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SUPERVISOR: PROFESSOR M S BLACKMAN

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"THE POWERS OF COMPANIES TO WAIVE THEIR DIRECTORS' DUTIES AND CONDONE BREACHES THEREOF, AND THE VALIDITY OF CONTRACTS IN WHICH DIRECTORS PURPORT TO CONTRACT OUT OF, OR INSURE THEMSELVES AGAINST LIABILITY".

STUDENT'S NAME: MICHAEL SPISTO
FACULTY OF LAW, UNIVERSITY OF CAPE TOWN

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(i) INTRODUCTION

> "Scores of men are politely declining offers they once would have jumped at to serve on prestigious boards ... . There now is a real shortage of competent men willing and able to serve as directors"[1].

It would seem that one must balance the need for punishing faithless fiduciaries, against the need to protect aggressive directors who are willing to take good faith risks in search of profits. This would assist in inducing responsible business men to accept the post of directors.

This paper examines the extent to which directors and officers of a company can indemnify themselves against liability and protect themselves against financial risk when accepting the posts as directors of companies. Furthermore the extent to which breaches of duty can be condoned and/or waived will be considered, as well as the extent to which directors may contract out of or insure themselves against liability.

More specifically this paper commences with an analysis of the personal liability which may be attached to directors and officers and proceeds from the basis that directors and officers are not liable for the debts of the company.

The paper then examines the various fiduciary duties attached to the position of directorship having regard to the fundamental duties of acting *bona fides* in the interests of the company, care and skill, and interest and duty.

The paper examines in detail the powers of companies to waive their directors' duties and condone breaches thereof and the validity of contracts in which directors purport to

[1]. Gartner in *Wall Street Journal*, March 13 1969 ("Many Executives Reject Proffered Board Seats as Perils of Post Mount".) p1, col 6.

contract out of liability. Indemnity and relief by way of common law and statute is thoroughly examined, and the most recent case law has been noted and fully discussed. Furthermore, ss247 and 248 of the *Companies Act* 61 of 1973 have been considered and examined.

This paper further examines the approach(es) to the aforementioned problems and considers in detail the various viewpoints surrounding the very controversial nature of s247 (s310 of the *English Companies Act* 1985 - formerly s205 of the *English Companies Act* 1948.)

Finally, this paper examines the approach(es) found in the United States of America, especially of that found in the State of Delaware, regarding the nature and extent of insurance liability for directors. In this regard analyses and recommendations of Tentative Draft No 6 (October 10, 1986) of the American Law Institute *Principals of Corporate Governance* is also examined, some of which deals with damages resulting from a breach of duty and the limitations on damages for certain breaches of the duty of care. In addition the concept of directors and officers (D & O) insurance is examined as well as the extent to which such insurance can provide the protection to directors and officers precluded by the indemnification statutes.

This paper proposes to recommend possible approaches which may be useful in South Africa to develop and improve a system which would encourage directors to act in the best interests of the company rather than causing them to be deterred from doing so by virtue of the fact that liability in respect of companies' debts and loans may attach to them and thus prove to be ultimately financially ruinous.

(ii) THE LIABILITY OF DIRECTORS AND OFFICERS

The general rule is that directors and officers are not liable for the debts of the company. This rule can be traced back to the eighteenth century cases of *Ferguson v Wilson*[2], *Anderson & Co v Reynolds and Tillard*[3], and to more recent cases of *Major v Business Corners (Pty) Ltd and Phear*[4] and *Quinton v Rodwell*[5]. There are, however, certain statutory exceptions which can be noted to this general rule.

In terms of the *Companies Act* 61 of 1973, it is noted in terms of s53(b) that the memorandum of a private company could provide that its directors during their term of office and past directors will be held liable with the company jointly and severally for the debts and liabilities of the company.

In terms of s172 of the *Companies Act supra*, it is noted that if a company with a share capital commences business before the registrar has issued a certificate entitling a company to do so, the directors and subscribers to the memorandum will be held jointly and severally liable for any debts or liabilities arising during this period[6].

Furthermore in terms of s50(3)(b) of the *Companies Act supra*, it is noted that if a director or an officer signs or authorizes to be signed on behalf of the company any bill of exchange, promissory note, endorsement, cheque or order for

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2. (1866) 2 Ch 77.

3. (1844) 4 EDC 215.

4. (1940) WLD 84.

5. (1949) 3 SA 1183 (SR).

6. *Comet Electrical Wholesalers (Pty) Ltd v SATV Cabling and Wiring (Pty) Ltd* (1977) 4 SA 254 (W).

money or goods where the company's name is not indicated legibly, the director or officer is liable to the holder for this amount unless it is to be paid by the company.

In terms of s424 of the *Companies Act supra*, it is noted that if the business of the company is being carried on recklessly or with the intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the court may declare any person who was knowingly a party to such a contract personally liable for any debts or liabilities of the company.

The question of the conflict of interest and duty arose in *Ex parte Lebowa Development Corporation Ltd*[7] where s424(1) was noted and discussed. The remedy, provided for by s424(1), supplements the common law remedies available to anyone injured by wrongdoers who carry on the business of a company and who cause injury by their *dolus* or *culpa*. The statutory remedy presupposes the existence of debts or other liabilities on the part of the company. These may include claims against the company itself, arising out of *dolus* or *culpa* or arising out of contracts. Unless there is already some independent cause of action against the company, s424 cannot be brought into operation. However, when a pre-existing cause of action lies against the company alone, s424 enables the court to extend the company's liability under that cause of action to such persons who can be shown to have knowingly carried on the company's business recklessly or fraudulently. Thus, claims by persons already enjoying a cause of action against the company may then, in terms of section 424(1), enforce an action against the wrongdoers personally. When the pre-existing cause of action lies not only against the company, but also against the wrongdoers, s424 provides the claimant with an additional remedy against the wrongdoers. It may also serve

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[7]. (1989) 3 SA 71.

to render the wrongdoers liable to additional causes of action which, in the absence of a declaration under s424(1), would be available against the company alone.

It would appear that a declaration under s424(1) is also intended to be for the benefit of the company. If a claimant should choose to recover from the wrongdoer, thus forgoing his claim against the company, the company would derive an indirect benefit from the declaration.

Regarding the conduct rendering a director personally liable, it is noted that s424(1) specifies four ways of conducting the business of a company resulting in a declaration, that is, (i) recklessly, (ii) with intent to defraud creditors of the company, (iii) with intent to defraud the creditors of some person other than the company, (iv) for any fraudulent purpose. A reckless or fraudulent act (or omission) by a director or other officer in the name of the company need not necessarily occur in the carrying on of the business of the company. In this situation, a person so injured will not be able to obtain a declaration under s424(1) and will be confined to his common law right of action. It is to be further noted that in the context of s424, "recklessly" is used in contradistinction to the term "fraudulently". That is, "recklessly" implies the existence of the objective standard of care that would be observed by the reasonable man in conducting the business of the company. A departure from that standard constitutes negligence, while a more serious departure constitutes gross negligence which, in the context of the section, is the same as recklessness.

(iii) FIDUCIARY DUTIES OF DIRECTORS

(A) General

In ***Aberdeen Rly v Blaikie***[8], Lord Cranworth LC stated that:

> "a corporate body can only act by agents and it is the duty of those agents so to act as best to promote the interests of the corporation whose affairs they are conducting. Such agents have duties to discharge of a fiduciary nature towards their principal. And it is a rule of universal application that no one, having such duties to discharge, shall be allowed to enter into engagements in which he has ... a personal interest conflicting ... with those whom he is bound to protect. So strictly is this principle adhered to that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into".

It is to be noted that a director, from the time of his appointment, stands in a fiduciary relationship to the company. This fiduciary relationship arises for the purpose of benefitting the company. Thus the fiduciary nature of the relationship ensures that they are used and exercised for that purpose alone.

In *Fisheries Development Corp supra*[9], it was noted that the director's duty is to observe the utmost good faith towards the company and in discharging that duty, the director is required to exercise an independent judgment and to take decisions according to the best interests of the company as principal. He may be representing the interests of the person who nominated him, and he may even be the servant or agent of that person but, in carrying out his duties and functions as a director, he is in law obliged to serve the interests of the company to the exclusion of the interests of any such nominator, employer or principal. He cannot

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[8]. (1854) 1 Macq 461 (H.L.Sc).

[9] 163 E to H.

therefore fetter his vote as a director except where there is a contract for the board to vote in the interests of the company and as a director, he cannot be subject to the control of any employer or principal other than the company.

The director has two fundamental duties:

(a) he must exercise his powers *bona fide* in the interests of the company;

(b) he must not place himself in a position where his personal interests may conflict with his duties to the company.

From these duties, various other duties follow: a director may not fetter his discretion or act for a company in which he has an interest or deal with the company otherwise than in good faith or make a secret profit or take certain economic opportunities or compete with the company.

The company's two primary remedies for breach of duty are:

(a) a right to claim any benefit or profit acquired by the director from the breach;

(b) a right, in certain circumstances, to set aside contracts entered into by it.

In *Industrial Development Consultants Ltd v Cooley*[10], *Canadian Aero Services Ltd v O'Malley*[11] and *Atlas Organic Fertilizers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd*[12], it is noted that the company may claim damages in respect of loss it has suffered as a result of the breach.

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10. (1971) 2 All ER 162 176.

11. (1974) 40 DLR 3d 371 392.

12. (1981) 2 SA 173 (T) 200-201.

In *Transvaal Lands Co v New Belgium (Tvl) Land and Development Co*[13] and *Bamford v Bamford*[14], it was stated that an exercise of a power in breach of a fiduciary duty is, nevertheless, a valid act and is voidable only against the directors themselves and third parties with knowledge of the director's breach of duty. Furthermore, because fiduciary duties do not replace other duties of directors, if directors do act, they not only breach their fiduciary duties, but also their duties to act within their powers and may therefore be guilty of theft or fraud or unlawful competition.

In *Percival v Wright*[15], it was noted that directors owe their fiduciary duties to the company alone and not to shareholders individually or to the company's holding company, as noted in *Bell v Lever Bros Ltd*[16] or to its subsidiary, as noted in *Lindgren v L & P Estates Ltd*[17] or where the company is a member of a group of companies, to the group as a whole, as noted in *Charterbridge Corp Ltd v Lloyds Bank Ltd*[18].

(B) Duty to act *bona fides* in the interests of the company

The general principle is that directors must act *bona fide* in the interests of the company. This has been noted in the decision of *Levin v Felt and Tweeds Ltd*[19], *SA Fabrics Ltd v*

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13. (1914) 2 Ch 488; 1914-1915 All ER 987 (CA).

14. (1970) Ch 212 238; (1969) 1 All ER 969 (CA) 972-973.

15. (1902) 2 Ch 421.

16. (1932) AC 161 228; 1931 All ER 1 (HL).

17. (1968) Ch 572; 1968 1 All ER 917 (C).

18. (1970) Ch 62; 1969 2 All ER 1185 (Ch).

19. (1951) 2 SA 401 (A).

Millman[20] and *Atlas Organic Fertilizer (Pty) Ltd supra* at 197. Directors may act only for purposes within the interests of the shareholder *qua* shareholders, as noted in *S v Hepker*[21]. Therefore directors may not act arbitrarily, capriciously or for an improper purpose as noted in *Mills v Mills*[22]. In *Re Smith and Fawcett Ltd*[23], it was noted that directors must act *bona fide* in what they consider and not what the courts consider to be in the interests of the company. That is, the courts will not consider what is best for the company from a business point of view, as noted in *Levin v Felt and Tweeds Ltd supra* at 414. However, directors may not exercise their powers to defeat or injure the interests of the company.

Thus, as noted in *Fraser v Whalley*[24] and *Piercy v S Mills & Co*[25], directors may not exercise their powers for the purpose of furthering their own interests or in the interests of persons other than the shareholders. In *Parke v Daily News*[26] it was noted that where exercising a power for an improper purpose, directors may act in breach of duty even where they act without conscious dishonesty. Directors may not act sectionally, thereby favouring one section of the shareholders over another. Furthermore, as stated in *Hogg v Cramphorn Ltd*[27] and *Howard Smith v Ampol Petroleum*

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20. (1972) 4 SA 592 (A) 596.

21. *S v Hepker* (1973) 1 SA 472 (W).

22. (1938) 60 CLR 150 153.

23. (1942) Ch 306; (1942) 1 All ER 542 (CA).

24. (1864) 2 HEM & M 10.

25. (1920) 1 Ch 77; 1918-1919 All ER 313.

26. (1962) Ch 927; (1962) 2 All ER 929.

27. (1967) Ch 254; (1966) 3 All ER 420.

Ltd supra[28], directors may not exercise their powers for the purpose of defeating the wishes of the majority of the shareholders in general meeting or for the purposes of altering their voting power.

In *Howard Smith v Ampol Petroleum Ltd supra* and in *Teck Corp Ltd v Millar*[29] it was stated that where there is more than one purpose for which the directors acted, the court will determine what the primary purpose for their action was. Therefore if that primary purpose is improper, the directors' action is a breach of duty notwithstanding that they also acted for other purposes which were improper. However, where the primary purpose is a proper one, the exercise of the power is not improper merely because the effect may be to bring about a state of affairs which, if the achievement thereof would have been the proper purpose, this would have rendered improper their exercise of the power as noted in *Harlowe's Nominees (Pty) Ltd v Woodside (Lakes Entrance) Oil Co*[30] and *Teck Corp Ltd v Millar supra*. The mere fact that the directors benefitted from an exercise of the power does not make it improper.

In *Bamford v Bamford supra*[31] and *SA Fabrics Ltd v Millman supra*[32], it was noted that where directors exercise a power for an improper purpose, the transaction is voidable at the instance of the company. Where the transaction is with a third party, it will be voidable against the third party if he was aware that the directors were acting for an improper

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28. (1974) AC 821 835; (1974) 1 All ER 1126 (PC) 1134.

29. (1973) 33 DLR 3d 288 327.

30. (1968) 121 CLR 483.

31. (1970) Ch at 238; All ER at 972-973.

32. At 596.

purpose, as noted in *Charterbridge Corp Ltd v Lloyd's Bank Ltd supra*[33] and *Bamford v Bamford supra*[34].

In *Hogg v Cramphorn Ltd supra*, *Bamford v Bamford supra* and *Prudential Assurance Co Ltd v Newman Industries Ltd (2)*[35], it was noted that the company in general meeting may ratify or condone a director's breach of duty. The director who breached his duty may, in his capacity as shareholder, vote in favour of such a resolution provided that in so doing he does not commit a fraud on the minority, as noted in *Alexander v Automatic Telephone Co*[36] and *Prudential Assurance Co Ltd v Newman Industries (2) supra*[37]. Furthermore, in the *Atlas Organic Fertilizers* case *supra*, it was stated that where the company suffers damage as a result of the director's breach of duty, such damages flowing from a breach of duty may be claimed from him.

