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DECLARATION

Research dissertation presented for the approval of Senate in fulfilment of part of the requirements for the Masters in Commercial Law degree in approved courses and a minor dissertation. The other part of the requirement for this qualification was the completion of a programme of courses.

I hereby declare that I have read and understood the regulations governing the submission of Masters in Commercial Law degree dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

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ACKNOWLEDGEMENTS

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I would also like to express gratitude to my mother, Peta Becker, for her support and encouragement throughout the degree.
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ABSTRACT

Following the major corporate collapses of the past decade, companies around the world have been considering whether these collapses are a result of the failure of directors of corporations to curb their appetite for excessive risk taking. A director’s duty to promote the success of the company places great pressure on directors to maximise profits in the short term. In addition to shareholder pressure directors are tempted with huge bonuses and remuneration packages for producing short term profits. This paper will examine how corporate governance as a sub-species of corporate law can work effectively with regulation to prevent and discourage excessive risk taking behaviour.
1. CHAPTER ONE

1.1 Introduction

1.1.1 Aims of Research

The Aim of this paper is to highlight the possible causes of the current global financial crisis; both legal and regulatory, and to examine how corporate governance, as a sub-species of corporate law can be used to curb excessive risk taking. This paper will examine the failure of current corporate law and regulation to curb excessive risk taking behaviour and present proposals for reform of the existing system. This necessitates comparison between South Africa, the U.S.A (particularly the State of Delaware) and the United Kingdom, where the crisis has lead to recent legislative and regulatory reforms.

The paper will culminate in an assessment of South Africa’s current legislative and governance landscape and make proposals for mechanisms, which allow corporate governance and corporate law to work together to achieve good governance across all corporations is South Africa.

1.1.2 Statement of the Problem

Following the major corporate collapses of the past decade¹, countries around the world have been considering whether the directors of corporations are fulfilling the fiduciary duties investors legitimately expect in the modern commercial world. Others have voiced their beliefs that it is not corporate law, but a failure in regulation, which is to blame for the current

¹ We have recently witnessed the collapse of major financial institutions such as Lehman Brothers, HBOS, Worldcom, Northern Rock and the Enron group of companies as well as the fraudulent ponzi schemes of Madoff and Stanford, which may all have been prevented through effective corporate governance.
financial crisis. Justice Strine, in his speech on the role of Delaware in the American Corporate Governance system, emphasises that corporate law works most effectively when it is backed up by strong government regulation.

The USA adheres to a form of ‘rule based’ regulation in which lawmakers and regulators try to prescribe in great detail exactly how companies must behave. This form of regulation is often referred to as ‘comply or else’. The UK and South Africa use ‘principle based’ regulation where regulators evaluate companies’ behaviour according to broad principles. This approach gives regulators more leeway in judging whether a company is really acting in the best interests of shareholders and consumers.

‘Principle based’ regulation is often referred to as ‘comply or explain’. Although the UK and South Africa both use a ‘principle based’ approach to regulation, the recent codification of directors duties in both countries appears to move towards more of a ‘rule based’ form of regulation, as the codification has introduced rigidity to the system.

In practice, of course, these distinctions aren’t quite so neat: regulators in a rules-based system still have to interpret the rules, and principles-based systems are hardly rule-free, but the models do represent genuinely different approaches. Principle-based regulation can make life easier for ‘honest’ corporations, since they have to spend less time

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2 Strine, L.E. Jr. *The Role of Delaware in the American Corporate Governance System, and some Preliminary Musings on the Corporate Meltdown’s Implications for Corporate Law* 1
3 Ibid
4 Bank regulators in Italy, following a principles-based strategy, succeeded in keeping big Italian banks from heavily investing in subprime derivatives, even though such investments wouldn’t have broken any laws. (The New Yorker, Apr. 28th)
5 The Financial Services Authority, for instance, has thousands of pages of rules and guidance.
6 Analogy or rules-based vs. principles-based and American football and soccer. Football, like most American sports, is heavily rule-bound. There’s an elaborate rulebook that sharply limits what players can and can’t do (down to where they have to stand on the field), and its dictates are followed with great care. Soccer is a more principles-based game. There are fewer rules, and the referee is given far more authority than officials in most American sports to interpret them and to shape game play and outcomes. For instance, a soccer referee keeps the game time, and at game’s end has the discretion to add as many or as few minutes of extra time as he deems necessary. There’s also less obsession with precision—players making a free kick or throw-in don’t have to pinpoint exactly where it should be taken from. As long as it’s in the general vicinity of the right spot, it’s O.K.
complying with overly complex rules, and also thwart dishonest ones, since regulators can spend more time looking at the substance, rather than the trivial details, of corporate bad behaviour. It has been argued that Enron might have found it harder to get away with its fraudulent actions under a principles-based system, since many of the company’s gambits, while following U.S. accounting rules, nonetheless violated fundamentals of financial reporting.

In the latest Draft Code of Corporate Governance Principles for South Africa 2009, the King Committee acknowledges the economic crisis facing leading financial institutions. The committee emphasises that although many blame corporate governance for these failings, they should not be interpreted to mean South African and UK corporate governance models are not working, where values-based principles are followed and governance is applied in substance and not only in form. The revised King Code and Report on Governance for South Africa (King III) was launched on September 2009 and will come into effect and replace King II on 1 March 2010.

The committee states that South Africa should focus its attention on any defects in its financial regulatory framework, both at home, and on a global basis. However, the committee warns that calls for general legislative corporate governance reform must be treated with caution. One must remember that the highly regulated US model, which some believe South Africa should adopt, did not stop the financial crisis we face today. The financial crisis itself originated in the US and even the Sarbanes-Oxley Act (SOX) with all of its statutory requirements for rigorous internal controls, has

7 King Code and Report on Governance for South Africa (25 February 2009) available at http://www.iodsa.co.za/king.asp (King III)
8 Ibid at 9
9 The review of King II was prompted by international changes in governance trends as well as the reform of South African Company law with the introduction of the new Companies Act 71 of 2008 which is expected to come into force on 1 June 2010.
10 Sarbanes-Oxley Act of 2002
not prevented the collapse of many of the leading names in US banking and finance.\textsuperscript{11}

1.1.3 The Concept of Risk

Risk taking is one of the most fundamental parts of a director’s job. In order to make profits for the company and ultimately, the shareholders, directors need to make high-risk business decisions on a regular basis. It is often the case that the higher the risk, the higher the possibility of large returns on investments. The law recognises that directors are tasked with these decisions, and in return for the fulfilment of their duty of care, the courts have not questioned the business decisions of directors. A business decision is often a risk-based decision.\textsuperscript{12}

Business risks are uncertainties that can impinge on a company's ability to achieve its objectives and can result in many interdependent outcomes, which may prove negative or positive for a corporation's profits and long-term sustainability. Risks are a function of severity and likelihood as they may or may not occur, and if they do, a variety of exposures are possible.

Business risks relate to business objectives, because risk-taking is a prerequisite to success, as without risk, there is no reward. Therefore, in order to take advantage of strategic opportunities, risks must be exploited. Conversely, risks that threaten success must be mitigated. These risks include threats of problems occurring, such as misappropriation of assets, or opportunities not occurring, such as a failure to achieve strategic goals.

Corporate governance is a process a board of directors should carry out to provide direction, authority, and oversight of management for the

\textsuperscript{11} Op cit note 8
\textsuperscript{12} For example, a decision of how much money to invest, and in what fund.
benefit of company's shareholders. Unfortunately, it is often the case that directors, management, internal and external auditors, and risk managers do not understand what corporate governance requires from them as it "means different things to different people." Moreover, while the board of directors is the owner of the governance process, day-to-day guidance and oversight by the board may not be feasible, as the board often relies on other parties, such as executives, managers, and auditors to help it fulfil its governance responsibilities. Problematically, practical guidance for executives, managers, and auditors who are involved in corporate governance on a day-to-day basis is often sparse. This provides some reasoning as to why the concept of codification of directors' duties has now found favour in certain jurisdictions.

1.1.4 The Role of Excessive Risk Taking within the Current Global Financial Crisis

The sub-prime crisis originated in the United States, due to the high amount of loan foreclosures, which accelerated towards the end of 2006. The crisis went global during 2007 and with the resulting recession, we still feel its impact in 2010. In fact, the crisis seems to be growing larger and larger, with some of the world’s biggest and most reliable banks having lost billions of dollars. From the summer of 2007, the US and Europe noted a sudden reduction in the availability of credit, and by October 2008 it had escalated to the full-blown financial crisis we see today.

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13 This definition of corporate governance is adapted from the Institute of Internal Auditors' definition of "governance process," which can be found in the IIA's International Standards for the Professional Practice of Internal Auditing. The definition also incorporates ideas of effective corporate governance expressed in Principles of Corporate Governance: A White Paper from the Business Roundtable, Washington, D.C., May 2002. This publication describes the roles of the board of directors and management in corporate governance from a CEO's perspective. Cited in Sobel and Reding in 'Aligning corporate governance with enterprise risk management: melding enterprise risk management with governance means directors, senior management, internal and external auditors, and risk owners must work interdependently.' Management Accounting Quarterly, Wntr, (2004)
15 Op cit note 13
16 Both the United Kingdom and South Africa have attempted a codification of directors’ duties in their Companies Acts
In the US, there was an increase in ‘sub-prime loans’ being granted to borrowers with poor credit histories. These loans have resulted in the loss of billions of dollars. Lending institutions, facing shareholder pressure, wanted to make a ‘quick profit’ rather than stick it out for the long run, and soon hedge funds and other financial institutions were seen to follow, acquiring loans and re-selling them. Following this behaviour by banks and financial institutions, housing prices started to decrease and many sub-prime borrowers found it difficult to refinance their loans. This resulted in a mass wave of loan defaults.

Some of the multiple factors contributing to the crisis, were the inability of homeowners’ to make their mortgage payments, primarily due to loss of employment or health related issues; poor judgment by either the borrower and/or the lender; inappropriate mortgage incentives such as buy-downs and short fixed term adjustable rate mortgages. These, coupled with rapidly rising adjustable mortgage rates and declining home prices made re-financing more difficult for borrowers and lenders. All of these factors could and should have been considered by directors implementing effective risk management strategies for the long-term sustainability of the business.

In 2004, the Securities and Exchange Commission (SEC) exempted the five largest investment banks from the Net Capital Rule. Under the rule, banks must hold a certain amount of capital to loan money. As expected, banks began to dramatically increase corporate lending, so the amount that they were owed in debt far outweighed the amount they held in capital.

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18 The Average Mortgage is repaid in 20-25 years – with sub-prime lending the institutions were able to recoup their money almost immediately.
19 Prem Shekker, ‘Sub-Prime Drama Reveals the New Crisis of Capitalism says Prem Shika’ Nov 16 (2007) at 2
22 Exemption from the Net Capital Rule can be seen as a regulatory failure and factor contribution to the financial crisis. Ironically, since the corporate meltdown regulators around the world are calling for reform of capital adequacy requirements for financial institutions.
Leverage levels increased dramatically, in some cases to a ratio of 30:1, exposing them to severe risk if their revenues decreased, or corporate borrowers defaulted on loans.23

Another contentious issue, which is currently being addressed by proposed regulatory reforms, is the bonus structures at investment banks and financial institutions. This structure encouraged high risk-taking investments for short-term returns. The eventual losses suffered on these investments were not reflected in the bonus payments based on those shorter-term gains. High-risk investments led to high bonuses, which encouraged further high-risk investments. This resulted in investment banks over-leveraging themselves with dubious investments while their leverage ratios soared.24 Executive remuneration has been highly debated by such regulators as the Financial Services Authority (FSA) in the UK, and more recently, by the King Committee Report on Corporate Governance in South Africa. What is clear about the previous remuneration system for corporate executives is that, in the years leading up to the crisis, executives were rewarded for excessive risk-taking despite this remuneration not being commensurate with company profits.

Today it is evident that the ripple effects of the crunch have affected more than just borrowers and lenders; inflation is on the rise, and banks are calling on the government to buy assets on which lenders have defaulted with taxpayer’s money.

Due to the tightening of credit standards, banks are becoming increasingly reluctant to loan money to each other. This is due to the fact that one bank does not know whether the other is harbouring billions in toxic mortgage-backed debt. When banks are hesitant to lend to each other it

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shows there is uncertainty as to the solvency of other banks, and this slows down commerce for the economy as a whole.  

It is now impossible for many creditworthy applicants to obtain loans from the banks. More than 50% of the mortgages granted between 2006 and 2008 have been unconventional loans. In some cases, the banks have not even asked for a down payment or any verification of income. They have granted extremely generous packages to high-risk borrowers, such as interest-only, negative amortization, piggyback, 2-28s, teaser rates and adjustable rate mortgages “ARMs”. It is not surprising that the banks are holding $300 billion of these "unmarketable" mortgage-backed CDOs (Collateralized Debt Obligations) and another $200 billion in equally-suspect CLOs. (Collateralized loan obligations; the CDOs corporate-twin).

The investment vehicles, known as "conduits" and SIVs, are designed to operate separately from the banks and off their balance sheets. Citigroup, for example, owns about twenty-five percent of the market for SIVs, representing nearly $100 billion of assets under management. The largest Citigroup SIV is Centauri Corp., which had $21 billion in outstanding debt as of February 2007, according to a Citigroup research report. However, there was no mention of Centauri in Citigroup’s 2006 annual filing with the Securities and Exchange Commission (SEC).

