.

A director owes two distinctive types of duties to a company: the fiduciary-type duties and the negligence-type duties of care, skill and diligence. Both forms of directors' duties function concurrently to restrict the powers of directors.¹⁴ The South African law concerning directors' duties is intricate under both the common law and the Companies Act. This is an area of corporate law which allows for a wealth of practical and theoretical difficulty.¹⁵ I aim to deconstruct the intricacy of the

¹² RM Jones 'Rethinking Corporate Federalism in the Era of Corporate Reform' (2004) 29 *Journal of Corporation Law* 644 at 625; L Herzel and L Katz 'Smith v Van Gorkom: The Business of Judging Business Judgment' (1986) 41 *Business Lawyer* 1187 at 1188.

¹³ AM Scarlett 'A Better Approach for Balancing Authority and Accountability in Shareholder Derivative Litigation' (2008) 57 *University of Kansas Law Review* 39 at 40-1. SM Bainbridge 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 *Vanderbilt Law Review* 84 at 109; V Finch 'Company Directors: Who Care about Skill and Care?' (1992) 55 *Modern Law Review* 176.

¹⁴ C Giraldo 'Factors Governing the Application of the Business Judgment Rule: An Empirical Study of the US, UK, Australia and the EU' (2006) *Vicpresidencia Juridica Bogota* (Colombia) No.111 at 120; T Mongalo *Corporate Law and Corporate Governance: A Global Picture of Business Undertakings in South Africa* 1st Ed. (2003) 158.

¹⁵ BS Butcher *Directors' Duties: A New Millennium, A new Approach* Vol.7 (2007) 5.

American experience of the business judgment rule, with particular reference to the rule in Delaware, so as to present what I perceive to be the correct practical application of the rule in South African corporate law. This dissertation does not address the wisdom of the decision to transplant and codify the American business judgment rule within the Companies Act.

Part 2 will briefly discuss the relevance and importance of the duty of care in South Africa with regard to the introduction of the business judgment rule. Part 3 will outline the business judgment rule's history and modern development in America. Particular focus will be on the law of Delaware which is the jurisdiction that contains the most developed business judgment rule. Part 4 will discuss the rule in South Africa prior to the coming into force of the Companies Act and then as codified in South Africa. Part 5 will discuss the relationship and interaction between the fiduciary duties (especially the duty to act in the best interests of the company), the duty of care and the business judgment rule. Part 6 will briefly justify the inclusion and importance of the business judgment rule in the Companies Act. There are many different explanations of the manner in which the rule operates and how the rule should be commonly understood under Delaware law. I will discuss two differing interpretations of the rule which are currently competing within the academic literature in Part 7: whether the rule is more theoretically correct as either a doctrine of judicial abstention or as a doctrine of immunity. In Part 8; I will discuss which of these two interpretations should be adopted given South Africa's unique socio-economic context and in Part 9 I will present what I perceive to be the correct practical operation of the rule. Part 10 will be the conclusion and a bibliography is found within Part 11.

2. UNDERSTANDING THE DUTY OF CARE AND SKILL

The business judgment rule is inseparable from the duty of care and skill.¹⁶ The rule applies to the specific aspect of decision making under the duty of care. Understanding the duty of care is accordingly imperative for correctly understanding the business judgment rule. This chapter will discuss the general application and

¹⁶ S Kennedy-Good & L Coetzee 'The Business Judgment Rule (Part 1)' (2006) *Obiter* 62 at 63.

importance of the duty of care generally as well as the operation of the statutory duty of care, skill and diligence under section 76(3)(c) of the Companies Act.¹⁷

General Application and Common Law Understanding

A director owes two distinct forms of duty to a company. These may be broadly divided between the fiduciary duties and the duty of care and skill. These duties together act to restrict the powers of directors. The duty of care and skill is owed to the company in general and not to the shareholders. Directors are required to manage the business of the company as a reasonably prudent persons would manage their own affairs.¹⁸ The duty of care and skill is a non-fiduciary duty and is founded on the law of negligence. Directors may consequently be held liable for the negligent non-performance their duties of care and skill. The more difficult investigation is the extent to which directors who have negligently caused a loss to the company are liable for that loss.¹⁹

The duty of care is rooted within the law of delict and the concept of negligence.²⁰ One must be careful to recognise that under the South African law of delict, fault and wrongfulness are distinct concepts and both must be present if delictual liability for negligent conduct is to attach to a director.²¹ This is different from the position under English common law duty of care, for wrongfulness is not a clearly defined independent requirement that must be proved for liability to attach to a director. In contrast to the general law of negligence in South Africa which is a primarily objective determination based on the ‘reasonable person standard’; the duty of care in corporate law has been applied using a primarily subjective determination and subjective nomenclature.²² The repercussion of this has been to apply a low threshold standard of director conduct for directors were under the common law expected to exercise only that degree of care and skill that the individual director was capable of.

¹⁷ The duty of care, skill and diligence under section 76(3)(c) will be referred to throughout this dissertation as ‘the statutory duty of care’.

¹⁸ MM Botha (supra).

¹⁹ FHI Cassim (ed.) *Contemporary Company Law* 2nd Ed. (2012) 554.

²⁰ *Ex parte Lebowa Development Corporation Ltd* 1989 (3) SA 71 (T); *Du Plessis NO v Phelps* 1995 (4) SA 165 (C).

²¹ *Minister of Safety and Security v Van Duivenboden* [2002] ZASCA 79; *Trustees, Two Oceans Aquarium Trust v Kantey & Templar* 2006 (3) SA 138 (SCA).

²² *Contemporary Company Law* (supra) 555.

Under this formulation a director may have even acted with ‘galactic stupidity’²³ and yet still be found not liable for it would have been the director’s lack of experience, ignorance, or sheer lack of competence which protected the director from liability.²⁴

Prior to the coming into force of the Companies Act, the duty of care was wholly encapsulated within the common law. The courts did not actively enforce adherence with the duty of care in the same strenuous manner as the fiduciary duties.²⁵ This approach was based on the belief that ultimately it was shareholders who were responsible for the loss to the company – for it was the shareholders who appointed the directors and therefore should suffer the loss of their own foolishness.²⁶ The difficulties which were prevalent in the common law derivative action also affected the enforcement of the duty of care and skill. The common law derivative action was severely limited in both its scope of application and the persons to whom it was available. It was largely limited to instances where the persons who caused harm to the company were simultaneously in control of the company which suffered a harm.²⁷ The ratifiability principle, the cost of litigation, the onerous burden of proving which person or persons caused the harm to the company, problems attaining evidence to prove a claim, and the limited number of persons who could enforce the derivative action meant that there was a lack of willing and able litigants who had the ability to enforce the duty of care and skill.

Clearly the common law and the position under the 1973 Companies Act did not enhance judicial enforcement of the duty of care and skill. There is accordingly a dearth of cases in South African law where liability has been imposed on a director for breach of the duty of care and skill. This duty has subsequently been described as a “tenuous and risky foundation” on which to bring a claim against a director and to hold that director personally liable for harm caused to the company.²⁸ South Africa is not alone in this problematic experience. The jurisdictions of the United Kingdom,

²³ D Rosenberg ‘Galactic Stupidity and the Business Judgment Rule’ (2007) 32 *Journal of Corporation Law* 301.

²⁴ FHI Cassim ‘Fraudulent or Reckless trading and s.424 of the Companies Act of 1973’ (1981) 98 *SALJ* 162.

²⁵ *Ibid.*

²⁶ *Daniels (formerly practising as Deloitte Haskins & Sells) v Anderson* (1995) 37 NSWLR 438; (1995) 16 ACSR 607 (NSW) (referred to from here as *Daniels v Anderson*).

²⁷ *Foss v Harbottle* (1843) 2 Hare 461; 67 ER 189; Section 266 of the Companies Act 71 of 1973; *Contemporary Company Law* (supra) 775-779.

²⁸ E Jones ‘Directors’ Duties: Negligence and the Business Judgment Rule’ (2007) 19 *SA Merc LJ* 326 at 326-7.

Australia²⁹ and America³⁰ have a similar history and will likely continue to grapple with many of the same problems as South Africa does. Recent statutory developments and judicial decisions³¹ in these jurisdictions may be evidence of a swing towards a more stringent application and enforcement of the duty of care and skill; but it may be concluded that under the common law the position regarding the duty remains somewhat more skewed to the benefit of the director.

There is a strong case to be made for the duty of care and skill which applies to directors to remain primarily a subjective determination.³² The context within which individual directors function are vastly different. The courts throughout the development of the common law duty of care and skill have as a result constantly tackled with prescribing a single unified standard for all directors. A director is not required to have any special education nor qualifications in order to hold office as a director. Nor are directors members of a single unified professional body in the same manner as say a doctor or lawyer is a member. There are different types of companies which vary greatly according to size, form and function. To further complicate matters there are different types of directors within companies, each of whom may be required to fulfil differing roles and functions. It is intuitively obvious from this brief description that not all directors are the same. A single objective standard which may be prescribed to all directors is consequently not feasible. The duty of care and skill which relates to each director “must depend on the type of company the type of director...and his or her particular skills and knowledge...”³³

One of the earliest and certainly law defining decisions which grappled with this very problem was that of *Re Brazilian Rubber Plantations & Estates Ltd.*³⁴ It was held in this case (which subsequently became a leading authority on the matter) that

²⁹ A Finlay ‘CLERP: Non-Executive Directors’ Duty of Care, Monitoring and the Business Judgment Rule’ (1999) 27 *Australian Business Law Review* 98.

³⁰ JW Bishop Jr. ‘Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers’ (1967-1968) 77 *Yale Law Journal* 1078.

³¹ RM Jones (supra) at 62. See in particular the decisions of: *In re Walt Disney Co Derivative Litigation* (825 A 2nd 275 (Del Ch, 2003)); *Telxon Corp v Meyerson* (802 A 2nd 257 (Del 2002)); *Krasner v Moffat* (826 A 2nd 277 (Del 2003)); *In re Oracle Corp Derivative Litigation* (824 A 2nd 917 (Del Ch, 2003)).

³² See generally the argument presented in CA Riley ‘The Company Director’s Duty of Care and Skill: The Case for an Onerous but Subjective Standard’ (1999) 62 *Modern Law Review* 697.

³³ *Contemporary Company Law* (supra) 555.

³⁴ *Re Brazilian Rubber Plantations & Estates Ltd* [1911] Ch 425 (CA) 437 (from here on referred to as *Re Brazilian Rubber*).

a director's duty of care and skill is to act with the level of care that is reasonably to be expected of that particular director, which is based upon his own knowledge and experience. Under this test the more experience and knowledge a particular director has, the higher the threshold of reasonableness becomes. Of interest for this dissertation is to note that in *Re Brazilian Rubber* there is the judicial recognition that a director is not liable for any damages caused to the company by imprudence or errors of judgment.³⁵ At closer inspection, this would seem to be a simplistic and fairly rudimentary recognition of the business judgment rule.

The most defining case within the development of the duty of care in the common law based jurisdictions is that of *Re City Equitable Fire Insurance Co Ltd*³⁶ which authoritatively confirmed the subjective test as laid down in *Re Brazilian Rubber*. *Re City Equitable* was subsequently applied and confirmed in South Africa by the court in *Fisheries Development Corporation of South Africa v Jorgensen; Fisheries Development Corporation of South Africa v AWJ Investments (Pty) Ltd*³⁷ despite the half century time-gap between the decisions. The decision in *Fisheries Development* is widely regarded as the pariah of corporate law jurisprudence in South Africa for a complete lack of understanding of the realities, complexity and the role of directors within a modern corporation. There was no recognition in the decision of the fact that a modern director is a completely different corporate actor as opposed to the directors at the time of *Re City Equitable*.³⁸ *Fisheries Development* laid down three fundamental principles which apply to the adjudication of the duty of care which are particularly important for the proper understanding of the statutory duty of care under section 76(3)(c) of the Companies Act:

- (1) A director need only exhibit in the performance of his or her duties a degree of skill that may reasonably be expected from a person of his or her knowledge and experience. Directors are not liable for mere errors in judgment.

³⁵ *Contemporary Company Law* (supra) 556.

³⁶ *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407 (from here on referred to as *Re City Equitable*).

³⁷ *Fisheries Development Corporation of South Africa v Jorgensen; Fisheries Development Corporation of South Africa v AWJ Investments (Pty) Ltd* 1980 (4) SA 156 (W) (from here on referred to as *Fisheries Development*).

³⁸ *Contemporary Company Law* (supra) 556-7.

(2) A director need not give continuous attention to the affairs of the company – the duties of a director are of an intermittent nature which are primarily performed within periodical board meetings;

(3) In respect of all duties that may properly be delegated to another official, a director is justified (in the absence of grounds for suspicion) in trusting that official to perform the duties properly and honestly. This does not apply however to persons not authorised to perform the duties, in which case unquestioning reliance is not justified.

Cassim argues that this common law formulation of the duty of care in South Africa is “manifestly inadequate in modern times to protect shareholders from the carelessness and the negligence of directors of the company”.³⁹ This view has been endorsed by the Australian courts in *Daniels v Anderson* and it is a view with which I agree. I am also in agreement with Julie Cassidy where she argues that it is this more stringent enforcement of director duties that should be followed.⁴⁰ Outdated precedents and overly subjective tests leave the door too ajar for directors to avoid liability for breaches of the duty of care. Clearly it was necessary for the Companies Act to put in place a more onerous test that applied to the duty of care and skill. Of significant interest is that section 8.30b of the US Model Business Corporation Act⁴¹ - a section which has had a great impact on the current section 76(3)(c) of the Companies Act - entails an objective determination of the duty of care. The liability of directors for breaches of this statutory duty of care is largely dependent upon the operation of the business judgment rule which underlies the importance of correctly understanding the duty of care and skill under the Companies Act.

Section 76(3) of the Companies Act 2008 – The Modern Duty of Care

The duty of care and skill is now rooted within the Companies Act in section 76(3)(c). The name has been changed under section 76(3)(c) to be ‘the duty of care, skill and diligence’. The duty has been partially codified in line with the general proposition that director duties must be accessible in order for directors to easily

³⁹ *Contemporary Company Law* (supra) 558.

⁴⁰ J Cassidy ‘James Hardie: The resurrection of *Re City Equitable* and beyond?’ (2009) 37 *Australian Business Law Review* 312. See in this regard the case of *Australian Securities and Investments Commission v Macdonald (No 11)* (2009) 256 ALR 199 and the possible shift in Australia to a more lenient duty of care.

⁴¹ US Model Business Corporation Act 1984 (as revised through 2002).

know and be aware of the duties that apply to them. Underlying this is that the relevant standards of a director's conduct can influence the profitability of a company, determine the extent of foreign and domestic investments and ultimately determine the success of a company.⁴² Section 76(3)(c) provides that:

(3) Subject to subsections (4) and (5), a director of a company, when acting in that capacity, must exercise the powers and perform the functions of director—

...

(c) with the degree of care, skill and diligence that may reasonably be expected of a person—

(i) carrying out the same functions in relation to the company as those carried out by that director; and

(ii) having the general knowledge, skill and experience of that director.

It should be seen that the statutory duty of care is immediately less subjective and generally more onerous than the standard under the common law. This more onerous duty of care is a vital improvement upon the common law for it reflects the modern commercial realities which are relevant to directors. The modern director is no longer merely a figurehead person who may be unskilled in a particular commercial enterprise. Corporate directors are generally qualified persons with a vast experience of business.⁴³

The statutory duty of care is not a wholly objective determination. The particular context (i.e. the position and responsibilities of the director, the nature of the decision that was taken as well as the size and nature of the company)⁴⁴ will all be factors which enhance the duty from a minimum objective threshold duty towards a higher subjective determination. In this way the duty of care remains flexible to cater for the situations in which it is applied and the factual scenarios which are adjudicated. The default position is that the duty is to be objectively determined and applied in accordance with the reasonable person standard rather than the reasonable director standard. This is a vital improvement on the common law. It means that the

⁴² J Kiggundu & M Havenga 'The regulation of directors' self-serving conduct: perspectives from Botswana and South Africa' (2004) 37 *CILSA* 272 at 290.

