THE BUSINESS JUDGMENT RULE -
ITS APPLICATION IN SOUTH AFRICA

by

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THE BUSINESS JUDGMENT RULE - ITS APPLICATION IN SOUTH AFRICA

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SUMMARY

The business judgment rule is used by American courts to establish whether a director has fulfilled his duty of care. It is based on the concept that the directors are legally empowered to manage a corporation's affairs, and the courts accordingly do not interfere with the exercise of those powers unless a board's action is tainted by fraud or self-interest. The courts will not review a business decision where, acting in good faith, the board has truly applied itself to making an informed decision. In certain circumstances, where self-interest on the part of directors is more likely to be a factor, a stricter test is applied. The business judgment rule is implicit in the judgments of English and South African courts and the King Committee has recommended its formal recognition in South Africa. The need for such formal recognition and stricter interpretation of the duty of care and skill discussed.
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THE BUSINESS JUDGMENT RULE -
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1 Introduction and outline of the development of the rule

The topic of corporate governance is one which has been the subject of discussion for some years. The debate, at least in the United States, started in the 1930s with the published work of Berle and Means\(^1\), and proceeded by way of Ralph Nader’s consumerism\(^2\) in the 1970s; the attempts at codifying United States law\(^3\), undertaken by the American Law Institute and the American Bar Association have evoked much comment, not all of it favourable. Better known in South Africa are the report of the Cadbury Committee\(^4\) in Britain, which dealt mainly with the financial aspects of corporate governance, and more recently that of the King Committee;\(^5\) these have postulated a demand for higher standards of attention to corporate affairs, particularly on the part of outside or non-executive directors, as well as the role of the courts in ensuring that stakeholders - in the wider application of the term which is coming to be more generally accepted - are not prejudiced by the conduct of boards of directors.

An aspect of corporate governance which has been largely neglected in the past is the duty of directors to employ care and skill in carrying out their functions; although the duty has been recognized for some 250 years, the level of care required of a director has generally been set at a very low level\(^6\).

The existence of the duty has been generally acknowledged. In Charitable Corporation v Sutton the Lord Chancellor said "(b) by accepting a trust of this sort, a person is obliged to

\(^1\) The Modern Corporation and Private Property (1932).

\(^2\) See, eg, The Company State (1973); Constitutionalizing the Corporation (1976).

\(^3\) See section 4 infra.


\(^5\) Institute of Directors The King Report on Corporate Governance (1994).

\(^6\) See below, p 7.
exercise it with fidelity and reasonable diligence." The existence of a similar duty, which stems from the common law rather than from statute, has been acknowledged by the South African courts in, for example, *Fisheries Development Corporation of South Africa v Jorgensen*.

The level of application sufficient to satisfy the duty of care and skill has been widely discussed; these discussions are considered in section 2 below. The duty is merged by many American authorities with the director's fiduciary duty, but is clearly recognizable - and is acknowledged as such - as the duty outlined by the court in *Charitable Corporation v Sutton*. Among the decisions most frequently quoted in this respect is that of the court in *Briggs v Spaulding* which held that directors must act as would "ordinarily prudent and diligent men ... under similar circumstances ...".

The American courts have developed a practice, known as the business judgment rule, by which the conduct of directors is judged in deciding whether they have fulfilled their duty of care and skill. The most frequently quoted, if not the earliest, expression of this rule is to be found in an 1829 case, *Percy v Millaudon* where the court ruled that

"the occurrence of difficulties ... which offer only a choice of measures, the adoption of a course from which loss ensues cannot make the [director] responsible, if the error was one into which a prudent man might have fallen." \(^{11}\)

This interpretation of the limitations on the duty of care and skill were echoed by a number of courts in subsequent judgments. \(^{12}\) In *Pollitz*, the rule was expressed in the following terms:

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\(^{7}\) 2 Atk 400 (1742) at 402.

\(^{8}\) 1980 (4) SA 156 (W) at 165-6; see also *Cronje NO v Stone* 1985 (3) SA 597 (T); *Howard v Herrigel NO* 1991 (2) SA 660 (A).


\(^{10}\) 141 US 132 (cited in Block, supra at 1).

\(^{11}\) 8 Mart ns 68 (La 1829) at 77-78.

\(^{12}\) See eg, *Godbold v Branch Bank* 11 Ala 191 (1847); *Hodges v New England Screw Co* 3 R 19 (1853); *Smith v Prattville Mfg Co* 29 Ala 603 (1857); *Pollitz v Wabash Railroad Co* 207 NY 113, 100 NE 721 (1912).
"[The business judgement rule] bars judicial enquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes."  

In spite of the courts' recognition of the duty of care, the standard of enforcement has been low having reached the position where according to some writers, any judicial responsible for enforcing the duty has been totally abdicated. This view has also been advanced in relation to the English courts.

However, certain decisions in the 1980's have suggested that the American courts are prepared to recognize the duty and enforce it in appropriate cases. The collapse of many Savings and Loan institutions in the same period has drawn further attention to the need for higher standards of conduct by directors.

The majority of American reported judgments on corporate law subjects originate from the courts of the state of Delaware. The Delaware legislature is widely regarded as being in the forefront of the development of corporate law, and consequently many large corporations are incorporated in that state. Second in importance are the courts of the state of New York - New York City being the major centre of banking and other financial activities in the United States.

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13 supra at 724, cited with approval in Auerbach v Bennett 47 NY 2d 619, 629, 393 NE 2d 994, 1000, 419 NYS 2d 920, 926 (1979).
14 See eg Bishop JW "Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers" 77 Yale Law Journal 1078, 1099 (1968) : "The search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a large haystack." Or, as perhaps more simply (and more recently) expressed by the US Supreme Court in Joy v North (F 2d 880 at 885 (2d Cir 1982)): "... the fact is that liability is rarely imposed upon corporate directors simply for bad judgment ..."
15 An article which sets out to illustrate this point and suggests some possible solutions is Cohn SR "Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions through the Business Judgment Rule" (1983) 62 Texas Law Review 591.
17 Revlon v McAndrews & Forbes Holdings Inc 506 A 2d 173 (Del 1986); Hauser Trust plc v ML SCM Acquisition Inc 781 F 2d 264 (2nd Cir 1986); Zapata Corp v Maldonado 430 A 2d 779 (Del 1981) ; Treadway v Care Industries 490 F Supp 668, on appeal as 638 F 2d 357 (2nd Cir 1980).
The King Committee has recommended that something similar to the business judgment rule be introduced in South Africa and it becomes appropriate to consider the nature and content of the rule and how the American courts and commentators have viewed its application over the years. Similar principles have been adopted in other jurisdictions and these must also considered in attempting to predict the impact on South African corporate law.

2 The content and nature of the rule

The American courts have been remarkably consistent in their statement of the business judgment rule. The case of *Percy v Millaudon*, decided by the Louisiana Supreme Court in 1829, used words which do not differ in substance from those used 150 years later. The most commonly cited recent statement of the rule appears in *Aronson v Lewis*, where the Delaware Supreme Court said:

The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors under Section 141(a). See *Zapata Corp v Maldonado* 430 A 2d at 782. It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. *Kaplan v Centex Corp* Del Ch 284 A 2d 119, 124 (1971); *Robinson v Pittsburgh Oil Refinery Corp* Del Ch 126 A 46 (1926). Absent an abuse of discretion, that judgment will be respected by the courts.

This exposition of the rule has been cited with approval in many subsequent cases.

Most American writers state that the common law business judgment rule contains four elements - some authorities suggest five. The four elements are clearly set out by the
American Law Institute in its Corporate Governance Project:\(25\):

(a) the absence of personal interest or self-dealing,

(b) an informed decision, which reflects a reasonable effort (subject to permitted reliance upon the advice and efforts of others) to become familiar with the relevant and available facts, as well as an actual decision,

(c) a reasonable belief that the decision serves the interests of the corporation, and

(d) good faith.\(26\)

The fifth element, that the director must exercise his powers in the honest belief that he acts in the best interests of his company, and must not abuse his discretion, is no more, it is suggested, than an extension of the duty of good faith.\(27\)

In order to understand the rule, it is necessary to consider the context in which it operates, and the rationale for its existence.