On September 19, 2008, the Treasury and Federal Reserve began discussions with Congress on a massive bailout plan to restore the market. Similar measures were adopted internationally. In the midst of this financial fiasco questions have been raised as to the liability of directors, banks and

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26 Ibid
27 Ibid
28 In the Wall Street Journal, David Reilly pointed out that many investors are unaware of the fact that banks such as Citigroup Inc. could find themselves burdened by affiliated investment vehicles that issue tens of billions of dollars in short-term debt known as commercial paper “Conduit Risks are hovering over Citigroup” (WSJ 9-5-07) available at http://online.wsj.com/article/SB118895110892617533.html (accessed on 10 November 2007)
29 Op cit note 25
30 http://transcripts.cnn.com/TRANSCRIPTS/0809/19/ldt.01.html
professional advisors. Some suspects have conveniently resigned. The boards of directors at these firms bear ultimate responsibility. Specifically, while it is the CEO’s job to manage risk, the NYSE listing requirements mandate that it is the responsibility of the board’s audit committee, or other designated committee, to review the firm’s major financial risks and assess the steps management has taken to control such exposure. The banks’ board failures are especially egregious since it was apparent by mid-2005 that mortgage lenders were loosening lending standards and an overheated U.S housing market was at risk of collapse.

Directors focused their attention on short-term gains to reward investors and themselves via bonus and remuneration schemes. In its current state, the law places immense pressure on directors to produce profits for their shareholders. In addition to this, many shareholders are not focused on long-term investments and demand immediate high returns. This pressure, combined with the fact that the law makes it difficult for shareholders to question directors’ business decisions, and a lack of risk and remuneration oversight, is what encourages directors to engage in excessive risk taking.

Some argue that directors owe their duty to act in the best interests of the company to other constituencies, in addition to the shareholders. Professor Shikka highlights the recent economic crisis and the fact that shareholders were not the only losers. The general public was heavily impacted by directors of large corporations’ decisions and Shikka believes that due to the lack of protection the law offers to the general public there

31 Stan O’Neal – Former Chairman and Chief Executive of Marrill Lynch and Citigroups Charles Prince
33 The Business Judgment Rule recognizes that a court of law should not question the correctness of a business decision adopted by the company in the management of its own affairs. See Blackman Commentary on the Companies Act Vol 2, (2002) 8-64
35 Op cit note 19
should be significant changes in director’s duties and the governance of major corporations.\(^{36}\)

Others have voiced their beliefs that it is not corporate law, but a failure in regulation, which is to blame for the current financial crisis.\(^{37}\) South Africa has recently taken the route of partial codification of the common law fiduciary duties in the Companies Act 71 of 2008.\(^{38}\) With regulation such as SOX and Basel II appearing to prove ineffective in preventing corporate meltdowns, this paper will question what went wrong, why, and how corporate governance as a sub-species of corporate law can be used in a more effective manner.

1.2 Methodology and Overview of Chapters

Chapter one will present an overview of the global financial crisis and assess how corporate risk taking and equity based remuneration contributed to the financial crisis from the point of view of both corporate governance and corporate law. The chapter will assess proposals for legislative and governance reforms in South Africa and discuss the research methodology to be used throughout the paper. The paper shall refer to the Common Law, the Companies Act (2008), the draft King Code and Report on Corporate Governance (King III) and jurisprudence and legislation from the United Kingdom and the United States of America, with particular reference to the State of Delaware. The paper will not make use of empirical studies and is limited to the three jurisdictions mentioned previously.

Chapter two will present the background to corporate risk taking and an overview of directors’ fiduciary duties, in particular the duty to promote the interests of the company. Various interpretations of what ‘the interests of the company’ actually are will be discussed with the conclusion that the interests

\(^{36}\) Ibid at 4
\(^{37}\) Op cit note 2
\(^{38}\) Companies Act 71 of 2008
of the company are the interests of the shareholders, both present and future, as a general body. The argument that this definition may also mean other stakeholders’ interests in addition to those of shareholders will be considered. The partial codification of directors’ duties in the new Companies Act, particularly the duties to act in good faith in the best interests of the company, and to act with care and skill, will be assessed. It will be argued that these onerous duties may scare qualified persons away from holding office as director due to the subjective element involved in the tests for whether these duties have been fulfilled. The recent codification of the US Business Judgement rule in the South African Companies Act and its role in corporate risk taking shall be discussed. This addition to the Act provides directors with a new statutory defence, where there has been an alleged breach of their duty of care. This defence will be available to a director who asserts that he had no financial conflict, was reasonably informed, and made a rational business decision in the circumstances. The effect of equity based compensation on corporate risk taking will be considered as well as the views of Justice Leo Strine on the correlation between regulatory relaxedness and risk taking.

Chapter three will examine the current corporate governance standpoint in South Africa and what the corporate governance response should in fact be. Reference shall be made to risk management and will question who is responsible for risk management of corporations today. Questions shall be raised over whether the already overburdened audit committee should be faced with the challenge of risk management oversight, or whether separate risk committees should be established to perform this function. Justice Strine’s views expressed in his speech on ‘the Role of Delaware in the American Corporate Governance System and some Preliminary Musings on the Meltdown’s Implications for Corporate Law’ will be evaluated. The issue of how to use shareholder activism in a manner, which encourages long term growth and profitability, and whether this can be

39 Ibid subsection 76(4)(a)
done through compelled disclosure in the annual financial. Arguments that this approach is not a practical one will be assessed, and the possibility of a change in legislation in order to guide shareholders towards long-term profits and create a strengthening of managerial autonomy, will be considered as a possible solution to the problem. The possibility of re-defining the meaning of independence of directors to include some financial experience will be considered, with reference to the provisions for independence of King III, the new Companies Act and SOX. Problems associated with the requirements for ‘independence’ mean experienced directors cannot hold office.

Suggestions for the appointment of stand alone risk committees, a task currently undertaken by the audit committee, shall be assessed. Audit committees need to look at fundamental economic risk and King III has recommended a stand alone risk management committee. Risk is the responsibility of the BOD as a whole, which means it may not be abrogated. King III looks at governance vs. management of risk; governance is the responsibility of the board of directors while management of risk rests with the risk committee. The impact of the establishment of an independent risk committee may help with excessive risk taking, by scaling down the number of responsibilities placed on the BOD, allowing them to monitor.

The duties placed on the BOD by King III and the Companies Act shall be examined for the purpose of evaluating whether the responsibilities are too excessive and whether they prevent the BOD from monitoring management effectively.

Chapter Four will consider the role effective risk management could play, and whether the establishment of an independent risk committee, separate to the audit committee, would be a more effective way of managing directors’ excessive risk taking tendencies, than the imposition of more stringent and onerous duties on directors. The new role of the codified duty of care and skill shall be discussed in relation to corporate risk taking and the codified business judgement rule. The chapter shall conclude with a recommendation for the establishment of independent risk and remuneration
committees as effective corporate governance mechanisms to prevent and monitor excessive risk taking.

2. CHAPTER TWO

2.1 History of Corporate Risk Taking

As mentioned in Chapter One, the success of any business ultimately relies on leaders’ ability to evaluate risks, and pursue them, based on the likelihood and magnitude of gain that each promises. Therefore, risk-taking is an essential part of every business. Shareholders understand this, and place decision-makers in charge whom they believe will adopt risk-taking strategies that will produce profits for the business. The courts of South Africa and the USA also recognise this and do not question the business judgements of corporate directors. The recent events that led to the global economic meltdown have tested the courts’ long-held policy of abstention, since a variety of factors contributed to the meltdown, the most prominent of which, was the mishandling of risk.

2.2 The Corporate Director and Shareholder Pressure

2.2.2 Fiduciary Duties of Directors: Overview

Director’s fiduciary duties have been criticised as being a 19th century English law creation, which is now unable to cope with the complexities of the modern world. Many lawyers, judges and legislators, fail to recognise that the corporate vehicle driven by directors today is very different from that driven by Aron Salomon.

40 Levin v Felt & Tweeds Ltd 1951 (2) SA 401 (A)
The directors’ duties originate in the 19th century where the courts of chancery treated directors as ‘trustees’ or ‘quasi-trustees’. Directors were treated as well meaning amateurs and free from liability from anything less than gross negligence. As trustees usually acted gratuitously, out of a sense of moral obligation, they were expected to exhibit a higher level of care in administering a trust than they would be expected to when dealing with their personal affairs. The extension of the duty to company directors was largely due to the adoption of the standard imposed on commercial agents by the common law courts of equity. This applied appropriate terms into the agents’ contract of employment.

However, the trustee/director analogy cannot be pressed too far, as their functions are essentially quite different. A director’s role is to employ the company’s assets in business, which involves an element of risk-taking whereas a trustee’s role is primarily to preserve the trust estate and safeguard it from risk.

In South Africa, apart from the statutory duties imposed on directors under the Companies Act, a director is subject to fiduciary duties under the common law to exercise his or her powers in good faith and for the benefit of the company, and to act with reasonable care and skill when carrying out his or her office. A director cannot be relieved of these duties in any way and the Appellate Division (as it then was) has suggested that no distinction

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44 Pennington Directors’ Personal Liability (1987) p81
45 In re City Equitable Fire Insurance Company Ltd [1925] 1 Ch 407 at 426 per Romer J.
47 Sealy LS ‘The Director as Trustee’ [1967] CLJ 83 at 89; Butcher (note 41) at 18.
49 Companies Act 71 of 2008; Barlow’s Manufacturing Co Ltd v RN Barry (Pty) Ltd 1990 (4) SA 608 (C); Ibid at 140
50 Now the Supreme Court of Appeal
should be drawn between executive and non-executive directors’ fiduciary duties.\textsuperscript{51}

A director’s fiduciary obligation commences from appointment or at the time he or she commences to act as a director. The most fundamental duty of directors, both collectively and individually, is to exercise their powers in good faith and in the best interests of the company.\textsuperscript{52} The general rule is that directors owe their fiduciary duties to the company and not to individual shareholders.\textsuperscript{53} The position under South African Law is very similar to that in the UK. In both the UK and South Africa there is no concise definition of the “interests of the company”\textsuperscript{54}. One view is that the interests of the company are the interests of both present and future shareholders,\textsuperscript{55} but other more modern views are that a director should consider not only the interests of the shareholders, but the interests of other groups, including employees, creditors, the State and the general public.\textsuperscript{56}

The notion that directors’ duties are owed to the shareholders of the company has been criticised on numerous grounds, as it disregards the existence of the company as an entity, separate from its members.\textsuperscript{57} Some argue the interests of the shareholders are not the same as the interests of the company and therefore, directors owe their duties to the company and not the shareholders.\textsuperscript{58} Blackman advocates the view that the interests of the company are in fact the interests of the shareholders qua shareholders, and points out that although it has been suggested the company, as a legal entity,

\begin{itemize}
  \item \textsuperscript{51} Howard v Herrigel 1991 (2) SA 660 (A) 678A-B
  \item \textsuperscript{52} Treasure Trove Diamonds Ltd v Hyman 1928 AD 464; Mills v Mills (1938) 60 CLR 150 (High Court of Australia); Havenga Fiduciary Duties of Company Directors with Specific Regard to Corporate Opportunities (1998) 331; Op cit note 48 at 285
  \item \textsuperscript{53} Percival v Wright [1902] 2 Ch 421
  \item \textsuperscript{54} Op cit note 52 at 332
  \item \textsuperscript{55} Coronation Syndicate, Limited v Lillenfeld and the New Fortuna Co. Limited 1903 TS 489 at 497; Op cit note 33 at 8-64
  \item \textsuperscript{56} Havenga (note 52) at 333
  \item \textsuperscript{57} Op cit note 52; Op cit note 33 at 8-69.
\end{itemize}
can have interests of its own,\textsuperscript{59} it seems obvious that a mere legal entity can have no interests of its own.\textsuperscript{60}

South Africa's Company Act has recently been reviewed.\textsuperscript{61} One of the main goals of the review process was to provide greater clarity on directors’ responsibilities, duties and liabilities.\textsuperscript{62} The review process culminated in the Companies Bills 2007 and 2008, repealing the Companies Act 1973.\textsuperscript{63} The Companies Bill 2008 has become the Companies Act of 2008,\textsuperscript{64} which was assented to in April 2009. The new Act rewrites this nation's company laws, including the introduction of legislative directors’ duties in section 76. Directors’ common law fiduciary duties have been codified, and the duty to promote the interests of the company can now be found in subsection 76(3).\textsuperscript{65} This marks the first statutory incorporation of South Africa's directors’ duties.

As noted above, there is some ambiguity as to whether the directors’ duties set out in section 76 of the Companies Act will operate in addition to the existing common law and fiduciary duties, or whether they will replace them completely. While both Explanatory Memorandums refer to the new provisions as a codification,\textsuperscript{66} suggesting a legislative replacement of the common law, the Explanatory Memorandum to the Companies Bill 2007 states that the new “directors’ duties operate in addition to existing common law duties.”\textsuperscript{67} However, upon examination of the Explanatory Memorandum to the Companies Act 2008, one finds no equivalent statement, and Section 76 of the Companies Act 2008 does not contain any express provision as to whether the section shall operate in combination with the existing common law duties. Further to this, the general import of the ‘good faith’ doctrine in subsection 76(3)(a), combined with a lack of explicit exclusion of the common

\textsuperscript{60} Ibid
\textsuperscript{61} Explanatory Memorandum Companies Bill 2008 186.
\textsuperscript{62} Ibid
\textsuperscript{63} Ibid at 188.
\textsuperscript{64} Companies Act 71 of 2008
\textsuperscript{65} Ibid at section 76
\textsuperscript{66} Explanatory Memorandum Companies Bill 2007 13; op cit note 61 at 192.
\textsuperscript{67} Ibid
law, and the imposition of common law liability for breach of the fiduciary duties, and the duty of care and skill under section 77 of the act, points to a partial, rather than exhaustive codification of directors’ duties. Although the equivalent provision in the Companies Bill 2007 was silent on the issue, it was clearly intended to operate in addition to the common law duties and it is also arguably implicit in section 77 of the Companies Act 2008 that section 76 is intended to operate side by side with the common law. Subsection 77(2) provides that a director may be liable for any loss, damages or costs sustained by the company for a breach of, *inter alia*, section 76 “in accordance with the principles of the common law relating to a breach of a fiduciary duty” and “in accordance with the principles of the common law relating to delict.” While this may simply be seen as a legislative adoption of the common law consequences of breach, it appears implicit that the common law fiduciary duties and the law of delict continue to apply. This view is in line with the intention that the reform proposals should not jettison the body of jurisprudence built up over more than a century.68

2.2.3 Duty to Enhance the Interests of the Company

When directors act, they must do so bona fide and in what they (not the courts) consider to be in the interests of the company.69 This is a subjective duty as the courts will not interfere with a director’s decision, where they honestly believe that decision was for the benefit of the company as a whole.70 There is also an objective element to the test for acting in the best interests of the company, as directors must act in the ‘interests of the company as a whole’ as the law defines it.71 The general rule is that the interests of the company’ are the interests of the shareholders as a general body. In addition to this, directors should treat the company as a going concern and consider the interests of both present and future shareholders. Directors may not exercise their powers for the benefit of the company as a legal or commercial entity distinct from the shareholders, and they may not

68 Op cit note 61 at 187.
69 Op cit note 33 at 8-64; per Lord Greene MR in *RE Smith and Fawcett Ltd* [1942] Ch 304-306.
70 Ibid
71 Ibid at 8-67
favour one section of shareholders over another.\textsuperscript{72} In its current state, the law places immense pressure on directors to produce profits for their shareholders. In addition to this, many shareholders are only focused on short-term rewards.\textsuperscript{73} This pressure, combined with the fact that the law makes it difficult for shareholders to question directors' business decisions\textsuperscript{74}, is what encourages directors to engage in excessive risk taking.