⁴³ *Contemporary Company Law* (supra) 556-9. This is obviously a generalisation that applies particularly to listed public companies.

⁴⁴ This is required by section 157 of the New Zealand Companies Act of 1993 and which will, according to Cassim in *Contemporary Company Law* (supra) 560, likely be similarly applied under section 76(3)(c) of the Companies Act. I agree with this point for variability in the application of the business judgment rule is vital.

subjective factors only have the capacity to raise the standard rather than lower it (which was the result of the reasoning in *Re City Equitable* and *Re Brazilian Rubber*).

The statutory duty of care is accordingly hybrid in nature: it has both objective and subjective components: section 76(3)(c)(i) is objective whilst subsection (ii) is subjective. This was also the position under the common law whereby the skill and knowledge components have been classified as subjective whilst the care component has been classified as objective.⁴⁵ Skill is variable, whilst care may be objectively determined irrespective of the director in question. The common law understandings and precedent regarding the duty of care and skill consequently remain relevant. There is a minimum objective threshold determination which is applied in accordance with the reasonable person standard that may be more onerously applied depending on the subjective knowledge, skill and experience of the individual director. In this way the subjective factors are no longer capable of being used to deaden the effect of the duty of care, they may only be relevant in creating a subjectively more onerous duty on the director.⁴⁶ The shift in application of the subjective elements between the common law and the codified duty of care means that the more experienced, skilled and knowledgeable a director is; the more onerous the duty of care becomes.⁴⁷ A director is not required to take all possible care – only the care that may reasonably be expected of that individual director is relevant to the determination of whether the duty has been breached or not. However: a director may never act in a manner less than may be expected of the reasonable person.

3. THE HISTORY AND DEVELOPMENT OF THE BUSINESS JUDGMENT RULE

The business judgment rule is particularly widely entrenched into most facets of American corporate law jurisprudence. It is a principle of corporate governance that has been a cornerstone of American corporate law jurisprudence since the early 19th Century.⁴⁸ It is not the purpose of this dissertation to fully trace the genesis and

⁴⁵ *Daniels v Anderson* (supra).

⁴⁶ *Ibid* at 559.

⁴⁷ *Dorchester Finance Co Ltd v Stebbing* [1989] BCLC 498 (Ch); *Re D'Jan of London Ltd* [1994] 1 BCLC 561 (Ch).

⁴⁸ *TM Aman* (supra) at 7.

history of the rule. This has been fully accomplished elsewhere.⁴⁹ It is important to highlight, however, that the early judicial development of the business judgment rule expresses the rule's core logic and limitations. These early decisions⁵⁰ stress the importance of respecting "human fallibility" – each court stressing that directors who "dutifully attends to his or her duties will not be personally liable for good faith business decisions."⁵¹ The business judgment rule was understood not as a complete defence that precluded judicial review of the process that was followed in making a decision. It was the actual final decision that the business judgment rule was seen to protect; but not the failure in process in reaching that decision. Despite the decision being one made in good faith, courts were not prepared to excuse directors from liability on the basis of their judgment being made without procedural due care.

There has been much academic and judicial time and focus spent on attempting to understand the rule's underlying policy justifications, what the rule's correct theoretical formulation is, and what the proper practical application of the rule should be. Despite the business judgment rule's longevity, the vast amount of relevant information that has been debated and discussed, and the different views on the subject; it seems as though there is general consensus within academics that there is no single unified theory that explains the rule's practical application and where the boundaries of the rule should be pegged.⁵²

In the eyes of many commentators the business judgment rule remains an anomaly – a fundamental corporate law principle that is misunderstood despite its wide reach.⁵³ Weinberger argues, for example, that the rule is a judicially developed *sui generis* privilege that is granted to corporations which is the judicial recognition of the importance of the autonomy of corporations in society.⁵⁴ Even the jurisdiction of Delaware "lacks a coherent theory that explains why the rule exists and where its

⁴⁹ S Arscht 'The Business Judgment Rule Revisited' (1979-1980) 8 *Hofstra Law Review* 93.

⁵⁰ *Percy v Millaudon* 8 Mart. 68 (La. 1829). *Percy* is probably the earliest recognition of the business judgment rule in America. See also: *Goldbold v Branch Bank* 11 Ala. 191 (1847); *Hodges v New England Screw Co.* 1 R.I. 312 (1850).

⁵¹ S Arscht (supra) at 99.

⁵² KB Davis Jr. 'Once More, the Business Judgment Rule' (2000) *Wisconsin Law Review* 573, at 573.

⁵³ DP Lee 'The Business Judgment Rule: Should it Protect Non-profit Directors?' (2003) 103(4) *Columbia Law Review* 925 at 939; S Arscht (supra).

⁵⁴ LD Weinberger 'The Business Judgment Rule and Sphere Sovereignty' (2010) 27 *T.M. Cooley Law Review* 279.

limits should be placed”⁵⁵ despite having arguably the most developed business judgment rule.

Under Delaware law there is a “triad” of duties that a director owes to the company.⁵⁶ These are the duties of care, good faith and loyalty. There has been some debate as to whether the business judgment rule should act as the mechanism from which the judiciary should review all fiduciary analysis en bloc.⁵⁷ Despite being primarily linked with the duty of care; the business judgment rule has relevance to not only the “triad” of duties, but to corporate law in general.⁵⁸ As the business judgment rule has steadily developed over modern times in America (Delaware in particular), so this development has coincided with the diminished significance of the duty of care and the blurring of the fiduciary-type and negligence-type director duties into a single unified ‘fiduciary duty-type’ analysis.⁵⁹ It seems intuitive to suppose that the duty of care would be violated if a director acts negligently. But judicial precedent, particularly in Delaware, makes allowance for the business judgment rule to act as a shield for directors to evade liability for a breach of the duty of care. The business judgment rule can accordingly operate to deflect a claim of negligence against a director.⁶⁰ The importance of the rule lies particularly where the rule has operated as a shield to liability by insulating directors’ decisions against derivative actions against the directors for breach of the duty of care.⁶¹

In what has become an oft-cited article both by academics and by the courts, Samuel Arscht described “both the substance of the rule itself and the principal limitations on its availability as a defence”.⁶² Arscht’s formulation of the rule endorsed both a defence allowed to directors for honest mistakes of judgment, and

⁵⁵ SM Bainbridge ‘The Business Judgement Rule as Abstention Doctrine’ (supra) at 84.

⁵⁶ *Cede & Co. v Technicolor, Inc.* 634 A.2d 345 (Del. 1993) (from hereon *Cede & Co. v Technicolor*).

⁵⁷ This is the effect of the judgment of the Delaware Supreme Court in the *Cede & Co.* litigation which will be dealt with below: *Cede & Co. v Technicolor, Inc.*, 634 A.2d 345 (Del. 1993), *modified*, 636 A.2d 956 (Del.1994), *aff’d sub nom. Cinerama, Inc. v Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995) (referred to jointly as the ‘*Cede Litigation*’).

⁵⁸ DM Branson ‘Intracorporate Process and the Avoidance of Director Liability’ (1989) 24 *Wake Forest Law Review* 97, at 97; AR Palmiter ‘Reshaping the Corporate Fiduciary Model: A Director’s Duty of Independence’ (1989) 67 *Texas Law Review* 1351, at 1437.

⁵⁹ RM Jones (supra); SR Cohn ‘Demise of the Director’s Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule’ (1983) 62 *Texas Law Review* 603; E Jones (supra).

⁶⁰ *Joy v North*, 692 F.2d 880, 885 (2d Circ. 1982).

⁶¹ MB Hemraj ‘The Business Judgment Rule in Corporate Law’ (2004) 15(6) *International Company and Commercial Law Review* at 192 and the case examples cited therein.

⁶² S Arscht (supra) at 111-2.

also an outline for the relevant inquiries in determining whether the directors were entitled to the defence. The business judgment rule according to Arsch is:⁶³

“A corporate transaction that involves no self-dealing by, or other personal interest of, the directors who authorised the transaction will not be enjoined or set aside for the directors’ failure to satisfy the standards that governs a director’s performance of his or her duties, and directors who authorised the transaction will not be held personally liable for resultant damages, unless:

The directors did not exercise due care to ascertain the relevant and available facts before voting to authorise the transaction, or

The directors voted to authorise the transaction even though they did not reasonably believe or could not have reasonably believed the transaction would be for the best interest of the corporation, or

In some other way the directors’ authorisation of the transaction was not in good faith.”

The following statement is a summary of his position and the purpose envisaged for the business judgment rule:⁶⁴

“The rule functions not to preclude inquiry but to guide it...this inquiry is made, not for the purpose of ascertaining whether the decision made was correct or one which the court would have made, but to ascertain whether the evidence does or does not establish that the directors exercised due care and believed, on a reasonable basis, that the challenged transaction was in the corporations best interests.”

This seems like such a straightforward explanation of the rule, and it draws a clear parallel with judicial review of administrative decisions in South Africa.⁶⁵ But the picture unfortunately is not that clear nor simple. In Delaware for example, the courts have wrongly formulated and applied the business judgment rule, and in Lyman

⁶³ Ibid.

⁶⁴ Ibid at 114.

⁶⁵ C Hoexter *Administrative Law in South Africa* 2nd Ed. (2012) Chapter 3.

Johnson's opinion have "unsoundly made it the centrepiece of corporate fiduciary analysis".⁶⁶

Much of the uncertainty stems from the Delaware Supreme Court decisions in *Aronson v Lewis*⁶⁷ and the protracted *Cede Litigation*.⁶⁸ The Delaware Supreme Court decision of *Aronson v Lewis* expressed the business judgment rule as "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company".⁶⁹ This statement remains the leading expression of the business judgment rule under Delaware law.⁷⁰ The jigsaw is further muddled by the decision of *Cede & Co v Technicolor* which subsumed the *Aronson*-type reasoning within a broader fiduciary analysis. The court argued that the business judgment rule was a development on the core basic principles that directors are under the fiduciary duties to protect the interests of the corporation and to act in the best interests of the shareholders. The court argued that as a corollary of these basic principles, the business judgment rule "operates to preclude a court from imposing itself unreasonably on the business and affairs of a corporation" and adopted the policy decision that the rule contains "a powerful presumption in favour of actions taken by the directors."⁷¹

This analysis attempted to centre the business judgment rule within fiduciary analysis en bloc.⁷² Read together these cases have provided for not only a faulty formulation of the business judgment rule but also the seeping of the rule into the judicial analysis and review of fiduciary duties. According to Johnson there are two fundamental errors with this understanding of the business judgment rule. First: the legal principle that the business judgment rule is a presumption in favour of directors, although correct in principle, is not encompassed within the business judgment rule. Second: the extension of the business judgment rule to envelop the

⁶⁶ L Johnson 'The Modest Business Judgment Rule' (1999-2000) 55 *Business Law Review* 625 at 625.

⁶⁷ *Aronson v Lewis* 473 A.2d 805, 812 (Del. 1984) (from here on referred to as *Aronson v Lewis*).

⁶⁸ The facts of the *Cede Litigation* cases are protracted and I simply refer readers of this dissertation to the discussion of the facts to see: JA Finkelstein & RC Silberglied 'Technicolor IV: Appraisal Valuation in a Two-Step Merger' (1997) 52 *Business Law Review* 801.

⁶⁹ *Aronson v Lewis* at 812.

⁷⁰ *Parnes v Bally Entertainment Corp.*, 722 A.2d 1243, 1246 (Del. 1999).

⁷¹ *Cede & Co. v Technicolor* at 360.

⁷² L Johnson 'Rethinking Review of Director Care' (2000) 24 *Delaware Journal of Corporate Law* 787.

fiduciary analysis in order to organise the fiduciary analysis into a single coherent framework as prescribed by the court in *Cede & Co.*⁷³ is flawed. Johnson's argument; with which I agree, is that the business judgment rule should not act as a generalised shield to liability on which directors are entitled to rely. It should not be seen as a hybrid form of the duty of care or a 'care light'.⁷⁴ The duty of care should remain linked with yet independent from the business judgment rule. The rule is also not simply at its core "a presumption that directors did not breach their duty of care."⁷⁵ If the business judgment rule is neither a legal presumption, nor an overarching mechanism from which fiduciary duties are analysed, nor a hybrid formulation of a reduced duty of care - what then actually is the business judgment rule? How should the rule be conceived and how should it be applied in South Africa?

4. THE BUSINESS JUDGMENT RULE IN SOUTH AFRICA

Common Law

The classic statement regarding the business judgment rule under the common law comes from Lord Greene MR in the case of *In re Smith and Fawcett Ltd.*⁷⁶

"They [the directors] must exercise their discretion bona fide in what they consider – not what a court may consider – is in the best interests of the company"

The essence of this statement is abundantly clear: it is "not the function of the courts to be the arbiter of commercial decisions".⁷⁷ There was a concern under the common law that this statement provided for an overly subjective standard to be applied in instances of director negligence. The subjectivity was however tempered

⁷³ L Johnson 'The Modest Business Judgment Rule' (supra) at 628-636.

⁷⁴ *Norlin Corp. v Rooney Pace Inc.*, 744 F.2d 255 (2d Cir. 1984) (from here on referred to as *Norlin Corp. v Rooney Pace Inc.*).

⁷⁵ D Gordon Smith 'The Shareholder Primacy Norm' 23(1998) *Journal of Corporate Law* 277 at 280.

⁷⁶ *In Re Smith and Fawcett Ltd.* [1942] Ch 304 (CA) at 306 (from here on referred to as *Re Smith and Fawcett Ltd.*).

⁷⁷ JS McLennan 'Duties of Care and Skill of Company Directors and Their Liability for Negligence' (1996) 8 *SA Merc LJ* 94 at 95.

by the requirement for the directors to act rationally and with good faith.⁷⁸ In this way the fiduciary duties and the duty of care and skill overlapped.⁷⁹

The classic statement in *Re Smith and Fawcett Ltd.* has been applied by numerous courts in a variety of contexts. There has been a generally cautious approach under South African common law to second-guess decisions of directors.⁸⁰ The common thread that runs through much of the discourse is the same:⁸¹ the courts are not to act as a supervisory board over directors' decisions that are honestly arrived at within the powers of their management,⁸² or alternatively that it is not for the courts to review the substantive merits of a decision that the directors have arrived at honestly.⁸³ This is especially so considering the strained resources of the judicial system at present.⁸⁴ Although these statements are often linked with the fiduciary duty to act in good faith and in the best interests of the company, the same reasoning applies equally to the duty of care and skill. Under the common law – the courts were not in a position to review the merits of the decision if the final decision was a rational one and the directors had arrived at the decision in accordance with the fiduciary duties and using a proper procedure.

⁷⁸ See especially the reasoning of Scrutton LJ in *Shuttleworth v Cox Brothers & Co (Maidenhead) Ltd.* [1927] 2 KB 9 (CA). It is worth quoting from the relevant section of the judgment in full:

“...when persons, honestly endeavouring to decide what will be for the benefit of the company and to act accordingly, decide upon a particular course, then, provided there are grounds on which reasonable men could come to the same decision, it does not matter whether the court would or would not come to the same decision or a different decision. It is not the business of the court to manage the affairs of the company. That is for the shareholders and directors. The absence of any reasonable ground for deciding that a certain course of action is conducive to the benefit of the company may be a ground for finding lack of good faith or for finding that the shareholders, with the best motives, have not considered the matters which they ought to have considered...But I should be sorry to see the court go beyond this and take upon itself the management of concerns which others may understand far better than the court does.”