(C) Conflict of interest and duty

The second fundamental fiduciary duty of directors of the company is that they must not place themselves in a position where their personal interests may conflict with their duty to act in the interests of the company[38].

In *Sibex Construction (SA) (Pty) Ltd and Another v Injectaseal CC and Others*[39], Goldstone J noted that in *Atlas*

33. At 75; 1194.

34. Ch at 241; All ER at 975.

35. (1980) 2 All ER; 841 (Ch) 862.

36. (1900) 2 Ch 56 (CA).

37. At 869.

38. *Robinson v Randfontein Gold Mining Co Ltd* (1921) AD 168 178-179; *Boardman v Phipps* 1967 AC 46 123-124; 1966 3 ALL ER 721 (HL) 756.

39. (1988) 2 SA 54 (T).

Organic Fertilizers supra, Van Dijkhorst J said that the general principle stated by Innes, CJ in the *Robinson* case *supra* is that where one man stands in a position of confidence involving a duty to protect the interests of that other, he is not allowed to place himself in a position where his interests conflict with his duty. This general statement is narrowed down in the field of company law. Van Dijkhorst, J further notes that an individual director is not, as such, an agent of a company and is therefore as a rule free to transact business on his own account, even in competition with the company of which he is a director. This principle was stated by Lord Blanesburgh in *Bell and Another v Lever Brothers Ltd and Others*[40], where it was held that, "it not appearing from the regulations of the company that a director's services must be rendered to that company and to no other company, he was at liberty to become a director even of a rival company and it not being established that he was making to the second company a disclosure of information obtained confidentially by him as a director of the first company, he could not at the instance of that company be restrained in his rival company". However, Lord Blanesburgh notes that it is inconceivable that this freedom to hold directorships in competing companies can exist where managing directors have been employed. It is impossible for one to advance the conflicting interests of two actively competing businesses as managing director of both. Laskins[41] notes, however:

> "It is eminently more satisfactory to apply the no power without responsibility principle and simply to say that if a person is in fact in a position of trust - be he agent, mandatory director or whatever - he cannot escape the duty that inevitably attaches to the trust".

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[40]. (1932) AC 161 (HL) at 195.

[41]. (1982) 99 *SALJ* AT 403.

Furthermore, in *Bellairs v Hodnett and Another*[42] it is noted, "That they chose the form of a company to give effect to and carry out that relationship, does not affect the existence, nature or extent of any fiduciary duty resting upon Bellairs that is relevant to the present dispute. Since principles of equity underlie a fiduciary duty we think that the substance of their relationship and not the form in which it is cast must be looked at in order to ascertain its existence, nature and extent".

However, Goldstone, J in *Sibex Construction supra* assumed that the fiduciary duty of an individual director of a company and that of a member of "top management", only arises where he acts as an agent for the company. There is, however, no question as to the continuing fiduciary duty of a managing director and general manager (even if such manager were not a director).

In *Atlas Organic Fertilizers (Pty) Ltd supra* it was noted that this matter must be approached "on a common sense basis".

Furthermore, in *Robinson v Randfontein Estates Gold Mining Co Ltd supra* and *Gundelfinger v African Textile Manufacturers Ltd*[43], it was noted that a director may not act on behalf of his company in which he has an interest. Therefore a director must:

(i) disclose his interest in the contract;

(ii) correct any material misstatements which may have been made and which may influence the company to contract;

(iii) respond truthfully to questions put to him concerning the contract;

[42]. (1972) (1) SA 1109 (A) at 1130 E-F.

[43]. (1939) AD 314 323.

(iv) disclose information which he may know will influence the company to contract.

Furthermore in *Gray v New Augarita Porcupine Mines Ltd supra*[44] and *Imperial Mercantile Credit Association v Coleman*[45] and *Benson v Heathorn*[46], it was noted that such disclosure must be made to the members in general meeting and they alone have the power to sanction the contract. This they may do either by way of an ordinary resolution or by unanimous consent. In *North-West Transport Co Ltd v Beatty*[47] it was noted that in a general meeting, the interested director may vote in his own interests on any shares of which he is the holder, except where this would constitute a fraud on the minority. In *Novick v Comair Holdings Ltd*[48] *supra* it was noted that the articles of a company may relax this rule to a certain extent, thereby allowing disclosure to be made to other directors and empowering them to enter into contracts on behalf of the company. However, no provision in the articles can allow for a greater relaxation of the rule than permitted by sections 234-237 of the Act. In *Morgan-Smith v Elektro Vroomen (Pty) Ltd*[49], it was noted that where disclosure is to be made to all members, it is not necessary that a general meeting be called if disclosure is made to all members and their unanimous approval of the contract is obtained.

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44. At 13.

45. (1871) 6 Ch 558; (1873) LR 6 HL 189.

46. (1842) 1 Y & C Ch Cas 326.

47. (1887) 12 AC 589 (PC) 593-594.

48. At 152-153.

49. (1977) 2 SA 191 (O) 195.

Pennington at 535[50] notes, however, that *prima facie* a director is not accountable, unless the terms of his service contract preclude him from competing for profits earned by carrying on a business of his own in competition with the company, as noted in *Bell v Lever Bros supra*[51]. However, as noted in *Hivac Ltd v Park Royal Scientific Instruments Ltd*[52], a director will be accountable if he uses the company's property or trade secrets or his knowledge of the company's customers or any special skill acquired by him while engaged in the company's business, in order to carry on his own rival concern.

(D) Duties of care and skill

In *Fisheries Development Corporation of SA Ltd supra*, where it was noted that to determine whether there was negligence of the conduct alleged it is necessary to have regard to relevant aspects of a director's duty of care and skill. That is, the extent of a director's duty of care and skill depends to a considerable degree on the nature of the company's business and or any particular obligations assumed by or assigned to him.

In this regard there is a difference between full-time or executive directors who participate in the day-to-day management of the company's affairs and the non-executive director who has not undertaken any special obligation. The latter is not bound to give continuous attention to the affairs of his company and his duties are therefore of an intermittent nature, to be performed at periodical board meetings which may require his attention.

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[50]. *Penningston's Company Law* 4ed (1979) Part 3 493-556.

[51]. (1932) AC 161; (1931) All ER Rep 1.

[52]. (1946) Ch 169; (1946) 1 All ER 350.

Furthermore, in *Fisheries Development Corporation of SA Ltd supra* and *Re City Equitable Fire Insurance Co Ltd supra*, it was noted that if a director fails to exhibit, in the performance of his duties, that degree of skill which may be reasonably expected from a person of his knowledge and experience, he is liable to his company for any damage it may have suffered. He is, however, not liable for mere errors of judgment and is not required to have special business acumen or expertise or even experience in the business of the company. In *Pavlides v Jensen*[53] and *Prudential Assurance Co Ltd v Newman Industries Ltd (2) supra*[54], it was noted that a company in a general meeting may condone a director's breach of his duty of care and skill. Furthermore, the director guilty of the breach of duty may, as a shareholder, vote in favour of such a resolution provided that he is not committing a fraud on the minority.

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[53]. (1956) Ch 565; 1956 2 All ER 518.

[54]. At 874-5.

(iv) THE EXTENT TO WHICH THE COMPANY CAN RELEASE DIRECTORS FROM THEIR DUTIES

Section 70, sext of the 1926 Act, now s247 of Act 61 of 1973, was introduced by Act 23 of 1939. s247 states that:

> "any provision, whether contained in the articles of a company or in any other contract with the company, and whether express or implied, which purports to exempt any director or officer or the auditor of the company from any liability which by law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company, or to indemnify him against any such liability, is void".

The corresponding section in the English Act was s205 (presently s310 of the *Companies Act* 1985) which was first introduced for the purpose of altering the existing law that articles could effectively exempt a director or other officer from liability for loss caused by breach of duty, unless the breach was dishonest or wilful. There is some controversy as to the effect of the provisions, that is, whether they prohibit exemption from liability only or also invalidate provisions in the articles which, being consistent with the general law, reduce or abrogate any duty of a director or other officer[55]. Henochsberg, at 385, submits that the intention is to invalidate only a provision in the articles or in any contract with the company which purports to exempt a director from or to indemnify him against any liability which, if such provision were absent, would exist in law. Subsection (1) has no application at all to a provision in the articles which purports to reduce or abrogate any duty which, if such provision were absent, would by law otherwise attach to the director. Whether any such reduction or abrogation is, or is not, effective is to be determined by the application of the general law.

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[55]. Henochsberg at 384.

In terms of subsection (2) a company may lawfully indemnify any director, officer or auditor in respect of any liability envisaged by the subsection. However, it is submitted that the relevant proceedings must arise out of the conduct of the person concerned in his capacity as a director, officer or auditor.

It is submitted that a provision in the company's articles purporting to abrogate a director's duty of skill and care is invalid as being *contra bonos mores*. Furthermore, in terms of s247(1), the articles or a contract binding the company cannot effectively exempt a director from or indemnify him against liability for breaches of this duty.

Cilliers and Benade at 327 note that in terms of s247 of the Act, any provision or term which purports to exempt a director from liability in respect of "negligence, default or breach of trust" is void. Thus any act which attempts to evade this duty is seen in the same light as a breach of the duty itself. It is in the existence of this duty that the company and its members find their best protection against directors exploiting their office.

Cilliers and Benede agree that in terms of s247(1) no provision in the articles or clause in a contract can validly indemnify a director, officer or auditor of a company against any liability towards the company which would normally result from their negligence, default, breach of duty or breach of trust. This provision, they state, was introduced to end an earlier practice of providing in the articles for the indemnity of directors for all liability other than for dishonesty. The only indemnity which can still be provided for is to indemnify a director, officer or auditor against liability incurred by him in defending himself in any court proceeding which was decided in his favour. The same applies to acts in respect of which the court granted relief from liability in terms of s248 of the

Act. It is to be noted that it is the practice to have a provision in the articles to ensure that a director will not suffer loss where he has won his case or has been unsuccessfully prosecuted, but has nevertheless not been able to recover his costs for some reason, for example, where the other party is unable to pay or where the court did not award him costs or all of the costs or where costs are unrecoverable as in a criminal case or where the law does not provide for the costs and expenses of an accused who has successfully defended himself.

Let us consider the arguments by various writers on Section 205 of the *Companies Act* 1948, (presently s310 of the *Companies Act* 1985) so that we can trace the development and outline the difficulties with this rather controversial section of the Act.

Gregory submits at 421[56] that the literal effect of section 205 (s247 of our Act) is to avoid all forms of exclusions from liability, drawing no distinction between exemptions from the scope of the duty and exemptions from the consequences of a breach of duty. In Table A there is nothing which can be said to allow directors to hold their offices safe in the knowledge that they can commit negligence, default, breach of duty or breach of trust. He states that Table A, article 84(3), does not alter this position for two reasons:

(1) In the case where a director's liability to suffer rescission or an account is under the "automatic rule", the courts refuse to consider whether there has been a breach of duty. Thus s205, which is endangered only by articles allowing breaches of duty, is unaffected.

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[56]. "The Scope of the Companies Act 1948, Section 205" *Law Quarterly Review* vol 98 1982 at 413-422.

(2) Where a director's liability does depend upon proof of a breach of duty, Table A, article 84(3), does not protect him because it does not preclude rescission or an account where a breach of duty is committed.

Accordingly he states that there is no reason to cut down the literal meaning. Gregory submits that draftsmen of Table A in the 1948 Act, have consequently linked the legitimate needs of the business world to the requirements of equity.

Gregory submits that English law reports do not seem to have made any progress in determining the meaning and scope of s205 of the *English Companies Act* 1948.

Gregory notes that the narrow interpretation placed upon the section by writers such as Gower, is related to the fact that Table A, article 84(3), is said to contain an exemption clause. Gower states[57]:

> "Notwithstanding section 205, waiver clauses have ... continued to be inserted in articles, and since they appear in Table A, they must be regarded as permissible and, at any rate to some extent, as effective. Presumably that is so because if the articles permit a director to place himself in certain situations and to retain the benefits he derives thereby, it can no longer be said that the situations are ones in which there could be a conflict with his duty in the light of the permission.
>
> [It] is open to a company subject to certain limits, to include in its articles, provisions which render one or more of the general duties ... inapplicable to its directors. Any such provision must, however, take the form of a reduction or abrogation of the relevant duty, as opposed to an exemption of the directors from liability for breach of duty. This follows from section 205 ... . [It] is submitted that directors cannot be effectively released from their primary duty of honesty, though it must be admitted that there is no express authority for this proposition".

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[57]. *Principles of Modern Company Law* 4ed 1979 at 601-602.

Gregory notes that the support of this view stems from Table A, articles 78 and 84. Gore-Browne argues that Table A, article 84, exempts a director from the full scope of the equitable duties and such exemption must be valid because it appears in the *Companies Act*. That is, if an article reduces a director's duty, it can reduce any duty. Since articles exempting a director from the scope of an equitable duty are valid, section 205 can only apply to something other than clauses of this type. Thus the section applies only to clauses which exempt the director from the consequences of a breach of duty.

Gregory submits at 414, that this analysis is logical, but that it leads to an unsatisfactory result. That is, a director is exempted from liability just as effectively by a provision which says that the rules do not apply to him, as by one which says that the consequences of a breach of the rules do not apply to him.

Thus Gregory submits that literally the section prohibits exemptions, both from the scope of the duty, and from the consequences of a breach of duty for the following reasons:

(i) The section strikes down "any provisions ... for exempting" any director. The word "for" should not be regarded as superfluous. It shows intention or aim. Thus, it is the *consequence* of exemption rather than the *type* of exemption that is the dominant consideration under the section.

(ii) A test to determine the scope of s205 could be by way of a hypothetical situation. Gregory considers an article prescribing a director's standard of care which was lower than that imposed by the general law. The director's conduct measured up to the standard required by the article, but not imposed by the general law. If the company sued the director for negligence, could he

plead the article as a complete defence or would the article fall under the prohibition in the section? Gregory submits that:

" if one affords a defence to the director founded on his compliance with the article, one would be exempting him from liability which by the operation of the rule of law would otherwise attach to him in respect of ... negligence".

One weakness which gives validity to an article prescribing a standard of care lower than the legal standard, is that s205 states that to test whether a provision is an exempting clause or not, one must compare the director's position under that provision with his position under the general law as modified by that provision.