The duties of directors and officers of corporations are of a fiduciary nature\(28\) - in other words, they "owe to the corporation and its shareholders the duty of honesty, loyalty, good faith, diligence and fairness; they must act for the benefit of the corporation and its shareholders, and never use their fiduciary positions to further their personal interests."\(29\) While the English courts and commentators have traditionally divided a director's common law duties into a duty of good faith or loyalty and a duty of care and skill\(30\), their American counterparts at times

\(25\) Corporate Governance Project: Analysis and Recommendations (proposed final draft 1990); see also Special Project Note "The Corporate Governance Debate and the ALI Proposals: Reform or Restatement?" (1987) 40 Vanderbilt Law Review 693.

\(26\) At 717-718.

\(27\) Block et al, op cit, §1.B.5.

\(28\) Bosworth v Allen 168 NY 157, 61 NE 163; Bodell v General Gas and Electric Corp 132 A 442, 446 (Del Ch 1926).


appear to group them all under the category of fiduciary duties. The distinction may for many purposes appear academic, but the American approach has led to the inclusion in the business judgment rule of three elements which, had the English approach been followed, could have been excluded.

The elements of disinterestedness and good faith, in which latter we may include the director's duty to act in what he honestly believes to be the best interests of his corporation, if categorized under the heading of fiduciary duties (in the English sense), would not need to be referred to, since the business judgment rule in fact applies only to the director's compliance with the duty of care and skill. These elements of the rule, as expressed by the American commentators - elements (a), (c) and (d) of the American Law Institute's description of the common law rule referred to - will therefore not be discussed in detail in this review. Suffice it to say that, if the duties of good faith and loyalty are breached, then any consideration of the duty of care and skill is irrelevant. The American courts have themselves expressed this by describing the duty of good faith as a hurdle which must be cleared by the plaintiff before a court will even consider whether the business judgment rule is applicable. The situation may be considered analogous to charging a director with fraud or with negligence - if he is guilty of fraud, a defence that he carried out his duties with due diligence will not assist him.

The business judgment rule must therefore be considered primarily in the context of an action against a director, or a board of directors, for loss to the corporation or its shareholders caused by a failure to fulfil the director's duty of care and skill.

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Block, Barton & Rodin The Business Judgment Rule - Fiduciary Duties of Corporate Directors and Officers (1987) 1; Lewis CD "The Business Judgment Rule and Corporate Directors' Liability for Mismanagement" (1970) 22 Baylor Law Review 157,161; Hanson Trust plc v ML SCM Acquisition Inc 781 F 2d 264, 274 (2d Cir 1986) ("[T]he exercise of fiduciary duties by a corporate board includes more than avoiding fraud, bad faith and self-dealing. Directors must exercise their 'honest judgment in the lawful and legitimate furtherance of corporate purposes' Auerbach v Bennett 419 NYS 2d 926, 393 NE 2d R 1000.")

Joy v North 692 F 2d 880, 886 (2d Cir 1982); Aronson v Lewis 473 A 2d 805, 812 (Del 1984); Unocal Corp v Mesa Petroleum Co 492 A 2d 946, 958 (Del 1985); Hanson Trust plc v ML SCM Acquisition Inc 781 F 2d 264, 274 (2d Cir 1986).
The duty of care and skill has been the subject of much discussion. English cases until relatively recently demonstrate a reluctance to impose on directors any duty which could be regarded in a serious light; so an infant of six months could be appointed chairman of the board of directors and attend only a single board meeting in 38 years, and still escape liability for the mismanagement of the company by certain of the directors and managers. Numerous examples of this nature are to be found in the commentaries. In the United States, a director was placed under no more strenuous obligations. In what was admittedly an extreme case, two directors of a bank who were found to be of "unsound mind during the entire time they were on the board" were held not to be liable for the negligent conduct of their co-directors. It is interesting to note that many of the cases in which the conduct of directors was challenged on the grounds of lack of due care (in both countries) concerned directors of banks - an area where one would logically expect a greater degree of care to be required of directors. The lack of insistence on even a limited standard of care on the part of directors has drawn much comment from academic writers, and it was not until Dorchester Finance Co Ltd v Stebbing in England and Smith v Van Gorkom in America that the courts began to give more serious consideration to this aspect of what has now come to be styled "corporate governance".

The rationale for the business judgment rule is simple. A successful business requires directors who can react quickly to changing market needs and technological developments; business is about taking risks, and directors must be able to take risks without fear of their conduct being judged, to their financial prejudice, by hindsight. If a director faced the possibility of a

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34 See eg Overend, Gurney & Co v Gibb and Gibb (1872) LR 5 HL 480; Lagoonas Nitrate Co v Lagoonas Syndicate [1899] 2 Ch 392; Re Brazilian Rubber Plantations and Estates Ltd [1911] 1 Ch 425 .

35 Re Cardiff Savings Bank (The Marquess of Bute's Case) [1892] Ch 100.

36 Anderson v Akers 7 F Supp 924 (WD Ky 1934).


38 [1989] BCLC 498. It is interesting to note that although this case was decided in 1977, it was not considered of sufficient importance to be reported until 12 years later.

39 488 A 2d 858 (Del 1985).
negligence action whenever he made an honest mistake, few competent persons would be willing to take on the office. As long ago as 1847, the Alabama Supreme Court, in *Godbold v Branch Bank*, expressed its opinion that "no man of ordinary prudence would accept a trust surrounded by such perils." After *Van Gorkom*, corporate America, together with many academic lawyers, threw up its hands in horror. It would be difficult, if not impossible, for public corporations to recruit directors who were prepared to subject themselves to a stricter regime of liability, and the cost in terms of indemnity premiums would be astronomical.

Moves were made to introduce statutory limits on directors' liability for negligence. Nevertheless, the courts continued to tighten the screw, particularly in those cases where "the omnipresent specter [arises] that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders."

The business judgment rule is an extension of the principle that a corporation is managed by its directors, under powers given by its founding statutes, or by statutory provision. The selection of the directors is in the hands of the shareholders (technically, at least). It would therefore be "unfair, and ultimately counterproductive, to allow shareholders to elect directors

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80 11 Ala 191, 199 (1847).
82 Eg Delaware General Corporation Law (C 8) §102(h)(7).
83 Particularly in *Unocal Corp v Mesa Petroleum Co* 493 A 2d 946 (Del 1985); *Moran v Household but' l Inc* 500 A 2d 1346 (Del 1985); *Revlon v MacAndrews and Forbes Holdings Inc* 506 A 2d 173 (Del 1986); *Hauton Trust plc v ML SCM Acquisition Inc* 781 F 2d 264 (2d Cir 1986); *In re JP Stevens & Co Inc* 542 A 2d 770 (Del Ch 1988); *Investors Partners v Newmont Mining Corp* 535 A 2d 1334 (Del 1989); *Mills Acquisition Co v Macmillan Inc* 559 A 2d 1261 (Del 1988); *Citron v Fairchild Camera & Instrument Co* 569 A 2d 53 (Del 1989); *Gilbert v El Paso Co* 575 A 2d 1131 (Del 1990).
84 *Unocal Corp v Mesa Petroleum Co* 493 A 2d 946, 954 (Del 1985). See the discussion in the following chapter.
85 eg 8 Del C § 141(a); see *Pogostin v Rice* 480 A 2d 619, 624 (Del 1984); *Citron v Fairchild Camera & Instrument* 569 A 2d 53, 64 (Del 1989).
of their choosing and then to collect damages from those directors when their judgment - as opposed to their honesty and diligence - proves faulty."\textsuperscript{46}

The second leg of the rationale for the business judgment rule is formed by the belief that the courts are ill-equipped to take upon themselves the role of business decision makers. The Delaware Chancery Court expressed the matter eruditely:

> Because businessmen and women are correctly perceived as possessing skills, information and judgment not possessed by reviewing courts and because there is great social utility in encouraging the allocation of assets and the evaluation and assumption of economic risk by those with such skill and information, courts have long been reluctant to second-guess such decisions when they appear to have been made in good faith.\textsuperscript{47}

The corollary to this principle is that directors who constantly show poor business judgment will become an unmarketable commodity, whereas judges are under no such pressure.