⁷⁹ JS McLennan (supra) at 95.

⁸⁰ *Howard v Herrigel NNO* 1991 (2) SA 660 (A); *Ozinsky NO v Lloyd* 1992 (3) SA 396 (C); and more recently *Triptomania Twee (Pty) Ltd v Connolly* 2003 (3) SA 558 (C). See also S Kennedy-Good & L Coetzee ‘The Business Judgment Rule (Part 2)’ (2006) *Obiter* 277 at 279-281.

⁸¹ For an analysis of the position in Korea see: JC Park & D Lee ‘The Business Judgment Rule: A Missing Piece in the Developing Puzzle of Korean Corporate Governance Reform’ (2003) 3(2) *Journal of Korean Law* 15 at 30.

⁸² *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 at 832; [1974] 1 All ER 1126 at 1131h.

⁸³ *Hogg v Cramphorn Ltd.* [1967] Ch 254 at 268.

⁸⁴ JC Park & D Lee (supra) make this point with regard to the Korean judiciary; however the same reasoning may be transplanted into the South African context.

This general policy of non-review was based on the understanding that despite the directors being in managerial control of the company; it is the shareholders who are vested with ultimate control of the board of directors. It was generally accepted that save for in specific and rare instances, the shareholders were essentially to 'blame' for the losses suffered by the company for appointing the directors who made the decisions which led to the loss.⁸⁵ This is a questionable justification for non-review of directors' decisions. The reality of the corporate democracy context is that many shareholders are not involved in the process of appointing of directors or will simply be silent on issues such as directorial appointments. Many director appointments are also linked with large shareholding and majority voting power and therefore the minority shareholders may practically have only a limited say in who is appointed as director if at all. It is therefore incorrect to simply classify *all* shareholders as being responsible for the appointment of directors who subsequently cause a loss to the company.⁸⁶

Section 76(4)(a) of the Companies Act of 2008

The codified business judgment rule is encapsulated within Section 76(4)(a) of the Companies Act. For ease of application I will quote section 76(4)(a) in full:

- (4) 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) 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 personal financial interest in the matter; or
 - (bb) the director complied with the requirements of section 75 with respect to any interest contemplated in subparagraph (aa); and

⁸⁵ *Daniels v Anderson* (supra).

⁸⁶ It is beyond the scope of this dissertation to fully discuss this issue. It remains an important issue for corporate law generally. See the argument presented by P Carey 'Select lesson in how shareholder democracy is squashed by 'big guys'' (12 January 2014) viewed at <http://www.theage.com.au/comment/select-lesson-in-how-shareholder-democracy-is-squashed-by-big-guys-20140111-30nr0.html#ixzz2sRxIygcU> [last viewed 5 February 2014].

(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 first important feature to notice of this statutory business judgment rule is the cross reference to section 76(3)(b)-(c). This therefore demarcates the business judgment rule as only applying to the statutory duty of care and to the statutory duty to act in the best interests of the company.⁸⁷ The business judgment rule in section 76(4)(a) consequently does not apply to the common law. When the sections are read together it is clear that a director will “have satisfied” the statutory duty of care if the requirements of subsection (a)(i)-(iii) have been complied with. These are that (i) the decision must be an informed one, (ii) the director must have had no financial interest in the decision; or made a full and proper disclosure in accordance with section 75, and (iii) the director must have had a rational basis for believing (and the director must have in fact believed) that the decision was in the best interests of the company.

These are the three fundamental propositions of the business judgment rule. The codified rule under section 76(4)(a) of the Companies Act may seem at first glance to be a rule which is capable of shallow interpretation and simple straightforward application. In my opinion this is not so. The oversimplification of the rule as creating “a ‘safe harbour’ from liability” or that “section 76(4) thus protects only informed and reasonable business decisions”, or “the merits and wisdom of business decisions fall outside the scope of judicial review” may lead to the incorrect application of the rule.⁸⁸ Section 76(4)(a) is in fact imbued with a deep level of intricacy which must be analysed in accordance with the common law and experience from other jurisdictions in order to avoid the misapplication of the business judgment rule. The uncertainty with which the business judgment rule is currently vested in America must be understood and avoided in South Africa.⁸⁹

⁸⁷ C Stein with G Everingham *The Companies Act Unlocked: A Practical Guide* (2011) 245-6.

⁸⁸ *Contemporary Company Law* (supra) 564-5.

⁸⁹ B Manning ‘The Business Judgment Rule and the Director’s Duty of Attention: Time for Reality’ (1984) 39 *Business Lawyer* 1477 at 1478. Manning warns that uncertainty in the application of the business judgment rule “can lead only to undesirable social consequences and ultimately to a dead-end of unworkability”. It is self-evident that this must be avoided in South Africa.

5. RELATIONSHIP BETWEEN THE BUSINESS JUDGMENT RULE, THE FIDUCIARY DUTIES AND THE DUTY OF CARE

The American experience of the business judgment rule and the current uncertainty which imbues the rule should be a warning shot to those dealing with the relationship between the business judgment rule and the duty of care, skill and diligence in South Africa. In Delaware in particular; the growth and development of the business judgment rule neatly, and unfortunately, runs parallel with the diminished value and importance of the duty of care.⁹⁰ The current situation is a murky mess whereby the business judgment rule has been infiltrated into the fiduciary examination so that the fiduciary duties and the duty of care resembles a single incoherent jumble of legal precedent.

Nowhere is this more prevalent than in an examination of the cases in America where the business judgment rule has been described as a less stringent duty of care – a ‘care light’.⁹¹ Under this conception of the business judgment rule the duty of care standard will be met if the lesser standards of “good faith” and “honest judgment” are present.⁹² *Norlin Corp. v Rooney Pace Inc* clearly misunderstands the inter-relationship between the duty of care and the business judgment rule. This misunderstanding no doubt stems from the courts requiring directors to have “exercised a reasonable amount of diligence” as a precondition to the rule being applied.⁹³ The distinction between the duty of care and the business judgment rule as a lesser duty of care has been carried forward to the Model Business Corporation Act.⁹⁴ This obviously complicates the distinction between the standards of liability and review, thus raising the question whether the business judgment rule is a standard of review or a standard of liability. Under the Model Business Corporation Act a director may be simultaneously in breach of the standard of liability under

⁹⁰ RM Jones (supra).

⁹¹ *Norlin Corp. v Rooney Pace Inc* (supra).

⁹² L Johnson ‘The Modest Business Judgment Rule’ (supra). Good faith is cannot be described to be an independent fiduciary duty because the term ‘good faith’ denotes a state of mind. This is contrary to fiduciary duties which describe and define the manner in which a director is to act rather than the state of mind of that director. See: CW Furlow ‘Good Faith, Fiduciary Duties, and the Business Judgment Rule in Delaware’ (2009) *Utah Law Review* No.3 1061 at 1062.

⁹³ J Hinsey ‘Business Judgment and the American Law Institute’s Corporate Governance Project: The Rule, the Doctrine, the Reality’ (1984) 52 *George Washington Law Review* 609 at 615. C Hansen ‘The Duty of Care, The Business Judgment Rule, and The American Law Institute Corporate Governance Project’ (1993) 48(4) *Business Lawyer* 1355.

⁹⁴ The Model Business Corporation Act (1998) §8.30-8.31.

§8.30 (the equivalent to the duty of care) whilst being not liable provided the director has adhered to the lessened duty of care requirements of §8.31 (the statutory business judgment rule).

The Model Business Corporation Act does not codify the business judgment rule.⁹⁵ The matter is accordingly further complicated because despite this divergence under the Model Business Corporation Act; a director may be exonerated from liability under the common law business judgment rule. This reasoning has been confirmed by the courts, which allows for possibly three different standards to be applied: (1) §8.30 of the Model Act, (2) the less onerous §8.31, and (3) the common law business judgment rule.⁹⁶ This three tiered formulation of the business judgment rule and the standards of director conduct is the same as the position of the American Law Institute.⁹⁷ Under both formulations (which are similarly structured), fulfilling the less stringent business judgment standard is a means of fulfilling the higher duty of care standard.⁹⁸ All this is then further complicated by the manner in which the courts have practically applied the business judgment rule to act as a mechanism for fiduciary analysis, therefore fudging the distinction between the fiduciary duties and the duty of care.⁹⁹

This type of situation is untenable and South African law should avoid a similar scenario. As I have already discussed, the development of the business judgment rule in American corporate law has led to a situation whereby the duty of care and

⁹⁵ Official Comment to the Model Business Corporation Act in Committee on Corporate Laws ‘Changes in the Model Business Corporation Act – Amendments Pertaining to Electronic Filings/Standards of Conduct and Standards of Liability for Directors’ (1997) 53 *Business Lawyer* 157 at 179.

⁹⁶ *Kreischer v Kerrison Dry Goods Co.* (4th Circ. Jan. 26, 1999). This case applied the business judgment rule of South Carolina rather than the standards of conduct delineated by the Model Act. The reasoning of the court in *Kreischer* may apply to other states: RW Hamilton ‘Reflections of a Reporter’ (1985) 63 *Texas Law Review* 1455.

⁹⁷ American Law Institute *Principles of Corporate Governance: Analysis and Recommendations* (1994) (from here on ‘*Principles of Corporate Governance*’). Under the ALI’s formulation, the codified business judgment rule is functionally regarded as a broad based standard of review whilst also setting a less onerous standard for director conduct than the codified duty of care. This is exactly the same formulation as that of the Model Business Corporation Act and the decision in *Norlin Corp. v Rooney Pace Inc* (supra). See especially §4.01 of the *Principles of Corporate Governance*.

⁹⁸ *Principles of Corporate Governance* §4.01(a) and §4.01(c).

⁹⁹ See especially WO Hanewicz ‘When Silence is Golden: Why the Business Judgment Rule Should Apply to No-Shops in Stock-for-Stock Merger Agreements’ (2003) *Journal of Corporation Law* 213; TJ Lasfer ‘Exposing a False Dichotomy’ (2000) 3 *Delaware Law Review* 94; D Botha & Jooste ‘A critique of the Recommendations in the King Report regarding a Director’s Duty of Care and Skill’ (1997) 114 *SALJ* 65.

fiduciary duties are lumped together into a single ‘business judgment rule-type’ analysis. It can safely be concluded that at present there is a wide divergence between the current state of the law in South Africa compared with the law in America;¹⁰⁰ and South African courts should be wary of following the American example. It should be immediately obvious that this cannot, and certainly should not, be the manner in which the business judgment rule develops in South Africa. Under the Companies Act it seems to be clear that the business judgment rule; the fiduciary duties; and the statutory duty of care are to remain distinct concepts.¹⁰¹

The Duty to Act in the Best Interests of the Company

A fiduciary duty is one where a person is in control of the assets of another. A fiduciary stands in a position of trust and confidence to another, i.e. a director stands in a fiduciary relationship with regard to a company. The fiduciary duties are largely derived from the English common law and entail acting honestly and for the best interests of the company.¹⁰² They are founded upon the concepts of honesty, loyalty and good faith.¹⁰³ Incompetence without more should accordingly not be regarded as a breach of fiduciary duty. There is merely a relationship of trust between the company and the director, with the director undertaking to act on behalf of the company, and therefore subsequently the director is under the duty to act in the best interests of the company.¹⁰⁴

Section 76(3)(b) has codified this common law principle and the codified duty to act in the best interests of the company is subject to the operation of the business judgment rule under section 76(4)(a). It is clear from the wording of the section 76(3)(b) that directors owe their fiduciary duties to the company and only the company, which subsequently means that only the company may enforce directorial compliance with this fiduciary duty. The statutory derivative action does make allowance for shareholders to enforce the fiduciary duties but this is still *on behalf of the company* to protect the interests *of the company* (and not the shareholders or

¹⁰⁰ E Jones (supra) at 335-6.

¹⁰¹ See R Matimela ‘The Business Judgment Rule in South African Company Law: A Miss or Hit?’ (2011) *Company Law Hub Journal of Student Research* Volume (1)(1) Article 5 at 8.

¹⁰² *Contemporary Company Law* (supra) 507.

¹⁰³ *Fisheries Development* at 165F-G.

¹⁰⁴ *Bristol and West Building Society v Mothew* [1998] Ch. 1.

another person connecting with the company).¹⁰⁵ The primary difficulty with section 76(3)(b) is that the term ‘the company’ is not defined in the section nor in the Companies Act and consequently the common law interpretation of ‘the company’ remains relevant.¹⁰⁶

Cassim raises the concern that “section 76(4) blurs the distinction between the fiduciary duties and the duty of directors to exercise reasonable care and skill”.¹⁰⁷ The codified business judgment rule under section 76(4)(a) of the Companies Act makes no reference to, nor requires as a precondition for the operation of the rule, that the decision must have been made for a ‘proper purpose’. The codified business judgment rule does apply to the duty to act in the best interests of the company as well as the duty of care, skill and diligence. By including the reference section 76(3)(b), does the codified business judgment rule leave open to possibility for the American-type of uncertainty regarding the relationship between the fiduciary duties, the statutory duty of care, and the business judgment rule? And if so, how can this problem be solved?

Avoiding the Problems of the American Experience

The cause of action in cases where the breach of a fiduciary duty is alleged is a claim for the breach of trust. Under our law the liability for breach of trust is Roman-Dutch law based.¹⁰⁸ It is therefore not founded in a breach of contract nor delict, but has classically been regarded as *sui generis* in nature.¹⁰⁹ In contrast with the fiduciary-type duties, the duty of care is a concept which is derived from the English common law of negligence. It addresses the negligence (i.e. the reasonableness of conduct) of a director rather than that director’s honesty *per se*.¹¹⁰ Up until the codification of the duty of care, skill and diligence in the Companies Act, the duty of care and skill was developed within the common law and the cause of action for the breach of the duty lay within the law of delict.

¹⁰⁵ Section 165 of the Companies Act and the requirements that are listed therein.

¹⁰⁶ *Contemporary Company Law* (supra) 515-521. There is a vast amount of detail concerning the correct interpretation of what exactly ‘the company’ entails. It is beyond the scope of this dissertation to fully discuss the relevant debates and positions.

¹⁰⁷ *Ibid.* 564.

¹⁰⁸ E Jones (supra) at 334.

¹⁰⁹ M Havenga ‘Directors in Competition With Their Companies’ (2006) 16 *SA Merc LJ* 275 at 286. *Robinson v Randfontein Estates Gold Mining Co Ltd.* 1921 AD 168 at 242; *Phillips v Fieldstone Africa (Pty) Ltd* 2004 (3) SA 465 (SCA) at para [30]; *Cohen NO v Segal* 1970 (3) SA 702 (W) 706G.

¹¹⁰ E Jones (supra) at 334.

An examination of what may be claimed by the company exemplifies the difference between a breach of the fiduciary duties and a breach of the statutory duty of care under the Companies Act. A breach of fiduciary duty (including section 76(3)(b)) leads to liability under section 77(2)(a) which allows for liability to include “any loss, damages or costs sustained by the company as a consequence of any breach” in accordance with the common law principles regarding the breach of fiduciary duties.¹¹¹ A breach of the statutory duty of care under section 76(3)(c) leads to liability under section 77(2)(b)(i) which states that the liability of a director who is in breach of the duty is in accordance with the common law of delict. A plaintiff would therefore need to prove the requirements of a delict. The distinction between the fiduciary duties and the duty of care and skill are accordingly maintained under the operation of the business judgment rule.

