AN ASSESSMENT OF THE IMPACT OF CORPORATE GOVERNANCE CODES AND LEGISLATION ON DIRECTORS AND OFFICERS LIABILITY INSURANCE IN SOUTH AFRICA

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A dissertation submitted to the Faculty of Commerce, Law and Management of the University of the Witwatersrand, in fulfilment of the degree of Master of Commerce (Insurance and Risk Management) by dissertation.

January 2009

Declaration

I hereby declare that this is my own unaided work, the substance of or any part of which has not been submitted in the past or will be submitted in the future for a degree to any university and that the information contained herein has not been obtained during my employment or working under the aegis of, any other person or organisation other than this university.

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(Name of Candidate) Signed

Signed this…………….. day of………………………. 2009 at the University of the Witwatersrand, Johannesburg.

Acknowledgments

I wish to show appreciation to my entire family (especially my parents) in South Africa and in Europe, and to all my closest friends at home and abroad, for their support, inspiration, and patience throughout my academic studies.

I would like to thank Camargue Underwriting Managers for the sponsorship provided, without which, the study would not have been possible. I look forward to many great years at this outstanding company.

I am forever indebted to my supervisor, Frank Liebenberg, for all his guidance, support and advice throughout the years. A special thank you is also in order for Professor Robert Vivian for his direction and knowledgeable backing.

Finally I would like to thank my beautiful girlfriend, Julie, for all her care, support, and love.

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Abstract

This dissertation assesses the potential impacts of corporate governance codes and legislation on Directors and Officers (D&O) Liability Insurance. Corporate failures lead to numerous losses for stakeholders especially shareholders. Worldwide including in South Africa, this has resulted in an increase in legal liability claims against directors and thus insurers. Often these failures are ascribed to corporate governance breaches giving rise initially to corporate governance codes and more recently many countries are legislating certain aspects of corporate governance; this includes a codification of director's duties. South Africa, in-line with the United Kingdom, Australia and to an extent the United States has followed suit with the Companies Bill of 2008. This dissertation seeks to assess the possible effects of the codes of practice and new Companies Act on Directors' and Officers' Liability insurance. This will be done by ascertaining what impact the new Act will have on directors' liability using *inter alia* the Delphi Technique.

Keywords: corporate governance, directors and officers liability insurance, Companies Bill.

INTRODUCTION

The objective of this research is to assess the effects which codes of practice and forthcoming company legislation will have on Director's and Officer's (D&O) Liability Insurance. Specifically the research will assess the possible outcomes of the proposed Companies Act (due to be passed by parliament in 2010) on D&O insurance.

In the past two decades or so there has been an increase in the incidence of directors being sued resulting in increasing insurance premiums. Recently in discussing the decline of Lloyd's profits, Lord Levine, Lloyd's chairman singled out the adverse performance of the D&O class as one of the causes for the decline.[1] By February this year over 100 civil actions had been launched in the US arising out of the subprime crisis, totally in excess of $3.6 – billion.[2] Since the early 1990s there have been an increasing number of events, and scandals, in which directors and officers of companies have been accused of causing losses to company stakeholders, which forms the basis of the increasing claims against directors and officers and thus their insurers.

This dissertation will first assess whether or not director liability has indeed increased and then discuss what mitigating steps have been taken to contain claims against directors. An opinion will be formed as to whether or not the mitigating steps have been successful. Finally this will be tested by performing a Delphi Technique study in order to assess the opinions of the dissertation. In order to make certain that the study is robust separate interviews will be conducted with industry experts, which should confirm the findings.

The dissertation is structured as follows: Chapter 1 introduces the board of directors and assesses whether or not director liability has increased as a result of the doctrinal issues. Chapter 2 will inspect whether director liability has increased as a result of the complexity issues; this will mostly look at corporate failures which have occurred.

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[1] 'Lloyd's posts its first profit fall in two years' *Business Report* September 9, 2008.
[2] Paul Tower 'A parting of the ways', *Risk Specialist* August 2008

Chapter 3 looks at the first mitigating step which is codes of corporate governance. An opinion will be formed as to whether the codes of practice have been successful in containing directors' liability. Chapter 4 will analyse the second mitigating step of legislation. The focus will be on the new South African Companies Act which is due to be passed in 2010. By inspecting the various sections of the Bill which affect directors, one will form an opinion as to whether this new legislation will succeed in containing director liability. Chapter 5 explicates D&O liability insurance by looking at its history, cycles, the policy, as well as D&O literature. Chapter 6 will contain a Delphi Technique study with industry experts in order to assess the views of the dissertation. In order to make the study more robust, interviews will be conducted separately with some of the industry experts and the opinions will be summarised.

1 DIRECTORS' LIABILITY – DOCTRINAL ISSUES

The objective of the first chapter is to introduce the concept of the board of directors and to analyse the doctrinal issues related to the legal liability of a director. The doctrinal issues refer to whether or not courts and society have become more willing to hold directors liable for their actions, carried out as a result of their duty towards the company. In order to do this it is necessary to discuss directors' liability, which can arise out of four different sources; contract, delict, statute and *sui generis*. These aspects of the law will be discussed in order to assess whether or not directors' liability has increased and expanded over the years. Further, directors' common law duties will be looked at with the aim of discovering if these duties have become more onerous leading to increasing liability exposures and whether or not courts and society have become more willing to hold directors accountable for losses. One must differentiate between sources of liability (contract, delict, statute and *sui generis*), and common law duties. A breach of common law duties will lead to liability under two (delict and *sui generis*) of the four sources mentioned.

The first section will introduce the concept of a director by providing definitions and explanations according to statute, common law and corporate governance codes. Subsequently the board of directors will be looked at as well as its functions and committees. The office of the Chairman, Chief Executive Officer, and the company secretary will be examined. The section ends off with a brief description of the relationship between the board of directors and management. The second and third sections look at director's liability and directors' common law duties respectively.

1.1 Describing the board of directors

Definitions of 'director' and 'officer'

In South Africa and internationally the board of directors is regarded as the "directing mind and will"[3] of the company. This is due to the fact that the company is an artificial legal entity or juristic person. Therefore the company operates through its board of directors.[4] This section looks at the definitions, as well as the duties and liabilities of company directors.

The Companies Act defines a director as "any person occupying the position of director or alternate director of a company, by whatever name he may be designated."[5] An officer is defined as "any managing director, manager or secretary thereof."[6]

Another South African statutory definition may be found in Section 332 (10) of the Criminal Procedure Act: "any person who controls or governs that corporate body or who is a member of a body or group of persons who controls or governs that corporate body or where there is no such body or group, who is a member of that corporate body."

Categories of directors

Company directors may be split into two classes: executive and non-executive. Corporate governance codes such as the King Codes have made a distinction since the early part of the 1990s. It is unfortunate that the Companies Bill[7] has not defined the

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[3] *Lennard's Carrying Co Ltd v Asiatic Petroleum Co* Ltd [1915] AC 705 (HL) 713; *Canada and Dock Co v The* Queen 1985 SCR 662; *AL Mostert NO v Old Mutual Life Assurance Co (SA)* Ltd (not reported).

[4] *R v Kritzinger* 1971 (2) SA 57 (A)

[5] Companies Act 1973 S 1

[6] Companies Act 1973 S 1

[7] B 61D – 2008 – referred to throughout the Dissertation.

two separate positions. However this is in-line with the Corporations Act 2001[8] of Australia and the British Companies Act 2006.

A distinction between the two categories of directors may be found in King II:

- Executive directors: a director who is engaged in the day-to-day management of the company or is salaried as full time. This includes directors of any subsidiaries of a company.
- Non-Executive directors: a director who is not engaged in the day-to-day management of the company and is not under full time salary. This includes directors of any subsidiaries of a company. A person who is employed full-time by the holding company or its subsidiaries may be considered as a non-executive director, unless his/her actions could be interpreted as being involved in directing the day-to-day business of the company.

Non-executive directors may also be independent. According to King 2 an independent director is a non-executive director who:

- is not an agent of a shareholder who can influence management
- has not been employed by the company for the preceding three financial years
- is not a related to any individual that has been employed by the company in the preceding three financial years
- is not a professional adviser to the company
- is not a customer or supplier of the company
- has no contractual relationship with the company, and
- is not involved in any business or relationship of a nature which could interfere with his/her independence.

The board of directors

It is necessary to first comprehend the environment in which a director operates prior to understanding the office of a director as well as the duties and liabilities attached

[8] Corporations Act No. 50 of 2001

therein. This subsection looks at the definition of the 'board', some of the board's functions and duties, as well as the relationship between the board of directors and management. However it is initially essential to explain the scope and categorisation of the company according to the Companies Bill.

Company classification

According to clause (c) l8 of the Companies Bill there are two types of companies which may be formed and incorporated under the Act (in the event that it is passed); namely profit companies and non-profit companies. According to c8 (2) a profit company is:

a) a state-owned enterprise; or
b) a private company if –
    i. it is not a state-owned enterprise; and
    ii. its Memorandum of Incorporation –
        - prohibits it from offering any of its securities to the public; and
        - restricts the transferability of its securities;
c) a personal liability company if –
    i. it meets the criteria for a private company; and
    ii. its Memorandum of Incorporation states that it is a personal liability company; or
d) a public company, in any other case.

According to c8 (3) any association formed after 31st December 1939 which was formed with the intention of creating benefits for the association or its members may not be a company unless it is registered as a company under the new Act, is created according to another law, or was created according to Letters Patent or Royal Charter before 31 May 1962.

Defining the board of directors

The Companies Bill, in c66 (1) states that the business of a company must be either managed by the board of directors, or run under the direction of a board. This section also states that the board has the authority to perform all its functions as needed unless the Memorandum of Incorporation provides otherwise. This section applies equally to prescribed officers.[9]

C66 (2) provides for the number of directors required for the board of the various types of companies:

- a private or personal liability company must have at least one director;
- a public or non-profit company must have at least three directors.

However the Memorandum of Incorporation may specify a greater number of directors if the circumstances of the company so require, according to c66 (3).

C66 (4) provides that a company's Memorandum of Incorporation may: allow the election and removal of any company director; permit a person to be an *ex officio*[10] director of the company; and permit the appointment of one or more persons as alternate directors of the company. The Memorandum of Incorporation must also state that the shareholders of a profit company, other than a state-owned enterprise, must elect at least 50% of the directors, as well as 50% of the alternate directors.

C66 (5) states that an *ex officio* director may not serve as a director in the event that he is disqualified according to c69 (contemplated later). The ex officio director has all the powers of any other director unless the Memorandum of Incorporation restricts otherwise. The *ex officio* director also carries the same liabilities toward the company as any other director.

[9] Defined by c66 (11) of the Companies Bill.
[10] The Companies Bill defines an *ex officio* director as a person who holds office as a director of a company only as a consequence of that person holding some other office, title, designation, or similar position according to the company's Memorandum of Incorporation.

C66 (6) nullifies the appointment of a director, if at the time of election that director is disqualified according to c69.

C66 (7) states that a person becomes a director when he is elected in accordance with the provisions of the Bill or when he is allowed to do so as an *ex officio* director. The person must also furnish the company with written consent to being a director of that company.

C66 (8) makes it mandatory for at least one director of a company to be resident in the Republic of South Africa.

C66 (9) and (10) deal with remuneration of directors. The company may remunerate directors unless the Memorandum of Incorporation states otherwise. This remuneration may only be carried out by a special resolution of the shareholders within the preceding two years.

C66 (11) confers powers on the Minister to create regulations which assign specific functions to a prescribed office within the company.

C66 (12) states that in the event that a company does not have the minimum required number of directors serving on its board, according to the Bill or the Memorandum of Incorporation, the board will not be considered unsound and the decisions taken by the board in the said circumstances will still be considered valid.

Functions of the board of directors

It is stated in the King 2 Code that the board of directors is the central position regarding the corporate governance practices of a company. This involves accountability and responsibility for the functioning and affairs of the organisation. A unitary board structure is common practice in South Africa and this is supported by the King Code.

Some of the key functions of the board of directors according to King 1 and King 2 are:

- The construction of the company's strategy and arrangement.
- The board must ascertain which businesses the company will partake in.
- The board must monitor executive management and ensure the execution of the company strategy.
- The board must appoint the company CEO.
- The board must ensure that a succession plan is in place in the event that the position of the CEO is vacant. This is to minimise any disruption.
- The board must ensure company compliance with applicable laws, regulations and codes of business practice.
- The board must make certain that the company communicates with shareholders and relevant stakeholders.
- The board should ensure that the company has satisfactory systems of internal controls.
- Information must be supplied to all shareowners and relevant stakeholders.
- It is the board's duty to ensure that the company functions in an ethical manner.
- The board must produce a code of corporate conduct for the company which focuses on conflicts of interest relating to directors and management. This code must be constantly reviewed and updated.
- Systems must be in place allowing directors to seek independent professional advice relating to the company's affairs.
- It is important for the board of directors to deliberate whether its size, diversity and demographics render it successful.
- The board of directors should acknowledge focal risk areas and performance indicators of the company.
- An evaluation must be regularly performed on the company's technology and operational systems.
- Identification and monitoring of non-financial aspects of the company.
- The board of directors must record the reasons for the belief that the company will be a going concern. In the event that the company is believed not be a

going concern, the reasons must be provided as well as an action plan to resolve the situation.

- All items discussed at the annual general meeting (AGM) must be supplemented by a description of the consequences of a proposed decision.
- The board of directors must promote the attendance of shareholders at the AGM. Directors should be present at the AGM as well as the chairpersons of the board committees.
- The company annual report must contain the CV of all directors.
- The board of directors must create a charter which establishes its responsibilities. This must be disclosed in the annual report.
- The board of directors must perfect a method of conforming to corporate governance constraints, whilst still executing their duties in an entrepreneurial manner.[11]

C46 of the Companies Bill deals with the fact that distributions must be authorised by the board of directors. A company may only make a distribution if it is as a result of a legal obligation, a court order, or by a resolution of the board. The company must be able to satisfy the solvency and liquidity test after the distribution has been made. It is the duty of the board to acknowledge the application of the solvency and liquidity test.[12] Once the board has made this acknowledgment the distribution must be made in full as originally contemplated.[13]

If the distribution has not been made 120 days after the board made the acknowledgment, the board must reconsider the solvency and liquidity test. A new resolution will have to be passed by the board unless the distribution is subject to a court order or legal obligation.[14] If the distribution will lead to an incurrence of debt or an obligation by the company, the requirements of this c46 apply after the board decides that the company may incur the debt or obligation.[15]

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[11] This point is very important when looking at the codification of director's duties under the Companies Bill. There is an ongoing debate as to whether imposing high standards on director conduct and duties will inhibit the entrepreneurial spirit with which companies undertake risky operations in order to generate high returns for shareholders.
[12] C46 (1)
[13] C46 (2)
[14] C46 (3)
[15] C46 (4)

If as a result of carrying out the solvency and liquidity test, it is evident that the company will not satisfy the requirements of c46 for a court order distribution, the company may apply to a court in order to vary the original order. The court may change the order if it is just and equitable with respect to the financial circumstances of the company, and if the person to whom the company owed money will be repaid within a reasonable time period.[16] A director of a company will be personally liable if that director is present at a board meeting, at which a resolution is passed that is contrary to this section.[17]

It is evident that the board of directors carries an enormous amount of corporate duties. Although the functions are set out in corporate governance codes, existing and potential legislation such as the Companies Bill are now holding directors accountable to ever increasing standards. Compliance with the King codes is a necessity only for current public companies, however only to the extent that conformity is described in the annual report as is obligatory in the JSE Listing Requirements.

Board of directors' committees

According to c72 (1) of the Companies Bill, the board of directors may arrange any number of committees of directors, as well as delegate any authority of the board. This is subject to possible restrictions contained in the company's Memorandum of Incorporation.

C72 (2) states that a committee may contain persons who are not directors of the company; however these persons must not be ineligible to be directors according to c69. Further, these persons may not actually vote on a matter which is to be decided by the committee. The committee may receive advice from any person and possesses the authority which is conferred to it by the board of directors.

[16] C46 (5)
[17] C46 (6)

It is important to note that according to c72 (3) the creation, delegation of a matter, or action taken by a committee does not constitute a satisfaction of a director's duty toward the company relating to c76 (discussed later).

C73 sets out the requirements and procedures of board meetings. A director when authorised by the board, is permitted to call a board meeting. If the board consists of at least twelve members then 25% of the directors must necessitate the meeting, otherwise only two directors must require the meeting if the board consists of less members than specified. However the Memorandum of Incorporation may set out any other number of directors who must require a meeting in order for it to take place.

The board meeting may be carried out through electronic communication, or certain members may partake via electronic communication unless the Memorandum of Incorporation states otherwise. The method of electronic communication is required to be clear and concise. The board may determine the means and time in order to give notice of meetings; however this must comply with the Memorandum of Incorporation. No meeting may be assembled unless all the directors of the company have received notice thereof. It is however possible for a meeting to occur even though the company did not manage to give the required notice of the meeting. This will be allowed if all the directors of the company admit receipt of the notice, are present at the meeting, or waive notice of the meeting. This is unless the Memorandum of Incorporation states otherwise.

In order for a vote to be carried out at a board meeting, the majority of the directors of the company must be present. A majority of votes cast is sufficient to pass a resolution and each director only has one vote in the matter. If there are an equal number of votes regarding a certain resolution, the Chairman of the company will possess the deciding vote; only in the event that the Chairman did not actually originally vote on the matter. If the Chairman has already voted and the numbers are still tie, the matter is not carried.

The company is required to keep minutes of board meetings and those held by any board committees. The minutes must contain any resolutions approved by the board, as well as any declaration of a director's personal financial interest in any matter. The resolutions adopted by the board must be dated and numbered consecutively in order to provide a clear understanding if ever required. The resolutions adopted by the board are effective as soon as they are passed, unless otherwise specified. The chair's signature on the minutes of the board meeting renders the proceedings effectual and may be used for evidentiary purposes.

According to King 2, board committees are there to support the board of directors in accomplishing their duties. The duration and function of committees must be formally determined and committees should ideally be chaired by an independent non-executive director. Committees must be subjected to reoccurring evaluation and must have the ability to seek outside independent professional advice regarding company business.

King 2 states that all company boards must contain a minimum of an audit committee and a remuneration committee. The following is a list of the more often used board committees, as well as their basic roles.

- Audit committee: the committee is meant to help the board regarding the safeguarding of assets, maintaining systems and the production of accurate financial statements conforming to prescribed accounting standards (King 2). This committee is particularly important as it ensures company compliance with corporate governance standards.
- Remuneration committee: the committee is charged with the duty to ensure that directors are compensated accordingly for their duties. The approach must accommodate for the need to recruit, retain and motivate directors with necessary skills. It is necessary to remunerate directors and executive managers appropriately in order make certain that their interests mimic those of the shareowners. The remuneration committee holds a monumental task as conflicts of interest arise easily when rewards are set for the directors themselves (Wixley & Everingham, 2005).
- Actuarial committee: generally found in long-term insurance companies. The main purpose of this committee is to assess the technical features of a company's actuarial policy and to make proposals to the board (Wixley & Everingham, 2005).

- Chairperson's committee: the main objective of this committee is to provide the chairperson with a forum for strategic analysis. A chairperson's committee is most often found in companies with a sizeable board of directors (Wixley & Everingham, 2005).
- Credit committee: the aim of this committee is to evaluate the company's credit policy; it is mostly found in banks and lending organisations (Wixley & Everingham, 2005).
- Employment equity and skills retention committee: the main aim of this committee is to ensure strategically that the company can appeal to and retain skilled employees (Wixley & Everingham, 2005).
- Environmental, health and safety committee: the aim is to develop and monitor environmental, health and safety procedures (Wixley & Everingham, 2005).
- Executive committee: the purpose of this committee is to support the CEO in management tasks.
- Governance committee: it is essential that the governance committee make certain that the board of directors and the organisation as a whole conforms to good corporate governance practices. This committee should consist of non-executive directors (Wixley & Everingham, 2005).
- Information technology committee: deals with governance and operational issues relating to IT.
- Investment committee: deals with operational and governance issues regarding the investment of company capital.
- Nomination committee: it is the main objective of this committee to make certain that the company's board contains directors with relevant skills and knowledge.
- Risk management committee: this committee deals with the continuing improvement and monitoring of the company's risk management system.

Chairman

The chief function of the chairman of a company is to lead the board of directors in a sense that one may attain the utmost participation by all members of the board. According the King 1 the chairman must head board meetings and ensure compliance with corporate governance standards, as well as to direct company shareholder meetings. Other primary functions of the chairman are to oversee the selection of board members, supervise the succession plan of executives (Wixley & Everingham, 2005), provide a link between the board of directors and management, preserving contact with the shareholders, introducing new directors to their roles on the board, and initiating the elimination of inept directors from the board.

The chairman should be an independent non-executive director and it is recommended that one person should not preside over both the roles of chairman and CEO. Due to the fact that there is a shortage of skills in South Africa, it is not feasible to expect all companies to separate the two roles. However where one person presides over both offices, it is a corporate governance requirement that this decision is explained in the company's annual reports.

Chief executive officer

The CEO is appointed by the board of directors and is thus accountable to them. The CEO is charged with the operational performance of the company. Some of the main objectives of the CEO according to the King Report are:

- to provide for the monitoring and management of the business of the company
- to provide a competent management group
- to be the chief representative of the company
- to ensure that the corporate culture is one of corporate governance observance
- to create and progress the strategy and vision of the company, and
- to supervise the functioning of corporate policies

Company secretary

As in s268 (a) of the Companies Act,[18] the Companies Bill under c86 (1) renders the appointment of a company secretary mandatory for a public company or state-owned enterprise. The company secretary must be a permanent resident in the Republic of

[18] Under Section 268 (A) of the Companies Act, the appointment of a company secretary is compulsory for public companies.

South Africa. C86 (3) states that the first company secretary of a public company or state-owned enterprise may be assigned by the incorporators of the company or within 40 business days of the incorporation by either the directors, or an ordinary resolution of the shareholders. The company secretary must be appointed within 60 days subsequent to a vacancy on the board of directors, by a person whom the board considers to possess the required experience and expertise.

C87 states that a juristic person[19] or a partnership may be a company secretary; that is provided that certain requirements are met by the entity, such as those under c84 (5)[20] and c86. An alteration of the membership of the juristic person or partnership does not amount to a vacancy in the office of the company secretary so long as the requirements are still met. According to c87 (3), the juristic person or partnership, which is serving as company secretary must inform the directors in the event that the said juristic person or partnership, no longer satisfies the requirements necessary to hold the office. The directors are justified in assuming that the company secretary satisfies the necessary requirements if it is comprised of a juristic person or partnership. The company secretary’s actions are not considered invalid if the juristic person or partnership does not satisfy the necessary requirements to hold the office.

It is mentioned in King 2 that the company secretary bears a fundamental part of the corporate governance of a company. It is for this reason that widely held companies are compelled to appoint a secretary; corporate governance is much more highlighted when dealing with public companies. The public requires more protection when dealing in the shares of a company as they have less access to information than the shareowners of private companies. King 2 states that the board of directors must enable the company secretary to conduct his/her duties in an unproblematic manner. Some of the most important functions of the company secretary according to King 2 are as follows:

- to provide direction to the board and individual directors relating to the performance of their duties in the best interests of the company

[19] According to the Companies Bill definition a juristic person includes a foreign company and a trust, whether it was formed in South Africa or abroad.
[20] The requirements refer to those in c69 (8) which is one of the instances where a person may be disqualified from being a company director. C69 is discussed later.

- to instruct new and inexperienced directors regarding their duties
- to support the chairman and CEO in the establishment of the annual board plan
- to assist in strategic matters at board level, and
- to offer guidance to the board of directors regarding issues of corporate governance and ethics.

King 2 also recommends that the company secretary must be weighed up by the fit and proper test as is the case for new director appointments.

The Companies Bill goes on to state the duties of a secretary under c88 (2) (a-g). The list is not however exhaustive:

- providing directors with guidance regarding their duties, responsibilities and powers
- bringing to the attention of directors any law affecting the company and making any failure of legal compliance known at shareholders meetings
- informing the board on whether the company or any director is not complying with the proposed legislation
- making certain that the minutes of shareholder, board and committee meetings are recorded correctly
- certifying in the annual financial statements that the company has filed the requisite returns in accordance with the proposed legislation, as well as that the returns are true, correct and up to date, and
- making certain that everyone who is entitled to the company's financial statements receives a copy
- carrying out the responsibilities of a person selected in accordance with c33 (3).[21]

C88 (1) states that the company secretary is accountable to the board of directors.

[21] C33 deals with the company's annual transparency and accountability report. In terms of c33 (3), the company must select a person who is responsible for the company's compliance with the requirements of this section, in its annual return, which is filed.

The relationship between board and management

It is essential to look at the board-management relationship as the board of directors may be held accountable when not performing their oversight duties. Executive management may also be held accountable to the same standards as the board when duties have been delegated or by simple fact that a person in a managerial position may be regarded as a company officer.

The relationship between the board of directors and management is a simple one, in theory at least. The business which a company undertakes is managed under the supervision and direction of the company's board. By delegating to the CEO, the board delegates the power and responsibility of running the business of the company to management. In this manner the board of directors monitor management on behalf of the company shareholders (Principles of Corporate Governance, 2002).

The duties of management are beyond the scope of this paper however some of the main functions are as follows:

- operating the company's day-to-day business
- suggest strategic plans to the board and implement them if necessary
- presenting and discussing the financial situation of the company with the board
- setting up a suitable organisational structure, and
- the identification and management of key company risks.

Although it is the board of directors' duty to select, monitor and if necessary dismiss management, in actuality the board is often dependent on management for among other things, information. Individual directors do not have the time and resources to completely comprehend the daily business of an organisation; therefore management is often in a commanding position. It is for this reason that one often finds that even when an executive manager is dismissed, the severance pay is nevertheless enormous. Two examples of this are those of the CEOs of Home Depot, the world's largest home improvement retailer, and Pfizer, the world's largest research-based pharmaceutical company who were dismissed in 2006. The mentioned CEOs were both granted \$200 000 000 severance packages (Monks and Minow, 2008).

1.2 Director's liability

Broadly speaking, a director may be liable under four sources of law: delict, contract, statute, and *sui generis*. It is crucial to understand that the above are sources of liability. This is contrary to directors' common law duties. Should a director not uphold a common law duty, he/she will potentially be held liable under either delict or *sui generis*. Breaches of contract or statute are dealt with under the respective titles.

The common law duties of directors towards a company are that of a fiduciary duty as well as a duty of care, skill and diligence. In South Africa breaches of fiduciary duties have had consequences under *sui generis*; whilst a breach of the duty of care possesses delictual repercussions.

This will however change due to the fact that the Companies Bill has attempted a partial codification of the director's common law duties under c76 (3). It will be interesting to see what will be the effects of this partial codification on directors, and more importantly for this dissertation, on director's liability and insurance. Before one inspects the possible effects of the Companies Bill on director's liability insurance, it is important to look at director's liability in South Africa. Firstly all the potential areas of liability will be discussed: delict, contract, *sui generis*, and statute. Then the common law duties of directors will be deliberated.

The two common law duties are discussed in detail in the Dissertation as this is one of the main topics of change under the Companies Bill relating to directors. A breach of director common law duties will now have consequences in statute (the new Companies Act) in addition to delict and *sui generis*, which was only the case until the Bill gets passed.

1.2.1 The fields of director liability

This subsection is intended to introduce the four fields of director liability. These are delict, contract, statute and, *sui generis*. A brief description will be provided for each of these, as well as an explanation of the manner in which they affect directors.

Delict

The law of delict may be classified under the area of private law, the law of obligations (Van der Walt & Midgley, 2005). The notion is that everyone is responsible for the wrongs which they cause. There is thus an obligation to compensate the party which suffered damage as a result of one's wrongful act.

However the simple fact that one has caused damage to another does not entail that the wrongdoer is liable in delict (Neethling *et al*, 2006). There are five requirements or elements which must be met in order for delictual liability to attach to a person: act, wrongfulness, fault, causation, and harm. If any of the mentioned requirements are not present, there is no delictual liability. A delict has therefore been defined as an act of a person, which in a wrongful and culpable way, causes harm to another (Van der Walt & Midgley, 2005).

The above requirements also apply to the delictual question on part of company directors. The fact that a director or officer of a company was acting on behalf of that company when a third party suffers damage does not denote that the director is liable in delict. In the same manner, being a director of a company is not a defence in stating that the company is liable and not the director in question (Ferreira, 2005). The delictual elements are relevant no matter what interest is infringed and irrelevant of the manner in which the infringement resulted. In South Africa this generalising method is used whilst in England and in Roman law, a *casuistic* style is utilised (Neethling *et al*, 2006). The English law of torts (delict) is made up of a set of detached delicts, which contain their own requirements. Therefore one may be liable under an English law of torts if the conduct of the wrongdoer fulfils the requirements of a specific delict (Neethling *et al*, 2006).

In delict a distinction may be made between patrimonial damage (*damnum iniuria datum*[22]) and injury to personality (*iniuria*). These two actions create the basis for the law of delict: *actio legis Aquiliae* – action for damages regarding wrongful and culpable patrimonial damage, and *actio iniuriarum* – action for damages regarding the wrongful, intentional harm to personality (Neethling *et al*, 2006). The two actions are the very core of the law of delict although the field has been stretched and added to. Some other important extensions are that of *pure economic loss* and the *action for pain and suffering* (Neethling *et al*, 2006). The five delictual elements will now be looked at briefly.

Conduct:

In order for an action in delict to exist, a person must cause damage or harm to another by way of an *act* or *conduct*. The damage to a person which is actionable in delict is caused by conduct. With regards to delict, conduct, may be defined as a voluntary human act or omission (Neethling *et al*, 2006).

Conduct may be split up into *commissio* (positive conduct) and *omissio* (omission). Roman-Dutch law made a distinction between the two types of conduct but only positive acts would actually lead to liability. This was also the case in South Africa; however omissions slowly started being recognised as legitimate causes for claims under delict. At first one would only be held liable for an omission if there was a connection between prior conduct – *factum praecedens* (of the defendant) which led to a situation of potential loss (Ferreira, 2005). In this case the liability only attached due to the prior conduct not as a result of the omission. Eventually omissions were legally recognised in South African law as a form of conduct under delict in *Minister van Polisie v Ewels*.[23] In this case it was also stated by Rumpff CJ that it is important to first ascertain whether wrongfulness exists before looking at conduct. This is due to the fact that a person may only be held liable for a loss to another in delict if the conduct in question was wrongful. One must also keep in mind that the conduct in question must be voluntary for the delictual element to apply.

[22] This was created by a plebiscite named the Lex Aquilia around 287 BC (Van den Heever, 1944).
[23] *Minister van Polisie v Ewels* 1975 (3) SA 590 (A)

The basic inference here regarding directors is that one may be held liable not only for action but also for failing to take action. Due to the fact that it may not be feasible for a director or officer to determine whether or not their conduct will lead to delictual liability, the scale may then be extremely wide.

Wrongfulness:

In order for a harmful act to lead to delictual liability, a loss must occur in a *wrongful* manner. 'Wrongful' may be expressed as unreasonable or legally reprehensible (Neethling *et al*, 2006). Wrongfulness may only be established in the event that a harmful effect has been produced; that is, a legally accepted interest must be violated. Alternatively a duty must not be undertaken on part on the respondent. The next step is then to decide, making use of legal norms, whether the wrong was performed in an unreasonable or legally reprehensible manner (Neethling *et al*, 2006). Therefore the act or omission must lead to an undesirable consequence, which is evaluated regarding the reasonableness of the respondent's action or inaction.

A basic test for the element of wrongfulness was created in *Minister van Polisie v Ewels*[24] named the 'legal convictions of the community' or 'boni mores' test. The test is an objective one which is based on the reasonable standard. One must inquire into whether or not in the eyes of the legal convictions of the community, as well as in light of the circumstances of the case, the respondent infringed an interest of the plaintiff in an unreasonable manner (Neethling *et al*, 2006). In *Minister van Polisie v Ewels* the legal convictions of the community found that an omission may be regarded as wrongful. It was also stated that wrongfulness may attach to an act or omission as well as to the resulting consequences. The test seeks to attain a balance of interests in establishing wrongfulness.

[24]In *Minister van Polisie v Ewels* 1975 (3) SA 590 (A), Mr. Ewels was battered by an off-duty policeman whilst other on-duty policemen witnessed the event and failed to act. The plaintiff chose to sue the Minister of Police due to the 'deep pocket' concept. The Minister was found vicariously liable as a result of the omission on part of the off-duty policemen in not preventing the assault.

Fault:

Two main types of fault exist: intention (*dolus*) and negligence (*culpa*). Fault represents the legal blameworthiness of a person who has acted wrongfully (Neethling *et al*, 2006). It is traditionally said that dolus requires legally reprehensible conduct and culpa requires a legally reprehensible attitude (Boberg, 1984). However some explain that fault is the blame attached to a person by means of the law (Van der Merwe & Olivier, 1989).

Fault is to an extent a subjective element as it deals with a person's state of mind; however the test for negligence is inherently objective. For actions involving patrimonial damage and for pain and suffering, one may attach either dolus or culpa, for an infringement of personality, dolus is necessary as culpa is inadequate (Neethling *et al*, 2006).

In order to hold a respondent liable in delict under the element of fault, one must establish that the person may be held accountable. In order to do this it must be shown that the respondent's mental state allows for intent or negligence to attach to him. In some instances a person may not be held accountable depending on age, mental stability, intoxication, and provocation (Neethling *et al*, 2006).

It is known that in reality claims against directors and officers infrequently involve intent; negligence is generally dealt with. The general test which is employed for negligence is that of a reasonable man or *diligens paterfamilias* test.[25] The test proceeds as follows: "would a reasonable man in the same situation as respondent foresee a reasonable possibility that his conduct might result in harm to another person or his property or cause him patrimonial loss and what steps would a reasonable man take to prevent such damage or loss? If the defendant failed to take the necessary precautions he is at fault" (Bouberg, 1984: 274).

The 'reasonable person' is a fabricated concept which serves as an objective norm regarding behaviour in society. This reasonable person lies somewhere in between

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[25] *Weber v Santam Versekeringsmaatskappy Bpk* 1983 1 SA 381 (A)

one that possesses qualities of extreme care, highly developed skills and education, and one that is uneducated, careless and lacks any useful skills. The fabricated person is said to be a legal personification (Neethling *et al*, 2006) of the qualities which a community expects from its members. The following is taken from *Weber v Santam Versekeringsmaatskappy Bpk* in which Joubert JA states (Neethling *et al*, 2006: 121):

> *"*In my opinion it serves no purpose to ascribe various anthropomorphic characteristics to the *diligens paterfamilias*, because we are not dealing with a physical person, but only with the name of an abstract, objective criterion. We are furthermore not concerned with what the care of a legion of reasonable person types would have been, such as a reasonable educated person, a reasonable illiterate person, a reasonable skilled labourer, a reasonable unskilled labourer, a reasonable adult or a reasonable child. There is only one abstract, objective criterion, and that is the Court's judgement of what is reasonable, because the Court places itself in the position of the diligens paterfamilias.*"*

This is interesting when the test is applied to directors of companies. As will be seen later a person may be tested versus the reasonable person who possesses knowledge and skill which is more advanced than that of an ordinary man. This is important when a professional person is involved, and this altered test is applied to directors of companies. In the event that a person, such as a director, holds advanced knowledge or skill, he is expected to implement the affiliated standard of care. The requisite standard of care then develops into that of a reasonable person who possesses the person's expertise and knowledge. Thus the standard is higher. Further discussion on this topic will be held under the section of the common law duties of directors; specifically the duty of care.

Causation:

'Causation' refers to the *causal nexus* between the act of a respondent and the consequent damage which the plaintiff suffers. It is inappropriate to hold someone accountable if the person in question did not actually cause the damage. One should always look at the facts of each case and decide using the relevant evidence (Neethling *et al*, 2006). Causation can sometimes be easily ascertained, for example when an act leads to physical harm. However the situation tends to get complicated in the event that the delict involves an omission, the harm caused is not physical, and a time lapse exists between the conduct and the damage. For this reason theorists have contemplated this element for a long time and different theories are used in order to establish legal causation: *conditio sine qua non* theory, the direct consequences theory, the adequacy theory, the foreseeability theory, as well as the flexible approach (Neethling *et al*, 2006).

One should also distinguish between factual and legal causation. Factual causation is concerned with showing that the conduct of the respondent actually, in fact, caused the harm. This is done by inquiring into the facts and probabilities of each case in question. The test used most often by courts in order to determine a causal nexus is that of the *conditio sine qua non*. This is aimed at determining whether one fact leads to another. Legal causation on the other hand is concerned with which consequences should be legally attributed to the person whose conduct may have led to the harmful event. This is needed due to the fact that factual causation can be endless; one act may lead to an infinite number of harmful events and it is legally unjust to hold a respondent liable for all possible consequences (Neethling *et al*, 2006).

The above was distinctly pointed out in *Minister of Police v Skosana*[26] in which Corbett JA stated that only once one has established that the negligent act or omission caused the harm to the plaintiff, one may then inquire into whether the said negligent act or omission is correlated to the harm directly enough for liability to attach. This will be decided as the facts of the case are considered. In the same judgment it was stated that the appropriate test to be used in determining causation is that of the *conditio sine qua non* test. The inquiry was said to be as follows: "Would the result have set in but for the negligent act or omission of the person concerned?"[27]

This approach has changed from the earlier one, which first started with the influence of English law into South African law: only proximate outcomes which are not removed from the act should be considered material. Other approaches were to only contemplate direct consequences or those consequences which are 'natural and probable' or 'foreseeable' outcomes (Ferreira, 2005). Judges have now elongated the

[26] *Minister of Police v Skosana* 1977 (1) SA 31 (A)
[27] *Minister of Police v Skosana* 1977 (1) SA 31 (A) at 44

interpretation of factual and legal causation and this has led to the necessity of finding a balance between policy considerations and unlimited liability.

Damage:

This is the loss which is consequent to a wrongful act. In order for the law of delict to provide compensation to a plaintiff some form of damage must have taken place. Damage (*damnum*) is defined as "the detrimental impact upon any patrimonial or personality interest deemed worthy of protection by the law." (Neethling *et al*, 2006: 196). The law of delict has a compensatory function which exists in two forms: the first is to compensate for damage monetarily for past and future patrimonial damage. The second is called satisfaction, which is monetary payment to a plaintiff in order to proportionately compensate for the wrong done to him/her. This is most often as a result of violation of personality rights (Neethling *et al*, 2006).