(iii) The distinction between exemptions from duty and exemptions from the consequences of breach of duty is based by Gower and Gore-Browne on Table A, article 84(3), which they argue merely relaxes the duty. Gregory does not agree. Table A, article 84(3), provides:

> "A director may hold any office or place of profit under the company (other than the office of auditor) in conjunction with his office of director for such period and on such terms (as to remuneration and otherwise) as the directors may determine and no director or intending director shall be disqualified by his office from contracting with the company with regard to his tenure of any such other office or place of profit or as vendor, purchaser or otherwise, nor shall any such contract or any contract or arrangement entered into by or on behalf of the company in which any director is in any way interested be liable to be avoided nor shall any director so contracting or being so interested be liable to account to the company for any profit realised by any such contract or arrangement by reason of such

> director holding that office or of the fiduciary relation thereby established".

Thus paragraph (3) expressly states that a director is not liable to suffer rescission or to account in certain circumstances, which is not a reference to the scope of a director's duty, but can only be construed as a direct exemption from consequences. Thus, Gregory submits that since Gower and Gore-Brown allow Table A to dominate the construction of s205, the flaw in the construction of article 84(3) can only dismiss their interpretation of the section.

Construction of Table A, articles 84 and 78

Article 84

Assuming that s205 avoids exemptions, whether to relieve from the scope of the duty or the consequences of a breach of duty, it is to be asked whether Table A, article 84(3), can be reconciled with it. The articles in the *Companies Act 1948* represent a new approach to the directors' conflicts of interest and duty. Before then, such conflicts of interest and duty met, subject to various exceptions from time to time, with automatic disqualification. The treatment of conflicts of interests and duty in Table A, article 84(3), is better defined than in earlier statutes, as distinct provision has been made for various kinds of conflict. Gregory submits that this presents no obstacle to adopting the literal interpretation of s205.

In *Bray v Ford*[58], Lord Herschell said that:

> "It is an inflexible rule of a Court of Equity that a person in a fiduciary position ... is not, when otherwise expressly provided, entitled to make a

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[58]. (1896) AC 44, 51.

> profit. He is not allowed to put himself in a position where his interest and duty conflict".

Thus, following Lord Herschell, "unless otherwise expressly provided", the articles permit a director to hold other offices within the company, to contract with his company whether a vendor, purchaser or otherwise and to have any kind of interest in his company's contract. Gregory notes that the articles define the consequences from which a director is relieved by that consent:

> "... nor shall any such contract or any contract or arrangement entered into by or on behalf of the company in which any director is in any way interested be liable to be avoided nor shall any director so contracting or being so interested be liable to account to the company for any profit by any such profit realised by any such contract or arrangement by reason of such director holding that office or of the fiduciary relation thereby established".

Gregory notes from this that two rights evolve - to demand rescission or to obtain an account against the fiduciary. He submits that the automatic avoidance rule is clearly reduced by the aforementioned words. Thus he states that there is nothing to effect s205, which applies only to provisions for exempting directors from various types of breach of duty. Thus, regarding the automatic avoidance rule, the remedy does not depend, according to Lord Porter in *Regal (Hastings) Ltd v Gulliver supra*, upon profit of the commission of a breach of duty. Hence Gregory submits that these words cannot be said to authorize the commission of a breach of duty.

However, Gregory notes that the court will award rescission or an account *only* by reason of the fact that the director has committed a breach of duty. The limits of Table A, article 84(3), are evident. The paragraph does not say that a director is relieved when rescission or account would be awarded "by reason of the director committing a breach of trust, breach of duty or default". Gregory submits that

there is nothing in the words to suggest that the failure to give proper advice, the concealment of material information or the imposition of an unfair bargain, are intended to be included within the scope of the section, nor is there any justification for reading extra words into the article to achieve such a purpose. Since there is nothing in the article which can be said to authorize directors to commit breaches of duty, there is nothing to limit the ambit of s205.

Article 84 does, however, take advantage of Lord Herschell's words in other parts of Table A. That is, a director is permitted to count towards the quorum, article 84(4), and he can act and charge for his services either personally or through his company, article 84(5). There is, however, nothing in the wording of those permissions entitling a Court of Equity to authorize a director to charge excessive remuneration, that unjustifiable work be done or that unfair terms be imposed.

Article 78

This provides that:

> "a director of the company may be or become a director or other officer of, or otherwise interested in, any company promoted by the company or in which the company may be interested as shareholder or otherwise, and no such director shall be accountable to the company for any remuneration or other benefits received by him as a director or officer of or from his interest in, such other company unless the company otherwise directs".

Gregory submits that there is no justification for reading extra words into the articles to the effect that a director is not liable to account "irrespective of whether he thereby commits any default, breach of duty or breach of trust". It is only by adding such words to Table A, article 78, that a director, Gregory states, could claim secret profits or corporate opportunities. Thus, only by adding such words

would a conflict with s205 arise. Therefore to adopt the literal interpretation of the section, Gregory submits that it is not necessary to accept Bird's proposal to ignore "Article 78 as a 'statutory aberration'"[59].

On the other hand, Parkinson[60] notes that the extent to which a company may relax the duties imposed by the common law and equity on its directors, is practically significant. That is, in his view Schedule 1, Table A of the *Companies Act* 1948 provides two examples of directors being permitted to act in a way which would otherwise amount to a breach of duty. Article 78 permits *inter alia* a director to be interested in a company in which his company is interested and article 84 allows a director to be interested in a contract made with his company. Parkinson argues that the two articles are examples of the ability of a company to free its directors from a specific head of fiduciary duty, namely the duty not to place themselves in a position where their private interests may conflict with their duty to the company. Thus, Parkinson argues that articles 78 and 84 of Table A constitute releases of the duty imposed by equity on directors not to place themselves in a position where private interests may conflict with their duty to the company. He argues that these articles and similar articles which a company might adopt to release the "no-conflict duty" as it applies in other circumstances, are valid because s205 only invalidates articles which exempt directors from liability for breach of duty. Thus, while the no-conflict duty may be released in this way, the duty to act in good faith and the duty of care may not, because this release would constitute a breach of the fiduciary

59. "The Permissible Scope of Articles Excluding the Duties of Company Directors" *The Modern Law Review* 1976 vol 39 at 394-401.

60. "The Modification of Directors' Duties" *Journal of Business Law* (1981) 335-345.

relationship between the director and company. The duty to act for a proper purpose may not be relieved either, because this would undermine the rationale of the duty, which is to prevent the board from interfering with matters which are not management functions, but are rather the concern of the shareholders. Thus it is not open to a company to circumvent s205 by including a provision in its articles releasing the whole range of directors' duties.

While it is argued that the no-conflict duty is releasable by a provision in the articles, Parkinson submits that this is not necessarily always desirable. That is, a blanket release in the articles deprives a company of its ability to scrutinize the transaction which gives rise to the potential conflict of interest and duty. Furthermore, the likelihood that a director will exploit his position to the company's detriment, is increased. However, duty-releasing provisions often avoid the expensive and time-consuming process of obtaining shareholder consent.

Parkinson submits that it may be desirable to appoint non-executive directors to perform a supervisory role where the appointees will often be directors of other companies with overlapping interests, and hence, possible conflict of interest. Thus, in the absence of a statutory relaxation of the duties owed by non-executive directors, Parkinson submits that a provision in the articles is an attractive way of solving this problem.

Parkinson notes that there have been numerous opinions raised on the effect of s205 on articles 78 and 84. He notes the argument of Baker[61], which can be stated that article 84(1) notes that:

> "A director who is in any way, whether directly or indirectly, interested in a contract or proposed

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[61]. (1975) *Journal of Business Law* 181.

> contract with the company shall declare the nature of his interest at a meeting of the directors in accordance with section 199 of this Act".

Baker contends that unless article 84(3), cited *supra*, is conditional on compliance with article 84(1), it is rendered void by s205 because it is an exclusion clause. If article 84(3) is conditional, it is valid because it does not exempt a director from liability for breach of duty, but merely modifies the duty, requiring a director to disclose an interest in a contract with the company to the board, instead of to the shareholders in general meeting. Thus, according to Baker, the duty should be regarded as modified, rather than abrogated.

Parkinson, however, rejects that its effect is merely modificatory, even assuming that article 84(3) is conditional on article 84(1). He states that a director who has an interest in a contract with the company will *prima facie* be liable for breach of duty, but liability may be avoided if the breach is ratified by the shareholders in general meeting or if the shareholders have given prior permission to the director. Thus, it is not simply a matter of disclosure. The shareholders, in general meeting, must authorize the breach of duty. Parkinson states that it would be appropriate to describe article 84 as modificatory if its effect were to substitute the board for the general meeting to authorize the breach of duty. This is not so, however, because directors do not authorize a breach of duty when disclosure is made to them in accordance with article 84. Thus, he argues that it is article 84 itself which authorizes the breach of duty and hence the article would be better described as a conditional exclusion, rather than a modification of duty.

Furthermore, the modification argument cannot be relied on in support of article 78, because the article unconditionally permits a director to have an interest in a

company in which his company is interested and hence it excludes the duty altogether.

However, Parkinson states that there is no justification for reading s205 as subject to Table A in such a way that where they are inconsistent, Table A prevails. Gower notes that this would suggest that only articles identical in all respects with articles 78 and 84 would be valid, which is unlikely.

Parkinson rejects a third approach by Rule and Brar[62], dealing with article 84. These authors argue that article 84 is unnecessary because, if a director who is interested in a contract with the company discloses his interest to the board and does not vote on the contract, he will not have breached his duty and the validity of article 84(3) is insignificant because it does not affect a director's liability.

However, Parkinson notes that a director who contracts with the company or who has an interest in a contract with the company, is in breach of duty because he has placed himself in a position where his interest and duty may conflict. Thus, merely because a director takes no part in the company's decision to enter into the contract, this does not mean that he has put himself into a position of potential conflict. As a director he owes the company a general duty not to harm it and in contracting with the company, he may well do so. Thus, Parkinson states that although a director may comply with article 84(1) and (2), he will still be in breach of duty if he contracts with the company and thus, article 84(3) is essential to save him from liability.

Thus it is evident that the variety of explanations mentioned *supra* illustrates the difficulty in determining

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62. "Exempting the directors" (1979) *New Law Journal* 6.

the relationship between s205 and articles 78 and 84. Parkinson submits that the effect of s205 on these articles was never properly considered by the statutory draftsmen.

Parkinson, however, submits that the best method to obtain a workable solution is by recognizing that the "no-conflict duty" is a distinct head of fiduciary duty, the special characteristics being that it is releasable and that the effect of articles 78 and 84 is to release the no-conflict duty as it applies to the particular circumstances set out in these articles. Thus, like Gower[63] and Gore-Browne[64], Parkinson maintains that the releasability of the no-conflict duty is crucial because s205 does not invalidate provisions which are duty-releasing, but only those which exempt liability for breach of duty. Thus, Parkinson argues that the section refers to provisions which exempt a director from liability "which would otherwise attach to him" in respect of a breach of duty. Thus, the words "which would otherwise attach to him", must refer to the exclusion of liability for breach of duty and not to the release of duty, because a director cannot be guilty of a breach if he is not subject to the duty, and the words "negligence, default, breach of duty or breach of trust", all presuppose the existence of a duty which has been breached.

Parkinson, however, submits that the duties of care and good faith are not releasable by a provision in the articles, because such a provision would amount to permission to harm the company, which would be inconsistent with the fiduciary position of a director.

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63. *Op cit* at 601.

64. *Op cit* at para 27-34.

Citing *North-West Transportation v Beatty*[65] *supra*, Parkinson notes that it is because the no-conflict duty may be breached without harming the company, that breaches thereof are normally ratifiable. However, breaches of duty which harm the company shall not be capable of ratification by a majority in general meeting. As noted in *Allen v Gold Reefs of West Africa*[66], a ratifying resolution may be set aside as a "fraud on the minority", if it is not passed "bona fide for the benefit of the company as a whole".

However, Parkinson states that where the no-conflict duty has been breached, the company will not normally have suffered any damage and so the minority could have no grounds for complaint. Thus Parkinson emphasizes that a breach of the no-conflict duty is ratifiable in general meeting, whereas breaches of the other duties considered so far, are not. He submits that the no-conflict duty is waivable, as it involves no inconsistency with a director's fiduciary status, whereas release of the other two duties does.

Furthermore, Parkinson considers whether the duty to act for a proper purpose is releasable. He notes *Hogg v Cramphorn*[67], *Bamford v Bamford*[68] and *Howard Smith v Ampol*[69], which illustrate the operation of the duty in its modern form. The proper-purpose duty is distinct from the duty to act in good faith for the benefit of the company, because a director may act in a way he believes to be for the benefit of the company and yet still be in breach of the proper-

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65. At 589.

66. (1900) 1 Ch 656.

67. At 254.

68. At 212.

69. (1974) AC 821 (PC).

purpose duty. These judgments *supra* note that the duty of proper-purpose is a head of fiduciary duty and not a power conferred on the director by the articles. Thus, as with other heads of fiduciary duty, the proper-purpose duty is a general law duty imposed by equity.

Parkinson notes that, although there is no clear authority, he submits that the duty of proper-purpose is not releasable. In *Howard Smith supra*[70] it is noted that the function of the duty is to prevent the directors from acting outside the "sphere of management" which Parkinson submits to mean that directors may not use their powers to manipulate voting control.

Lord Wilberforce *in casu* stated that it is:

> "unconstitutional for directors to use their fiduciary powers over the shares in the company purely for the purpose of destroying an existing majority, or creating a majority which did not previously exist. To do so, is to interfere with that element of the company's constitution which is separate from and set against their powers".

Thus the proper-purpose duty exists to maintain the constitutional separation of powers within a company. Parkinson submits that an article which released the duty would serve to undermine the corporate structure because it would permit the board to determine matters which would be for the exclusive concern of the shareholders. However, as noted in *Hogg v Cramphorn* and *Bamford v Bamford supra*, breach of proper-purpose duty is potentially ratifiable and the duty could be released by the shareholders in general meeting. This does, however, not support the releasability of the duty by a provision in the articles, since release or ratification by the shareholders is consistent with the duty. That is, a duty-releasing article would direct such

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70. At 837.

issues away from the shareholders to the board and would be objectionable.

Birds submits at 400[71] that articles purporting to exclude any duty which the general law casts upon a company director and are void under s205, despite the fact that, literally read, that section refers only to exclusions of liability being void, will apply to most other heads of directors' duties. However, it is possible to modify these duties, according to Birds, by, for example, absolving a director from liability for making a profit by disclosure to the board. The articles in Table A, which do seem to exclude a duty, must be treated as exceptional, but valid, because of their appearance in a statute.

Birds, however, submits that one head of duty can be excluded by the articles because it arises from the articles themselves and not from a principle of general law. This is the duty of proper purpose.