Although not included directly under section 77(2)(a): the common law regarding the damages which may be claimed for breach of fiduciary duty provides for the disgorgement of profits.¹¹² A director stands in the position where there is a duty to protect the interests of the company, and accordingly a director may not make a profit at the expense of the company.¹¹³ Although a claim for breach of fiduciary duty has typically been regarded under the common law as *sui generis*, I agree with Du Plessis where he argues that it is rather a claim properly conceived as being one of unjustified enrichment.¹¹⁴ What is vital for the current discussion is that it remains clear that a claim for the breach of fiduciary duties is not delictual in nature and is therefore distinct from the duty of care, skill and diligence.¹¹⁵ Delictual damages are clearly provided for by section 77(2)(b) – the section which explicitly refers to the statutory duty of care. The typical scenario is one where the company has suffered pure economic loss as a result of the negligent non-performance of a director’s duty of care. A claim in delict is one to restore the company to the position it would have

¹¹¹ Section 77(2)(a) of the Companies Act.

¹¹² *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378 (HL).

¹¹³ *Robinson v Randfontein Estates Gold Mining Co Ltd.* (supra) at 177-180. See also the case examples of: *Phillips v Fieldstone Africa (Pty) Ltd* (supra); *Da Silva v CH Chemicals (Pty) Ltd* (supra); *Dorbyl Ltd v Vorster* 2011 (5) SA 575 (GSJ) para [25].

¹¹⁴ J Du Plessis *The South African Law of Unjustified Enrichment* (2012) Cape Town: Juta 365-8. This is an ancillary discussion and one which cannot be fully addressed in this dissertation. For a thorough discussion of this see particularly: JSA Fourie ‘Die Sui Generis Aksie Teen Direkteure Weens Verbreking van Vertrouenspligte’ (1995) 6 *Stellenbosch Law Review* 408.

¹¹⁵ *The South African Law of Unjustified Enrichment* 366. See also: D Visser & D Kleyan ‘The borderline between delict and enrichment’ (2000) *Acta Juridica* 300.

been in, had there been no breach of the duty of care which typically would not include the disgorgement of profits by the director to the company unless it was foreseeable that those profits would have accrued to the company at the time of the delict being committed.

In what way then does the business judgment rule fudge these concepts together in the manner which Cassim contends? Does the business judgment rule lead to either the fiduciary duties allowing for a delictual claim, or the duty of care a claim for restitution? Are the fiduciary duties suddenly delictual in nature and the duty of care no longer so? Clearly there is a problem and the potential for the business judgment rule to be applied in a manner where the delictual statutory duty of care and the fiduciary duty to act in the best interests of the company may be confused. This is certainly an issue which must be addressed. It mustn't be forgotten, however, that under the the common law it has been recognised that although the duty of care and the fiduciary duties are distinct concepts (which may lead to different claims being pursued); there are many instances where there "is no sharply delineated borderline between the fiduciary duty and the duty of care and skill. Situations may arise where the two overlap."¹¹⁶

This response to the concern merely sidesteps the concern rather than deals with it directly. To address the concern directly is important. References to good faith or proper purpose have been explicitly excluded under the business judgment rule in the Companies Act. The scope of the rule under section 76(4)(a) has been clearly defined to apply only to the section 76(3)(b) fiduciary duty to act in the best interests of the company rather than all the fiduciary duties en mass. There is no cross reference or application of the rule to either the duty of care or the fiduciary duties under the common law. Although the rule does apply to the fiduciary duty of acting in the best interests of the company under the Companies Act, there remains a clear definition between the fiduciary duties and the duty of care. Accordingly – I propose that there should be no similar problems as to those which have riddled American jurisprudence on this point.

I acknowledge that the drafting of section 76(4)(a) is not clear, and further I propose that the legislature should remove the reference to section 76(3)(b) from the

¹¹⁶ JS McLennan (supra) at 96.

ambit of the business judgment rule. The reason for this will be made abundantly obvious below. This does not mean that the argument presented by Cassim is a critical flaw in the South African business judgment rule as codified in section 76(4)(a). The problem is a valid one, but it should not lead to the removal of the statutory business judgment rule from the Companies Act. At most it may require an amendment to the Companies Act in order to remove the cross reference in section 76(4)(a) to section 76(3)(b), and the phrase “the decision was in the best interests of the company” in section 76(4)(a)(iii).

A Brief Comparison with Australia

Australia has, like South Africa, adopted a codified business judgment rule despite academic criticism warning against doing so.¹¹⁷ Unlike the Australian law regarding the codified business judgment rule which requires the decision to have been made for a proper purpose, our business judgment rule does not.¹¹⁸ In comparison with the rule under section 76(4)(a) the Companies Act, section 180(2) of the Corporations Act makes provision for the business judgment rule to operate as a defence to both the common law and statutory duties of care.¹¹⁹ This may obviously present a problem of the business judgment rule encroaching too far into the common law duty of care analysis and may open the door to being applied within the broader fiduciary analysis as is the situation in America.

These are problems which are not particularly relevant to the law in South Africa as has been discussed above. The codified business judgment rule has no operation to the common law in any form. The Australian experience of a codified business judgment rule does have inherent value, for South Africa can learn the lessons from

¹¹⁷ B Keller ‘Australia’s Proposed Statutory Business Judgment Rule: A Reversal of a Rising Standard in Corporate Governance?’ (1997-2000) 4 *Deakin Law Review* 125.

¹¹⁸ DA DeMott ‘Directors’ Duty of Care and the Business Judgment Rule: American Precedents and Australian Choices’ (1992) 4(2) *Bond Law Review* Article 2 133; N Bouwman ‘An Appraisal of the Modification of the Director’s Duty of Care and Skill’ (2009) 21 *SA Merc LJ* 509.

¹¹⁹ Section 180(2) of the Corporations Act 2001. This section embodies a legislative business judgment rule. Unlike section 76(4); the Australian business judgment rule provides a defence to both the statutory and the common law duties of care, skill and diligence and subsequently allows for an “unwarranted undermining” of the duty of care, and “involves an unnecessary divergence in the standard of conduct and standard of review”. She argues that the business judgment rule should not be adopted in reforming developing jurisdictions. See: J Cassidy ‘Directors’ Duty of Care in Australia – A Reform Model?’ (2008) 16 *Asia Pacific Law Review* 19 at 23; JJ Du Plessis ‘A comparative analysis of directors’ duty of care, skill and diligence in South Africa and in Australia’ (2010) *Acta Juridica* 263; J Cassidy ‘Models for Reform: The Directors’ Duty of Care in a Modern Commercial World’ (2009) 3 *Stellenbosch Law Review* 373.

another English common law derived jurisdiction which has codified a business judgment rule into company law. Most importantly it does raise the point which I stress throughout this dissertation: in order for the business judgment rule to find a proper place within South African corporate law it must be applied in a limited manner which avoids the uncertainty and overreaching nature of the common law business judgment rule in America.

The Position in a Nutshell

The business judgment rule is not a substitute for the fiduciary duties or the duty of care and skill. It is limited in its scope of application as merely an adjunct principle to the duties under sections 76(3)(b)-(c); and then it is further limited only to the single directorial function of decision-making rather than director functions *en bloc*. This will be made clearer below. If the decision-making process is found to have been appropriate with reference to the requirements of section 76(4)(a), a court will not subsequently review the merits of the decision for doing so may involve the court possibly substituting its own “business judgment” for that of the directors.¹²⁰ The obvious concern is that doing so would impinge on the core responsibility and role of directors which the legislature saw fit to specifically reserve for them.¹²¹

The confusion which vests in the American business judgment rule (especially the interrelationship between the fiduciary duties and the rule) can simply be avoided by noting that when the duty of care is at issue; and thus the business judgment rule; it is the process the decision was come to rather than the merits of the decision which is under investigation. It is this process oriented review which is within the ambit of the courts’ competency. It is not the role of the courts to assess what a board of directors should or should not do or what policies should or should not be pursued; nor whether a particular business decision was substantively correct or not. The courts can review the process as to how the decision was reached and then whether the decision was a rational one. As was the case under the common law, the courts would severely overstep the line of the recognised juristic personality and independence of corporations and undermine the office, role and functions of directors if they were to adjudicate the substantive merits or wisdom of a business

¹²⁰ SR Cohn (supra) at 602-3.

¹²¹ Section 66 of the Companies Act.

decision. A review of the substantive merits of a particular decision is something which should only be done, if at all, in the most extreme cases. The individual legal personality and resultant 'free will' of a corporation's directors must be respected by the courts.

6. JUSTIFYING THE BUSINESS JUDGMENT RULE AS A STANDARD OF REVIEW RATHER THAN A STANDARD OF LIABILITY

On the face of it, the business judgment rule seems straightforward. However; the business judgment rule is imbued with a deep level of intricacy despite the apparent simplicity of the its operation. The rule may be theoretically conceived and subsequently practically applied in three different ways. First: the rule can be understood as a standard of liability which courts can adopt as the yard-stick by which to review the decisions of directors. Second: the rule may be understood as a doctrine of judicial abstention or deference. Or third: it may be viewed as a doctrine of immunity which insulates the directors from liability resulting from bad decisions provided certain requirements are met. Under each of these formulations there will be different procedural and practical rules which develop from the theoretical base. The theoretical base determines the method, manner and form of judicial application of the business judgment rule which will ultimately have the capacity for "outcome-determinative effects".¹²² It is important therefore to fully investigate what the correct conception of the rule should be.

Ultimately the decision as to which theoretical conception is best is not a simple decision. The decision will need to be determined by reference to the particular policies and philosophy (of which there will be varying competing interests) which underpin corporate law. The crux of the matter is to determine the appropriate balance between judicial respect for directors' business decisions against the judicial review of those decisions which are seen to be flawed with the power of hindsight.¹²³ The focus of this chapter will be to propose the justification as to why the business

¹²² SM Bainbridge 'The Business Judgement Rule as Abstention Doctrine' (supra) at 87.

¹²³ MA Eisenberg 'The Director's Duty of Care in Negotiated Dispositions' (1997) 51 *University of Miami Law Review* 579.

judgment rule should “shield directors from liability for good faith business decisions, even those that turn out to be mistaken”.¹²⁴

The Difference Between Standards of Review and of Liability

A standard of liability specifies the manner in which directors should conduct the affairs of the company. It prescribes the how to act; when to seek advice or defer a decision to another; the relevant process to be followed and so forth. A standard of review is the test (or tests) that courts employ in order to determine whether a particular director’s conduct gives rise to liability – i.e. whether the standard of liability has been breached in some manner.¹²⁵ According to Professor Eisenberg, it is a fundamental feature of corporate law that “standards of conduct pervasively diverge from standards of review”.¹²⁶

This distinction between a standard of review and a standard of liability is incorporated within The Model Business Corporation Act. §8.30 requires that directors act in good faith and in a manner which the director reasonably believes to be in the best interests of the company. This is a standard of liability. Director conduct which adheres to this standard cannot lead to liability. A director will not be liable if that director’s conduct adheres to the provisions of §8.31. This section is a standard of review – therefore liability may only result only if the director acted in bad faith, did not reasonably believe to be in the corporations best interest, was not informed to the extent the director reasonably believed to be appropriate given the situation, was interested in the transaction, was not independent, engaged in self-dealing, or failed to exercise oversight over a sustained period.

The reason for this divergence is rooted within the juridical nature of reviewing directorial decisions – the judiciary is institutionally not in the correct position to judge with the power of hindsight a decision which, at the time of making the decision, was *ex ante* correct or reasonable; but which *ex post facto* was not. There are many other policy factors which may be relevant in this argument, but which are not the primary focus of this dissertation. Some factors may include a lack of

¹²⁴ *Strassburger v Earley*, 752 A.2d 557, 582 (Del. 2000).

¹²⁵ MA Eisenberg ‘The Divergence of Standards of Conduct and Standards of Review in Corporate Law’ (1993) 62 *Fordham Law Review* 437 at 444-5.

¹²⁶ *Ibid.* at 438.

expertise and skill among the members of the judiciary and hindsight bias.¹²⁷ The crux of the argument is that each business decision is imbued with uncertainty in a manner which differentiates directorial decision making from those of other professionals subject to a typical agent-principal setting (i.e. doctors or lawyers). Persons in this typical agent-principal setting may be held to objective standards of conduct which are capable of *ex post facto* judgment. The reasonableness of a doctor's decision for example, may be assessed *ex post facto*.¹²⁸

Contrast this situation to one where the success of directors is differentiated by the innate ability to determine which business risks are worth taking or not. Every business decision is unique in terms of the factors and context which imbues the decision. Much of the time business decisions are infused with uncertainty. A director's success is determined by the ability to identify which opportunities will or will not be successful. This is fundamentally different to the doctor-type of situation where an objective *ex post facto* assessment may determine negligence. It is exactly because business decisions are inherently subjective in their nature which makes the review of business decisions so tricky. It is for this exact reason that business decisions should not be judged according to a standard of liability.¹²⁹

Applied to the Business Judgment Rule

The business judgment rule is the mechanism adopted to facilitate judicial respect for directorial decisions. It would not be fair to impose liability on every director whose decisions fall foul of bad luck. The concept of uncertainty is at the core of the business judgment rule. One of the main functions of a director as opposed to other professions is that directors must of necessity take commercial risks. Even in instances where the most careful investigations have been concluded it can never be said that a particular business decision is perfectly secured from uncertainty. It is important to state that we are dealing here with uncertainty and not risk (i.e. the potential of harm occurring is not necessarily foreseeable). Risk may be assessed by

¹²⁷ MA Eisenberg 'The Director's Duty of Care in Negotiated Dispositions' (supra).

¹²⁸ There can be a clear comparison made between the conduct of one doctor and the conduct of the hypothetical reasonable doctor. For a specific case example where the duty of care is compared with the "exercise of judgment" standard which is applied to medical professionals see: *Aiello v Muhlenberg Regional Medical Center*, 733 A.2d 433 (N.J. 1999) at 438-42.

¹²⁹ AM Paces *Rethinking Corporate Governance: The law and economics of control powers* (2012) Abingdon, Oxford: Routledge 250-1.

way of foreseeability, whereas uncertainty lacks this sense of foreseeability. Uncertainty may thus be regarded as unforeseeable risk. It is trite law in delict that a person should not be held liable for harm which was *ex ante* unforeseeable.¹³⁰ The same should apply in the context of the duty of care – a director should not be held liable for the harm that occurs but which was not foreseeable at the time of making the decision. The power of hindsight should not be used as a mechanism with which to impose liability on directors for making a particular decision if that decision turns out to be an incorrect one.

Unlike other professions, directors in many instances assess situations and make context based decisions upon uncertainty; not risk.¹³¹ What this implies is that outcomes can hardly be predicted with a sufficient degree of particularity at the time the decision is made. Predictions and probabilities will often be difficult to ascertain with any degree of specificity.¹³² However – these are the features of business decisions. Uncertainty is an inherent factor in most (if not all) business decisions. Consequently nearly every business decision when viewed *ex post facto* may potentially be viewed as negligent. Honest, cautious, attentive, qualified and intelligent directors may in certain instances be found negligent despite his or her best efforts in making a business decision if the decision is viewed against a standard of liability.¹³³ This is obviously unfair and incommensurate with the role of the corporate law and the duty of care that applies to directors.