\textbf{2.2.4 Fiduciary Duties in the UK}

The key source of corporate governance recommendations for UK listed companies is the Combined Code, which consolidates the work of the Hampel report\textsuperscript{75}, the Cadbury report\textsuperscript{76}, the Greenbury report\textsuperscript{77}, the Higgs review\textsuperscript{78} and Smith report\textsuperscript{79}. It consists of principles of good governance, most of which have their own set of more detailed provisions, which, in most cases, amplify the principles.\textsuperscript{80} Although most of the provisions of the Combined Code are not legally binding they work together with the Companies Act to form a comprehensive framework for ensuring that private

\begin{itemize}
\item the composition and effectiveness of the board;
\item the respective roles of the chairman,
\item executive and non-executive directors;
\item the board's role in risk management;
\item the role of the remuneration committee;
\item the quality of support and information available to the board and its committees; and
\item the content and effectiveness of the section addressed to institutional shareholders.
\end{itemize}
and public UK companies are managed for the benefit of shareholders. This is echoed in South Africa by the King Report and Code and the Companies Act.

Unlike United States corporate law, company law in the UK has traditionally provided that directors owe a duty to the company, not to the shareholders. Gower and Davies state that the UK Companies Act provides a mechanism to ensure that UK companies are managed and operated in the interests of shareholders.\textsuperscript{81}

Although English company law has traditionally stated that directors owe a duty to the company and the not the individual shareholders, the UK corporate governance model has continued to focus on the maximization of shareholder wealth.\textsuperscript{82} For this reason, some have interpreted the position as meaning that directors owe duties of care and fiduciary duties directly to the shareholders, collectively, in the form of the company, and not to the shareholders, individually.\textsuperscript{83}

\textbf{2.2.5 Jurisprudence}

In the case of \textit{Percival v Wright},\textsuperscript{84} the court held that directors of a company are not trustees for individual shareholders and may purchase their shares without disclosing pending negotiations for the sale of the company.\textsuperscript{85} Therefore, directors’ duties are owed to the company and not the individual shareholders themselves. However, if a director discloses certain information to shareholders, he has a duty not to mislead the shareholders with respect to that information. The rule in \textit{Percival v Wright} has been criticized and the courts now recognise that a fiduciary duty may be owed by directors to individual shareholders in special circumstances.\textsuperscript{86}

\begin{footnotes}
\footnote{Gower & Davies \textit{Modern Company Law} (2003) at 294-95}
\footnote{Ibid at 374-75}
\footnote{Ibid at 374}
\footnote{Op cit note 53 at 425-26}
\footnote{Ibid at 428}
\footnote{I.e. family run business}
\end{footnotes}
Although directors owe their duties to the company, it is always a difficult task to separate the interests of the company from those of the shareholders as they are in many instances, one and the same, and can be divided further, into the interests of the present and future shareholders. Therefore, although the technical legal duty is owed to the company, directors’ duties must be directed toward the maximisation of shareholder interests, which in the majority of cases, means the maximization of profits.

2.2.6 Duty to Promote the Success of the Company in the UK

A director of a company must act in a way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.87 Such evidence as is available from the law reports suggests that section 172 simply codifies the common law obligations of company directors. In Re Southern Counties Fresh Foods Ltd88, the court compared the new form of words with the old (acting "bona fide in the interests of the company") and concluded that they came to the same thing, with the modern formulation giving a more readily understood definition of the scope of the duty.

In the House of Lords decision in Moore Stephens v Stone & Rolls Limited (in liquidation)89, Lord Mance (dissenting) emphasised not only that the duty is expressly based on common law rules and equitable principles (section 170(3)), but also that it is expressly subject to requirements on directors, in certain circumstances, to consider or to act in creditors’ interests (section 172(3)).

The court in Re Southern Counties90 also confirmed that the test under (at least the first limb of) section 172(1) remains subjective in nature. One will examine whether the director honestly believed that he acted in a

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87 The first limb of section 172(1) of the 2006 UK Act (section 172).
88 Re Southern Counties Fresh Foods Ltd [2008] EWHC 2810.
90 Ibid
way most likely to promote the company’s success. This mirrors the pre-2006 Act position as set out in *Re Smith & Fawcett Ltd.* However, it should not be taken to mean that directors’ decisions are immune from challenge. There is yet to be reported a judgment, which directly addresses the "enlightened shareholder value" philosophy supporting the second limb of section 172(1).

As highlighted above, S172 of the 2006 UK Companies Act raised much debate over the meaning of ‘the company’ and ‘in the interests of the company’ and specified that a director’s duty is to promote the success of the company for the benefit of its members as a whole, and not for the benefit of other stakeholders or constituencies. This adopts the ‘enlightened shareholder value’ approach as recommended by the law Commissions and CLR. The reason for choosing this route as opposed to the ‘pluralist’ approach is that the pluralist view would leave directors accountable to no-one, as no clear yardstick would exist for judging their performance.

### 2.2.7 Delaware Corporate Law

Strine emphasises the benefits of the Delaware corporation law. Unlike many European jurisdictions, Delaware corporate law only governs the internal affairs of the company. Matters such as labour law, competition law and filing of disclosures to public investors are governed by regulatory regimes. South African corporate law is also primarily concerned with the regulation of the company’s internal affairs and matters such as labour law, etc. are separately regulated. In addition to this, Delaware Corporation law keeps statutory mandates to a minimum, and even some statutory mandates

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91 *Re Smith & Fawcett Ltd* [1942] Ch 304.
92 *Stimpson & Ors v Southern Landlords Association* [2009] EWHC 2072, where a company’s objects include purposes other than the benefit of members
94 Committee on Corporate Governance, *Final Report*, para 1.17
95 Op cit note 2 at 3
are subject to being overridden through charter and by-law provisions. This is also the case in South Africa under the new corporate law dispensation as reflected in section 6 of the 2008 Act. Under Delaware Corporate law the certificate of incorporation of a company may only be altered upon recommendation by the board of directors and shareholder approval, which reflects the ‘contract’ between managers and shareholders, which Delaware corporate laws govern.

In Delaware, certain aspects of company law, such as the filing of disclosures to the public, are governed by regulatory regimes and administered through the agencies of federal government, as opposed to being covered by Delaware corporate law. It is not surprising that Delaware has become known as a corporate haven with over 50 percent of US publicly-traded corporations and 60% of the Fortune 500 companies incorporated in the state.

Delaware’s statutory law is made by a mix of corporate lawyers, who represent both corporate managers and shareholders. Unlike other US states, the corporate law of Delaware maintains its integrity by taking the only two relevant constituencies’ views into account, managers and shareholders. Delaware’s corporate law only deals with the internal affairs of the corporation and provides a body of contract law, which governs the relations between directors and shareholders of companies incorporated within the state.

With regard to the many corporate failures emanating from the US, Justice Strine is of the view that the institutional investors of these organizations are to blame, as they were best placed to use their influence to sound warning alarms on risky business strategies. Instead of doing this,

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96 Ibid at 4
97 Ibid
99 Op cit note 2 at 12, in North Carolina the legislature made changes to the states corporate law for the sole purpose of defeating a takeover bid of Wachovia Bank from Sun Trust
100 Ibid at 13
they called for higher risk-taking and greater returns. Strine is adamant that a failure in regulatory law is what led to the current financial crisis. He reinforces the role of the business judgment rule in corporate law in his argument against directors and managers being to blame for their actions.

Compared to the UK and South Africa’s corporate law regarding the liability of directors, Delaware corporate law is extremely lax, and actually serves to insulate directors from potential claims. It has been criticised due to the fact that it is very difficult for a director to be found in breach of their duty of care, as the business judgment rule insulates directors from much of their liability.

2.2.8 Delaware Jurisprudence

According to the Delaware Code the business and affairs of every corporation organized under this chapter, shall be managed by or under the direction of a board of directors. As in the UK and South Africa, if a director breaches one of their fiduciary duties they can be sued by their shareholders, directly or derivatively, on behalf of the corporation. However, unless the conduct complained of involved conflicted directors who acted in their own interests or committed fraud or waste, it is difficult for shareholders to move lawsuits forward against directors of Delaware corporations for fiduciary duty violations.

Smith v. Van Gorkom is the landmark case on directors duties and is extremely important as its criticisms lead to the eventual adoption by the

101 Ibid at 19
102 Ibid at 22
103 Delaware General Corporate Law §102(b)(7)
105 DEL. CODE ANN. tit. 8, § 141(a) (2001)
108 Smith v. Van Gorkom 488 A.2d 858 (Del.1985)
Delaware legislature of Delaware General Corporation Law S102(b)(7), which will be discussed in more detail later. The facts of the case were that Marmon Group had proposed a leveraged buy-out merger of TransUnion. Van Gorkom, who was TransUnion's Chairman and CEO, proposed a price for the buy-out, without consulting outside financial experts. He only consulted with the company's CFO, and that consultation was to determine a per share price that would work for a leveraged buyout. Van Gorkom and the CFO did not determine an actual total value of the company. The proposed merger was subject to Board approval. At the Board meeting, a number of items were not disclosed, including the problematic methodology that Van Gorkom used to arrive at the proposed price. Also, previous objections by management were not discussed. The Board approved the proposal. The Court found that the directors were grossly negligent, because they quickly approved the merger without substantial inquiry or any expert advice. For this reason, the board of directors breached the duty of care that it owed to the corporation's shareholders. As such, the protection of the business judgment rule was unavailable.

The Court stated,

"The rule itself 'is 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.' ...Thus, the party attacking a board decision as uninformed must rebut the presumption that its business judgment was an informed one."\textsuperscript{109}

The decision clarified the directors' duty of disclosure, stating that corporate directors must disclose all facts germane to a transaction that is subject to a shareholder vote.

After the case directors' and officers' insurance premiums sharply increased and the outcry resulted in the introduction of Delaware General Corporation Law S102(b)(7). Since S102(b)(7) came into effect, nine out of ten Delaware companies have, by this method, essentially overturned the

\textsuperscript{109} Ibid at 872
result in the Van Gorkom\textsuperscript{110} case. This is strange given the amount of corporate failures since the case. One theory regarding Delaware courts reluctance to hold directors liable where there is no self-dealing is called "judicial nullification."\textsuperscript{111} This theory proposes that the court's reluctance to impose personal liability on directors is due to the fact that the damages disinterested directors will have to pay, once liability is established, are thought to be draconian and disproportionate to the wrongful conduct.\textsuperscript{112}

Due to the extreme procedural, common law and statutory hurdles now shielding directors from liability, some scholars say Delaware has created a 'no liability' conduct of directors.\textsuperscript{113} The three hurdles that together create this "no liability" environment are the demand requirement, the business judgment rule presumption, and section 102(b)(7), the latter two hurdles will be discussed in more detail later.\textsuperscript{114}

The demand requirement requires shareholders who bring a derivative lawsuit to first make a demand on the board of the corporation at issue, to allow the board to either fix the problem, or exercise its managerial discretion, and decide whether the lawsuit is appropriate and should be brought by the board, itself, on behalf of the corporation.\textsuperscript{115} Under such demand the usual result is the board deciding not to continue the lawsuit against the directors.\textsuperscript{116} Even if a derivative lawsuit is maintained beyond the demand requirement, it is likely to be dismissed by the court, due to the protection of the business judgment rule presumption.\textsuperscript{117}

\textsuperscript{110} Op cit note 108
\textsuperscript{112} John C. Coffee, Jr. & Donald E. Schwartz, ‘The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform’, 81 COLUM. L. REV. 261, 317 (1981) An example of the draconian amounts payable upon personal liability can be seen in re Walt Disney Co. Derivative Litig., 906 A.2d 27, 35 (Del. 2006) where the directors were alleged to have cost the corporation approximately $130 million by failing to adequately oversee the hiring and firing of Ovitz. If the court had found that the directors liable they would have had to pay over $7.5 million each.\textsuperscript{113} Black et al., ‘Outside Director Liability’, 58 STAN. L. REV. 1055, 1060-61 (2006)
\textsuperscript{114} Op cit note 111 at 117
\textsuperscript{115} Aronson v. Lewis, 473 A.2d 805, 811-12 (Del. 1984).
\textsuperscript{116} Ibid at 813
\textsuperscript{117} Ibid at 814.
With the inclusion of S102(b)(7) in the Delaware Corporate Code, liability-limiting charter provisions were introduced.118 This provision compels summary dismissal of duty of care claims for monetary damages asserted against the corporation’s disinterested directors,119 and means the only fiduciary duty claims that can be brought against disinterested directors are those based on either (a) a duty of loyalty violation or (b) acts or omissions not in good faith.120 Section 102(b)(7) operates as an affirmative defence for a defendant director who is sued for violating his or her fiduciary duties, and the director can raise the section 102(b)(7) defence.121

With regard to a duty of loyalty Delaware courts have historically drawn narrow parameters and held that the duty of loyalty is implicated only when a director has acted to benefit herself personally.122 In the recent case of Lyondell Chemical Corporation v. Ryan123, the Delaware Supreme Court addressed directors’ fiduciary duties relating to the sale of a Delaware corporation. The decision overturns the earlier decision from the Delaware Court of Chancery and granted summary judgment to Lyondell’s board of directors, dismissing the claim that it failed to act in good faith in conducting the sale of its company through an accelerated negotiation process. In the case, the BOD approved a merger of Lyondell and Basell after only one week of consideration. In its decision, the Supreme Court had reference to the Revlon v. MacAndrews and Forbes Holdings124 case where the directors failed to obtain the best available price in selling the company.