The most concerning threat to directors of companies is that of a pure economic (financial) loss. This is a financial loss which is not consequent to damage to corporeal property or the person (Boberg, 1984). This type of loss normally occurs as a result of a negligent miss-statement, which misleads certain individuals, causing a pure financial loss. With due regard, it is important to note that pure financial loss may encompass patrimonial loss, which is not consequent upon damage to property or injury to personality (Neethling *et al*, 2006). Pure economic loss may however come from damage to property or injury to personality, so long as the said damage or injury is not upon the plaintiff (Neethling *et al*, 2006).

South African courts were for a long time apprehensive regarding claims for pure economic loss. This was as a result of (Ferreira, 2005):

- liability for pure economic loss did not exist in Roman-Dutch law
- there was a fear that the floodgates would open to a high amount of claims
- it was thought feasible to spread losses instead of expecting one defendant to carry the burden of liability, and
- it was thought that the plaintiffs and amounts claimed would be indefinite.

In the UK the first successful attempt to extend the law of torts in order to recognise pure economic loss was in *Dutton v Bognor Regis*.[28] This case involved negligence on part of a housing council for not identifying faults in a house foundation. However progress had already been made in *Hedley Byrne v Heller*[29] in which a bank was sued as a result of the information it provided regarding the creditworthiness of a company. Another case, *Anns v Merton London Borough,*[30] then became the foundation for pure economic loss in the UK until all decisions were overturned by the House of Lords in *Murphy v Brentwood District Council*.[31] This rendered all previous decisions on the matter incorrect and pure economic loss was no longer recognised as actionable under the general law of torts (Cover, 1992). Each case would now have to be looked at on a factual basis, to see if it falls within a known category as opposed to falling within some general principle, leading to a pure financial loss.

In South Africa, up until 1977 there were two main cases (although others did exist) involving an action in delict, regarding losses other than those to corporeal property or to the person: *Perlman v Zoutendyk*[32] and *Herschell v Mrupe*.[33] It is worth observing that in both these cases professionals were held liable for their errors; as may be the case of directors and officers (Ferreira, 2005). The concept of pure economic loss as an upshot of negligence or miss-statements was formally introduced in South Africa in *SA Bantoetrust v Ross en Jacobz*.[34] Here the court found that there: "it is no longer arguable that such a ground of liability does not exist." (Translation at 187F-G).

In *Ewels, SA Bantoetrust* confirmed in *Administrateur, Natal v Trust Bank van Afrika Bpk*[35] the limits of liability for pure economic loss were said to be established by looking at the elements of the Lex Aquilia. It was said that indeterminate liability will be avoided if 'unlawfulness' and 'fault' are given due regard. It would then be up to the court on a case-by-case basis to resolve whether the defendant owes the plaintiff

[28] *Dutton v Bognor Regis UDC* [1972] 1 QB 373
[29] *Hedley Byrne v Heller* [1964] AC 465
[30] *Anns v Merton London Borough* [1977] 2 WLR 1024 HL
[31] *Murphy v Brentwood District Council* [1990] 2 All ER 908 HL
[32] *Perlman v Zoutendyk* 1934 CPD 115 – This case involved a pecuniary loss to the plaintiff as a result of incorrect valuations by a sworn appraiser.
[33] *Herschell v Mrupe* 1954 (3) SA 464 (A) – This case involved a loss on the plaintiff's part due to incorrect statements made by an attorney. The decision was overturned on appeal.
[34] *SA Bantoetrust v Ross en Jacobz* 1977 (3) SA 184 (T)
[35] *Ewels, SA Bantoetrust and Administrateur Natal v Trust Bank van Afrika Bpk* 1979 (3) SA 824 (A)

the duty not to create a misrepresentation (negligently) in the circumstances provided. It would also depend on whether the defendant took reasonable care in order to ensure that the representation in question was correct. It was stated that in the event that a legal duty does not exist toward the plaintiff, the defendant did not act wrongfully and may not be held liable. The element of 'causation' will also be inquired into so as to understand the nature of the misrepresentation.

In *Durr v ABSA Bank Ltd*[36] the appellant successfully recovered money for failed investments in debentures and preference shares which were purchased on the recommendation of ABSA's regional manager. It was stated that the required level of skill and diligence on part of the manager was that which would be expected of the members of the profession which the man was a part of. As it was, the manager had not taken advice from colleagues or investigated the credit worthiness of the issuing company. The manager was held liable in his personal capacity jointly and severally with ABSA.[37]

In *McLelland v Hulett and others*[38] the plaintiff was a director and shareholder of a company who attempted to hold other directors liable for failing to purchase some land. The acquisition would have profitable to the plaintiff director as a shareholder of the company. An agreement had been made between all the directors to acquire the land however the defendants failed to exercise the option. In this case the court looked at a policy founded on reasonableness. One must make a decision based on moral standards and the legal convictions of the community: was the act unlawful? Should the defendant be liable to the plaintiff for the loss suffered[39] (or profit not gained)? If the defendant could reasonably foresee that his conduct will lead to a loss on part of the plaintiff, then the conduct is regarded as unlawful. One must now distinguish between the circumstances in *McLelland v Hulett and others* and those in *Ewels, SA Bantoetrust and Administrateur, Natal v Trust Bank van Afrika Bpk*. In the latter case

[36] *Durr v ABSA Bank Ltd 1997 (3) SA 448 (A)*
[37] ABSA was held vicariously liable as a result of negligence in not properly training the defendant and for putting the public at a risk of loss due to a negligent manager.
[38] *McLelland v Hulett and others* 1992 (1) SA 456 (D)
[39] *Minister van Polisie v Ewels* 1975 (3) SA 590 (A)

the losses endured by the plaintiff were those of expenditures. However in *McLelland v Hulett and others* the plaintiffs claimed damages in the form of speculative losses.[40]

In *McLelland v Hulett*[41] *and others* the court deliberated the following policy considerations:

1. Is the loss to the plaintiff finite?
2. Is the number of potential plaintiffs foreseeable and determinable?
3. Regarding the knowledge of the defendant of potential harm to the specific plaintiff, does that knowledge isolate that plaintiff from a mass of unforeseeable plaintiffs?
4. Would the acknowledgment of liability indicate a fair assessment of:
    a. the interests of the parties involved and their relationship to one another;
    b. the social outcomes of the imposition of liability;
    c. the extent of the duty which would be implicated on other persons who find themselves in the same position as the defendant?
5. Would the imposition of the duty be just, taking into account:
    a. the simplicity with which the loss could have been foreseen;
    b. the probability of risk that a loss would be suffered;
    c. the availability of methods to the defendant which could or would have avoided the loss;
    d. the potential that those methods would have been a success;
    e. the ease with which a person in the position of the defendant could have taken such measures, as well as the cost to him of doing so.
6. Does the law actually sanction the conduct of the defendant, or, on the other hand, does the defendant's conduct actually fall into one of the accepted categories of unlawfulness, albeit in relation to a person other than the plaintiff?

In the relevant case the court opted to award the plaintiff R28 million. The South African law is not at a stage where all financial harm is *prima facie* wrongful,

[40] A speculative risk is one where the potential gain or loss in unknown in advance.
[41] *McLelland v Hulett and others* 1992 (1) SA 456 (D) at 464 I-J and 465 A-E

therefore a duty to prevent pure economic loss for other persons is non-existent. The onus lies with the plaintiff to prove to the court that the conduct (or lack thereof) of the defendant is unlawful. The court will then decide, on a case-by-case basis, whether or not in light of the relevant circumstances, a legal duty to avoid a pure economic loss existed on part of the defendant (Neethling *et al*, 2006). This should theoretically be done by considering the legal convictions of the community and *boni mores*.

Other South African cases in which liability for pure economic loss was determined are: *EG Electric Co (Pty) Ltd v Franklin;*[42] *Greenfield Engineering Works (Pty) Ltd v NKR Construction (Pty) Ltd;*[43] *Administrateur, Natal v Trust Bank van Afrika BPK;*[44] *Kern Trust (EDMS) BPK v Hurter;*[45] *Coronation Brick (Pty) Ltd v Strachan Construction Co (Pty) Ltd;*[46] and *Pilkington Brothers (SA) (Pty) Ltd v Lillicrap, Wassenaar and partners*.[47]

This section is important due to the fact that directors that breach their duty of care, skill and diligence will be held liable in delict. Further discussion on the actual duty of care may be found under the section of director's common law duties.

One may get an indication that courts and society are more willing to hold directors accountable by the fact that the new Companies Act will place the duty of care in legislation. Therefore, eventually it may no longer be necessary to show that all the delictual elements are in place in order to hold a director accountable. It is easier to pin liability under statute than under delict.

[42] *EG Electric Co (Pty) Ltd v Franklin* [1979] 4 All SA 79 (E)
[43] *Greenfield Engineering Works (Pty) Ltd v NKR Construction (Pty) Ltd* [1978] 4 All SA 616 (N)
[44] *Administrateur, Natal v Trust Bank van Afrika BPK* [1979] 2 All SA 270 (A)
[45] *Kern Trust (EDMS) BPK v Hurter* [1981] 2 All SA 286 (C)
[46] *Coronation Brick (Pty) Ltd v Strachan Construction Co (Pty) Ltd* [1982] 2 All SA 330(D)
[47] *Pilkington Brothers (SA) (Pty) Ltd v Lillicrap, Wassenaar and partners* [1983] 3 All SA 111 (W)

Statute

Company directors and officers are held personally liable for the fraudulent conduct or reckless trading of business[48] under the Companies Act 61 of 1973. There are a number of provisions in the Act in terms of which directors can be personally liable for committing fraud; however a discussion of each of these is beyond the scope of this dissertation. For a more detailed discussion on the effects of the Act on company directors and officers, one may be referred to Ferreira (2005). This section will look at the main section of liability for directors (regarding fraud) under the Act, as well as some of the case law relevant to the application of the Act. A list of South African legislation which affects director liability is provided in Appendix 2.

S424 of the Act is entitled: "Liability of directors and others for fraudulent conduct of business". S424 (1) reads as follows:

> "When it appears, whether it be in winding-up, judicial management or otherwise, that any business of the company was or is being carried on recklessly[49] or with the intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the Court may, on the application of the Master, the liquidator, the judicial manager, any creditor or member or contributory of the company, declare that any person who was knowingly[50] a party[51] to the carrying on of the business[52] in the

[48] Fraud may be defined as: "Fraud consists in unlawfully making, with intent to defraud, a misrepresentation which causes actual prejudice or which is potentially prejudicial to another." (PMA Hunt in *South African Criminal Law and Procedure*, 2nd ed., Vol. 2, at 755)

[49] The word 'recklessly' is used to involve an objective standard of care which would be expected of a reasonable man in carrying out the business of a company. Reckless conduct therefore would represent gross negligence.

[50] The word 'knowingly' is intended to mean that one had the knowledge that the business of the company was being carried out recklessly. This is according to the interpretation in *Howard v Herrigel and another NNO* [1991] 2 All SA 113 (A); *Philotex (Pty) Ltd and others and Braitex and others v Snyman and others* [1998] JOL 1881 (A); and *Terblanche and others v Damji and another* [2003] JOL 11359 (C).

[51] Being a 'party' to the conduct in question it does not necessarily mean that a director has to have taken positive steps to carry out the business of the company recklessly; in some circumstances it is sufficient that the director assents to the harmful conduct, as stated in *Howard v Herrigel and another NNO* [1991] 2 All SA 113 (A).

[52] In *Cooper and others NNO v SA Mutual Life Assurance Society and others* 2001 (1) SA 967 (SCA) a principle regarding the 'business' of a company was reiterated as in *Powertech Industries Ltd v Mayberry and another* 1996 (2) SA 742 (W). It is stated that a 'party' to the conduct of a company's business is one who has united with the company towards a common goal. This would obviously include the directors and officers of a company. If the business of the company was carried out recklessly the said directors and officers are personally liable as they may not hide behind the limited liability of the organisation, or the 'corporate veil'. However as was the case in *Cooper and others*

> manner aforesaid, shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court may direct."

Some of the prominent cases involving directors' and officers' personal liability under s424 will now be looked at.

In *Ex parte Lebowa Development Corporation Ltd*[53] the general guidelines for the application of s424 were stated. It was said in this case that s424 does not replace the common law remedies available to those who suffer damage at the hands of directors and officers, whilst carrying on the business of the company, be it intentional or negligent. Therefore the statutory provision is there to supplement the common law by presenting the victim with a supplementary remedy. The s424 resolve is available if there is a claim against the company as a result of an intentional act, recklessness or breach of contract. In the event that there is no existing claim against the company, s424 is inapplicable.

In this manner s424 allows the court to infer liability on the directors and officers who carried on the business of the company fraudulently or with the intention to defraud. However s424 may also be applied when the original claim is not only against the company but also against the wrongdoers themselves (directors and officers). It is clear from the wording of s424 that there are four means by which a person may be held personally liable, that is if the business of the company was carried on: recklessly, or with the intent to defraud creditors of the company, with the intent to defraud creditors of others, or for any fraudulent intention (Pretorius *et al*, 2006). One must note that a claim under s424 will not be available in the event that a director or officer of a company was reckless or committed fraud outside the scope of the company's business. In that event only the common law rules apply.

NNO v SA Mutual Life Assurance Society and others, one may not be liable due to the fact that in carrying on the business of a company, one may incidentally enable another company to carry out its business in a reckless manner. For example a broker may not be held personally liable for the wrongful conduct of a company, due to the fact that the broker enabled business between the wrongful company and another. The broker would in this case simply be pursuing his own objectives.

[53] *Ex parte Lebowa Development Corporation Ltd* 1989 (3) SA 71 (T)

In *Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman*[54] a subsidiary of the Rentmeester group named Wolnit had been performing at a loss for a number of years. The financial statements did not reveal how Wolnit would be kept in operation; however the company was kept as a going concern by utilising monetary funds from its holding companies. The directors nevertheless continued to project that the company would thrive in the future. Despite that, Wolnit was voluntarily liquidated 1989.

The creditors of Wolnit were seeking to hold the directors accountable under s424 of the Act. Two actions were brought: the first was to hold the directors personally liable for all the debts of Wolnit incurred after a certain date, and the second (alternatively) was to recover debts owed to the creditors at the time of liquidation. The court *a quo* (Transvaal Provincial Division) dismissed the claims as it was found that recklessness on part of the directors had not been proved.

However the Supreme Court of Appeal found that the directors knew the correct condition of the company and purposely intended for the financial statements to portray a misleading depiction. It was stated that no reasonable person in the position of the directors would have acted the same if they had no intention to defraud. It was held that there was no reasonable prospect for the company to settle its debts in the future and that the directors knew that the creditor's finances were being risked unnecessarily. The directors were therefore knowingly parties to the proved reckless trading of Wolnit, on a balance of probabilities.

This case as well as that of *Howard v Herrigel*[55] confirms the fact that a director can be held personally responsible for the liabilities of a company even though there may be no causal link between the conduct and loss incurred by the plaintiff. The onus is on the person who is claiming recklessness, on part of the defendant, to prove it. To this one must show that the defendant was reckless on a balance of probabilities. The case also confirms that the test for recklessness is objective in that the defendant's actions are measured against those of a reasonable person. However the test is also subjective in that the defendant's conduct is compared to that of individuals who have

[54] *Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman* 1998 (2) SA 138 (SCA)
[55] *Howard v Herrigel NNO* 1991 (2) SA 660 (A)

the same abilities, skills and knowledge as the defendant actually has. It must also be pointed out that 'recklessness' refers to a minimum of gross negligence. When the court attempts to decide whether a director was reckless in the conduct of the company's business, the following aspects must be taken into account (non exhaustive): the capacity of operation of the company, the role, functions and powers of the directors, company debts, and the company's financial situation.

In *Kalinko v Nisbet and others*[56] the plaintiff who was a major shareholder of the company in liquidation sought to hold the directors of the company liable under s424 of the Companies Act for debts owed to the plaintiff by the said company. These debts were incurred as a result of a retail agreement entered into by the company and a third party, which included a subordination clause, whereby shareholders' loans would be secondary to claims of the creditors of the company. Other claims against the defendants were for an alleged breach of fiduciary duties towards the company shareholders.

The important principle which resulted from this case was that of the 'timing' of the wrongful conduct. The defendants claimed that the loan was entered into two years prior to the wrongful conduct; therefore they could not be held personally liable to debts resulting from that transaction. First it was once again stated that the claimant has no duty to prove a causal link between the wrongful conduct of the director and the loss to the plaintiff. Secondly it was held that the fact that a debt is incurred prior to the wrongful conduct does not absolve the defendant under s424. The debt was incurred prior to the wrongful conduct, however it continued throughout the time when the conduct in question took place. The question must be one of when the wrongful conduct took place, irrespective of when a debt was incurred which may influence the wrongful conduct in turn.

S93 (2) of the Companies Bill should operate in the same manner as its predecessor. The company must be liable for a debt which the directors and officers may be held personally liable for provided that they undertook the business of the company in a reckless or fraudulent manner. However the Bill seems to 'codify' some of the

[56] *Kalinko v Nisbet and others* 2002 (5) SA 766 (W)

principles which have been set-out in case law. Directors and officers may be held personally liable for the signing of, consenting to, or publishing of financial statements, prospectuses or written statements, if knowingly, or with reckless disregard for the fact that the said documents were false, misleading or untrue. This is an addition to s424 of the Act.

Further, the Bill also holds directors and officers personally liable if they were knowingly party to the reckless carrying on of the company's business, or for an act or omission which intended to defraud a creditor, employee or security holder of the company. To add to this 'any other fraudulent purpose' is also included in c93 (2). It is worth noting that the Bill has stipulated that the director or officer will be held personally liable for either an act or omission, which is wrongful and results in harm to the plaintiff.

Perhaps one must assume that the legislators are reacting to the increasing tendency of society and courts to hold directors accountable. Not only is there potential additional liability under statute, there is also the fact that the common law duties of directors are being codified under the new legislation. Even though the codification is in addition to the common law, it is easier to prove liability under statute. In this manner two sources of liability (statute and delict) will be running concurrently which will probably increase the chances of directors being held liable. This is a clear indication that courts and society are increasingly looking to point the finger when a loss occurs to a company. The pointing is progressively more in the direction of company directors.

Contract

The law of contract in South Africa was originally derived from Roman-Dutch law, which itself initially was Roman law. In the Cape Colony in 1826 the Bigge and Colebrooke report was produced (Christie, 2006). This report suggested, among other things, that the Cape Colony should initiate a replacement of Roman-Dutch law with English law. The first Charter of Justice created the Supreme Court in the Cape Colony an 1826. The first case regarding the application of rules of contract law was that of *Louisa and Protector of Slaves v Van den Berg*[57]; it was related to an oral gratuitous *stipulation alteri*[58]. South African law was not willing to enforce an oral gratuitous promise and reference was only made to Roman-Dutch law in this case. However English law would slowly be introduced at the Cape Colony and eventually in the rest of South Africa. The first case to apply English rules of contract was that of *Jacobson v Norton*[59] in which the English concept of *quid pro quo*[60] was in issue (Christie, 2006).

One may point out six requirements in order for a contract to be valid: agreement (consensus), contractual capacity, certainty, possibility, formalities, and legality (Bhana, 2007). In the event that the requirements are met, the contracting parties will be legally bound in terms of the contract. The following is a brief summary of the requirement for the validity of a contract (Bhana, 2007):

- Agreement: A subjective agreement must be reached between the contracting parties regarding the following aspects: who the parties to the contract are, the rights and duties which the contract generates, and that the contract itself must be legally binding.
- Contractual capacity: The contracting parties must possess the legal capacity to enter into a contract. This entails the capability of comprehending the nature and effect of the contract, as well as to act in accord with the awareness. It is usually accepted that persons over the age of majority possess the required capacity to contract.
- Certainty: In order for the contract to be valid, the contracting parties must understand completely their respective rights and duties in accordance with the contract. That is, there must be certainty as to what the contract entails.
- Possibility: A valid contract requires that at the time of conclusion, it must be feasible to perform the duties in respect of the said contract. It may happen that performance under a contract may be possible at the time of conclusion; however it consequently becomes impossible to perform. The contract will

[57] *Louisa and Protector of Slaves v Van den Berg* (1830) 1 M 471
[58] Contract for the benefit of a third party.
[59] *Jacobson v Norton* (1841) 2 M 218
[60] An exchange of something for a *contractual* promise in this case.

still be valid but certain rules will exist which establish who must execute which duties, as well as who carries the risk of impossibility.

- Formalities: Certain kinds of contracts have statutes which stipulate formalities that must be met prior the validation of a contract. The contracting parties themselves may sometimes set out formalities for a contract. In the event that the formalities are not met, the contract will not be valid.
- Legality: No terms of a contract may be contrary to the law or public policy. The law spoken of may be derived from either statute or common law. The court will have to decide whether a contract is contrary to public policy by taking into account policy considerations as well as the Constitution of South Africa.

Parties to a contract may be held liable as a result of the contractual arrangement. Regarding directors' and officers' liability, the majority of claims arise consequent to a disagreement as to whether the director or officer assumed personal liability for the obligation under the contract, or whether the director or officer only intended to bind the company which he represents. It is possible that a director may be held personally liable for the terms of a contract entered into as a representative of the company, even if that director only intended binding the said company. This would be the case if, in light of the circumstances and terms of the contract, the other party to the contract is justified in judging that the director intended being bound in his personal capacity.

There are three other main areas regarding contract which are relevant to directors; breach of warranty of authority in conclusion of contract, fraudulent misrepresentation of belief relating to a company's ability to pay, and procuring a company's breach of contract or prevention of performance by the company of its obligations. These three topics are covered briefly; however one may see Ferreira (2005) for a more detailed explanation.

Breach of warranty of authority in conclusion of contract:

A company, being a juristic person, can only act through its human agents or representatives, such as the directors and officers. The directors are not granted complete freedom to bind the company in any circumstance or manner; certain limits are established. The general rule is that if a director or officer acts outside the limit of his binding authority regarding a contract, he will be held personally liable under the terms of that contract. That is assuming that the other contracting party lacked the knowledge of the director or officer's lack of capacity to enter into the contract. However one must keep in mind that the company itself may still be bound by the contract regardless of the director's lack of authority.

In *West London Commercial Bank Ltd v Kitson*[61] the directors of a company accepted a bill, which was taken by the court to mean that the directors made a statement that they were sanctioned by the company to accept it on its behalf. However the statement was false and the directors were aware of this. Thus with regard to the circumstances, the directors were held personally liable to the other contracting party (Ferreira, 2005). This may be seen as a fraudulent misrepresentation which was reasonable relied upon by the other contracting party. In South Africa the law acknowledges actions for negligent misrepresentations. Therefore if the directors or officers of a company are not aware of the lack of authorisation, however they should reasonably know, one could still attribute personal liability as a result of a negligent misrepresentation (Fereirra, 2005).

Fraudulent misrepresentation of belief relating to a company's ability to pay:

The entry into a contract by a director or officer of a company relating to the an assumed obligation by that company to render performance is considered, by South African law, to be a representation by the said director or officer that they believe that the company concerned possesses the means to render the performance in question. In the event that at the time of the representation, the director or officer was aware that the company would be unable to render performance, then the said agents would be held personally liable for any ensuing damages as a result of the fraudulent misrepresentation of the director or officer's belief. As stated above, a negligent misrepresentation could also lead to a director or officer being held personally liable for subsequent damages. This is in the event that the director or officer ought

[61] *West London Commercial Bank Ltd v Kitson* 1884 13 QB 360

reasonably to have known that the company would be unable to render the performance specified in the contract (Ferreira, 2005).

The representation made must be based on an actual aspect; therefore the representation which is scrutinised is that of the director or officer's belief regarding the company's ability to carry out its obligations. The belief in a fraudulent circumstance would not have been held or in a negligent circumstance would have been unreasonably held (Ferreira, 2005).

Procuring a company's breach of contract or prevention of performance by the company of its obligations:

A director or officer of a company may be held personally liable under the common law for losses arising out of the procurement of a breach by the company of its contractual obligations or preventing the company from observing with the said obligations. It may be thus deduced that a director or officer of may also be held personally liable for losses arising out of a failure to act in order to make certain that the company observes its contractual obligations. In *Torquay Hotel Company Ltd v Couzens and others*[62] it was stated that if a third party interferes with a contracting party's ability to observe performance, that third party may be held personally liable for any resulting losses due to an actionable interference (Ferreira, 2005).

Contractual and delictual liability:

A breach of contract may be defined as a wrongful act by one contracting party, which causes damage to another contracting party. This may seem very similar to a delictual action as they are both a part of private law. However the two legal fields do possess some elementary differences.

A breach of contract occurs when one party to a contract does not fulfil certain rights or obligations expected in the contract. Therefore the remedies for a breach of contract are essentially intended to enforce or execute the contractual duties. One may

[62] *Torquay Hotel Company Ltd v Couzens and others* [1969] 2 Ch 106

say the remedies for breach of contract are intended to fulfil the contract (Neethling *et al*, 2006). This is in contrast to delict which is the violation of a person's legally recognised interests. In this manner the objective of a delictual remedy is damages; to put a person in the same position as before the infringement took place. Therefore contractual remedies are aimed at fulfilment, whilst delictual remedies are aimed at damages. This may be seen clearly in the case *Trotman v Etwick*:[63]

"A litigant who sues on contract sues to have his bargain or its equivalent in money or in kind. The litigant who sues on delict sues to receive the loss which he has sustained because of the wrongful conduct of another, in other words that the amount by which his patrimony has been diminished by such conduct should be restored to him."

Both fields of law also have their own rules which apply; that of delict and contract law. These rules are generally not applicable to the other. It is also possible that one may be liable *ex contractu* and *ex delicto* (Neethling *et al*, 2006).

In *Lillicrap, Wassenaar and Partners v Pilkington Brothers*[64] the dissimilarities between an action in contract and an action in delict were pointed out by the Appellate Division. When one is attempting to decide whether or not to extend an action for a breach of contract to delict, it must first be ascertained whether there is a requirement for it. If there is a clear contractual connection between the plaintiff and the defendant, and ample remedies already exist then there is no reason to bring an action in delict. One may not apply certain delictual rules, such as that of the diligent paterfamilias in measuring the degree of diligence, to contractual situations as the matter would only be made more complex. Further, delict is not necessary in a contractual relationship as the contract itself should specify what the parties' respective obligations are. One may not remove the contractual terms which the parties to the contract agreed to with the intent of protecting themselves (Ferreira, 2005).

[63] *Trotman v Etwick* 1951 (1) SA 443 (A) at 449B-C
[64] *Lillicrap, Wassenaar and Partners v Pilkington Brothers* (SA) Pty Ltd 1985 (1) SA 590 (A)

Sui generis

A director may be held liable for a breach of fiduciary duties towards the company when that director commits a breach of trust. That may be the case if the director acts in order to further his own benefits or if he causes prejudice to the company. The cause of action in the event of a breach of fiduciary duties by a director does not exist in delict or in contract. The actual cause of action is *sui generis*.[65] However the Companies Bill aims to legislate against a breach of fiduciary duty by a director, thus eventually holding him liable under statute. Certain writers have suggested that delict should be the basis for a breach of fiduciary duty, as well as that sui generis should be a form of strict liability within the law of delict.[66] However this has been to no avail.

The South African Concise Oxford Dictionary defines *sui generis* as meaning 'unique' from Latin origins meaning 'of its own kind'. That is precisely what sui generis is: unique legal rules and regulations which deal with specific instances. It is not possible to classify certain areas or to determine set elements, as is the case with delict. This will be described further under the common law fiduciary duty of directors.

1.3 Directors' common law duties

Directors assume duties from contract, statute, the company's Memorandum of Incorporation, as well as common law. The common law duties may be categorised under fiduciary duties and a duty of care, skill and diligence. The common law duties will now be described commencing with the fiduciary duty towards the company.

One must comprehend that a breach of common law duties will lead to liability under delict or *sui generis*. However as a result of the fact that courts and society are increasingly more willing to hold directors accountable, liability under delict and *sui*

[65] Havenga (1996); Havenga (2000); Havenga (2004); Havenga (2006); Jones (2007); McLennan (1996); Bekink (2008); Cilliers and Benade (2000); *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168; *Cohen NO v Segal* 1970 (3) SA 702 (W); *Du Plessis NO v Phelps* 1995 (4) SA 164
[66] See Havenga (1996) regarding the arguments contrary to these suggestions.

generis is being codified under corporate governance codes and legislation (new Companies Act).

The rest of this Chapter will illustrate how director's liability has been on the increase. This is as a result of society and courts wanting to hold directors accountable for company losses and failures. Society has made it the norm for company shareholders, and other stakeholders, to take directors to court when losses occur. This has been done by increased media exposure, as well as the fact that courts themselves are increasingly making judgements against directors. This in turn entices society to blame directors whenever a loss is sustained by a company. The following sub-headings will show that society is increasingly taking directors to court, whilst courts are increasingly holding directors accountable.

1.3.1 Directors' fiduciary duty

The South African law regarding fiduciary duties is derived from that of Roman-Dutch law (Jones, 2007). This duty is a negative one in that it prescribes that directors actually reframe from doing wrong to the company (Bekink, 2008). A fiduciary relationship is entered into when one person manages the assets of another or has the right to act on that person's behalf. Thus a director controls the assets of the shareholders and has the power to act on their behalf. A director therefore must act in good faith regarding the company, must use his powers for the benefit of the company, and must avoid conflicts of interest between himself and the company (Cilliers & Benade, 2000).

The fiduciary duties of a director may not be in any way mitigated whether in the Memorandum of Incorporation, contract, or any other conceivable way.[67] Further, it ahs been stated that an attempt to avoid the fiduciary duty is taken as an actual breach of the duty itself.[68] As stated in the 'Corporate Governance' chapter there is no difference between the fiduciary duties of an executive and a non-executive director.

[67] *Barlows Manufacturing Co Ltd v RN Barrie (Pty) Ltd* 1990 (4) SA 608 (C); *Movitex Ltd v Bulfield* 1988 BCLC 104 (CH); McLennan (1991)
[68] *S v Ressel* 1968 (4) SA 224 (A) 232; *S v Shaban* 1965 (4) SA 646 (W)

This may be observed by certain decisions of the Appellate Division.[69] The director's fiduciary duty towards the company offers the shareholders a first line of defence against wrongful acts on part of the directors. In the event that a director creates a benefit for himself or causes a loss to the company, as a result of a breach of a fiduciary duty, the loss or benefit may be recuperated by the company; the company may then opt to cancel the operation involved (Cilliers & Benade, 2000). The fiduciary duty of a director is held towards the company on which board he sits. This is the case even though the company on which board the director sits may be part of a group of companies. However the director still owes a duty to any subsidiary company, of the company on which board the director sits. The director in this case owes a duty to the subsidiary company to not allow the holding company to disallow the subsidiary to act in its own best interests (Cilliers & Benade, 2000).[70]

One may categorise the fiduciary duties of directors towards a company as follows: the duty to avoid a conflict of interest, the duty to maintain and exercise an unfettered discretion, the duty to exercise powers for the purposes which they were conferred, and the duty to act legally, honestly and within their powers. These duties will now be looked at in turn and accompanied by the relevant case law (Cilliers & Benade, 2000).

Duty to avoid a conflict of interest:

The director being a fiduciary to the company has the duty to avoid a conflict of interest between himself and the said company. The director may not gain any benefit from his office with the exception of remuneration. In *Cook v Deeks*,[71] company T was in the business of railway construction contractors and owned in equal proportion by four shareholder directors. Two of the directors obtained a new contract and created a new company D to perform the work. This was later ratified by a board majority vote of three to one. The three directors (including the two that obtained the new contract) stated that a part of the plant belonging to T must be sold to D and that T had no interest in the new contract. The minority director claimed against the other three in court (Cilliers & Benade, 2000).

[69] *Howard v Herrigel NNO* 1991 (2) SA 660 (A)
[70] See *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168 in this regard.
[71] *Cook v Deeks* [1916] 1 AC 554 (PC)

The Privy Council held that the contract belonged to T and that the majority directors could not ratify their positions simply by being the majority. The directors' knowledge and reputation had been obtained whilst working for T and this position could then not be used to gain a personal advantage. Whilst still under the employment of T the directors owed a duty to the company to not allow a conflict of interest to arise. The directors would have to first end their positions as such, which could have been accomplished by dissolution of T at a general meeting.

It is interesting to note that in 1916 the court was reluctant to create a rule regarding director's duties which would be so burdensome that one may decline the position of a director in order to avoid the duty. Yet the court held that once a director is in the fiduciary position he may not let his own interest conflict with that of the company which he is meant to protect. It was also stated that allowing a majority to vote away a company's interest in a contract as well as property owned by the company would be discriminatory to the minority (Cilliers & Benade, 2000).

In *Robinson v Randfontein Estates Gold Mining Co Ltd*[72] the defendant was the chairman of the board of the company, and the company itself was the plaintiff. The company had interests in a farm regarding the lease of certain mineral rights. However no deal was concluded and the defendant favoured a purchase of the farm. The plaintiff then went on to purchase a half-share of the farm through an agent for £60 000 and re-sell it to the company (in the form of a trust created to hold the farm) for £275 000. The Appellate Division held that the director was not allowed to make a profit as a result of his office due to the fact that he found himself in a position in which his interests conflicted with those of the company. This was a breach of his fiduciary duty toward the company. The plaintiff was ordered to compensate the company in form of the £215 000 benefit which he obtained.

The benefit which the director derives from his position as such in a company is referred to as a secret profit. However the fiduciary duty toward the company still applies in the case that the benefit is obtained in good faith and with no detriment to

[72] *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168

the company. The court will consider only whether the director obtained a benefit due to his office being held in the company; it matters not that the company itself may not have been disadvantaged by the situation (Cilliers & Benade, 2000).

In *Regal (Hastings)Ltd v Gulliver*[73] the company in question owned a cinema. The directors of the company wanted to purchase two other cinemas in order to sell them for a profit, however the company could not afford it. In order to do this a subsidiary company was created which had £5000 in £1 shares. The company then subscribed for 2000 shares and the directors and their friends undertook the other 3000 shares on par. The sale of the three cinemas to the new shareholders resulted in a profit for the directors. The company successfully sued the former directors for the profit which they had obtained. The court held that the directors made a profit out of their office in the company and this goes against their fiduciary duties towards the said company. This profit was only obtained as a result of the directors' office, which furnished them with certain knowledge, and it matters not whether it was done in good faith and with no actual loss to the company. Therefore the directors' liability does not necessarily depend on a breach of fiduciary duty but simply on the fact that a benefit was obtained consequent to their directorship (Cilliers & Benade, 2000).

It is also considered a breach of the fiduciary duty to avoid a conflict of interest if the director utilises information obtained as a result of his office in order to make a personal gain. In *Magnus Diamond Mining Syndicate v Macdonald & Hawthorne*[74] the defendant directors acquired information regarding a profitable piece of land as a result of their directorship in a company. The directors went on to purchase the land even though this caused obvious competition with their company. The court ordered the directors to transfer the land into the name of the company as well as to pay back any profits which were obtained consequent to the purchase (Cilliers & Benade, 2000).

In *Industrial Development Consultants Ltd v Cooley*[75] the defendant, C, was an architect and managing director of the plaintiff company. C sought a contract with a

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[73] *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378 (HL)
[74] *Magnus Diamond Mining Syndicate v Macdonald & Hawthorne* 1909 ORC 65
[75] *Industrial Development Consultants Ltd v Cooley* [1972] 1 WLR 443; [1972] 2 All ER 162

company, E, however the company informed him that it was unwilling to do business with the plaintiff company and offered the contract to C personally. C then went on to resign from his office with the plaintiff company on the basis of ill-health and consented to work with E. C was held liable to the plaintiff company for any advantage which he was accredited with as a result of the contract. This occurred even though the plaintiff company had no prospect of concluding a contract E. The court held that this was consequent to the fact that C made a profit only as a result of his position as a managing director for the plaintiff company (Cilliers & Benade, 2000).

In *Canadian Aero Service Ltd v O'Malley*[76] (Canadian case) offered services regarding mapping and geophysical studies, mainly to government institutions. The two plaintiffs were former directors of the plaintiff company and had undertaken preliminary work regarding a project in Guyana. The Canadian government requested that the plaintiff company and others present tenders for the project. The defendants thus terminated their directorships with the plaintiff company and created their own, which was successfully received the contract. The court held that the defendants were liable to the plaintiff company as a result of the loss of the contract. The plaintiffs were in the position to win the contract only as a consequence of their knowledge gained through their directorships. Their fiduciary duty to the plaintiff company had been infringed.

In *Bellairs v Hodnett*[77] B, the appellant, was the exclusive shareholder of a property development company, N, one of the respondents. N owned a lot named N15 in the Township of Northcliff. In 1966 B and the other respondent, H, decided to develop the property jointly, therefore B sold H 33 of the shares he owned in B. It was then decided that N would purchase N19 which was adjacent to N15 and develop it. Later N20 which was adjacent to N19 was purchased by B in his personal capacity; B had formed a company named P in 1967 which would be a holding company for four township development companies comprising of N. H did not want to partake in P when it was offered. B sold his shares in N to P for R 28 300 and did not first offer it to H. the actual value of the shares was R 116 375 (Cilliers & Benade, 2000).

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[76] *Canadian Aero Service Ltd v O'Malley* (1974) 40 DLR (3d) 371 (SCC)
[77] *Bellairs v Hodnett* 1978 (1) SA 1109 (A)

In 1970 H bought B’s shares in N for R 232 750, after which N which was owned completely by H as well as H himself sued B for the profits which had accrued to him in purchasing N20. H claimed that B had a fiduciary duty towards N to purchase N20 for the company and not himself. The claim was successful in the court a quo but on appeal the decision was overturned and the claims were rejected. The Appellate Division held that the scope of N’s business was not to purchase more land in Northcliff therefore, no fiduciary duty existed on part of B. Regarding competition, the scope of N was to develop property owned by it, not to purchase more. H had been aware that B had other property interests from the outset; therefore the aspect of competition must have been foreseen by H. Therefore no breach of fiduciary duty was found (Cilliers & Benade, 2000).