Furthermore, regarding s310 of the *Companies Act* 1985 (formerly s205), Gore-Browne notes that, until the passing of the *Companies Act* 1989, it was uncertain whether s310 rendered void policies of professional indemnity insurance effected by companies on behalf of their directors and officers. Section 137 of the *Companies Act* 1989, substituted a new subsection (3) in the section which was brought into force on 1 April 1990. Thus, s310(3)(a) does not prevent a company from purchasing and maintaining for any officer or auditor, insurance against the liabilities in subsection (1). Gore-Browne notes that this provision can only apply to policies effected or renewed after 1 April 1990. It does not automatically validate all such

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71. "The permissible scope of articles excluding the duties of company directors" *Modern Law Review* (1976) vol 39 394-401.

insurances. Thus, indemnity against the deliberate commission of a breach of duty could be unenforceable on grounds of public policy.

Further, whereas previously s310(3) permitted a company to have a provision indemnifying any officer or auditor who is a successful dependent in civil or criminal proceeding, this express provision is unnecessary by virtue of the new s310(3)(b) of the 1985 Act which provides for this.

Thus, it is evident that exactly what provisions in the articles s310 (formerly s205) covers has been the subject of much academic debate. Gore-Browne notes that this is because Table A contained provisions in both its 1948 and 1985 Act which appeared to "modify" or "exclude" the duties of directors. Gore-Browne states that these articles must be valid as they have statutory authority, but the question which still remains is whether articles adopted by companies which do not follow them exactly, are valid.

Gore-Browne further notes, citing *Re Joint Stock Trust and Finance Corporation Ltd*[72], that a director may furthermore:

> "be released by an appropriately worded agreement with the company from liability for a particular breach of duty, provided that the company was fully aware of the nature and extent of the breach. It is submitted that a release of this nature, being akin to a settlement or compromise of an action, would not fall within the terms of s310 and would thus still be valid".

Gore-Browne[73], referring to Vinelott J's reasoning in *Novitex Ltd v Bulfield*[74], notes that:

> "it would seem that the non-excludable duties of directors are those obligations which seek to prevent a

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[72]. (1912) 56 SJ 272.

[73]. At para 27-21.

[74]. (1986) 2 BCC 99, 403.

> director from damaging the interests of the company. These probably comprehend the primary duties of good faith and proper purpose, the duty to show proper care and skill, the duty not to misappropriate company property and any statutory duty imposed on directors. However, the general rule imposing accountability for secret profits, as well as that avoiding a transaction involving a conflict of duty and interest, would, on Vinelott J's analysis be excludable, so long as the director acts in good faith".

In *Movitex Ltd v Bulfield supra*, Movitex (the company) contracted to buy business premises. B, P and D were at this time the only directors of the company. Because the company was unable to raise the finance to complete the purchase, B, on behalf of the board of the company, conveyed the property to CRS (a company set up by B and P), of which B and P were directors and shareholders. CRS paid the purchase price and granted leases of the property to the company, this being the first transaction.

Later, B, P and T, being the directors of the company at this time, executed a mortgage in favour of Harper to secure payment of its indebtedness to them, this being the second transaction. Most of the shares in Harper were held by the trustees for P's children, and B was a director of Harper. The benefit of the mortgage in favour of Harper was transferred to Harper.

The articles of the company modified the self-dealing rule and provided that a director could be interested in a contract with his company provided he made full disclosure of his interest. Where a director was so interested he could not vote on the matter or be counted towards the quorum.

Article 100 (iv) provided that these prohibitions did not apply to "any contract or dealing ... with a corporation where [his] sole interest is that he is a director or other officer, member or creditor thereof".

The company sought to have the first transaction set aside on the ground that it constituted a breach of the self-dealing rule.

Gore-Brown argues that a provision may, without infringing s205, reduce or abrogate a duty owed by a director, provided it does not exempt the director from liability for breach of it.

However, Vinelott J disagrees and notes that Gore-Browne's argument leads to the absurd result that an article could, without infringing s205, modify a director's duty to use reasonable skill and care and thereby avoid a liability for damages for breach of duty which would otherwise arise. Vinelott thus states that one can merely exclude the duties of self-dealing and fair-dealing as they do not impose duties. That is, these duties are not duties in the true sense, but likened rather to disabilities.

Thus Vinelott J held that the self-dealing rule imposed a disability on directors in entering into contracts with a company so that breach thereof would render the contract voidable by the company. However, shareholders could exclude or modify the rule in the articles of association without infringing s205, since this did not involve exempting directors from liability for "breach of duty or breach of trust", and therefore articles 98-100 were not rendered void by s205. However, other duties cannot be waived or excluded.

Vinelott J, however, notes at 114c that the general exclusion of the self-dealing rule is made subject to two qualifications. First a director who is interested in any transaction to be entered into by the company must declare his interest at the time and place specified in article 99. Second, a director is not to vote in respect of the transaction or, if he does, his vote is not to be counted

and, whether he votes or not, he is not to be counted as one of the necessary quorum.

Thus if a director's interest is not disclosed in accordance with article 99, the self-dealing rule applies.

Thus it can be said that the exclusion of the self-dealing rule is subject to two qualifications - that full disclosure is made and that, subject to the exceptions in article 100, an interested director does not vote and does not count in the necessary quorum.

Regarding section 205 and articles 78 and 84 at 120G, Vinelott J notes that the true principle is that if a director places himself in a position in which his duty to the company conflicts with his personal interest or his duty to another, the court will intervene to set aside the transaction without inquiring whether there was any breach of the director's duty to the company. The shareholders of the company, in formulating the articles, can exclude or modify the application of this principle and thereby avoid exempting the director from the consequences of a breach of a duty owed to the company. Furthermore, Vinelott J at 121e notes that the duty "to declare the nature of his interest" must impose a duty on the director to disclose full information as to the nature of the transaction which he proposes to enter into. The disclosure must be such that the other director(s) can see what his interest is and how far it goes. Thus Vinelott J at 125b does not think that:

> "It is strictly accurate to say that a director of a company owes a fiduciary duty to the company not to put himself in a position where his duty to the company may conflict with his personal interest or with his duty to another. The true rule is that if a director puts himself in such a position then (unless he can rely on a provision entitling him to do so in the articles) the transaction will be set aside *ex debito justitiae* and without enquiring into the fairness of the transaction. But the director owes a duty of disclosure to the board

> and under the usual articles (in this case articles 99 and 100) cannot rely on the protection of the articles unless he can show that full disclosure was made".

Blackman at 410 in his PhD thesis[75], expresses his view on the extent that directors can be released from their fiduciary duties.

He submits, at 439, that a director, apart from statute:

> "can never be released from his duty to act in the interests of the company for such a release must be, by definition, an abuse of the corporate device, for it is entirely dependent upon the fulfillment by the members and the directors of their duty to act in the company's interests. Provided, however, he acts in these interests, there appears to be no reason why a director should not be released from his other fiduciary duties".

Blackman considers the view of Parsons[76] and also Gower[77], who consider that clauses allowing directors to disclose to the board, rather than the general meeting, are exclusion or release clauses. Blackman cites the following passage from Gower *supra*, who suggests that:

> "... just as the normal obligations of trustees can be waived or modified by express provision in the trust deed under which they were appointed, so, within limits, can the normal fiduciary duties of directors be modified by express provisions in the company's constitution. Such provisions have become common form in the articles of registered companies. The length to which they go varies. At their narrowest, they provide that an interested director shall disclose his interest to the board, shall not be counted in determining whether a quorum is present, and shall not vote; at their widest, they enable an interested director to

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[75]. *The Fiduciary Doctrine and its application to Directors of Companies* (1970) Ph.D Thesis, University of Cape Town 401-439.

[76]. "The Director's Duty of Good Faith" (1967) 5, *MLR* 395.

[77]. *Modern Company Law* 3rd ed at 529.

> attend and vote just as if he were not interested. However wide or narrow the conditions may be, it is invariable to provide that if complied with, the contract shall be fully effective, and the director not liable to account for any profit made".

Blackman notes, at 410, that certain provisions discussed by Gower *supra* do release the director, at least partially, from his fiduciary duties, while others maintain the duty and require the director to make disclosure to the board instead of the general meeting. Blackman submits that the alteration of the latter duty does not release the director from this duty as the director is still under a duty to disclose.

Blackman submits, at 411, that a director cannot be released from his duty to act *bona fide* in the interests of the company. He notes that directors act in the "intermediate interests of the shareholders". He submits that should the shareholders wish to change this, this would not amount to the directors being released from their duty to act in the interests of the company, but would be merely a variation or an alteration of the content of that duty. Blackman notes, at 411, that:

> "release from such a duty can only mean the granting to the directors the right to manage the company in whatever interest they please, including their own ... (this) would amount to an abuse of corporate device".

Thus Blackman submits that directors can neither be released from their duty to act in the interests of the company, nor can they be permitted to take for themselves what they might take for the company.

Blackman submits that it is generally accepted that a director may be released from his duty not to act for the company in a matter in which he has an interest. However, both Gower and Parsons, cited by Blackman at 412, consider that although such a duty may be excluded, the director is

still under a duty to act in the interests of the company[78]. That is:

> "release from a duty not to put himself in the way of temptation does not mean that he is entitled to yield to temptation. He remains subject to the discipline of the principle that he must act in the interests of the company".

Blackman, at 412, submits further that the director's duty to act openly and to disclose certain information cannot be waived. He submits, in respect of the duty to disclose, that this duty arises out of the director's duty to act in the interests of the company and therefore cannot be waived.

Furthermore Blackman submits that the duty to account for profits includes:

(i) the director's duty to account for property of the company which he has taken;

(ii) property which he has acquired for himself and which he ought to have acquired for the company, and

(iii) incidental profits.

He submits (i) and (ii) *supra* fall within the duty to act *bona fide* in the interests of the company preventing the director from being released from this duty, while (iii) does not fall within the scope of this duty. Blackman therefore submits that there is no reason why a director should not be permitted to take incidental profits for himself.

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78. Parsons *op cit* 396, Gower *op cit* 532.

(v) THE EXTENT TO WHICH THE COURT CAN EXEMPT DIRECTORS AND GRANT RELIEF AGAINST LIABILITY

In terms of s248(1)[79]:

> "If in any proceedings for negligence, default, breach of duty or breach of trust against any director, officer or auditor of a company, it appears to the court that the person concerned is or may be liable in respect of negligence, default, breach of duty or breach of trust, but that he has acted honestly and reasonably and that having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for the negligence, default, breach of duty or breach of trust, the court may relieve him, either wholly or partly, from his liability on such terms as the court may think fit".

Re J Franklin & Son[80] notes *obiter* that "honestly" means "without direct motive".

Furthermore, in terms of s248(2), read with s248(1):

> "Any such director, officer or auditor who has reason to apprehend that any claim will be made against him in respect of any negligence, default, breach of duty or breach of trust, may apply to court for relief and the court has on any such application the same powers to grant relief as are conferred upon it in any proceedings for negligence, default, breach of duty or breach of trust against such persons".

Section 248 (formerly s217) which is substantially the same as s448 of the English Act, enables total or partial relief from liability in proceedings for negligence to be granted to a director, officer or auditor of the company where it appears to the court that he acted honestly and reasonably and in the circumstances ought fairly to be excused. The relief may be granted on such terms as the court deems fit. It is submitted by Henochsberg at 385 that, in the ordinary

79. *Companies Act* 61 of 1973.

80. (1937) All ER 43 47.

meaning of the language, the section applies in respect of any proceedings by anyone against a director, officer or auditor provided only that they are proceedings for negligence, default, breach of duty or breach of trust by the defendant in his capacity as director, officer or auditor of the company. However, in *Customs & Excise Commissioners v Hedon Alpha Ltd*[81], it was held that regarding directors, s448 of the English Act applies only to proceedings by or on behalf of or for the benefit of the company for breach of duty to the company.

The defendant could invoke the court's power in terms of subsection (1) by way of a sole or alternative defence, giving particulars of the grounds on which he claims such power should be exercised in his favour. The proceedings under subsection (2) should be by way of motion. The word "apply" is more apposite to motion than to trial proceedings[82]. However, as noted in *Re Barry & Staines Linoleum Ltd*[83], the court will not act merely on the *ex parte* statements of the applicant, but will afford other interested parties an opportunity to be heard. However, as noted in *Re Gilt Edge Safety Glass Ltd*[84], the court may grant relief even if the claimant opposes the application. Furthermore, if the matter cannot be resolved without hearing *viva voce* evidence, the court may hear such evidence.

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81. (1981) 2 All ER 697 (CA).

82. Henochsberg at 386.

83. (1934) Ch 227 at 234.

84. (1940) Ch 495 at 502; (1940) 2 All ER 237 at 241.

In *Niagara Ltd v Langerman*[85] and *Selangor United Rubber Estates Ltd*[86] *supra*, it was noted that the burden of proof is on the person seeking relief to establish on a balance of probabilities his entitlement to it. That is, he must show that (a) he acted honestly, (b) that he acted reasonably and (c) that he ought fairly to be excused. In *Re J Franklin & Son Ltd*[87], Cronman J stated *obiter* that where directors act recklessly "but without considering the interests of the company at all ... they might well be said to be dishonest". In *Re Duomatic Ltd*[88], the court noted that whether or not the person acted reasonably depends upon a consideration of his conduct by virtue of the practice adopted by the company in the past. The fact that the person concerned was paid for his services may count against him in determining whether he acted reasonably. In *Re Claridges Patent Asphalt Co Ltd supra*, the court took into account in favour of a director the fact that he acted on legal advice but, as noted in the *Duomatic* case *supra* at 377, the court held against him the fact that he did not act on legal advice. In *Selangor's* case *supra* at 1155 it was further held that directors act unreasonably if they act without consideration for minority shareholders.

Furthermore, a director has been relieved from liability in respect of penalties resulting from him having acted without obtaining his share qualification, as noted in the *Barry v Staine's* case *supra*, and from liability arising from his failure to have obtained the approval of a general meeting concerning the determination of his remuneration, as noted in *Duomatic's* case *supra*.

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85. (1913) WLD at 202.

86. At 1155.

87. (1937) 4 All ER 43 (Ch) at 47.

88. (1969) 2 Ch 365 at 375; (1969) 1 All ER 161 at 170.

It is submitted that where a director acts negligently it could be difficult proving to the court that he, nevertheless, had acted reasonably, since acting negligently implies that he fails to act as a reasonably prudent director. Thus Henochsberg, at 386, submits that where the question is whether or not relief should be granted in respect of negligence, "reasonably" should be interpreted as meaning "understandably".