In Revlon, the court said that the directors should have tried to maximize the sale price for the benefit of the shareholders, rather than

120 Stone v. Ritter, 911 A.2d 362, 367 (Del. 2006) section 102(b)(7) provision in a corporation’s certificate of incorporation can protect directors from monetary liability for a breach of the duty of care, but not for conduct that is not in good faith or a breach of the duty of loyalty.
121 Walt Disney Co., 907 A.2d at 751 Stone, 911 A.2d at 370
122 Lyondell Chemical Corporation v. Ryan C.A. No. 3176 (Del. March 25, 2009)
attempt to minimize their own liability to the shareholders. The court stated that the Chancery Court had applied the law in Revlon incorrectly. Unsurprisingly, the Lyondell charter contained a Section 102(b)(7) provision, which protects directors against claims for breaches of the duty of care. The court reiterated that S102(b)(7) will not protect directors in instances of a breach of duty of loyalty or acts or omissions not in good faith, which is what the Plaintiffs would have had to prove to be successful in their claim.\footnote{Delaware Supreme Court Overturns Delaware Chancery Court's Lyondell decision, Clarifying Delaware Law on Directors' Fiduciary Duties under Revlon (April 2003) available at \url{http://www.dwpv.com/en/17620_23492.aspx} (accessed on 26 October 2009)}

### 2.3 The Business Judgement Rule

Justice Strine points out that it is ‘managerial ingenuity’ that creates profits for shareholders through the invention and exploitation of new products, efficient developments and provision of services and sound financial management.\footnote{Op cit note 2 at 5}

Delaware corporate law recognises the above fact and allows directors a wide discretion to make business decisions. The business judgement rule prevents the judiciary from second guessing the business decisions of management, even when they turn out badly, and thus allows managers to take high risks for high rewards.\footnote{Ibid}

In order to regulate abuse of power by directors, Delaware uses statutory means to prevent and remedy disloyalty. One important mechanism is that under Delaware law all directors must stand for election annually. Accountability to shareholders encourages ‘before-the-fact’ responsiveness and ‘after-the-fact’ accountability.\footnote{Ibid at 6} Another tool to keep managers in check is the identification of certain transactions, which require shareholder approval. South Africa has similar provisions in its companies act. For
example, the sale of a greater part of the companies’ assets will require a special majority of 70 percent of the company.129

There is a rebuttable presumption that directors have acted in good faith, on an informed basis and in the interests of the company, when making business decisions. This rule serves to protect directors against claims from the company and its shareholders for losses suffered due to a poor decision. In essence it protects directors against potential claims on the grounds of breach of the duty of care.130 The rationale for the rule is the recognition by courts that, in the inherently risky environment of business, Boards of Directors need to be free to take risks without a constant fear of lawsuits affecting their judgment.131

When it comes to acting with care and skill the question is not whether you got it right or wrong, but whether the decision was reasonably informed and rational. A director is not liable for a mere error of judgement. The question is then, whether there is such a thing as a reasonable business decision?

The Business Judgement rule was developed in the USA and looks at whether a decision was properly informed and rational. Although the business judgement rule has never been codified, S R4.01(c) of the American Law Institute’s Principles of Corporate Governance: Analysis and Recommendations proposes the most commonly used test:

‘A director or officer who makes a business judgement in good faith fulfils his duty [of care] if:
(1) He is not interested in the subject of his business judgment;

129 The Companies Act, No. 71 of 2008 S112(2)(a)
131 See Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919) in which the court ruled that courts shall not interfere in the management of the directors unless it appears clear that they are guilty of fraud or misappropriation of the corporate funds, or a refusal to declare a dividend when the corporation has a surplus of net profits which it can, without detriment to its business, divide among its stockholders, and when a refusal to do so would amount to such an abuse of discretion as would constitute a fraud, or breach of that good faith which they are bound to exercise towards the stockholders.
(2) He is informed with respect to the subject of his business judgement to the extent he reasonably believes to be appropriate in the circumstances; and
(3) He rationally believes that the judgement is in the best interests of the corporation.\textsuperscript{132}

The business judgment rule creates a presumption that disinterested directors made a reasonable business judgement, unless the complaining party can prove directors' actions were not in good faith, were undertaken on the basis of an information-gathering process that was grossly negligent, or were irrational as a substantive matter.\textsuperscript{133} The presumption allows directors to make business decisions without the fear of incurring liability if they act in good faith and exercise reasonable care in gathering information to make an informed decision.\textsuperscript{134}

In Delaware, the business judgment rule arises from the fundamental principle that the business and affairs of a Delaware corporation are managed by, or under, its board of directors.\textsuperscript{135} In carrying out their managerial roles, directors owe a fiduciary duty to the corporation and its shareholders.\textsuperscript{136}

In \textit{Brehm v. Eisner},\textsuperscript{137} the Delaware Supreme Court found that the Business Judgment Rule shielded the Board, which the Court found to have exercised bad business judgment, since it essentially complied with the decision in \textit{Smith v. Van Gorkom}\textsuperscript{138} of informing themselves, via an expert, before approving the severance package. Thus the rule seems to protect even terrible business decisions from judicial review and has been called "one of the worst decisions in the history of corporate law."\textsuperscript{139}

\begin{flushleft}
\textsuperscript{132} American Law Institute’s Principles of Corporate Governance: Analysis and Recommendations S R4.01(c)
\textsuperscript{133} \textit{Aronson v. Lewis}, 473 A.2d 805 at 812
\textsuperscript{134} Ibid
\textsuperscript{135} Del. Code Ann. tit. 8, § 141(a)
\textsuperscript{136} Op Cit note 108
\textsuperscript{137} \textit{Brehm v. Eisner} 746 A. 2d 244 (Del. 2000)
\textsuperscript{138} Op cit note 108
\end{flushleft}
2.3.1 The South African Business Judgement Rule

In 1951 Levin v Felt Tweeds Ltd\textsuperscript{140} confirmed the use of the business judgement rule in South Africa. The case involved a proposed scheme of reconstruction by a company in order to pay off all its preference shareholders. The case confirmed that it is not the duty of the court to consider what is in the best interests of the company.\textsuperscript{141}

Most recently in South Africa a statutory version of this common law rule has been included in the Companies Act of 2008.\textsuperscript{142} The decision to codify the business judgement rule in South Africa was met with much resistance as it has been argued that its codification will lower the standard expected of directors for exercising the duty of care.\textsuperscript{143}

Section 76(4) states:

\textit{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—}
\textit{(a) will have satisfied the obligations of subsection (3)(b) and (c) if—}
\textit{(i) the director has taken reasonably diligent steps to become informed about the matter;}
\textit{(ii) either—}
\textit{(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}
\textit{(bb) the director complied with the requirements of section 75 with respect to any interest contemplated in subparagraph (aa); and}
\textit{(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 reasonableness of this belief will depend on whether the director was properly informed, whether the director had a personal interest in the subject matter of the

\textsuperscript{140} Levin v Felt & Tweeds Ltd 1951 (2) SA 401 (A)
\textsuperscript{141} Ibid at 401, 414
\textsuperscript{142} The Companies Act, No. 71 of 2008 S76(4)(a)
\textsuperscript{143} Botha & Jooste ‘A Critique of the Recommendations of the King Report regarding a Directors Duty of Care and Skill’ (1997) 114 S.A.L 65
belief, and the belief was rational. This is, in effect a codification of the US business judgement rule, and creates a presumption that the duty of care and skill referred to in the act have been complied with.

Borrowing legislation from foreign legal regimes can be tricky and often unsuccessful. In South Africa, the courts have already made it clear that directors are not liable for mere errors of judgment, and a court will not question the correctness or substitute its opinion for that of directors. With the codification of both the business judgement rule, an American principle, and the codification of directors’ duties, a route followed in the UK, South Africa may have caused more confusion than clarity.

The test laid down in the Act for care and skill has both subjective and objective elements which differ from the common law position and the business judgement rule may encourage directors to take on high risk when they believe the decision is in the best interests of the company. This creates a double standard where directors are expected to fulfil both the objective and subjective requirements of the duty of care in subsection 76(3). Subsection 76(4) states that the requirements in subsection 76(3)(b) and (c) will be complied with if the requirements for the business judgement rule are met. Subsection 76(4) seems to imply that when the business judgement rule is fulfilled, a director will automatically be deemed to have complied with the duty of care and skill. Essentially, subsection 76(4) appears to make subsections 76(3)(b) and (c) redundant.

In the US the development of the business judgement rule has led to a decrease in the distinction between directors’ fiduciary duties and the duty of care and skill. This is not a route one may wish to follow in South Africa as the fiduciary duties find their origins in Roman-Dutch law, whereas the duty of

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144 The Companies Act 2008 Subsection 76(4) and see Companies Bill of 2007 cited in Jones, E. op cit note 130
145 Howard Smith Ltd v Ampol Petroleum Ltd & Others (1974) 1 All ER 1126 (PC) at 1131-1132
care originates from English law and there are different consequences for the breach of these respective duties. 147

2.3.2 Comparison of the Business Judgement Rule in the USA and South Africa

One of the most notable differences between the South African codified business judgement rule and the United States’ business judgment rules is the absence of the requirement of a ‘business judgment.’ Under the South African Companies Act all that is required is a “decision” by the director or that the director support a “decision” of a committee or the board within subsection 76(4)(iii). Thus subsection 76(4)(a) potentially has a more expansive reach than the United States’ rule. 148

Other than the abovementioned difference, subsection 76(4)(a) appears to mimic the United States’ business judgment rule. Subsection 76(4)(a)(i) includes a duty to be informed; to meet this duty the director is required to take “reasonably diligent steps to be informed” allowing for an objective test, which may be more favourable than the United States subjective approach. In addition to this, neither the South African provision, nor the United States’ business judgment rule, requires that the director’s decision be made in good faith and for a proper purpose. 149

A major failing in the South African provision is the wording regarding the requirement for an absence of a financial interest in the subject matter of a decision. In the United States the provision allows for both a personal and financial conflict but, the South African provision is confined to a director’s own personal financial interests. It is clear that personal as well as financial interests may cloud directors’ decision-making process as directors may compromise their independence for reasons other than financial interests. 150

147 Ibid
149 Ibid
150 Ibid
Subsection 76(4)(a)(ii)(aa) follows the United States provision with the requirement of an absence of a financial interest by the director and by “any related person.” The section further states that there be “no reasonable basis to know that any related person had a personal financial interest in the matter.” This extension is important as it safeguards against a director stating they have no personal conflict, while a member of their family has a financial interest in the matter. The shortcoming of this provision is the subjective test allowing a director who had “no reasonable basis” for knowing the related party has a financial interest to escape liability. As Directors would not always know of the financial interests of related parties, the addition of an objective test for reasonableness may prove more effective.\textsuperscript{151}

Subsection 76(4)(a)(ii)(bb) allows a director to escape the duty discussed above upon compliance with the disclosure requirements set out in section 75. There is no equivalent provision to this in the United States, and one of the serious pitfalls of this provision is that subsection 75(4) allows the director to disclose a financial interest in advance. The danger of this provision is that it allows a director the protection of the South African business judgment rule when they not only had a financial interest in a decision, but did not formally declare that conflict of interest in the relevant board meeting.

Another pitfall in the South African business judgement rule is the reduction of the standard of review to rationality rather than reasonability under Subsection 76(4)(a)(iii). Therefore, a director may discharge his duty to act in the best interests of the company by merely stating there was a rational basis for believing a decision was in the best interests of the company. This allows directors to make unreasonable decisions, as long as the judgement, in making the decision, was not irrational.\textsuperscript{152} To illustrate the severity of this problem, one may often consider another's behaviour as unreasonable, while one would rarely find another's conduct irrational.\textsuperscript{153}

\textsuperscript{151} Ibid
\textsuperscript{152} Tunc ‘The Judge and the Businessman’ 1986 (102) \textit{LQR} 560.
\textsuperscript{153} Eisenberg 1993 \textit{Fordham L Rev} 443; Eisenberg 1990 \textit{Uni Pitt L Rev} 960.
The main problem with the impact of Subsection 76(4)(a)(iii) is that it conflicts with the provisions of subsection 76(3)(c). While subsection 76(3)(c) imposes a reasonable director test as the standard of conduct, subsection 76(4)(a)(iii) merely calls for rationality. As discussed above, such a divergence in the standards of conduct and review is inappropriate. Subsection 76(4)(a) is expressly confined to the statutory duty of care and does therefore not create a presumption of compliance with the common law duty of care. This creates a further divergence in the standard of reviews under the common law and the Companies Act. As mentioned above, ‘rationality’ is an inappropriate standard of review in the contemporary world of corporate governance.  