> Managers who make such judgment calls poorly ultimately give way to superior executives; no such mechanism 'selects out' judges who try to make business decisions. In the long run firms are better off when business decisions are made by business specialists, even granting the inevitable errors.\textsuperscript{48}

Having eliminated three of the four elements, we are left with the core of the rule - the statement that "[directors] enjoy a presumption [in making business decisions] of sound business judgment .... which courts will not disturb if any rational business purpose can be attributed to their decisions".\textsuperscript{49}

This remaining element of the rule itself contains a number of sub-elements.

The use of the word "presumption" raises the question of the nature of the rule. A review of

\textsuperscript{46} Soderquist \& Sommer \textit{Understanding Corporation Law} (1990) 173.

\textsuperscript{47} Sokash \textit{v} Telex Corp (Del Ch Jan 19, 1988) cited in \textit{In re JP Stevens \& Co Inc} 542 A 2d 770, 780 (Del Ch 1988).


\textsuperscript{49} Panter \textit{v} Marshall Field \& Co 486 F Supp 1168, 1994 (ND Ill 1980).
authoritative pronouncements attempting to answer the question reveals a confusion which is perhaps more apparent than real. In *Citron v Fairchild Camera and Instrument Co*, the Delaware Supreme Court said “[t]he rule operates as both a procedural guide for litigants and a substantive rule of law.”\textsuperscript{50} Two leading writers have expressed their view in the following words: “The business judgment rule is a judicial standard for the review of corporate decisionmaking”\textsuperscript{51}; and, “The business judgment rule is thus a tool of judicial review rather than a standard of conduct.”\textsuperscript{52} The practical application of these concepts is discussed when considering the application of the rule.

At least one writer\textsuperscript{53} distinguishes between the business judgment rule, which normally prevents courts from reviewing board decisions, and the business judgment doctrine, which protects the decisions themselves from judicial interference. There appears to be little practical value in the distinction, and the courts themselves use the two terms interchangeably.\textsuperscript{54}

The definition of the rule refers to the making of business decisions. By extrapolation, it offers no protection in those cases where a board does not make a decision. In *Aronson v Lewis* the court said:

\begin{quote}
[It should be noted that the business judgment rule operates only in the context of director action. Technically speaking, it has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act. But it also follows that under applicable principles, a conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment and enjoy
\end{quote}

\textsuperscript{50} 569 A 2d 53, 64 (Del 1989).


\textsuperscript{52} Block DJ, Radin SA & Barton NR “The Business Judgment Rule and Shareholder Derivative Litigation” in *Directors' and Officers' Liability* 1993 68.


\textsuperscript{54} See eg, *Hanson Trust plc v ML SCM Acquisition Inc* 781 F 2d 264 (2d Cir 1986) which refers to “the business judgment rule” (at 273) and “the business judgment doctrine” (at 274) without any apparent distinction. *Citron v Fairchild Camera and Instrument Co* 569 A 2d 53 (Del 1989) refers to the business judgment rule as protecting “the directors and the decisions they make” (at 64).
The second part of the above citation casts an important light on the true content of the rule; there must be a conscious decision. If, having fully considered a particular matter, a board takes a decision not to act, that decision will enjoy the protection of the rule. This reflects the basic tenet of the rule - directors' fulfilment of their duty of care and skill is judged by the procedure they adopt when taking business decisions, not by the content of their decisions.

The next step in the inquiry into the content of the rule is therefore what standards of conduct a director is required to satisfy, and there are differences between the jurisdictions and, in some cases, between statutory law and the common law. The principle laid down by the Delaware Court of Chancery in *Graham v Allis-Chalmers Mfg Co* reflects the approach most commonly adopted: "Directors of a corporation in managing corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances." This standard was adopted by the American Law Institute in its Corporate Governance Project. The Project recognizes the historical corporate governance debate, in the context of the propensity of managers of large corporations to usurp the control functions of the stockholders, and seeks to coordinate the various proposals for reform and to compile a single Act which may be used as a model for reforming state corporate law. The Project is divided into seven sections dealing with:

1. definitions;
2. objectives and conduct of the business corporation;
3. structure of the corporation;
4. duty of care and the business judgment rule;

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55 473 A 2d 805, 813 (Del 1984).

56 See Bradbury SG "Corporate Auctions and Directors' Fiduciary Duties - A Third-Generation Business Judgment Rule" (1988) 87 Michigan Law Review 276: "The traditional rule protects from liability disinterested directors who have, in the exercise of their business judgment, satisfied the standards of conduct required ..." (at 281).

57 41 Del Ch 89, 188 A 2d 125 (1963).

58 At 130.

(5) duty of loyalty;
(6) transactions in control;
(7) remedies.\textsuperscript{60}

The Institute considered that a less rigorous standard than simple negligence was required, since such a standard could potentially impose liability on a director for any incorrect decision. This view was expressed by the court in Stern v Lucy Webb Hayes National Training School for Deaconesses and Missionaries:

Both trustees and corporate directors are liable for losses caused by their negligent mismanagement of investments. However, the degree of care required appears to differ in many jurisdictions. A trustee is uniformly held to a high standard of care and negligence, while a director must often have committed "gross negligence" or otherwise be guilty of more than mere mistakes of judgment.\textsuperscript{61}

The standard of conduct required is emphasized in Aronson v Lewis:

While the Delaware cases have not been precise in articulating the standard by which the exercise of business judgment is governed, a long line of Delaware cases holds that director liability is predicated on a standard which is less exacting than simple negligence.\textsuperscript{62}

The standard of gross negligence adopted by the Delaware courts was confirmed in Smith v Van Gorkom\textsuperscript{63}. In this case, which is frequently referred to as the Trans Union case, Jerome W Gorkom, the Chairman and Chief Executive Officer of Trans Union, negotiated a merger agreement in respect of the corporation. He called a meeting of directors at a day's notice to approve the agreement. Immediately prior to the board meeting, he called a meeting of senior management to advise them of the proposed merger. At that stage only the president of the corporation and one other manager were aware of the proposal. The reaction of senior management was almost entirely negative.

At the subsequent board meeting, Van Gorkom made a twenty minute oral presentation. Copies of the merger agreement were not made available to the directors in time for study, and

\textsuperscript{60} Special Project Note "The Corporate Governance Debate and the ALI Proposals : Reform or Restatement?" (1987) 40 Vanderbilt Law Review 693.

\textsuperscript{61} 381 F Supp 1003 (DCC 1974).

\textsuperscript{62} 473 A 2d 805 (Del 1984) at 812 n 6.

\textsuperscript{63} 488 A 2d 858 (Del 1985) at 873; "We think the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one."
no information was given as to how the proposed price for Trans Union's stock had been established, nor were the corporation's bankers or financial advisers present at the meeting, or even consulted. The corporation's chief financial officer, who was not a director, told the directors that he had not been aware of the proposal until the morning of the meeting, and that he could not confirm that the price offered was a fair one until he had a chance to study the matter further. Nevertheless, after a two hour meeting, the directors resolved to approve the merger, the agreement being executed by Van Gorkom in the course of a social function that same evening. Van Gorkom later signed a number of amendments without further reference to the board and the transaction was ratified at a meeting of stockholders some four months later. Certain aggrieved stockholders brought an action against the directors for negligence in approving the merger.

In dismissing the action, the Delaware Court of Chancery found that the directors had acquired sufficient information during the four month period between the board approval and the ratification by the stockholders to satisfy themselves that the deal was fair to stockholders, and had thus fulfilled the requirements of the business judgment rule.

On review, the Delaware Supreme Court upheld the stockholders' claim and awarded substantial damages. The Supreme Court found that the trial court had erred in finding that the directors had fulfilled their duty of care and attention by not informing themselves sufficiently of the Chairman's role in forcing the merger, and in establishing the true value of the corporation's stock. There had been no need for the board meeting to be held at such short notice or for the decision to approve the merger being taken after a comparatively short discussion, without the advice of the company's financial advisers and contrary to the opinions of senior management. The fact that information had subsequently been obtained and the decision ratified by the stockholders was irrelevant.