Provided that the proper procedural steps have been followed throughout the decision making process, and provided that the pre-decision steps were reasonable and the decision a rational one; a decision that leads to an unlucky or negative result should be protected by the business judgment rule. It is the uncertainty that imbues the decision at the time the decision is made that is the root cause of the loss and not the directors' conduct in making the decision. The business judgment rule can be justified as it does not permit the *ex post facto* judicial assessment of a decision that is

¹³⁰ Foreseeability is an integral part of the law of delict and there is a vast amount of intricacy the surrounds the place of foreseeability in the law of delict: *Sea Harvest Corp v Duncan Dock Cold Storage* 2000 (1) SA 827 (SCA) (wrongfulness); *Kruger v Coetzee* 1966 (2) SA 428 (A); *Herschel v Mrupe* 1954 (3) SA 464 (A) (negligence); *Standard Chartered Bank of Canada v Nedperm Bank Ltd* 1994 (4) SA 747 (A) (causation).

¹³¹ *Rethinking Corporate Governance* 250.

¹³² *Ibid.*

¹³³ EB Rock & ML Wachter 'Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation' (2000-2001) 149 *University of Pennsylvania Law Review* 1619 at 1665-6.

ex ante reasonable. What is of concern within the context of judging director decisions is not whether the decision in question was objectively the correct decision or not. The duty of care does not apply to the actual making of the decision. Rather it applies to the decision making process. It is the procedure relevant to the decision making process to which the business judgment rule and the duty of care and skill relate, and not to the actual result of the decision making process.¹³⁴

When *ex post facto* adjudicating upon a business decision, it will at times be impossible to attempt to decipher between whether a particular business decision was a bad decision, or whether it was a proper decision which unluckily turned out badly. A director at the time the decision is made is faced with making a judgment which is vested with uncertainty. Provided the director makes a decision in accordance with the correct process and the duty of care, and provided that decision was a rational one; then the director has not made a decision from which liability should attach to him. Inevitably there will always be some decisions which fall on the fortunate side of luck, and some which do not. Should a director be held liable for being unlucky in a particular decision that was taken properly, but which turned out to be wrong in hindsight? The answer must clearly be no. And this is the importance of the purpose of the business judgment rule.

In corporate law there is a clear divergence between the standards of liability and review which apply to directors. In Eisenberg's opinion – the duty of care is a standard of liability whereas the business judgment rule operates to be a standard of review.¹³⁵ In typical negligence *lex aquilia* cases the reasonable person standard is applied to both the standard of conduct and review. In corporate law and the directors' duty of care the position is different. There is a clear divergence between the standard of review and standard of liability. The business judgment rule creates a less demanding standard of review than the standard of liability such that despite a particular breach of the standard of conduct no liability attaches despite the breach.

Eisenberg argues that the business judgment rule consists simply of four preconditions which if satisfied allow for directors' decisions to be reviewed under a

¹³⁴ *Rethinking Corporate Governance* 249-250; MA Eisenberg 'The Divergence of Standards of Conduct and Standards of Review in Corporate Law' (supra).

¹³⁵ *Ibid.*

limited standard compared to the standard of liability or conduct which is relevant.¹³⁶ Accordingly – the business judgment rule, if applicable, lowers the standard of review from the duty of care standard to a lower business judgment-type standard. What this lower business judgment-type standard of review is remains contested in American jurisprudence. Attempting to define what this lower standard of review should be raises difficult theoretical problems which have been prevalent in causing the uncertainty in America.

South African the courts are extremely hesitant to sanction actions made *mala fides*. Section 77(9) of the Companies Act makes it clear that any decision which is to be protected by the business judgment rule must be absent *mala fides*. Whether the standard is objective or subjective, or alternatively the level to which a decision must be objective, is a trickier problem to address. At a minimum it would seem that intuitively the standard could not be purely subjective. If this standard were adopted as a standard of review serious problems would arise. As an example: an irrational decision would be protected so long as the decision was made in subjective good faith. In my opinion – it would appear that there is no simple solution to this problem. At a minimum it would appear that the decision must be rational.¹³⁷ But this does not bring about a proper solution. It is but a minimum threshold determination.

Professor Eisenberg makes the argument that the business judgment standard is one based wholly within rationality. In his opinion a rationality based standard preserves a “minimum and necessary degree of director and officer accountability”.¹³⁸ This argument is based upon the conception that a rationality based standard of review is more demanding of a director than a subjective-good faith standard; but remains sufficiently subordinate to the level of conduct that is required by a standard based upon reasonableness. In an attempt to justify this lower business judgment-standard of review as being one of rationality rather than reasonableness; Eisenberg argues that any standard of review which imposes liability on a director “for unreasonable as opposed to irrational decisions might therefore

¹³⁶ Ibid. at 441-2.

¹³⁷ *Principles of Corporate Governance* §4.01(c)(3).

¹³⁸ MA Eisenberg ‘The Divergence of Standards of Conduct and Standards of Review in Corporate Law’ (supra) at 443.

have the perverse incentive effect of discouraging bold but desirable decisions”.¹³⁹ In his opinion the role of the business judgment rule is therefore to offset the tendency that directors may have in not pursuing risky yet potentially lucrative decisions. This tendency is rooted within the divergence between corporate gain and director loss: if a decision turns out to be lucrative then it is the company benefits directly; not the directors. Directors may legitimately benefit indirectly through bonus payments and possible increases in remuneration. This is a separate matter. In the case of corporate loss it is the directors who may be required to make up to loss.¹⁴⁰

7. BUSINESS JUDGMENT RULE AS A DOCTRINE OF JUDICIAL DEFERENCE OR A DOCTRINE OF IMMUNITY

In my opinion this is not the correct solution for I am of the view that not only must a decision be rational, but it must have a sufficient degree of reasonableness, i.e. the decision must also be reasonable to some degree. The answer is not as simple as stating that it is sufficient for the business judgment rule to apply that a particular decision must simply be rational. There is another plausible solution. In the following chapters I propose what I believe is the correct theoretical conception and practical formulation of the business judgment rule in section 76(4)(a) of the Companies Act. It is imperative that uncertainty be removed from the application of the rule in South Africa and my solution removes much of the uncertainty which Eisenberg raises.

The business judgment rule needs to be applied and developed on a case-by-case basis going forward, especially considering the lack of authoritative precedent concerning the rule in South Africa. It would be a mistake to simply adopt and apply the authorities and case precedent from the American jurisdictions. The approach of South African courts needs to take into account the unique corporate laws, corporate governance provisions, the role and position of corporate actors and the particular socio-economic realities of South Africa. It is vital to determine exactly how the business judgment rule should be applied considering the rule’s recent introduction to, and its position within, South African corporate law.

¹³⁹ Ibid. at 445.

¹⁴⁰ Ibid.

Given the wording and formulation of the business judgment rule in the Companies Act, it is more appropriate that the elements listed in subsections section 76(4)(a)(i)-(iii) be conceived as threshold requirements which allow for directorial immunity from personal liability (or for judicial deference to the directors' decision) rather than lowering the standard of review within the decision-making context of the duties of sections 76(3)(b)-(c). Accordingly – a business decision may be incorrect or result in harm to the company, but directors will “have satisfied the obligations of” sections 76(3)(b)-(c) and therefore personal liability cannot attach to them. This conception of the business judgment rule allows for judicial deference or directorial immunity from personal liability if the listed requirements are met, therefore it accords with the American common law and removes much uncertainty in the application of the rule. This chapter will examine and discuss whether the rule is best conceived as a doctrine of immunity or as a doctrine of judicial deference; or alternatively whether it is possible to model a South African specific business judgment rule that cherry-picks elements from each conception.

Business Judgment Rule as a Doctrine of Judicial Deference

Professor Bainbridge advocates the business judgment rule to be a doctrine of judicial abstention, or an abstention doctrine. The ‘core proposition’ upon which his analysis is founded is that the business judgment rule in effect seeks to balance the inherent tension between authority and accountability on a case by case basis.¹⁴¹ It is true that a proper balance needs to be struck between allowing for the exercise of directorial discretion whilst concurrently requiring directors to be held accountable for their decisions; but is the business judgment rule the appropriate mechanism by which to accomplish this balance? And further – how can the business judgment rule facilitate an effecting balance between these competing interests?

One of the primary arguments within American jurisprudence at the current time is that the balance to be struck should be skewed towards allowing for greater director authority over accountability. Bainbridge argues that directors' decision-making procedures and processes function best when directors' decisions are insulated from being undermined by the courts through judicial review mechanisms. For Bainbridge, the most efficient model of director decision making is one where

¹⁴¹ SM Bainbridge ‘The Business Judgement Rule as Abstention Doctrine’ (supra) at 84.

there is no risk of judicial review; in essence a practical application of a director primacy model of corporate governance.¹⁴² The director primacy model stands in contradistinction to the widely accepted shareholder primacy model of corporate governance in America and advocates that a board of directors do not act as an “agent of the shareholders” but rather as “the embodiment of the corporate principal”.¹⁴³

The business judgment rule is the mechanism by which the inherent tension between accountability and authority is resolved. Under this director primacy model of corporate governance, accountability through judicial intervention should yield to directorial authority. The business judgment rule consequently functions as a policy of judicial abstention of the review of directorial authority. Using the terms which are no doubt well-known to South African lawyers, the business judgment rule is therefore a rule which mandates judicial deference to directors’ decisions; review of the decisions is permitted only when specific preconditions are met.

There is an inherent appeal to the judiciary not having the intrinsic jurisdiction to second-guess or review the decisions of directors, and in turn to either supplement or substitute a particular decision with their own. This has already been discussed above and need not be repeated in full here. Bainbridge argues that when the traditional leading case of *Schlensky v Wrigley*¹⁴⁴ is closely re-examined, it becomes clear that the core discourse of the business judgment rule is merely a “strong presumption against judicial review of duty-of-care claims.”¹⁴⁵ This formulation of the business judgment rule is clearly different to that of the common law in Delaware and especially the conception of the rule in *Cede & Co. v Technicolor, Inc.* which presents the business judgment rule as a substantive doctrine which allows for the courts to substantively review the merits of a particular directorial decision. Lyman Johnson is also of the opinion that the common law business judgment rule is

¹⁴² Ibid. at 85-6. See also: SM Bainbridge ‘Director Primacy: The Means and Ends of Corporate Governance’ (2003) 97 *North Western University Law Review* 547; MP Dooley ‘Two Models of Corporate Governance’ (1992) 47 *Business Lawyer* 461.

¹⁴³ SM Bainbridge ‘The Business Judgement Rule as Abstention Doctrine’ (supra) at 86; SM Bainbridge ‘The Board of Directors as Nexus of Contracts’ (2002) 88 *Iowa Law Review* 1.

¹⁴⁴ *Schlensky v Wrigley*, 237 N.E.2d 776 (Ill. App. Ct. 1968).

¹⁴⁵ SM Bainbridge ‘The Business Judgement Rule as Abstention Doctrine’ (supra) at 87.

misconceived and is rather nothing more than a policy of judicial non-intervention or deference.¹⁴⁶

The argument within the decisions of the courts during the prolonged *Cede Litigation* and the subsequent cases clearly treats the business judgment rule as a substantive standard of judicial review.¹⁴⁷ It seems to be so embedded into the American corporate law jurisprudence, and particularly that of Delaware, that the minority of cases argue that the objective reasonableness of directorial decisions is not capable of review by the courts.¹⁴⁸ It is best to use a direct quote from the *Corporate Directors Guidebook: Third Edition*¹⁴⁹ to illustrate how engrained this has become in American jurisprudence:

“The business judgment rule is not a description of a duty or standard used to determine whether a breach of duty has occurred; rather it is a standard of judicial review.”

The Delaware Supreme Court in the *Cede & Co. v Technicolor, Inc* decision described the business judgment rule as a rule which is aimed at precluding “a court from imposing itself unreasonably on the business and affairs of a corporation.”¹⁵⁰ It is the use of the term “unreasonably” in the description which has created the serious confusion. The problem becomes immediately apparent when compared to the description of the business judgment rule in the previous leading case authority (and the authority which much of the argument and the final decision of the Delaware Supreme Court was based).

The business judgment rule as stated in *Smith v Van Gorkom*¹⁵¹ makes it clear that the purpose of the rule is to “protect and promote the full and free exercise of the managerial power granted to Delaware directors”.¹⁵² At the risk of being overly semantic in the analysis of the description and although perhaps not intended by the

¹⁴⁶ L Johnson ‘The Modest Business Judgment Rule’ (supra).

¹⁴⁷ *Omnicare, Inc. v NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003) at 917. WO Hanewicz (supra) at 217.

¹⁴⁸ SM Bainbridge ‘The Business Judgement Rule as Abstention Doctrine’ (supra) at 91.

¹⁴⁹ *Corporate Directors Guidebook: Third Edition* (2001) 56 *Business Lawyer* 1571 at 1586.

¹⁵⁰ *Cede & Co. v Technicolor* at 360.

¹⁵¹ *Smith v Van Gorkom*, 488 A.2d 858 (Del. 1985).

¹⁵² *Ibid* at 872. For a thorough analysis of *Smith v Van Gorkom* see: DR Fischel ‘The Business Judgment Rule and the *Trans Union Case*’ (1984-1985) 40 *Business Lawyer* 1437; DA Burgman & PN Cox ‘Corporate Directors, Corporate Realities and Deliberative Process: An Analysis of the *Trans Union Case*’ (1986-1986) 11 *Journal of Corporate Law* 311.

court in *Cede & Co. v Technicolor*; the formulation of the business judgment rule using the term “unreasonably” very clearly allows for substantive judicial review. The result has in due course shown to be the confusion as to whether the business judgment rule should be properly understood as a substantive standard of liability or a standard of review; or rather an evidence-based “presumption” against judicial interference; a procedural rule; or as a policy of judicial deference to directorial decisions.

The wealth of both judicial and academic literature on the subject speaks for itself. There is a mass of uncertainty in the American jurisprudence that should be avoided in the application of the business judgment rule in South Africa. The South African courts need to avoid the clear confusion present within the dictum of the Delaware Supreme Court in *McMullin v Beran*:¹⁵³

“The business judgment rule “operates as both a procedural guide for litigants and a substantive rule of law”.

Section 76(4)(a) uses the phrase “will have satisfied the obligations of subsection 3(b) and (c) if ...”. This phrase implies that the South African business judgment rule is certainly not a substantive standard of directors’ liability. It does not connote an enquiry as to whether the duty of care, skill and diligence has been breached by a director or a board of directors. It also does not require an investigation into the substantive correctness of the decision that was taken. It seems clear from the wording of section 76(4)(a) that the business judgment rule as encapsulated in the Companies Act is to allow for the section 76(3)(b)-(c) enquiry to be avoided by a defendant director. It would be incorrect to see the business judgment rule under section 76(4)(a) to require the shareholder challenging the directors’ decision in litigation “(t)o rebut the rule” by assuming “the burden of providing evidence that directors, in reaching the challenged decision, breached any one of their triads of fiduciary duty”.¹⁵⁴

Another inappropriate formulation of the business judgment rule for South Africa is any formulation of the rule that holds “for the rule of judicial deference to be invoked, directors of a board must be found to have met not only their duty of loyalty

¹⁵³ *McMullin v Beran* 765 A.2d 910 (Del. 2000) at 916-7.

¹⁵⁴ *Cede & Co. v Technicolor* at 361.

(i.e. fiduciary duties) but also their duty of care”.¹⁵⁵ Such a formulation of the business judgment rule in South Africa would require directors to prove a lack of the breach of the duties under section 76(3)(b)-(c) to avoid liability. This approach to the application of the business judgment rule would simply not fit with the requirements of the Companies Act. The rationale of the business judgment rule as formulated under section 76(4)(a) of the Companies Act is surely to prevent a court from enquiring into whether the statutory duty of care and the duty to act in the best interests of the company had been breached. At a minimum, the rationale is to mandate judicial respect of corporate independence and the role and functions of directors within corporations. It goes without saying that the relevant threshold criteria and information would need to be presented before the business judgment rule under section 76(4)(a) would apply.