With the codification of directors’ duties in the new Companies Act, the danger of directors being held liable for the detrimental results of unsuccessful transactions has increased. However, subsection 76(4)’s codification of the business judgment rule creates a balancing effect. It should be noted that if South Africa’s corporate environment becomes too hostile to attract capable management then the overall quality of business shall inevitably deteriorate, to the obvious disadvantage of shareholders. Placing onerous duties on directors detracts highly qualified business people from wanting to hold office, as higher qualification and experience increases the burden of duty placed on a director. There has been much debate as to whether the codification of directors’ common law duties should be extensive or partial to serve primarily as a form of education. Michele Havenga has argued in favour of partial regulation in order to retain flexibility and make the law more accessible.

154 Op cit note 149 at 35
155 Companies Act 71 of 2008 section 76
2.4 Role of Compensation (equity related) in Corporate Risk Taking

2.4.1 Directors’ Compensation and its Role in Corporate Risk Taking

One of the most prominent concerns exposed by financial crisis is how executive pay encourages risk taking and in some instances rewards for pay-for-failure. As the executives who made investment decisions were not placing their own money at risk, they were benefiting, in some instances, regardless of the outcome. This encouraged high-risk behaviour. 157

John C. Coffee Jr. assesses the role of company directors and outside gatekeepers and links recent company failures to managerial and gatekeeper compensation. He states responsibility for these failures lies with managers, gatekeepers and shareholders, particularly institutional investors. 158 He believes the fundamental developments that led to the destabilisation of our corporate governance system were those that changed the incentives offered to both senior executives and corporations’ outside gatekeepers. 159

In the 1990s, the growing takeover movement combined with the increased use of equity compensation, an increase in institutional investor activism calling for deregulation and the media’s growing fascination with the market, resulted in taking greater risks to inflate their stock prices. 160 During the period 1990 – 1999 CEO’s of public corporations remuneration went from amounting to five percent of their total annual remuneration, to an estimated

157 Countrywide Financial, Merrill Lynch and Citigroup were collectively responsible for a loss of $20 billion in the last two quarters of 2007. It is no surprise that the 3 companies CEOs have departed. These CEOs all received extremely high pay packages while their companies prospered then ultimately suffered a huge loss. From 2002 to 2006 the 3 CEOs collectively received more than $460 million while the alignment between CEO compensation and shareholder interests ceased in 2007. However, CEOs continued to receive extremely high compensation.
159 Ibid at 279 The term gatekeeper refers to intermediaries who provide verification and certification services to investors.
160 Ibid at 275
sixty percent.\textsuperscript{161} There was a shift from cash-based remuneration to stock-
based remuneration. During this time there was an increase in accounting
scandals, most of which were based on the premature recognition of
income.\textsuperscript{162} Directors took on high risks and collected large salaries based on
the recognition of this premature income.

The South African Reserve Bank's annual report on bank supervision
highlighted key concerns on executive remuneration. Firstly, incentive
schemes were misaligned and linked to short-term performance, rather than
the long-term interests and objectives of the institution, and the second
concern was that the incentive schemes had significant upside with no, or
limited, downside and might encourage excessive risk-taking.\textsuperscript{163}

After the introduction of SOX, firms decreased CEOs' incentive
compensation, increasing their non-forfeitable fixed salaries, thereby
providing insurance to managers for the increased risk.\textsuperscript{164} Of course, such
adaptation comes at a cost, since it is probable that prior to the regulation,
firms had optimized compensation contracts. Moreover, that cost is borne by
shareholders, the purported beneficiaries of the regulation, and not
managers, the objects of the regulation. Further, there may well be
unintended negative consequences of such legislation. During the debates
over SOX, for example, some members of Congress contended that the
federal legislation limiting the tax deduction for managerial compensation to
$1 million unless it was performance-based, caused firms to increase
managers' stock and option compensation, the increased use of which, is
now being identified as the reason for the accounting misconduct by the

\begin{footnotes}
\item[161] See Altman, D. How to Tie Pay to Goals, Instead of Stock Prices, N.Y. Times Sept 8 2002 3
Business at 4 (citing data collected by Harvard Business School Professor Brian J. Hall); Between
1992 and 1998 Standard and Poor's median remuneration for 500 Chief Executives increased by
approximately 150%. Option based remuneration accounted for the majority of this increase. Op cit
note 158 at 275
\item[162] Ibid at 277
\item[163] In 2007, the big five banks in South Africa paid their directors a total of R422m, according to
research recently compiled by the Financial Mail. More than 20% of total pay was made up by
incentives. Available at http://www.reservebank.co.za (accessed 2 December 2007)
\item[164] Cohen, et al. The Sarbanes-Oxley Act of 2002: Implications for Compensation Structure and Risk-
Taking Incentives of CEOs (manuscript 2004).
\end{footnotes}
managers of Enron and other scandal-plagued firms.\textsuperscript{165}

Coffee highlights the fact that it is almost impossible to legislate or formulate optimal executive compensation rules for all publicly held companies as a one-size fits all approach shall not work.\textsuperscript{166} He suggests a more practical solution is to encourage institutional investors to address this problem. This can be done by introducing mechanisms to pass shareholder proposals approved by majority vote at shareholder meetings, or by allowing institutional investors to nominate one or more minority directors on the corporation’s own proxy statement in order to minimize the costs of shareholder activism.

2.4.2 Remuneration Reforms in the UK

In the UK the Financial Services Authority (FSA) has highlighted concerns that inappropriate remuneration schemes, particularly in the areas of investment banking and trading, may have contributed to the financial crisis. Schemes, which place excessive emphasis on short-term performance, and encourage and reward the taking of immediately profitable positions, without equally dis-incentivising the accompanying risk to shareholders, are, therefore, inconsistent with sound risk management.\textsuperscript{167}

UK law states that directors are not entitled to any remuneration unless their company’s constitution expressly permits it. Modern articles of association of listed companies will usually provide the maximum for directors’ fees, which can only be altered by ordinary resolution of shareholders. The board will, however, normally be empowered to

\textsuperscript{166} Op cit note 158 at 305
determine the remuneration of directors as executives under their service contracts.\textsuperscript{168}

The FSA's goal is to ensure that remuneration policies are "aligned with sound risk management systems and controls, and with the firm's stated risk appetite"\textsuperscript{169}. On 26 February 2009, the FSA published a draft code of practice on remuneration policies\textsuperscript{170} (The Code) to ensure that all firms have remuneration policies which are consistent with sound risk management, and which do not expose them to "excessive risk". The Code shall apply to all companies regulated by the FSA.

The Code will be used to "assess the quality of a firm's remuneration policies and linkage, if any, between such policies and excessive risk-taking by staff".\textsuperscript{171} Further to this, the FSA may ask a firm's remuneration committee to provide it with evidence of how well the firm's remuneration policy complies with the principles, and where the principles are not being met, it will ask for the firm's plans for improvement. The FSA will also ask firms to use the principles as part of the Internal Capital Adequacy Assessment Process (ICAAP), in order to assess their exposure to risks arising from their remuneration policies.\textsuperscript{172} The FSA is also working with the EU and

\textsuperscript{168} It is now common practice for listed companies to have separate remuneration committees. The Higgs review found that all except two of the companies in the FTSE 350 have a remuneration committee, as do 85 percent of companies outside the FTSE 350. PLC: Remuneration Committees and the role of non-executive directors available at: http://www.pwc.ch/user_content/editor/files/publ_tls/pwc_uk_fsa_gov_code_best_practice_e.pdf (accessed on 23 November 2009)

\textsuperscript{169} This is consistent with the obligations under Principle 4 of the FSA's Principle for Businesses that requires each firm to maintain adequate financial resources; See TEXT-"Dear CEO"; UK regulator's statement on executive pay, Mon Oct 13, 2008 4:31am EDT, available at: http://www.reuters.com/article/idUSLD20599920081013 (accessed on 25 November 2008)

\textsuperscript{170} FSA draft code on remuneration practices, 26 February 2009. The Code states that a remuneration committee should:
(a) exercise, and be constituted in a way that enables it to exercise, independent judgment;
(b) be able to demonstrate that its decisions are consistent with a reasonable assessment of the firm's financial situation and future prospects;
(c) have the skills and experience to reach an independent judgment on the suitability of the policy, including its implications for risk and risk management; and
(d) be responsible for approving and periodically reviewing the remuneration policy and its adequacy and effectiveness.


\textsuperscript{172} Ibid
international bodies and regulators to create a global framework on bank incentive schemes, to stop executives from holding banks to ransom.173

2.5 Effect of Regulatory Relaxedness and Risk Taking

Corporate law exists to govern the relationships between shareholders and managers of corporations. Corporate law is not designed to protect society; what protects society is regulatory law. For this reason, regulatory law acts as a critical component to corporate law in situations where profit-seeking incentives cause companies to overreach and take on high risks. It does this by assessing the impact of profit-seeking activities against the interests of third parties and society as a whole.174 In Delaware, corporate law reinforces regulatory law by requiring corporations to take lawful actions for lawful purposes. Corporate law demands directors act in shareholders’ best interests. Strine makes note of the fact that where regulatory law is too weak, profit-seeking can result in systematically dangerous consequences for society.175 Although similarly, over-regulation is not without problems, as over-regulation may over-burden directors and prove costly for shareholders.

3. CHAPTER THREE

3.1 What should the corporate governance response be?

As Strine emphasises, it is regulation and not corporate law that provides safety to ensure the national economy is not endangered by firm failures. It is corporate law that goads directors to create wealth for shareholders and provides shareholders with the tools for holding directors accountable for the failure to create profits.176 This, combined with the short-

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174 Op cit note 2 at 23
175 Ibid
176 Ibid at 2
term goals of shareholders, creates a stimulus for risk taking, which requires careful regulation.

Strine highlights the fact that the corporate failures today are due largely to the fault of institutional investors as these investors are often in a position to influence corporations. In this regard corporate law could be used as a tool to hold institutional investors accountable for the generation of durable profits, and focus their activism on that objective. Here, they should be held accountable for acting in a way which is more consistent with their end user investors’ interests.

3.2 Who is responsible for risk management at the moment?

At the moment the Audit committee, in many corporations, has been delegated the task of risk management. This places a great deal of responsibilities on the already overburdened committee. For this reason, many have raised the possibility of the establishment of a separate risk management committee, which would create a scaling down of responsibilities.

In an empirical study by RiskMetrics Group of 11 corporations impacted by the financial crisis it was noted that most responsible corporations already had some mechanism in place to mitigate relevant risks for their corporation. However, it was also noted that only three percent of S&P 500 companies have stand-alone risk committees in place at present. As observed in the financial sector, some boards delegate risk management responsibility to audit committees, finance committees, or asset quality committees, while other smaller institutions may reserve it for the full board.

177 According to Professor Gupta, “Audit Committees should be responsible for financial reporting and disclosure related risks but not for operational and credit risks. That is the function of a risk committee or asset committee in case of a financial services company.”

178 King III, RiskMetrics Group (2008) Credit Crisis and Corporate Governance Implications: Guideline for Proxy Season and Insight in to Best Practice


180 Op cit note 178
Determining which committee will be responsible for risk oversight will depend on which committee has the resources. In the RiskMetrics study, although the committees responsible for risk varied across the 11 companies observed, it was noted that from 2006 to 2008, a vast majority of the financial institutions have not changed their committee responsible for risk management, which is usually the Audit Committee, in accordance with regulatory requirements.

The study found that only JP Morgan and Wachovia had stand-alone risk committees over the specified time period, and, incidentally, suffered comparatively smaller declines in shareholder value in conjunction with the sub-prime crisis.\textsuperscript{181} Although there is no compelling evidence to suggest that certain committee structures responsible for risk work better than others, the RiskMetrics study showed JP Morgan, Wells Fargo, and Goldman Sachs, three companies that were less affected by the sub-prime storm, relative to their peers, all had different committees responsible for risk (JP Morgan--Risk Policy Committee; Wells Fargo—Audit and Examination Committee; and Goldman Sachs—Audit Committee).\textsuperscript{182}

Risk is broadly defined as anything that could preclude a company from achieving its objectives and is inherent in doing business. From the audit committee’s perspective, risk can fall into two general categories: financial reporting risks, such as critical accounting judgments and estimates, and non-financial reporting risks with possible financial reporting implications, such as a supply chain problem, product recall, or a marketing practice affecting revenue recognition.

As the risk/reward relationship underlies virtually every aspect of business, the question is not \textit{whether} to undertake risk, but \textit{how much} risk to take and how to manage that risk effectively. Stated simply, it is management’s role to implement business strategies and manage their associated risks based on the amount of risk the company deems

\textsuperscript{181} Ibid
\textsuperscript{182} Ibid
acceptable, and the return it aims to achieve. The role of the board, audit committee, and other board committees as guardians of shareholder interests is to provide risk oversight: to help ensure the company’s process for identifying, assessing, and managing its risks is effective and in line with the company’s strategies and the expectations of shareholders and regulators.

The management and the oversight of risk, both formidable responsibilities, are made more difficult in the absence of a formal risk management process. Heavily regulated industries, such as financial services, utilities, and healthcare, tend to have more mature risk management processes in place for certain categories of risk; generally, however, risk management is still an emerging practice, often lacking a common vocabulary, consistent context, and formal framework.

Under SOX, audit committees are established “for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer.”183 In addition, however, given the spectrum of non-financial reporting risks that could affect financial statements and financial reporting policies, such as operational, strategic, regulatory, cultural, and other risks, there is growing recognition that the audit committee should also consider non-financial reporting risks that may have financial reporting implications.