In *Atlas Organic Fertilizers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd*[78] the managing director, L, of the plaintiff company had resigned from his office and whist still in the period of notice under his service contract, he constructed a company which would be in competition with the plaintiff company. Further, L interfered in the plaintiff’s opportunity to acquire a raw material contract. L then attained the contract for the company he set up and convinced some of the employees of the former company to work for him. The action brought to court was one of damages for unlawful competition. The court held that L had breeched his fiduciary duty towards the plaintiff company in that he redirected the raw materials contract to himself, which he only had knowledge of as a result of his office with the plaintiff company. He was also liable as a result of encouraging employees of the plaintiff company to work for him. However the court held that it was not an unlawful act to set up a competing company. This was due to the fact that he had already terminated his office with the plaintiff and was entitled to create some form of employment for himself, even though this would place him in competition with his former employers.

In *Sibex Construction (SA) (Pty) Ltd v Injectaseal CC*[79] the appellant company was an on-line maintenance sealing company, which seals leeks in a plant or equipment without having to first switch off operations. The respondent was a close corporation (CC) which was formed by B (the former managing director of the appellant) and C (a

[78] *Atlas Organic Fertilizers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd* 1981 (2) SA 173 (T)
[79] *Sibex Construction (SA) (Pty) Ltd v Injectaseal CC* 1988 (2) SA 54 (T)

former general manager of the appellant). The business of the respondent was in competition with that of the appellant. Both B and C had resigned from the appellant in June 1987 but C remained in the company's service until the end of July 1987. The bulk of skilled workers also left the appellant to work for the respondent in July 1987 (Cilliers & Benade, 2000).

Whilst still in the service of the appellant, C proposed a tender for work with Sasol and Natref on behalf of the appellant. Yet in July the respondent submitted a price list to Sasol in order to offer their services; these prices were slightly lower than that of the appellant. The appellant applied to the court for limited relief in that the respondent could not perform work for Sasol and Natref as a result of the quotations offered. The court held that the respondent retreat the quotations offered to Sasol and Natref. This was as a result of the former directors of the appellant utilising confidential information in order to arrange competitive quotations. This was a breach of fiduciary duties toward the former company.

A director may serve on the board of numerous companies irrespective of whether the companies may be in competition with each other. However the director is not allowed to utilise the confidential information obtained in order to bestow a benefit on to either company (Cilliers & Benade, 2000). However a managing director may not hold any other directorships due to the fact that the being involved in the management of the affairs of a company will place the director in a situation where he is forced to deal with conflicting interests. Thus if a director is permitted to hold an office in alternate companies he may also do that for himself; therefore a director may compete with a former company of employment (Cilliers & Benade, 2000).

The general rule is that in the event that a director enters into a contract with his company in which he has a conflict of interests, the contract is voidable if the company so decides (Cilliers & Benade, 2000). This rule is also applicable when the company contracts with another company in which the director has an interest. However the contract may not be voidable if an exclusion clause is placed in the Articles of Association allowing the director to contract with the company. If the clause is non-existent the contract will still be voidable after a general meeting held by the shareholders in which an informed decision may be taken (Cilliers & Benade, 2000).

In *Cyberscene Ltd and others v i-Kiosk Internet and Information (Pty) Ltd*[80] the applicant company applied for interdictory relief in order to inhibit the respondents (former directors of the company during the court trial), who during their directorships with the applicant attempted to launch a competing business. This was done by utilising information acquired as a result of their office at with the applicant company. Further, the applicants required that certain property of theirs be returned from the respondents. The court granted the applicants interim relief whilst awaiting final judgement (Cilliers & Benade, 2000). The court held that the respondents had used their office with the applicant company in order to create a competing company, whilst still working for the applicants. Further, the respondents used confidential information from the applicant company in order to create a business plan and marketing brochure for the competing company, thus unlawfully saving time and money in compiling their own. The respondents also utilised confidential information in order to gain access to certain business prospects belonging to the applicants. The fiduciary duty to not allow a conflict of interest to arise between the directors and the company had clearly been breached. The interim order was eventually made final.

In *Movie Camera Company (Pty) Ltd v Van Wyk and another*[81] the defendant was a technical supervisor who was employed by a company which rented motion picture camera apparatus. The company was sold to a subsidiary of a rival company in 1996; the subsidiary was the plaintiff. The defendant was made a director and in terms of the sale agreement was put under a restraint of trade. The restraint period was effective from 1 January 1997 until thirty months following the termination of the defendant's employment. In 1999 the defendant wished to resign and the company stated it would liberate from the restraint if he signed a new contract of employment with them. The defendant signed a new contract but resigned soon after. The plaintiff thus applied for specific enforcement of the original restraint by means of an interdict. The damages claimed by the plaintiff were twofold: one was a breach of the restraint agreement, and the other was a breach of fiduciary duties owed to the plaintiff due to the fact that

[80] *Cyberscene Ltd and others v i-Kiosk Internet and Information (Pty) Ltd* 2000 (3) SA 806 (C)
[81] *Movie Camera Company (Pty) Ltd v Van Wyk and another* [2003] 2 All SA 291 (C)

the defendant was a director of the company. The later claim is relevant to this discussion (Cilliers & Benade, 2000).

Regarding the alleged breach of fiduciary duty on part of the defendant; the court held that the director had not placed himself in a position where his personal interests conflicted with those of the company. It was stated that the director's actions did not amount to taking advantage of a corporate opportunity which was actually available to the plaintiff company. The court held that the defendant had not acted unlawfully in any other manner either. Thus an order was made that the plaintiff should for the defendant's defence costs.

In attempting to determine whether or not a corporate opportunity was available to the company which the director took advantage of the court among other things referred to Havenga (1996).[82] Havenga (1996) states that the South African courts have not set concrete procedures in order to determine a corporate opportunity. It seems however that certain general notions have been applied:

- Can it be said that the opportunity actually belongs to the company?
- Is the company justified in believing that the director would attain the opportunity for the company?
- Is the company justified in believing that the director would give the company a chance to attain the opportunity?
- Is the company justified in believing that the director would give the company a chance of attaining the opportunity?

It is therefore necessary for the courts to decide whether the opportunity was in-line with the business of the company and whether it was reasonable for the company to expect the director to attain the opportunity on its behalf (Pretorius *et al*, 2006). The court referred to a Canadian case which is commonly looked at regarding corporate opportunities; *Canadian Aero Service Ltd v O'Malley*[83]Judge Laskin J stated the following at 391:

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[82] Havenga MK 'Corporate Opportunities: South African Update' 1996 *SA Mercantile Law Journal* 8
[83] *Canadian Aero Service Ltd v O'Malley* (1974) 40 DLR (3d) 371 (SCC)

"Among them are the factors of position or office held, the nature of the corporate opportunity, its ripeness, its specificness, and the director's or managerial officer's relation to it, the amount of knowledge possessed, the circumstances in which it was obtained and whether it was special or, indeed, even private, the factor of time in the continuation of fiduciary duty where the alleged breach occurs after termination of the relationship with the company, and the circumstances under which the relationship was terminated, that is whether by retirement or resignation or discharge*."*

The judge was referring to the fact that it is necessary to look at the circumstances of each case in question in order to determine whether a director has breached his fiduciary duty to the company not be in a position in which his interests conflict with those of the company in which he holds an office (Pretorius *et al*, 2006). This is relating to the taking advantage of a corporate opportunity. In the case of *Movie Camera Company (Pty) Ltd v Van Wyk and another*[84] the court held that based on the facts the defendant had not breached his fiduciary duty towards the company.

Duty to maintain and exercise an unfettered discretion:

A company director has a fiduciary duty not to permit his sound judgement to be impeded. The director is also required to utilise his mind in an objective manner regarding the affairs of the company. Therefore a contractual agreement which requires that a director must vote in a certain manner; will not be enforced against the director in the event that the director believes it will be to the detriment of the company. In *Coronation Syndicate Ltd v Lilienfeld and New Fortuna Co Ltd*[85] a director, L, bound himself in a contract with a third party, which required him to vote for the adoption of an agreement at a meeting of the shareholders of a company in order to increase the capital of that company from £70 000 to £127 000. The court held that the director had bound himself in an agreement with a third party; not even a shareholder. A shareholder would be expected to look out for his own interests as he is dealing with his own assets. However a director, in looking after other people's assets, has a fiduciary obligation towards all the shareholders of a company. The court stated that if a director binds himself to perform in a certain way, and subsequently

[84] *Movie Camera Company (Pty) Ltd v Van Wyk and another* [2003] 2 All SA 291 (C)
[85] *Coronation Syndicate Ltd v Lilienfeld and New Fortuna Co Ltd* 1903 TS 489

decides bona fide that this would not serve the best interests of the company; the court will not interfere with the director's judgement and compel him to act to the detriment of that company (Cilliers & Benade, 2000).

However it must follow that where a director is bound in contract to perform in a certain manner, if the performance is to the benefit of the company, the director will be compelled to act as per the contract even if he consequently changes his mind. It is possible that a director may be appointed as a nominee who carries out the interests of certain shareholders, or other company objectives, however the said director must still only act towards those interests if it is for the benefit of the entire company (Cilliers & Benade, 2000). In the event that a director is appointed by a third party as a 'puppet' who does not fully comprehend the business of the company; such appointment will be deemed illegal[86]. In *S v De Jager*[87] it was stated that a former director will still owe a fiduciary duty to a company if he positioned a puppet director in order to still carry out his work at that company (Cilliers & Benade, 2000). King 2 talks about a shadow director, who is a person with whose instructions the directors of the company are accustomed to act. Shadow directors are discouraged by the King 2 report.

In an English case, *Selangor United Rubber Estates Ltd v Cradock Messrs*[88] two puppet directors of Mr. C prompted the transfer of company funds to Mr. C in order for him to purchase some of that company's shares. This was in breach of the UK Companies Act and the court held that the directors did not exercise any discretion and did not carry out their fiduciary duties toward the company. The directors simply did as they were ordered, just as a puppet would have done.

Duty to exercise powers for the purpose which they were conferred:

A director of a company may not utilise his powers bestowed upon him, as a result of his office, for any other purpose besides that for which they were given. The board of directors may not use its power to issue unissued shares in order to prolong its control

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[86] See *S v Shaban* 1965 (4) SA 646 (W) and *Sage Holdings Ltd v The Unisec Group Ltd* 1982 (1) SA 337 (W) in this regard.
[87] *S v De Jager* 1965 (2) SA 616 (A) at 622-623.
[88] *Selangor United Rubber Estates Ltd v Cradock Messrs* [1968] 2 All ER 1073

over the company. In *Punt v Symons & Co Ltd*[89] the board of directors issued shares in order to acquire an adequate number of votes and amend the articles of association. This was then used to make sure that specified shareholders would not be able to appoint and remove directors. The court held that the powers of the board of directors were not used for the purpose for which they were conferred and the allocation of shares was removed (Cilliers & Benade, 2000).

In *Piercy v S Mills & Co*[90] the board of directors issued additional shares in order to preclude anymore directors from joining the board. This was carried out in order to make certain that the existing board of directors does not get converted into a minority. The court held that the board of directors may only use its powers in order to carry forward the best interests of the company; the act in question was done with the aim of protection of the existing board. The additional shares issued were thus removed (Cilliers & Benade, 2000).

In *Mears v African Platinum Mines*[91] the majority of the directors of a company passed a resolution which created a maximum call. This call could produce an amount which exceeded the requisite of the company within the minimum period given by the articles of association upon a shareholder who owned unpaid shares. Consequent to non-payment of the call the owner of all of the unpaid shares would have been barred from a general meeting of the company which was to be held five days following the termination of the notice of call. The meeting was extremely important regarding matters of relevance for all shareholders, as well as the company. Subsequent to an application by the shareholder who owned the unpaid shares, the court made an order interdicting the directors from seeing out the call resolution. No call could be made prior to the general meeting. The court held that although courts should generally not intervene in the developments of a limited company, such interference is justified if there is mala fides – the act of the directors which raises concern is incited by an ulterior motive. Directors may only use their powers for the purpose for which it was given to them (Cilliers & Benade, 2000).

[89] *Punt v Symons & Co Ltd* [1903] 2 CH 506
[90] *Piercy v S Mills & Co* [1920] 1 CH 77
[91] *Mears v African Platinum Mines* 1922 WLD 57

The board of directors of a company is also prohibited from using its powers in order to obstruct a potential take-over bid for the shares of the company. It is considered a breach of a director's fiduciary duty to utilise his power to ensure that a majority gets outvoted; this is irrespective of whether the majority is part of a take-over operation. The board of directors may not use its powers to impede a take-over, only due to the fact that the board does not want the company to operate in the manner in which the new majority will run it (Cilliers & Benade, 2000). However the directors of a company will be considered as carrying out their fiduciary duties in the event that they prevent a take-over which will not be in the best interests of the company. The board may also not use its powers to allot shares in the company in order to overcome a majority (Cilliers & Benade, 2000).

In *Howard Smith Ltd v Ampol Petroleum Ltd*[92] the plaintiff company, A, with another company owned 54.9% of the issued shares of company M. A made an offer for the remainder of the shares, but this was rejected by the board of directors as the price was too low. Company S, which was a rival company presented an offer for M, however this was rejected by A. The board of directors of M allotted unissued shares to S, which then meant that A was now in the minority. The board undertook this task in order to discontinue A's resistance. The bid from S would then be likely to be accepted due to the fact that A was in the minority. The court held that the allotment was unacceptable due to the fact that the self interest of the directors was involved. The directors had breached their fiduciary duty by using their power for an ulterior motive (Cilliers & Benade, 2000).

Duty to act legally, honestly and within their powers:

The board of directors has a fiduciary duty towards the company to comply with the limits of the powers of the company, as well as their own constraints of authority to act on behalf of that company. In the event that a director enters into an agreement with a third party on behalf of the company, which is outside the limits of the company itself, neither the third party, nor the company may rescind the agreement.

[92] *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] 1 All ER 1126 (PC)

The director will be personally liable to the company in the event that any losses occur as a result of the transaction (Cilliers & Benade, 2000).

Regarding the above, directors are actually in a peculiar position; as a general rule, an agent may bind the principal only in the event that he is authorised to do so and if the agent is acting within the ambit of his duty (Cilliers & Benade, 2000). However a director may bind the company if he is not empowered to do so. This will only be permitted if the agreement or contract is covered by the *Turnquand*[93] rule or estoppel[94]. Therefore a company will be forced to see out the terms of a contract which was entered into beyond the powers of the director; however the director, having breeched his fiduciary duty towards the company will be personally liable.

In *S v De Jager*[95] a director and shareholder, J (defendant), of a public company which dealt in shares in the domain of banking, finance and insurance, removed company funds for his own interest and not that of the company itself. The defendant argued that between himself and another shareholder, S, an agreement was made regarding the payments. The court held that the argument was invalid due to the fact that a shareholder may not take part in the company's decision to be exploited in his capacity as a director. A director owes a fiduciary duty to the company and the assets of a company belong to the company itself. The shareholders have a right to the assets once the company is wound-up and the creditors have been paid off. These rules of company law may not be inhibited regardless of what the articles of association stipulate. The director in this case was attempting to preserve the advantage of limited liability as a shareholder, and yet release himself from his fiduciary duties toward the company (Cilliers & Benade, 2000).

[93] The Turnquand rule was created by the British courts and states that if a third party contracts with a company in good faith, that third party is allowed to presuppose that the internal prerequisites and specifications have been observed by the company. Thus, the company will be bound by the terms of a contract even if the required authority has not been granted to a director.

[94] The principle of estoppel entails that a company will not be permitted to refute liability in the event that the third party (with whom the contract or agreement was entered into) can show that the company misrepresented, either by way of negligence or intention, the fact that the agent or director possessed the required authorisation to act for the company. The third party must also show that subsequent to the misrepresentation it was encouraged to transact with the director and that the third party was in fact prejudiced by the said misrepresentation (Cilliers & Benade, 2000).

[95] *S v De Jager* 1965 (2) SA 616 (A)

There was a dissenting judgement however which stated that the shareholders of a company cannot be considered to commit theft in the event that the company (by resolution of the shareholders) rids itself of its assets in a manner which does not contradict the memorandum of association. The shareholders do not owe a duty to the company to act in its best interests.

In *S v Shaban*[96] the accused was a former director of an insurance company and was charged with fraud due to the exploitation of company funds. This was in breach of the director's fiduciary duties towards the company. The accused argued that at the time of the use of company funds he was no longer a director of the company; there were in fact two others in charge of the board, S and W. The court held that S and W were actually the puppet directors of the accused and followed his instructions blindly. The former director was found guilty as he still owed the company a fiduciary duty to act legally, honestly and within his powers (Cilliers & Benade, 2000).

1.3.2 Directors' duty of care and skill

In carrying out the fiduciary duties towards a company a director must also implement the required degree of care and skill. It seems to be established that in the event that a director fails to carry out an appropriate level of care and skill, that director will be liable to the company in delict for damages.[97]

Lord Goldsmith, on the Lords Grand Committee, on the 9th February 2006 stated that (DTI, 2007):

"… we take the view that the 'duty to exercise reasonable care, skill and diligence' is not a fiduciary duty. It may be owed by someone who is a fiduciary. But that is not the same thing."

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[96] *S v Shaban* 1965 (4) SA 646 (W)

[97] Havenga (1996); Havenga (2000); Havenga (2006); Jones (2007); McLennan (1996); Bekink (2008); Cilliers and Benade (2000); *Cohen NO v Segal* 1970 (3) SA 702 (W); *Ex parte Stubbs NO: In re Wit Extension Ltd* 1982 (1) SA 526 (W); *Dorchester Finance Co Ltd v Stebbing* [1989] BCLC 498 (Ch); *Du Plessis NO v Phelps* 1995 (4) SA 164

A director may further be liable under contract if one exists between himself and the company, which is generally the norm regarding executive directors.

The South African principles of the director's common law duty of care originated from the English law of tort. The generalisations regarding a director's standard of care toward a company were first laid out in English case law in cases such as *Sheffield and South Yorkshire Permanent Building Society v Aizlewood* [1889] 44 ChD 412; *Marquis of Bute's Case* [1892] 2 Ch 100; *In re Kingston Cotton Mill Co (No 2)* [1896] 1 Ch 331; *Lagunas Nitrate Co v Lagunas Syndicate* [1899] 2 Ch 392; *Re National Bank of Wales Ltd* [1899] 2 Ch 626; and *Prefontaine v Grenier* [1907] AC 101 (Havenga, 2000; Bekink, 2008).

English law originally did not make the duty of care extremely onerous on directors. At first a director would only be held liable for a breach of the duty of care if there was gross negligence involved. This can be confirmed in cases such as *Turquand v Marshall* [1869] LR 4 App 376 (ChD); *Overend & Gurney Co v Gibb* [1872] LR 5 HL 480 (HL); *Re Cardiff Saving Banks* [1892] 2 Ch 100 (ChD); and *Re National Bank of Wales Ltd* [1899] 2 Ch 626 (Bekink, 2008). The very moderate approach to directors' duty of care was applied by the courts as a result of the prevailing public perceptions of directors at the time (Havenga, 2000):

- The shareholders of a company should be responsible for the people whom they select to be directors. It is an inherent risk in business that the directors chosen may be incompetent; therefore shareowners have to bear the risk.
- During the time of the early English cases there were not as many companies as there are today. The directors of these early companies were generally selected according to reputation as opposed to skill; moreover most of the directors were generally non-executive who, at the time, were not required to bear too much responsibility towards the company.
- There was also a general notion that directors were inexperienced and did not possess the knowledge or skill of a professional.

In *Re Brazilian Rubber Plantations and Estates Ltd*[98] the directors of the company contracted on behalf of the company in order to acquire a plantation. This was centred on a fraudulent report of which the directors were aware. The directors did not make the effort to expose the problems with the report and the plantation and the company suffered a loss. The court held that the directors were not grossly negligent in the relevant case. (Cilliers & Benade, 2000)

Although in some ways outdated, one of the most fundamental cases regarding director's duty of care and skill toward a company is *In re City Equitable Fire Insurance Co Ltd*[99]. In this case the chairman of the company, B, defrauded the company in question of £1 200 000. The action was brought against the other directors of the company who acted in good faith but nevertheless did not inspect any of B's actions or decisions. This was due to the fact the B was a highly regarded and trusted businessman. The court held that the shareholders of the company did not intend for all their finances to be looked after by only one director. Had this been the case there would not have been an entire board appointed. The duties were owed by all the directors of the company not just B on his own. However the directors avoided liability due to a clause in the articles of association which limited liability only to dishonesty. This clause was subsequently prohibited (McLennan, 1996). The case did however found certain common law principles which would apply to a director's duty of care (Cilliers & Benade, 2000):

- The degree of skill which a director executes in the performance of his duties does not have to be any higher than that expected of a person with that director's knowledge and experience.
- A director does not have to give continuous attention to the affairs of the company. The director has to perform his duties at board and committee meetings periodically, and it is not compulsory to attend all the meetings; only those which can reasonably be expected in the specific circumstances.
- A director may delegate any duty to another official, which may be passed on according to the articles of association and the circumstances of the business. The director is justified in entrusting any official with the stated duties to

[98] *Re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425
[99] *In re City Equitable Fire Insurance Co Ltd* [1925] Ch 407

perform those duties reasonably and honestly; in the absence of any suspicion otherwise.

The first proposal makes it clear that the test for negligence is mostly subjective. The degree of skill expected is one which that director actually has. That sets a very low standard as there is no minimum objective criterion to go by. The second proposal states that the director's duty is of an intermittent nature and this proposal is mostly outdated. The third proposal states that a director may delegate duties; however that director may not be negligent in doing so. The court will have to determine each case based on the prevailing circumstances. It has been stated that most of the decisions in the above English cases were relating to non-executive directors.

South African position on the duty of care and skill of directors:

It is generally agreed that it is possible to determine 'care' objectively, however the 'skill' factor is more complicated as it may fluctuate from person to person (Cilliers & Benade, 2000; Bekink, 2008). The problem is that a person may serve on the board of a company no matter what skills he may have. Therefore a person may serve on the board of a vehicle construction company and not have an in depth notion of building cars; he may for example be a legal specialist. That director must use whatever skills he does possess to his best ability for the benefit of the company. The South African case of *Fisheries Development Corporation of SA Ltd v Jorgensen*[100] drew on the earlier English court decisions in order to set a standard for South African common law. In this case the plaintiff company sued the defendants as sureties due to loans made by the plaintiff to company I. The shares of I were held by the plaintiff company and its employees served on the board of I as nominees. The defendants stated that the plaintiff company had been reckless in the conduct of I's business which led to a prejudice against themselves; the defendants should not be held liable. The court held that a creditor has no obligation to exercise a duty of care. Therefore the judgement was handed down for the plaintiff company. This case also laid down three broad principles which were then applied to the South African common law regarding a director's duty of care and skill toward a company:

[100] *Fisheries Development Corporation of SA Ltd v Jorgensen* 1980 (4) SA 156 (W)

1. A director's required level of care and skill depends on the nature of the company's business as well as the responsibilities allocated to him. The court confirmed that there should be a difference between a full-time, executive director and a non-executive director. Whilst the first is comprehensively involved in the running of the business, the latter does not possess any particular duties. The non-executive director is not required to furnish the company with continuous attention as his duties are of an irregular nature. The non-executive director is only required to attend board meetings when it is reasonably required of him to do so. This confirms the position adopted by the court in *In re City Equitable Fire Insurance Co Ltd*.[101]
2. The director of a company is not obligated to have any particular skill or knowledge. However the director is required to utilise the care and skill which can be reasonably expected of a person with his[102] knowledge and experience. The director is further not liable for mere errors of judgement (Cilliers & Benade, 2000.
3. The third proposition refers to the fact that a director may delegate any duties (which may be delegated) to other officials of the company. This is acceptable where there is no reason to suspect that the selected official will not perform the duties honestly. To add to this, a director may make use of information from management unless there is reason to believe otherwise. The director must be reasonable when accepting the advice or information and use his own knowledge to deliberate the material (Bekink, 2008).

The above principles slowly started to get adjusted in subsequent South African court decisions. In *Howard v Herrigel*[103] the respondents were the liquidators of company L. The case was brought against several defendants including Mr. H. The liquidators sought to hold the defendants liable for the debts of L under s424 of the Companies Act and alternatively, in the common law of delict for fraud. The claim succeeded only against Mr. H. The court held that in contrary to *Fisheries Development Corporation of SA Ltd v Jorgensen*, it is not correct to differentiate between executive

[101] *In re City Equitable Fire Insurance Co Ltd* [1925] Ch 407
[102] This statement confirms that the test for negligence is a subjective one as was the case in *In re City Equitable Fire Insurance Co Ltd*.
[103] *Howard v Herrigel* NNO 1991 (2) SA 660 (A)

and non-executive directors for the purposes of determining their duties toward the company. It must be a universal norm that once a director accepts the position as such, he automatically becomes a fiduciary to the company and must observe due care and skill in carrying out these duties. It will be necessary to look at the fact of each case in the application of the rule. It may be relevant whether or not the director was involved in the company's business full time or part time; however the rules regarding duties and application of those duties must be homogenous for all directors.

In *Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman*[104] the court concurred with the decision in *Howard v Herrigel*. The court stated that the test for recklessness is actually objective due to the fact that the director's conduct must be measured against that of the reasonable person. Once the minimum objective standard has been set, the test is also subjective as the director's conduct is measured against the reasonable director in that particular director's position. That means that one must look at what skill and knowledge the actual director, in fact possessed. The word 'recklessly' must mean at least gross negligence. When a court decides on whether a director has been negligent or reckless the following factors must be taken into account: what business the company undertook, the role, function and powers granted to the director in question, as well as the company's financial situation (Bekink, 2008). When enquiring into the subjective element of the test the court must also consider any supplementary knowledge and skill, which that particular director may possess (Bekink, 2008).

In *Du Plessis NO v Phelps* 1995 (4) SA 164 the liquidator of Cape Investment Bank (CIB) was the plaintiff who sought to hold the director of CIB liable for certain payments. The claim arose as a result of a breach of fiduciary duties due to an interest in another company. The plaintiff failed to prove a causal connection between the alleged wrongdoing of the defendant and the loss to the company. The court however did concur with the decisions in *Howard v Herrigel* NNO and *Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman* in that the test for negligence is both objective and subjective. One must compare the director's conduct to that of a reasonable person in the same circumstances as the director in question. There must be an

[104] *Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman* 1998 (2) SA 138 (SCA)

objective minimum as well as a subjective standard which takes into account the skill and knowledge of the director, as well as the circumstances in which the company finds itself (Bekink, 2008).

The UK and Australia; from a subjective standard to the codification of directors' duty of care and skill:

Both the UK and Australia commenced with a subjective standard for negligence regarding a director's duty of care and skill toward a company. In both countries the test then became both objective and subjective and the duty was eventually codified. The two countries will now be looked at briefly.

In the UK the community and legal attitude relating to directors started to change away from the lenient approach in *In re City Equitable Fire Insurance Co Ltd*. In cases such as *Norman v Theodore Goddard*[105] and *Re D'Jan of London Ltd*[106] the court began to impose a subjective and objective standard on director's conduct regarding negligence. In *Re D'Jan of London Ltd* the court applied s214 (4) of the United Kingdom Insolvency Act of 1986 which reads as follows (Bekink, 2008):

"the facts which a director of a company ought to know or ascertain, the conclusion which he ought to reach and the steps which he ought to take are those which ought to be known or ascertained, or reached or taken, by a reasonable diligent person having both

a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same function as are carried out by that director in relation to the company, and
b) the general knowledge, skill and experience that the director has."

There is a clear use of both a subjective and objective test regarding the degree of skill which a director must use. Thus, if a director possesses special skill or knowledge he will be judged accordingly (Bekink, 2008). In *Re Barings pcl (No5)*[107] the court stated

[105] *Norman v Theodore Goddard* [1991] BCLC 1028 (CLD)
[106] *Re D'Jan of London Ltd* [1994] 1 BCLC 561 (Ch)
[107] *Re Barings pcl (No5)* [2000] 1 BCLC (CA) 523

that directors have a constant duty to keep themselves informed of the company's business in order to make the best decisions possible. In *Re Queens Moat House pcl (No2)*[108] the court stated that non-executive directors should exercise an independence of judgement and monitor executive management (Bekink, 2008). In the UK both the 1973 and 1978 Companies Bills attempted to codify the director's duty of care and skill (Bekink, 2008). However this was eventually accomplished in the UK Companies Act of 2006 in s174:

> 1) A director of a company must exercise reasonable care, skill and diligence.
> 2) This means the care, skill and diligence that would be exercised by a reasonable person with –
>   i. the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by a director in relation to the company, and
>   ii. the general knowledge, skill and experience that the director has.

This has completely resulted in an objective and subjective standard regarding the director's duty of care and skill.

In Australia the propositions from *In re City Equitable Fire Insurance Co Ltd* were at first applied regarding the duty of care and skill. However as in the UK, the standards slowly started to become more onerous as the public sought greater protection of their assets (Bekink, 2008). This has been evident in the common law and statute. In 1958 the State of Victoria in s107 of the Companies Act set out the duty of care, skill and diligence and stated that a director will receive a penalty, and will be liable for compensation to the company in the event of a breach. Other similar legislation was also passed such as the Uniform Companies Code of 1981 (Bekink, 2008). During the application of such legislation in *AWA Ltd v Daniels*[109] the court stated that an objective standard is most appropriate for the director's duty of care and skill. Directors would be obliged to have a good understanding of the company's business,

[108] *Re Queens Moat House pcl (No2)* [2004] EWHC 1730 (Ch)
[109] *AWA Ltd v Daniels* [1992] 10 ACLC 33 (SC, NSW)

as well as to take reasonable steps to supervise the concerns of the company (Bekink, 2008). This was a very influential case which resulted in similar application in others. Other cases which followed an objective standard were: *Metal Manufacturers v Lewis*[110]; *Commonwealth Bank of Australia v Friedrich*[111]; *Australian Securities Commission v Gallagher*[112]; and *Vrisakis v Australian Securities Commission*[113] (Bekink, 2008).

The Uniform Companies Code was re-instated in 1991 as s232 (4) of the Corporations Law of 1991. This was then amended by s11 of the Corporate Law Reform Act of 1992. Eventually the previous section was amended by s180 of the Australian Corporations Act of 2001. The relevant section reads as follows:

1) A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:
    a. were a director of a corporation in the corporation's circumstances; and
    b. occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.

The Australian Corporations Act has also codified the director's duty of care and skill to which one must apply both an objective and subjective standard.

It seems that in the UK, Australia, as well as South Africa the duty of care and skill started out as extremely lenient on directors of companies. In fact, directors were only liable for gross negligence. This position has changed dramatically in all three countries as higher standards of care are being applied to directors of companies. It has been showed above that the UK and Australia have codified the duty of care in their relevant company legislation. South Africa too is aiming to achieve the same with the provisions of the Companies Bill of 2008. However this will be looked at in a later section.

[110] *Metal Manufacturers v Lewis* [1988] 13 ACLR 357 (SC, NSW)
[111] *Commonwealth Bank of Australia v Friedrich* [1991] 5 ACSR 115 (SC, Vic)
[112] *Australian Securities Commission v Gallagher* [1993] 11 ACLCSR 286 (SC, WA)
[113] *Vrisakis v Australian Securities Commission* [1993] 11 ACLC 763 SR 162 (SC, WA)

1.4 Conclusion

Directors' liability exposures have increased over recent years, according to the various sources on the subject. Liability at law may arise from the following areas: contract, delict, statute and *sui generis*. Under common law, directors owe two duties to the company which they serve: a fiduciary duty, and a duty of care and skill. Courts have tended to increase director liability by expanding the law of delict, which now allows for claims for pure economic losses. This may lead to liability to an indeterminate plaintiff for an indeterminate amount of loss. Legislation is also placing more onerous duties on directors and holding them more accountable for their actions taken on behalf of the company. Moreover, it is increasingly commonplace for directors to be held liable to third parties; more usually known as 'stakeholders'. This may include competitors, employees and the government. The company itself is increasingly expected to take up processes for corporate social responsibility; the weight of this task is being placed on the shoulders of the company directors.

Society has also increased its expectations on directors; the world has moved away from the scenario where directors are put in place in order to achieve board prestige. Directors are also no longer thought to lack the necessary skill and knowledge to run a company. A director is now regarded as a professional who will be held liable according to the standard of skill and knowledge which he or she possesses. The media has played a major role in the increase of society's awareness of director liability.

One can now get a sense of the increasing liability of company directors. This can be visible from the vast amount of cases which continue to expand the possible instances under which directors may be liable for not only losses to companies, but also losses to stakeholders. Directors were never meant to owe a fiduciary duty or one of care to anyone else, except the company itself; the situation has however changed.

Director liability has already been expanding under delict and *sui generis*; now the common law duties are being placed in statute under the new Companies Act. This will render it even easier to hold directors accountable. It is clear that society is more willing to take directors to court, whilst courts are more willing to hold the directors liable.

This increased liability as a result of doctrinal issues has led to increased claims against directors. Thus, as a result there has been an increase in D&O liability claims. As director liability rises exponentially, so too will claims against directors. A positive relationship exists between liability and claims: as liability increases, claims increase too. If it is possible to hold someone accountable for a loss, the likelihood is that it will happen. This is especially true with regards to monetary losses. As society realises that others are holding directors liable for monetary losses to companies, many people opt for that option too. If courts are more willing to hold directors liable, than many more cases will be brought before the judge. Thus the notion of increasing liability and therefore increasing claims is actually a vicious cycle.

The major corporate scandals, which have occurred worldwide as well as in South Africa, have been widely publicised. This has increased the responsiveness of potential plaintiffs. The following chapter looks at some of the corporate failures which have occurred.

2 BREACHES OF CORPORATE GOVERNANCE AND COMPANY LEGISLATION IN SOUTH AFRICA – COMPLEXITY ISSUES

The second chapter aims to show that director liability has increased as a result of the escalating complexity of the modern business environment. The complexity issues examine the ever changing and increasingly complicated worldwide economic and corporate environment. This may also result in ever increasing corporate failures of enormous size, contributing to the increased claims against directors.

The question is: why has there been such a worldwide requirement for updating and clarifying corporate governance and company law since the early 1990's, especially relating to company directors? As will be explicated later, corporate governance has been present for a long time, and the reasons for this will be understood in a while. However the urgency which has presented itself over the past twenty years may be arguably put down to an increase in company failures. Corporate failures are often ascribed to breaches of corporate governance or company law. In this manner new corporate governance codes are added and old ones are updated, in the hope of preventing future losses.

However one may be missing the point; merely putting a law or regulation in place does not necessarily prevent persons from breaking the rules. Murder for example, has never been legal, yet there has never been a need to create a law against it. One must assume that creating a law against murder would certainly not reduce its occurrence at all. The point here is that persons that are willing to commit fraud will always do it no matter what corporate governance or legislation says. This holds even truer for negligence; putting a law in place against negligence will certainly not prevent persons from behaving that way as it is something which is not even done with intent.

An economic crisis will occur, consequent to which many frauds are discovered. The reaction then is to put laws and regulations in place in order to stop that from happening again in the future. However these frauds do not necessarily cause the crises. The complexity of the modern economic world increases director's exposure to liability which in turn leads to increased claims against company directors.

Corporate scandals and failures have also been present since the notion of the 'company' itself was created. However major losses worldwide since the 1980's, which have generated substantive losses for shareholders and other stakeholders due to the complexity of the modern economic environment, director inabilities and fraud have, time and time again, sparked a public outcry. This is often fuelled by the media, leading increasingly to holding directors legally liable as discussed in Chapter 1. Society is ever-more willing to take directors to court, whist courts and increasingly willing to hold directors liable for company losses. A historical account of corporate governance and international scandals will be presented later on.

This section is designed to familiarise the reader with South African corporate failures which have led to an increased interest in corporate governance, company law, and most importantly (for the purposes of this paper) codification of directors duties and liabilities. The impact of codifying duties and setting higher standards of liability for directors on D&O liability insurance will be the main objective of this paper. The following studies are presented in chronological order.

Masterbond

In 1991 the collapse of Masterbond was South Africa's most expensive corporate failure. The R 650 000 000 catastrophe unsettled the country; however on the 3rd September 1991, newspapers were advertising Masterbond's fantastic results; this was one month prior to the granting of the liquidation order against the company (*Mail & Guardian*, 15/03/2005).

Masterbond was established in 1984 and when its directors stated (untruthfully) that it was registered by the South African Reserve Bank (Reserve Bank). Investment consultants as well as the media began to recommend the group's ideas as reliable financial proposals for investors. The company would soon produce desirable announcements guaranteeing 21% returns on investments (*Fin24.com*, 02/09/2002). Financial disgrace was inevitable as short-term borrowings from investors were matched by long term investments into property schemes.

Investors were ‘sold’ a portion of land Kaliya, which was a unit at Club Mykonos in Langebaan on the West Coast South Africa. Among other schemes Masterbond also invested in Marina Martinique (a development in Port Owen, which was rendered ineffectual due to poor design) and Fancourt in Constantia. The investors were unaware that they had purchased shares that were non-existent on a likewise portion of land in fabricated share-block schemes (*Mail & Guardian Online*, 15/03/2005). The investors were told that money was being put into Masterbond projects; the truth was that funding was placed in numerous schemes to which the money was being further lent.

Unfortunately the funding which supported the various Masterbond schemes was provided mostly by pensioners; approximately 20 000 of them. The team which was appointed by the curators during liquidation to investigate Masterbond were told that funds were flowing into the debenture at such a high rate, one month prior to the crash that the staff were struggling to cope (*Business Day*, 06/03/2006). The period of July to October 1991 saw R 131 000 000 lent to borrowers, R 76 000 000 was received in interest and capital repayments from borrowers, as well as an inundation of new funds for investment of R 44 000 000.

In November 1997 the first report on Masterbond found many instance of exploitation by directors and auditors, as well as severe deficiencies in the supervisory system and contraventions of sections of the South African Companies Act which are intended to protect investors. A class action arrangement was unavailable to the investors who suffered losses (*IOL*, 29/04/2001). This would have offered a reasonable prospect of success against the directors of Masterbond; however those affected were elderly with modest monetary abilities. This deterred litigation.

The former directors of Masterbond were convicted in the Cape Town Supreme Court on seven charges of fraud and handed ten years in prison. Ernst & Young, Masterbond’s former auditors negotiated a R 40 000 000 out-of-court settlement with investors and further accepted losses of R 232 000 000 in further claims due to inadequate auditing measures (*Mail & Guardian*, 15/03/2005). A noticeable investor of R 140 000 created the Masterbond Victims’ Association and faced an uphill battle to recover losses from the directors. Unfortunately 16 Masterbond investors committed suicide as many lost their entire pensions. The name (and amounts claimed) of the D&O insurance company which underwrote Masterbond is confidential; however one can safely suggest that the respective monetary amount was substantial.