In *Ex parte Lebowa Development Corporation Ltd*[89], Stegman J noted various important aspects regarding s248 of the *Companies Act* 61 of 1973. He notes that while under the common law anyone who injures another by fraud or negligence is personally liable to the victims for patrimonial loss, directors and officers are accorded a limited measure of protection from personal liability by s248. However, neither s248 nor any other section of the Act enables a director or other officer to obtain immunity from personal liability for fraud committed by him. That is, the requirement that such a director or other officer should have acted "honestly" means that s248 does not empower the court to relieve a director from any liability resulting from fraudulent conduct. Such director or officer remains personally liable for damages caused by his fraud, including loss resulting from his causing or allowing a company to obtain goods or services on credit whilst its liabilities exceeded its assets.

As to relief from personal liability for loss caused by negligence, s248 provides only limited relief to directors and other offices. In terms of this section, the court is only empowered to grant relief against a claim by the company (or its liquidators) or against criminal liability. Section 248 does not empower the court to grant relief to a

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[89]. (1989) 3 SA 71.

director or officer against a claim by a third party such as a creditor of the company.

Furthermore, in *ex parte Lebowa Development Corporation Ltd*, it is noted that s248 does therefore not assist a director or officer of a company when faced with a personal claim by a creditor for damages as a result of negligence. He remains personally liable for damages caused by his negligence. The only relief under s248, if any relief at all can be justified, is relief from liability to the company itself, not outsiders, and from criminal accountability.

The liability of a director for negligence in the conduct of the company's affairs depends upon various factors. They include the part which each director in fact played in the conduct of the company's business and the manner in which he played his part.

Because the court in terms of s248 may grant the director or officer relief provided that he has acted not only honestly, but also reasonably, *in casu*, it is noted that the provision therefore envisages a situation where a director's act or omission may be both negligent and reasonable at the same time. Since an act (or omission) is only "negligent" if it is something which would not have been done or left undone by a reasonable man acting reasonably, there is some uncertainty as to what the legislature could have intended when it empowered the court to relieve a director from liability to the company for his negligence, provided that he acted reasonably. Hence, Stegman J noted that the concept of "reasonable negligence" appears *ex facie* to be self-contradictory.

The predecessor section of s248, s210 of the *Companies Act* 31 of 1909, was applied in *Niagara Ltd (in liquidation) v*

Langerman and Others[90]. The company's liquidator sued its directors for the recovery of amounts paid out of the company's funds as commission in terms of a particular contract or the directors were held to have been grossly negligent to have concluded. The directors contended that they had acted honestly and reasonably and that the circumstances were such that they ought fairly to be excused by the court in terms of this section. The court held that they had acted with gross negligence and that they had not acted reasonably and that they could therefore not be excused from liability. It appears therefore that the legislature may have intended that the court's readiness to find that a director or officer who was shown to have been guilty of negligence, but who nevertheless acted reasonably for the purposes of s248, should vary inversely in relation to the degree of negligence proven; the less serious the departure from the standard of the reasonable man, the greater the readiness of the court to find "reasonableness" for the purposes of s248. In a case of *culpa levissima*, reasonableness may be found relatively easily; in a case of *culpa levis*, less easily; and in the case of *culpa lata* or gross negligence (such as in *Niagara Ltd supra*), reasonableness may virtually never be found[91].

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[90] (1913) WLD 188.

[91] *Ex parte Lebowa Development Corporation Ltd supra.*

(vi) THE EXTENT TO WHICH THE COMPANY CAN CONDONE BREACHES OF DUTY OR "RATIFY" THE WRONG

Gower notes[92] that the question of which breaches of duty are ratifiable and which are not, is one of the most difficult in company law.

In Gore-Browne[93], it is stated that there are various ways whereby a director may be relieved from liability, the most important being ratification by ordinary resolution of the general meeting or ratification by unanimous consent. Concerning the former, Gore-Browne notes:

> "that some, but not all, breaches of duty can be 'cured' through the director's conduct being disclosed to the general meeting and ratified thereat by the passing of an ordinary resolution".

The authors cite *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*[94], which states that the director may vote upon shares that he holds, in favour of the conduct being sanctioned provided that it does not constitute a "fraud" or "oppression".

Gore-Browne distinguishes between breaches of duty which are ratifiable and those that are not. The authors note that various cases expressly state certain breaches to be ratifiable which are:

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[92]. "The Principles of Modern Company Law" 3rd ed 1969 at 564 *et seq* cited by Beck in the *Canadian Bar Review* vol 49 1971 "The Saga of Peso Silver Mines: Corporate opportunity reconsidered".

[93]. *Gore-Browne on Companies* 44th ed vol 2 part 5 "The Enforcement of Directors' Duties" para 27.21ff at 27.21.

[94]. (1980) 2 All ER 841.

(i) failure to disclose an interest in a contract to which the company is a party, as noted in *North-West Transportation Co Ltd v Beatty supra*;

(ii) obtaining a secret profit in circumstances not involving misappropriation of company property, as noted in *Regal (Hastings) Ltd v Gulliver supra*;

(iii) breaches of the duties of care and skill, as noted in *Pavlides v Jensen supra*;

(iv) using a power to call in initial payments on shares to suit personal interests, as noted in *Alexander v Automatic Telephone Co*[95];

(v) using a power of allotment for improper purposes.

The authors *supra* submit that there must be "an overriding qualification to the effect that the directors' conduct must have been honest and well intentioned".

Gore-Browne[96] further considers breaches of directors' duty which are incapable of ratification by an ordinary resolution of the general meeting:

i) Any breach of duty involving dishonesty on the directors' part, as noted in *Attwool v Merryweather*[97].

ii) A breach of duty resulting in the company performing an act which it cannot lawfully do, either because it may be *ultra vires* the company or because of some

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[95]. (1900) 2 Ch 56, 67 CA.

[96]. Para 27.21.

[97]. (1867) LR 5 Eq 464 n.

prohibition imposed upon it by statute or general law, as noted in the *Flitcroft's* case[98].

iii) Any act which, although lawful and *ultra vires* the company, cannot be done under the company's articles without some special procedure, such as a special resolution.

iv) A breach of duty bearing directly upon the "personal rights" of individual shareholders as defined in the articles, as noted in *Re Smith v Fawcett*[99].

v) A breach of duty involving "fraud on the minority", which, as noted in *Burland v Earle*[100], is when the majority of the shareholders succeed in expropriating, at the expense of the minority, the "money, property or advantages" of the company.

In respect of ratification by the consent of all members or by special resolution, Gore-Browne notes[101] that any breach of duty by directors, ratifiable by an ordinary resolution, is ratifiable by a special resolution. This common law principle may be thus effective in relieving a director from liability "for any breach of duty, provided only that the breach is not *ultra vires* the company and does not involve a fraud on its creditors, as noted in *Re Horsley v Weight Ltd*"[102]. Gore-Browne notes further that a "fraud on creditors" would generally arise only where the company is going out of business. Where a company is a healthy going concern, the only limit on ratification by unanimous consent

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98. (1882) 21 ChD 519 (CA).

99. (1942) Ch 304 (CA).

100. (1902) AC 83, 93 (PC).

101. At para 27.21.2.

102 (1982) Ch 442 (CA) at 1055.

at common law would be that which is *ultra vires* the company.

However, Gore-Browne states that, regarding breaches of duty which are beyond the capacity of the company, while s35(1) in effect abolishes the *ultra vires* doctrine regarding third parties, s35(3) expressly preserves the duty of directors "to observe any limitations on their powers flowing from the company's memorandum". The subsection states further:

> "that action which but for subsection (1) would be beyond the capacity of the company, may be ratified by special resolution, but that such ratification shall not affect any liability incurred by the directors or any other person; relief for such liability must be agreed to separately by special resolution".

In *Gundelfinger v African Textile Manufacturers Ltd*[103], *Regal (Hastings) Ltd v Gulliver*[104] and *Hogg v Cramphorn*[105], it was noted that, except in the case where a director purports to exercise a power which the company itself could not exercise, the company in general meeting may ratify or condone a director's conduct in breach of a fiduciary duty subject to there being no fraud on the minority. Furthermore, in the *Robinson* case *supra*[106] and *Gundelfinger's* case *supra*[107], it was noted that a transaction in breach of a fiduciary duty between the company and the director is voidable at the instance of the company, while *restitutio in integrum* is possible. Furthermore, a transaction between the company and a third party is voidable at the instance of

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103. (1939) AD 314 at 326.

104. (1967) 2 AC 134 n (HL) at 150; (1942) 1 All ER 378 at 389.

105. At 268; 428.

106. At 179; 200.

107. At 325-326.

the company, while *restitutio in integrum* is possible if the third party had knowledge of the breach as noted in *Rolled Steel Products (Holdings) Ltd v British Steel Corporation*[108]. Where the transaction is affected by the exercise of a non-existent power, the voidability of the transaction both as between the company and the third party and as between the company and the director, is governed by the provisions of s36 of the *Companies Act* 62 of 1973. No provision in the company's articles or in any contract binding the company can effectively exempt a director from or indemnify him against liability for breach of any fiduciary duty. Such provisions would be *contra bonos mores* except that the articles may validly qualify the duty to avoid a conflict of interest and duty by permitting a director to have an interest in a contract with the company.

In *Cullerne v The London & Suburban General Permanent Building Society*[109], it was noted that directors commit a breach of trust if they purport to exercise powers which are non-existent because they are beyond the corporate capacity of the company or, as noted in *Sparks & Young Ltd v John Hoatson*[110], they act beyond the powers conferred upon them by the articles. Furthermore, directors breach their fiduciary duty to the company where they act in contravention of the common law by paying dividends out of capital, as noted in *Re Exchange Banking Co: Flitcroft's case*[111] and in *Re Sharpe*[112], but not if they honestly and without negligence erroneously believe that these are profits for distribution,

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108. (1982) 3 All ER 1057 (Ch) at 1080-1082.

109. (1890) 25 QB 485 (C) at 488,490.

110. (1906) 27 NLR 634 at 642.

111. (1882) 21 Ch 519 (C) at 533-534, 535.

112. (1892) 1 Ch 154 (CA) at 165-166.

as noted in *Re Kingston Cotton Mill*[113]. However, the company will not ratify a director's breach of duty by compensating a director for loss of office without the sanction of a special resolution, as noted in *Re Duomatic Ltd supra*[114] or by causing the company to give financial assistance as envisaged by s38(1)[115], as noted in *Jacobson v Liquidation M Bulkin & Co Ltd*[116]. Where directors act in breach of this duty, it is irrelevant whether they believe they do so in the interests of the company. In terms of s36[117], an act beyond the corporate capacity of the company is incapable of ratification by the general meeting.

Regarding s234[118] which deals with the interests of directors and officers in contract, Henochsberg at 375, citing *North-West Transportation Co Ltd supra*[119], *Transvaal Lands Co v New Belgium (Transvaal) Ltd v Development Co*[120] and Robinson's case *supra*[121], notes that the rule at common law is that unless the articles provide otherwise, a director cannot have an interest in a contract with the company, whether direct or indirect, unless the company in the general meeting approves the contract after disclosure to it of his interest. This rule stems from the fiduciary relationship between the director and the company where any situation of

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113. (1896) 1 Ch 331 at 347-348; (1896) 2 Ch 279 CA.

114. At 374-375.

115. *Companies Act* 61 of 1973.

116. (1946) 3 SA 781 (T) at 790-791.

117. *Companies Act* 61 of 1973.

118. *Companies Act* 61 of 1973.

119. At 593-594.

120. (1914) 2 Ch 488 (C) at 502-505.

121. At 177-178.

conflict between interest and duty is to be avoided. In *Imperial Mercantile Credit Association v Coleman*[122], it was noted that approval of the contract by the other directors is insufficient because, while the director having the interest cannot participate in the decision as to whether to approve the contract, the director cannot, because of his interest, deprive the company of any services relating to this decision as the company is entitled to the services of all its directors. In the *North-West* case *supra*, where the articles permit a director to have an interest in a contract with the company subject to the approval of a general meeting, a director who has such an interest and who, as a member is entitled to vote in general meeting, may vote at the meeting on a resolution to approve the contract unless the articles provide otherwise and provided his doing so does not involve a fraud on the minority.

However, as noted in *Gundelfinger's* case *supra*[123] and *Trek Tyres Ltd v Beukes*[124], where the articles permit a director to have an interest subject to the general meeting's approval, he cannot vote as a director on a resolution to approve the contract when the articles permit him to do so, being *qua* director this interest and duty would conflict.

In the *Transvaal Lands* case *supra*[125], *Robinson's* case *supra*[126] and *Hely-Hutchinson v Brayhead ltd*[127], it was noted that a contract concluded without disclosure by the director of his

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[122]. (1873) LR 6HL 189.

[123]. At 323.

[124]. (1957) 3 SA 306 (W) at 310.

[125]. At 505.

[126]. At 179, 200.

[127]. (1968) 1 QB 549 (CA) at 585-586, 589-590, 594: (1967) 3 All ER 98 at 103-104, 106, 109.

interest, where the articles contain no provision qualifying the common law rule, or where it contains such a provision but where this requires disclosure by the director of this interest either to the board or to the general meeting, it is voidable at the option of the company. Furthermore *restitutio in integrum* is possible if the contract is with the director himself or with a third party who was aware of the non-disclosure.

However, where the company, on becoming aware of the non-disclosure, elects to affirm the contract or if *restitutio in integrum* is no longer possible, the company may claim his profits from the director provided, in the circumstances, the profits can be shown to have been derived as a result of a breach of fiduciary duty. Henochsberg, citing *Cavendish Bentinck v Fenn*[128] at 375 notes that, if in terms of the contract, the defaulting director sold his own property to the company, the director is not liable to account to the company for his profits merely because of the non-disclosure. The director is only liable if, when he acquires the property, he was under a duty to have acquired it for the company.

Where the articles contain no qualification of the common law rule, Henochsberg submits at 376 that if the contract was not approved by the company in general meeting, all the consequences as described would result, notwithstanding that the director may have complied with the statutory obligation to declare his interest at a meeting of directors. Thus, if the articles contain such a qualification and they were observed, no consequences would arise even if the director failed to declare his interest in accordance with the statutory obligation. Therefore, if the articles permit the director to have an interest in a contract with the company

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[128]. (1887) 12 AC 652 (HL).

subject to disclosure of his interest to, and with the approval of, a general meeting and such disclosure was made, and such approval was obtained, the contract is not voidable at the instance of the company because the director failed to declare his interest at a meeting of directors.