The audit committee’s increasing involvement in the oversight of risk is also reflected in various regulatory compliance requirements and activities, including NYSE listing standards requiring “discussion” of risk management policies; oversight of compliance with SOX sections 302 and 404; and SEC financial reporting disclosures specifically, 10-K filings and, as appropriate, 10-Q filings mandating discussion, in plain English, of “risk factors.” In a recent review of the audit committee charters of Fortune 100 companies, the

183 Sarbanes-Oxley Act of 2002, section 205
Conference Board found that 66 percent assigned *sole responsibility* for oversight of risk management to the audit committee.\(^\text{184}\)

This broad range of views points to the need for audit committees to review their charters to ensure they understand the scope of their risk oversight responsibilities, and that their oversight activities correspond to those responsibilities. Over time, the diversity of opinion about the audit committee’s role in risk oversight may narrow, with the evolution of oversight practices, regulatory guidance, and court decisions on the matter. There is currently no “bright line” outlining such responsibilities, and therefore, leading audit committees are taking a common sense and prudent approach to determining which risks are (or should be) within the committee’s ambit.

### 3.3 Audit committee

The financial crisis has resulted in reforms, which have redefined and reemphasized the roles, responsibilities, and expectations of all the participants in a public company’s financial reporting process. Most notably, these reforms have intensified scrutiny of audit committees, whose role as protectors of investors’ interests now attracts substantially higher visibility and expectations. As a result, audit committees face the formidable challenge of effectively overseeing the company’s financial reporting process, in a dramatically changed and highly charged corporate governance environment.\(^\text{185}\)

Audit committees were first recommended by the New York Stock Exchange (NYSE) in 1939 and the SEC first recommended that publicly held

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\(^{184}\) The Role of U.S. Corporate Boards in Enterprise Risk Management, The Conference Board (in conjunction with KPMG’s Audit Committee Institute and McKinsey & Co.) When polled during the ACI Roundtable series, about 30 percent of participants said the audit committee should have primary responsibility for “all major risks” facing the company; 35 percent said the audit committee should only have primary oversight responsibility for financial reporting and regulatory compliance risks; the balance of respondents said the audit committee’s responsibilities lay somewhere in between.

companies establish audit committees in 1972. The audit committee was initially responsible for oversight of the financial reporting process, selection of the independent auditor, and receipt of audit results. However, the responsibilities of the audit committees dramatically intensified with the release of SOX in 2002. SOX adopted the following definition of the audit committee as:

A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer, and audits of the financial statements of the issuer.

SOX increased audit committees’ responsibilities and authority, and raised membership requirements and committee composition to include more independent directors. In response, the SEC and the U.S. stock exchanges proposed new regulations and rules to strengthen audit committees.

The corporate governance reforms have focused on the role and independence of audit committees and have raised expectations of their effectiveness. In a review and synthesis of the audit effectiveness literature, DeZoort et al. offer the following definition:

‘An effective audit committee has qualified members with the authority and resources to protect stakeholder interests by ensuring reliable financial reporting, internal controls, and risk management through its diligent oversight efforts”.

The above definition highlights the ultimate goal of the audit committee, which is the protection of stakeholder interests, as well as the manner in

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186 Ibid at 116
187 SOX, Section 2, Definitions, Number [3][A]
188 Audit committees are responsible for pre-approving audit and non-audit services, overseeing the auditor engagement and compensation, and providing procedures to receive, retain, and treat employee complaints. Further, audit committees have the authority to engage special counsel or expert to advise, with funding for the advisor provided by the company.
which the audit committee achieves its goals (i.e., the use of qualified members with the authority and resources to provide diligent oversight). 190

3.4 Should we have a risk committee?

Two of the new requirements under King III are the positioning of an internal audit as a strategic function that conducts a risk-based internal audit and provides a written assessment of the company’s system of internal control, including internal financial controls and the governance of risk, through formal risk management processes.

King III became necessary because of the anticipated new Companies Act and changing trends in international governance. As with King I and King II, the King Committee endeavoured to be at the forefront of governance internationally and this has again been achieved by focusing on the importance of reporting annually on how a company has both positively and negatively affected the economic life of the community in which it operated during the year under review. In addition, emphasis has been placed on the requirement to report on how the company intends to enhance those positive aspects and eradicate or ameliorate any possible negative impacts on the economic life of the community in which it will operate in the year ahead.

3.5 Encouraging shareholder activism in a manner which encourages long term growth and profitability via Institutional Investors

3.5.1 The Principal-Agent Problem

The principal-agent problem occurs due to the ability of managers to improve their remuneration by engaging in high-risk unobserved behaviour and a lack of information on these decisions being made available to external monitors of the firms, such as the shareholders and other relevant

190 Op cit at note 185
stakeholders.\textsuperscript{191} The idea that managers have an information advantage that gives them the opportunity to take self-interested actions is the standard \textit{principal-agent} problem.\textsuperscript{192} It is for this reason that the role of institutional investors is so important. Institutional investors often wield large voting power and are experienced in financial etiquette. They are therefore ideally placed to monitor the internal affairs of the company and should do so on behalf of their constituents.

The problem caused by the separation of ownership and control is a common characteristic of most companies. Berle and Means point out the problems that can occur when ownership and control are separated. Problems occur when shareholders do not have the power of information to monitor and control their managers (directors).\textsuperscript{193} Various factors can help reduce shareholders’ costs in monitoring their managers.\textsuperscript{194} One possibility is to allow shareholders direct control over management, but this also has its problems as shareholders are often widely dispersed groups and when large shareholders are involved there may be a conflict of interests. Burkhart, Gromb and Panunzi also suggest that if shareholders are in direct control it may discourage new initiatives on the part of management.\textsuperscript{195}

Unlike the widely dispersed individual shareholders, institutional investors are in a position to influence our system of corporate governance, but instead of exerting this influence and calling on firms to refrain from business strategies which involved too much leverage, institutional investors have called for their companies to take on more leverage and run on a private equity-like model to deliver higher immediate returns to investors.\textsuperscript{196}

\textsuperscript{193} Berle & Means \textit{The Modern Corporation and Private Property} (1932)
\textsuperscript{194} Shareholders can offer incentive based compensation for managers and managers should always be weary of the possibility of hostile takeovers.
\textsuperscript{195} Burkhart, Gromb and Panunzi (1997) ‘Large Shareholders, Monitoring, and the Value of the Firm’ \textit{Quarterly Journal or Economics} 112 no 3 (August) 693 - 728
\textsuperscript{196} Op cit note 2 at 19
For this reason it is argued that institutional investors should be held accountable to their constituencies for the durable consistency of wealth.  

However, the hypothesis that shareholder activism could bring about a closer alignment of company practice with stakeholder interests is not problem free. First, as investment practices today are almost always on an international level the fate of institutional investors is not necessarily locked into any particular economy. Second, it is far from clear that boards and managers will necessarily see stakeholder-friendly policies as in the best long-term interests of their companies. It is difficult to see how the comply-or-explain approach of King would have much impact on this framework. Third, accounting conventions for many aspects of social and environmental performance do not yet exist, or at least not in the form that they do for financial performance. Capital markets can act only on the information available to them, and at present, no mechanisms exist for the production of information needed to factor stakeholder-related issues into a company’s share price. As long as this situation persists, there is a need for regulation to counteract the distortions that could arise from capital market short-sightedness on these issues.

3.5.2 Disclosure of Risk

Principle 4.10 of King III demands timely, accessible and accurate risk disclosure to stakeholders including any current, imminent or envisaged risk, which may affect the long-term sustainability of the company as well as the effectiveness of the company’s risk management process. King III recommends this is done via an integrated report for the period under review. This may be done through compelled disclosure in the annual reports on financial instruments acquired in the previous financial year and

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197 Ibid
198 Armour et al (2003) ‘Shareholder primacy and the Trajectory of UK Corporate Governance’ *British Journal of Industrial Relations* 41:3 September 2003 0007-1080 pp531-555 at 549; See studies carried out by Deakin et al. (2002) which show, it is open to companies to take a low-human-capital-intensity route to competitive success, in particular in product markets with a lower quality segment.
199 Ibid at 549
200 King Report of Corporate Governance 2009 Chapter 4, Principle 4.10, 54
the risks associated with them. Although this approach may not be practicable, as one would need a system to quantify risks and this may prove an overly onerous method of encouraging shareholder activism while shareholders remain focused on short-term rewards. One answer could be the strengthening of managerial autonomy, which will require a reassessment of the law to gear shareholders towards long-term profits. This has been attempted in King III and the latest Companies Act by focusing on what the ‘interests of the company’ are and including a stakeholder-orientated approach.

Perhaps a balancing act is needed when defining the ‘interests of the company’. As mentioned previously, when a director acts in the best interests of the company, he is acting in the best interests of the shareholders as a general body. Of course, it is in the shareholders’ interests to maximise profits, but it is also in the shareholders’ interests that the company remains solvent in the long run. The long term sustainability of profit appears to be the main area of concern, which was overlooked in the years running up to the current economic crisis.

3.6 Re-defining the meaning of ‘Independence’ of Directors to Include Some Financial Experience

Strine highlights that it is not a lack of hours, but a change in board composition and tighter independence rules, which demand directors are completely independent of the corporation that are to blame for the lack of oversight and subsequent financial meltdown.201 Due to these tight independence requirements many directors have no industry experience at all. In the past it may have been commonplace for the company’s lenders or suppliers to sit on the board, but today, this is disallowed due to a potential conflict of interest. These directors may have had some conflicting interests, but their long-term concerns for the solvency or the company and for the company’s affairs, place them in a far more favourable position to manage

201 Op cit note 2 at 26
these affairs than today’s ‘independent directors’. 202 Today’s directors are interested with the concerns of equity holders who also happen to possess the most interest in aggressive risk taking.

On top of these independence requirements there is an ever increasing checklist of regulations for directors to consider. Even S404 of SOX has proved ineffective as disclosures of failed firms have revealed that none disclosed the material risks around credit default swaps, sub-prime mortgages, or mortgaged back securities. 203

In the USA the stock exchange mandates continue to be vested in one committee, the audit committee, who are tasked with responsibility for all areas of legal and accounting compliance and risk management. 204 Many companies do not have a separate board dedicated to risk management and continue to delegate this function to the audit committee. 205 With the audit committee working overtime there is a far greater likelihood something will be missed. It is clear that ‘independent’ directors need to possess some prior financial experience in order to access fundamental economic and financial risks the company may face. Therefore the stringent independence criteria appear to do nothing other than hinder companies’ ability to effectively oversee their risk taking activities.

3.7 Weighing up S301(3)(B)(II) of the Sarbanes Oxley Act: Audit Committee Member ‘Independence’ Against South Africa’s Approach

The US SOX states the criteria for an independent director in S301. 206 However, the concept of independence of board members is not new to the

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202 Ibid
203 Ibid at 27, this may be due to the fact that S404 of Sarbanes Oxley focused on control for financial reporting rather than issues of fundamental economic risk.
204 Op cit note 2 at 27
205 This is in accordance with the New York Stock Exchange Rules which require the audit committee to discuss policies with respect to risk assessment and risk management.
206 (3) INDEPENDENCE-
(A) IN GENERAL- Each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent.
USA as the Securities and Exchange Commission (SEC) first recommended ‘outside directors’ in 1972 and in 1976 a Congressional Committee expressed the need for directors to be detached from management and any other possible conflict of interest.\textsuperscript{207}

After the 2002 amendments in the USA, the belief amongst financial institutions and government is that genuinely independent directors who owe their allegiances entirely to the corporation and its shareholders are valuable to investors.\textsuperscript{208} S301 of SOX adds to the directors’ duty to be informed. Directors on the audit committee have to resolve disagreements between management and the auditor regarding the financial reporting, which requires the directors enhance their knowledge on the process used.\textsuperscript{209} To do this they should be able to rise above the boardroom atmosphere and ask challenging questions. Section 301 of SOX requires all listed companies to have audit committees composed entirely of independent directors, as defined by Congress.\textsuperscript{210} Congress also mandated disclosure of whether any of those directors were “financial experts,” along with an explanation - for firms with no expert on the audit committee - of why no committee members were experts.\textsuperscript{211}

The New York Stock Exchange (NYSE) says that directors must be majority independent and that the audit, compensation and nomination

\textbf{(B) CRITERIA—}In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee--
(i) accept any consulting, advisory, or other compensatory fee from the issuer; or
(ii) be an affiliated person of the issuer or any subsidiary thereof.
\textsuperscript{207} Speech by SEC Commissioner:
\textsuperscript{210} Codified as §10A(m) of the Securities Exchange Act. To qualify as independent, the director may not accept any “consulting, advisory or other compensatory fee” nor be an “affiliated person” of the issuer or a subsidiary.
\textsuperscript{211} Section 407. SOX’s substantive corporate governance mandates in this context are expressed as directions to the SEC to adopt rules rendering the governance provisions mandatory.
committee must be entirely independent. This comes from SOX. Some say the NYSE’s definition of ‘Independent director’ has made it almost impossible to find someone who is not affiliated with the company in a way that would disqualify him or her from being ‘independent’. In terms of the NYSE, in order to be ‘independent’ the director cannot have a ‘material relationship’ with the company.212

S301 of SOX can be divided into a two-stage test for independence. The first part of the test states that in order to be independent a director must not accept any consulting, advisory, or other compensatory fee from the company, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee.213 This section tries to protect the ‘independent’ director from possible outside monetary influence and corruption. There is nothing like this in the South African Companies Act.214

The second part of the test states that the director may not be an ‘affiliated’ person of the company or of any of its subsidiaries. The term ‘affiliated’ which covers both direct and indirect control and has been interpreted very strictly by the NYSE as mentioned previously. The South African Companies Act defines the requirements for an independent director in subsection 94(4).

Subsection 94(4) states that each member of the audit committee of a company must:

a) be a director of the company, who satisfies any applicable requirements prescribed in terms of subsection (5);
b) not be –
   i. involved in the day-to—day management of the company’s business or have been so involved at any time during the previous financial year;

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212 Op cit note 209 at 12, this ‘material relationship’ includes commercial, industrial, banking, consulting, legal accounting, charitable or family relationships.
213 Sarbanes Oxley Act 2002 S301(3)(B)(B)(i)
214 Companies Act 71 of 2008
ii. a prescribed officer, or full-time employee, of the company or another related or inter-related company, or have been such an officer or employee at any time during the previous three financial years; or

iii. a material supplier or customer of the company such that a reasonable and informed third party would conclude in the circumstances that the integrity, impartiality or objectivity of that director is compromised by that relationship; and

c) not be related to any person who falls within any of the criteria set out in paragraph (b).