Professor Bainbridge’s conception of the business judgment rule as an abstention doctrine is founded upon a director primacy model of corporate governance. He argues that the director primacy model should be supported by both shareholders and directors; for shareholders will tolerate risk-taking whilst directors will not be hesitant to take risks if the threat of liability is not present. The argument is that shareholders should be willing to accept less accountability, and also greater risk of loss, for the result of potentially gaining greater corporate profits.¹⁵⁶

As I will argue below – this director primacy-based conception of the business judgment rule does not sit well with the South African approach to corporate governance. In conjunction with this, I am not persuaded that this reasoning holds true in the current context. I am not convinced that shareholders are willing to place a gamble on greater corporate gain and accept risking similar losses which recent experience has shown to be so devastating. I am suspicious of an argument proposing that shareholders should be willing to invest in a corporate law framework that would allow for shareholders to accept the risk of another Enron or WorldCom type of scandal. Corporate greed and directorial accountability has been a topic with which there is a vast amount of interest from both genuine prospective shareholders and the

¹⁵⁵ *Litwin v Allen* 25 N.Y.S.2d 667 (Sup. Ct. 1940) at 678; HR Horsey ‘The Duty of Care Component of the Business Judgment Rule’ (1994) 19 *Delaware Journal of Corporate Law* 971 at 976.

¹⁵⁶ SM Bainbridge ‘The Business Judgement Rule as Abstention Doctrine’ (supra) at 110-116.

public in general since these and other corporate scandals.¹⁵⁷ It would be incorrect to advocate for a corporate governance system or business judgment rule that further shields directors from being accountable to their shareholders; especially in South Africa where there is the scope for both immense corporate growth and concomitantly great corporate greed and subsequent scandals.¹⁵⁸

The greatest concern with the abstention doctrine conception of the business judgment rule is that the substantive matter of director liability is by default largely removed from judicial review. It is true that if the business judgment rule does apply (i.e. the requirements of section 76(4)(a) are met) the practical effect of the rule will be the courts abstaining from substantively evaluating the merits or correctness of the directorial decision. If the business judgment rule is to be applied in the manner advocated by Bainbridge (i.e. whereby the default position of the judiciary is deference rather than review of the decisions of directors), judicial abstention will become the norm and review would be the exception to the rule.¹⁵⁹ The issue of directorial liability will be dealt with only in very exceptional circumstances. Once again the oft cited statement of Joseph Bishop would likely ring true – the search for cases where a corporate director would be held liable for a breach of section 76(3)(b)-(c) would be “a search for a very small number of needles in a very large haystack”.¹⁶⁰

Business Judgment Rule as a Doctrine of Immunity

McMillan presents an interesting argument as to the correct theoretical foundation and practical application of the business judgment rule in America. Her argument is based upon the parallels between immunities (whether public or private) and the business judgment rule. For the purposes of her argument she defines a legal immunity as having the effect of shielding “the recipient of the immunity from civil

¹⁵⁷ The “Occupy Wall Street” is an example of a general public discontent with a lack of corporate greed and directorial accountability: <http://occupywallst.org/forum/occupy-wall-street-worldwide-objectives-and-demand/> [last viewed on 14 January 2014].

¹⁵⁸ <http://mg.co.za/article/2009-10-30-collusion-widespread-in-the-construction-industry> [last viewed on 14 January 2014]. The then Head of the Competition Commission, Shan Rambruth, stated that “collusion is the cultural norm of large businesses operating in the construction industry”. See also: <http://mg.co.za/article/2013-06-24-competition-commission-orders-construction-firm-to-pay-up> [last viewed on 14 January 2014].

¹⁵⁹ AM Scarlett (supra) at 79; SM Bainbridge ‘The Business Judgement Rule as Abstention Doctrine’ (supra) at 127-8.

¹⁶⁰ JW Bishop Jr. (supra) at 1099.

liability for actions undertaken by individuals acting in a specific capacity”.¹⁶¹ The effect of the business judgment rule is to shield directors from civil liability for decisions made whilst acting in the office of a director. Immediately there would seem to be an intuitive similarity between the concept of a legal immunity and the business judgment rule.¹⁶² This similarity provides the basis upon which her argument is developed and which may provide the theoretical model which is useful in correctly understanding and practically applying the business judgment rule under section 76(4)(a) of the Companies Act.

According to McMillan’s argument, the philosophical grounds underpinning immunities in general closely resemble the justifications which are associated with the business judgment rule.¹⁶³ The most notable of these is that immunities reassure persons making decisions that involve the exercise of discretion to make the best decision possible rather than forcing them to make the obviously safe decision.¹⁶⁴ Further – immunities grant the recipient of the immunity protection against hindsight bias, which whether explicit or not, may be a factor in any *ex post facto* adjudication of the merits of a business decision. Directors may be ‘forced’ to defend their decisions against aggrieved shareholders who rely on the power of hindsight in *ex post facto* alleging directors’ conduct as being negligent which may potentially detract from the proper exercise of directors’ role and purpose. Directors cannot guarantee perfection in the fulfilment of their obligations.¹⁶⁵ Fallibility is simply a facet of human nature and any director is capable of mistakes. Mistakes will always be made. To require absolute substantive perfection in every business

¹⁶¹ LA McMillan ‘The Business Judgment Rule as an Immunity Doctrine’ (supra) at 542.

¹⁶² Ibid. at 542.

¹⁶³ Ibid. at 564-7 and 570. The value of the comparison between the business judgment rule and other legal immunities must be seen as a loose one and should not be over zealously relied upon despite the intuitive appeal of doing so.

¹⁶⁴ LA McMillan ‘Honest Services Update: Director’s Liability and Concerns after *Skilling* and *Black*’ (2011-2012) 18 *Texas Wesleyan Law Review* 149 at 180.

¹⁶⁵ LA McMillan adopts the phrase “nuisance that might detract from the exercise of the recipient’s duties, roles, or rights” in ‘The Business Judgment Rule as an Immunity Doctrine’ (supra) at 564-5. I am hesitant to accept the shareholders acting in accordance with their rights to enforce directorial accountability to shareholders as a “nuisance”. She also argues that to do so would “impose too high of a burden upon directors”. This is trivialising the relationship between directors and shareholders; especially considering that the directors are mandated under the Companies Act to be accountable to shareholders and stakeholders in general.

decision is simply an unreasonable expectation!¹⁶⁶ It is the errors which a reasonable person would not have made that should be subject to judicial review.

There are two primary justifications for the business judgment rule to function as a doctrine of immunity. First is the argument that if directors are making “safe” decisions which are based largely on the fear of personal liability, there is potential for the company to suffer; and hence for the wider economy to also suffer. Second is that viewing the business judgment rule as a doctrine of immunity may inhibit the judiciary from assessing whether the duty of care, skill and diligence has been breached; for provided that the threshold requirements of section 76(4)(a) have been adhered to then the directors are “immune” from liability and the decision may be insulated from judicial review. No further enquiry may be made as to whether the duties under section 76(3)(b)-(c) have been breached.

Practically there will be little difference between conceiving the rule as either an immunity doctrine or as a doctrine of judicial deference. Under the immunity doctrine the directors are entitled to use their full discretion in making a certain business decision. They will be immune from liability attaching to them for that decision provided that at the time of making the decision the decision was one that a reasonable person would have made. Provided the requirements of section 76(4)(a) have been met, then the court is not permitted to review whether the section 76(3)(b)-(c) duties have been breached. The business judgment rule would not function as an absolute immunity but rather as a qualified immunity in that the protection afforded by the rule is dependent upon the defendant directors proving their entitlement to the protection.¹⁶⁷

The philosophical underpinnings of immunities in general are largely commensurate with the policies and justifications which have been presented for the business judgment rule.¹⁶⁸ The practical effect of the operation of the business judgment rule under section 76(4)(a) would certainly be to “insulate directors from liability for their business-related decisions”.¹⁶⁹ Provided the requirements of section 76(4)(a) are met, the directors are immune from liability for that decision. The value

¹⁶⁶ LA McMillan ‘Honest Services Update: Director’s Liability and Concerns after *Skilling* and *Black*’ (supra) at 179-180.

¹⁶⁷ LA McMillan ‘The Business Judgment Rule as an Immunity Doctrine’ (supra) at 569.

¹⁶⁸ Ibid. at 566.

¹⁶⁹ Ibid. at 569.

of this approach is that the defendant directors are necessarily required to prove their entitlement to the immunity. There is no examination into the merits of the decision, nor whether the directors have breached the duties in sections 76(3)(b)-(c). There is not even an examination into good faith. Under this conception the list of requirements in sections 76(4)(a)(i)-(iii) operate to demarcate what the directors must prove in order for the business judgment rule to apply. This approach certainly does have an intuitive appeal. But does this mean that it is this approach which should be favoured over the deference-based approach already discussed?

8. THE MOST APPROPRIATE FORMULATION FOR SOUTH AFRICA

The Practical Differences the Different Models of the Business Judgment Rule

The court in *Kamin v American Express Co.*¹⁷⁰ provides a prime example of the practical operation of the deference construction of the business judgment rule. In *Kamin* the decision of the board of American Express was clearly incorrect and yet the court dismissed the litigation for the failure to state a claim.¹⁷¹ The court developed upon the reasoning of *Schlensky v Wrigley*¹⁷² to present the strongest formulation of the deference based formulation of the business judgment rule:

*“The directors’ room rather than the courtroom is the appropriate forum for thrashing out purely business questions which will have an impact on profits, market prices, competitive situations or tax advantages.”*¹⁷³

The underlying discourse is that the courtroom is not the appropriate forum, nor litigation the correct mechanism, for shareholders to enforce directorial accountability. Directors should not be held “liable for simply making mistakes, even if those mistakes result in substantial costs to the corporation and its shareholders”.¹⁷⁴

¹⁷⁰ *Kamin v American Express Co.* 383 N.Y.S.2d 807 (Sup. Ct. 1976) *aff’d*, 387 N.Y.S.2d 993 (App. Div. 1976).

¹⁷¹ *Ibid* at 815.

¹⁷² *Schlensky v Wrigley* (supra).

¹⁷³ *Kamin v American Express Co.* (supra) at 810-11.

¹⁷⁴ Ellen Taylor ‘New and Unjustified Restrictions on Delaware Directors’ Authority’ (1996) 21 *Delaware Journal of Corporate Law* 837 at 877.

The business judgment rule will only operate if certain threshold requirements are met, which will be adherence to the requirements as listed in section 76(4).¹⁷⁵

The business judgment rule should not practically permit the courts to merely authorise, confirm or rubberstamp the decision of the board of directors irrespective of its merits. Nor should the rule be confused as a standard of liability. As both the courts in *Schlensky*¹⁷⁶ and *Kamin*¹⁷⁷ make it clear: the deference based conceptualisation of the business judgment rule does not preclude a court from reviewing whether a particular decision was imbued with either fraud or self-interestedness. This does not mean that the court should be permitted to review the substantive correctness, wisdom or otherwise of the decision. In this way the deference-based conception of the business judgment rule functions to preclude courts from deciding whether the duty of care was breached during the decision making procedure whilst concurrently protecting the company from directors who abuse their position and fraudulently or intentionally cause a harm to the company.

The role of the courts in applying the business judgment rule will be to correctly balance the interests of respecting directorial authority and deferring to the decisions of directors provided those decisions were properly taken whilst maintaining director accountability to both stakeholders and shareholders. Balancing this tension is the central problem with the practical application of the business judgment rule as conceptualised as a doctrine of judicial deference. There is no easy solution as to how this balance should be struck. The decision as to what the default position should be will be based upon a policy decision that accords with the corporate laws and corporate governance provisions of South Africa in general.

In the case where the business judgment rule is conceptualised as an immunity doctrine the position is somewhat different. The business judgment rule can only be

¹⁷⁵ In Delaware the situation is different for it is well established that directors may only rely on the business judgment rule when they have made a conscious decision and there is a wealth of both academic and judicial authority which is relevant in determining whether this threshold determination has been met or not. See especially *Aronson v Lewis* (supra). Further requirements are acknowledged as being the good faith and disinterested independence of the directors, and that the decision must be a rational one. See generally in this regard the discussion in SM Bainbridge *Corporate Law and Economics* (2002) 270-1 and 276; MP Dooley (supra) at 478-81. See more specifically: *Auerbach v Bennett*, 393 N.E.2d 994 (N.Y. 1979); *Brehm v Eisner*, 746 A.2d 244, 264 (Del. 2000); *Principles of Corporate Governance* § 4.01(c)(3).

¹⁷⁶ *Schlensky v Wrigley* (supra).

¹⁷⁷ *Kamin v American Express Co.* (supra).

seen as a qualified immunity rather than an absolute immunity.¹⁷⁸ To argue that the office of a director imbues that director with absolute immunity from liability would be contrary to all law concerning director liability, most notably the duty of care, skill and negligence. To do so would also open the gates for directors to act without adherence to any such duties for the fear of liability would be irrelevant.

There is intuitive appeal in requiring a defendant director to prove that the protection afforded by the business judgment rule should apply in any given instance.¹⁷⁹ This requirement allows for each case to be approached on its merits and allows for variation in the application of the rule to each and every case. The practical effect (i.e. if the rule is found to apply and therefore that the immunity becomes enforceable) remains that the director is insulated from liability, but the theoretical rationale is different to the deference based conception of the rule. Rather than the judiciary deferring to the decision of the director, the director is entitled to the protection of the rule only if the court finds that this should be so.

The court decides, based upon the evidence and argument presented by the director, whether the director is entitled to qualify for the protection of the business judgment rule. The burden of proof falls squarely on the shoulders of the director who must accordingly prove entitlement to the protection of the rule. This would mean proving adherence to the requirements of section 76(4)(a)(i)-(iii) of the Companies Act. The focus of the immunity doctrine is therefore a “procedural checklist” of factors with which the director must comply.

This approach is intuitively appealing for it requires the director to positively prove his or her entitlement to the immunity rather than having the default position being merely shielding the director from review which is what the deference-based approach advocates. The immunity doctrine would seem to closer align with South Africa’s corporate governance ideals regarding the conduct of directors. More particularly – the immunity doctrine would lead directors to be in a position to account for their decisions rather than allow for directors to be in a default position where their decisions are shielded from judicial review and the onus is placed on the shareholders to justify review.

¹⁷⁸ LA McMillan ‘The Business Judgment Rule as an Immunity Doctrine’ (supra) at 570-1.

¹⁷⁹ Ibid. at 569.

Taking this approach a step further; it is correct to regard the requirements of section 76(4) as “the elements of the objective standard required for the application of a qualified immunity.”¹⁸⁰ Qualified immunities require the actor who may be accorded the immunity to prove the reasonability of his actions, after which an evaluation of that conduct is made by the court and the immunity is either granted or not. It is not the substantive correctness of the conduct that is judged. In many instances liability may not attach even if the conduct is seen as having being incorrect *ex post facto*. For liability to attach the conduct must be *ex ante* unreasonable. Conduct which is *ex ante* justified will not be wrongful and therefore liability will not result.¹⁸¹ This is a similar approach to the evaluation of wrongfulness in delict.¹⁸²

South African Approach to Corporate Governance

Corporate governance may be defined as being the appropriate principles and practices which directors and managers should adhere to in the fulfilment of their roles and duties.¹⁸³ It is “ultimately about effective leadership” and control of companies and is concerns those who control companies; i.e. the management and directors of companies.¹⁸⁴ Integrity is recognised as the foundation of the South African corporate governance provisions which in practice equates to “ethical values of responsibility, accountability, fairness and transparency”.¹⁸⁵ Investment and the

¹⁸⁰ *Ibid.* at 571.