Regarding the power to ratify *mala fide* acts of the board, Cohen[129] notes at 285 that where directors have interests other than those of the company, they may have acted *mala fides* the company and such acts may not be ratified by the general meeting. The decision on point here is *Ngurli Ltd v McCann*[130]. This rule has been questioned since the decision of the Appeal Court in *Bamford v Bamford supra*. Cohen notes at 285 that there are commentators, such as Prentice[131], who aver that Harman LJ's judgment *in casu* supports the proposition that acts of the board, exercised *mala fide*, may be condoned. *In casu*, there was no suggestion of fraud, but it is noted, at 242, that "the assumption is merely that the board exceeded its powers, not that it acted *mala fide*". Thus the good faith of the directors was not in question. This decision, it is submitted, is not authority for the proposition that *mala fide* acts of the directors may be ratified. If the directors do not act in the interests of the company or have not directed their minds to the question whether what they are doing is in the best interests of the company, a resolution of the general meeting will not protect them.

Cohen submits that any suggestion in the judgment that goes beyond this, is *obiter* and submits further that it would be unlikely that the directors could "carry on the business of

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[129]. "The distribution of powers in a company as a matter of law" vol 90 1973 *SALJ* at 284.

[130]. (1953) 90 CLR 425 (H Ct of Australia) at 447.

[131]. (1969) 47 *Canadian Bar Review* 648 at 652.

the company in the way in which if properly constituted they should carry it on", if they were acting *mala fide*. Furthermore, citing *Bamford v Bamford supra*, Cohen notes that in the circumstances where the general meeting does have the power to ratify an excess of the fiduciary duties, it may do so either prospectively or retrospectively. A court would not, Cohen submits at 286, approve of a general meeting giving its approval prospectively for a *mala fide* act to be performed by the board.

Furthermore, Jooste[132], citing *Cohen v Directors of Rand Collieries Ltd*[133], notes that in terms of the common law, a director may enter into a contract with his company only if either the members in general meeting approve of the contract or if there is an exclusion clause in the articles permitting the directors to have an interest in such a contract. If this rule is contravened, the contract is voidable at the option of the company and Jooste, citing *Aberdeen Railways Co v Blaikie*[134] and *Transvaal Lands Co v New Belgium (Transvaal) Land and Development Co*[135], notes that this rule is so strictly construed that no question can be considered about the fairness or unfairness of a contract entered into.

At a general meeting the interested director, if he is a member of the company, may vote on the resolution ratifying the contract, unless the articles provide otherwise, as noted in *North-West Transportation Co v Beatty*[136].

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[132]. (1981) 10 *Businessman's Law* at 140.

[133]. (1906) TS 197.

[134]. (1854) 2 Eq Rep 1281.

[135] (1914) 2 Ch 488.

[136]. (1887) 12 App Cas 589.

Jooste notes that the common law rule goes further and applies not only to contracts directly between a company and a director, but also to those contracts in which a director is interested, either because he benefits personally or because he is subject to a conflicting duty as noted in the *Transvaal Lands* case *supra*.

If there is such an interest and there is no exclusion clause in the articles and no approval by the members in the general meeting, the contract is voidable at the option of the company. However, although voidability may be prevented by way of an exclusion clause, Jooste notes that it is clear on general principles that no clause can protect directors against the consequences of their own fraud. Jooste cites, in support of this, *Re Greymouth Port Elizabeth Rail & Coal Co Ltd, Yuill v Greymouth Port Elizabeth Rail & Coal Co Ltd*[137] and *Blythe v Phoenix Foundry Ltd, Wilson and Muir*[138].

Furthermore, Cohen, at 284, notes that until recently it was thought[139] that where directors acted within the express terms of the articles, but for a collateral purpose, although honestly, their actions could not be condoned by the general meeting. However, the court in *Hogg v Cramphorn Ltd supra*[140] took a different view. It held that the general meeting could condone an act of the directors which had been performed honestly in what the board believed to be the best interests of the company, and which was *intra vires* the company as well as the directors, but for a purpose not contemplated by the articles. The general meeting in

137. (1904) 1 Ch 32.

138. (1922) WLD 87.

139. Gower *op cit* 2ed 512 n 37.

140. (1967) Ch 254 at 269, (1966) 3 All ER 420 at 428-9.

condoning the directors' actions was not usurping the board's powers. The court noted that:

> "there is ... a great difference between controlling the directors' exercise of a power vested in them and approving a proposed exercise by the directors of such a power, especially where the proposed exercise of the power is a kind which might be assailed if it had not the manifest approval of the majority".

This decision was approved of by Plowman J in *Bamford v Bamford supra*, but on the basis that where a general meeting has a residual power, it may condone by resolution such an act of the board, provided that the resolution does not conflict with the constitution of the company. Where the articles explicitly exclude the general meeting's residual powers, then "an improper use by the directors of their powers cannot be cured by ratification". On appeal[141], Harman LJ held that:

> "... if directors do acts ... which, perhaps because there is no quorum, or because their appointment was defective, or because sometimes there are no directors properly appointed at all, or because they are actuated by improper motives, they go on doing for years, carrying on the business of the company in the way in which, if properly constituted, they should carry it on, and then they find that everything has been so to speak wrongly done because it was not done by a proper board, such directors can, by making a full and frank disclosure and calling together the general body of the shareholders, obtain absolution and forgiveness of their sins; and provided the acts are not ultra vires the company as a whole everything will go on as if it had been done all right from the beginning".

Thus there can be no doubt, Cohen notes at 285, that collateral acts of the directors may be ratified if exercised in good faith, provided that the company had the power itself to perform those acts.

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141. (1970) Ch 212 CA at 237-8.

Blackman at 439 in his PhD thesis submits that:

> "the question of ratification should be approached by first drawing a distinction between those cases where the directors have exercised powers which they were under a duty to exercise in the 'interests of the company' and those where they have exercised power which they were under a duty to exercise in the interests of the shareholders *qua* shareholders. The former can always be ratified provided the members act in the interests of the company. The latter can always be ratified provided the rights of a minority are not affected".

Blackman, at 401, submits that in determining when a minority may bring an action, the court must determine whether or not the wrong could have been ratified. Wedderburn notes that:

> "if it could not be ratified it is referred to as a 'fraud on the minority - frauds on the minority' are the exceptions to the rule"[142].

Blackman, at 402, notes that if the question is asked why "frauds" cannot be ratified, the only answer the court will give is that:

> "they cannot be ratified because they are 'frauds', and they are 'frauds' because they cannot be ratified".

Thus, Blackman submits that provided it is not a fraud, all breaches should be ratifiable. He says that there is no reason why the shareholders should not be able to ratify any transaction provided they act in the interests of the company.

Blackman however, at 409, cites Gower[143] who states:

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142. Wedderburn *op cit* at 96.

143. *Modern Company Law* 2nd ed 566-567.

> "And here too 'fraud' is used in a wider sense than actual deceit or dishonesty. It seems to cover all cases in which they have not acted *bona fide* in what they believe to be in the best interests of the company. If they have acted dishonestly or have not directed their minds to the question whether what they are doing is in the best interests of the company, a resolution in general meeting will not protect them".

Thus Gower, noting that the majority cannot release the directors from their duty of good faith, states that the majority cannot ratify where the directors have been fraudulent.

However, it is submitted that it may not be realistic today to hold the view that the majority cannot ratify where the directors have been fraudulent. That is, it may not be in the company's interest to waste time and money on law suits against their directors, particularly where these directors can still contribute greatly to the running and the profitibality of the company concerned. Thus, it is submitted that the courts could perhaps permit, in certain circumstances, the articles to ratify these "frauds".

(vii) THE EXTENT TO WHICH DIRECTORS CAN INSURE THEMSELVES AGAINST LIABILITY

The middle ground between encouraging fiduciaries to violate their trust and discouraging them from serving at all, is to be sought. That is, methods must be developed for the protection of directors and officers against personal risks in order to ensure that the most capable people are attracted to business careers. Thus one must balance the need for punishing faithless fiduciaries against the need to protect aggressive directors who are willing to take good faith risks in the search for profits.

Knepper[144] notes at 588, that prior to various statutory enactments there was very little law on indemnification. He notes that under the common law, indemnification was not permitted unless the director or officer was successful in his defence. The rationale of such a decision was that a corporation was not justified in paying the expenses of an officer or director who had been derelict in his duties. Furthermore, some courts were reluctant to allow indemnification unless the litigation had been beneficial to the corporation.

However, Knepper, citing *Solimine v Hollander*[145], notes that indemnification was approved as it would assist in inducing "responsible business men to accept the post of directors".

Gartner in the *Wall Street Journal*[146] states that:

> Scores of men are politely declining offers they once would have jumped at to serve on prestigious boards

144. "Liability of Corporate Officers and Directors" 3rd ed 587-673.

145. 1929 *NJ* Eq 264, 272, 19 A 2d 344, 348 (1941).

146. "Many Executives Reject Proffered Board Seats as Perils of Post Mount" p1 col 6.

> .... There now is a real shortage of competent men willing and able to serve as directors".

Thus the courts have recognized that indemnification and reimbursement have their foundations in a sound policy favourable to the development of some corporate management as a prerequisite to responsible corporate activity as there are gaps in the protection afforded to directors under the common law. Thus, it became obvious that the protection afforded to directors and officers at common law was inadequate and that a statutory remedy was critical[147].

New York was the first state to adopt a statute in 1941, followed by Delaware in 1943. Today all fifty states in the United States have enacted some form of statute providing for indemnification of corporate officers and directors. The enactment of statutes permitting indemnification by all states indicates a firm and positive public policy attitude. This is that:

> "legislative bodies have been confronted with the need to punish unfaithful fiduciaries and, at the same time, provide protection for aggrieved corporate managers willing to take good faith risks in the search for profits"[148].

The revised Delaware indemnification statute, Section 145 of the *Delaware General Corporation Law*, became effective in 1967. Section 145(f) provides that the Delaware statute is not exclusive of any other rights to which a director or officer may be entitled by by-law, contract or otherwise. Thus, a by-law or agreement could be drafted which would provide more extensive protection to the directors and officers than specified in the other provisions of the statute, although there are public policy limitations on how

147. "Corporate Indemnification and Liability Insurance for Directors and Officers" *Business Law* (1975) vol 33.

148. Knepper at 592.

far such a by-law or agreement could go beyond the statutory formulation.

Furthermore section 145(f) specifically permits indemnity with respect to actions in a capacity other than the director's or officer's official capacity.

The Delaware statute, sections 145(a) and (c) respectively, differentiates between derivative and third-party actions. In derivative actions, indemnification is permitted for expenses only and there may be no indemnification without court approval if the indemnitee is negligent or guilty of misconduct in the performance of his duty to the corporation. In third-party actions, the indemnification may include judgments, fines and amounts paid in settlement, in addition to expenses incurred. Thus, regarding derivative action indemnification proceedings, an exception to the aforementioned rule is made whenever the court determines that despite the adjudication of liability, but in view of all the circumstances of the case (the indemnitee) is fairly and reasonably entitled to indemnity for such expenses which the court shall deem proper.

Regarding the question of contribution and sharing the loss, Knepper, at 613, notes that contribution has been recognized as a useful method of allocating damages fairly amongst all the wrongdoers, without absolving one at the expense of the other. Contribution involves a sharing of the burden amongst those who are jointly and severally liable[149]. Knepper notes that whether such contributions should be *pro rata* or according to the benefit that each received, may be decided on a case by case basis.

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[149]. Section 11(f) of the 1933 Act, 15 USC;Section 77K(f) and section 9(e) and section 18(b) of the 1934 Act, 15 USC; Ss 78i (e), 78r (b) of the *Federal Securities Laws* establish the right to contribution.

(a) The question of liability insurance

In the United States liability insurance for corporate officers and directors has recently come into its own. That is, there are areas of potential liability which are excluded by most indemnification statutes for public policy reasons and otherwise. Judgments in derivative actions and expenditures in either derivative or third-party actions wherein the proposed indemnitee does not measure up to statutory duty standards, are not subject to corporate indemnification. However, D & O (directors and officers) insurance can provide the protection precluded by indemnification statutes.

The insurance policies that are presently available to officers and directors are wider than those proceeding them, but still contain important limitations and exclusions. That is, such policies do not cover outright fraud or intentional wrongdoing. Knepper notes that in most instances there is also an express exclusion of losses brought about or contributed to by the dishonesty of the insured, noting further that one cannot insure oneself against one's own reckless, wilful or criminal misconduct.

Furthermore, because of insurance policy provisions, statutory requirements and public policy, it is probable that neither corporate indemnification nor D & O insurance will cover:

(1) Judgments or settlements in a derivative action based on conflict of interest or self-dealing.

(2) Violation of Federal Securities laws involving conduct more serious than ordinary negligence.

(3) Loses arising out of dishonesty or intentional misconduct or other conduct which the court finds to violate accepted violations of public policy.

Because of the fundamental principle that no one shall be permitted to take advantage of his own wrong, a contract to indemnify a person for his own fraudulent or wilful misconduct is not enforceable, as a matter of public policy. Thus, one cannot insure oneself against one's own reckless, wilful or criminal misconduct. At one time it was argued that D & O insurance was contrary to public policy as it was wider than what state indemnification statutes permitted. Furthermore directors should not be allowed to evade their duties through the purchases of such insurance. However, he notes that because most states expressly authorize the purchase of such insurance at corporate expense, such arguments carry little weight.

In respect of the Delaware statute, section 145(G) thereof, a corporation is empowered to purchase and maintain insurance against liability arising out of the acts or omissions of a director, officer, employee or agent. Furthermore, a portion of the statute authorizes insurance for an officer or director:

> "whether ... the corporation would have the power to indemnify him against such liability under the indemnification provisions of section 145(g). This permits the purchase and maintenance of insurance to cover areas included in the indemnification statute unchartered by statutes or case law and authorizes the corporation to pay the entire premium for such a policy".

Knepper notes, at 626, that British D & O insurance is written in a two-part form. The first part is a corporation reimbursement contract that is intended to repay to the corporation any amount it is required to pay to individual corporate directors or officers to indemnify them for claims made against them. The second part is the D & O insurance to cover payments made by the directors and officers of losses arising from claims made against them.

However in the two-part policy, the two coverages are mutually exclusive, but complimentary, by virtue of the fact that when combined they protect both the corporation and its directors and officers from liability arising out of the actions of the insured directors and officers. Thus, although the policy consists of two separate contracts, it is issued as a single application in consideration of a single premium and constitutes a single transaction. However, some American insurers have also written the two-part policy, although the trend is to employ a one-part form where the coverages are combined.

The typical D & O policy insures loss arising from wrongful acts of corporate directors and officers in accordance with policy terms and conditions and subject to specified exclusions. Thus, it is similar to any other liability insurance policy.

Furthermore, all D & O policies provide for "deductibles" or "retentions" for each individual with respect to each loss up to an amount deductible for all directors and officers against whom claims are made. In addition, some D & O policies have a co-insurance feature, whereby the insured must bear about five per cent of each loss which cannot be insured.