Tollgate

In August 1997 the R 28 630 000 fraud trial commenced regarding Tollgate Holdings Ltd (Tollgate). At the time this was one of South Africa's most prominent corporate scandals. Only one director (first) was present at the trial, as the chairman and other colleague director at Tollgate had fled to the United Kingdom (UK) in 1993 (*Mail & Guardian*, 05/08/1997).

In 1998 the high court-sanctioned inquiry by the Browde Commission into the 1992 collapse of the Tollgate group of companies was complete. The report stated that the former chairman of Tollgate played a major role in the breakdown of the company. This was said to have been due to dishonesty of senior management as well as ignorance of legal principles regarding which govern companies (*Mail & Guardian*, 03/09/1998). Testimony from a previous director of Tollgate showed that the former chairman in question had exploited company funds in order to purchase antique furniture, acquire personal entertainment activities, as well as maintaining a private helicopter in the UK. During the financial year of 1991/1992, no company board meetings took place at all. The report recommended that the former chairman be extradited from the UK in order to face charges of fraud in the South African courts (*Business Times*, 05/03/1998).

The report further absolved Absa Bank, a Tollgate creditor whom the company in question owed over R 300 000 000, of any wrongdoing or negligence whilst observing Tollgate's finances a short while prior to its downfall. This is due to the fact that Absa did not take on the responsibility of a director and was not involved in management or running of the business (*Mail & Guardian*, 03/09/1998).

The first director of Tollgate was acquitted after being found 'not guilty' in the Cape High Court on eight charges of fraud and theft relating to liquidation in 1992. The colleague director was also found not to have been involved in the demise of Tollgate, following the court trial (*Business Times*, 05/03/1998). However evidence still implicated the former chairman of the company due to the fact that Tollgate funds were transferred into a Swiss bank account belonging to the man in question.

It is worthwhile mentioning briefly the part played by Absa and the Reserve Bank in the Tollgate saga. In 1990 Tollgate was carrying a hefty amount of debt, as was discovered by the former chairman who arrived around that time from the UK to take charge of the company. In 1992 Tollgate shares plummeted as rumours began to circulate regarding insider trading as assets of the company were being sold to directors and funds were transferred into offshore bank accounts. At the end of 1992, Tollgate Holdings Ltd. owed Absa R 300 000 000 through TrustBank (*Mail & Guardian*, 03/09/1998). Tollgate's chairman argued that Absa's objective of liquidating the company was unnecessary and it was due to bad management on part of TrustBank, Bankcorp and the parent company, Sanlam. Nevertheless, Absa went ahead with the liquidation and Tollgate was condemned.

Absa was created in 1991 when the United Building Society bought Allied Group and Volkskas, Trustbank and Part of the Sage Group were taken on. Rumours circulated regarding trickery in the take-over of Allied. However in 1992 TrustBank was collapsing and the Tollgate issue was widely blamed. It seems that poor management at TrustBank would inevitably have led to its collapse in any case. The South African Reserve Bank then secretly assisted TrustBank with an amount R 1.1 – billion (the well known, so-called, 'lifeboat'. This is a normal occurrence as long as it serves the economic interests of the country (*Mail & Guardian*, 03/09/1998). However many claimed that the Reserve Bank was simply sympathetic to TrustBank's major shareholder, Sanlam, in providing the monetary relief. What followed was a number of cross-border accusations as to who was at fault regarding the demise of Tollgate and why the Reserve Bank kept the rescue a secret.

It must be noted that regarding any matter, wherever liability is pinned is only one aspect, the other is the importance of sound corporate governance systems which promote transparency and accountability. With such standards in place it is more difficult to reach concerns such as the ones mentioned regarding Tollgate Holdings Ltd.

Macmed

In 1985 Macmed was created following a management buy-out of Kendall, which was a subsidiary of Colgate South Africa. By 1987 turnover had already reached R 5 000 000 and the company was listed on the Development Capital sector of the JSE. In 1996 Macmed completed a black empowerment deal with Thebe Investment Corporation; making Thebe the largest shareholder. The year 1997 brought about the acquisition of Sherwood Medical in order to create export potential throughout Africa. In 1998 Macmed Zimbabwe was listed on the Zimbabwe Stock Exchange. In 1999 Macmed's turnover reached R 673 000 000, whilst Intramed, Seravac and Fine Chemicals Corporation were acquired (*Financial Mail*, 29/10/1999). However by September that year the shares were suspended on the JSE and by October the simultaneous Chairman and CEO, Mr. M, as well as the group company secretary, Mr. H, were suspended and submitted their resignations. In mid-October 1999 Macmed was placed under provisional liquidation and the debt owed to a consortium of sixteen banks was set at R 986 000 000 (*Financial Mail*, 29/10/1999). Unfortunately for the shareholders it was already too late; Macmed shares were trading at R 0.25, which is outrageous considering that the same shares were available for R 5.20 only eighteen months prior.

At its peak the company owned approximately 96 subsidiaries as it did business in Africa (Swaziland, Zimbabwe and Zambia) and the United States (US). Macmed was mainly involved in the sale of specialised hospital equipment, hospital development and the sale of hospital consumable products (*Mail & Guardian*, 18/11/2005). This was mainly done through the black empowerment partner, Malesela Holdings. During liquidation an inquiry was performed in terms of Section 417 of the Act, which allows the Master of the High Court to summon any person or information regarding the reasons for the company's collapse. This was further followed by an application of Section 424 of the Act in order to hold the directors personally liable for the debts of the company, as trade was performed in reckless or insolvent circumstances (*Business Report*, 21/11/2005).

It became evident that numerous fraudulent acts were performed in order to create an image that Macmed was financially sound and to aid the directors in making profits from share options. This was done by convincing the banks to continue lending. In November 2005, three executives of Macmed were arrested by the Scorpions on charges of fraud, corruption and racketeering. They were released on bail of R 500 000 each by the Pretoria High Court. The sixteen that banks had lent money to Macmed included Standard Bank, Absa, Imperial Bank, Nedbank, Peoples Bank, Mercantile Bank and Nedcor (*Business Day*, 02/01/2005).

The main accusations were aimed at Mr H, who due to the 1991 collapse of Sure Group, was an un-rehabilitated insolvent and was disallowed from being a Macmed director (*Business Report*, 23/01/2004). However it was found that although he was the company secretary, Mr H had acted as a *de-facto* financial director. In the course of the civil trial it was found by forensic auditors, KPMG, that Macmed's 1998 and 1999 financial statements displayed no trace of the reality of the company's financial position. The published financial statements claimed that 1998 and 1999 produced a R 31 000 000 and R 51 000 000 profit respectively; in reality losses had been incurred to the values of R 14 000 000 and R 95 000 000 respectively (*Business Day*, 02/01/2005).

The consortium of banks filed a lawsuit against the former auditors of Macmed, Fisher Hoffman PKF, due to the fact that they had been encouraged to lend money to the medical supplies company based fraudulent financial statements. The initial negligence lawsuit was for R 870, 000, 000; however a settlement of R 23, 000, 000 was reached with the auditor's professional indemnity (PI) insurer (*Business Day*, 02/01/2005).

The courts did however dispatch a powerful message to company directors when Mr. H and Mr. M were found personally liable by the Pretoria High Court, for the R 647 000 000 debts of the company, in the civil trial (*Business Day*, 02/01/2005). Former employees and innocent directors of Macmed also lost out as liquidators demanded R 51 000 000 for share options which had not been exercised.

This case study emphasises the emerging pattern of corporate governance and legislation (Section 424 of the Act) to render any person who is involved in the reckless trading, or intentionally defrauds a company's creditors, personally liable for any losses incurred – without constraint. This is not only occurring in South Africa, but also in other parts of the world, as countries like Australia are codifying director's duties in order to increase accountability.

LeisureNet

On the 13th of September 1996 *Financial Mail* reported that if one had purchased shares in LeisureNet in 1995, by the time the article was in print the value of the investment would have trebled. In 1995 LeisureNet shares were trading at R 1.00; in September 1996 the shares were worth R 3.25. The company was exciting and sound, especially when considering that the Johannesburg Stock Exchange (JSE) Industrial index only increased by 15% that year (*Financial Mail*, 13/09/1996).

LeisureNet was the owner of the Health and Racquet Club chain of fitness gyms. The company had 900 000 members and 7 000 employees at the end of 2000. The last accounts presented an annual turnover of over R 1 – billion. LeisureNet was provisionally liquidated in 2000; it had liabilities of R 1.2 – billion and assets of R 302 000 000. Members who had entered into ten, twenty and even forty-year contracts found themselves holding worthless pieces of paper. The company would eventually be bought out by Richard Branson's Virgin Group and renamed 'Virgin Active gyms' (*Mail & Guardian*, 03/04/2002). When LeisureNet was under final liquidation in 2000 some of the following liabilities were discovered (*Mail & Guardian*, 07/12/2000):

- International Bank of South Africa; R 115, 900, 000
- Wesbank; R 4, 200, 000
- BoE Limited; R 19, 700, 000
- Cape of Good Hope Bank; R 3, 600, 000
- Barclays Bank; R 25, 000, 000
- Stannic; R 3, 400, 000
- Saambou; R 7, 500, 000

- Absa Bank; R 13, 600, 000
- Bankfin; R 14, 500, 000
- Rand Merchant Bank; R 6, 200, 000
- Nedbank; R 79, 000, 000
- PSG Bank; R 15, 000, 000
- Marriot Merchant Bank; R 1, 800, 000
- Citibank; R 17, 400, 000
- Commerzbank; R 45, 100, 000

LeisureNet owned 85 gymnasiums in South Africa as well as a Planet Hollywood franchise at the V&A Waterfront (Cape Town), and had a 50% investment in Millennium Expotainment, owner of IMAX theatres. The company also owned 57.8% of the issued share capital in Healthland International, which owned seventeen subsidiaries, which further owned twenty-two health clubs in the UK, Germany, New Zealand, Spain, Australia, France, Belgium and Sweden. It seems that uncompromising international development of Healthland regarding a financial commitment of R 82 000 000 damaged LeisureNet's resources (*Mail & Guardian*, 07/12/2000).

In April 2002 two executive directors of LeisureNet were arrested by the Scorpions; the two men faced charges of fraud, income tax and VAT evasion (*Mail & Guardian*, 03/04/2002). In October 2005 the directors reached a R 30 000 000 settlement with the liquidators, which was 2.5% of the initial R 1.2 – billion claim (*Business Day*, 13/10/2005). The CEOs were then cleared of civil charges; however the criminal charges were not brushed off as smoothly. In August 2006 the former executives of LeisureNet were acquitted of the main charge of fraud regarding a R 1 900 000 kickback. However the two men could still face other criminal charges of fraud, money laundering, theft, and income-tax evasion. The former directors were then discharged on counts under the Prevention of Organised Crime Act 80 of 1998, the Income Tax Act 28 of 1997 and a Companies Act charge of reckless trading (*Mail & Guardian*, 23/04/2007).

Eventually, in April the former executives were handed down eight and seven years jail sentences. More accurately, the jail sentences were of twelve years of which four and five years were suspended. One month prior, the men had been convicted on charges of fraud relating to R 12 000 000 of an undisclosed interest in a German gym venture, which LeisureNet acquired in 1999. The charge was finalised even though the former executives paid back the R 12 000 000 plus an additional R 4 500 000 to the liquidators (*Mail & Guardian*, 23/04/2007).

The former LeisureNet executives were sentenced in the Cape High Court where the acting Judge, Dirk Uijs, rightly stated: "You let society down very, very badly… Business, economic enterprise, economic intercourse, is based on trust." (*Mail & Guardian*, 23/04/2007). This quote is extremely important in the context of corporate governance. The systems of checks and balances are in place in order to avoid exactly what occurred at LeisureNet. The amount covered by the D&O liability insurer of LeisureNet is unclear; however this case shows the importance of possessing such cover as well as the potential costs to the insurer of rogue company directors. The aim of the codification of director's duties is to further prevent these unfortunate occurrences; however the potential outcomes on D&O liability insurance are thus far unknown.

<u>Regal Bank</u>

In June 2001 Regal Treasury Private Bank Ltd. (Regal Bank) was placed under curatorship due to the fact that it had lost the trust of its shareholders and depositors. Numerous reasons may be cited for the bank's collapse:

- The Chief Executive Officer (CEO), Mr. L, carried on the business of the bank and the holding company (Regal Treasury Bank Holdings Ltd.) in a reckless manner. The said Mr. L was not a fit and proper person to be in the position of CEO and director of the Bank.
- Regal Bank's board of directors acted in breach of the Banks Act 94 of 1990 (Banks Act), other banking regulations, the Companies Act 61 of 1973 (Companies Act), as well as South African standards of good corporate governance.

To make matters worse, the external auditors, Ernst & Young, breached the Public Accountants and Auditors Act 80 of 1991, by consenting to the release of the 2001 preliminary financial statements of the holding company without completing the audit in a proper manner (Myburgh Commission, 2001). Further, the Reserve Bank fell short in October 2000 by not taking appropriate action regarding the removal of Mr. L.

According to the Report of the Commissioner, Myburgh SC (available online: www.reservebank.co.za/internet/Publication.nsf/WCEV/A83BCC8822AD8FF8C42256B720046D15F/?opendocument), Mr L did not exercise the utmost good faith and integrity, as well reasonable care and skill regarding Regal Bank. The CEO also did not always act in the best interests of the bank, whilst often allowing a conflict of interest to exist between himself and the company, as well as the shareholders. The management of the bank was incompetent and Mr. L acted dishonestly and fraudulently. Corporate governance was given minimal attention.

Regal Bank's inconsistencies relating to legislation and corporate governance could cover an entire academic paper on their own; however this is not the aim of this paper. Nevertheless some of the wrongdoings will be mentioned briefly (Myburgh Commission, 2001).

- Mr. L forced certain directors to resign without proper justification.
- In contrast to the advise of the Reserve Bank and the King Report on Corporate Governance 1994 (King 1), Mr. L became chairman and remained CEO of Regal Bank with support from the board of directors.
- Mr. L also appointed a family member as chairman with support of the board of directors, once again contrary to the advice of the Reserve Bank.
- In July 1999 Mr. L handed out an unlawful order to the asset management division of Regal Bank not to sell any shares of the holding company on behalf of its clients, as this would lead to a lowering of the share price.
- It was alleged that any board members who disagreed with the CEO would be forced to resign.

- In financial statements it seemed as though Regal Bank had no bad debt; this was due to the fact that no review of credit existed. Review of credit is common practice in other banks.
- Executive directors and senior managers of Regal Bank received shares in the said bank in order to compensate them for the fact that they were under-remunerated and no specification was made for pension. Non-executive directors only received remuneration in the form of shares.

In 2001 Regal Bank collapsed after a run on deposits had the consequence of R 250 000 000 being withdrawn in two days as a result of Ernst & Young retracting the 2001 financial statements of the holding company, which had previously been signed off (*Business Report*, 16/02/2004). Mr. L was arrested in May 2003 when it was found that he had received secret payments from Regal Bank of over R 3 000 000 in fifteen months. This was on top of a basic salary of R 38 000 as well as a R 10 000 monthly expenditure allowance.

The Myburgh Commission recommended that certain directors and officers of regal Bank must be criminally charged on eighteen counts of fraud, contraventions of sections 38, 226, 249, 250, 251, 286, 288, 298 and 305 of the Companies Act, and sections 75 and 91 of the Banks Act. By 2007 Mr. L appeared in court in order to be charged regarding six counts of fraudulent misrepresentation and two for contravention of the Companies Act (*MoneyWeb*, 16/08/2007). Prosecution of commercial crime is hampered by red tape and legal complexities. This is made far worse by the fact that the accused will always attempt to hamper investigations by counter-attacking the accuser. This is yet another illustration of the importance of corporate governance and the manner in which directors of a company may abuse their responsibilities. It seems that D&O liability insurance is of increasing importance as codification of directors duties looks to simplify the manner in which rogue directors are prosecuted.

Saambou

Saambou was South Africa’s seventh-largest bank prior to its collapse in 2002. The bank failure occurred when depositors lost their confidence and frantically withdrew over R 1 – billion of savings. When the bank went under curatorship in February 2002, it possessed 35 000 clients as well as R 16 – billion in assets (Issued Statement by South African Reserve Bank, Registrar of Banks and Curator, 17/01/2003).

In 2005 Saambou Bank's former CEO, the late Mr. M, as well as former directors, Mr. C and Mr. E, were arrested by the Scorpions. The men faced ten charges of fraud, one of theft as well as two of contravening the Companies Act to which they pleaded not guilty. The charges which entailed R 640 000 000 were due to allegations that certain schemes undertaken had not taken into account the risk to the company and separate disclosures were not provided regarding the schemes concerned in the financial statements of Saambou Bank and Saambou Holdings, as is required by law (*Business Day*, 30/01/2008).

The Saambou Holdings share scheme was approved in 1992 in order to supply senior managers with incentives. The bank issued 'phantom' shares to its staff at a price which reflected the company's share price at the time. Over 500 000 shares, which were unpaid, were given to managers in 1993 at a price of R 0.87 each. The first payouts occurred in 1998 and 1998 were equal to R 30 000 000. The company had not prepared for the risk; therefore the large payouts affected the primary capital of Saambou. The payouts were not disclosed separately in the financial statements of Saambou Holdings or Saambou Bank from 1997 to 2001 (*Business Day*, 31/01/2008). The scheme was negated in 2000, which was then followed by another share incentive scheme. This was created in order to reconcile the debt owed as a result of the 1992 phantom scheme.

The approach was for a trust to purchase shares from Saambou Holdings on behalf of three private companies. Saambou forwarded R 96 000 000 to the share incentive trust in 2001; when the bank went under curatorship in 2002, the incentive companies were indebted the amount to Saambou. The setback was that the loans were unsecured and dependent exclusively on the share price. Once again, no provision was made for the loans in the financial statements, which should have stated the risks; such as that interest was not payable. The aim had been to hedge the fixed requirement of the phantom scheme and to raise more secondary capital (*Business Day*, 01/02/2008).

However, in early 2008 the Pretoria High Court discharged the two directors of Saambou as it was found that there was no evidence of wrongdoing. Mr. C stated at the beginning of the trial that he was never a director of either Saambou Bank or Saambou Holdings and was simply respecting orders from superiors in the normal course of his work. It seems that the decisions to execute the allegedly fraudulent schemes were taken before Mr. C had started working for Saambou, and the directors had taken the measures based on expert advice. The judge found that the accused did gain from the schemes and that the operations expressed by the prosecution had been authorised by the bank’s board of directors (*Business Day*, 01/02/2008).

Even though it was found that there was no breach of corporate governance or legislation by the directors involved, this case still exemplifies the importance of the mentioned regulation. A perception of breach led to a trial which could have held the directors personally liable for hundreds of millions of Rands. This case is also relevant due to the fact that, as will be seen later on, D&O insurers still have to bear the legal costs of a successful court defence. Even when directors are found not guilty the insurers still have costs involved. For this reason an increase in corporate governance and legislation which holds directors more accountable is of concern to D&O insurers.

<u>Deel-Smith</u>

The Financial Mail in 2001 quoted Mr. D as saying: “The danger is that the activities of a few Long Term Capital Managements or Nick Leesons give the investor entirely the wrong impression of products that originated in a desire to limit risk, rather that gear it up.” (*Financial Mail*, 20/04/2001) The products that Mr. D was referring to were investments in futures and derivatives which he claimed his company could use as a safety net for those wanting to develop and protect their pensions. This Financial Mail article ironically entitled “Low Risk As A Way Of Life” was referring to the Deel-Smith & Company (an investment management company) and Deel-Smith Benefit Administrators (a retirement fund administrator), which were started up by Mr. D in 1997.

Unfortunately for investors, in October 2002, the Financial Services Board (FSB) was successful in their application to the High Court of South Africa requesting that the Deel-Smith group of companies be placed under curatorship (*Business Report*, 28/11/2002). This was subsequent to inspections performed by the Registrar of Pension Funds, the Registrar of Financial Markets and a surveillance division of the JSE (Press Release by FSB, 17/10/2002).

The reports presented revealed that the financial records of the companies investigated were deficient and the undertakings were intermingled. The directors of the companies completely disregarded the boundaries of the entities. It seems that client investments were moved without consent and the investment vehicles utilised were never discussed. There were material losses in the futures and options; however there were no funds accessible to settle future margin requirements (Press Release by FSB, 14/07/2003).

A representative of Deloitte & Touche was appointed as curator of the Johannesburg based companies: Deel-Smith Investment Holdings Limited, Deel-Smith & Company (Pty) Ltd, Deel-Smith Benefit Administrators (Pty) Ltd, Deel-Smith Securities (Pty) Ltd and Deel-Smith Nominees (Pty) Ltd.

One month later the curatorship was extended to include five pension funds run by the Deel-Smith group. This was due to allegations against the former trustees and administrators regarding maladministration and misappropriation. The curator stated that four of the funds were not feasible as their liabilities exceeded their assets, and the fifth fund was technically solvent but would be unable to carry on as it had lost crucial staff and could not continue to observe the rules of the JSE. The five umbrella pension funds were (Press Release by FSB, 14/07/2003):

- Small and Medium Enterprise Independent Preservation Pension Fund;
- Small and Medium Enterprise Independent Pension Fund;
- Small and Medium Enterprise Independent Provident Fund;
- Small and Medium Enterprise Independent Retirement Annuity Fund; and
- Small and Medium Enterprise Independent Preservation Provident Fund

The pension funds had experienced losses of over R 18 000 000, which meant that over 350 members were left with not retirement funding. The assets remaining in the funds were under R 1 500 000. Losses were incurred due to the fact that directors had not followed the regulations regarding pension fund investment and funding had been used by Mr. D in investments on behalf on non-pension fund members (Press Release by FSB, 21/07/2004).

In this manner, another R 50 000 000 was lost which was held in private client portfolios managed by Mr. D. This brought total losses to nearly R 70 000 000. The endeavour was concealed by drawing up fictitious statements of investment returns in order to create time for the investments to turn around. This was not quite what Mr. D had in mind regarding low-risk investment. Further, it was also discovered that Deel-Smith and Company was not registered as an investment manager as is required regarding the Pension Funds Act 24 of 1956 (as amended). The directors of the Deel-Smith group could be held liable under criminal and civil law.

It is interesting to note that the retirement funds had been insured for losses resulting from negligence, fraud and dishonesty of officers; however the insurance company, Santam, would not indemnify the insured. This was on the basis that material facts were discovered to have been in existence prior to the inception of the policy, which were not disclosed to the insurer (*MoneyWeb*, 21/07/2004).

Even though this study involves umbrella pension funds, it was the breach of corporate governance by the directors of the holding companies that resulted in losses. It is not difficult to realise how important corporate governance can be when so many elderly are left without a pension.

<u>Unifer</u>

In January 2002 Absa saw its shares plummet 27% when its micro-lending subsidiary ran into R 1.5 – billion bad debt. Unifer was created in 1999 as a result of a merger between four companies: Creditsure, Unibank, Global Insurance Company and MBI Underwriting. Supergroup also sold their emerging market interests to Creditsure. According to the non-executive chairman of Unifer, the company was meant to be the second largest micro-lender behind Theta. The prospects were of a 50% return rate per annum and the company would soon enter diverse markets in southern Africa (*Business Times*, 01/05/1999).

By August 2001 Absa had acquired a 60% share in Unifer Holdings Ltd. The collapse of Unifer upset South Africa's banking industry when Absa had to deal with the R 2.2 – billion losses incurred by the micro-lender. The scandal was due to gross mismanagement which resulted in Absa's profits being halved for that financial year *Mail & Guardian*, 02/06/2003).

Investigations into the collapse of Unifer exposed the following possible causes (*Business Report*, 03/07/2003):

- conflicts of interest among management;
- unsustainable growth in the quantity and volume of loans;
- unauthorised granting of loans;
- executives received unfitting payments from brokers; and
- a breakdown in control systems by the unauthorised provision of codes for credit control systems.

Much controversy was centred on the accounting treatment of R 27 000 000 income at Lantern Financial Services, a subsidiary of Unifer in based in East London; the company was acquired systematically in the period of 1998 to 2000. It was alleged that, in order to lend out more funds and create an impression of more business, an excessive amount of loans were authorised but recorded in separate books. The effect was that it seemed as though not that much funding was leaving Unifer. The amount lent actually exceeded the limits set by regulation (*Financial Mail*, 01/02/2002). Another major issue was that low-quality loans were added to Unifer's books; management would control the loans as well as businesses in which they had a direct interest. The safer loans were always directed towards personal interests. In this manner, Unifer gathered quantity not quality regarding loans.

Thus a number of Unifer staff members faced criminal and civil charges following the collapse of the company. In 2004 the former company secretary of Unifer admitted liability and agreed to pay the FSB a sum of money.

Absa instituted a rescue plan in order to minimise the losses to the subsidiary; the scandal cost the banking group around R 1.78 – billion. However Absa did recover with a profit of R 3.4 – billion in 2003. The bank has since increased control over Unifer by delisting it from the JSE, buying out minority shareholders and forming a new division named UB Microloans. Unibank' banking licence was annulled in March 2003 (*Business Report*, 03/07/2003).

This case example is important as corporate governance systems are now forcing directors to take a more proactive role in the decisions taken by the companies they are employed by. This corporate collapse did not involve any directors, however management too has a duty toward the company and D&O insurers could find themselves liable.

<u>Tigon</u>

Tigon Limited was primarily a money lending and financial services company, based in Peitermaritzburg – KwaZulu-Natal, which imported and dealt in the wholesale of food, sport equipment as well as Phillips electronic products. Some management of KwaZulu-Natal farms was also undertaken. The company was the top performing new listing as well as the top performer on the JSE in 1995 and 1996 respectively (*Financial Mail*, 1997).

The intricate labyrinth of charges faced by former Tigon executives, Mr. P and Ms. B, has left many baffled. Numerous allegations from 1997 until 2002, when Tigon collapsed and Mr. P was arrested, are still being investigated and the court trial is still pending in 2008. One must understand that this is in part due to the fact that former Tigon executives have attempted numerous means to stall the process. Provided that the allegation are well founded, the executives of Tigon managed to deceive the JSE, the South African Reserve Bank, the South African Revenue Service (SARS), as well as thousands of investors in order to attain hundreds of millions of Rands (*Financial Mail*, 1997).

It is alleged that the breaches of legislation and corporate governance began in 1997, when another company under Mr. P's control, Shawcell Holdings, was listed on the JSE only due to countless lies. On the foundation of overstatements regarding Tigon and Shawcell, a 1998 transaction was completed in which Tigon bought R 58 000 000 for a telecommunications company named Europoint. Tigon then inflated the value of the intellectual property of Europoint to R 1.2 – billion. Europoint was then sold to Shawcell for the said amount, which deceptively inflated the profits and assets of Tigon. The deceptions also permitted Shawcell to list on the JSE and illegally shift assets out of South Africa (*Business Day*, 03/05/2005).

PSC (Progressive Systems College) Guaranteed Growth fund was chaired by Ms. B, whom together with Mr. P enticed investors in order to attract monetary funding. The glossy and impressive brochures guaranteed a yearly growth rate beyond that of the JSE. However the former managing director and founder of PSC, Mr. M, in a desperate attempt to minimise a five year prison sentence entered into a plea bargain with the prosecution. This was subsequent to serving out eleven months for being held personally liable under Section 424 of the Act regarding the losses of PSC. In return Mr. M will have to present evidence against Mr. P and Ms. B (*Business Report*, 02/03/2008).

The truth about PSC is astonishing; approximately four thousand investors were lured into spending R 250 000 000 into the fund of which there is nothing left (*Business Day*, 2005). The money was unlawfully expropriated by the executives of Tigon: funds either directly or indirectly landed up with Mr. P and Ms. B as well as with companies controlled by them. PSC funds were in actual fact routed to Tigon, Shawcell, Awethu Trust, EBN Trading, Synergy Management and Brangus Ranching, which were all controlled by Mr. P (*Business Day*, 10/13/2005).

One example in which the funds were abused was a plot intended to assist non-residents to get money out of South Africa without declaring it to the authorities. It is claimed by prosecutors that foreigners holding South African stocks would sell their shares and utilise the money in order to purchase shares in Shawcell (illegally on the JSE to begin with) through a Hong Kong based company named Plenny. The Shawcell shares would than be sold back to Plenny which would shift approximately 78% of the money out of South Africa, whilst awarding Mr. P and Ms. B with 22% of the commission (*Business Day*, 10/13/2005).

Mr. P and Ms. B are now facing countless charges including contravention of the Income Tax Act, the Companies Act, the Stock Exchange Control Act 40 of 2001, the Prevention of Organised Crime Act, as well as exchange control regulations (*Business Report*, 02/03/2008).

The Tigon study shows clearly why breaches of corporate governance and legislation by company executives have led to an increasing need to hold directors more accountable, as well as to activate more extreme measures of checks and balances.

<u>Corpcapital</u>

In 2002 Corpcapital Ltd (the old one was formed out of TPN Ltd in 1997), a public company listed on the JSE, published its Annual Financial Statements. Little did anyone know that the seemingly prosperous company would be turned into an inter-director corporate dilemma; an ‘affair’ which would last for years and lead to the collapse of the company. Mr. F was a co-founder of Corpcapital and a director who opted to resign in 2002 alleging a considerable breach of corporate governance and legislation on behalf of the company and its directors. Among other things this would also lead to an out-of-court settlement regarding invasion of privacy, in which Mr. F accused Corpcapital of instructing the Associated Intelligence Network (AIN), a private investigation company, to probe into his affairs (*Business Day*, 25/08/2006).

It was alleged that between 1999 and 2003 the directors of Corpcapital created fictitious financial statements regarding the value of a subsidiary, Cytech, and breached other ethical and legal borders. An investigative report was commissioned in 2003 and handed to the Trade and Industry Minister in 2004.

The main issue was that of Cytech, an online gambling subsidiary in which Corpcapital held 50% shares when it commenced operations in 1999. The shares would be later diluted to 47.5%. The problem was that Corpcapital bought its stake for R 4 500 000 and re-evaluated the worth at R 149 000 000 in one year and R 221 000 000 in the next, utilising questionable means. It seemed that in 2000 Corpcapital took R 101 000 000 of the difference in the Cytech valuation and added it to its own profits. Further, R 23 000 000 was paid as bonuses to directors that year. Cytech would later be sold for R 20 000 000 (*Business Day*, 21/06/2005). It was alleged, by Mr. F, that had it not been for questionable accounting methods and mark to market accounting (which values future financial instruments based on current market price), that the year 2000 would have been a period of financial decline for Corpcapital.

In 2001 there was a merger between three entities to create Corpcapital (new). The three companies were Corpgro, Corpcapital (old) and Corpcapital Bank. Mr. F claimed that the inflated valuation of Cytech influenced the merger, which would not have been a success without the perceived profit of Corpcapital (*Business Day*, 21/06/2005).

The main allegations were centred on the former CEO, Mr. L, and the chairman, Mr. E. The dispute would last about four years, which would cost the South African taxpayer around R 10 000 000. The investigative report was held by the Minister for an extensive amount of time and when released, it vindicated the accused. It was concluded, in the 1 800 page report, that the on-goings of the Corpcapital group was not being conducted in an unjust manner or inequitably towards the shareholders. Although it was stated that Corpcapital did not fraudulently inflate profits in order to boost director bonuses, mention was made that Cytech should have been disclosed separately in the income statements. Further, KPMG did not evaluate the company, but simply reviewed the valuation performed by management. It was therefore assumed by the company that the valuation was correct (*Business Day*, 06/06/2005).

The negative perception of the CEO, Mr. L, also assisted in fast-tracking the downfall of Corpcapital due to previous business ventures. The scepticism from investors, analysts as well as the press was boosted during the dispute with Mr. F which led to a loss of credibility of the company (*Business Day*, 01/12/2006).

This case example does not involve an actual breach of corporate governance or legislation; however it is useful in that it points out the importance of transparent governance, director reputation and accurate auditing.

<u>Fidentia</u>

The Cape based asset management company (financial services and technology), Fidentia, was placed under provisional curatorship by the Cape High Court in February 2007 (*Business Report*, 02/02/2007). This was the most prevalent corporate scandal arising in the financial services sector up to that point. At the time Fidentia Holdings and its two subsidiaries, Fidentia Asset Management and Bramber, were holding nearly two billion Rands of investors money (*IOL*, 24/02/2007).

Unfortunately the funding was made up of R 1.47 – billion from the Living Hands Umbrella Trust, which paid out money invested in Fidentia by the Mineworkers' Provident Fund to orphans and widows of those who deceased in mining accidents (*Fin24.com*, 07/02/2007). Another R 245 000 000 was invested by the Transport Education and Training Authority (TETA).

A team was set up by the Financial Services Board (FSB) which investigated Fidentia and delivered an alarming method of doing business. Such things were mentioned as misrepresentation towards clients, misappropriation of client funds, misrepresenting investments, material conflicts of interest (regarding directors) and deficient corporate governance standards (*Mail & Guardian*, 15/03/2007). The director of Fidentia as well as certain followers used much of the monetary funding received for personal interests and contravened a number of laws which govern the administration of a company, the manner in which asset management should be handled and the general methods of fund trust protection. The scandal even went far enough to dispose of double-entry bookkeeping - to a certain extent (*Business Day*, 14/02/2007).

The occurrences found at Fidentia which were condoned by the directors were outrageous. Some fabricated enhancements in the valuations of assets were recorded as income, whilst other existent sources of income, when stopped (Sante Wellness

Certre), were not recorded as losses at all. Transfers of funds were performed among Fidentia companies which were then shown as income – in reality this effect should have been neutral (*IOL*, 24/07/2007). In order to enhance the public image of Fidentia, invested funds were used to sponsor sports organisations such as Boland Rugby and Manning Rangers; these were then recorded as capital investments. Due to the fact that at one stage a director of Fidentia was also an auditor at the same time (which goes against statute and corporate governance code); it was unproblematic to back-date certain transactions in order to avoid legal duties and taxation (*IOL*, 24/07/2007).

The director of Fidentia finally came under scrutiny when a business relationship with Kopano, the business unit of the Congress of South African Trade Unions (COSATU), became adverse. Fidentia was sued for millions of Rands utilising the untrue profits which had been produced. The financial statements illustrated the excessive spending of the company and the directors: the monthly salary bill of Fidentia Holdings was R 20 000 000 (excluding executive bonuses), R 2 000 000 per month was spent on 'staff welfare', and R 4 000 000 per month was spent on entertainment (*IOL*, 24/07/2007).

The funds which were 'invested' by Fidentia Asset Management was being used to purchase other companies at unreasonable prices, and companies which were running at a loss such as Motshati Holdings which was insolvent (R 15 000 000 was paid for a 26% share). R 100 000 000 per month was being used to pay operational costs of the Fidentia group companies (*IOL*, 24/07/2007).

Funds were also utilised to compensate a director for failed personal investments and business schemes. When a personal venture would go wrong it would be sold to Fidentia at a profit. An example is that of the commodities trading company, Bayview Commodities, which had accrued a loss of R 8 000 000 when the director sold it to Fidentia for R 14 000 000. As will be seen later, this is a major illegality regarding the Companies Act and corporate governance rules. Numerous assets which were held in the name of a company director were reflected in the books of Fidentia companies as assets belonging to those companies (*IOL*, 10/02/2007). Some examples are Cape Town properties and farms in the Eastern Cape. The wife of a director was also provided with a beauty centre in Canal Walk compliments of Fidentia, which was then sold back to the company when losses were incurred.

The director of Fidentia and the co-accused (former accountant) face charges of theft and fraud which total over R 200 000 000. The directors have now been imprisoned – one was arrested by the Federal Bureau of Investigation (FBI) on arrival in Los Angeles after fleeing to Australia shortly before the Scorpions were given permission to investigate the matter (*Business Day*, 02/02/2007). It remains to be seen how much personal liability the directors will incur. A quarter of the staff at Fidentia was retrenched straight away in order to cut overhead costs while many more lost their jobs. In the meantime, companies purchased by Fidentia at inflated prices are being built up and sold in order to provide compensation to the widows and orphans of the deceased mineworkers. Such an example is that of Infinity (*Business Day*, 14/02/2007). In this case extreme amounts of personal liability will be incurred by the company directors due to fraud and theft; more adequate systems of corporate governance as well as checks and balances may have had the ability to lessen the losses.

Conclusion

The modern era has witnessed a vast increase in the size and complexity of companies operating within an integrated economic system. Companies no longer small or operate in a single country, but undertake complex inter-company, inter-continental ventures, operating within a global economy. This is such that often accounting methods have not possessed the capacity to keep up – as was the case with Enron. Further, accounting standards have been forced on companies in which directors have little say in the matter. The diverging needs of companies and goals of accounting methods have often led to financial ruin, under which circumstances, directors are held accountable. World economic factors must also be taken into account, for example, the US releases employment figures and the South African equity market declines. Company directors may increasingly be held accountable for factors which on the face of it are out of their control.

The reality is that the economic world has become more complex. This has resulted in larger and much more expensive company failures. The complexity issue has led to increased director's liability exposure. As company failures increase in size and number, so too does the need to hold somebody accountable. One has already seen that society and courts are looking to hold directors liable for company losses. The increased probability of company failures due to complexity issues means that director's exposure to liability increases too.

An increase in potential director liability, as a result of the complexity of the modern economic world, means that there is an increase in claims against directors. Therefore there would potentially be an increase in claims against D&O insurance policies. As per the increased claims against directors due to increased liability, as a result of the doctrinal issues (Chapter 1), so too does increased liability as a result of the complexity issues lead to increased claims against directors. The increased exposure to liability of directors due to the complexity of the modern economic environment, has led to increased claims against company directors.

3 CORPORATE GOVERNANCE

Chapter three looks at the first mitigating step which was taken which should, to some extent, contain claims against directors; that of codes of corporate governance practice. This is not to say that the central purpose of corporate governance codes is to contain director liability; however it is intended that less causes for claims should result.

As a result of certain corporate failures in the UK (such as Maxwell, BCCI and Polly Peck) and in the US (such as Drysdale Government Securities, Washington Public Power Supply System, Baldwin-United Corp., and ESM Government Securities) the Treadway Commission and the Cadbury Commission were set up in the US and the UK respectively. It was recommended that investigations take place into corporate governance and thus the Cadbury Report was eventually published in 1992. This led to numerous codifications of corporate governance all over the world, including South Africa with the King Reports (1994 & 2002).