Part of the director's duty of care is the duty to inform himself\textsuperscript{54}, to the extent that he

\textsuperscript{54} Hanson Trust plc v ML SCM Acquisition Inc 781 F 2d 264, 274.
reasonably believes necessary in the circumstances, about the business of the company in
general, and about the matter under discussion in particular. Some writers have elevated
the "duty to be informed" to the status of a separate duty; it is probably more correct to
consider its fulfilment as part of the duty of care and skill, or of diligence, required to be
exercised by a director or officer. The duty to be informed has been formulated in at least one
statute.

The rule may thus be summarized as protecting a director who has taken a business decision
after proper inquiry and deliberation from liability for the consequences of such decision.

3 The application of the rule

It has already been noted that the business judgment rule has been held to operate as both a
presumption and as a substantive rule of law. As a presumption, it places on the party seeking
to attach liability to the directors the onus of proving that circumstances exist, which prevent
the application by the court of the substantive rule that it will not interfere with the decision-
making process of corporate directors. In Citron v Fairchild Camera & Instrument, the court
said:

"The burden falls upon the proponent of a claim to rebut the presumption by introducing evidence either of
director self-interest, if not self-dealing, or that the directors either lacked good faith or failed to exercise
due care.

If the proponent fails to meet her burden of establishing facts rebutting the presumption, the business
judgment rule, as a substantive rule of law, will attach to protect the directors and the decisions they
make."


Hanson Trust PLC v ML SCM Acquisition Inc 781 F 2d 264, 274; Francis v United Jersey Bank 432 A 2d 814, 821-22 (NJ 1981).

Stern v Lucy Webb Hayes National Training School for Deaconesses and Missionaries 381 F Supp 1003 (DCC 1974). "A director who fails to acquire the information necessary ... has violated his fiduciary duty to the corporation." (at 1013)

Supra, pp 6-7.

California Corporation Code § 3.09(a).

569 A 2d 53, 64 (Del 1989); see also Puma v Marriott 283 A 2d 693, 695 (Del Ch 1971); Aronson v Lewis 473 A 2d 805, 812 (Del 1984); Smith v Van Gorkom 488 A 2d 858, 873 (Del 1985); Revlon Inc v MacAndrews and Forbes Holdings 506 A 2d 173, 180 n 10 (Del 1986); Hinsey J "Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, The Doctrine and the Reality"
If it were accepted that the business judgment rule applied only to the exercise of a director's duty of care and skill, the presumption would not arise in the case of an alleged breach of the director's fiduciary duty (as defined by the English authorities); it would merely be necessary for the applicant to allege that a director acted in bad faith or out of self-interest. The onus would of course remain on the applicant to prove the alleged facts, if denied by the director, but the applicant would not be faced with the additional burden of overcoming a presumption in favour of the respondent. 71

There are however, in broad terms, two sets of special circumstances which restrict the application of the rule as a presumption in favour of the allegedly negligent director.

Where the board of a corporation takes steps in face of a hostile take-over, it is logical to expect the courts to protect these steps in terms of the business judgment rule. In Unocal Corp v Mesa Petroleum Co the Delaware Supreme Court endorsed this view:

"When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. In that respect a board's duty is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they would otherwise be accorded in the realm of business judgment." 72

However, the court in the same case drew attention to the need to be particularly vigilant in those cases where there is a possibility that the directors may be acting in their own interests rather than those of the corporation and the stockholders in general. 73

The action in Unocal was brought by a minority shareholder who had made a hostile takeover bid, and sought the prevent the corporation resisting his bid by, in effect, tendering for its own shares. Unocal has become a benchmark case in establishing the responsibilities of directors in takeover situations and the court's duty to establish whether there are special circumstances excluding the application of the business judgment rule. The court commenced by examining


71 See Federal Rules of Evidence §301.

72 493 A 2d 946 (Del 1985) at 954.

73 At 954. See supra p 5, n 43.
the directors' power to take steps to resist a takeover bid. It established clearly that, without such power, "[n]either issues of fairness nor business judgment are pertinent."74 Having concluded that the directors were indeed authorised by the inherent powers conferred by the Delaware General Corporations Law,75 and by their "fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm reasonably perceived, irrespective of its source."76

The court then set out the procedure it should adopt to satisfy itself that the directors are prima facie entitled to the protection of the business judgment rule:

"Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.

This Court has long recognized that:

We must bear in mind the inherent danger in the purchase of shares with corporate funds to remove a threat to corporate policy when a threat to control is involved. The directors are of necessity confronted with a conflict of interest, and an objective decision is difficult.

Bennett v Propp Del Supr 187 A 2d 405, 409 (1962). In the face of this inherent conflict directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership. Cheff v Mathes 199 A 2d at 554-55. However, they satisfy that burden "by showing good faith and reasonable investigation .... " Id at 555."

It appears from this decision of the Delaware Supreme Court that, in a takeover situation, the onus is on the directors to show that they exercised good faith, carried out reasonable investigation, and that the course of action resolved upon was "reasonable in relation to the threat posed."78 However, the court had previously stated: "We will not substitute our views

74 At 953.
75 § Del C §141(a), and more specifically the power of a corporation to deal in its own stock contained in §160(a).
76 At 954. The court referred, in particular, to Pauter v Marshall Field & Co 646 F 2d 271, 297 (7th Cir 1981); Croes-Hoob & Co v Interborelli Inc 634 F 2d 690, 704 (2d Cir 1980); Heit v Baird 567 F 2d 1157, 1161 (1st Cir 1977); Cheff v Mathes 199 A 2d 548, 555 (Del 1964); Martin v American Potash & Chemical Corp 92 A 2d 295, 302 (Del Ch 1952); Kaplan v Goldsamt 380 A 2d 556, 568-569 (Del Ch 1977); Kors v Carey 158 A 2d 136, 141 (Del Ch 1960); Northwest Industries Inc v BF Goodrich 301 F Supp 706, 712 (MD Ill 1969); and Johnson v Trueblood 629 F 2d 287, 292-293 (3d Cir 1980).
77 493 A 2d 946 at 954-955.
78 Id at 955.
for those of the board if the latter's decision can be 'attributed to any rational business purpose'\textsuperscript{79}, which appears to broaden the test of reasonableness somewhat. The approach of the court in \textit{Unocal} has been approved in a number of subsequent judgments.\textsuperscript{80}

The other circumstances under which a need arises for the court to be convinced of the applicability of the business judgment rule, given the enhanced probability that the directors are acting out of self-interest, occur when the board, or a duly authorised committee of the board, resolves on the desirability of continuing with a derivative action by a shareholder. In most American jurisdictions, a shareholder wishing to bring an action on behalf of the corporation of which he is a member, usually an action against the directors for breach of their fiduciary duties (including, in the American model, the duty of care and skill), must first demand of the directors that they bring such action in the name of the corporation. Only if they refuse or fail to bring the action may he himself approach the courts.\textsuperscript{81}

Logically, as in the case of opposition to a takeover, a decision by the directors not to continue with a derivative suit should enjoy the protection of the business judgment rule, assuming it satisfies the requirements of the rule. However, the possibility of a conflict of interests, where directors have to rule on the desirability of bringing suit against some of their own number, cannot be regarded as merely illusory. As the Circuit Court said in \textit{Joy v North}, "The ... fiduciary obligations of directors ... can hardly be said to exist if the sole enforcement method can be eliminated on a recommendation of the defendant's appointees".\textsuperscript{82}

In \textit{Auerbach v Bennett}\textsuperscript{83} the New York Court of Appeals held that the court's obligation

\textsuperscript{79} At 949, citing \textit{Sinclair Oil Corp v Levien} 280 A 2d 717, 720 (Del 1971).

\textsuperscript{80} \textit{See eg Revlon Inc v MacAndrews and Forbes Holdings Inc} 506 A 2d 173, 180 (Del 1986); \textit{Ivanhoe Partners v Newman Mining Corp} 555 A 2d 1334, 1341 (Del 1987); \textit{Mills Acquisition Co v Macmillan Inc} 559 A 2d 1261, 1279 (Del 1988); \textit{Gilbert v El Paso Co} 575 A 2d 1, 131, 134 (Del 1990).

\textsuperscript{81} \textit{Joy v North} 692 F 2d 880, 888 (2d Cir 1982). See also Block DJ and Pnissin HA "Termination of Derivative Suits against Directors on Business Judgment Grounds: From \textit{Zapata} to \textit{Aronson}" (1984) 39 \textit{Business Lawyer} 1503 at 1508-1513.