A typical insurance policy extends coverage to:

1) directors and officers of subsidiaries in existence at the beginning of the policy period;

2) directors and officers of the parent company, and

3) directors and officers of subsidiaries acquired during the policy period (if notice is given).

Thus, additional insureds may be added thereto usually by the payment of additional premiums. Hence, by an

"extension" provision, the policies may extend coverages to the estates, heirs, legal representatives and assigns of the directors and officers.

Regarding the insurance clauses of the D & O policies, with the corporation reimbursement contact being one of two divisions of the insuring clause in the one-part form, this insures the corporation against loss on account of wrongful acts by directors and officers for which the corporation is required to indemnify such directors and officers. This coverage involves only the corporation's obligation to indemnify its directors and officers and does not cover the corporation's liability to any plaintiff who seeks to recover damages.

The other part of the policy form is the contract for insurance of the directors and officers against loss on account of any wrongful act. This means actual indemnification and not merely a duty to indemnify. Thus, this coverage is of particular significance where the corporation cannot, or will not, indemnify its officers and directors.

Regarding the corporate reimbursement part of the policy, the "loss" is the amount the corporation is required to pay to directors or officers as indemnity for a claim against them for a "wrongful act" subject to policy limits and exclusions. "Loss" includes damages, judgments, settlements and costs and amounts incurred in the defence of actions, suits or proceedings and appeals therefrom.

The other part defines "loss" in the same may, save that it omits reference to indemnity, but speaks of the amounts directors or officers are legally obligated to pay.

However, in all events a "loss" must be the result of the "wrongful act". All of the policy forms define "loss" to exclude fines or penalties.

The term "wrongful act" in most D & O policy forms means any breach of duty, misstatement, misleading statement, act or omission by the directors or officers in that capacity.

There are two parts in the definition of Wrongful Act, the first relating to "conduct" and the second to "statutes". Typically, Wrongful Act is defined as:

1) Any actual or alleged error or misstatement or misleading statement or act or omission or breach of duty by directors or officers in their individual or collective capacities, or

2) any matters claimed against them solely by reason of their being directors or officers of the company.

It is important to note that coverage problems may arise when a director or officer acts in another capacity as he then does not act in his capacity as a director and probably not as an officer and thus his activities would probably fall outside the Wrongful Act definition.

Regarding further exclusions in D & O policies, in the directors' and officers' part of the policy, Knepper notes at 633, that there are additional standard exclusions which apply to claims for which directors and officers cannot be indemnified by their corporation. These include:

(i) libel and slander;

(ii) claims based on gaining personal profit or advantage to which they are not legally entitled;

(iii) claims for the return of remuneration illegally paid to them, and

(iv) claims brought about by their dishonesty.

Typical insurance policies, premised on a "reasonable grounds" approach exclude claims based upon the directors and officers having acted dishonestly or acted in bad faith with knowledge or with reasonable cause to believe that they acted in violation of the law.

(v) Typical D & O policies exclude coverage of amounts for which directors and officers are reimbursed by the corporation.

It is to be noted that the typical D & O policy form expressly states that it covers claims made against the directors or officers during the policy period. Thus, if a claim is not made during the policy term, there will be no policy coverage.

Furthermore it is to be noted that several insurance covers are providing both D & O and fiduciary liability insurance in a single policy. This would avoid the gray area in the separate coverages, as the D & O policy covers claims made solely by reason of the insured's being directors and officers, while the fiduciary policy covers claims arising "solely" out of the insured's capacity as a fiduciary. Thus, such a combination policy would provide separate limits for each coverage.

Typically, coverage is extended to the plan itself to cover present trustees, former trustees and successor trustees, the estates, heirs and legal representatives of such persons and employees of the trust which would include the administrator. Thus, the policy would cover any past, present, additional or replacement director, officer or employee of any person or organization specifically named in the policy schedule as an additional insured.

Most policies provide for payment in respect of wrongful acts, which are defined to include any breach of fiduciary duty by the insureds in the discharge of their duties and actual or alleged errors or omissions. These include misstatements or misleading statements. Many policies may make no direct reference to "prohibited transactions", but the intention is to cover losses or damages resulting therefrom. Furthermore, he notes that protection would be provided for claims resulting from a co-fiduciary's wrongful act. Thus, a policy may provide payment for an act or omission committed by the insureds or by any persons for whom the insureds are legally responsible. Hence, many forms state that the insurance applies separately to each insured against whom a claim is made. Thus, the acts or omissions of any one insured shall not be imputed to any other insured.

In considering the nature of the allegations made by claimants, Knepper at 649 considers the 1978 Wyatt Survey, made by the Wyatt Company, an actuarial firm, which concluded as follows:

> "... of the claims reported, 56.1% were reimbursable by the corporation (that is, they came within its powers of indemnification and thus would fall under the corporate reimbursement part of the D & O insurance policy). In 23% of all claims the survey disclosed uncertainty as to the applicability of insurance and in 30% there was uncertainty as to corporate reimbursement. Thus ... the delineation of what is insured and what is not appears to be clearer than the delineation of reimbursability found in corporation by-laws or indemnification statutes".

(b) Indemnification Statutes - Tentative Draft No 6

(i) Section 7.16

In terms of section 7.16[150], "Damages Resulting from a Breach of Duty : General Rules":

"(a) Except as otherwise provided in section 7.17[151], a defendant who violates the standards of conduct set forth in Parts IV and V is liable for all loses to the corporation or its shareholders legally caused by the violation and for any other gains derived by him to the extent necessary to make full restitution.

(b) An omission that constitutes a breach of the standards of conduct set forth in Parts IV and V is the legal cause of loss incurred by the corporation or its shareholders if the plaintiff proves that:

(i) the performance of the duty would have been a substantial factor in averting the loss, and

(ii) the likelihood of injury to the corporation or its share-holders would have been foreseeable to an ordinarily prudent person in like position to that of the defendant and under similar circumstances. If such an omission is on the part of two or more defendants, each is jointly and severally liable.

(c) A Plaintiff bears the burden of proving causation and the amount of any losses incurred by the corporation or the shareholders as the result of a defendant's violation of a standard of conduct set forth in Parts IV and V, but a defendant is entitled to offset against such liability any gains to the corporation that the defendant can establish arose out of the same transaction.

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[150] The American Law Institute : *Principals of Corporate Governance : Analysis and recommendations* : Part VII: Remedies. Tentative Draft No 6 (October 10, 1986) Section 7.16 - "Damages Resulting from a Breach of Duty : General Rules" at 202-223.

[151] *Supra* "Limitations on Damages for Certain Violations of the Duty of Care" at 223-250.

(d) The losses legally caused by a knowing violation of a standard of conduct set forth in Part V include the costs and expenses to which the corporation was subjected as a result of the violation, including the counsel fees and expenses of a successful plaintiff in a derivative action, except to the extent the court determines that inclusion of some or all of such costs and expenses would be equitable under the circumstances.

(e) The court having jurisdiction over a derivative action may direct that all or a portion of the damages be paid directly to individual shareholders, on a pro-rata basis, when adequate provision has been made for the creditors of the corporation and such a recovery is equitable under the circumstances".

A commentary hereon by the writers of the American Law Institute states at 202, that section 7.16(a) establishes the measure of damages for a defendant's breach of duty under Parts IV and V and is in accordance with the general rule that recovery should be of the full corporate loss and injury to the corporation.

The commentators note further that the Delaware Supreme Court case of *Lynch v Vickers Energy Corporation*[152], specifies that the corporation should be entitled to recovery of gains received by the defendant in addition to losses incurred by the corporation.

The commentators further note that section 7.16(b) recognizes the necessity of an adequate causal relationship between the defendant's breach of duty and any loss to the corporation. Thus, the burden is placed on the plaintiff to show that the defendant's conduct or omission was the cause of the loss sustained by the corporation.

Furthermore, section 7.16(c) follows the rule that the plaintiff bears the burden of proving loss and causation. In addition, it permits the defendant to prove gains that

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[152]. 429 A 2d at 497.

can be offset against any losses incurred by the corporation.

Section 7.16(d) provides that an agent of the corporation who knowingly breaches a duty to the corporation must hold it harmless from the resulting liabilities. This would normally include fines and penalties as well as plaintiff's counsel fees in a derivative action.

Section 7.16(e) authorizes the court in its discretion, to award a pro-rata recovery where equitable principles so dictate.

Thus, in terms of section 7.16(a), a wrongdoer who breaches a duty is liable for all damages legally caused by his act.

This formulation precludes reduction of liability to reflect either the defendant's proportionate ownership of the corporation's stock or the tax effect of the loss. Section 7.16(a) applies both to derivative actions and direct actions, including those brought by the corporation. However, it is not intended to apply to non-derivative actions that a shareholder may have against a corporate official under some other body of law if a different measure of damages has been established under that body of law.

Furthermore, the defendant must account for gains derived by him as a result of the breach, even though the corporation suffers no independent monetary loss. In addition, the defendant will be required to account for gains that the corporation itself could not have realized according to the principle that the agent is liable to his principal for any gains realised through improper use of the latter's property.

However, section 7.16(a) does not authorize a double recovery. Thus the defendant should be held liable for gains that are distinct from or in excess of the

corporation's loss, but not for gains that are already reflected in the loss element of the damages.

Regarding the issue of causation, the commentators note that an adequate causal relationship between the wrong and the loss is a prerequisite to liability in American tort law. The most difficult causation problem concerns liability for omissions. Section 7.16(b) adopts a two-pronged test in this regard:

i. the defendant's omission must have been a "substantial factor" in the causation of the loss, and

ii. the likelihood of injury must have been foreseeable to a reasonable person in his position.

The phrase "substantial factor" cannot be precisely quantified.

Essentially, the commentators, citing *Francis v United Jersey Bank*[153], state that focus in causation problems should be on "the reasonable steps a director should have taken and whether that course of action would have averted the loss".

When multiple corporate officials fail to perform a duty whose omission is a legal cause of the loss, the problem of concurrent causation arises. Each defendant might claim that his conduct was less causally significant than that of others. Thus, to prevent each member from evading liability by pointing to the concurrent omissions of others, section 7.16(b) specifies that each member shall be jointly and severally liable. The commentators note that although it may be appropriate that a defendant has a right of equitable contribution against other corporate officials, especially when the director was not an active wrongdoer, section 7.16 does not cover the aspect of the rights to contribution.

[153] 432 A 2d 814 826 (NJ 1981).

Section 7.16(c) places the burden on the plaintiff to prove both causation and the amount of the loss, but allows the defendant to offset the damages if he can show a gain to the corporation arising out of the same transaction. Thus, the section allocates the burden of proof so that the plaintiff must prove any actual loss, including any intangible loses suffered by the corporation, while the defendant must prove any offsetting gains. Hence, the defendant must prove offsetting gains and thus bears the burden of proving that there was no "net loss" because of any illegal gains. Furthermore, the "same transaction" test in section 7.16(c) should deny the defendant the ability to mitigate his liability by offsetting gains on unrelated transactions.

Section 7.16(d) provides that an agent who knowingly violates a duty of loyalty to the corporation should normally be liable for the expenses to which he thereby directly subjects it. This reflects the general principle of agency law where an agent must indemnify his principal when a wrong committed by the agent subjects the principal to liability in respect of a third party.

Thus, section 7.16(d) expressly applies only to duties of loyalty arising under Part V, thereby excluding due care liability and has never been extended to cases where the agent was simply negligent. It is to be noted that section 7.16(d) does not apply to settlements recognizing the inherent difficulty of establishing the responsibility of the parties. Furthermore, section 7.16(d) does not require full-shifting of the corporation's expenses. It rather recognizes an equitable limit and permits the court to shift that portion of the expenses it deems just under the circumstances. Section 7.16(d) will apply to expenses to which the corporation is required to reimburse the plaintiff, but it is not contemplated that it would shift the corporation's indirect expenses.

Section 7.16(e) does not attempt to specify when pro-rata recovery may be equitable. Generally, however, when a substantial portion of the shares are held either by persons who had assisted the defendants to commit the fiduciary breach or by shareholders who bought at a lower price, suffered no injury, a pro-rata recovery in favour of the other shareholders is likely. However, it should not be assumed that pro-rata recovery should be granted merely because persons who committed or assisted the breach remain as shareholders. A corporate recovery does not mean that the defendants will receive unjust enrichment. The commentators' note that a proration of a partial recovery among other shareholders reduces the damages defendants must pay and thereby minimizes both the sanction against them and the amount of compensation that will benefit creditors and others affected by an injury to the corporation.

(ii) Section 7.17

"7.17 Limitations on Damages for Certain Violations of the Duty of Care[154].

(A) If a failure by a director ... or an officer ... to meet the standard of conduct specified in section 4.01 did not:

(1) involve a knowing and culpable violation of law; or
(2) enable the defendant, or an associate ... to receive an improper benefit to which the defendant, or such associate was not entitled under Part V; or
(3) show a conscious disregard for the defendant's duty to the corporation under circumstances that threatened serious injury to the corporation; or
(4) constitute a sustained and unexcused pattern of inattention that amounted to an abdication of the defendant's duty to the corporation;

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[154] The American Law Institute "Principals of Corporate Governance" at 223-250.

damages for the violation should be limited to an amount that is not disproportionate to the economic benefits to the defendant for serving the corporation".

Because of the threat of liability, this may deter the willingness of directors to serve if the potential burdens of office outweigh the benefits and thereby make them excessively paranoid in their decision-making, thus injuring shareholders and diminishing efficiency.

The commentators note that damages for a violation of the standard of conduct is limited to an amount that is not disproportionate to the economic benefits received or expected by the defendant for serving the corporation.

Section 7.17 does not attempt to quantify more precisely what the minimum level of liability should be. However, it is premised on the belief that damages should not be so low that the duty of care would fail of its essential purpose. Thus, considerable discretion is given to the corporation to its level of damages for due care violations.

The commentators note that the rationale for such a limitation rests on a variety of considerations:

1) A ceiling is justified on grounds of fairness, because the potential liability in cases where the ceiling could apply would otherwise be excessive in relation to the nature of the defendant's culpability and the economic benefits expected from serving the corporation.

2) Economic logic suggests that a ceiling would reduce the pressures on directors to act in an unduly risk-averse manner. The risk of liability for due care violations tends to be one-sided and directors can be held liable for excessively risky acts, but not for excessively cautious ones. A substantial risk of liability for

negligence might lead risk-averse directors to opt for more hesitant policies than shareholders desire.