According to the Companies Act all the directors on the audit committee must satisfy the independence requirement. They must not have been involved in management and not have been a full time employee in the past three financial years. However, there are no financial literacy requirements.215 As mentioned above, SOX requires disclosure in annual reports on whether any of the independent directors on the audit committee is a financial expert, and if not, the report must explain why.216

The South African test for independence defines the targeted relationship i.e. with the company or shareholders, suppliers or customers or any other director but does not mention any relationship with employees or the community, which are both capable of compromising one’s independence. It also defines the intimacy of the relationship i.e. where the relationship would lead a third party to reasonably believe that the director’s integrity, impartiality or objectivity is compromised. While SOX recognises that family, professional or financial ties may endanger a director’s independence, it does not consider personal friendships and social ties as a possible means of fettering independence.217 There is no reasonable person standard used in the US legislation.

The South African Companies Act also appears to place no restrictions on the number of non-executive directorships a person may undertake which may be problematic. It is also unclear whether independent

215 S94(5) allows the minister to prescribe minimum qualification requirements for members of the audit committee to ensure the committee is comprised of people with relevant knowledge and experience to equip the committee to perform its functions.
216 Sarbanes Oxley Act of 2002 §407(a)
217 Op cit note 208 at 6
non-executive directors are precluded from holding shares in the company or any of the companies in the group. However, as mentioned below, the latest King Report on Corporate Governance deals with this issue.\(^{218}\) SOX makes it clear that to be independent a director may not be an ‘affiliated’ person of the company, or any of the company’s subsidiaries.\(^{219}\) This requires a facts-and-circumstances test of whether the director controls, or is controlled by or is under common control with the company.\(^{220}\) A test for affiliation was incorporated in King III, which uses a figure of 5% as opposed to the 10% threshold proposed for ‘control’ by the SEC.

In South Africa we have a far smaller pool of individuals who would meet both the formal and substantive requirements of an independent director. However, the US Act has made is almost impossible to find an independent director, thus making their pool even smaller. This limited pool does not make the position competitive enough and hence, the best qualified person may be qualified in form rather than substance.\(^{221}\)

As well as Annex 3.1 of King III incorporating S94 of the Companies Act, King III elaborates on S94(4) of the Companies Act’s definition of independence of directors for the purposes of appointment to the audit committee.\(^{222}\) King III defines independent non-executive director as a director who:

67.1 is not a representative of a shareholder who has the ability to control or significantly influence management or the board;
67.2 does not have a direct or indirect interest in the company (including any parent or subsidiary in a consolidated group within the company) which exceeds 5% of the group’s total shares in issue;
67.3 does not have a direct or indirect interest in the company which is less than 5% of the groups total number of shares in issue, but is material to his personal wealth;

\(^{218}\) King Report on Corporate Governance Principle 67
\(^{219}\) Sarbanes Oxley Act of 2002 section 301
The SEC has interpreted ‘control’ to mean a non-executive officer or shareholder owning more than 10% of any class of voting security of the company but, executive officers, employee directors, general partners and managing members of a company affiliate are deemed affiliated persons
\(^{69}\)
\(^{221}\) Op cit note 209 at 12
\(^{222}\) Companies Act 71 of 2008 S94(4)
67.4 has not been employed by the company or the group of which it currently forms part in any executive capacity, or appointed as the designated auditor or partner in the group's external audit firm, or senior legal advisor for the proceeding three financial years
67.5 is not a member of the immediate family of an individual who is, or has during the three preceding financial years, been employed by the company or the group in an executive capacity;
67.6 is not a professional advisor to the company or the group, other than as a director;
67.7 is free from any business or other relationship (contractual or statutory) which could be seen by an objective outsider to interfere materially with the individuals' capacity to act in an independent manner, such as being a director of a material customer of or supplier to the company, or
67.8 does not receive remuneration contingent upon the performance of the company\footnote{King Report on Corporate Governance p38-39. Principle 67}

3.8 The difficulty faced by people with industry experience from acting as non-executive directors of companies

In the USA, state courts have fashioned doctrines that encourage the use of independent directors. For instance, Delaware courts apply a lower level of scrutiny to actions undertaken by independent directors.\footnote{In Delaware case law, director independence figures prominently in assessments of defensive tactics; derivative litigation procedural requirements; and the business judgment rule’s applicability.} That approach undoubtedly created an incentive for firms that furthered the trend throughout the 1980s and 90s toward a supermajority of independent directors on boards. But the courts’ approach to director independence is highly contextual, considered in the evaluation of whether fiduciary standards have been met, in contrast to the bright line rule approach in SOX, which simply bans entire categories of individuals from audit committee service.

Moreover, state legislatures have not codified a definition of what constitutes independence, as was done in SOX. The absence of a statutory definition facilitates the courts’ adaptation of the concept to a changing business environment. For example, the Delaware courts’ definition of independence has focused on an absence of financial interest, although a recent chancery opinion found other factors—philanthropic contributions and
personal relations among directors involving the same university—created a lack of independence.\(^{225}\) Since 1999, the stock exchanges have had listing standards requiring audit committees comprised of all independent directors, but they gave boards the discretion to appoint a non-independent director and also exempted small businesses from the requirement.\(^{226}\) These listing requirements were adopted at the behest of the SEC.\(^{227}\) In implementing the SOX audit committee independence provisions, which require the delisting of any firm that does not comply with them, the SEC eliminated the exemptions contained in the pre-SOX listing standards.\(^{228}\)

Further to this, in Chapter 3 of the King Report, there is recommendation for an independent audit committee, using the definition of independence mentioned above. These definitions of independence make it extremely difficult for people with current industry experience to take up office without removing themselves from the business arena for a period of three years. The restriction in S94(4)(b)(iii) of the Companies Act and principle 67.7 of the King Report means an aspiring ‘independent’ director must pass an objective test which forbids him or her from carrying out business as a supplier or customer of the company. This appears to create a requirement that all independent directors must be inexperienced in the business of the company to which they are appointed as independent directors. Further to this, even if the director passes the test laid out above, the requirement of a


\(^{226}\) See 17 C.F.R. parts 210, 228, 229 and 240, Audit Committee Disclosure, Final Rule, SEC release no. 34-42266, 64 Fed. Reg. 73389 (1999). These listing standards required audit committees consisting of three independent directors, but permitted one non-independent director “under exceptional and limited circumstances” if the board determined it was “required by the best interests of the corporation and its shareholders,” and the American Stock Exchange and National Association for Securities Dealers required small businesses (companies with less than $25 million in revenues and market capitalization) to have only two-member audit committees, a majority of whom were independent.

\(^{227}\) See Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (New York, NY: NYSE and NASD, 1999) where the Board concluded that consulting services should not be severed from auditing firms, and focused its recommendations on audit committees instead. The stock exchanges submitted to the SEC proposed rules that would tighten the definition of independence and impose an independence requirement on compensation and nominating committees as well as audit committees in 2002 (the proposal was the exchanges’ response to Enron predating the enactment of SOX).

three year break adds to the lack of industry knowledge independent
directors shall possess.

This high standard of independence coupled with the fact that audit
committees are already overburdened highlights the need for stand alone risk
committees whose members have relevant industry experience and are up to
date on the business of the company and the industry in which the company
operates.

However, there is no guarantee that independence guarantees good
governance and Enron is a prime example of this, having the majority of its
board of directors as 'independent'. In 1982 Professor Victor Brudney voiced
his opinions on the role of independent directors and warned that the
‘independent director is not the institution to legitimate corporate power or to
substitute for regulation in the interest of investors or society’.229 The
introduction of the ‘independent’ director has still not solved the many
corporate governance problems we face.

3.9 The Establishment of Stand-alone Risk Committees

Strine suggests the appointment of stand alone risk committees in
order to help boards and managers by reducing unnecessary mandates.
Boards need to be held accountable, not only for the generation of profits but,
for the effective management of risk.230 Principle 4.3 of King III suggests the
establishment of standalone risk committees. This task may also be
delegated to the audit committee, however delegation of this nature must be
considered carefully with reference to the available recourses of the audit
committee to adequately deal with risk governance in addition to its audit

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229 Brudney, V. ‘The Independent Director: Heavenly City or Potemkin Villiage?’ (Jan 1982) Harvard
Law Review, Vol. 95 No. 3 p659
230 Op cit note 2 at 28 Suggestion of a reduction in mandates the stock exchange rules place on boards,
particularly in instances where a separate risk committee is established separate from the audit
committee and changing the system from quarterly reporting to twice annually
responsibilities. The committee should consist of both executive and non-executive directors.

3.10 The delegation/allocation of risk responsibility by the board of directors

Directors act collectively, but based on inescapable individual responsibility of each individual director to become informed about the affairs of the company, join other directors in supervising and controlling these affairs, and not commit an individual to dominate and use them.

Directorial management does not consist of a detailed inspection of day-to-day activities, but a general monitoring of corporate affairs and policies. Matters dealt with by the board will vary from company to company, but there are certain essential functions apart from statutory duties:

1. Setting goals for the company
2. Appointing the Chief Executive
3. Overseeing managers plans for attainment of companies goals
4. Reviewing at reasonable intervals the progress of the company towards its goals

This means directors are not required to control everything, know everything, or supervise co-directors, but they are required to see that the company’s monies are properly invested, to be familiar with its financial status by regular review of financial statements and further enquiry where it is called for. There is a continuing duty, individually and collectively to acquire and maintain enough knowledge and understanding of the companies’ business to discharge these duties properly. Directors must meet as often as is necessary for this, ensuring the company has the means to monitor management and be informed by management, not of details, but of anything untoward or appropriate of their consideration. The larger the business, the

231 King Report on Corporate Governance Ch4 Principle 4.3
232 Op cit note 33 at 5 -6
more numerous and more important are the matters directors have to leave to others. Therefore, to ascertain what functions the directors have undertaken to perform, it is necessary to consider the nature of the company’s business and the manner in which work is distributed, provided that this is reasonable in the circumstances and not inconsistent with the articles. 233

Directors cannot delegate their functions unless permitted to do so by the articles. If they are permitted to delegate, they must still supervise and remain responsible. There is always a residual duty of supervision and control. The extent of this residual duty and whether it has been discharged is a question of fact. Directors can trust suitably qualified officers and in the absence of proper reasons for enquiry, can rely without verification on the judgment, information and advice of such officers. However, they cannot do so blindly and must be reasonable in the circumstances. There must be no grounds for suspicion and there may be problems where advice ought not to be relied upon without confirmation. Finally, a director must always give a matter consideration and exercise his own judgment in the light of information and advice given. 234

Prior to making a decision, directors must inform themselves of all material information reasonably available to them. If a situation is complex and requires specialist knowledge they may be required to seek expert advice and can rely upon information provided by specialists. 235 As complexities of commercial life have increased, courts have accepted that communities expect more than formerly of directors, especially where there are substantial resources and numbers of employees involved. 236

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233 Ibid at 6-7
234 Ibid at 7-10
235 Ibid at 10
236 Ibid at 13
Principle 4.4 of King III allows the board to delegate the responsibility to design, implement and monitor the risk management plan although the responsibility for risk management shall remain with the board as a whole. 237

3.11 King III on Risk Governance vs. Risk Management

King III places the responsibility on the board to oversee effective corporate governance and monitor risks. The board should approve both long and short-term strategies and in doing this, the board should consider the legitimate interests and expectations of the company’s stakeholders. 238 The board needs to ensure that long-term planning will result in sustainable outcomes and weigh the risk against the opportunity. ‘Value’ is described using an enlightened shareholder approach and encompasses the ‘triple bottom line’ of social, economic and environmental performance. Therefore, directors need to consider the interests of other stakeholders besides the shareholders when assessing risks and the interests of the company. This approach is very important as it recognises that without regard to long-term sustainability issues, the company shall not be able to operate in an economically viable manner over a prolonged period of time. 239

It is the board’s duty to ensure that the company has an effective and independent audit committee. 240 Principle 2.14 states the board and directors must act in the best interests of the company in terms of the common law and with reference to the bill of rights, which departs from the traditional interpretation of the interests of the company. 241 The duty to act with care, skill and diligence is also referenced in principle 2.14 in line with S76 of the Companies Act.

237 King Report on Corporate Governance Ch2 Principle 2.7
238 Ibid at Ch2 Principle 2.2
239 Ibid
240 Ibid at Ch2 Principle 2.6
241 As mentioned in Chapter two of this paper, the traditional interests of the company are the interests of the shareholders. The King Report suggests a more stakeholder oriented approach in line with the Bill of Rights and focused on the long term sustainability of the company rather than the short term generation of wealth.
King also suggests a separation between the CEO and Chairman and the appointment of a Chairman who is an independent non-executive director.\textsuperscript{242} The failure to separate the Chairman and CEO was noted in RiskMetrics study in a high volume of corporate failures.\textsuperscript{243} The trend in the US is now also to split the role of chairman and CEO, although hardly any corporations have appointed an independent chairman.\textsuperscript{244}

As mentioned previously, Strine recommends scaling down on the number of responsibilities placed on the BOD so they can monitor, which is exactly what King III has suggested. By allowing the board to delegate, but maintaining their responsibility of oversight, directors become more effective watchdogs.