\textsuperscript{82} \textit{Id} at 889.

\textsuperscript{83} 47 NY 2d, 419 NYS 2d, 393 NE 2d 994 (1979).
extended no further than was necessary to determine whether the board or committee had acted independently, diligently and in good faith. Otherwise, the business judgment rule would apply, and the court would not review the substance of the decision. The Delaware Supreme Court expressly refused to adopt the business judgment rationale in such circumstances. In Zapata Corp v Maldonado it established a two-step analysis:

"First, the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions. The corporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness. If the Court determines either that the committee is not independent or has not shown reasonable bases for its conclusions, or, if the Court is not satisfied for other reasons relating to the process, including but not limited to the good faith of the committee, the Court shall deny the corporation’s motion [to dismiss the shareholder’s action]. ... [As the] second step ... the Court should determine, applying its own business judgment, whether the motion should be granted. ... The second step is intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation’s interest." 8

The same court, in Aronson v Lewis 85 limited the application of the two-step test in Zapata by ruling that it only applied to demand excused cases - those cases where the plaintiff could approach the court directly, without first requiring the directors to institute action in the name of the corporation, on the grounds that the directors were not disinterested and that demand would therefore be futile. As expressed in Aronson, demand is only excused where the plaintiff can show self-dealing on the part of the directors. 86

Cases in other jurisdictions show a variety of approaches. In Miller v Register & Tribune Syndicate Inc, 87 the Iowa Supreme Court ruled that directors who are defendants in a derivative action may not appoint a special litigation committee, as even the appointment would be tainted with self-interest. The court claimed to follow the recommendations of the American Law Institute that litigation committees must be appointed by disinterested directors. 88

85 473 A 2d 805 (Del 1984).
87 336 NW 2d 709 (Iowa 1983).
88 Id at 717.
The North Carolina case of *Alford v Shaw*[^89] is an interesting one; the district court ruled that the business judgment rule applied to the decisions of a special litigation committee and dismissed the action; on appeal, the decision of the trial court was reversed, and the court applied *Miller*[^90]. The Supreme Court, on further appeal, reversed the decision of the appeal court, and in doing so approved *Auerbach*[^91], in which the business judgment rule was applied in the traditional manner, excluding the court's power to review a board decision; *Zapata*, which it ruled did not apply to the current case, as it was not a demand excused application; and *Miller*, which it rejected on the surprising grounds that it was not "in the best interests" of North Carolina's corporate community. The court applied *Auerbach*, making it more onerous for the defendant directors by ruling that the onus of proving disinterestedness rested on such defendant directors.[^92]

The United States Court of Appeals, asked in *Joy v North* to decide between following *Auerbach* or *Maldonado*, approved, in a majority judgment, the two-step approach adopted by the Delaware court, which it called an "independent business judgment" test. In the course of his judgment, Winter CJ considered the fact that part of the rationale for the business judgment rule was that judges are not the best makers of business judgments, even by hindsight[^93]. He considered that this rationale could scarcely apply to the evaluation of the recommendations of special litigation committees appointed by boards of directors:

"[T]he difficulties courts face in evaluation of business decisions are considerably less in the case of recommendations of special litigation committees. The relevant decision - whether to continue litigation - is at hand and the danger of deceptive hindsight simply does not exist. Moreover, it can hardly be argued that terminating a lawsuit is an area in which courts have no special aptitude."

[^89]: 349 SE 2d 41 (1986).
[^90]: 324 SE 2d 878, 881 (NC 1985).
[^91]: *Supra*.
[^92]: 349 SE 2d 41, 50 (NC 1985).
[^93]: *Supra* pp 8 - 9.
[^94]: 692 F 2d 880, 888 (2d Cir 1982).
the trial court's discretion."^{95}

In a later decision the United States Court of Appeals, applying New York law, held that the normal application of the business judgment rule must be followed; since the rule presumed that directors had acted properly, the burden of proof must rest on the party alleging absence of disinterestedness on the part of the directors, even in a derivative suit situation.^{96}

4 Codification of the rule

The director's duty of care and skill has been codified in the majority of American states.^{97} Most codifications are based on §8.30(a) of the Revised Model Business Corporation Act^{98}:

A director shall discharge his duties as a director, including his duties as a member of a committee:

(1) in good faith;
(2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
(3) in a manner he reasonably believes to be in the best interest of the corporation.

However, no state has yet codified the business judgment rule, and at least one has effectively removed the requirement of the exercise of care and skill by a director, restricting liability to cases where a director has been guilty of wilful misconduct or recklessness.^{99} In spite of, or perhaps in reply to, the attitude of its courts to the duty of care of directors, Delaware has amended its General Corporation Law to permit a corporation to include in its charter a provision eliminating or restricting the liability of its directors for breaches of the duty of care, and most other states have followed suit.^{100}

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^{95} Id at 898 - 899.

^{96} Hanson Trust plc v ML SCM Acquisition Inc 781 F 2d 264, 273 (2d Cir 1986).


^{98} Frequently referred to as the "safe harbor" provision.


The American Bar Association's Corporate Laws Committee considered including the relevant provisions in the Revised Model Business Corporation Act, but found it impossible to agree on a suitable draft, even after three years of debate. In its Official Comment on the Revised Model Act, the committee concluded that the "elements of the business judgment rule and the circumstances for its application are continuing to be developed by the courts. ... [The codification of the rule] is a task to be left to the courts and possibly to later revisions of this Model Act."

The American Law Institute's corporate governance project was intended inter alia "to propose desirable changes in prevailing legal norms or corporate practice where such judgments can be made."

Unlike the American Bar Association, the recommendations of the Institute included a formulation of the business judgment rule. Paragraph 4.01 deals with the directorial standard of conduct, and paragraph 4.01(c) is drafted as follows:

A director or officer who makes a business judgment in good faith fulfills his duty [of care] if:

1. he is not interested [as defined] in the subject of his business judgment;
2. he is informed with respect to the subject of his business judgment to the extent he reasonably believes to be appropriate under the circumstances; and
3. he rationally believes that his business judgment is in the best interests of the corporation.

The recommendations of the Institute have not been without their critics. The American Business Round Table feared that the inclusion of the word "rationally" in paragraph 4.01(c)(3) would permit the courts to examine the merits of a decision to establish whether the director's

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101 Block et al., supra at 19.
102 At 221.
103 Principles of Corporate Governance and Structure: Restatement and Recommendations (Tentative Draft No 1, April 1982) Introductory note at xxi.
104 Tentative Draft No 4, Apr 12, 1985.
belief was in fact rational.\textsuperscript{105} The following statement, on the other hand, is a clear endorsement of the approach adopted in the drafting of the Model Act:

"The general comments' suggestion that section 4.01 be implemented through state legislative action is unwise. The genius of the common law is well exemplified by the courts' gradual development of the business judgment rule. The courts' response to new developments, through the evolutionary process afforded by case-by-case adjudication, has been heartening. Codification would create a rigidity that would have a chilling affect upon part-time directors and a stultifying effect upon the rule's further development by the courts."

The writer clearly approves of, and refers to, the process of judicial development previously referred to in \textit{Auerbach v Bennett, Zapata Corp v Maldonado} and \textit{Joy v North}.\textsuperscript{107} He also suggests that a director's decision making function and his oversight function should be separated, the former applying to a series of discrete transactions, and the latter to an ongoing process. The business judgment rule applies only to the decision-making process, and Hinsey suggests that, if it necessary to retain paragraph 4.01(c), the introductory part should be redrawn to reflect this:

"In performing his decision making functions, a director or officer does not violate his duty under this Section with respect to the consequence of a business judgment if ..."

He also suggests that a limit be specified for sustained and unexcused inattention either to the performance of his functions or conscious disregard of or indifference to duties that is reckless under the circumstances.

\section{5 The director's duty of care in England}

The approach of the English courts to the director's duty of care and skill has been briefly outlined in the course of discussing the development of the American law relating to the fiduciary duties of corporate directors and officers.\textsuperscript{108} Mention has been made of some of the more spectacular cases in which the low level of attention to their duties required of directors...
was set out. The common law has changed little since *The Marquess of Bute's Case* or *Re Brazilian Rubber Plantations and Estates Ltd*, in which directors of a company which purchased a rubber plantation were not expected to know anything about the production of rubber.