¹⁸¹ *Ibid.*

¹⁸² See in general the discussion regarding the elements of fault and wrongfulness in A Fagan ‘Rethinking Wrongfulness in the Law of Delict’ (2005) 122 *SALJ* 90 and also in A Fagan ‘Blind Faith: A Response to Professors Neethling and Potgieter’ (2007) 124 *SALJ* 285. See more particularly the decisions of: *Minister van Polisie v Ewels* 1975 (3) SA 590 (A); *Municipality of Cape Town v Bakkerud* [2000] ZASCA 174; *Minister of Safety and Security v Van Duivenboden* [2002] ZASCA 79; *Trustees, Two Oceans Aquarium Trust v Kantey & Templar* 2006 (3) SA 138 (SCA).

¹⁸³ M King ‘The Synergies and Interaction between King III and the Companies Act 71 of 2008’ (2010) *Acta Juridica* 446 at 447; *Contemporary Company Law* Chapter 11. This section is aimed at aiding in the understanding of the corporate governance culture that is relevant to corporate law in South Africa. It is not a complete discussion of corporate governance.

¹⁸⁴ *South Africa Broadcasting Corporation Ltd. v Mpofo* [2009] 4 All SA 169 (GSJ) at para 60. See in general: UK Cadbury Report 1992; T Wixley and G Everingham *Corporate Governance* 3ed (2010) 1; *Corporate Governance: An Essential Guide for South African Companies* (supra) 2-4; T Mongalo *Corporate Law & Corporate Governance: A Global Picture of Business Undertakings in South Africa* (2003).

¹⁸⁵ *Contemporary Company Law* (supra) 473.

subsequent growth of the economy are indisputably linked with an effective and proper corporate governance framework and is therefore vital in South Africa.¹⁸⁶

The corporate governance framework in South Africa has undergone various changes since the introduction of the first publication of the King Report on Corporate Governance in 1994.¹⁸⁷ The Third King Report and Code on Corporate Governance (“King III”) read together with the provisions relating to corporate governance within the Companies Act form the backbone of the current corporate governance regime in South Africa. Read together these regulate directors and directorial conduct so that there is compliance with minimum statutory requirements (as required by the Companies Act) as well as seeking to adhere to international best practice (as encapsulated in King III).¹⁸⁸

The first notable difference between the provisions in America¹⁸⁹ and those of South Africa is that the King III provisions rely on a philosophy of ‘apply or explain’. The purpose is for directors to consider the manner in which the principles and recommendations of King III may be practically applied. It is aimed at creating an awareness and understanding within company management and directors “why” the principles should apply, rather than requiring blind compliance and it is hoped that this will have the practical result of wider and more thorough compliance.¹⁹⁰

Most business judgment litigation in America has been concerned with the shareholder-director relationship. Claims have been brought by aggrieved and disgruntled shareholders as a result of directorial decisions which have caused losses or harm to companies. It is the board of directors and management, and not the shareholders, whom are mandated with the day-to-day management of the business and affairs of the company.¹⁹¹ The ultimate authority over directors (i.e. the appointment and removal of directors, and whom the directors are accountable to)

¹⁸⁶ *Minister of Water Affairs and Forestry v Stilfontein Gold Mining Co Ltd*. 2006 (5) SA 333 (W).

¹⁸⁷ *Corporate Governance: An Essential Guide for South African Companies* (supra) 2.

¹⁸⁸ JF Olson ‘South Africa moves to a global model of corporate governance but with important national variations’ (2010) *Acta Juridica* 219.

¹⁸⁹ The Sarbanes-Oxley Act 2002 contains most of the corporate governance provisions which apply to companies which are publically traded in, in the same manner as the compliance with the King III is a mandatory listing requirement for companies wishing to list with the JSE.

¹⁹⁰ King III Report at 7; *Contemporary Company Law* (supra) 475.

¹⁹¹ Section 66(1) of the Companies Act. This section requires the business and affairs of a company to be managed by the board of directors. The board has the authority to exercise all the powers and perform any function of the company.

remains vested with the shareholders.¹⁹² The second important difference between the corporate governance in America and that in South Africa is that the relationship between the shareholders and directors is balanced in the favour of the shareholders rather than the directors.¹⁹³

This does not mean that shareholders are in the position to determine how the company is administered, nor are they capable of usurping the roles and duties of directors. Shareholder litigation which is aimed at a review of the substantive merits of a directorial decision should not be easily entertained within the courts. The courts are not the appropriate forum for this process for there are internal mechanisms which allow for such review and shareholder enforcement of directorial accountability. One mechanism is the potential for removal of a director by the shareholders which, on the whole, is a more appropriate mechanism for enforcing the accountability of directors to the shareholders. Section 165 of the Companies Act is an example of an external accountability enforcement mechanism. This codified derivative action is aimed at being more streamlined,¹⁹⁴ broader in reach and available to a wider range of applicants.¹⁹⁵ These accountability-focused provisions provide more ammunition to shareholders in holding directors to account for their actions as opposed to the shareholders in America.

The general thrust of the corporate governance provisions regarding decision-making in America remains primarily concerned with shareholder profit maximisation.¹⁹⁶ The King III Report requires that companies should conduct their business with economic, social and environmental responsibility.¹⁹⁷ This mandates directors to account and be responsible for the company's "triple bottom line" rather than merely the financial bottom-line.¹⁹⁸ The King III Report also mandates a

¹⁹² Sections 68 and 71 of the Companies Act.

¹⁹³ C Ncube 'You're Fired! The Removal of Directors under the Companies Act 71 of 2008' (2011) 128 *SALJ* 33; Section 71 of the Companies Act; Delaware Code Ann. Tit. 8, §141(k). See the discussion regarding the intricacies of shareholder voting in L Harris 'The Politics of Shareholder Voting' (2011) 86 *NYU Law Review* 1761; *Contemporary Company Law* (supra) 441-3. A prime example of this is that it is easier for shareholders to remove directors in South Africa than in Delaware.

¹⁹⁴ Memorandum on the Objects of the Companies Bill, 2008, Companies Bill [B61D – 2008] para 11.

¹⁹⁵ *Contemporary Company Law* (supra) 775-780.

¹⁹⁶ *Principles of Corporate Governance* § 2.01(a)-(b); J Du Plessis *Corporate Governance: An International Perspective* (2012) at 293.

¹⁹⁷ King III Report at 22 para 18.

¹⁹⁸ *Ibid.* at 22 para 16.

‘stakeholder-inclusive’ approach for when directors assess in whose interests the company should be managed.¹⁹⁹ A company may have a multitude of stakeholders that have the potential to affect the long-term success of the company.²⁰⁰ It is consequently no longer proper for directors to only consider the interests of shareholders which allows increased scope for directors to exercise their discretion in determining what is in the best interests of the company.

South Africa also has unique factors which relate to the South African business context in particular, and to Africa in general. One such example is that directorial decisions will often be influenced by reference to black economic empowerment partnerships.²⁰¹ Racial as well as economic and financial considerations form part of social and corporate responsibility in South Africa. These are issues upon which directors of South African companies will base their decisions.²⁰² Coupled with the ‘stakeholder-inclusive’ approach to corporate governance mandated by the King III Report, the pure profitability of a company may suffer as directors are driven towards implementing corporate responsibility policies. This in turn may lead to shareholder discontent, and then litigation which claims for the breach of section 76(3)(b)-(c) of the Companies Act.²⁰³

Closely linked with the business judgment rule and a fundamental principle of corporate governance in general is the management of risk. Risk is a concept that lacks a precise legal definition and subsequently has different meanings depending on the context within which it is used but is defined under King III as being “the taking of risk for reward”.²⁰⁴ Principles 4.1 and 4.2 of the King III Report mandate

¹⁹⁹ Ibid. at 100 para 6.

²⁰⁰ L Muswaka ‘Corporate Governance under the South African Companies Act: A Critique’ (2013) 3(3) *World Journal of Social Sciences* 11-19. The ‘stakeholder-inclusive’ approach requires directors when assessing the best interests of the company to take account of the legitimate interests and expectations of company stakeholders.

²⁰¹ E Jones (supra) at 331.

²⁰² There has been academic recognition of the shift away from a purely profit based approach to decision making for more than 40 years. See especially: CR Wetzel and JL Winokur ‘Corporations and the Public Interest – A review of the corporate purpose and business judgment rules’ (1971) 27(1) *Business Lawyer* 235; M Hecht Jr. ‘Responsibility for use of corporate resources to help solve social problems – A corporate officers view’ (1971) 27(1) *Business Lawyer* 173.

²⁰³ For an in-depth examination into the link between the business judgment rule and sustainable or social entrepreneurship see: JE Kerr ‘Sustainability Meets Profitability: The Convenient Truth of How the Business Judgment Rule Protects A Board’s Decision to Engage in Social Entrepreneurship’ (2007-2008) 29 *Cardozo Law Review* 623.

²⁰⁴ King III Report at 74 para 11; *Corporate Governance: An Essential Guide for South African Companies* (supra) at 225-8.

the board of directors to be responsible for managing the level of risk that the company can be exposed to. There is a wealth of detailed provisions which concern the assessment, management and documentation of risk in the provisions of King III.²⁰⁵ Adherence with these principles may potentially provide evidence for directors as to their compliance with listed under the business judgment rule in section 76(4)(a). This would then allow for protection from liability which may have resulted under section 76(3)(b)-(c). This is particularly so considering the requirement under section 76(4)(a)(iii) “that the decision was in the best interests of the company”.

Now more than ever it is appropriate for shareholders of South African companies to respect the exercise of directorial discretion in making decisions. All these differentiating factors must be assessed along with the general judicial policy of the courts which in America; especially the courts in Delaware and in particular the Delaware Supreme Court; have been generally sympathetic to directors and have erred on the side of deferring to their judgment.²⁰⁶ These are but some of the differences between the corporate governance provisions, philosophy and policies of America and those of South Africa.

It should go without saying that it is necessary to develop and apply the business judgment rule so that it accords with the nuanced features of South African company law in general and in particular the corporate governance regime. South African corporate law has a different core focus and policies compared to those of American corporate law. The director primacy model of corporate governance that Bainbridge argues as so important and which provides the basis of his analysis of the business judgment rule in America is a perfectly understandable approach for the American corporate culture and the policies inherent to American corporate law jurisprudence in general. This justification of the business judgment rule as being tantamount to a doctrine of judicial deference simply does not fit correctly with the general trends and policies inherent to corporate law in South Africa. South Africa should not adopt verbatim the precedent regarding the application of the business judgment rule as it has been applied in the American jurisdictions. The inconsistencies between corporate law in South Africa and that of America, in particular the law and policy regarding corporate governance, will no doubt create inconsistencies and confusion

²⁰⁵ Principle 4 of the King III Code; *Contemporary Company Law* (supra) 491-2.

²⁰⁶ RM Jones (supra) at 625-6.

in the South African law regarding the application of the business judgment rule if we do not clarify and apply a consistent interpretation of the rule.

Formulating a South Africa Specific Model

Each approach has intuitive appeal but for different reasons. It is important to determine which elements of each approach are appealing and will gel within the South African law. It must be remembered that the section 76(4)(a) business judgment rule is a new addition to South African corporate law and so a firm assured footing is vital for the lucid growth and development of this area of the law. The formulation of a South Africa specific business judgment rule is necessary and its application will require sensitivity and “judicious restraint”.²⁰⁷ To present the decision as a decision between either the deference or immunity doctrines would be to create a false dichotomy. It is appropriate in this instance to “cherry-pick” from each doctrine and formulate the business judgment rule in a manner that best adheres to South African corporate law provided that the various elements once pulled together can be individually justified and the business judgment rule is practically effective.²⁰⁸

The immunity doctrine conceptualisation of the business judgment rule closer aligned with the rule as one being a ‘standard of liability’ which is inappropriate for South Africa.²⁰⁹ Yet the procedural aspects of this conceptualisation have a definite appeal in that it aids to greater directorial accountability and may potentially aid in making directors aware of their duties and obligations under sections 77(3)(b)-(c) and 76(4)(a). Requiring the directors to have the onus of proving entitlement to the protection afforded by the rule is perfectly justifiable. Directors should be under the burden of proving entitlement to the protection of the business judgment rule, rather than the plaintiff shareholders proving that the directors are disentitled to the protection of the rule. This is a policy-based decision which in my opinion creates the best balance between accountability and authority that is demanded by South Africa’s corporate governance policies, the approach to directorial accountability, equity and fairness.

²⁰⁷ LA McMillan ‘The Business Judgment Rule as an Immunity Doctrine’ (2013) 4(2) *Wm. And Mary Business Law Review* 521 at 540-1.

²⁰⁸ MA Eisenberg ‘Corporate Laws and Social Norms’ (1999) 99 *Columbia Law Review* 1253.

²⁰⁹ LA McMillan ‘The Business Judgment Rule as an Immunity Doctrine’ (supra) at 572.

There should be no chilling effect on decision making nor on justified and reasonable risk taking. What is required of directors under this functional approach is the preparedness to justify a decision in accordance with the requirements of section 76(4). They will not be asked to justify their conduct under the duties under section 76(3)(b)-(c) which means that they are not required to present evidence as to the *ex-ante* reasonableness or substantive correctness of their decision. This has the appeal of making the law in this complicated area more accessible to directors which aligns with the stated aims of the Companies Act. The procedure would hypothetically be a straightforward one. Directors would have a clear understanding of what is expected from them as directors when making a decision, and also an understanding as to what the procedure is for when those decisions turn out badly.

This approach serves to create a viable balance in terms of the inherent tension between the accountability and authority of directors. Directors should not enjoy unfettered *carte blanche* in the performance of their duties; yet should not be overly hindered in the performance of those duties by the shackles of accountability. Placing the onus on directors in requiring them to account for the threshold requirements of section 76(4) is not a hindrance. All the director is required to do during the fulfilment of his or her duties is to document adherence with the requirements of the business judgment rule. This does not invade the authority of directors.

I propose that both directors and shareholders will support this functional approach. Directorial authority will only be impinged by the judiciary if the substantive correctness of the decisions are regularly reviewed. This will not happen under the operation of the business judgment rule and is therefore a means to protect the director from an assessment as to whether the has been breached. This approach does not provide an easier method for aggrieved shareholders to hold directors liable for losses to the company. Nor is the door opened wider for liability to attach to directors for decisions which subsequently turn out to cause harm to the company.

The procedural aspects of the immunity doctrine should therefore be applied to the business judgment rule under section 76(4)(a). Section 76(4)(a) however aligns with the deference approach mandated by Bainbridge for if the preconditions required by section 76(4)(a) are proved in the proceedings then the court abstains

from the review of the merits of that decision.²¹⁰ Perhaps it is more appropriate in both semantics and policy, to use the term “respect” rather than the typical terms “abstain” or “defer”. The question to be addressed under section 76(4)(a) is accordingly whether the directors’ conduct satisfied the standard for judicial respect?²¹¹ In comparison to the rule as applied in America, there is not the same concern as to determine exactly what conduct is relevant or required for the rule to come into operation. There is not the same flexibility and variability dependent upon the facts of each case at bar for the threshold requirements are listed in section 76(4) that section, and only if those requirements are met will the rule protect the directors from personal liability and their decision from review.

It is worth noting at this stage that Scarlett presents an argument as to the ineffectiveness of the abstention doctrine type of formulation of the business judgment rule. In her argument the business judgment rule is:

*“too limited to be useful...because it would not prohibit court review in cases alleging fraud or breaches of the duties of loyalty or good faith, it is designed to apply only to a small category of business judgment rule cases – those alleging a breach of the fiduciary duty of care”.*²¹²

Simply put – this is not a problem for the application of section 76(4)(a). In fact it supports the argument that has already been presented above: section 77(9) protects the company against director fraud and intentional wrongdoing, whilst it is clear that the business judgment rule should not apply to the fiduciary analysis.