This chapter will look at corporate governance as a mitigating step regarding director liability. A conclusion will finally be drawn as to whether or not it has been, or will be, a successful undertaking. If the corporate governance codes have been successful in containing director liability, then claims against company directors should decrease.

3.1 Definition

'Corporate governance' is subject to broad and narrow definitions. Predominantly, most definitions situated in corporate governance codes worldwide refer to a form of control; of company, corporate management, and of corporate conduct (European Commission, 2002). The most straightforward definition is probably that found in the *Cadbury Report*: "Corporate governance is the system by which businesses are directed and controlled." (Cadbury, 1995). This simplistic description is also adopted by the South African Institute of Directors *King Report on Corporate Governance*, 1994 (King 1). However, other more elaborate definitions do exist:

- "Corporate governance… involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined." (OECD Principles, 1999)
- "Corporate governance comprehends that structure of relationships and corresponding responsibilities among a core group consisting of shareholders, (supervisory) board members and managers designed to best foster the competitive performance required to achieve the corporation's primary objective." (Millstein Report to OECD, 2000:13)

Other collective themes regarding definitions of corporate governance are:

- 'supervision' of the respective company or management,
- a legal framework, rules and modus operandi, private sector behaviour, and
- defining the relationships between shareholders, and the boards and management.

The King Report on Corporate Governance (2002) (King 2) states that corporate governance is primarily involved in two concepts; that of performance and conformance. The report goes on to declare that it is necessary to find a balance between the two notions (King 2, 2002: 8). Corporate governance may be classified as broad or narrow. The narrow model refers to governance of companies from within. One example is that of monitoring by the board of directors: the board possesses the legal capacity to observe management and take action accordingly. Regular board meetings in theory ensure that any obstruction of regulations are brought out in the open and dealt with immediately. Non-executive directors are there to provide an independent and non-biased opinion of the dealings of the company.

Remuneration may also be used as an internal control; this means that some portion of the executive's salary is related to performance. This is used as an incentive to avoid errors and opportunistic behaviour. The broad definition encompasses controls over the company from the outside. Some examples include the following: state (legislation) and judiciary (precedent rulings) control over companies, the demand for financial statements, and media pressure. The last example is extremely important and vastly unexplored. The media has become instrumental as a corporate governance tool, especially in the age of information technology. It is one of the first institutions that many unsettled financial analysts turn to and holds the ability to influence public perception. Future studies should be directed toward the influence of the media on corporate governance (Romano, 1998). The intention behind internal and external governance controls is to protect the interests of company stakeholders, as well as to defend against market failure due to malpractice (Rossouw, 2002).

Although corporate governance has come under the spotlight since the early 1990's it has actually been in existence ever since the separation of ownership and control of companies occurred. This paved the way for a requirement, on part of the owners or investors, of systems to regulate and monitor the functioning of managers. The emergence of corporate governance was especially accelerated due to the Industrial Revolution: up until then a business had involved owners and undertakings were for a once-off purpose. The requirement of substantial amounts of capital led to the incorporation of companies and the need for continuity. The high amount of shareholders and continually growing complication of processes necessitated the development of controls and regulations in order to protect the concerns of company owners (Wixley & Everingham, 2005).

Before the discussion on corporate governance can continue it is important to see where the need for it came from. It is thus necessary to embark on a brief examination of *agency theory*.

3.2 Agency theory

The pioneering paper by Jensen and Meckling (1976) defines the agency relationship as a contract under which one individual (principal) appoints another individual (agent) to perform a service on his behalf. As a result, the principal assigns some decision-making authority to the agent. Jensen and Meckling (1976) go on to explain that if both parties to the contract are utility maximizers it is likely that the agent will not always act in the best interests of the principal. Companies were defined as "… legal fictions which serve as a nexus for a set of contracting relationships among individuals." (Jensen and Meckling, 1976: 310)

It is then in the best interests of the principal to try and restrict the departure from his best interests by setting up incentives for the agent and incurring certain monitoring costs. This is where corporate governance comes in. *Monitoring costs* are spent on undertakings in order to control, measure and observe the activities of the agent. Some examples are that of corporate governance codes and auditing measures (McColgan, 2001).

Jensen and Meckling (1976) further suggest that in some cases it may be in the interest of the agent to disburse resources in order to assure that no action will take place that will prejudice the principal, or that the principal will be compensated in the event that a loss does occur. These expenditures are called *bonding costs* and it is arguable that D&O liability insurance may be an example, even though the cost of this specific type of insurance is borne by the company. Agents will stop sustaining bonding costs when the marginal reduction in monitoring is equal to the marginal increase in bonding costs (McColgan, 2001).

However regardless of monitoring and bonding costs, it is improbable that the interests of managers and shareholders are likely to be completely parallel. According to Jensen and Meckling (1976), agency losses will still occur due to conflicts of interest; this is known as the *residual loss*. This is as a result of the fact that the costs of total implementation of the principal-agent contract will overshadow the benefits derived. The consequence is an optimal level of residual loss, which is a trade-off between management limitation and reduction in principal losses (McColgan, 2001).

Jensen and Meckling (1976) define agency costs as the sum of monitoring payments by the principal, bonding spending by the agent and the residual loss incurred.

It is evident that the main source of obstacle regarding agency theory is that of information asymmetries. Asymmetrical information occurs when one party (in fact both) to a contract has more knowledge regarding critical information required in the contract than the other (Douglas, 1989). For example, a shareowner may inspect the CV of a potential director/manager; however one can never truly know the applicant's abilities, expertise or honesty. In fact the potential agent may be aware of who would be a better candidate for the position, however the principal will not. In this manner one gets a glimpse of the first market failure known as *adverse selection*. Due to asymmetrical information, low-quality applicants are selected. This will tend to drive out high-quality workers from the pool, which ultimately may lead to a collapse. Additional information on adverse selection may be acquired in Rothschild and Stiglitz (1976) and Akerlof (1970).

Another market failure which may occur due to information asymmetry is that of *moral hazard*. Once a director/manager is selected, the shareowner may not know how the work is actually performed. Whether or not the director keeps himself well informed or works hard enough (shirking). The director may also be opportunistic and purse his own self-interests (Shapiro, 2005). Will the director take advantage of the perquisites that are inherent in the job function? Anyone who has ever: made personal calls from the office, used the internet at work to monitor the stock market, or outsourced work to close contacts even though their competitors may have been better equipped, will have contributed to the moral hazard factor of their employing company. Additional reading may be done on moral hazard in Shavell (1979).

An understanding of information asymmetry is crucial for the discussion on directors and corporate governance. The contractual relationship between shareholders and directors is one of a principal-agent nature. In order for the shareowners to ensure the interests of managers/directors are aligned with their own, corporate governance structures are put in place. In the event of a breach on part of a director, of either corporate governance codes or legislation, the director may be held personally liable for any losses incurred. That is where D&O liability insurance is vital.

It seems that agency theory is interested in solving two problems which occur in agency relationships: the first is the fact that the objectives of the principal and agent are likely to be inconsistent, the second is that it may be costly or impossible for the principal to ensure that the agent is performing in the best interests of the company (Eisenhardt, 1989). The problem may be seen as one of risk-aversion; the principal and agent may also have dissimilar risk appetites and therefore it will be difficult to achieve the aims of the company.

It is worth mentioning that two types of agency theory exist (Jensen, 1983): positivist and principal-agent. Positivist researchers concentrate on the classification of instances in which the principal and agent are expected to possess incompatible objectives and thus providing for the governance mechanisms which constrain the agent's 'selfish' behaviour. Principal-agent work is connected to the general theory of the principal-agent relationship and its relevance in the work environment. Research conducted entails listing assumptions and creating mathematical proofs (Eisenhardt, 1989).

Having looked at the origins of corporate governance one can now endeavour to describe other crucial factors which are necessary in the understanding of this type of corporate regulation. It is necessary to remember that corporate governance did not come about as a result of increased research in the area of agency theory in the 1970's; to the contrary both corporate governance and the principal-agent problem have existed since the separation of ownership and control of companies. This is a crucial section in the understanding of where the need for D&O liability insurance comes from.

It is appropriate to conclude this section as Jensen and Meckling (1976) began; with a quote from Adam Smith's *Wealth of Nations*: "The directors of such companies, however, being the managers rather of other people's money than their own, it cannot be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation form having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company." (Smith, 1776: 700).

3.3 Significance of corporate governance

When looking worldwide, it is clear that shareholder activism is on the rise. This is evident from an increasing amount of shareholder claims against company directors and an increase in corporate governance codes and legislation. Shareholder activism may be defined as the monitoring of performance and corporate governance of companies by shareholders, be they individuals, groups or institutions (Investopedia). There is undoubtedly a general consensus that improved corporate governance structures will result in increased shareholder returns; however due to the multifaceted relationship between the two variables, academics have generally not succeeded in proving a positive relationship.

With this in mind McKinsey & Company undertook the 'Investor Opinion Survey' which was published in 2000. The objective of the study was to determine how shareholders perceive and value corporate governance in developed and developing economies. The study was performed in conjunction with the World Bank and the Institutional Investor's Regional institutes.

According to the McKinsey & Company (2000) survey a soundly-governed company is defined as having a majority of outside directors on the board who possess no management ties, formal assessments must be performed on directors, and the company must be receptive to investor requests regarding information on governance issues. To add to this, directors should hold substantial stockholdings in the company, and a percentage of directors' pay must be in the form of stock options. Utilising then mentioned criteria for good corporate governance, the following key results were discovered:

- Of over 200 global institutional investors, more than 80% signalled a motivation to pay a premium for shares in a well-governed company over a poorly governed one with a comparable financial record.
- 75% of investors stated that the board of directors' practices are at least as crucial as financial performance when assessing companies for investment. This was especially predominant in Latin America. This finding is crucial to

the study performed in this dissertation, as it demonstrates that a director's procedures are as important as financial performance in the eyes of investors. Therefore on the other hand, poor director performance may lead to a highlighted demand for compensation which is where D&O liability insurance comes in.

- Investors were found willing to pay a premium for good corporate governance systems. However the amounts of premium differed across certain countries: UK investors were willing to pay 18% more for shares in a soundly-governed company, compared to one with poor governance and similar financial performance. In emerging economies the premium rose to 27% in countries such as Indonesia and Venezuela.

The importance of corporate governance (quantified) was further reinforced in the McKinsey & Company 2002 Global Investor Opinion Survey. The reinforcement of the quality of accounting disclosure was of top priority. Some of the key findings of the survey were:

- Investors still viewed the quality corporate governance on par with financial indicators when assessing investment options.
- Investors were willing to spend a premium on companies which demonstrate good corporate governance measures. The mentioned premiums were: 12 – 14% in North America and Western Europe, 20 – 25% in Asia and Latin America, and over 30% in Eastern Europe and Africa.
- Over 60% of investors stated that corporate governance measures would lead them to avoid certain companies, whilst 33% said that poor governance would lead them to completely avoid certain countries regarding investment.
- Other findings were: support for a global unified accounting system, a need for systems to deal with corruption, requirement for board of directors' transparency and accountability, board independence, and a need to enforce existing regulations.
- The relative slight decrease in the significance of corporate governance may have been due to the fact that many countries introduced governance-related reforms which settled the investor's urgent needs.

Yet another study was performed by the Association of British Insurers (ABI) entitled: ‘Governance and Performance in Corporate Britain’ which was released in 2008. The research enquired into whether good corporate governance leads to stronger operating performance and whether it leads to higher share price returns. The findings suggest a positive answer to both those questions. The ABI’s Institutional Voting Information Service (IVIS) was utilised in order to measure the quality of company governance over a four-year period (2004 – 2007 inclusive). The information was then compared to data on company performance and shareholder returns provided by Thompson Financial. The 361 companies which were assessed were all in the FTSE All-Share Index.

The key findings may be summarised as follows (Selvaggi & Upton, 2008):

- The years which marked major governance concerns (red top) were strongly and negatively correlated with performance. Companies which had a red top underperformed other companies by about 3 to 5 percentage points per year.
- Companies which breached pre-emption guidelines on share issues had an annual decrease of 3 percentage points as well as a 0.2 point decrease in the market value of assets.
- A glaring indication was found that corporate governance leads to better performance rather than good performance leading to better governance.
- Over the study period, the shares belonging to well-governed companies produced an extra return of 37 basis points per month.
- The share-price returns volatility seemed to be lower regarding portfolios of well-governed companies.
- A significant finding which has been difficult to attain thus far is that: the balance of the board of directors is significant. An increasing number of Non-Executive Directors (NEDs) on a board improves performance, however if the increase is too high it will lead to a decrease in profitability.

There is little doubt in any person’s mind that corporate governance plays a significant role in investor decisions and therefore the global economy. The McKinsey & Company reports, as well as that of the ABI, illustrate the value which is placed on governance systems, with a great emphasis on directors who perform a key function in the corporate governance of a company. More than ever this shows the importance of protection of the mentioned directors which will most likely come in the form of D&O liability insurance.

3.4 Good corporate governance

3.4.1 Characteristics of good corporate governance

According to King 2 the following characteristics are typical of good corporate governance:

- Discipline: This is the commitment by a company's senior management to observe and take part in conduct which is collectively recognised and received as correct and proper. It is referred to as corporate discipline.
- Transparency: It is crucial that outsiders have the ability to analyse a company's actions, economic activities, as well as non-financial aspects regarding business. Information must be available in an honest, accurate and timely manner. Investors should be offered a true picture when deciding on investment options.
- Independence: This concept refers to the mechanisms which are in place in order to minimise or annul potential conflicts of interest which may occur, such as a dominant director or shareowner. No undue influences should be acceptable.
- Accountability: Any individual working for, or acting on behalf of, a company must be held accountable for the actions or decisions taken. Mechanisms must be created in order to allow investors to enquire and consider actions taken by the board of directors and its committees.
- Responsibility: Responsibility relates to conduct which allows for corrective action to occur in the event of mismanagement. The board of directors is accountable to the company; however it is required to act with responsibility towards the stakeholders of a company.

- Fairness: There must be mechanisms in place which take into consideration the interests of all who hold an interest in the company. Therefore rights must be acknowledged equally irrespective of dominant or subservient positions regarding the company.
- Social responsibility: The concept of corporate social responsibility has attracted much attention as it is becoming increasingly evident that companies should be conscious of, and react to social issues. The emphasis here is placed on ethical standards. The organisation should be responsible not just for creating an economic profit but also take due regard to environmental and human rights matters. It is said that companies will consequently receive indirect economic gains, such as a corporate reputation, by taking social factors into account.

Tricker (1984) explicates the corporate governance process regarding four activities:

- Direction: This involves creating the long-term strategic direction of the company.
- Executive action: Executives have to be implicated in crucial company decisions, which should be made with regards to timely and accurate data.
- Supervision: The board of directors must monitor and oversee management performance on a regular basis. Reports should then be produced in order to be inspected.
- Accountability: This concept is once again mentioned as due respect must be awarded to those who require accountability.

3.4.2 Triple bottom line

Another important evolution in corporate governance is that of the triple bottom line approach. This change in corporate governance thinking adopts the economic, environmental and social aspects of a company’s activities. According to King 2, the economic feature entails the financial and non-financial activities applicable to that company’s business. The environmental side comprises of thee effect on the environment of the product or service created by the company. The social facet adopts values, ethics as well as the mutual relationships with stakeholders besides shareholders. The basic notion is that ownership creates responsibility – to more than just shareowners.

3.4.3 Corporate social responsibility

The concept of corporate social responsibility states that a company's obligations to the society from which it profits reach beyond the legislative measures set up by the state. The World Business Council for Sustainable Development defined corporate social responsibility as the persistent dedication by companies to act ethically and factor in the economic development, whilst enhancing the quality of life of the workforce as well as the local community and society at large.

Although many view corporate social responsibility as a cost, it may have benefits for the company in question. That is with respect to reputation, attracting and maintaining a good and ethical workforce, and acquiring assistance in times of collapse (Collier & Robberts, 2001).

3.5 Corporate governance structures

There exist two major corporate governance board structures on an international basis. One is referring to the unitary and two-tier board systems. The unitary system may be referred to as the Anglo Saxon model which is derived from the first UK Companies Act of 1844 (Wixley & Everingham, 2005). This was as a result of the concept of a company first being considered a separate legal entity from its owners. The basic notion is that shareowners appoint executive directors (which involve a managing director and CEO) as well as non-executive directors.

In the mainland of Europe, one major corporate governance structure developed most predominantly in Germany – the two-tier system. The board of directors is actually composed of two sections; a supervisory board and a management board. The supervisory board (which represents both shareowners and employees) possesses no executive power but does however retain the authority to select, endorse or subtract a manager of the board (McConvill *et al*, 2005). The management board is responsible for the day-to-day management of the company as well as the obligation to report to the supervisory board at certain time periods.

Although one may point out some structural differences between the two systems (the number of dissimilarities are lessening), many similarities do exist regarding board practices (Weil *et al*, 2002):

- Both systems acknowledge a supervisory and a managerial function; however the differences between the two are more prescribed in the two-tier structure.
- It is common in both the unitary and two-tier board structure for directors to be appointed by the shareowners; however in some states the employees may elect supervisory board members too.
- The unitary board and the supervisory board (of the two-tier system) select the members of the managerial body – which is the management board in the two-tier system or the managers to whom authority is delegated from directors in the unitary arrangement.
- The unitary board and the supervisory board (of the two-tier system) are responsible for making certain that financial reporting and control systems operate correctly, as well as that the company is complying with the legal system.

3.6 Significant corporate governance occurrences

The aim of this section is to create a chronological summary of the major corporate governance events and codes which have shaped the constantly evolving subject matter. Due to the fact that directors hold such an important function in the application of corporate governance it is therefore crucial to attain a background understanding of the topic.

3.6.1 1987: Treadway Report

The National Commission on Fraudulent Financial Reporting (Treadway Commission – named after the chairman, Mr. JC Treadway Jr.) was established in the US in 1985. The Treadway Commission was formed as a result of some dramatic corporate failures in the US during the 1980's such as Drysdale Government Securities, Washington Public Power Supply System, Baldwin-United Corp., and ESM Government Securities (Grundfest & Berueffy, 1989). US Congress was questioning whether or not the failures could have been avoided and what better audit practice measures should have been in-force.

According to the Treadway Report (1987), the Treadway Commission's primary purpose was: "… to identify causal factors that can lead to fraudulent financial reporting and steps to reduce its incidence." 'Fraudulent financial reporting' was defined as "Intentional or reckless conduct, whether act or omission, that results in materially misleading financial statements." This could be performed in several manners: distortion of corporate records, falsified transactions and misapplication of accounting principles.

The three primary objectives of the Treadway Commission were (Grundfest & Berueffy, 1989):

- to discover potential of fraudulent financial reporting and the effects on the integrity of financial reporting, as well as methods of prevention and detection,
- to discover the role of the independent public accountant in fraud detection, as well as the necessary auditing standards changes which should occur, and
- to discover the corporate characteristics which lead to fraudulent financial reporting.

Some of the proposals made by the Treadway Commission which were endorsed by the SEC included (Grundfest & Berueffy, 1989):

- A requirement that a ‘management report’ should be handed in with the company’s annual financial report regarding responsibility for financial statements and controls.
- A requirement that independent accountants review quarterly financial data prior to release.
- A suggestion that corporate directors and officers may be barred or suspended from service regarding acts or omissions of fraudulent financial reporting.

It is interesting to note that the term ‘corporate governance actually originated in the US during the 1970’s and law journals, and would slowly be incorporated into British culture.

3.6.2 1992: Cadbury Report

The UK based report entitled Financial Aspects of Corporate Governance, chaired by Sir Cadbury, is still today considered a great milestone in the progress of corporate governance. This is probably due to the fact that the recommendations made in this report have been to varying degrees applied in the European Union (EU), US and the World Bank to name but a few. As was the case of the Treadway Report, the Cadbury Report was mostly produced as a result of certain corporate failures, which this time occurred in the UK during the 1980’s.

Maxwell Communication Corporation was one of the world’s largest media groups and incorporated in 1964 (FundingUniverse.com). Certain high-risk undertakings led the Maxwell into extreme debt, which was being financed by diverting finances from the company’s pension funds. After Mr. Maxwell’s death it materialised that some of the company’s subsidiaries possessed liabilities exceeding assets and that £440 000 000 was missing from the pension funds. During the same time the Bank of Credit and Commerce International failed when billions of dollars went missing belonging to depositors, employees and shareholders. Concurrently a textile company named Polly Peck went under in 1990 as a result of serious fraud (FundingUniverse.com).

As a result of the corporate failures, the Cadbury Committee was appointed to examine the UK corporate governance system and propose steps in order to restore investor confidence. The Cadbury Report contains a Code of Best Practice predominantly associated with the composition of the board of directors, the appointment and independence of non-executive directors, the service contracts and remuneration of executive directors, as well as the company's financial reporting mechanisms and controls.

The central recommendations which were proposed are as follows (Arcot & Bruno, 2006):

- non-executive directors must be selected for precise terms of office;
- non-executive directors should be independent of management;
- service contracts must not exceed three years;
- executive remuneration should be shaped by a Remuneration Committee, which consists of mainly or completely non-executive directors only;
- an Audit Committee should be established which must comprise of at least three non-executive directors.

Consequent to the publishing of the Cadbury Report and Code of Best Practice, the London Stock Exchange instituted a requisite into the Listing Rules, that all companies submit a report of compliance or non-compliance with the provisions in annual reports.

3.6.3 1994: King 1

Corporate governance in South Africa was authoritatively commenced following the publication of the King Report on Corporate Governance (King 1) in November 1994. the King Committee on Corporate Governance was created in 1992 with former High Court Judge, Mervyn E. King as chairman. The assignment was undertaken with the support of the Institute of Directors (IOD) of South Africa in order to deliberate the issue of corporate governance, in line with the rest of the world.

Although at the time South Africa had seen its fair share of corporate failures, the undertaking was not prompted as a result of this; it was due to concerns regarding the competitiveness of the South African private sector consequent to the reenrolment of the country into the global economy (Armstrong *et al*, 2005). The end of the apartheid era and the commencement of democracy brought hope to many; however it also resulted in many challenges. Corporate governance was acknowledged as crucial to the well-being and revitalisation of South Africa's capital markets as well as to the possibility of a commercial economy (Malherbe & Segal, 2001). Corporate governance would be critical in augmenting the international investor's confidence in the new democracy.

King 1 was innovative as it inquired past the financial and regulatory outlooks of corporate governance and encouraged an integrated methodology to good governance concerning a wide range of stakeholders[114], whilst looking at the triple bottom line. This move formalised the requirement that companies acknowledge that they do not operate outside of the societies and environments in which they do business.

The King Committee's task was more extensive than that of the Cadbury Code as it also included a Code of Ethical Practice for business enterprises in South Africa. Further, the undertaking was complicated as the special circumstances abound in South Africa had to be considered, especially those of previously disadvantaged communities (King 1, 1994). This only exemplifies the monumental task which was performed. It was thus decided that five task groups would be created which would explore five aspects of corporate governance (King 1, 1994):

[114] Corporate governance is slowly moving away from the Shareholder Perspective toward the Stakeholder Perspective. In a sense this looks at whose interests the board of directors is aiming to achieve as well as who the directors are ultimately accountable to. The Shareholder Perspective states that a company aims to maximise shareholder wealth. Shareholder value is satisfactory in the maintenance of investor confidence. The residual risk holders are seen to be the shareholders alone; therefore directors are ultimately accountable to shareholders (Kochan & Rubinstein, 2000). The Stakeholder Perspective states that the aim of a company is to satisfy numerous goals of all those involved with or affected by the company's on-goings. The company's undertakings should be aimed at preserving the allegiance of multiple stakeholders. All stakeholders are seen to be the residual risk holders; therefore directors are accountable to all (Ayuso & Argandona, 2007). Some examples of 'stakeholders' are: employees, creditors, government and trade unions. Although the stakeholder approach is noble in premise, it is often extremely difficult to execute in practice. It is often said that in the board of directors being accountable to all they are in fact accountable to none.

- Director task group: approached the responsibilities of executive and non-executive directors as well as the availability of information to stakeholders.
- Audit task group: inquired into the role of auditors, remuneration and nomination committees and the interim report.
- Stakeholder Links task group: explored the relation between numerous stakeholders.
- Ethics task group: developed a Code of Conduct which established the ethical practices in business undertakings.
- Compliance task group: examined the issue of acceptance and implementation by all parties concerned of the recommendations.

The main purpose of King 1 is to promote the highest standards of corporate governance in South Africa. The Code was accepted worldwide as a groundbreaking achievement towards good corporate governance practices.

3.6.4 1997: Asian financial crisis

The East Asian currency crisis occurred round about July of 1997 during which time the supply of capital from foreign investors ceased. This led to major liquidity setbacks in Asian capital markets, which had a negative impact on local economies as a result of inadequate capital and investor nervousness (Cheung & Chan, 2004). The crisis is thought to have commenced in Thailand as a result of the financial breakdown of the Thai Baht and then spread to the rest of East Asia. South Korea and Indonesia were also seriously affected, whilst Hong Kong, Malaysia, Laos and the Philippines were also substantially impacted. India, Taiwan, Singapore and Vietnam were also involved but to a lesser extent, whilst Japan had already been suffering from an economic downturn.

According to a study performed at country level, there is evidence that frail legal institutions for corporate governance were the fundamental reason in aggravating the stock market downturns during the Asian financial crisis (Johnson *et al*, 2000). Weaker investor protection leads to greater susceptibility to events which deteriorate investor confidence.

In 1998 the Symposium – Corporate Governance in APEC: Rebuilding Asian Growth – was held in Australia in order to put forward propositions regarding corporate governance in Asia. It was agreed the one of the most influential determinants of the vulnerability of Asia's corporate and financial sectors was a deficiency of sound corporate governance. Most of the insufficiencies were that of a lack of disclosure and accountability standards in banks and companies. Some of these included poor accounting and auditing standards, weak regulatory processes for shareholder protection and faint risk assessment practices (APEC Symposium, 1998).

The Asian financial crisis did however have the positive effect of improving corporate governance standards in the region. Asian corporate governance codes and standards would soon be created:

- Corporate Governance Principles: A Japanese View (1997)
- SET Code of Best Practice for Directors of Listed Companies (1998) in Thailand
- Desirable Corporate Governance in India – A Code (1998)
- Code of Best Practice (1999) in Hong Kong
- Code of Best Practice for Corporate Governance (1999) in South Korea
- Code for Good Corporate Governance (2000) in Indonesia
- Malaysian Code on Corporate Governance (2000)
- ICD Code of Proper Practices for Directors (2000) in the Philippines
- Code of Corporate Governance (2001) in Singapore
- Taiwan corporate Governance Best-Practice Principles (2002)

3.6.5 1999: CACG Guidelines

The Commonwealth Association for Corporate Governance (CACG) was created in 1998 as a reaction to the Edinburgh Declaration of the Commonwealth Heads of Government meeting in 1997. The scope of this meeting was to promote excellence in corporate governance in the Commonwealth. The CACG was established with two principal aspirations in mind:

- To encourage good standards of corporate governance and business systems throughout the Commonwealth;
- To assist the advancement of organisations which will be able to progress, teach and distribute such standards.

The first edition of the CACG Guidelines was introduced at the International Corporate Governance Symposium, which was held in Johannesburg, South Africa. It was stated that regulatory barricades between national economies have been lessened and global competition for capital has increased; investment capital will only stream towards countries that have implemented efficient corporate governance standards. The standards have to include investor protection, satisfactory board practices and accounting standards. Corporate governance is important as it will ensure the Commonwealth's: profitability, competitiveness, stability, relations with global players and relations with stakeholders.

The CACG Guidelines are there to ease best business practice in both the public and private sectors. The guidelines are neither compulsory nor rigid and are designed to have the ability to evolve. That is in order to ensure that the Guidelines remain flexible and responsive to progress in the global environment.

The Guidelines were aimed at boards of directors as it was stated that it is the responsibility of the company directors to guarantee good corporate governance. There must be a relationship between the board, management, shareholders and other stakeholders. The board of directors is said to be accountable to shareholders and responsible for relations with company stakeholders. The fifteen CACG Guidelines are as follows:

- Leadership: the board must exercise leadership in directing the company whilst ensuring transparency, accountability and responsibility.
- Board appointments: the board must ensure an efficient process for board selection which selects directors that add value to the company.
- Strategy and values: the board must establish the company's values and purpose, as well as to ensure implementation.

- Company performance: the board must monitor and evaluate the company’s strategy, policy and management performance.
- Compliance: the board must ensure the company’s compliance with applicable laws, regulations and rules of best business practice.
- Communication: the board must ensure efficient communication between the company, shareholders and stakeholders.
- Accountability to shareholders: the board must make certain that the lawful interests of the shareholders are provided for.
- Relationships with stakeholders: the board must make certain that the company’s stakeholders are acknowledged and resolve establish fruitful relationships.
- Balance of powers: the board must ensure that no individual or group has complete power; this may be accomplished by separating the roles of CEO and chairman and providing a mix of executive and non-executive directors.
- Internal procedures: the board should consistently reassess internal processes as well as the systems of financial reporting and control.
- Board performance assessment: the board should repeatedly consider its performance as well as that of individual directors including the CEO.
- Management appointments and development: the board should appoint a CEO and take part in appointment of management, as well as training and development.
- Technology: the board should ensure that the technology used by the company is up to date in order for the organisation to remain a healthy competitor.
- Risk management: the board must ascertain crucial risk areas and performance indicators and monitor these aspects.
- Annual review of future solvency: the board must ensure annually that the company will remain a going concern in the following fiscal year.

3.6.6 1999/2004: OECD Principles of Corporate Governance

The Organisation for Economic Co-operation and Development (OECD) Council met at Ministerial level during April 1998 in order to request that the OECD, together with national governments, relevant international organisations and the private sector; create a set of corporate governance standards and guidelines.

The Principles were created in order to support member and non-member states in the evaluation and improvement of the legal, institutional and regulatory structure for corporate governance in their countries. The Principles may also be utilised by stock exchanges, investors, companies, and others that are interested in developing good corporate governance.

It is acknowledged by the OECD that there is no single model of good corporate governance. However the OECD isolated certain factors worldwide which inspire good corporate governance. The Principles were developed using these common elements and are improved upon to encompass the various models that exist. The OECD Principles are non-binding and are not prescriptive; their rationale is to operate as a basic reference point. The Principles are also meant to evolve and adapt to an ever-changing world which will ensure innovation in the field of corporate governance (OECD Principles of Corporate Governance, 1999).

The OECD Principles were published in 1999, however they were revised and a new report was published in 2004. The revision was performed in order to consider the later developments and new knowledge in OECD member and non-member states. It was agreed that policymakers were more conscious of the positive contribution that good corporate governance makes to financial market stability, investment as well as economic growth. Companies were also more aware of the manner in which good corporate governance factors in their competitiveness (OECD Principles of Corporate Governance, 2004).

The following is a summary of the OECD Principles (2004) which encompasses the first version:

- Ensuring the Basis for an Effective Corporate Governance Framework: the corporate governance system must encourage transparent and efficient markets. There must be consistence with relevant laws and a statement must be made regarding the separation of responsibilities among supervisory, regulatory and enforcement powers.

- The Rights of Shareholders and Key Ownership Functions: the corporate governance system must protect as well as assist the application of shareholders' rights. This should cover basic rights such as shareholders' registration as well as a right to take part in decisions regarding major corporate change. Effective shareholder participation must be ensured at general meetings.
- The Equitable Treatment of Shareholders: the corporate governance structure must make certain the equitable treatment of all shareholders, which includes minority and foreign shareholders. Effectual rectification must be easily accessible in the event that a shareholder suffers from a violation of rights. Insider trading and self-dealing must be forbidden; this may be facilitated by allowing members of the board to specify when any self interest may arise regarding a company transaction.
- The Role of Stakeholders in Corporate Governance: the corporate governance framework must acknowledge the rights of stakeholders which may be instituted by law or by means of mutual agreements. There must be a committed co-operation between companies and stakeholders in order to create wealth, jobs, as well as providing the going concern of enterprises. Stakeholders should be provided with effective compensation in the event of an infringement of their rights.
- Disclosure and Transparency: the corporate governance structure must provide for precise and timely disclosure regarding information relating to the company. This includes finances, functioning, ownership, as well as the governance of the company. Accounting and auditing are of utmost importance here.
- Responsibilities of the Board: the corporate governance system must ensure the strategic direction of the company as well as the successful monitoring of management by the board of directors. In turn, the board must be accountable to the company and the shareholders. The board must only take informed decisions, in good faith, with due diligence and care, and with the best interests of the company and shareholders in mind. The board must also employ objective independent judgement regarding company affairs.

3.6.7 1999/2005: ICGN Principles

The International Corporate Governance Network (ICGN) was established in 1995 as a result of interest from institutional investors, companies, financial intermediaries, academics and others concerned with the advancement of global corporate governance practices. It is the objective of the ICGN to encourage conversation between international investors, as well as to facilitate a contribution to corporate governance by owners of companies.

The ICGN endorsed the OECD Principles and stated that it is respectable record of minimum acceptable standards for investors and companies worldwide. However the ICGN considered it necessary that the OECD Principles have some augmentation in order to give them weight. It seemed that companies and investors required assistance on the implementation of the OECD Principles. The ICGN therefore encourages companies to implement the OECD Principles as magnified in the ICGN Statement on Global Corporate Governance Principles (1999 – revised in 2005). The most significant points on the OECD Principles are extracted and condensed in order to provide greater guidance to the interested parties. Many of the Principles have also been added to by the ICGN.

In 2005 the ICGN Statement on Global Corporate Governance Principles (Revised) was published. The revision was an indication of the OECD Principles (2005) review, as well as new principles developed by the ICGN. The ICGN revision supports the OECD Principles (2005) and once again adds additional principles of corporate governance.

The following is a summary of the ICGN (2005) Principles:

- Corporate Objective-Shareholder Returns: the overall objective of the company is to optimise shareholder returns in the long term. This may be achieved by ensuring the long term prosperity of the business by implementing an appropriate strategy.

- Disclosure and Transparency: companies must reveal relevant information on a timely basis in order for investors to make knowledgeable decisions. The company must also disclose issues regarding ownership and voting rights. These include risk factors and corporate governance issues. The flow of information must be guaranteed by the board of directors.
- Audit: the ICGN supports the progression of superior accounting and financial reporting standards. It is also recommended that worldwide accounting and auditing practices be harmonised in order to have comparable attributes. Annual audits must also be carried out on behalf of shareowners and the audit must be undertaken by external and independent auditors. These auditors must be selected by the Audit Committee of the board and approved by the shareholders. The board of directors is then required to approve the Audit.
- Shareholders' Ownership, Responsibilities, and Voting Rights and Remedies: as in the OECD Principles, shareowners must be facilitated with the means to exercise ownership rights, as well as to be granted protection and access to vote. Shareholders also have the right to partake in major corporate governance changes regarding the company. Remedies must be available and easily accessible to shareholders in the event of an infringement of their rights.
- Corporate Boards: in line with international codes of corporate governance, the ICGN Principles endorse all types of board structures, as long as governance rules are adhered to. The code specifies director's duties such as monitoring of management and oversight of financial statements (director's duties are discussed later on). Directors should possess certain competencies regarding skills and knowledge in order to properly carry out their duties to the company and shareholders. Board evaluation and independence are also advocated.
- Corporate Remuneration Policies: it is vital that remuneration is aligned with the interests of shareholders.
- Corporate Citizenship, Stakeholder Relations and the Ethical Conduct of Business: the board of directors is accountable to shareholders and is responsible for the active management of relations with stakeholders. Companies have the responsibility to comply with all relevant laws and regulations in the course of their business. The board of directors is responsible for upholding, application and the establishment of a culture of

integrity. Companies must implement a code of conduct in order to assure corporate social responsibility and to embrace the concept of the triple bottom line.

- Corporate Governance Implementation: companies must ensure that there is compliance with and disclosure regarding corporate governance codes and systems. It is necessary to disclose which corporate governance code is applicable, whether there is compliance, and in the event of non-compliance, the reasons for not doing so. Should governance issues arise between the board of directors, shareholders and management, these should immediately be dealt with through negotiation, mediation or arbitration.

3.6.8 2000: Euroshareholders Corporate Governance Guidelines

The European Shareholders Group (Euroshareholders) is a confederation of European shareholders associations. The confederation was established in 1990 and its headquarters are in Brussels. The establishment's mission is to stand for the interests of individual shareholders in the European Union (EU). The primary purposes are:

- The facilitation of harmonisation throughout the EU on topics such as minority shareholder protection, transparency of the capital markets and cross-border proxy voting.
- The development of shareholder value in European companies.
- The reinforcement of corporate governance issues in the EU.

The Euroshareholders Guidelines are based on the OECD Principles (1999), however they are more particular and comprehensive. The Guidelines are meant to provide for the specific requirement of the EU. The following is a summary of the Recommendations contained in the Euroshareholders Guidelines (2000):

Objectives:

- The central aim of a company is to maximise shareholder wealth in the long term. The company's should state their financial objectives and strategy in the annual report.

Influence of the Shareholders/Voting Rights

- Resolutions which have an elementary consequence on the nature, size, structure and risk profile of the company, as well as those which change the corporate position of shareholders must be subject to shareholder approval.

Takeovers and Defensive Measures

- If an anti-takeover or defensive measure limit, the influence of shareholders on the company it should be evaded.
- Mergers and takeovers must be regulated and compliance must be supervised.
- There should be a landmark (threshold) regarding the stake which a shareholder holds in a company; in the event that the limit is exceeded the said shareholder must be obligated to provide an offer for the remaining shares.

Right to Information

- It is the company's duty to information instantly regarding an influence on share prices, as well as information relating to shareholders that pass a 5% threshold.
- The auditors of a company must be independent and should be elected at general meetings.
- Shareholders must have the ability to add entries to the programme of the AGM.
- Shareholders must be supplied with price-sensitive information via regular as well as electronic means.

Role of the Board(s)

- Shareholders have the right to nominate members of minimum one board, as well as the ability to file for dismissal. Shareholders also have the ability to offer suggestions regarding applicant members to the board.
- Non-executive directors should have a limit on the membership of a board of twelve years.
- At any time, a maximum of one non-executive board member may have served as an executive board member of the company.

3.6.9 2000: The Combined Code

The UK Committee on Corporate governance aimed to construct a set of principles and code which was comprised of the Cadbury and Greenbury codes, as well as the Committee's own input. The London Stock Exchange also had contributions to make in the form of alterations and consultation.