### 3.12 Responsibilities placed on the BOD by King III and the Companies Act

Chapter 2 of the King III places numerous duties on the BOD. The board is responsible for corporate governance and risk oversight and is responsible for appointing and independent audit committee. In addition to these responsibilities, King III reinforces the common law duties to act in the best interests of the company, to act with care, skill and diligence and to avoid a conflict of interests.\textsuperscript{245}

The Companies Act of 2008 partially codifies all the fiduciary duties but, also introduces a statutory version of the business judgement rule to aid directors who acted in good faith on a rational and informed basis.\textsuperscript{246}

\textsuperscript{242} King Report on Corporate Governance Ch2 Principle 2.16  
\textsuperscript{243} Op cit note 178 at 10-11, the study noted that the majority of financial firms in their empirical study had a combined chairman and CEO in the years leading to the corporate meltdown.  
\textsuperscript{244} As of 2007 37 percent of S&P 500 Companies had a separate Chairman and CEO although only 11 percent had an independent chairman.  
\textsuperscript{245} King Report on Corporate Governance Principles 2.1-2.14  
\textsuperscript{246} Companies Act 2008 S76(4)
3.12.1 Are the Responsibilities too Excessive and do they Prevent the BOD from Monitoring Management?

A director cannot shirk his duties by leaving everything for the other directors or by sheltering behind ignorance, being a puppet or blindly following others instructions. In earlier cases very little was expected of directors. Today, even though directors are selected for their personal knowledge and experience, they are expected to exercise a greater duty than just representing their field of expertise. They are required to understand the nature of the duty of directors, become familiar with the fundamentals of the business of the company, how it is run, and keep up to date with its activities. If a person believes he is incapable of doing this he should acquire knowledge by enquiry or refuse to act.\(^{247}\)

A director must devote a sufficient amount of time and energy to discharging his responsibilities to the company and to being generally informed with its business and financial conditions, but need not give continuous time if not required to do so by his contract. At meetings he is bound to give attention to and exercise informed and independent judgment to matters brought before the board. It has been said that he is not bound to attend all meetings, but ought to do so when reasonable able. Today directors are probably bound to attend unless exceptional circumstances exist and they ought to call for further meetings if reasonable grounds for them exist. The higher the remuneration, the more responsibilities that may reasonably be expected.\(^{248}\)

\(^{247}\) Op cit note 33 at10-11
\(^{248}\) Ibid at 11-12
4. CHAPTER FOUR

4.1 Recommendations and Conclusions

In conclusion, the following corporate governance mechanisms could serve as effective tools for the monitoring and prevention of excessive risk-taking behaviour:

4.1.1 Directors Duties

Today, directors are required to address an ever increasing checklist of specific mandates that are dictated by stock exchange rules and codes of corporate governance. These mandates leave directors with scarce time to think about the big picture. By establishing separate committees to address risk and remuneration, directors may be able perform their duty to monitor and oversee management in a more effective manner.

However, although boards should not micro manage a company’s risk system, they should be held accountable for overseeing management’s decision-making and risk monitoring process. The formation of committees and controls may serve as part of the infrastructure of a strong risk management system. Equally important is the extent to which the boards are engaged and whether they are asking management the right questions.249

Therefore, if some of the onerous duties placed on the board are removed via the establishment of independent committees to deal with issues such as risk and remuneration, the board will be able to exercise judgement and perform its oversight duties in a more functional manner. The

249 Op cit note 178 at 12
establishment of these committees will further reduce the responsibilities of the audit committee, who as mentioned previously, currently carry the burden of financial and operation risk oversight, at a majority of corporations. It is clear that when boards are overburdened they may not always see the big picture and important risks facing the company may be overlooked.

### 4.1.2 Stand Alone Risk Committees

King III recommends the establishment of a risk committee, separate from the audit committee. The establishment of a stand-alone risk committee would serve to lessen the audit committee’s already onerous duties and allow the BOD to monitor risk taking activity in a more effective manner.

As mentioned previously, risk management rules focus more on controls for financial reporting rather than issues of fundamental economic risk. The financial crisis reveals that there is thus a need for companies to constitute distinct risk management committees which are separate from audit committees and which must report twice a year rather than quarterly. At present, companies vest audit committees with such overwhelming and impossible responsibilities such that they (the audit committees) are destined to miss something of grave fundamental (operational) risk. By passing the duty of risk oversight to a separate committee, the audit committee will be better equipped to deal with their already copious duties of financial reporting.

### 4.1.3 Re-Defining the Requirements for ‘Independence’

As mentioned previously, King III requires the company to appoint both executive and non-executive directors, with the majority of non-executive directors to be independent, to protect minority interests. King III strengthened the evaluation for independence given by King II, and recommended that the check for independence should be reviewed annually. The Companies Act also supplies strong requirements for ‘independence,’ which make it almost impossible for skilled directors to take up office.
Non-executive directors have long been used as instruments of corporate governance. This is due to the fact they are in a position to observe the way the company is being run from a detached standpoint. However, in order to supervise management, non-executive directors need free access to company information. Even when an audit committee is in place to assist non-executive directors, its efficiency will be largely dependant on the quality of information supplied by external auditors and the co-operation of the board.

The IOD’s Code of Practice pointed out the fact that non-executive directors are often appointed by executives and may be retired executives of the same company. When there is some form of collegiality involved it makes it all the more harder to monitor ones ‘friends’. There is no incentive for a non-executive director to monitor his executive counterparts, as it appears he will not be held personally liable unless he has some kind of accounting experience. Due to corporate governance’s insistence on independence, most of the directors are completely independent of the corporation, with the result that many of the directors lack any industry-specific experience or knowledge. For these reasons it is essential that we review the new definitions for ‘independence’ put forward by King III and the Companies Act to include some financial experience.

4.1.4 Directors Remuneration

The financial crisis has helped expose pay which encourages excessive risk taking as well as potential pay-for-failure scenarios. Directors do not risk their own capital and may benefit regardless of the outcome.

250 Op cit note 43 at 197
251 Ibid at 198
252 IOD’s Code of Practice for Non-Executive Director (undated), Ch1 ref 7; Op cit note 251 at 199
253 John Shaw and Sons (Salford) Ltd v Shaw [1935] 2 KB 113
254 If the company is successful the director shall share in the success and if the risky behaviour does not materialize the director may walk away with a lucrative departure package.
The objective of a remuneration committee is to ensure that companies have a formal process of considering directors’ remuneration. Executive directors should play no part in decisions on their own remuneration; there should be an alignment of the remuneration schemes and the performance objectives of the company, and the remuneration schemes should attract and retain talented individuals. To be effective any remuneration committee should be properly constituted with a clear remit and identified authority.255

The challenge for remuneration committees is to structure pay and incentives to reasonably reward performance, while avoiding pay-for-failure scenarios, which can severely impact long-term shareholder value. However, whilst remuneration committees need flexibility to respond to changing market conditions to attract, retain and provide incentives to skilled managers, directors must also ensure that the remuneration policies are aligned with the goal of sustained long-term value creation.256

King III has recommended an appropriate mix between fixed and variable pay, which should be periodically assessed. In addition to this incentive linked compensation should not be offered to the Chairman or non-executive directors. Compensation schemes should be designed to effectively link remuneration to company performance.257 This can be achieved by structuring remuneration plans, which provide both short and long-term incentives linked to company performance, which reflects value to stakeholders.258

256 Op cit note 178 at 14
258 See ICGN Short term incentives should be linked to performance measures while long term incentive tools should consist of an appropriate mix of equity and equity like incentive structures such as share options, restricted shares and share appreciation rights available at http://www.pc.gov.au/__data/assets/pdf_file/0009/89748/sub071-attachment5.pdf (accessed on 22 August 2009)
King III further proposed that formal and transparent remuneration policy should be published in the annual financial report. These remuneration policies should be approved by the shareholders and an annual remuneration report should be issued.259

4.1.5 Institutional Investors

Strine talks about the “separation of capital from capital”.260 The separation of ownership and control was mentioned previously, but the separation of capital from capital refers to the current day phenomenon where individual investors no longer directly own shares in corporations. Instead they own shares in institutional investors such as pension funds and hedge funds who in turn own the shares in corporations. These institutional investors’ interests are not perfectly aligned with their shareholders as they make money through fees and do not have a profit motive to undertake shareholder activism at company level.

Large institutional investors have the opportunity, resources and ability to monitor, discipline and influence managers which forces managers to focus more on corporate performance and less on self-serving behaviour.261 Strine recommends a system whereby institutional investors are held accountable to their constituencies for the generation of durable wealth.262 In Delaware, the default rule is that directors should stand for election annually. This election should give shareholders, in particular institutional investors, with large voting powers, the ability to remove directors who exhibit inappropriate risk taking qualities.

259 King III
261 Op cit note 257
262 Op cit note 2 at 25
Coffee highlights a problem with institutional investor oversight, which he calls ‘herding behaviour’. This behaviour is caused by their desire to perform no worse than their competitors. By following the herd the investor will not underperform most of its rivals. Policy makers will have to grapple with the agency problem of how to make institutional investors accountable to their end-user investors.

4.1.6 Effective Regulation

The purpose of regulation is to ensure the interests of society are protected. The goals of financial regulation range from safety and stability to innovation and growth. In order to achieve these goals the regulatory system must manage risk effectively. As mentioned previously, corporate law is only effective when backed up by a strong regulatory system. It was regulation, which failed to adequately monitor and control excessive risk taking behaviour.

It is the duty of the government and not corporate law to protect its citizens from corporate meltdowns. The ‘comply or explain’ approach of South Africa appears to be working effectively as South Africa’s exposure to the recent financial crisis was limited, but South Africa’s codification of directors fiduciary duties appears to lean towards the ‘comply or else’ system advocated in the United States. Despite King III advocating the ‘comply or explain’ approach and the introduction of a codified business judgement rule to assist directors who must now comply with statutory fiduciary duties, many problems were identified with this codification in Chapter two.

4.1.7 What should the role of ‘care, skill and diligence’ be in reducing the scope for excessive risk taking?

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263 Op cit note 153 at 299
264 Ibid at 300
265 Congressional Oversight Panel Special Report on Regulatory Reform at 9
In the current economic climate with rising standards of commercial education it has been argued that the standard of care and skill required from directors should be raised. On the other hand, directors need to be free to take risks and non-executive directors should not be discouraged, by overly onerous standards, from taking up office.\footnote{Sorensen ‘Direction and its Limits – An Analytical Framework for Understanding and Applying the Duty of Care to Corporate Directors’ (1988) 66 Wash ULQ 553 at 573} It has been argued that the notion of the need to take note of other stakeholders also calls for a more rigorous standard of the duty.\footnote{Op cit note 43 at 202}

South Africa has followed the UK and codified both director’s fiduciary and common law duties.\footnote{The Companies Act, No. 71 of 2008 Section 76} The new Companies Act has been criticised by some on the basis that company directors and officers who are tasked with making difficult decisions may face a heightened threat of litigation due to the directors’ duties being made more onerous.\footnote{New South Africa Companies Bill to tighten regulation (April 2009), available at: http://international.lawsociety.org.uk/node/5884 (accessed on June 21 2009) Philip Hobson, financial lines manager at AIG SA, said on Monday, “SA is following the trend in countries such as the US, the UK and Australia in becoming more litigious, and directors and officers need to be more prepared for this,” Hobson said. “The change in regulation combined with a dire economic environment is not a nice concoction for directors to swallow.”} In addition to this, under the Act, directors can be held personally liable for breaches of their fiduciary duties and sued for loss and damages caused to creditors, employees, customers, competitors, shareholders or other stakeholders of a company.\footnote{The Companies Act, No. 71 of 2008 Section 77}

The test for care and skill proposed in both the Companies Act and King III is not in line with Romer J’s decision in Re City Equitable and Blackman’s proposition of an objective test for care and a subjective test for skill. The test put forward in codified form means that both care and skill have subjective and objective elements. If the section imposed a purely objective test it may raise the bar on what is expected from directors in order to fulfill their duty of care and skill.

More onerous duties may serve as a deterrent to potential directors taking up office. The gap between the common law and the Act is very
apparent and may lead to confusion rather than the clarity some suggested the codification would bring. While some argue that directors today should meet the same objective standards of reasonableness expected of other professionals such as accountants and lawyers\(^{271}\) the counter argument is that directors often run multi-billion dollar corporations and stand to lose a lot more financially than many other professions. This was illustrated in the American Disney\(^{272}\) case, where the directors would have been liable for approximately $130 million if the court had ruled against them. As mentioned at the outset, the purpose of this paper is to highlight the failings and dangers of corporate law reform and contrast this with the need for more efficient regulation.

With the codification of the duty of care and skill along with the incorporation of a statutory business judgement rule, directors appear to be released from exercising any duty of care whatsoever. It has been said that director’s duties of loyalty and good faith are extremely strict, while their duties of care and skill are extremely lax.\(^{273}\) This is illustrated by the fact that in South Africa there has only ever been one case where a director has been found liable for a breach of his duty of care and skill.\(^{274}\) If this is the case it seems ludicrous that the King Report recommendations seek to further decrease the instances when a director may be held liable for a breach of the duty of care and skill.

4.2 Conclusion

The establishment of effective governance procedures will help align the interests of shareholders and management. Strong regulation reinforces corporate law and ensures directors are faithful to shareholders’ best


\(^{272}\) re Walt Disney Co. Derivative Litig., 906 A.2d 27, 35 (Del. 2006)

\(^{273}\) Botha & Jooste ‘A Critique of the Recommendations in the King Report Regarding a Directors Duty of Care and Skill’ (1997) SA Law Journal Vol 114 at 68

\(^{274}\) McLennan ‘Duties of care and Skill of Company Directors and Their Liability for Negligence’ (1996) 8 SA Merc LJ 94 at 100
interests by monitoring profit-seeking behaviour. The solution is to better align the overall system of corporate governance, so that institutional investors and managers are all focused on the durable creation of wealth through the corporate sale of high quality products and services.

Well conceived and implemented regulation has the potential to not only safeguard markets against excessive risk-taking activities and abuses, but also to strengthen markets as foundations of innovation and growth.
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