An assessment of the common law position can be easily derived from considering the comments of two leading English writers on company law.

Gower says:

> [T]here is a striking contrast between the directors' heavy duties of loyalty and good faith and their light obligations of skill and diligence. ... The law might, no doubt, have demanded of directors a degree of diligence comparable to that of trustees - a high degree particularly where they are paid. But the law cannot be too far in advance of public opinion, and public opinion has come to recognise that non-executive directorships are often little more than sinecures, requiring, at most, attendance at occasional board meetings.

The latest edition of Farrar says

> This [the duty of care and skill] is an area where the common law has failed to keep pace with modern developments and instead presents a lamentably out of date view of directors' duties. In the past the courts have been reluctant to impose onerous standards of care and skill on directors and have been willing to impose liability only when a director's imprudence has been so great and so manifest as to amount to gross negligence.

One commentator has referred to the standard of diligence set by the courts as "historically ... comically low."

The degree of care and skill a director is required to exercise was laid down by the Court of Appeal in *Re City Equitable Fire Insurance Co* and this case has been approved by many

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109 *Re Cardiff Savings Bank* [1892] Ch 100, *see p 7 fn 34.
110 [1911] 1 Ch 425.
111 *See also Re Denham & Co* (1884) 25 Ch D 752; *Lagunas Nitrato Co Ltd v Lagunas Syndicate Ltd* [1899] 2 Ch 392.
112 Principles of Modern Company Law 5 ed (1992) 585. The fact that the position has remained static can be readily seen from the fact that the words quoted are almost identical with those used 23 years previously - 3 ed (1969) 549.
115 [1925] Ch 407 CA 427 ff, per Romer J.
courts following English precedent, particularly in so far as they apply to non-executive directors. The court established three guiding principles:

1. A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience;

2. A director is not bound to give continuous attention to the affairs of his company. He is not bound to attend all directors' meetings, but should attend whenever he is reasonably able to do so;

3. In respect of all duties that, having regard to the nature of the business, he is entitled by the articles of association or other provisions to entrust to some other official, he is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.

The degree of care, skill and attention required of a director is thus related to the character of the director himself. This contrasts with the general law of negligence, where the standard of skill required is established objectively in relation to the act performed.

Although in a case decided in 1977 where no board meetings were ever held and the two non-executive directors took no steps to inform themselves of the managing director's (fraudulent) activities and those directors were consequently held liable for a breach of duty based on their failure to supervise the executive director's conduct, the case was not considered of sufficient importance to find its way into the law reports until 1989.

The significant changes which have occurred in recent years in English corporate law have been brought about by statute. Two enactments are of particular importance:

1. Section 214 of the Insolvency Act, 1986. This section empowers a court to impose on a director of a company which has gone into insolvent liquidation personal liability for...

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116 See, eg, Fisheries Development Corporation of South Africa v Jorgensen 1980 (4) SA 156 (W).

117 Wilsher v Essex Area Health Authority [1986] 3 All ER 801: "[The] notion of a duty tailored to the actor, rather than the act which he elects to perform, has no place in the law of tort." (at 813, per Mustill J). See also Parkinson op cit at 103-104.

the debts of the company if he is guilty of "wrongful trading". Wrongful trading is a new concept introduced by this Act, which did not occur in the comparable provision of the Companies Act, 1948, and occurs when a director is, or should be, aware that there is no reasonable prospect of his company avoiding liquidation, and fails to take timeous and appropriate action to minimize the potential loss to creditors. The provisions are similar to those of sections 423-425 of the South African Companies Act, and it remains to be seen whether they will prove as ineffective as those sections have been.

(2) Sections 6 and 8 of the Company Directors Disqualification Act, 1986, empower the court to disqualify from office a director who has been guilty of wrongful trading. In Re Lo-Line Electric Motors Ltd, it was held that, for the provisions of the Act to apply, the director must at least be guilty of gross negligence.

The business judgment rule has never been identified as such by the English courts, although its existence is recognised, by academics at least, by implication. Gower refers to "an understandable reluctance to interfere with the directors' business judgment", while Farrar comments on the continuing reluctance of courts to investigate the internal management of companies. Parkinson refers to the matter more directly:

[The business judgment] rule ... is an articulate version of the policy of judicial reticence that is implicit in the practice of the English courts...
That the courts have moved some way towards the normal standard of care applicable in a negligence action can be seen from the words of the court in *Norman v Theodore Goddard*, a case involving s 214(4) of the Insolvency Act, 1986:

[A] director performing active duties on behalf of the company need not exhibit a greater degree of skill than may reasonably be expected from a person undertaking those duties.127

However, the general view, expressed more than 100 years ago in *Turquand v Marshall*28 is that mismanagement should be controlled by shareholder supervision, and this, at least according to Parkinson, is underpinned by the provisions of section 303 of the Companies Act, 1985, with the court's role "merely to act as a longstop".129 The provisions of the Insolvency and Company Directors Disqualification Acts referred to are defensive provisions, which only come into play when a company is at best in serious financial difficulties, and do not give the courts (or shareholders) any right to deal proactively with mismanagement.

6 The director's duty of care in other jurisdictions

As might be expected, legal systems based on the common law have generally followed the Anglo-American pattern. The level of care and skill required of a director is generally no higher than that laid down by the English courts in *Re City Equitable Fire Insurance Co Ltd*30 or by their United States counterparts in *Smith v Van Gorkom*.131

In Canada, the approach appears to be closest to that of the American courts. The level of attention to his duties required of a director is codified in the Canada Business Corporations Act, 1985 as the "care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances".132 Following the recommendations of the Lawrence

128 (1869) LR 4 Ch App 376.
129 Op cit note 113 at 104.
130 [1925] Ch 407 (CA), supra, p 22.
131 488 A 2d 858 (Del 1985), supra p 11; see also Millard The Responsible Director (1989) 10.
132 S 112(1).
Commission\textsuperscript{133}, a higher standard was legislated in Ontario; a duty is imposed on a director who is not present at a board meeting to find out what business was transacted at that meeting; if he becomes aware of an illegal act by his company he must immediately register his dissent in writing. If, by the exercise of reasonable diligence, he should have discovered the act earlier, he may still be liable.\textsuperscript{134} A similar provision in the federal Act deems every director to have assented to a decision unless he expressly records his dissent in writing.\textsuperscript{135}

At least one writer assumes that the business judgment rule will be applied by Canadian courts.\textsuperscript{136}

In \textbf{Australia}, the director’s duty of care is laid down in s 229(2) of the Corporations Code:

\begin{quote}
An officer of a corporation shall at all times exercise a reasonable degree of care in the exercise of his powers and the discharge of his duties. Penalty: $5,000.
\end{quote}

It is interesting to note that a breach of the duty is a criminal act. It was originally the intention to specify a term of one year’s imprisonment as the maximum penalty, but this aroused such an outcry that the provision was dropped.\textsuperscript{137} Although the imposition of criminal sanctions appears to represent a stricter application of the duty of care, this does not appear to have been the case in practice. The Supreme Court of Victoria\textsuperscript{138}, applying a similar provision of the Uniform Companies Act\textsuperscript{139} (but without the penalties), held that the reference to “reasonable diligence” did not impose an objective test of a director’s conduct, but was merely a statement of the principles laid down by Romer J in \textit{re City Equitable Fire Insurance Commission}.

\begin{thebibliography}{139}
\bibitem{133} Report of the Committee on Company Law Reform in Ontario (1967).
\bibitem{134} The Business Corporations Act, s 137.
\bibitem{135} S 118(3).
\bibitem{136} Wainberg \textit{Duties and Responsibilities of Directors in Canada} (1975) 17 - 27.
\bibitem{138} In \textit{Byrne v Baker} [1964] VR 443.
\bibitem{139} S 124(1).
\end{thebibliography}
Recent cases, however, show a move by the courts towards applying an objective test to the required standard of care. In New Zealand, the law is substantially as laid down in City Equitable. However, the higher standards of diligence imposed by the Australian courts have also been reflected there. In the 1993 Companies Act, the duty of care was codified in terms similar to those used in the Australian Code:

a director of a company, when exercising powers or performing duties as a director, must exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances taking into account, but without limitation:

(a) The nature of the company; and
(b) The nature of the decision; and
(c) The position of the director and the nature of the responsibilities undertaken by him or her.