The Combined Code in the first part of its report will require the company to describe on the manner in which it applies the principles of the Code. Companies have the freedom to decide on how the report will be laid out in order to explicate their principles of corporate governance. It is in the interests of the shareholders to appraise this section of the company report. In the second part of the report by the company will have to verify that it compliance with the Code or provide an explanation in the case of non-compliance. Companies must be able to explain digressions from best practice. Those who evaluate the company's report must keep in mind the special circumstance of the entity in question.

It must be borne in mind that the Combined Code is not intended to deviate from the Cadbury and Greenbury reports; the aim is to supplement the previous work and combine them.

Section 1 of the Combined Code holds the corporate governance principles as well as code provisions relevant to all listed companies incorporated in the UK. Section 2 holds principles and code stipulations related to institutional shareholders regarding voting, communication with the company and appraisal of the company's governance structures.

The following is a summary of Section 1 regarding the board of directors (Combined Code, 2000):

- The company should contain a board which must control and lead the entity.
- The office of the CEO and Chairman should be held by different individuals.
- The board must contain a balance of executive and non-executive directors.
- Information must be available to the board promptly in order to make appropriate decisions.
- A formal and transparent system must be available for appointments on the board.
- Directors must be present for re-election at a minimum of three year periods.

3.6.10 2002: King 2

Since the inception of King 1 in 1994 numerous changes occurred in South Africa. Two democratic elections had been held and a third was soon underway; South Africa was now a fully-fledged member of the international community. A revision of South African corporate governance was essential. There was domestic and international pressure for the update: international pressure came from the constantly upgraded worldwide corporate codes which have already been discussed, as well as from institutional investors. Institutional investors act on behalf of others and pool resources together in order to invest funds. In the US alone institutional investor assets increased 144% from 1990 to 1998; $6.3-$15 trillion (Monks & Minow, 2008). Corporate governance is therefore of utmost importance with respect to institutional investors such as banks, mutual funds, insurance companies and pension plans. Domestic pressure came from the fact that the South African society was changing and an African renaissance was underway (Rossouw *et al*, 2002).

The review was based upon four principal Guiding Principles:

- the review of King1 and the evaluation of its prevalence against international and local developments;
- the reconsideration and elucidation of the 'inclusive approach'[115] proposed in Kind 1 regarding the sustainable success of companies;
- to acknowledge the escalating significance of non-financial issues worldwide, as well as to consider and recommend reporting on social and ethical accounting, auditing and reporting. Issues such as safety, health and the environment must also be considered; and
- to advocate on the compliance with a new Code of Corporate Governance for South Africa may be measured and based on outcomes. A 'balanced scorecard'[116] method must be adopted for reporting.

Task teams were once again appointed; however this time their scope was to review specified areas of corporate governance. The task teams selected were the following (King 2, 2002):

- Boards and Directors task team: considered matters regarding board practice, the status and responsibilities of executive, non-executive and independent directors, as well as executive and non-executive director remuneration. The 'Business Judgement Rule' was also looked into.
- Accounting and Auditing task team: deliberated the advancements in auditing and non-audit practices, accounting standards in South Africa in comparison to international standards, and auditor skills required.
- Internal Audit, Control and Risk Management task team: reconsidered the task and purpose of internal audit, as well as that of the internal auditor with international standards kept in mind. Risk management was also considered as a factor for boards and companies with respect to risk management.

[115] The Inclusive Approach refers to the acknowledgement of stakeholders (including community, customers, employees and suppliers) as important in the development of the company's strategy.

[116] The Balanced Scorecard is a strategic management tactic created by Dr. Kaplan of the Harvard Business School and Dr. Norton. The model involves four standpoints from which to view an organisation: financial, customer, learning and growth, and internal business process (JISC INFONET).

- Integrated Sustainability Reporting task team: dealt with areas of reporting regarding issues which were non-financial. Some examples are stakeholder partaking in ethics and ethical reporting, as well as social issues such as black economic empowerment.
- Compliance and Enforcement task team: deliberated the supervision and enforcement of statutory and regulatory codes and legislation already in existence in South Africa. This was done in order to recommend on how to develop observance of such governance guidelines.

Public listed companies in South Africa have to produce an annual compliance certificate and submit it to the JSE. This is a statement that the company will conform to the listing requirements of the JSE. Directors themselves have to individually state that they will carry out their duties towards the company and comply with the listing requirements of the JSE. This adds more potential liability to the company directors. Directors have many duties with regards the JSE requirements which include issues of financial statements, press releases and company dividends among others (Mammatt *et al*, 2004). It is beyond the scope of this dissertation to study the JSE requirements; however more information on this topic may be obtained from the JSE website: www.jse.co.za.

3.6.11 2002: Principles of Corporate Governance – United States

In the US the Business Roundtable is an association of chief executive officers of leading companies which has overtime produced numerous papers on corporate governance. Some of these include: Statement on Corporate Governance (1997), Executive Compensation/Share Ownership (1992), Corporate Governance and American Competitiveness (1990), Statement on Corporate Responsibility (1981), and The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation (1978).

Due to the ever increasing character of change, innovation and progress in the US and worldwide, the Roundtable decided to restate its guiding principles on corporate governance. The following is a summary of these corporate governance principles:

- The primary duty of the board is to choose the CEO and supervise the ethical business of the company regarding senior management and the CEO.
- Management has the responsibility to conduct the business of the company in an ethical manner in order to maximise shareholder value. Management must also be aware of the company's risks as well as where income is derived from. A conflict of interest must never be allowed to arise between management and the company.
- Management holds the responsibility under the supervision of the board and the audit committee to ensure that accurate and timely financial statements are produced in order for shareowners to make informed business decisions.
- The board of directors and audit committee have the responsibility to appoint an independent accounting company to audit the financial statements produced by management. The independence of the auditor must never be compromised.
- The accounting firm bears the responsibility to ensure that it is independent, with no conflicts of interest, and that it employs competent staff. The independent accounting firm also bears the responsibility to inform the board of directors, via the audit committee, of any faults in the company's accounting systems and weaknesses in internal controls.
- The company bears the responsibility of interacting with its employees in a fair and equitable manner.

The Principles of Corporate Governance (2002) looked at the role and function of the board of directors and management, as well as the company's relationship with shareholders and stakeholders.

3.6.12 2002: US Corporate Scandals and the Sarbanes-Oxley Act

In July, 2002 the President of the US, George W. Bush, signed the Sarbanes-Oxley Act also referred to as the Public Company Accounting Reform and Investor Protection Act (SOX). It is often stated that SOX was a response to numerous corporate and accounting scandals that occurred in the US between 2001 and 2002; this is predominantly correct. However the Act was not swiftly pieced together in order to create a fast reaction; to the contrary the provisions had been deliberated by the Senate and Congressional committees for a number of years (Monks & Minow, 2008). The Act in question would be the most considerable piece of federal legislation regarding public companies in the US since that which created the Securities Exchange Commission (SEC) consequent to the 1929 stock market crash[117]. The focus of SOX is on penalties due to breach, and disclosure of financial and corporate governance information.

Prior to a brief explication and summary of SOX it is essential to describe some of the more significant corporate scandals which occurred ahead of the inception of the Act. Those considered for discussion are Enron, Tyco and Worldcom, however others did occur such as Adelphia and Peregrine Systems.

Enron:

The origins of Enron may be traced as far back as the formation of Northern Natural Gas Company in 1932. However the actual company was founded by Mr. L in 1985 through the merger of Houston Natural Gas and Internorth. These were natural gas pipeline companies. The company would transport gas from producers to buyers. Enron possessed the biggest network of interstate pipelines. The company sought further expansion and diversified. Enron became a trader of electricity, coal, steel, paper and pulp, water, and broadband fibre optic facilities (Healy & Palepu, 2003). The company would become an international conglomerate trading its products and services in financial markets. From 1990 until 1998 Enron's stock increased by 311%.

Due to the intricate nature of Enron's business the company took advantage of certain accounting limitations in order to portray an unrealistic impression of its financial results. This was easily done as the contracts Enron was involved in were long term and current accounting regulations use the present value structure in order to portray business transactions (Healy & Palepu, 2003). Management therefore utilised a system known as mark-to-market accounting in order to forecast future earnings. The

[117] The SEC was created by Section 4 of the Securities Exchange Act of 1934.

primary reason for all the hidden losses at Enron was the fact that beyond natural gas, the company's business endeavours were largely unsuccessful.

Enron's losses remained hidden for so long due to poor corporate governance structures within the company. There was a lack of transparency and oversight which was fuelled by the negligence of the company's auditors, Arthur Andersen. In October 2001 Arthur Anderson initiated the shredding of documents concerning Enron and by December that year Enron filled for bankruptcy (Healy & Palepu, 2003). Mr. S, CEO of Enron, was sentenced to twenty-four years in prison. The corporate governance and legal infringements were so extreme that Mr. S stated in court (unconvincingly) that he had no knowledge of the corporate scandal which brought Enron to its knees. When the Enron stock price was at its peak of $90, the executives who were aware of the fraud which was taking place began to secretly sell their shares; whilst convincing other shareholders that the price would continue to increase. On the 28 of November 2001 news of Enron's losses reached the public and stock prices dropped to below $1 almost immediately.

Tyco:

Tyco International Ltd. was created as Tyco Inc. in 1960 as an investment and holding company. The main aim was the funding of research for inventors and private sector experiments. The company grew rapidly and in 1972 it listed on the New York Stock Exchange (NYSE). In the 1980's Tyco continued to grow through acquisitions – business ranged from medical supplies to electrical components (Monks & Minow, 2008). The 1990's saw the arrival of a new CEO, Mr. K, who managed to increase the size of the company considerably by utilising aggressive acquisition policies.

However the exponential increase in the size of the company saw its corporate governance standards decline. Monitoring of management decreased and the systems were non-transparent (Monks & Minow, 2008). It would later come to light that the former CEO and chairman, Mr. K, as well as the former CFO stole $600 000 000 from the company. In 2005 both men were found guilty on thirty counts, which carried a prison sentence of twenty-five years.

Worldcom:

Following the corporate scandals such as Enron and Tyco, the Sarbanes Bill would look to make considerable modifications to the operations of auditors, boards of directors and security analysts. However due to great opposition to the Bill, in 2002 it seemed it would not be passed as legislation. The situation changed when the Worldcom scandal became public (Monks & Minow, 2008).

Worldcom was the second biggest long-distance telephone company in the US, behind AT&T. The enlargement of the company was augmented by the acquisition of another telecommunications company named MCI Communications. In June 2002, a statement was made that Worldcom had exploited $3.8 – billion expenses by 'turning' them into assets. Other expenses had been paid by using resources from reserve accounts, which had the effect of falsely increasing the company's income.

Mr. E, the CEO of Worldcom had convinced the board of directors to provide him with massive personal loans, which he used in a failed attempt to hide the company's losses. Mr. E was convicted of conspiracy, fraud, as well as the falsification of documents intended for the SEC and sentenced to twenty-five years in prison. Worldcom's CFO pleaded guilty to conspiracy, fraud and the preparation of false statements in order to conceal the company's losses. By the end of 2003 investigators were lead to believe that Worldcom's assets had been inflated by $12 – billion.

Sarbanes-Oxley:

The passing of SOX saw the creation of the American Institute of Certified Public Accountants whose members are appointed by the SEC. The following is a summary of the organisation's primary functions (Monks & Minow, 2008):

- Registration and inspection of public accounting companies.
- Setting report standards relating to auditing, ethics, independence, and quality control.

- Carrying out investigations and proceedings on public accounting companies in the event of suspected malpractice.

The following is a brief summary of the most relevant sections of SOX (SoxLaw.com):

Section 302 (Title 3): Corporate Responsibility for Financial Reports

Statutory financial reports must contain certifications that:

- Signatory officers have reviewed the report.
- No material untrue statements or omissions are contained in the report.
- The financial statements represent the true financial condition of the company.
- Signatory officers have reviewed the internal controls of the company.

Section 401 (Title 4): Disclosures in Periodic Reports

- Financial statements may not contain incorrect information
- Financial statements must include off-balance sheet liabilities and transactions.

Section 404 (Title 4): Management Assessment of Internal Controls

- Annual reports must contain a statement on the adequacy of the company's internal control structure and system regarding financial reporting.
- The statement must consider the efficiency of the internal controls and systems.
- The registered accounting company must certify the mentioned statement.

Section 409 (Title 4): Real Time Issuer Disclosures

- The company must immediately reveal information pertaining to alterations in financial stance or operations.
- The information must be simplified and presented graphically hwere appropriate.

Section 802 (Title 8): Criminal Penalties for Altering Documents

- Penalties, fines and/or up to twenty years imprisonment are imposed for the alteration or destruction of documents with the intent to obstruct, impede or influence a legal investigation.

3.6.13 2009: King 3

In March 2009 the Draft Code of Governance Principles for South Africa by the King Committee on Governance was released for public comment. This is the much anticipated Third King Report which will be used in South Africa. The Draft Report states that the new King Code was a necessity as a result of the new South African Companies Act, as well as the international transformations in corporate governance tendencies. Some of the included international trends are: alternate dispute resolution, risk-based internal audit, IT governance, shareholders and remuneration, and evaluation. The King 3 Report will be applied from March 2010, up until which time King 2 will continue to be employed.

The Report emphasises the fact that the South African Corporate Governance Codes do not follow the US trend of the Sarbanes-Oxley Act; that is a 'comply or else' system.[118] This means that non-compliance would lead to legal action. The Report states that the US system leads to a waste of time and cost for companies. This is due to the time-consuming procedures as well as the expenses involved in carrying out the requirements of the Sarbanes-Oxley Act. The board of directors is charged with the responsibility of compliance which ultimately takes away from the company's main aspiration of performance.

It is for this reason, amongst others, that South Africa will use a 'apply or explain' system; in other words companies and their boards of directors will have to explicate why they did not utilise with King 3 in the event that they do not. This removes the

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[118] King Committee on Governance: Draft Code of Governance Principles for South Africa, p. 7.

pressure of possible burdensome sanctions which may cripple company operations. The ultimate objective should be that the best interests of the company are given the most importance; should this be done without compliance (and to the detriment of no other), it is believed that that should be good enough. One must bear in mind that although South Africa does not apply a 'comply or else' style approach, corporate governance is beginning to be legislated as in the new Companies Act; therefore legal sanctions could eventually become a reality.

The main principles applied to the King 3 report are:[119]

- Leadership;
- Sustainability;
- Innovation, fairness and collaboration;
- Integrating sustainability and social transformation; and
- Renewal of sustainability reporting.

The importance of the role of the board of directors with regards to corporate governance is emphasised by the fact that Chapter One is entitled 'Boards and Directors'. It is not the aim of this dissertation to discuss the King 3 Draft in great detail however the following is a brief summary of the 'Role and function of the board' as described in Chapter One:

- The board should be the central mechanism for corporate governance. This should be accomplished by managing relationships between the board itself, the company and all the relevant stakeholders. The endurance and success of the company should be a key concern for the board. Stakeholder involvement in the company must be a reality.
- The company must come across as a responsible corporate citizen. This has been discussed in the dissertation with respect to corporate social responsibility, which is increasing in importance worldwide in terms of company governance. Therefore the environment in which the company operates must be or concern.

[119] King Committee on Governance: Draft Code of Governance Principles for South Africa, p. 13.

- The board is responsible for the creation and continuation of an ethical corporate culture. The board must ensure that it demonstrates a support for good ethical behaviour within the company.
- The board must be involved in the creation and implementation of the company's strategy. This must be integrated with the reality of risk which the company faces. Finally the board is required to ensure the sustainability of the company's success.
- Further to sustainability, this must be regarded as a business prospect; the company is no longer there only for the benefit of shareholders. The triple bottom line of social, economic and environmental performance must be taken into account.
- The board is required to appoint a CEO as well as to set up structures for delegation of authority.
- The board is responsible for the risk management procedures of the company. This involves the setting of the company's risk appetite, overseeing the risk management procedure, as well as setting up a risk committee when necessary to do so.
- The board must act in the best interests of the company. This involves both the common law duties of care and skill as well as the fiduciary duty to act in good faith. The Report states that a director could be held personally liable for monetary damages incurred by the company as a result of the director's failure to uphold common law duties. This must be governed by the new Companies Act according to the Report.
- The board as well as the directors must manage conflicts of interest. No personal interests may ever be regarded as move valuable than that of the company.
- The board must ensure that a risk-based internal audit is in place.
- The board must ensure that financial reporting is carried out in a reliable and honest manner.
- The board must report on the usefulness of the internal financial controls.
- The board must ensure that full disclosure is made in a timely manner of relevant fact with regards to the company. This involves transparency between the board and relevant stakeholders.

- The board must ensure the efficient and successful resolution of internal and external disputes.
- The board must ensure that the company has procedures in place with regards to compliance with relevant laws and regulations.
- It is the duty of the board to ensure that business rescue proceedings are taken up as soon as the company is distressed. Business rescue is discussed in further detail in Chapter 4 of the dissertation.

It will be interesting to see how the King 3 Code will apply in conjunction with the new Companies Act, which are both due to be passed in 2010. These two measures of regulation were created to apply in conjunction with one another, however it remains to be seen whether or not the two mitigating steps will actually contain director liability.

3.7 Conclusion

Corporate governance has existed since the separation of ownership (shareholders) and control (management) of companies. It was thus necessary to introduce the board of directors in order to oversee the relationship between the company, shareholders and management. Interest in corporate governance increased in the US and UK due to certain corporate failures which led to the Treadway and Cadbury Codes being published. For nearly two decades since, corporate governance has increased in importance worldwide. This has been as a result of:

- Institutional investors have demanded high corporate governance standards due to the large quantities of funds which are invested on behalf of others. This is apparent as some institutions have created their own corporate governance standards as benchmarks for investment (CACG Guidelines, 1999).
- The importance of all stakeholders has increased to some extent; some corporate governance codes imply possible director liability towards all stakeholders. Thus principles of corporate governance have widened to include stakeholders (stakeholder theory).

- In South Africa the transition from apartheid to democracy has increased the need for sound corporate governance principles in order for South African companies to compete on a global level for investor funding.
- There has been an ongoing series of corporate governance failures and scandals worldwide, which have continued to persist. Corporate governance has increasingly attempted to hold boards of directors more accountable and to recommend governance systems, which support transparency and accountability. Such has been the case that many states are now codifying director's duties and liabilities within company legislation. This is the case of South Africa regarding the Companies Bill.

It is important to remember that without reliable corporate governance standards, a country stands the chance of watching investor funds surge elsewhere. It is the board of directors that are responsible and accountable for the implementation of company legislation and governance standards. Directors are therefore faced with a parallel increase in responsibility and liability.

It seems evident that the question, of whether or not the various corporate governance codes have been successful in containing claims against directors, answers itself. The answer unfortunately is that it has not contained director liability. Some of the greatest corporate failures and scandals occurred at the beginning of the 2000s; not only in South Africa (Leisurenet) but also elsewhere – such as Enron in the US. These occurrences took place well into the great tide of corporate governance codes, which had been put in place worldwide throughout the 1990s. It will be shown in chapter five (Directors and Officers Liability Insurance) that the highest claim frequency and severity occurred during the hard market of the early 2000s; this is according to studies performed by the Tillinghast D&O Liability Surveys.

Another self-evident conclusion may be drawn by the fact that corporate governance principles are now being codified by legislation. It will be shown in Chapter Four that an increasing amount of countries have codified directors' duties. A trend has formed under which certain aspects of corporate governance relating to directors are being legislated. This in a sense shows that corporate governance codes have not managed to contain claims against directors, and therefore countries are now turning to statutory law.

A possible explanation for the fact that the codes of practice have not sufficed to contain claims against directors is that they act like a double-edged sword. On the one hand the codes may contain director liability, whilst on the other they place more onerous responsibilities on company directors. A failure to comply with the necessary requirements of the codes leads to a motive for another claim. The amount of publicity which the codes have received has also played a part in informing potential claimants of the reasons why directors are at fault. Thus the corporate governance codes have led to increased expectations of company directors; much of the focus is placed on directors themselves.

There is thus only one link between the codes of corporate governance and the corporate failures which have occurred: there was a hope that the codes of practice would reduce the company failures. The codes of corporate governance have been a response to the corporate governance failures worldwide. Whilst the codes were aimed at reducing corporate failures and therefore reducing director liability – which would in turn reduce claims against company directors – this mitigating step may not have succeeded. Whatever positive impact (on claims against directors) the codes of corporate governance may have had has been outweighed by the *doctrinal* and *complexity* changes, as discussed in Chapter One and Chapter Two respectively.

4 IMPACT OF THE NEW COMPANIES ACT ON DIRECTORS AND OFFICERS LIABILITY

In chapter four one looks at the second mitigating step relating to directors' liability; legislation. It would be impossible to analyse all relevant statute which affects corporate directors and officers. A list of all relevant legislation in South Africa is provided in Appendix 2. This dissertation however is mainly focused on the new South African Companies Act (due to be passed into legislation in 2010).

According to the Professional Liability Underwriting Society (PLUS) Symposium (2008), the following countries have revised their company legislation and related laws which have increased directors' duties and liabilities:

- Ireland, Australia, Israel, Italy, France, Spain, EU Transparency Directive, Mexico, China, UK, Japan, Canada, and the US.

South Africa has followed suite and it will be interesting to see if this second mitigating step works to contain claims against directors. In 2004, the Department of Trade and Industry (dti) South Africa, produced a policy paper, *South African Companies Law for the 21st Century: Guidelines for Corporate Law Reform*, in the Government Gazette, in which the Minister of Trade and Industry stated that the dti decision to "… review and modernise company law in this country was based on the need to bring our law in line with international trends and to reflect and accommodate the changing environment for business, both in South Africa and globally." (dti, 2004: Foreword).

Thus in 2007, the dti put forward the Republic of South Africa Companies Bill (the Bill). The dti consulted with business practitioners, academics, other experts (local and international), as well as the National Economic Development and Labour Council (NEDLAC) and summarised five objectives regarding potential future South African law. These five objectives are:

- Simplification

- Flexibility
- Corporate efficiency: including a clarification of board structures and director responsibilities, duties and liabilities.
- Transparency: including acknowledgment of director accountability.
- Predictable regulation.

Due to the fact that the legislation has not been passed yet, this dissertation will study the Companies Bill and make some assumptions as to what the outcome will be. These assumptions will then be tested in the final chapter by performing a Delphi Technique study as well as a separate study which entails separate interviews with experts in D&O insurance, director liability and corporate governance.

The objective of this chapter is to consider the impact of the new company legislation on corporate directors and officers. This will be carried out by looking at the sections of the Companies Bill which affect directors and officers under Chapter Two (Formation, Administration and Dissolution of Companies), Part F (Governance of companies). The relevant sections will be examined individually.

The new company legislation is a response to the corporate governance failures worldwide, as well as the inability of corporate governance codes to mitigate director liability. Whilst this is aimed at reducing corporate failures and therefore reducing director liability – which would in turn reduce claims against company directors – this mitigating step may also not succeed. Whatever positive impact (on claims against directors) the new legislation might be outweighed by the *doctrinal* and *complexity* changes, as discussed in Chapter One and Chapter Two respectively.

4.1 C67 – First director or directors

A ‘first’ director is the incorporator of the company; thus if more than one person incorporated the company more ‘first’ directors will exist. The first director will be expected to serve as such, until such time that the minimum requisites of the Bill are met, regarding the required amount of directors. The first director may also serve until the Memorandum of Incorporation has first appointed ample directors in accordance with c66 (4)(a)(i) or first elected in accord with c68.

In the event that the sum of the incorporators of the company, the ex officio directors, and the directors to be selected in accord with c66 (4)(a)(i), does not add up to the minimum amount required by the Bill or by the Memorandum of Incorporation, the board of directors will be required to call for a shareholders meeting. This must be done within forty working days of incorporation. The purpose of this shareholders meeting is to elect an adequate number of directors to fill in the vacancies on the board. S208 (2) of the Companies Act states that all the subscribers to the memorandum of a company will be deemed directors until directors are appointed. The Bill does not mention any distinction between the liability of a first director and that of a normal director.

4.2 C68 – Election of directors

The directors of a company must be elected by persons who hold the right to vote at such elections. This is excluding first directors, directors appointed in the Memorandum of Incorporation, and ex officio directors. The elected director will then serve for an indeterminate term or as long as the Memorandum of Incorporation specifies.

The vote must be arranged such that a series of votes is carried out. That is, the persons who have the right to vote will vote for an individual to fill one vacancy. This vote must be performed until the board of directors has an adequate content. Each voting right may only be exercised once and the vacancy is filled if the majority of votes support the nominee. This process is standard unless the Memorandum of Incorporation provides otherwise.

The board of directors has the power to appoint a person temporarily, if that person satisfies the requirements for election, in order to fill a vacancy on the board, until the vacancy is taken up according to an election. This is unless the Memorandum of Incorporation provides otherwise. The person who is serving temporarily possesses all the powers, functions, duties, and liabilities of a normal director of a company. It is important in that case that the temporary director is furnished with adequate D&O cover during the time served.

4.3 C69 – Ineligibility and disqualification of persons to be director or prescribed officer

For the purposes of this section the term 'director' includes an alternate director,[120] prescribed officer, a board committee member, or an audit committee member. It is irrelevant whether or not the person is a part of the company's board of directors.

With regards to this section, if a person is ineligible or disqualified, that person may not be elected or appointed as a director. The person may further not consent to the election or appointment and may not act as a director of the company. The company is prohibited from allowing a person who is ineligible or disqualified from acting or serving as a director. Here it is relevant whether the company had knowledge of the ineligibility or disqualification. It seems that according to the Bill's definition of 'knowledge' if a person ought to know something but does not, he is deemed to have the actual knowledge. Therefore a company must not be negligent in this respect. This definition of knowledge will be looked at further in c78.

Upon ineligibility or disqualification, a person's office as a director is terminated instantaneously. That is unless the board has removed a director in terms of c71 (3) in which case the vacancy does not arise until the later of the two conditions found in c70 (2). If a person is placed under probation by a court in terms of c162 (Application to declare director delinquent or under probation) or s47 of the Close Corporations Act,[121] that person may not serve as a corporate director unless the probation itself stipulates otherwise. The Memorandum of Association may also implement additional bases of ineligibility or disqualification, as well as any minimum standards which must be met by the directors of that company.

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[120] An alternate director is defined in the Bill as a person who is appointed or elected to serve on the board of directors as a replacement for another person who was appointed of elected.
[121] Close Corporations Act, No 69 of 1984

The following are the grounds under which a person is considered ineligible to be a company director:

- if it is a juristic person;
- if the person is an emancipated minor, or under similar legal constraints (these are not specified); and
- in the event that any of the conditions set out in the Memorandum of Incorporation are not met by the person in question.

The following are the grounds under which a person is disqualified from being a company director:

- a court has prohibited the person from being a director;
- a court has proclaimed that the person is delinquent in terms of c162 of the Bill or s47 of the Close Corporations Act;
- the person is an unrehabilitated insolvent;
- the person id disallowed by public regulation from serving on the board of directors of a company;
- in terms of misconduct connected to dishonesty, the person has been stripped of an office of trust; or
- if the person has been convicted, in South Africa or abroad, and imprisoned without the option of a fine, or fined more than the prescribed amount, due to theft, fraud, forgery, perjury, or an offence involving:
  - fraud, misrepresentation or dishonesty;
  - the promotion, formation or management of a company;
  - a person who is disqualified or ineligible to be a director but nevertheless still consents to such an office or still acts as the director of a company;
  - a person who is placed under probation and still takes the office of a director;
  - the Companies Bill, the Close Corporations Act, the Financial Intelligence Centre Act 38 of 2001, the Securities Services Act 36 of

2004, or Chapter 2 of the Prevention and Combating of Corruption Activities Act 12 of 2004.

If a person is disqualified due to removal from a position of trust or as a result of theft, fraud, forgery, perjury, or an offence involving the above statutes, that disqualification will be terminated at the later of either five years subsequent to the removal from office, or on conclusion of the sentence which was handed down. This is unless there has been an extension on recommendation of the Commission. The commission may apply at any time before the termination of the disqualification in order to have it extended; the court may do so with a five year period at a time if it is considered necessary for the wellbeing of the public. The court must take into consideration, the behaviour of the disqualified person at the time in which the application is made.

A person who is disqualified in terms of the above may still be a director of a private company. However this may only be the case if all the shares are held by the disqualified person, or alternatively all the shares are also held by persons related to the disqualified person. Those relatives are required to consent, in writing, their approval for the disqualified person to be a director of the private company.

It is a concern of the Commission to create and sustain a public register of all persons who are disqualified from being a director or on probation.

4.4 C70 – Vacancies on board

When a directorship is terminated a vacancy opens up on the board of a company. The company is required to file a notice within ten business days once a person takes up or vacates the office of a director. This may occur if the term of office has ended, if the Memorandum of Incorporation stated a fixed term which has ended, or if, in case of a first director, a sufficient amount of directors have been elected. A vacancy will also arise on the board of a company in the event that:

- a director resigns or dies;

- an ex officio director concludes the office which entitled him to a position as a director;
- a director no longer resides in South Africa and all other directors of that company live abroad;
- the director becomes incapacitated and is unable to perform the necessary duties of the board;
- a director is confirmed as delinquent by a court or is put on probation. The terms of the probation must make it impossible for the director to perform the required duties;
- a director becomes disqualified or ineligible to serve on the board of a company; or
- a director is removed either by a resolution of the shareholders, by a resolution of the board, or by an order of the court.

In the event that the board itself has removed a director in terms of c71 (3), a vacancy will not arise until the later of either the end of the time allowed for filling an application for review as in c75 (5) or the permission by the court for the order. However the director will nevertheless be suspended from office during that time.

If a vacancy occurs on the board an election must take place at the subsequent annual general meeting if the company is required to hold such. Otherwise within six months consequent to the vacancy at a shareholder's meeting, held for the purpose of an election, or at a poll[122] of persons entitled to vote in such an election. A vacancy on the board may mean that a company is left with no directors, or no directors that reside in South Africa; in this event a person who holds the right to vote in the election of a director may summon a meeting with that purpose as its scope. The court will provide relief in order for the meeting to take place so long as it can be shown that the order will preserve the rights of shareholders and prevent any oppression of such.

[122] According to c60 (3) a director may be elected by a written polling of all shareholders who have the right to exercise voting rights with respect to a director election.

4.5 C71 – Removal of directors

A director of a company may be removed from the board by an ordinary resolution passed at a shareholders meeting. The shareholders who pass the resolution must have the right to vote at the election of the directors. This resolution will have effect even though the Memorandum of Incorporation may stipulate otherwise, or even if an agreement has been reached, between the director to be removed, and the company itself, or other shareholders. The right to remove a director is in supplementary to c162, the application to a court to declare a director delinquent, or the fact that a director may be put on probation. However the director must be given a chance to make a representation to the company regarding the removal from office before a vote can take place. Therefore the director in question must be furnished with a copy of the meeting as well as the resolution.

In the event that a company has more than two directors and there is an allegation by either a director or a shareholder that one of the directors of the company has:

- ineligible, disqualified, or incapacitated;
- decided not to reside in South Africa, and no other director of that company does;
- neglected or abandoned the functions and duties of a director;

the remainder of the board of directors will be required to decide, by resolution, whether or not to remove the director in question from office. Once again the director will first have to be provided with the opportunity to make a representation prior to an actual vote on the resolution. The director must be furnished with a copy of the meeting and the resolution, as well as the reasoning behind the proposed matter.

If the director is removed due to a resolution passed by the board as stated above, the said director has a time space of twenty business days to request a court to review the board's decision. The same applies to a director who voted to have the director in question removed, in the event that the board decided not to remove that director. Any director who had his decision declined may apply to a court to review the decision of the board. The court may then either concur with the board's decision or alternatively remove the director if the requirements for removal have been satisfied. However the applicant director will be liable to the company for the court expenses in the event that the board's decision is not overturned.

If a company has less than three directors, a removal of a director may not be contemplated by a resolution of the board of directors. However a shareholder or director of the company will be allowed to apply to the Companies Ombud[123] in order to remove a director if the requirements are met.

C171 of the Bill does not forbid a director who has been removed from office from application to a court for damages resultant from the loss of office of a director, or any other loss of office which occurred as a result of being removed.

4.6 C74 – Directors acting other than at a meeting

Any decision taken by a director which can be voted on at a board meeting may be implemented by the written consent of a majority of the company directors. This is valid as long as all the directors have been furnished with notice of the matter which is to be decided on. The Memorandum of Incorporation may however specify against this. A decision which has been approved by a majority of directors in writing is considered to be as valid as one which was accepted by a vote at a board meeting.

4.7 C75 – Director's personal financial interests

For the purposes of this section the term 'director' includes an alternate director, prescribed officer, a board committee member, or an audit committee member. It is irrelevant whether or not the person is a part of the company's board of directors.

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[123] Cl193 of the Companies Bill calls for the establishment of a juristic person known as the Companies Ombud. The Companies Ombud will be required to resolve disputes regarding the application of the Bill (if passed into legislation), other dispute resolution, as well as to perform any task assigned to it by the Bill or any other law. This is according to cl195.

According to c75 (3) if a person is the sole director of a company but does not possess all the issued securities of the company, that director may not endorse or bind the company into an agreement, in which he or a related person to him holds a personal financial interest. The director also may not conclude any other business of the company in which he or a person related to him has a personal financial interest. However the director with a personal financial interest in the business of a company may enter into an agreement or make decisions regarding an agreement if such is permitted by an ordinary resolution of the shareholders. The director must first reveal his interest in the matter to the shareholders of the company.

A director should disclose his personal financial interest in any matter to the board or to the shareholders (if that director is the sole director of the company) in writing and in advance. The written notice by the director must explain the nature and extent of his interest.

In the event that a director has a personal financial interest, or is aware that a related person to him has a personal financial interest in a matter, which is being considered by the board of directors, that director is required to:

- reveal his interest as well as the nature of it, prior to deliberation of the matter at the board meeting;
- expose any relevant information which the director has on the matter;
- reveal any other relevant knowledge on the matter which the board may require;
- leave the board meeting consequent to the revelation of a personal financial interest and any relevant information thereof;
- not participate in the matter any further than regarding the revelation of information; and
- not complete any document relating to the matter unless required to do otherwise by the board of directors.

While the director is absent from the board meeting as a result of a personal financial interest in a matter under deliberation, that director is still considered as in attendance in order to establish that enough directors are present, to create a meeting. However the director is then not considered present in order to ascertain whether a resolution has adequate backing.

It is possible that a director, or a person related to a director, may attain a personal financial interest in a matter that has already been accepted by the company. If this is the case, that director must immediately reveal the nature and extent of the interest, as well as how the interest was obtained, to the board of directors or the shareholders (if that director is the sole director of the company).

Any transaction or agreement that is accepted by the board of directors, or the shareholders will be considered legitimate, notwithstanding any personal financial interest of a director, or person related to him. This will only be the case if it was approved in accordance with c75 or it has been ratified by an ordinary resolution of the shareholders.

According to c75 (8) if a director with a personal financial interest in a matter fails to fulfil the conditions of this section, an interested person may apply to a court, to validate a transaction or agreement approved by the board or the shareholders.

C75 is inapplicable to a director if the decision in question affects all the directors of the company or a class of people, unless the members of that class are only directors or persons related to the directors. This section may also not be used in order to remove a director in terms of c71. C75 will not be applicable to a director or a company if one person possesses all the interests of all the issued shares of the company and is the only director of the company.

C75 relates to the South African Companies Act s234 – s240 (Interest of a director in contracts). Regarding s234 – s240, if a director has any significant interest in a contract, which is relevant to the company's business, that director must reveal this interest to the board. If the contract is accepted at a general meeting, the notice assembling the meeting must divulge the mentioned interest. The information unveiled by the director regarding interest in a contract at board meetings must be minuted. This information must also be documented in a register which must be available for examination to the public.

C75 has broadened the scope of s234 – s240 by including 'any' personal financial interest of a director as opposed to an interest in a contract relevant to the company. C75 may be said to prevent the director from reaching a situation where he can breech the fiduciary duty to not have a conflict of interest with the company. S177 of the UK Companies Act states that a director has a duty to declare any interest in a proposed transaction or arrangement. S177 (5) of the UK Companies Act states that a director must still make disclosure of an interests even when he 'ought reasonably to be aware of' an existing interest. That means that a director may not be negligent and not realise that an interest exists in a company matter. Thus an objective test will be applied in the UK by the courts in order to ascertain whether or not a director ought reasonably to have known of an interest in certain company business. This 'negligence' factor has not been provided for in the South African Companies Bill.

4.8 C76 – Standards of directors conduct

For the purposes of this section the term 'director' includes an alternate director, prescribed officer, a board committee member, or an audit committee member. It is irrelevant whether or not the person is a part of the company's board of directors.

According to c76 (2) a director must not utilise his office as such or any information acquired whilst in the capacity of a director to gain an advantage for himself or any other person with the exception of the company. The director must also not knowingly cause harm to the company or any of the company's subsidiaries. These duties are of a fiduciary nature; the director's duty to avoid a conflict of interest necessitates that a director may not use his position in the company to gain any benefit for himself or anyone else besides the company. This is obviously with the exception of directors' remuneration. The fiduciary duty is a negative one which requires that the director must not cause harm to the company.

The Companies Bill's definition of the word 'knowingly' must be taken into consideration; the director must either actually possess knowledge that harm is being caused to the company, or be in a position in which the director reasonably ought to have knowledge. This means that a director may not be negligent regarding the causation of harm to a company.

C76 (2) (b) states that a director must convey any information to the board as soon as possible, unless it is reasonably believed that the information is irrelevant, available to the board, or the public. The director will also not be required to reveal information to the board if he is compelled not to by ethical or legal commitments.

The fiduciary duty to avoid a conflict of interest was always well-established in common law; and the duty not to make a personal gain as a result of the being in the position of a director developed from there. This is evident in cases such as *Cook v Deeks* [1916] 1 AC 554 (PC), *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168, *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378 (HL), and *Industrial Development Consultants Ltd v Cooley* [1972] 1 WLR 443; [1972] 2 All ER 162 among others. The legislators most probably inserted the section which prevents directors from making a personal gain as a result of the directorship, as a precautionary and clarification measure.

The following clause of the Companies Bill is crucial regarding the codification of directors' common law duties. C76 (3) reads as follows:

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

a) in good faith and for a proper purpose;
b) in the best interests of the company; and
c) with the degree of care, skill and diligence that may reasonably be expected of a person –
    i. carrying out the same functions in relation to the company as those carried out by that director; and
    ii. having the general knowledge, skill and experience of that director.