3) Such a limitation may serve to reduce the cost of insurance as the exposure of the insurer is reduced. Thus, a limitation on due care liability contributes to cost reduction and ensures that the defendant is protected from the danger that his insurance coverage may be inadequate or that an exception to its coverage may be applicable.

4) It is likely that the duty of care will be more evenly and appropriately implemented by courts when the potential penalties are not perceived as being excessive.

However, in response to these justifications for a limitation on due care liability, the commentators *supra* submit that such a limitation might make courts more prepared to impose liability and would thus prove counter-productive. However, the commentators submit that it cannot be accepted that courts would become more reluctant simply because the potential damages are reduced. However, a consequence of a proposed limitation on due care liability is that it reduces the incentive to sue.

Hence, the policy reasons underlying section 7.17 is that reliance is placed on other spheres of corporate accountability, such as independent boards, rather than on litigation. Without a ceiling there may be an incentive for a plaintiff to bring a non-meritorious case, either because of the defendant's high exposure to damages or because of litigation costs favouring the plaintiffs.

Thus the commentary above notes three basic approaches available to implement a limitation on due care liability.

(a) By way of an enabling statute one can limit liability for due care to a reasonable level by adopting a mandatory ceiling. Thus, section 7.17 recommends that if a statutory approach is adopted, the statute should be an enabling one which would permit corporations to decline to adopt a ceiling, or to adopt one that is higher than the statutory minimum. Hence, those corporations that believe that a ceiling will increase the risk of litigation because courts may be less reluctant to impose liability, can decline to adopt any ceiling at all.

Where an enabling statute is adopted, it would be within the powers of the legislature to permit a charter amendment that abolished all liability. Section 102(b)(7) of the Delaware General Corporation law has done this by authorizing charter provisions "eliminating or limiting the personal liability of a director". However section 7.17 presupposes that the statute would not permit limitations on liability that would cause the duty of care to "fail of its essential purpose". Thus, although section 7.17 does not state that the additional liability should be imposed where the actual damages are less than the ceiling amount, it does require that there should be some liability for actual damages in order that the duties do not become merely precatory.

(b) The common law approach: A mitigation of damages formula. The measure of damages for a violation of the duty of care would be that which is legally caused by the defendant's conduct. The mitigating principle would become applicable where it would be unjust to put the risk of such a loss entirely on the defendant. However, a court would be justified in many instances in excluding remote or consequential damages, even

though they fell within the standards of proximate causation and were foreseeable. Primarily, section 7.17 gives the court discretion to consider limitations for damages where the interests of justice so require.

(c) Charter amendments: Even in the absence of enabling legislation, charter amendments represent a potential means whereby the liability of corporate officials may be reduced, although not abolished. Such an approach, however, lacks precedent and some doubt exists as to its validity. A charter amendment will not be given effect to by a court where it offends public policy. However, case law has indicated that charter amendments will be upheld that deviate from the common law where public policy is not offended and fraud or overreaching does not arise.

Thus, although corporate statutes frequently provide that directors must observe a specified standard of care, these statutes only define the standard of care and do not specify the extent of liability for a failure to meet this standard. Under section 7.17, a charter amendment should leave a minimum level of liability intact because, if all liability were to be abolished, the duty of care would become optional. Thus section 7.17 permits shareholders to substitute a more limited remedy for due care violations, as long as such a lesser measure of damages will not "fail of its essential purpose". This purpose necessitates that some threat of liability remains for a duty of care violation. This may well benefit shareholders by making corporate officials less risk-averse.

Section 7.17(a) does not specify what the minimal level of liability should be. The commentators suggest that section 7.17 should be satisfied if the shareholders adopt, as their measure of damages, a rule under which directors and officers, who breach the duty of care and cause damage to

the corporation as a direct result thereof, be required to restore any compensation received during the period of the breach to the corporation, but no more than the actual damages caused. This would include salary and stock options and other tangible considerations, but would not include intangible benefits, indirect consideration, or fringe benefits that were difficult to value. Thus, this measure of liability would substitute a restitution-based measure of damages for the traditional "tort" law test.

Section 7.17 does not legitimize charter amendments that restrict or reduce liability for "duty of loyalty" violations. Generally, the common law has drawn a line between negligence based liabilities, where exculpatory provisions have been regularly upheld and liabilities for fraud, recklessness or self-dealing where exculpatory provisions have been found to violate public policy.

The limitation on damages recommended by section 7.17 would not apply to that type of conduct or omission specified in section 7.17(a). These exceptions describe instances where a limitation on liability would be against public policy and would be outside the scope of charter amendments contemplated by section 7.17.

Section 7.17(a)(1) covers cases involving "a knowing and culpable violation of law", which means that the defendant had knowledge of the material elements of the crime, not knowledge of the statute. Thus, in general, ignorance of the law is not an excuse. However, section 7.17(a)(1) adds the requirement that the violation be "culpable", same adding a measure of judicial discretion and thus reflecting the reality that there are a limited number of circumstances where noncompliance with law may be justified or excusable.

Section 7.17(a)(3) applies where the defendant's conduct rises to a specified level of recklessness. Although some

courts have used the term "reckless" to mean gross negligence, the commentators *supra* submit that a subjective awareness of a serious risk to the corporation would have to be present before this exception becomes applicable.

(c) Gaps in the protection afforded by Indemnification Statutes

Johnston, at 2011[155], notes that there are important areas of liability for directors and officers that cannot be covered by corporate indemnification. Some statutes specifically provide that no indemnification shall be made in a derivative action in respect of any claim where the director or officer shall have been held to be liable for negligence or misconduct in the performance of his duty to the corporation. Because of public policy considerations, it is doubtful whether a by-law or contractual provision could, in this instance, be drafted which would protect the directors and officers. Furthermore, it is likely that the courts will refuse to permit indemnification for breach of the Federal Securities laws, which leaves directors and officers exposed to lawsuits involving the sale of corporate securities, the dissemination of various disclosure documents and the publication of corporate financial statements.

Moreover, the protection afforded to directors and officers by way of indemnification may be minimal if the corporation is insolvent at the time the suit is brought. Johnston states that this is a particularly dangerous situation for the directors and officers because, in the event of insolvency, lawsuits may be brought by stockholders claiming that negligence or misconduct by the directors and officers led to the company's demise and thus the potential damages

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[155]. "Corporate Indemnification and Liability Insurance for Directors and officers" *Business Law* vol 33 1978.

are likely to be substantial. To protect against these gaps in coverage under the indemnification statutes, Directors' and Officers' liability insurance became available.

(d) Liabilities that cannot be covered by corporate indemnification of Directors' and Officers' liability insurance

Johnston[156] notes the types of liabilities that cannot be covered by corporate indemnification and, regarding these, discusses whether they may nevertheless be covered by insurance.

He notes that indemnification statutes in most states do not permit indemnification of (i) judgments or amounts paid in settlement in a derivative action, (ii) judgments, amounts paid in settlement or other costs in either a derivative or third-party action in which the director or officer does not prevail and fails to meet the statutory standard of acting in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation. Furthermore, indemnification will be precluded on public policy grounds in cases involving breach of the federal securities laws.

However, some of the gaps in corporate indemnification can be covered by D & O insurance. The D & O policies cover judgments and amounts paid in settlement in a derivative action, but the "personal profit" clause excludes self-dealing or conflict of interests, although it would cover legal costs incurred in defending against such allegations. The courts, Johnston notes, will probably not sanction insurances of liability resulting from acts of intentional or wilful misconduct, or knowing breaches of the federal securities law. Thus, there are two significant types of

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156. *Supra* at 2034.

claims which are covered by D & O insurance and which are not covered by corporate indemnification. They are:

(i) A judgment or settlement in a derivative action based on negligence.

(ii) A judgment or settlement in an action under the federal securities laws based on negligence.

However, there are two types of claims against directors and officers which are covered by corporation indemnification, but are not covered by D & O insurance.

(1) Most state statutes permit indemnification for criminal fines as well as civil judgments in third-party actions if the applicable standard of conduct is met, but the D & O policies generally exclude coverage for "fines or penalties imposed by law or other matters which are insurable".

(2) Most indemnification statutes permit the corporation to indemnify a director or officer who was serving, at the request of the corporation, as a director or officer of another corporation.

The D & O policy, however, covers only claims made against the directors or officers in their capacities as directors or officers of the insured corporation.

However, certain types of liabilities which probably cannot be covered either by corporate indemnification or by D & O insurance. They are:

(1) judgments or settlements in a derivative action based on a conflict of interest or self-dealing;

(2) breach of the Federal Securities laws involving conduct more serious than ordinary negligence, and

(3) losses attributable to dishonesty or intentional misconduct or other conduct which is *contra bonos mores*.

(e) Future proposals

The business system has been more successful to date because of the willingness of corporations to take risks. However, if directors and officers cannot protect themselves against the personal financial disaster arising from a lawsuit alleging conduct to have been negligent, the dangers of risk-taking may exceed the rewards. The enterprise system itself would then begin to fail.

Thus, in the long term, a more permanent and stable solution is needed to the problem of directors' and officers' liability. The question of public policy and the interpretation of ambiguous statutes and by-laws are too uncertain to provide corporate managers with adequate knowledge of the legal risks that they are assuming. There must be a method of making the risk of liability a "knowable" risk. That is, where negligence or gross negligence is allegedly involved, Johnston at 2035, submits that directors and officers should be able to know what their maximum exposure could be so that they could adequately protect themselves against liability. Johnston notes that this has led to proposals by the Federal Securities Code, Tentative Draft No 2, s1403(g) thereof, that limits be placed by statute upon liabilities of directors and officers for conduct not amounting to knowing or intentional misconduct. However, Johnston notes that:

> "such proposal, however, exists only on paper at the present time. In the meantime, businessmen and their lawyers must continue ... (to) improve the basic

protective methods ..., as well as other methods such as legal and business education programmes"[157].

(iv) Indemnity Insurance in South Africa?

We have seen that, regarding section 247 of the *Companies Act* 61 of 1973, it is not open to the company to exempt a director from liability for breach of duty or breach of trust or to indemnify him against claims in respect thereof. However, the question has been raised as to whether it is open to a company to take out an insurance policy giving the director the indemnity against liability for negligence.

It is to be noted that indemnity insurance policy schemes in South Africa, unlike in the United States, has not been well-developed nor formulated.

It has, however, been stated that no insurance could ever be available to the directors or officers of the company against liability for dishonesty[158]. Furthermore, if any premium is paid by the company for such insurance, whether it be by an increase in the premium for the cover to which the indemnity for the directors is attached, or by separate premiums for a specific policy for the directors, the contract of insurance will be of no force and effect[159]. However, it is open to individual directors to take out personal insurance against the risk of liability and having regard to the fact that the 1973 Act has high-lighted the director's potential liability, directors may be well advised to seek such insurance cover. It might be possible to achieve this cover by a suitable addendum to the company's own Property and Liability Insurances on the basis that the director will bear the additional premium himself.

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[157]. Johnston at 2036.

[158]. *South African Company Law Journal* (1977) E-17-18.

[159]. *Supra at E-17-18.*

(viii) CONCLUSION

In this paper it has been noted that directors and officers of a company, from the time of their appointment, stand in a fiduciary relationship to the company. That is, directors have various fundamental duties according to South African Company law practice - the duty to exercise their powers *bona fide* in the interests of the company, the duty of care and skill, and the duty not to place themselves in a position where their personal interests may conflict with their duties to the company.

Thus, this paper examines to what extent the various duties of directors could be waived and or condoned in South African Company law and it can be said that the question of which breaches of fiduciary duty are ratifiable and which are not, is one of the most complex issues in Company law. However, it has been seen that in terms of section 248 of the *Companies Act* 61 of 1973:

> "if ... it appears to the court that the person concerned is or may be liable in respect of negligence, default, breach of duty or breach of trust, but that having regard to all the circumstances of the case ..., he ought fairly to be excused ... the court may relieve him, either wholly or partly, from his liability ...".

Thus the extent to which directors may safeguard themselves against personal liability and ultimate financial risk in terms of this section has been examined closely.

It can be generally submitted, however, that directors and officers of a company can never be released from their duties to act *bona fide* in the interests of the company but, in most other circumstances, directors should be able to be released, even if partially, from their other fiduciary duties according to South African Company law practice and case law studies.

The controversial nature of s310 of the *Companies Act*, 1985 (formerly s205 of the *Companies Act*, 1948) according to English company law practice has been considered, as well as the various view-points surrounding the scope of this section. The controversial nature of these sections existed due to Table A which contained provisions in both its 1948 and 1985 Acts which appeared to "modify" or "exclude" the duties of directors.

However, I submit that Gore-Browne is correct when the authors state that:

> "it would seem that the non-excludable duties of directors are those obligations which seek to prevent a director from damaging the interests of the company. These probably comprehend the primary duties of good faith and proper purpose, the duty to show proper care and skill, the duty not to misappropriate company property and any statutory duty imposed on directors. However, the general rule imposing accountability for secret profits, as well as that avoiding a transaction involving a conflict of duty and interest would ... be excludable, as long as the director acts in good faith"[160].

As noted, other view points expressed in this paper, if at all, support Gore-Browne's analysis of this section to varying degrees.

Regarding the issue of indemnity insurance for directors and officers of a company, in this paper, it has been seen that the American states, especially the State of Delaware, have formulated directors' and officers' (D & O) insurance which provides the protection precluded by the American indemnification statutes. Thus, these insurance policies may protect directors against judgments in derivative actions and expenditures in either derivative or third-party actions wherein the proposed indemnitee does not pass

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[160] Gore-Browne *supra* at 27.21, citing Vinelott J's reasoning in *Movitex Ltd v Bulfield supra*.

statutory duty standards and hence is not subject to corporate indemnification. However, these D & O insurance policies have their limitations and exclusions as well and therefore do not cover outright fraud or intentional wrong-doing. Furthermore, it was seen that in most instances there is an express exclusion of losses of the insured brought about by the dishonesty of the insured and thus one cannot insure oneself against one's own reckless, wilful or criminal misconduct.

Regrettably, South Africa has not, to a great extent, embarked upon, nor formulated, an indemnity insurance scheme, either through the statute book or through the common law and pressure of public policy demands, in terms whereof directors and officers could adequately protect themselves against liability and financial risk.

It is hoped, however, that South African Company lawyers in the near future will take cognizance of the fact that such an indemnity insurance scheme is not only vital for the survival of most companies and the enterprise system as a whole, but is also necessary if directors are to take good faith risks in the best interests of their companies without being concerned too greatly about liability attaching to them and, the associated personal financial ruin, should their ventures fail and thereby cause financial loss to their companies.
In this regard South African Company lawyers may have regard to the various systems and approaches regarding indemnity insurance as adopted in the United States of America and as proposed in this paper.

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