Jones suggests that this is once again likely to be interpreted by the courts as a restatement of the City Equitable principles. In both Australia and New Zealand, increasing reference is made to the duty of care and skill required by a company of an employee in the performance of his duties, as described by the House of Lords in Lister v Romford Ice and Cold Storage Co Ltd. This duty arises expressly or by implication out of the contract of employment. It is suggested that the same duty applies at least to an executive director who is an employee of his company. For practical purposes it is immaterial whether the duty arises from his

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140 [1925] ChD 407 (CA); see discussion at p 22.
144 S 137.
145 Op cit 120.
146 [1957] AC 555 (HL).
position as a director or from his status as an employee.\footnote{Corkery \textit{op cit} 139-140; Jones \textit{op cit} 110 - 111.}

In Ireland the position is much the same as in England, except that if a director uses a reasonable degree of care, diligence and skill in the conduct of his duties, and also acts \textit{bona fide} in the interests of the company, he will not be liable for any loss occurring if the act turns out not to have been advantageous to the company.\footnote{Thomas \textit{Company Law in Europe} (1992) p G/117 §348.}

The position in other European countries does not vary significantly from the Common Law jurisdictions. Thomas remarks, regarding the law in Denmark, that “the basis of liability is negligence, but the standard of care does not appear to very high”.\footnote{\textit{Id} p B/142 §368.} In France, the directors have a general duty to exercise their powers in good faith and with reasonable care in the best interests of the company\footnote{\textit{Id} p D/114 §327.}, while in Germany the \textit{Geschäftsführer} must “exercise the diligence of a prudent businessman”\footnote{\textit{Id} p E/130 §324.}.

The Italian courts have stated that, generally, directors cannot be held liable for their actions, provided that they acted with care, diligence and in a professional manner\footnote{\textit{Id} p H/114 §326.}, while in Norway “the provisions of the Act [the Joint Stock Companies Act 1976] do not extend such general liability beyond negligence so that such a director or officer is not liable for poor business judgment resulting in loss. The distinction between poor judgment and negligence may be difficult to make and there is very little case law on the subject”\footnote{\textit{Id} p K/114 §323.}.

It appears from the examples quoted that nowhere is the standard of care required of a director set at a very high level, and, if the Norwegian example is typical, the matter rarely comes
before the courts.

European Union law, if the proposed Fifth Directive on Company Law is adopted, will make significant changes to the position. The directive (which applies only to public companies or their equivalents) recommends, as a preference, the two-tier system of management. However, the proposals regarding liability of directors apply to both the supervisory and management organs - which may be equated to non-executive and executive directors respectively. In the preamble to the proposed Directive, the Council states that its starting point is that

[T]he members of the management and supervisory organs must be made subject to special rules relating to civil liability which provide for joint and several liability, reverse the burden of proof for wrongful acts and ensure that the bringing of proceedings on behalf of the company for the purpose of making those persons liable is not improperly prevented.

Article 14 of the proposed Directive provides that member states shall make provision in their company legislation for

1. Compensation ... for all damages sustained by the company as a result of breaches of law or of the memorandum or articles of association or of other wrongful acts committed by the members of those organs in carrying out their duties.

2. Each member of the organ in question shall be jointly and severally liable without limit. He may, however, exonerate himself from liability if he proves that no fault is attributable to him personally.

There has been a great deal of resistance to the proposed Fifth Directive by member states and it is by no means certain that it will be adopted in anything like its present form. Even if it is adopted, the effect on directors may not be as drastic as appears at first sight to be the case. Its apparent weakness lies in its failure to define "wrongful acts", and the interpretation of that concept would therefore be in terms of the law of the member state concerned - which may leave the position little changed. Once the wrongfulness of a board's act has been established, the requirement that a director will be liable unless he is able to exonerate himself does, however, reflect a significant change in emphasis.

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The concept of the onregmatige daad in South African law differs from the English tort of negligence, on which the action for a director's breach of his duty of care and skill is based. However, the English common law seems to have been adopted without question by the South African courts. Naudé, in 1970, said:

Tersaaklike Engelse vonnisse, en veral die locus classicus, In re City Equitable Fire Insurance Co Ltd [1925] Ch 407, word sonder die minste huivering deur bykans al die Suid-Afrikaanse skrywers as gesag behandel.

In Fisheries Development Corporation of SA Ltd v Jorgensen and Another, the nature of a director's duties was discussed, and Margo J said:

To determine whether there was negligence in any of the conduct alleged, it is necessary to have regard to relevant aspects of a director's duty of care and skill. In England certain principles have emerged from the decided cases on that duty. There has been a relative paucity of cases in South Africa, but the essential principles of this branch of company law are the same, and the English cases provide valuable guidance. 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 on any particular obligations assumed or assigned to him. See In re City Equitable Fire Insurance Co 1925 Ch 407 at 427. Compare Wolpert v Uitzigt Properties (Pty) Ltd and Others 1961 (2) SA 257 (W) at 267D-F.

It might be assumed from the learned judge's description of the director's duty as depending on the nature of the company's business and his actual functions that the test of the degree of care required is an objective one, relating to the act performed rather than the actor. He reinforces this view by distinguishing between the executive and non-executive director:

In that regard there is a difference between the so-called full-time or executive director, who participates in the day to day management of the company's affairs or of a portion thereof, 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. His duties are of an intermittent nature to be performed at periodical board meetings, and at any other meetings which may require his attention. He is not, however, bound to attend all such meetings, though he ought to whenever he is reasonably able to do so.

In 1984, the case of Cronje NO v Stone examined the duty of care and the test for negligence and

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156 Id 160 fn 1.


158 Id 165G-H.
came to the conclusion that it was perhaps not as objective as Margo J had considered it:

However, this case was somewhat unusual in that it in fact applied a much higher standard of attention to the duties required of a director, and found the defendant personally liable for the company’s debts in a case where she had played no part in the company’s management, but was found by the court to have made insufficient enquiry as to the state of its financial affairs. This judgment, which has been criticised by some writers, should probably, in the light of the subsequent attitude of the courts, be regarded as an aberration.

Most of the reported South African cases in which it was sought to hold a director liable for negligence have been in the context of a claim under s 424 of the Companies Act 61 of 1973, which empowers the court to impose personal liability on a director who has been a party to the carrying on of business by the company either fraudulently or recklessly. The provision corresponds generally with s 214 of the English Insolvency Act, 1986 (which refers to “wrongful trading”). The scope of the South African section is however wider than that of its English counterpart in that it is not necessary for a company to be in insolvent liquidation for its provisions to be applied. Although dealing with a statutory provision, the courts have applied common law principles in establishing the test for negligence, which are based on the same considerations as negligence constituting a breach of the duty of care. In *Ex parte Lebowa Development Corporation Ltd*, Stegmann J said:

"
[R]ecklessly’ implies the existence of the objective standard of care that would be observed by the reasonable man in conducting the business of the company in the particular circumstances. A departure from that standard constitutes negligence, a more serious departure gross negligence, which, in the context of the section, is the same as recklessness.
"

The duty of care was described further by Goldstone JA in *Howard v Herrigel and Another NNO*.

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159 1985 (3) SA 597 (T) 613E-F.


161 *See* above p 23.