C76 (3) (a) and (b) refer to the directors' fiduciary duty towards the company. The common law duty is now spelt out in the Bill intending to be passed as legislation. A fiduciary is expected to perform his required powers and functions in good faith and for a proper purpose. The director must carry out his functions for the purpose which they were conferred. This is as in the cases *Punt v Symons & Co Ltd* [1903] 2 CH 506, *Piercy v S Mills & Co* [1920] 1 CH 77, *Mears v African Platinum Mines* 1922 WLD 57, and *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] 1 All ER 1126 (PC). According to c76 (3) (b) the director must also act in the best interests of the company, as a fiduciary is expected to perform.

C76 (3) (c) legislates the directors' duty of care, skill and diligence. The international trend toward an objective and subjective standard relating to the test for negligence has been followed. This may be seen in the UK Companies Act of 2006, as well as the Australian Corporations Act of 2001.

C76 (3) (c) (i) sets the objective test as the acts of a director are considered in contrast to the standard of conduct of a notional reasonable diligent person. One would inquire into how a reasonable person would act if that reasonable person is carrying out the duties of the director in question. C76 (3) (c) (ii) sets the subjective standard; the actual knowledge, skill and experience of the director in question is transferred to the notional reasonable person. In other words the notional reasonable person must be part of the same rank as the director in question. Therefore if a director possesses any special or higher knowledge, skill and experience, that director is expected to apply the special attributes in the duties toward the company. In this manner, a director with special skills will be expected to perform according to those attributes. The objective and subjective test entails that a director will be required to have the general knowledge, skill and experience that may be reasonably expected of a person with the same responsibilities as that director toward the company, as well as the knowledge, skill and experience of the director in question.

This objective and subjective standard regarding directors' actions is also in line with international common law trends. In the UK a case example in which an objective and subjective standard is utilised is that of *Re D'Jan of London Ltd* [1994] 1 BCLC 561 (Ch) where the Insolvency Act of 1986 was applied. In Australia an objective and subjective standard was applied in *Commonwealth Bank of Australia v Friedrich* [1991] 5 ACSR 115 (SC, Vic). The South African equivalent in case law is that of *Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman* 1998 (2) SA 138 (SCA).

It is useful to have an objective standard from which to commence; a reasonable director. However this does not leave much room for flexibility, therefore the subjective elements make it possible to take into account the actual director's abilities, as well as the circumstances in which the company finds itself. The court will be required to account for purposes of the specific director in a company, as well as the size of the company itself. A director must be cautious when accepting an office as such, due to the fact that if the director does not have a minimum level of knowledge, skill and diligence which is expected of a notional reasonable director, that director will be held personally accountable in the event of a loss (Bekink, 2008).

The South African Companies Bill has not defined, or differentiated between, executive and non-executive directors. This means that the common law position in *Howard v Herrigel NNO* 1991 (2) SA 660 (A) has been adopted; a director is a fiduciary of a company irrespective of whether he is executive or non-executive. It must still be borne in mind that the courts will probably still look at whether the director was executive or non-executive as a factor when judging certain conduct (Bekink, 2008).

C76 (4) (a) states that a director will have fulfilled the duties in c76 (3) (b) and (c) – to act in the best interests of the company and to act with due care, skill and diligence – under three conditions:

- if the director took reasonable steps to become informed about the matter;
- if the director possessed no material personal financial interest in the matter and could not reasonably believe that any related person had a personal financial interest in the matter; or the director or a related person had a personal financial interest but complied with the requirements in c75;
- if the director had a rational basis for believing, and did in fact believe that the decision taken was in the best interests of the company.

This section introduces the concept of the 'business judgment rule' into South African law. In order to understand this better, a brief discussion of the business judgment rule is essential.

The business judgment rule:

The business judgment rule was first developed in the US relating to the director's duty of care. In order for the business judgment rule to apply, a director must make a decision regarding the business of the company. If the decision turns out to cause a loss, the director has a defence in that he acted on an informed basis, in the best interests of the company, and in good faith (Jones, 2007). In the US, the application of the rule depends to a large extent on the circumstances of each case. If a company is on the brink of insolvency, a director is expected to have taken a greater amount of care with the company's finances than a director of a company that is thriving.

The business judgment rule was created "… because of a desire to protect honest directors and officers from the risks inherent in hindsight reviews of their unsuccessful decisions, and because of a desire to refrain from stifling innovation and venturesome business activity." (The American Law Institute, 1982 quoted by Havenga, 2000: 28). This rule was intended to protect directors who do not have the luxury of assessing a business decision in retrospect at the time when the decision must be made. The courts are generally not willing to second-guess directors' choices due to the fact that doing business is not the objective of a judge. This was well explicated by Lord Greene MR in 1942: "They [directors] must exercise their discretion bona fide in what they consider – not what a court may consider – is in the interest of the company".[124] It is a general concept that any profitable business venture involves an element of risk. Sometimes even the safest endeavour may turn out to be unprofitable. Hence directors should not be held liable in the event that a decision taken in good faith, which is well informed, and with the best interests of the company in mind, turns out to be wrong.

However in the US the advent of the business judgment rule has led to the devaluation of the duty of care (Jones, 2007). In fact, the US has slowly started to move away from the use of the business judgment rule, as is shown in: *In re Walt Disney Co Derivative Litigation* 825 A 2nd 275 (Del Ch 2003); *Telxon Corp v Meyerson* 802 A

[124] *In re Smith and Fawcett Ltd* [1942] Ch 304 (CA) at 306 as quoted in McLennan (1996) at 94.

2nd 257 (Del 2002); *Krasner v Moffat* 826 A 2nd 277 (Del 2003); and *In re Oracle Corp Derivative Litigation* 824 A 2nd 917 (Del Ch 2003).[125] It must be borne in mind that although the business judgement rule was created in the US, it has never been inserted into legislation there. However the Australian Corporations Act No. 50 of 2001 in s180 (2) has codified the business judgment rule.

In South Africa the King Reports of Corporate Governance of 1994 and 2002 both suggested that there should be an inquiry into whether the directors' duty of care should be limited by statute in forthcoming company law. The reports recommended that if a director makes a decision in good faith and satisfies three criteria, that director should not be held liable if a loss results due to a poor business decision. The three criteria suggested were: the decision is informed, the decision is rational, and that no self-interest is involved.[126] Hence the Companies Bill has codified the business judgment rule. The introduction of this foreign legal concept has been heavily criticised by many legal experts for the following reasons:

- South African law encompasses an objective and subjective test for negligence regarding the director's duty of care. The subjective standard requires that a director act with the care, skill and diligence as may reasonably be expected of an individual with that director's skill and knowledge (Havenga, 2000). Therefore a director will not be held accountable for mere errors of judgment.
- If all three of the criteria are met in order for the business judgment rule to be applicable, then the director has already carried out the fiduciary duty and the duty of care and skill (McLennan, 1996). Therefore the business judgment rule would be superfluous.
- According to Jones (2007), in South Africa, there has only ever been one case[127] in which a director has been held liable for a breach of the duty of care. The addition of the business judgment rule seems unnecessary, as there is no need for it.
- The South African Companies Act under s248 (1) provides for relief for directors by the courts when proceedings against the director involve

[125] Jones, E (2007) 'Directors' Duties: Negligence and the Business Judgement Rule', *SA Mercantile Law Journal*, 19
[126] King Report on Corporate Governance at 9; paragraph 3.4 – 3.5.
[127] *Niagara Ltd (in liquidation) v Langerman & others* 1913 WLD 188

negligence, default, breach of duty or breach of trust. If the court believes that the director acted honestly and reasonably, and in the circumstances of the case it would be fair to excuse the director; the court may do so.

- C77 (9) will be discussed under the relevant section. This legal exoneration by the courts of directors has no counterpart in the US. The South African law therefore covers this action adequately (Havenga, 2000).
- One must keep in mind that US corporations law differs considerably from South African company law; therefore transplanting foreign concepts locally from abroad may lead to negative outcomes (Havenga, 2000).

It is difficult to ascertain how the courts will apply this new concept in conjunction with existing common law. If a director has carried out the fiduciary duty and the duty of care, the courts may not deem it necessary to apply the business judgment rule due to the fact that the conditions would already have been met. S248 of the Companies Act and c77 (9) of the Companies Bill require that the court may decide to exonerate a director. However the business judgement rule under c76 (4) (a) will compel the court to excuse a director. It will be interesting to see if the courts will be able to decide which section to apply depending on the circumstances.

C76 (4) (b) states that a director may rely on any persons contemplated in subsection (5), which will be looked at next, any person to whom the board legally delegated the authority to perform a function of the board, and any information, opinions, recommendations, reports, statements, financial statements or financial data prepared or presented by persons contemplated in subsection (5).

C76 (5) lists the persons whom the director may rely on for information, these are:

- employees of the company who the director reasonably believes to be competent;
- legal counsel, accountants or other professionals who the director reasonably believes to be experts in the relevant field; or
- any board committee of which the director may not be a member, unless the director believes that the said committee is not reliable.

4.9 C77 – Liability of directors and prescribed officers

For the purposes of this section the term ‘director’ includes an alternate director, prescribed officer, a board committee member, or an audit committee member. It is irrelevant whether or not the person is a part of the company’s board of directors.

C77 (2) (a) states that a director may be held liable as per the common law regarding a breach of fiduciary duty for any loss, damages or costs incurred by the company consequent to a breach by the director of the following duties:

- gaining a personal financial interest as a result of the position of a director;
- using the office of the director to gain a personal advantage;
- using the office of the director to knowingly cause harm to the company;
- not acting in good faith or for a proper purpose; and
- not acting in the best interests of the company.

C77 (2) (b) states that a director may be held liable as per the common law regarding delict for any loss, damages or costs incurred by the company consequent to a breach by the director of the following duties:

- carrying out the functions of a director with the required degree of care, skill and diligence that may be reasonably be expected of a person in the same position as the director, as well as the degree of care, skill and diligence expected of a person with the same knowledge, skill and experience as that director;
- any provision of the Companies Bill which is not mentioned under this section; and
- any provision of the company’s Memorandum of Incorporation.

C77 (2) maintains the current common law position in South Africa; a breach of fiduciary duty is actionable *sui generis*, whilst a breach of the duty of care, skill and diligence is actionable in delict. One must take note that the phrase “in accordance with the principles of the common law” means that the legislative aspects of directors’ common law duties are in addition to, not replacing, the existing common law rules. It is difficult therefore to say that the Companies Bill is codifying directors' common law duties, due to the fact that the common law has not been replaced. It may perhaps be more accurate to say that this is a 'partial codification'. This is contrary to the case of the UK; the UK Companies Act of 2006 has replaced the common law with a legislative codification of directors' duties.

C77 (3) lists the circumstances under which a director is liable for losses, damages or costs incurred by the company as a direct or indirect consequence of the director doing the following:

- If the director acts on behalf of the company event though the director has knowledge of the fact that he does not have the authority to do so. This includes acting in the name of the company, signing on behalf of the company, binding the company, authorising an action on behalf of the company. Here the definition of 'knowledge' might open up director liability. If the director is negligent in not knowing that the required authority was not granted, the director will be deemed to have had knowledge of the fact that no authority to act existed. Some of the contractual rules regarding directors have been legislated: breach of warranty of authority in conclusion of contract, fraudulent misrepresentation of belief relating to a company's ability to pay, and procuring a company's breach of contract or prevention of performance by the company of its obligations. One may refer to the section on contract in order to get a better understanding of these director breeches.
- The director will be held liable for any losses to the company if that director assents to the carrying on of the company's business event though the director knows that it is being carried on in a manner prohibited by c22 (1).[128] The definition of knowledge must be taken into account again. This subsection implies that a director may not hide behind the fact that he did not participate in the reckless trading of the company. Simply knowing of or the fact that a director was negligent in not knowing that the company was performing in the illegal manner, is enough to hold a director liable for any consequent losses.

[128] A company is prohibited from carrying on its business recklessly, with gross negligence, with the intent to defraud a person, for any other fraudulent purpose, or trade under insolvent circumstances.

- If the director was involved in an act or omission by the company which was performed with the intent to defraud a creditor, employee or shareholder of the company. This also applies to any other fraudulent purpose. If the director knew of this and participated regardless, that director will be held liable for any resultant loss to the company. The definition of knowledge will hold the director accountable if that director ought to have known of the forbidden act or omission.
- The director signed, consented to, or authorised the publication of: false or misleading financial statements, a prospectus or written statement relating to a secondary offer to the public (as in c101) which contained an untrue statement,[129] or a false statement in which a person consents to being a director. The director's liability relating to untrue statements in a prospectus is limited by c104 (3). This section may be used as a defence by a director when accused of making or supporting an untrue statement. C104 (3) will be deliberated under 'Liability for untrue statements in prospectus'.

According to c77 (3) (e) the director of a company will also be liable for any loss damages or costs incurred by the company as a direct or indirect result of the director attending a meeting or making a decision other than at a meeting (in accordance with c74) and neglected to vote against the following:

- the issuing of unauthorised shares; that is notwithstanding that the director knew that the shares had not been authorised with respect to c36;[130]
- the issuing of authorised securities, even though the director knew that the authorisation was incompatible with c41;[131]

[129] According to c95 an 'untrue statement' is a statement which is misleading in the form and context in which it is presented. This untrue statement may appear on the face of the prospectus, it may be incorporated by reference, or it may accompany the prospectus. For the purposes of the Bill, an untrue statement also includes an omission from a prospectus which is intended to misinform.
[130] C36 deals with the authorisation of shares. The Memorandum of Incorporation of a company sets out the number and class of shares which the company is permitted to issue. Unless the Memorandum of Incorporation states otherwise, the board of director may rectify the amount of shares which can be issued. If the board wishes to act in contrary to the Memorandum of Incorporation, regarding this section, the board must first file a Notice of Amendment.
[131] C41 sets out the rules for shareholders approval for issuing shares in certain cases.

- the consent to present options to a person considered in c42 (4)[132] even though the director knew that the shares for which the options could be exercised or securities changed, are not authorised regarding c36;
- the granting of financial assistance to a person regarding c44[133] in order to acquire securities of the company. In order for liability to attach, the director must have known that the grant was contradictory to c44 or the Memorandum of Incorporation. However the resolution or agreement must have been confirmed as void by c44 (5),[134] as considered with c218 (1),[135]
- the provision of financial assistance to a director in terms of c45 (Loans or other financial assistance to directors) even though this provision was contrary to the company's Memorandum of Incorporation or c45. The director who fails to vote against a provision of financial assistance to a director will also incur liability if the resolution has been deemed void in terms of c45 (6)[136] read with c218 (1);

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[132] C42 considers the options for subscription of securities.
[133] C44 deals with the financial assistance for subscription of securities.
[134] In terms of c44 (5) directors may be held liable if the board's decision to provide financial assistance is void as a result of an inconsistency with cl44, or the company's Memorandum of Incorporation. The board must ensure that the necessary conditions for provision of financial assistance have been satisfied. In terms of these requirements the board may not authorise financial assistance for subscription of securities unless (c44 (3)):

- the financial assistance relates to an employee share scheme which fulfils the requirements in terms of c97; and
- the financial assistance is resultant from a special resolution of the shareholders, which was passed within the previous two years.

The board of directors must also be convinced that the company will pass the solvency and liquidity test after the financial assistance has been granted, and that the conditions under which the financial assistance has been approved are reasonable to the company.
[135] C218 deals with civil actions.
[136] C45 (6) states that a resolution or agreement by the board to provide financial assistance to a director is void if it is incompatible with cl45 or any condition in c45 (4). That means the any condition in the company's Memorandum of Incorporation must be taken into consideration. This is in addition to the conditions set out in c45 (3):

- the financial assistance relates to an employee share scheme which fulfils the requirements in terms of c97; and
- the financial assistance is resultant from a special resolution of the shareholders, which was passed within the previous two years.

The board of directors must also be convinced that the company will pass the solvency and liquidity test after the financial assistance has been granted, and that the conditions under which the financial assistance has been approved are reasonable to the company.

According to c45 (5) in the event that the board passes a resolution for financial assistance or a loan to directors, the company is required to furnish the shareholders (unless all the shareholders are directors of the company) and the trade unions which represent the employees, with a notice of the resolution. This must be done within ten business days after the adoption of the resolution if the total value of the loans, debts, obligations, or assistance in that resolution, together with other resolutions adopted in that

- a resolution which endorses a distribution, even though the director knows that the distribution is contrary to c46 (distributions must be authorised by the board);
- the acquisition by the company of its shares, or the shares of a subsidiary company, despite the director knowing that the acquisition is not in line with c46 or c48;[137] or
- an allotment by the company even though the director is aware that the allotment is contrary to any condition of Chapter 4 (Public offerings of company securities). This is if the allotment is deemed void regarding c109 (1)[138] read with c218 (1).

According to c77 (4) a director will only be liable for failing to vote against a distribution contrary to c46 if consequent to the said distribution, the company does not pass the solvency and liquidity test. It is also necessary for it to have been unreasonable, before the vote on the distribution was held, to believe that the company could pass the solvency and liquidity test. C77 (4) (b) states that the liability of a director in terms of this section will not surpass, on aggregate, the difference between the total amount by which the worth of the distribution surpassed the amount that would have been distributed without leading to a failure of the company to satisfy the solvency and liquidity test, and any amount which the company recuperated from the persons to whom the distribution was made.

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financial year, is greater than one-tenth of 1% of the company's net worth, at the time when the resolution was passed. Otherwise the notice must be given within thirty business days after the end of the financial year.

[137] C48 deals with instances where the company or subsidiary acquires company shares.

[138] C109 looks at voidable allotments. According to c109 (1) if an allotment offered by a company or the acceptance of such by the applicant is inconsistent with c108 (2), the allotment is voidable and the directors who were aware of this are to be held liable. C108 looks at restrictions on an allotment. C108 (2) explains that when a company offers securities to the public, the securities must not be allotted unless the minimum amount, which in the opinion of the directors is intended to be raised to provide for matters prescribed to be covered by minimum subscription. This amount must also have been received by the company. It is up to the directors to decide what is the minimum amount required. According to c108 (6) if the conditions stated in subsection (2) have not been accomplished within forty business days consequent to the issue of the prospectus, the totals which have been received from the applicants must be restored swiftly without interest. C108 (7) states that if the money which was due to be returned to applicants in terms of c108 (6) has not been returned within fifty-five days of the issue of the prospectus, as a result of director misconduct or negligence, the directors will be liable. The extent of this liability is such that every director or prescribed officer of the company will be held jointly and severally liable to reimburse the outstanding money with an interest of 6% per annum. This is a requirement after the 55th business day consequent to the issue of the prospectus.

C77 (5) states that if the board of directors has acted against subsection (3) (e) (in terms of a decision which is in breach of the Bill), either the company or a director who may be held liable for the consequences, may apply to the court to set the board's decision aside. The court may completely set the decision aside, set aside certain aspects of the decision, or set the decision aside specific to certain conditions. The court may also make a decision which is just and equitable in the circumstances of each case. This can include a rectification, reversal, or restoration of any amount received by a person as a result of the board's decision. The court may also order the company to indemnify a director who may be held liable in terms of this section.

Any liability incurred in terms of c77 is joint and several with any other person who may also be held liable under this section.[139] A person may not endeavour to initiate proceedings to recover a loss, damages or costs in terms of c77 more than three years after the act or omission which resulted in the liability.[140] Any persons who are liable under the Companies Bill will also be liable to pay the costs of all parties for court proceedings unless they are discarded. Those persons are also liable to repay the company for any loss which is not recoverable under the Bill.[141]

C77 (9) relates to s248 of the Companies Act which allows the court to provide relief for directors in certain circumstances. C77 (9) states that during actions against directors, a court may relieve the director, either completely or partly from liability arising out of c77. This is only an option if the court believes that the director is liable (or might be) but nevertheless acted reasonably and honestly. The court may also take such action if the circumstances of the case, including those associated to the appointment of the director, it would be just to absolve the director. The court however will not be able to apply this section to actions relating to wilful misconduct or wilful breach of trust against directors. This is a departure from s248 of the Companies Act which allowed the court to excuse a director in matters regarding negligence, default, breach of duty, or breach of trust. The difference comes in the fact that the court may no longer excuse a director for a breach of trust; unless it occurred as a result of negligence on part of the director. Whilst this does not actually

[139] C77 (6)
[140] C77 (7)
[141] C77 (8)

widen the liability of directors, it certainly goes a long way to make it more difficult for directors to be exempt from liability when the circumstances of the case make it fair to do so.

C77 (10) states that a director who believes that there will be a claim made against him may apply to the court for relief, and the court may provide relief in the same circumstances as in c77 (9). This also excludes instances where the director is accused of wilful misconduct or wilful breach of trust.

C77 has set out instances of director liability. The liability in this section, in some cases, must be applied in conjunction with the common law. In some areas directors' liability has increased, whilst in others the common law has been legislated. A new defence has been added to South African law; that of the business judgement rule. Whether this foreign rule is superfluous, will assist directors, or simply confuse the courts still remains to be seen. What must be taken into account is that the definition of 'knowledge' in the Bill goes a long way to increase directors' liability due to the fact that honest but negligent directors will be deemed to have actual knowledge. This will inflict liability in cases where it would not have attached before.

4.10 C78 – Indemnification and directors and officers' insurance

For the purposes of this section the term 'director' includes an alternate director, prescribed officer, a board committee member, or an audit committee member. It is irrelevant whether or not the person is a part of the company's board of directors.

C78 (2) states that any stipulation of an agreement, the Memorandum of Incorporation, or any resolution taken up by a company is void if it directly or indirectly attempts to negate a director's duty in terms of cl75 or c76 and liability considered in c77. Therefore absolutely nothing may alleviate the director's common law or statutory duties or liabilities. The same applies for any attempt to restrict any legal outcomes as a result of an act or omission which represents wilful misconduct or wilful breach of trust by the director.

A company may not directly or indirectly pay for a fine which has been assigned to a director as a result of a contravention of any national legislation.[142]

According to c78 (4) a company may pay for the litigation defence of a director due to any matters that occur as a result of the director's office in that company. The company may further indemnify the director for the expenses of the defence, even though the company has paid for those expenses, if the proceedings against the director have been discarded or if the director has been exonerated. The company may also indemnify the director for the expenses of litigation if the matter is relating to any form of liability, for which the company may indemnify the director. The Memorandum of Incorporation may however forbid the company from paying for the litigation expenses or indemnifying the director regarding those expenses.

A company is allowed to indemnify a director (unless the Memorandum of Incorporation states otherwise) with regards to any form of liability[143] other than liability arising in terms of c77 (3) (a), (b) or (c).[144] That is, a director may not be indemnified if he acts in the name of the company, binds the company, signs on behalf of a company, or take action on behalf of the company even though the director knows he lacks the authority to do so.[145] The director may not be indemnified if he agreed to the carrying on of the company's business in a reckless manner, a negligent manner, or with the intent to defraud any person. This also applies to the insolvent trading of the company. This will only apply if the director knew that the company was being run in such a manner.[146] Lastly, the director may not be indemnified if he contributes to an act or omission by the company which is intended to defraud a shareholder, creditor, or employee, despite knowing that this is the case.[147] The company is further not allowed to indemnify a director for any wilful misconduct or wilful breach of trust[148] or for a fine contemplated in c78 (3).[149]

142 C78 (3)
143 C78 (5)
144 C78 (6) (i)
145 C77 (3) (a)
146 C77 (3) (b)
147 C77 (3) (c)
148 C78 (6) (a) (ii)
149 C78 (6) (b)

At this point it is necessary to look at the definition of 'knowledge' as presented in c1 of the Companies Bill. The words 'knowing', 'knowingly' or 'knows' is defined by as the person in question:

- actually had knowledge of the matter;
- was in a position in which the person ought reasonably to have –
  - had actual knowledge;
  - investigated the matter to an extent that could have provided the person with actual knowledge; or
  - taken other measures which, if taken, could reasonably be expected to have provided the person with actual knowledge of the matter.

The problem is that the second component of the definition allows for negligence. If an honest director did not actually have knowledge of a matter, but ought to have had, that director is considered to have possessed the knowledge. This will inevitably leave directors with a gap in cover. The company will not be able to indemnify directors in these circumstances. At the heart of liability insurance lays the notion that one may indemnify persons who are negligent. One must remember that the word 'knowledge' and its derivatives appear many times in the Companies Bill; therefore directors will have to be very careful when they ought to be aware of matters regarding the company, as no cover will be provided.

It is important to look at the definition of 'knowingly' with regards to the common law. After all, one of the main objectives of the Companies Bill is to codify the common law duties of company directors. The Companies Act (1973) did not contain a definition of 'knowledge' so the courts had to use common sense in order to produce a meaning. Three main cases may be used to derive a good understanding of the word 'knowingly' or 'knowledge'. These cases deal with s424 of the Companies Act or the liability of directors and others for the fraudulent conduct of business. The relevant part of the section reads as follows:

"… any person who was *knowingly* a party to the carrying on of the business in the manner aforesaid…"

Howard v Herrigel and another NNO [1991] 2 All SA 113 (A) Schreiner JA at 612 H:

"… the person sought to be held liable had knowledge of the facts from which the conclusion is properly to be drawn that the business of the company was or is being carried on recklessly or with intent to defraud…"

Philotex (Pty) Ltd and others and Braitex and others v Snyman and others [1998] JOL 1881 (A) at 6:

""Knowingly" means having knowledge of the facts from which the conclusion is properly to be drawn that the business of the company was or is being carried on recklessly…"

Terblanche and others v Damji and another [2003] JOL 11359 (C) at 41 (concurring with *Howard v Herrigel and another NNO*):

"Knowingly" has been held to mean, in this context that:
". . . the person sought to be held liable had knowledge of the facts from which the conclusion is properly to be drawn that the business of the company was being carried on recklessly or with intent to defraud…"

From the case law above it is clearly visible that 'knowledge' is supposed to mean, actual knowledge. In the event that a person ought to have knowledge, but does not, it may not be said that the person had knowledge, merely a lack thereof.

The indemnification by a company of its directors has always been a controversial issue in South Africa, which is probably as a result of poor wording and interpretation of legislation. S247 of the South African Companies Act (1973) deals with the indemnification of directors by a company. It used to read as follows:

"… Any provision, whether contained in the articles of company or in any contract with a company… which purports to exempt any director or officer… from any liability which by law would otherwise attach to him in respect of any liability which by law would otherwise attach to him in respect of any act of 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 shall be void"

A similar section also existed in the UK Companies Act (1985). Many writers in the UK and South Africa interpreted these sections to mean that a company may not take out D&O cover on behalf of its directors, or that a company may not pay premiums on behalf of its directors. This was as a result of the notion that the company would then be exempting directors from liability, which is obviously not allowed.

Some are of the view that s247 did not forbid companies to take out D&O cover for its directors or pay the premiums on their behalf. This is due to the fact that the purchase of D&O as well as the payment of premiums does not equate to an exemption from liability. The opposite is actually true: if the director was exempted from liability, the D&O policy would have nothing to respond to (as it is actually an indemnification policy). As consequent to the fact that the director is liable, the policy can essentially respond.

The South African Act, as well as that of the UK was then amended in 1998 (for the sake of clarity) and s247 of the South African Act now looks like this:

"Subject to the provisions of subsection (2), any provision, whether contained in the articles of a company or in any contract with a company, and whether expressed 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, shall be void: Provided that this subsection shall not be applicable to insurance taken out and kept by the company as indemnification against any liability of any director or officer towards the company in respect of any negligence, default, breach of duty or breach of trust."

This has served to clarify that a company may purchase insurance for its directors, however many are still concerned that it mentions nothing about the company's ability to pay for premiums on behalf of its directors. Regardless, companies continue to purchase D&O and pay the premiums in any case.

An interesting argument has actually developed from this; some are of the opinion that the legislation should state that a company may purchase insurance on behalf of its directors against liability from third parties. This is a typical depiction of the fact that in the public's eyes, directors are now accountable to all. Originally directors were only liable to the company and it is for that reason that derivative suits were created in order to sue directors. One would think that due to the fact that a director does not owe a fiduciary duty, or a duty of care to any third party, that the director in his capacity as such may not be liable to anyone else. However some distinguish between owing a duty and being liable. It is important to very cautious with this type of thinking, in that if a director is liable to all, he is in actual fact liable to none.

The Companies Bill has however gone some way in clarifying the matter. C78 (7) states that a company may purchase insurance to protect a director from liability or expenses for which a company is allowed to indemnify a director (therefore no insurance may be provided in the negligence matters discussed above). This insurance may also protect the company from expenses which the company may advance in terms of c78 (4) (a) or for which the company may indemnify a director regarding c78 (3) (4). The company will also be protected by this insurance from any liability incurred due to the indemnification of directors in accordance with c78 (5). If a company pays money on behalf of, or to a director contrary to c78, that company may claim restitution from that director.[150]

However the definition of 'knowledge' will probably cause much confusion when applied in the courts. This could have been avoided perhaps by inserting a simple clause such as the following:

"Nothing in this Act can be construed as prohibiting the company from purchasing directors and officers liability insurance against legal liability claims arising"

[150] C78 (8)

The Bill should not attempt to define the circumstances in which this cover will operate, that can be left to the policy wording. Insurers who will pay for the claims have an interest to limit their own liability to reasonable ground. Policy wording and legislation should not be confused.

4.11 C104 – Liability for untrue statements in prospectus

In the event that securities are offered to the public for subscription or sale, by means of an issued prospectus, which contains an untrue statement, and as a result of the untrue statement someone incurs a loss or damage by purchasing securities in good faith; the following persons are personally liable:[151]

- a person who becomes a director between the first issuing of a prospectus and the first general shareholder meeting at which directors are appointed or elected;
- a person who has given permission to be named as a director in the prospectus, or consented to being a director close to the time;
- a promoter of the company; or
- a person who authorised the issue of the prospectus or made the offer to the public.

The above still holds true even if the untrue statement was placed in a report of memorandum related to the prospectus.

According to c104 (2), the liability which may be incurred in terms of this section is in addition to that under c77 (3) (d) (ii).[152]

According to c104 (3) a person will not be liable for an untrue statement if:

- The person reasonably believed that the statement was true up to the time of the allotment of securities or acceptance of the offer. This has to be related to

[151] C104 (1)
[152] This section looks at directors' liability as a result of an untrue statement contained in a prospectus.

an untrue statement which is not claimed to be made with the authority of an expert or a public official document.

- Regarding an untrue statement asserting to be made by an expert, the person will not be liable if the untrue statement signified the statement, or if the person reasonably believed up to the time of the issue of the prospectus that the expert was competent.
- The untrue statement claiming to be made by an official was a fair representation of the document.
- The person had consented to being a director of the company, but retracted the consent and the prospectus was issued without that person's permission.
- The prospectus was issued without the permission of awareness of the person. The person must then give reasonable public notice of the prospectus was issued without the required permission or awareness.
- The person withdrew consent consequent to becoming aware of an untrue statement once the prospectus has been issued. The withdrawal of consent and reasoning thereof must be made public.

If a person's name is incorrectly (either because the person did not consent to being a director, withdrew consent to being a director or did not consent to the issue of the prospectus), placed in a prospectus as a director of the company, and that person suffers any loss, damage or expense as a consequence of the incorrect naming, the directors of the company are liable with any other person who issued the prospectus. This is with the exception of any directors who had no knowledge of, or did not consent to, the issue of the prospectus. The liable directors will also be held responsible for any costs of defending a legal action as a result of a person being incorrectly named in the prospectus which contained an untrue statement.[153] This applies to any requisite consent by any person with respect to any material aspect that is a requirement in a prospectus,[154] if that consent was either not given or withdrawn prior to the issue of the prospectus.

[153] C104 (4)
[154] C104 (5)

A person may incur liability in terms of this section by:

- being a director;
- agreeing to become a director;
- authorising the issue of a prospectus;
- becoming a director between the issue of a prospectus and the holding of the first general shareholders meeting at which directors a re appointed or elected.

If a person mentioned above has satisfied liability under this section by means of a payment to another person, that liable person may recover a contribution from any other person who would be liable to make the same payment (if sued separately). This is unless the person who has incurred such liability is guilty of fraudulent misrepresentation, and the person who will pay back the contribution is not.[155]

4.12 Chapter 6 – Business rescue and compromise with directors

It is necessary to pay some attention to the business rescue proceedings, which will be introduced for the first time into South African company law as a result of the new Companies Act. Although some of the directors' liabilities are done away with whilst a company is under business rescue, directors will nevertheless incur new responsibilities. It is also important to mention that the practitioner, who is in charge of the company during business rescue, will possess a set of duties and liabilities which should be covered under D&O liability insurance.

4.12.1 C128 – Application and definitions applicable to this chapter

The concept of 'business rescue' entails that certain measures are taken to rehabilitate a company which is in a financial crisis. This entails:[156]

[155] C104 (6)
[156] C128 (1) (b)

- temporary supervision, management of the assets, and the affairs of the company;
- a temporary suspension of claiming rights against the company;
- the development and implementation of a plan ,which must get approved, that will rescue the company. This may be performed by reorganising the company's business, affairs, property, equity and liabilities in a manner which will result in either the continued existence of the company as a profitable business, or to ensure that creditors and shareholders receive a maximum return from the company upon liquidation.

4.12.2 C129 – Company resolution to begin business rescue proceedings

The board of a company may decide that the company should commence voluntary business rescue proceedings and place the company under supervision if there are reasonable grounds to deem that the company is financially distraught and that there are reasonable possibilities that the company can be saved.[157] However one may not commence business rescue proceedings if the company has already been placed in liquidation and the proceedings will have no effect unless it is filed.[158]

The company is then required to inform all affected persons by notice, of the business rescue proceedings as well as the grounds for under which the board decided to take this action. The company must also assign a business rescue practitioner who must consent to this appointment in writing.[159] The company is further expected to file a notice of the appointment of the practitioner within two business days after appointing the person, and publish the notice within five business days after that.[160] In the event that a company fails to appoint a practitioner or to publish the notice of appointment, the business rescue proceedings will be void. Should this be the case, the company

[157] C129 (1)
[158] C129 (2)
[159] C129 (3)
[160] C129 (4)

may only apply for business rescue proceedings three months after the void resolution was assumed.[161]

A company that has commenced business rescue proceedings may not apply for liquidation unless the application for the proceedings has lapsed, or the actual business rescue has ended.[162] If the board of directors has reasonable grounds to ascertain that the company is in a financial crisis, but does not attempt to initiate business rescue proceedings, the board must inform all the parties concerned of the reasons thereof.[163] This may serve as an avenue for shareholders or creditors to sue company directors. If the board fails to institute business rescue proceedings and the company goes into liquidation, some might feel that the company should have been saved, or that the liquidation could have produced more returns. It will be interesting to see how the court determines the criteria of whether or not the board of directors should initiate business rescue proceedings.

4.12.3 Cl131 – Court order to begin business rescue proceedings

If a company has not commenced business rescue proceedings, any affected person may apply to a court in order to place the company under supervision and commence such proceedings.[164] The court may place the company under supervision and make an order to commence business rescue proceedings if:[165]

- the company is financially distressed;
- the company has not paid a required amount of money relating to employment-related matters; or
- it is just and equitable to do so when taking the company's financial situation into account and it is reasonably possible that the company can be saved.

[161] C129 (5)
[162] C129 (6)
[163] C129 (7)
[164] C131 (1)
[165] C131 (4)

The court may also decide to dismiss the application and place the company under liquidation.

4.12.4 C132 – Duration of business rescue proceedings

The business rescue proceedings of a company will end in a number of instances:[166]

- if the court sets aside the resolution or the order to begin the proceedings;
- if the court has placed the company under liquidation;
- if the practitioner has filed a notice of termination of the business rescue proceedings with the Commission;
- if the business rescue plan has been rejected and no affected person has attempted to extend the proceedings; or
- if the business rescue plan has been accepted and the practitioner has filed a notice of substantial implementation of the plan.

If the business rescue proceedings of a company last longer than three months (or longer if the court deems it necessary on application of the practitioner), the practitioner must prepare a report on the progress of the proceedings and update that report every month. The practitioner must also deliver this report to the court or to the Commission, if the proceedings were not instigated by a court.[167]

4.12.5 C133 – General moratorium on legal proceedings against company

If a company has been placed under business rescue proceedings, no legal action may be taken against that company or against any property either owned or possessed by the company. However certain exceptions do exist:[168]

- if there is written consent from the practitioner;
- with the permission of the court;

[166] C132 (2)
[167] C132 (3)
[168] C133 (1)

- against a claim made by the company itself;
- any criminal proceedings against the company or the directors and officers; or
- regarding any property or right which the company holds as a trustee.

If there is a surety by the company for a person, this surety may not be enforced against the company during business rescue proceedings. That is unless the court considers it to be otherwise just.[169] In the event that a right exists to claim against a company subject to a time limit, that time period must be placed on hold whilst the company is in business rescue proceedings.[170]

This section will prove to be extremely useful due to the fact that a company under business rescue proceedings requires all the assistance it can get. If the company has to receive legal claims against it during these times it will be impossible to attempt to save the organisation from financial distress. However it still remains to be seen if persons will be able to claim against the company or its directors and officers, for conduct or omissions, which occur during the business rescue proceedings, after these proceedings have been terminated. During difficult times such as financial distress, it will always prove extremely challenging to satisfy everyone's needs.

4.12.6 C137 – Effect on shareholders and directors

Any change in the classification or status of issued securities, except the transfer of securities in the ordinary course of business, is not allowed during business rescue proceedings. This is unless a court allows otherwise or the business recue plan itself states that changes or alterations are permitted.[171]

The following effects will take place on directors during a company's business rescue proceedings:[172]

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[169] C133 (2)
[170] C133 (3)
[171] C137 (1)
[172] C137 (2)

- the director must maintain the functions as such but subject to the authority of the practitioner;
- the director must carry out management functions towards the company under the instructions and direction of the practitioner. This must be done if it is reasonable to do so;
- the director must still adhere to the rules relating to personal financial interests to himself or a related person, in respect of the company, as in c75; and
- otherwise the director is relieved of all other duties and liabilities towards the company as set out in c76 and c77 respectively, with the exception of c77 (3) (a), (b) and (c). In other words the director may not act in the name of the company when not authorised to do so, the director may not allow the business of the company to be conducted in a reckless, grossly negligent, fraudulent, or insolvent manner, and the director may not be a part of an act or omission by the company which is intended to defraud a creditor, employee or shareholder.