9. THE PRACTICAL OPERATION OF THE RULE IN SOUTH AFRICA

Lyman Johnson describes the relationship between the duty of care and the business judgment rule as one of “the least understood relationships in corporate law”.²¹³ It is the purpose of this chapter to summarise what I propose the correct practical application of the business judgment rule should be and to clarify what I

²¹⁰ SM Bainbridge ‘The Business Judgement Rule as Abstention Doctrine’ at 87.

²¹¹ Ibid. at 128-9.

²¹² AM Scarlett (supra) at 73; L McMillan ‘The Business Judgment Rule as an Immunity Doctrine’ (supra) at 542.

²¹³ L Johnson ‘Modest Business Judgment Rule’ (supra) at 636.

perceive to be the correct relationship between the business judgment rule and the duty of care in South Africa.

The business judgment rule should be applied as a doctrine of judicial deference, but the courts should only defer to the decision of the defendant directors if those directors are able to prove the requirements of section 76(4)(a)(i)-(iii). It may accordingly be described as a qualified judicial policy of non-review rather than as an immunity or as a doctrine of judicial deference. The rule is intended to preclude judicial review of business decisions which by their very nature require the exercise of directorial discretion.²¹⁴ If the requirements of section 76(4)(a) are met by the directors then the business judgment rule will apply, which subsequently immunizes the substantive quality or correctness of the business decision from judicial review. In this way the business judgment rule will operate as a pre-enquiry to any duty of care proceedings.

It must be remembered that the business judgment rule and the duties of care, skill and diligence and to act in the best interests of the company are distinct legal concepts which have different purposes, but which remain fundamentally linked under the Companies Act. The statutory duty of care is a standard of liability which demarcates how directors must discharge their duties whilst the business judgment rule should be regarded as a qualified policy of judicial deference. It concerns the manner in which directors conduct themselves in the fulfilment of their role as director and applies to *all* the conduct of directors generally. Within the decision-making context it requires a specified degree of care to be used in making business decisions. The business judgment rule on the other hand, should be regarded as a narrow concept in comparison. It must be interpreted to apply specifically (given the commonly applied ‘name’ of the rule) to only if and when a ‘business judgment’ has been made by directors.²¹⁵

Immediately there is a problem with this argument in that section 76(4) of the Companies Act would seem to permit a far wider application of the rule to the duty of care, skill and diligence generally. The plain language drafting of the Companies Act, which although aimed at aiding in the accessibility of the law, has once again

²¹⁴ RF Balotti & JJ Hanks Jr. ‘Rejudging the Business Judgment Rule’ (1993) *Business Lawyer* 1337 at 1345.

²¹⁵ *Aronson v Lewis* (supra) at 813.

led to uncertainty for it is legally imprecise and unclear.²¹⁶ The exact scope of application of the rule to director functions is therefore vague and must be addressed. There are two points of vital interest:

First: the business judgment rule cannot be relied upon by defendant directors to protect “wilful misconduct or wilful breach of trust”.²¹⁷ Under section 77(9) it is required for the director to be relieved from liability, either wholly or partly, to have acted “honestly and reasonably”.²¹⁸ This section has an impact on the operation of the business judgment rule, for when read with section 76(4)(a) it adds the vital qualifier that no fraudulent conduct will be protected by the rule nor sanctioned by the courts.

Second: section 76(4) states that “(i)n respect of any particular matter arising in the exercise of the powers or the performance of the functions of director”;²¹⁹ provided that the elements in section 76(a)(i)-(iii) have been met, the director “will have satisfied the obligations of subsection 3(b) and (c)”. It is concerning to see that the introduction to section 76(4) generally would allow for an interpretation whereby the business judgment rule applies to the duty of care, skill and diligence *en bloc* rather than just within the decision making context. Compared with this introduction to section 76(4); the requirements of section 76(4)(a)(i)-(iii) nevertheless very clearly apply to the process of decision making. There is explicit reference to “*the subject matter of the decision*”, that “reasonably diligent steps to become informed above the matter” are required, and that “the director *made a decision*...and the director had a rational basis for believing, and did believe, that *the decision* was in the best interests of the company”.²²⁰

There is clearly a discord between the introduction to and the specific requirements of the business judgment rule in section 76(4). How should this section be interpreted? I propose that a narrow interpretation be adopted to the application of

²¹⁶ See for other examples: JJ Du Plessis (supra) at 269; E Davids, T Norwitz, and D Yuill ‘A microscopic analysis of the new merger and amalgamation provision in the Companies Act 71 of 2008’ (2010) *Acta Juridica* 337.

²¹⁷ Section 77(9).

²¹⁸ Section 77(9)(a).

²¹⁹ Emphasis added.

²²⁰ See section 76(4); emphasis added.

the business judgment in section 76(4). A narrow interpretation to the business judgment rule is to be preferred for the following reasons:

First; a wide interpretation would be overbroad. It would have the capacity of engulfing the statutory duty of care as a whole which surely cannot have been intended by the legislature. This must be the case given the correct position under the common law of the business judgment rule upon which section 76(4) is based. Second; there is no guidance in the discussion papers regarding the Companies Act or the amendments to the Companies Act as to the intended scope of application of the rule. It is only stated that ‘a business judgment type of defence’ was included to allay fears of the shift from the subjective duty of care to the more objective nature of the duty of care under the section 76(3)(c).²²¹ This allows for the narrow interpretation to be adopted as there is no guidance which suggests or requires a different interpretation.

Third; the purpose of the business judgment rule will be best served by the narrow interpretation of the rule. It is important to revisit what the purpose of the business judgment rule is and accordingly why the rule was born and developed in the American common law. There are many differing justifications for the business judgment rule and it is not important to list and discuss all the justifications here. It should suffice to state that the purpose of the rule is to allow judicial respect for the autonomy of corporations in society and the proper exercise of directorial discretion. It is not to protect defendant directors from the bounds of the duty of care in general. Directors should obviously be subject to the operation of the duty of care, skill and diligence in the fulfilment of their role as directors. Linked with this, and the fourth reason which lends support to my interpretation, is that this duty would be largely nullified if the business judgment rule is given a wide interpretation to include *all* directorial conduct. Finally; from the discussion above it should be clear that the business judgment rule is not a standard of liability and should not be allowed to muddy the waters of the duty of care. The distinction between the statutory duty of care and the business judgment rule should be clearly defined. This will be best accomplished by a narrow interpretation of section 76(4).

²²¹ JJ Du Plessis (supra).

10. CONCLUSION

Section 76(4) should be amended to clarify the position and to limit the application of the business judgment rule to instances where directorial discretion has been exercised and a business decision has been made. Until such time as a legislative amendment is made, this may be accomplished by adopting a narrow interpretation of section 76(4). The defendant director should be under the burden of proving that section 76(4) applies. This is simply a policy-based decision which has been addressed above. Provided the business judgment rule is found to apply, i.e. the defendant director is capable of proving the requirements of section 76(4), then the substantive reasonableness or correctness or wisdom of the decision will be removed from the scope of judicial review. This may be justified on the basis of avoiding judicial hindsight bias where judges run the risk of assuming “bad results as conclusive evidence of bad behaviour”.²²²

I have argued, given the increased burden of the statutory duty of care, that it is in the interests of shareholders, directors and the judiciary to have a statutorily mandated business judgment rule and that the rule is a necessary addition to South African company law. South Africa should be wary of allowing the judiciary to impinge upon free enterprise – the business judgment rule will act as the mechanism which ensures this doesn't occur.²²³ The rule is also an important factor in drawing highly qualified individuals to become directors. The dictum of Judge Winter in *Joy v North*²²⁴ best summarises the importance of the rule:

“Although the rule has suffered under academic criticism, it is not without rational basis. ... [B]ecause potential profit often corresponds to the potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions. ... Shareholders can reduce the volatility of risk by diversifying their holdings. In the case of the diversified shareholder, the seemingly more risky alternatives may well be the best choice since great losses in some stocks will over time be offset by even

²²² CA Riley (supra) at 710. See also: C Hansen ‘The ALI Corporate Governance Project: Of the Duty of Care and the Business Judgment Rule, a Commentary’ (1986) 41 *Business Lawyer* 1237 at 1240-42.

²²³ K Chittur ‘The Corporate Director’s Standard of Care: Past, Present, and Future’ (1985) 10 *Delaware Journal of Corporate Law* 505 at 507.

²²⁴ *Joy v North* (supra).

*greater gains in others. ...A rule which penalizes the choice of seemingly riskier alternatives thus may not be in the interest of shareholders generally.*²²⁵

At the core of the business judgment rule is whether courts should judge the reasonableness of directors' decisions. Judicial respect of directorial discretion and decisions is not the same as simply the abandonment of the judicial post. The judiciary retains the possibility of intervention in appropriate cases such as when there is fraud or self-interestedness which imbues a decision. But in what instances should directorial accountability trump directorial authority? What is the appropriate level of judicial respect to directors' decisions that should be adopted within the corporate law sphere in South Africa? Therein lies the crux of the problem.

Provided that the requirements under section 76(4) have been proved by the director in question, judges should be highly deferential to the decisions of directors under the business judgment rule. Section 76(4)(a) only protects rational decisions which are based upon reasonable premises. Judicial deference will accordingly be the default position, whilst review can occur in particular instances when appropriate. It is important for directors to freely exercise their discretion and for risky yet potentially lucrative decisions to be taken provided that there is adherence with the requirements of the corporate governance provisions under King III. Each case must be adjudged on its own merits.²²⁶ I propose that the more discretion that is required in a decision, the more respect the judiciary should show to the decision. Judicial deference is not an all or nothing exercise and should be capable of variable application. For after all – with the upmost respect, it still remains the case that many judges are “radically incompetent” to judge decisions which are inherently complex and made within a general sphere of uncertainty where perfect results are never possible.²²⁷

The most fundamental point I have addressed is that there must be a clear delineation between the business judgment rule and the duty of care. They must be conceived and applied as independent concepts despite the cross reference between the duty of care and the business judgment rule in the Companies Act. There must be

²²⁵ Ibid. at 885-6.

²²⁶ EN Veasey ‘New Insights into Judicial Deference to Directors’ Business Decisions: Should We Trust the Courts?’ (1984) 39 *Business Lawyer* 1461 at 1475.

²²⁷ EA Posner ‘A Theory of Contract Law Under Conditions of Radical Judicial Error’ (2000) 94 *Northwestern University Law Review* 749 at 754.

a clear differentiation between the analysis required under the duty of care, skill and diligence and the business judgment rule despite the two concepts being fundamentally linked. The courts must be cautious not to blur the two concepts together for this would recreate the ‘American-esque’ position of uncertainty regarding the rule in South Africa. This is best accomplished by a narrow interpretation of the business judgment rule and by adopting the practical approach which I have proposed.

I am strongly opposed to viewing the business judgment rule as formulated in section 76(4) of the Companies Act as a standard of liability for this may open the door to the adverse effects of hindsight bias and the problems which have ravaged the American experience of the business judgment rule. Conceiving of the rule as a standard of liability would allow for judicial evaluation of the statutory duty of care to take place before the rule is actually applied. This is obviously incorrect for it runs contrary to the purpose and function of the rule.

The rule should be understood as merely a policy of judicial deference that is applied in a South African specific manner that accords with our corporate law and legal policies. It is a hybrid device which has elements of both a qualified immunity and a doctrine of judicial deference. The business judgment rule under section 76(4) of the Companies Act will practically function as mandating judicial deference whilst requiring the defendant director to prove entitlement to the protection of the rule. Its function should be limited to merely removing the substantive correctness of business decisions from judicial review.

Prior to the introduction of the Companies Act, Jones concluded that:

“In South Africa, the law on the duty of care and skill owed by a director to his company is relatively clear, and adopting the business judgment rule is likely to confuse the issue for the courts and ultimately make it easier for errant or negligent directors to escape liability. Most commentators agree that there is no need for South African law to adopt the business judgment rule.” 228

²²⁸ E Jones (supra) at 336 citing the works of M Havenga ‘The Business Judgment Rule - Should we Follow the Australian Example’ (2000) 12 *SA Merc LJ* 28; D Botha & Jooste (supra); and JS McLennan (supra).

It is easy to understand why there has been academic concern with the codification of director duties and the introduction of the business judgment rule under the Companies Act.²²⁹ Probably the main reason behind the distrust with the adoption of a business judgment rule under the Companies Act was the uncertainty which abounds within the American jurisprudence on the topic and misunderstanding the operation of the rule.²³⁰ As enacted under the Companies Act, if the business judgment rule is seen as a statutorily mandated policy of judicial deference, the uncertainty is greatly avoided. When there is a defined list of requirements which a director must satisfy before the courts will defer to the directors' judgment, this uncertainty is accordingly further nullified. The business judgment rule should accordingly not be viewed with distrust. There is the potential for the rule to greatly enhance director accountability to shareholders if applied in the manner which I have proposed.

South Africa needs to avoid a situation where the business judgment rule may lead to a "culture of apparent indifference or deliberate disregard on the part of those responsible for the well-being of compan(ies)"²³¹ in that the rule must not operate as an "insurmountable barrier"²³² to liability. It should be self-evident that corporations are vital actors with society, and consequently that directors are in position to have a profound influence upon the economic growth of South Africa. Poor corporate guidance and the associated corporate failures and scandals have an adverse effect on investors, employees and creditors. Public confidence in financial markets may be negatively impacted which will have implications upon the economy as a whole. In short – there may be said to be a direct correlation between specific business judgments and the wider interests of the general public in South Africa. The adverse effects of decisions which are imbued by the breach of the statutory duty of care may accordingly have far wider effects than merely the dissatisfaction of shareholders. It is important to demarcate clearly what the correct position regarding the business judgment rule should be with regard to South Africa, for the application of the

²²⁹ P Sutherland 'The State of Modern Company Law in South Africa' (2012) 23(1) *Stellenbosch Law Review* 157.

²³⁰ G Hippert 'The King Report's recommended 'business judgment test'' (1997) 5 *Juta's Business Law* 18.

²³¹ *The Failure of HIH Insurance* (supra) at 10 per Justice Owen.

²³² RA Prentice 'Target Board Abuse of Defensive Tactics: Can Federal Law be Mobilized to Overcome the Business Judgment Rule?' (1982-1983) 8 *Journal of Corporate Law* 337 at 346.

business judgment rule may prospectively have a profound and wide-ranging impact upon directorial decision making.

The business judgment rule has constantly developed and has been undergoing significant development in recent years within the American common law. The decision to codify the rule in the Companies Act may therefore seem an odd one, especially given the recent developments regarding the position of good faith in corporate law jurisprudence and the law in general.²³³ Despite this concern there is no need to be wary of the operation of the business judgment rule in South Africa. The inclusion of the business judgment rule in the Companies Act potentially provides for better adherence to the statutory duty of care as well as facilitating directorial accountability.

In order to promote directorial accountability for decisions the business judgment rule needs to be applied in the manner suggested above. It is desirable for directors to be able to take corporate risks provided that the corporate governance provisions which govern corporatethe management of risk are adhered to. Directors must however remain accountable to shareholders in particular, and stakeholders generally, for their decisions. The business judgment rule under section 76(4)(a) is the judicial mechanism which can provide the means to balance this tension between accountability and authority. This may subsequently enhance effective corporate leadership and decision making which will have a direct impact upon the proper functioning and growth of the South African economy.

²³³ SJ Griffith 'Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence' (2005) 55(1) *Duke Law Journal* 1.

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