162 1989 (2) SA 71 (T) 111C-D.
the learned judge disagreed to some extent with Margo J in *Fisheries Development*, and held that it was

... unhelpful and even misleading to classify company directors as 'executive' or 'non-executive' for purposes of ascertaining their duties to the company or when any specific or affirmative action is required of them. No such distinction is to be found in any statute. At common law, once a person accepts an appointment as a director, he becomes a fiduciary in relation to the company ... Whether the inquiry be one in relation to negligence, reckless conduct or fraud, the legal rules are the same for all directors. In the application of those rules to the facts one must obviously take into account, for example, the factors referred to in the judgment of Margo J in the *Fisheries Development* case and any others which may be relevant in judging the conduct of the director. 163

Although superficially it might appear that the standard of conduct required of a director is judged by a more objective standard in South Africa, this stricter interpretation of the common law is generally illusory. Over the past four years, certain courts have attempted to apply more stringent tests of the conduct of directors, particularly in relation to the application of the provisions of ss 423-425 of the Companies Act. 164 Other courts have taken a contrary view, basing their decisions on the practical aspects of managing a company. 165 The Appellate Division has followed the latter path, leaving the duty of care imposed on directors at its former low level. 166

The duty of care has never been generally codified in South Africa. The only reference in a statute is in the Banks Act 94 of 1990, s60(2)(b) of which provides:

[a director] shall, in the performance of his functions as a director of such bank or controlling company, observe such guidelines and comply with such requirements as may be prescribed under s 90(1)(b).

Section 90(1)(b) empowers the Minister to make regulations:

providing guidelines relating to the conduct of, and prescribing requirements to be complied with by, a member of the board of directors of a bank in the performance of his functions as such a director.

The relevant provisions are to be found in regulation 11 - Guidelines relating to Conduct of Directors, which states, *inter alia*:

163 1991 (2) SA 660 678A-D.

164 See eg *Ex parte Lehowa Development Corporation Ltd* 1989 (3) SA 71 (T); *Ex parte De Villiers NO: In re MSL Publications (Pty) Ltd (In Liquidation)* 1990 (4) SA 59 (W); *ex parte De Villiers and Another NNO: In re Carbon Developments (Pty) Ltd (In Liquidation)* 1992 (2) SA 95 (W).

165 *Ex parte Strydom NO: In re Central Plumbing Works (Pty) Ltd (In liquidation)* 1988 (1) SA 616 (D); *Cooper v A&G Fashions (Pty) Ltd: Ex parte Millman NO 1991 (4) SA 204 (C);* *Ozinsky NO v Lloyd* 1992 (3) SA 396 (C).

166 In overturning the Transvaal Provincial Division's judgment in *Carbon Developments* 1993 (1) SA 493 (A) and upholding the Cape Provincial Division in *Ozinsky v Lloyd* 1995 (2) SA 915 (A).
(1) Every director of a bank or a controlling company shall, in the performance of his functions as such a director, observe the following guidelines

(a) In view of the fact that a bank is a public company incorporated and registered under the Companies Act, every director of a bank shall as far as reasonably possible be conversant with such provisions of the Companies Act, other statutes and the common law as directly or indirectly relate to the powers and duties of a director of a company.

(c) A director of a bank shall perform his duties as such a director with diligence and care and with such a degree of competence as can reasonably be expected from a person with his knowledge and experience.167

Even here the test is still a subjective one, but at least the supervisory process employed by the Registrar in vetting the appointment of bank directors, involving the submission of a detailed curriculum vitae, ensures that the level of knowledge and experience referred to is appropriate to the appointment.

Neither has the business judgment rule been specifically recognised by our courts. There are however a number of statements which suggest that the courts in fact follow the same principles as their American counterparts. In Robinson v Imroth and Others the court said:

It is an elementary principle of the law relating to joint stock companies that the Court will not interfere with internal management of companies acting within their powers, and in fact has no jurisdiction to do so.168

In 1927, the same court said:

It is a well-established principle that Courts of Law will not interfere with the internal management of companies, except in circumstances which are not present in this case.169

More recently, the Witwatersrand Local Division reiterated its view of the subject:

In general, the policy of the Courts has been not to interfere in the internal domestic affairs of a company, where the company ought to be able to adjust its affairs itself by appropriate resolutions of a majority of the shareholders.170

In the Fisheries Development case, Margo J held that "[a] director is not liable for mere errors
of judgment." The court was clearly following English precedent, as it included in the authorities cited the *City Equitable*, *Brazilian Rubber*, and *Lagunas Nitrate* cases.

The most recent development in South African Law has been the publication of the King Report. The Committee on Corporate Governance was established by the Institute of Directors in Southern Africa under the chairmanship of ME King SC. The terms of reference of the Committe were:

1. To consider and make recommendations on a Code of Practice on the financial aspects of corporate governance in South Africa.
2. To strive to recommend simpler reporting without sacrificing the quality of information.
3. To lay down guidelines for ethical practices in business enterprises in South Africa.
4. To have regard, in applying its terms of reference, to the special circumstances existing in South Africa, more particularly the entrance into the business community of members of disadvantaged communities.

The report deals somewhat superficially with the duty of care and skill; it merely states "[d]irectors must exercise the care and skill which reasonably can be expected of a person of their expertise" without attempting to define any of the terms used. This in effect seems a slightly more objective standard than the one currently applied. The report goes on to say:

> Particularly in the case of non-executive directors, their appointment is onerous in the context of the present tests of a breach of the duty of care and skill.

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171 1980 (4) SA 171 (W) 166B.
173 [1911] 1 Ch 425 437.
174 [1899] 2 Ch 392 435.
176 Report Appendix II.
177 Chapter 5 §2.10.
178 *Id* §3.3.
For the first time, a specific reference is made to the business judgment rule:

It seems to us that a director should not be liable for a breach of the duty of care and skill if they [sic] have exercised a business judgment in good faith in a matter in which the undermentioned three criteria are satisfied, viz:

1 that the decision is an informed one based on all the facts of the case; and
2 that the decision is a rational one; and
3 that there is no self-interest.\(^{179}\)

It is interesting to note that this is the only recommendation the report makes in respect of the duty of care and skill. The Code of Corporate Practice, the level of compliance with which is now required to be reported in a listed company's annual financial statements\(^ {180}\) makes no reference to the duty.

8 \textbf{Summary and Conclusions}

It is clear that the principles underlying the business judgment rule have been recognized by the South African courts, at least by implication, and that the reluctance of the courts to interfere in the management of companies is well established.\(^ {181}\) It is equally clear that the enforcement of a director's liability for a breach of his duty of care and skill remains at a level which, although it has perhaps become slightly stricter in recent years, certainly does not justify King's comment that "[the] appointment is onerous in the context of the present tests of a breach of the duty of care and skill."\(^ {182}\) This comment is reminiscent of the reaction of organised business in America to the \textit{Trans Union} case.\(^ {183}\) Although King recommends the introduction of the business judgment rule into the Companies Act, no discussion is reported, nor any recommendation made, with regard to the stricter enforcement - or the legislation -

\(^ {179}\) \textit{Id} §3.4 and recommendation 12, which is worded:

"In order to encourage entrepreneurship and the acceptance of appointments as non-executive directors, a director should not incur liability for a breach of duty of care and skill where they [sic] have exercised a business judgment in good faith in a matter in which the decision is an informed and rational one and there is no self-interest."

\(^ {180}\) JSE Listings Requirements (2nd issue September 1995) §8.52(a).

\(^ {181}\) See p 35.

\(^ {182}\) Chapter 5 §3.3.

\(^ {183}\) \textit{Smith v Van Gorkom} 488 A 2d 858 (Del 1985) \textit{supra} 7 - 8.
of an appropriate standard of conduct on the part of the director. Without such sanctions being applied as a regular occurrence, there would appear to be no need for the business judgment rule.

It seems that there is no legal system which has codified the business judgment rule. The provisions in the Revised Model Business Corporation Act\textsuperscript{184} which deal with the director's duty of care and skill, any reference to the business judgment rule was omitted as the committee was unable, after lengthy debate, to agree on a suitable draft. The provisions contained in paragraph 4.01(c) of the American Law Institute's \textit{Principles of Corporate Governance}\textsuperscript{185} are a lone attempt to commit the rule to words - and that attempt is also not without its critics. The American authorities, generally, have preferred to allow the rule to be developed by the courts, and such development remains an ongoing process.

The American approach appears to be the correct one. It seems unrealistic to talk of codifying the business judgment rule in a jurisdiction which is not by any means clear as to the extent of a director's duty of care. There is no need for a safe harbour\textsuperscript{186} against a storm whose threat is largely illusory.

\textsuperscript{184} \textit{supra} 18 - 19.

\textsuperscript{185} \textit{supra} 19 - 20.

\textsuperscript{186} See note 98 at p 18.