The directors of a company will be required to carry out any requests of the practitioner, and supply the practitioner with any information reasonably required regarding the company's business.[173] Any action by the board of directors which required the endorsement of the practitioner will be void unless the necessary consent to act is obtained.[174]

The practitioner may apply to a court in order to remove a director from office. The court may only approve this request if it can be shown that:[175]

- the director did not conform to the requirements set out in Chapter 6 (Business rescue and compromise with creditors); or
- the director either by an act or an omission is obstructing the performance of the practitioner regarding his powers and functions, the management of the

[173] C137 (3)
[174] C137 (4)
[175] C137 (5)

company by the practitioner, or the progress and functioning of the business rescue plan.

The ability of the practitioner to apply to the court in order to remove a director is in addition to the ability of a person to apply to have a director declared delinquent or under probation.[176]

During business rescue proceedings the directors of a company will be in a strange position; on the one hand some of the duties are nullified, whilst on the other, the director is expected to perform in accordance with the practitioner. The director is excused of all other duties which would include the fiduciary duty and that of care. However one is still expected to exercise the functions of a director subject to the authority of the practitioner. It is hard to believe that the fiduciary duty and that of care will actually be excused. This section also adds more grounds under which a director may be removed from office. If one is removed from office in accordance with this section, it will be interesting to see if that will make it easier to bring an action against the director once the business rescue proceedings have ended. For example, the company ends up in liquidation due to the fact that a director negligently obstructed the practitioner from performing his duties during business rescue proceedings. The Mean was 2.87, which was an increase from 2.7 during the first round of the study.

4.12.7 C138 – Qualifications of practitioners

A person may be a practitioner of a company during business rescue proceedings only if the following criteria are met:[177]

- the person must be a member (in good standing) of a profession which is under some regulatory authority;
- the person is not under probation as a result of a court order as in c162 (7);

[176] C137 (6)
[177] C138 (1)

- the person would not be disqualified from acting as a director of a company as in c69 (8);
- the person does not have a relationship with the company which could compromise the person's objectivity, impartiality or integrity; and
- the person is not related to anyone who is in a relationship with the company which could compromise the person's objectivity, impartiality or integrity.

The Minister may assign a person or organisation to regulate the system of practitioners. The person or organisation would have to be within the Republic South Africa and dedicated to realising the purposes of this Chapter. This person would also have to encourage sound principles of good practice regarding business rescue. This would require human, financial and operational resources in order to carry out the functions of this Chapter.[178]

The Minister may enforce certain reasonable conditions upon the person or organisation which will regulate the system of practitioners, as well as procedures to be followed. Certain minimum qualifications may be set by the Minister regarding who may be appointed into the practice of business practitioners.[179]

If there are certain levels of expertise required of practitioners, one would think that they would be judged accordingly when deciding whether the person has carried out his duty or care, skill and diligence towards the company. This is the case with company directors and practitioners are most likely going to be treated in the same manner by the courts. Therefore the higher the degree of skill and knowledge that a practitioner possesses, the higher will be the standard of expectation imposed.

4.12.8 C139 – Removal and replacement of practitioner

A practitioner may be removed from office by a court in accordance with c130 (Objections to company resolution) or as per this section.[180] The court may remove a

[178] C138 (2)
[179] C138 (3)
[180] C139 (1)

practitioner from office either on its own accord or on request of an affected person. In order to remove or replace a practitioner from any of the following justifications must be proven:[181]

- the practitioner is incompetent or has failed to perform certain duties;
- the necessary degree of care was not carried out with respect to the practitioner's duties;
- the practitioner was involved in illegal conduct;
- the practitioner no longer fulfils the requirements in c138 (1);
- the practitioner had a conflict of interest with the company or is no longer independent; or
- the practitioner has become incapacitated and can not function for a reasonably foreseeable amount of time.

It is the responsibility of the company, or the creditor who appointed the practitioner, to appoint a new person in the event that the practitioner dies, resigns, or is removed from office.[182]

4.12.9 C140 – General powers and duties of practitioners

The following are the practitioner's powers and duties during a company's business rescue proceedings; these are in addition to the rest which are set out in this Chapter:[183]

- the practitioner possesses complete management control over the company, which replaces the board of directors and management;
- the practitioner may delegate any power and function to a board member or a previous member of management;
- the practitioner may remove any person from management and appoint any other in place; and

[181] C139 (2)
[182] C139 (3)
[183] C140 (1)

- the practitioner must create and apply the business rescue plan of the company.

Unless the practitioner has permission from a court, the practitioner may not appoint a person as part of the management of the company if that person has, or knows anyone who has, a relationship with the company which would impair the integrity, impartiality, or objectivity of that person.[184]

The following applies to the office of a practitioner during company business rescue proceedings:[185]

- the practitioner is an officer of the court and must report back to the court on the status of the business rescue proceedings as required;
- the practitioner possesses the duties, responsibilities and liabilities of a director in accordance with c75 to c77;
- the practitioner will not be held liable for conduct which is performed in good faith; and
- the practitioner may be held liable for conduct which amounts to gross negligence.

In the event that the company is place under liquidation consequent to business rescue proceedings, the practitioner may not be appointed as a liquidator of the company.[186]

It seems that the practitioner will have the same duties and liabilities as company directors do. Even more so in that all the responsibilities of the board and management will be under the control of the practitioner. This places an enormous amount of responsibility on one person alone. One can imagine a multi-national company which requires many directors, both executive and non-executive, whom often are out of touch with all aspects of the business. In this case, one person will bear full responsibility. This may be an exaggeration, as the practitioner may delegate any of the duties, however he may be held liable if the delegation results in a loss.

[184] C140 (2)
[185] C140 (3)
[186] C140 (4)

Even though the practitioner has the same responsibilities and duties as company directors, the practitioner will not be held liable for conduct which is carried out in good faith. This is with the exception of gross negligence. It is hard to believe that if the practitioner causes a loss or damage as a result of negligence, but in good faith, that a claim will not arise. This section is also silent on whether or not the company may purchase insurance or indemnify the practitioner. Perhaps D&O liability insurance should automatically cover a practitioner in the event that the company is placed under business rescue proceedings.

4.12.10 C142 – Directors of company to co-operate with and assist practitioner

The directors of a company, which has been placed under business rescue, must furnish the practitioner with all the books and documents regarding the business of the company, which is in their possession.[187] Any director who is aware of the whereabouts of any other books or records must inform the practitioner.[188]

The directors of the company will be required to furnish the practitioner, within five business days (or longer if the practitioner allows), with statements relating to the following:[189]

- material transactions of the company which occurred twelve months prior to the inception of the business rescue proceedings;
- court, arbitration, or administrative proceedings relating to the company;
- the company’s assets, liabilities, income and disbursements from the previous twelve months;
- the number of employees that the company has, as well as any agreements regarding employee rights of the company;
- the debtors, as well as the debtors’ obligations to the company; and
- the creditors, as well as any rights or claims against the company.

[187] C142 (1)
[188] C142 (2)
[189] C142 (3)

No person may withhold any books or records of the company from the practitioner during business rescue proceedings.[190] The directors of a company, which is under business rescue proceedings, owe a number of duties towards the company and towards the practitioner. This may result in an increase in the instances of legal claims against directors. It may be advisable that D&O insurers prepare for the cover of companies which are under business rescue proceedings; from the following perspectives:

- a company under business rescue proceedings is more likely to incur legal claims as a result of financial distress;
- the directors of a company under business rescue proceedings may be under a greater threat of legal claims than otherwise, due to new responsibilities and a willingness of shareholders and creditors to reclaim certain funds; and
- the practitioner may be open to legal claims as a result of a high number of responsibilities, duties and liabilities.

4.13 C157 – Extended standing to apply for remedies

This section of the Companies Bill introduces the concept of a class action into South African law. Although the concept of a class action did already exist in terms of the Constitution of the Republic of South Africa Act No. 108 of 1996 under s38, the Bill will introduce it as a very possible reality in the business world.

In terms of c157 an application may be made, or a matter brought to a court, the Companies' Ombud, the Take-over Panel or the Commission. This right may be carried out by the following persons:[191]

- any person directly considered in terms of the Companies Bill;
- any person who is acting in the name of a person considered above if that person can not act on his own behalf;

[190] C142 (4)
[191] C157 (1)

- a person who is acting as a member, or in the interest of, a group or class of affected persons, as well as an association acting in the interests of its members; and
- any person acting in the interest of the public, with leave of the court.

The Commission or the Panel may initiate proceedings in a court in the name of a person who had made a written request to the Panel or Commission to do so. The Commission or Panel may also apply to the court in order to intercede in court proceedings if it is felt that certain necessary interests are not being considered.[192] According to c157 (3) this section does not construct grounds for any person to bring a derivative action in terms of c165.

It will be interesting to see what the results of the introduction of class actions will do for directors. Certainly there is a possibility that more legal claims will result, however the D&O policy wordings of South Africa have always covered this eventuality.

The norm thus far has been that in the event of a company which is being wound up, the liquidators will seek compensation for the creditors and shareholders of that company. This is a difficult task due to the fact that the creditors of large companies generally have competing interests. However the class action will allow shareholders and creditors to sue directors autonomously, therefore without the requirement of a liquidator.

4.14 C162 – Application to declare director delinquent or under probation

For the purposes of this section 'legislation' represents national and provincial legislation. The legislation here is related to different aspects of a juristic person. This includes promotion, formation, management, obligations, prohibitions as well as regulations for an industry.[193]

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[192] C157 (2)
[193] C162 (1)

Three different categories of persons may apply to a court for an order to declare a director delinquent or under probation:

- A company, shareholder, director, company secretary, prescribed officer, registered trade union representing the employees, or another representative of the employees of the company. For the purposes of this section these persons will be referred to as ‘commercial applicants’.
- The Commission or the Panel. For the purposes of this section these persons will be referred to as ‘regulatory applicants’.
- A state organ, which is responsible for the administration of any legislation. For the purposes of this section these persons will be referred to as ‘state applicants’. A state applicant may only seek to declare a director delinquent not under probation.

An application to a court to declare a director delinquent or under probation may only be attempted if the person in question either is currently a director of the company, or was a director of the company twenty-four months prior to the application.

The court must make an order which will deem a person as a delinquent director, if the person:[194]

a) consented to being or acted in the capacity of a director or prescribed officer, even though the person was disqualified or ineligible as in c69. This is unless the person was under a court order as in c69 (11), or was a director considered in c69 (12) – regarding a private company;
b) acted as a director even though the person was under probation in terms of this section or s47 of the Close Corporations Act No. 69 of 1984;
c) whilst acting as the director of the company:
    i. grossly abused the office of a director;
    ii. utilised information acquired through the office of a director in order to gain a personal advantage in contravention of c76 (2) (a);
    iii. acted in a manner:

[194] C162 (5)

- which is considered as gross negligence, wilful misconduct or breach of trust regarding the director's functions and duties towards the company; or
- discussed in c77 (3) (a), (b) or (c);

d) has been repeatedly given a compliance notice for similar conduct relating to any legislation;

e) has been personally convicted of an offence, fined or been subject to a penalty, at least two times, regarding any legislation;

f) within a period of five years was a director of a company, managing member of a close corporation or controlled a juristic person, that was convicted of an offence, or subject to an administrative fine or penalty, regarding any legislation. The person must have been in control, as explained above, of the entity when the contravention resulted in the said punishment. The court must also believe that the order of delinquency is warranted in light of the nature of the contraventions.

The following explains which of the circumstances above are necessary depending on which applicant is seeking a court order to declare a person as a delinquent director:

- commercial applicants will require any from (a) to (c) above;
- regulatory applicants will require any from (a) to (f) above; and
- state applicants will require any from (d) to (f) above. State applicants will be required to serve the Commission with a copy of the application.[195]

A declaration of delinquency from (a) or (b) above will exist for an entire lifetime. A declaration of delinquency from (c) to (f) above may be subject to any conditions which the court deems necessary, and will last for seven years from the order of delinquency, unless the court thinks it necessary to be longer.[196]

[195] C162 (13)
[196] C162 (6)

A court may make an order which will place a person under probation if:[197]

a) whilst in the office of a director the person:
    i. participated in a meeting in which he failed to vote against a resolution regardless of the fact that the company would not satisfy the solvency and liquidity test;
    ii. acted contradictory to the duties of a director; or
    iii. sustained or made a decision which led the company to act in a manner discussed in c163 (1);[198] or
b) within a period of ten years after the effective date:
    i. the person has been a director of more than one company, or a managing member of more than one close corporation; and
    ii. during that time two or more of those companies or close corporations neglected to pay its creditors or satisfy its obligations. This is with the exception of a business rescue plan consequent to a board resolution regarding c129[199] and a compromise with creditors regarding c155.[200]

According to c162 (8) a court may place a person under probation with respect to (a) (iii) above if the court believes that the declaration is justified in light of the circumstances of the company (or corporation), as well as the person's conduct regarding the management of the company (or corporation) at the time. The court may also only place a person under probation with respect to (b) above if the court believes that the method by which the company or close corporation was managed was, at least, moderately blameworthy for the failure to meet its obligations. The order of probation in terms of (b) above must also be justified in light of the circumstances of the company (or corporation), as well as the person's conduct regarding the management of the company (or corporation) at the time.

[197] C162 (7)
[198] This section deals with oppressive or prejudicial conduct, or abuse of separate juristic personality of the company.
[199] This is company resolution to commence business rescue proceedings.
[200] This is regarding a compromise between the company and its creditors.

The following explains which of the circumstances above are necessary depending on which applicant is seeking a court order to declare a person under probation:

- commercial applicants will require any from (a) and c162 (8) above; and
- regulatory applicants will require any from (a), (b) and c162 (8) above.

A declaration which places a person under probation may be subject to court conditions and does not exceed a period longer than five years as established by the court.[201]

The court may order, either as part of the declaration or in addition to it, that the person:[202]

- embark on a corrective education programme regarding the person's conduct as a director;
- undertake certain community service;
- pay compensation to a person who suffered a loss as a result of the director's conduct. This is in the event that the person adversely affected does not any other legal base for compensation. This will be a concern for directors due to the fact that it means that a director will be liable for compensation even when no legal basis for such damages exists. The D&O policies will have to either exclude or include such claims against directors; or
- regarding an order of probation:
  - o the person should be supervised by a mentor whilst still participating as a director, while the order stands; or
  - o the person is limited to being a director of a private company, or a company of which the person is the only shareholder.

A person who has been declared a delinquent director or is on probation may apply to a court to suspend the order of delinquency and substitute it for probation. This may only be attempted three years after the order of delinquency was made. The person may also apply to a court to set aside an order of delinquency two years after it was

[201] C162 (9)
[202] C162 (10)

suspended and substituted for probation. The person affected may also apply to a court in order to set aside an order of probation two years after the probation was ordered.[203]

When the court deliberates whether or not to substitute or set aside an order, the court will not grant the new order if any of the conditions attached to the original order have not been complied with. The court may however grant the new order if it is convinced that the applicant has made adequate progress towards rehabilitation, and if it seems possible that the applicant will be able to serve as a director of a company in the future.[204]

[203] C162 (11)
[204] C162 (12)

4.15 C165 – Derivative actions

This section replaces any common law right of a person (not a company) to bring legal action to court on behalf of a company.[205] The following persons may require that the company instigates legal action, continues legal action, or takes related legal steps in order to guard the interests of that company:[206]

- a shareholder of the company;
- a director or prescribed officer of the company;
- a registered trade union or other representation which looks after the company's employees; or
- a person who has been granted leave by the court to bring the action.

The company that has been required to take legal action in terms of the above may apply, within fifteen days, to a court in order to set the request aside. This may only be done on the basis that the demand is frivolous, vexatious or lacking merit.[207] In the event that the company does not apply to a court in order to set the request aside, or that the court turns down the company's application; the company is required to assign an independent and impartial person in order to examine the demand which was served. This person must then report to the board on matters which resulted in the action, the costs which the company may incur if the action is carried out, as well as whether or not it is in the best interests of the company to pursue the action. The company is further required to respond within sixty days of the request by either taking the necessary legal action to protect the company, or to let the person who served the demand know, by means of a notice, that the company will not comply with the request.[208]

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[205] C165 (1)
[206] C165 (2)
[207] C165 (3)
[208] C165 (4)

A person who has made a demand that a company take legal action to defend its own interests may apply to a court to commence or continue proceedings on behalf of the company. The court may allow this if:[209]

- the company failed to carry out the necessary requirements once served with the demand;
- the company did not appoint an impartial and independent person or committee to investigate the matter;
- the company accepted a report on the matter which was inadequate, irrational or unreasonable;
- the company performed contrary to the recommendations of a reasonable report on the matter; or
- the company served a report of refusal to comply with the request of a person contemplated in c165 (2).

The court may only allow a person to defend the company in its own name if the person is acting in good faith, the allegations are relevant and serious, and if it is in the best interests of the company to do so.[210]

It is possible that a person may apply to a court to defend a company on its own behalf without making a demand on the company as stated above, or without allowing the company time to respond to the demand. This will only be allowed in very rare circumstances. The court may allow for this type of urgency if the time delay which will result from subsections (3) to (5) will lead to irreparable damage to the company or prejudice to the applicant or another person.[211] The court may also allow this order if the company will not prevent the harm or prejudice which the applicant wants to guard, and if the requirements of subsection (5) (b) are fulfilled.

It will be assumed that the granting of leave is not in the best interests of the company. However this assumption will be refutable. In order for this assumption to appear it will have to be determined that the proceedings are by the company against a

[209] C165 (5) (a)
[210] C165 (5) (b)
[211] This 'other person' is not described in the Bill. That may be a concern due to the fact that prejudice to an undefined person may lead to a court allowing a person to represent the company's interests.

third party,[212] by a third party against the company, or that the company elected to either not commence, not defend or discontinue the proceedings. The presumption that leave is not in the best interests of the company will also exist if the directors of the company:[213]

- acted in good faith;
- did not possess a personal financial interest in the matter and were not related to any person who did;
- properly informed themselves about the matter; and
- reasonably believed that the decision in question was in the best interests of the company.

If a person has been appointed for action under this section by the court, the court is required to decide who will remunerate that person. The order as decided by the court may vary and if more persons are to be liable for carrying out the functions of the order, the court must state the extent of each person's liability. These persons are either the parties to the proceedings or the company itself. The person who is granted leave by the court in order to carry out proceedings in terms of this section may require an inspection of the company's financial books at any time. This is provided that the person gives reasonable notice to the company in advance.[214]

The court may at any point make decisions regarding the costs of the company, the person who was granted leave or another party to the proceedings in respect of leave granted for proceedings under this section.[215] The Bill states that an order made under this section may require security for costs.[216] It is not mentioned whether the court must make an order in respect of this matter and under what circumstances the security will be necessary.

[212] For the purposes of this section a 'third party' is such if the company and that person are not related or interrelated. The proceedings must include any proceedings taken up on appeal. This is according to c165 (8).
[213] C165 (7)
[214] C165 (9)
[215] C165 (10)
[216] C165 (11)

Once the court has granted leave in terms of this section, another person who may bring a derivative action (as mentioned above) may apply to the court in order to be substituted for the person to whom, leave to carry out proceedings, was originally given. The court may allow this substitution if the applicant is acting in good faith and if it is fair to do so in the circumstance of the case.[217] The substitution will have the effect that the new person will be regarded as been granted leave in the first place.[218]

Any ratification or approval of conduct by the shareholders of any company conduct does not mean that a person may not apply to the court for leave in order to bring a derivative action. This will also not prejudice the result of the application for leave or the derivative action itself. However the court is allowed to take into consideration any ratification or approval, by shareholders of company conduct, when making any judgment.[219] Any derivative action may not be stopped, compromised or settled without the approval of the court.[220] The right to apply for leave or bring an action as contemplated in this section may be carried out in accordance with c157.[221]

4.16 C218 – Civil actions

No agreement, resolution, provision or resolution of an agreement, Memorandum of Incorporation, or rules of a company that is prohibited, void, voidable, or may be declared unlawful in terms of the Companies Bill is actually void, unless the court declares it as such.[222]

According to c218 (2) if a person contravenes the new Act and, as a result another person suffers loss or damage, the person who committed the contravention is liable to the other person for the amount of loss or damage incurred. This section opens up directors' liability to third parties. In the event that a director contravenes any section of the new Act, be it fraudulently or negligently, and a third party suffers a loss (such as an employee) the director will be personally liable for that loss. A contravention

[217] C165 (12)
[218] C165 (13)
[219] C165 (14)
[220] C165 (15)
[221] C165 (16)
[222] C218 (1)

due to negligence will now be all the more possible as a result of the definition of 'knowledge' provided by the Bill. Therefore directors will be able to be held liable for matters which previously would have been excused. This is a concern due to the fact that directors were originally only meant to be liable for losses to the company. In this way, a director can perform his duties and carry out his responsibilities without the constant threat of possible litigation, which could inhibit necessary risk-taking.

The section on civil actions does not alter any other remedy that a person may have by law or other regulations.[223]

4.17 Conclusion

The second mitigating step of legislation and more relevantly for this dissertation, the new Companies Act, is also not likely to contain claims against directors. Perhaps like the codes of corporate governance legislation acts like a double-edged sword. Whilst attempting to clarify directors' duties through a codification, this may also serve to inform potential claimants.

The introduction of the business judgment rule may be seen as a mitigating factor in that directors may use it as a defence. However as was stated in this chapter the business judgment may be superfluous under South African law and may lead to unintended consequences.

The definition of 'knowledge' as provided in the new Act may also increase director liability due to the fact that it may lead to a gap in cover for directors with regards to negligence. Further, the introduction of class actions into South African law will surely lead to an increased number of claims. This will be amplified by the fact that c218 (2) allows for civil remedies; any person who contravenes the Bill will be liable to any person who suffers a loss as a consequence of that contravention.

As previously stated, company failures are usually ascribed to breaches of corporate governance or company law. Therefore new corporate governance codes are added

[223] C218 (3)

and old ones are updated. Further, corporate governance notions are being placed legislation, as has been seen in the Companies Bill. This is in the hope of preventing future corporate losses.

Once again one may be missing the point; putting a law or regulation in place does not necessarily prevent persons from breaking the rules. One assumes that creating a law against murder would certainly not reduce its occurrence at all. Persons that are willing to commit fraud will go through with it no matter what corporate governance or legislation permits. This holds even truer for negligence; putting a law in place against negligence will certainly not prevent persons from behaving that way, as it is something which is not even done with intent.

An economic crisis has occurred, consequent to which many frauds have been discovered. The reaction normally is to put laws and regulations in place in order to prevent that from happening again in the future. The doctrinal issues and the complexity of the modern economic world have led to an in increase directors exposure to liability. This in turn leads to increased claims against company directors.

Legislation (the new Companies Act) will be put in place in order to contain the increase in director liability. Although this mitigating step has the right intentions, the doctrinal and complexity issues will outweigh the expected results. Therefore it is expected that director liability and therefore claims against directors will continue to increase.

The fact that an entire chapter of the new act is focused on corporate governance and mainly directors may lead to increased expectations. It will be much easier to hold directors liable when their corporate duties are spelled out in legislation. The corporate governance expectations of directors will also be increased as they are now legislated in the new Companies Act.

5 DIRECTORS AND OFFICERS LIABILITY INSURANCE

5.1 History

This section will briefly examine the history and development of D&O liability insurance in the US, UK and South Africa respectively.

5.1.1 History – United States

D&O insurance was first developed as a reaction to the surge of lawsuits against directors and officers in the 1930s, consequent to the 1929 stock market crash in the US. The 1929 stock market crash also led to the enactment of federal securities laws, which tended to increase the risk of liability of directors and officers, whilst still providing some defensive protection. The first policy is believed to have been placed by Minet and underwritten by Lloyd's for a US corporation known as the Federated Department Stores. Due to the fact that this type of cover had never existed and no data was available, policy sales were very scarce. The policy was generally costly and complicated (Youngman, 1999).

This slowly developing market was stunted further with the advent of World War 2. As a result claims against directors were only significant enough for discussion during the 1950s (Youngman, 1999). During these years the growth of the US D&O market was held back once again by the fact that Lloyd's underwriters declined to reinsure US companies.[224] However eventually US insurers ended up writing the market's accounts.

The 1960s once again produced increased litigation against directors; this led to new players entering the market. From 1964 onwards insurers such as St Paul, American Home Assurance, Liberty Mutual and the Kemper Group entered the market. Most of

[224] During the 1950s the US D&O market was extended by a brokering company which was eventually undertaken by Willis.

the policy wordings followed that of Lloyd's, at which by this stage, was doing most of the reinsurance (Lockwood, 2003).

The 1970s became more difficult for D&O insurers; this was as a result of competitive pressures and numerous legislative measures (federal and state) being passed, which affected company directors. As a result of the success of early D&O insurers, many new entrants became active in the market. Competitive pressures led to policy alterations such as lowered premiums and increased limits. Consequent to new legislation the claims against directors and officers increased and D&O insurers began to experience losses (Lockwood, 2003). However the soft market continued until the mid-1980s when the D&O market began to suddenly harden. This will be discussed later on.

5.1.2 History – United Kingdom

The UK market was, and continues to be, dissimilar from that of the US. It was extremely rare to find a company purchasing D&O in the UK until the 1980s unless that company had US exposure (Youngman, 1999). S310 of the UK Companies Act (1985) stated that the company may not indemnify a director in terms of negligence, default, breach of duty or breach of trust. This section was similar to s247 of the South African Companies Act (1973), which is discussed under the indemnification section (c78) of the South African Companies Bill in this dissertation. Although arguments were made that this section prohibited companies from purchasing D&O insurance on behalf of directors, companies continued to do it anyway, as was the case in South Africa. However the UK company legislation was eventually amended in order to clarify any confusion; this allowed companies to purchase D&O insurance on behalf of their directors.

Although the recessions of the 1980s and 1990s led to companies spending less resources on what was considered 'non-essential' insurance, directors were more susceptible to claims and required cover (Youngman, 1999). A combination of new legislation and increasing case law against directors slowly led to an increase in the demand for D&O insurance. This was then amplified by EU directives which applied to companies in the UK. Eventually it was not only large public companies that purchased D&O insurance but also private companies (Youngman, 1999).

5.1.3 History – South Africa

If there is not much to say regarding D&O insurance history in the UK, there is certainly even less with respect to South Africa. In South Africa, the D&O insurance market only became significant as a result of the South African Companies Act (1973). However, as was the case in the UK, and as explained in the indemnification section (c78) of the Companies Bill in this dissertation, s274 (1) of the South African Companies Act (1973) raised concerns as to whether or not a company would be legally allowed to purchase D&O cover for its directors. Nevertheless, companies continued to purchase the cover in any case. The South African Insurance Brokers Association[225] made submissions to the Subcommittee on Legal Practices of the Standing Advisory Committee on Company Law in order to have the section amended. The amendment was made in 1998; however doubt still exists as to whether or not companies may purchase D&O insurance for directors in order to protect them from third party claims. This has been clarified in the Companies Bill (2008).

The South African courts have never actually had to deal with the legitimacy of a D&O policy. Most claims against directors are settled outside the courts between all the parties involved. This is however expected to change with the advent of the new Companies Act, which will make persons more aware of their rights against directors. Another reason for an expected increase in the number of claims against D&O policies is the fact that corporate governance codes are also providing an awareness of directors' duties and liabilities. The third King Report on Corporate Governance is expected to encourage the rights of all company stakeholders, which means directors' duties will increase to other sources. Due to the fact that South Africa is no longer being boycotted by overseas investors, as was the case during the early 1990s as a result of the apartheid regime, South African companies are now exposed to outside

[225] The organisation is now known as the South African Financial Services Intermediaries Association (SAFSIA), which recently merged to become the FIA.

investment, as well as laws and regulations. However this results in increased risk and therefore opens up directors to more potential claims.

South African D&O policies are shaped in accordance with overseas policies; mainly that of the US and the UK. Therefore one may say that South African policies are a hybrid of the overseas counterparts.

5.2 D&O insurance cycles

The insurance market, like most others,[226] is subject to cyclical patterns; the D&O market is no exception. The reason for labelling these occurrences as 'cycles' is as a result of repetitive trends, which will occur regarding certain factors of the market. Examples of some of the factors regarding the insurance industry are the price, availability, quality (of cover) as well as the capacity of insurance companies. The cyclical changes denote periods of time when the market may be either 'hard' or 'soft'.

The underwriting cycle is a sequence of premium stages which are typified by episodic soft and hard markets (Harrington & Niehaus, 2003: 151). Soft markets are exemplified by reduced coverage prices, whilst hard markets are distinguished by supply declines and price amplification. The hard market may be recognised by a diminution in cover and increasing premiums. Consequently, the increased premiums and additional borrowings will replenish capital and supply will increase whilst price will decrease (Harrington & Niehaus, 2003). This will then lead to a soft market and hence the cycles continue.

Insurance underwriting cycles may exist as a consequence of forces inside or outside the insurance industry. An example of a force within the industry is that of competition and new entrants in the market. This will normally occur when the market is at the end of a hard stage. New entrants will be attracted by the increase in premiums and therefore profitability of the industry at the latter stage of a hard market. The increase in competition will bring the price of premiums down, which

[226] In economic theory variations in business activity have been referred to as 'business cycles'.

may eventually lead to a softer unprofitable market; paving the way for the return of a hard market. An example of an outside force may be that of new legislation. Legislation may for example impose higher standards on the insured, which is the case of the Sarbanes-Oxley Act and arguably the South African Companies Bill. This could lead to a drastic increase in claims against the insurers and a hardening of the market. However some of the factors could swing the market in either direction (stringent legislation may lead to directors taking more care and therefore less claims will arise) therefore underwriting cycles are unpredictable to an extent. It is not the objective of this dissertation to provide an in-depth description of insurance cycles or the economic reason thereof. The aim here is to briefly describe what cycles the D&O insurance market has been through.

In the US the D&O insurance market was soft until the mid-1980s. The soft market may have been consequent to the fact that many new entrants meant decreased premiums and modest deductibles (Lockwood, 2003). However by 1985 the market began to harden which meant that premiums started to rise, the limits of indemnity were decreased, and it became increasingly difficult for D&O insurance companies to find reinsurance for this type of cover. This 'crisis' may have occurred as a result of multiple causes; D&O insurance companies were faced with new types of exposure, the number of bankruptcies increased, acquisitions and public offerings were on the rise, and judicial decisions started to effect the exposure to D&O risk (Romano, 1988). As a result, loss prediction became progressively more complex in this still relatively new line of insurance; therefore profitability in this sector of the insurance industry began to decrease. In 1985 around 75% of the D&O reinsurers had retreated and the total capacity of the market decreased significantly (Lockwood, 2003).

The D&O insurers that did remain in the market commenced the imposition of certain exclusions in policies such as insured versus insured, and claims arising out of mergers and acquisitions (Lockwood, 2003). Further explanations of the hardened market are the fact that interest rates were increasing in the US at the time, and that the reinsurance market was reducing worldwide (Romano, 1988).

The 1985 crisis also affected the Canadian D&O insurance market. According to Daniels and Hutton (1992) the 1985 crisis was brought on by a number of legal and industry factors. However the cyclical trends of D&O insurance have the ability to weaken directors' capability of guarding against legal actions. Some of the consequences of this hard market were that some persons refused to take up positions as directors, many captive insurance companies were created, and many new players entered the market, which led to increased capacity (Lockwood, 2003).

By 1989 the D&O insurance market began to turn soft; this was as a result of the new entrants into the market, as well as legislation which were passed by a number of states, aimed at limiting directors' liability (Lockwood, 2003). The softening of the market was despite the fact that severity of claims continued to increase. This soft market would begin to come to a close in 1999.

The new hard market was consequent to a number of factors (Lockwood, 2003):

- The 11 September 2001 terrorist attacks led to high claims against insurers. This also turned reinsurers to less risky lines of cover.
- A higher than usual amount of bankruptcies occurred among public traded companies in the US.
- A continued increase in the cost of claims due to class action suites.
- The well-publicised incidents of corporate failures in the US, such as Enron, WorldCom and Tyco.

From the beginning of 2000, the severity of D&O losses began to increase dramatically. This may have been as a result of the fact that investor losses were higher than ever before, the prospective of losses to investors increased due to market capitalisations, institutional investors were increasingly taking action against directors and officers in order to promote 'good' corporate governance, and many claims were related to accounting malpractice (Redington, 2005). In order to illustrate the increase in claims settlements, the following list is provided as from 2000:

Figure 1: Claims settlements

Company	Settlement
Enron	$7.2 Billion
WorldCom	$6.1 Billion
Cedant	$3.5 Billion
Tyco	$3.2 Billion
Citi Bank	$2.7 Billion
Lucent	$517 Million
Bank of America	$490 Million
Waste Management	$457 Million
Daimler/Chrysler	$300 Million
Oxford Heath	$300 Million

Source: Securities Class Action Clearinghouse

The first shareholder class action claim settlement over $100 million occurred in 1999; as a result of this most D&O insurers increased premiums during 2000. According to the Tillinghast 2000 D&O Liability Survey, premiums increased by 11% on average in that year. This trend continued throughout 2001 and 2002 as the cost and number of D&O claims continued to increase. According to the Tillinghast 2001 D&O Liability Survey, premiums increased by 29% on average that year; this was followed by another 29% increase in average premiums in 2002 (Tillinghast 2001 D&O Liability Survey).

The hardening of the D&O insurance market did also present itself in other means. Many insurers left the market, whilst others decreased the amount of cover which would be offered (Sirovatka, 2004). This meant that the D&O insurance market capacity declined. This has generally been attributed to the worldwide corporate governance changes which were taking place. Due to the numerous corporate scandals and failures which occurred, and the extent of coverage which the media presented on those cases, the public began to doubt company boards of directors (Sirovatka, 2004). As a result (although the Act had been contemplated for a while prior to this) the Sarbanes-Oxley Act was passed in the US. However the corporate failures continued to occur in spite of the new stringent legislation.

Eventually in 2004 D&O premiums began to decrease, which was contrary to what most expected in the wake of corporate failures such as Enron, WorldCom and Tyco. In the latter half of 2003 and during 2004, the premium average decreased by 10% (Tillinghast 2004 D&O Liability Survey). Certain segments of the business world, such as mining and agriculture, and personal and business services experienced the greatest declines in premiums. This was probably as a consequence of reductions in claim frequency (Sirovatka, 2004). However there were still minor increases in average premiums in segments such as banking and health services (Sirovatka, 2004).

At the same time the D&O insurance market was softening in other respects; such as the fact that coverage restrictions were being moderated. Most participants in the Tillinghast 2004 D&O Liability Survey reported an increase in average coverage limits and only 28% of the participants reported increases in deductibles. This was down from 44% in the 2003 survey. Another relevant pattern was that most participants in the Tillinghast 2004 D&O Liability Survey reported an increase in policy enhancements (Sirovatka, 2004).

It was not all good news however, as claim frequency and susceptibility continued to increase. The Tillinghast 2004 D&O Liability Survey showed that claims frequency increased by 11% since 2003. The highest increases in claims frequency were reported by the banking, biotechnology and pharmaceutical, and technology sectors. The susceptibility of claims increased from 18% to 19% from 2003 to 2004. Susceptibility is measured as: the number of participants with a claim/the total number of participants in the group (Sirovatka, 2004). Once again, the banking sector showed the highest increase in susceptibility to D&O claims in 2004.

Moreover, claims and defence costs were still on the rise in 2004, which was keeping with the trend which commenced in 1999. The average claim payment to shareholders or investors increased by 12% between the years 2003 to 2004.

The contradiction of decreasing premiums, and increasing cost of claims and claims frequency was explicated by a changing capacity of the D&O insurance market (Sirovatka, 2004). Due to an increase of new entrants in the D&O market, much capital was injected into the industry. The previous years' increases in premiums led to increased competition in the market, which tends to bring the price down eventually. In order to measure the competitiveness of the D&O market, the Tillinghast D&O Liability Survey looks at the full limits capacity of insurers. The full limits capacity was at $1.6 – billion in 2000 and declined consistently until 2003 to $1.35 – billion. However 2004 saw the full limits capacity increase to $1.5 – billion (Sirovatka, 2004). The increased premiums of the hard market attracted new players who looked to attract clients by charging lower prices. These new entrants had not gone through the hard market's fall in profits. The increased competition eventually led to a general lowering of D&O insurance premiums throughout the markets (Sirovatka, 2004).

In this manner the second hard market drew to a close and the second softer market slowly began to emerge. In 2005 the D&O insurance industry underwent a second consecutive year of premium decreases. To be precise, the Tillinghast 2005 D&O Liability Survey, found a 9% decrease in premiums from 2004 (for-profit participants). It was only the durable goods, education, health services and non-banking financial services sectors that reported slight premium increases (Tillinghast 2005 D&O Liability Survey). Policy limits increased in 2005, with the survey indicating that among for-profit companies, the average policy limit was $14.3 million, as opposed to $13.6 million in 2004. Deductibles were generally unchanged from 2004: the 2005 survey showed that 63% of the participants stated that their deductibles remained unchanged, whilst the corresponding 2004 figure was 65%.

In 2005 the Tillinghast D&O Liability Survey also found that policy enhancements increased, whilst exclusions decreased. This is in accordance with the pattern of the 2004 survey. Of the participants, 25% indicated an increase in enhancements, which is up from 13% in 2004. For a second consecutive year, 10% of the participants reported decreases in exclusions.

The 2005 Tillinghast D&O Liability Survey still showed that the frequency and cost of claims was still increasing. Claim frequency regarding for-profit companies was 0.34, as opposed to 0.33 in the 2004 survey. Non-profit participants indicated a claims frequency of 1.53, which was in increase from 1.34 in 2004. Regarding claims susceptibility, for-profit companies reported 19% in 2005 and 15% in 2004, whilst non-profit companies reported 6% in 2005 and 5% in 2004. Therefore the trends which started occurring in mid-2003 continued to persist in 2005 – the soft market was in motion.

In 2006 the D&O insurance market continued to soften in many respects. The average premium reduction from 2005 to 2006 was 6.5% regarding repeat participants (Tillinghast 2006 D&O Liability Survey). Among public companies, those that had assets less than $6 million reported a 21% reduction, whilst those that had assets greater than $10 – billion reported a 4% reduction in premiums. However private organisations actually reported a 5% increase in average premiums. Policy limits increased slightly with a 10% increase in average limits for repeat participants.

Coverage enhancements continued to grow with 31% of participants reporting an increase on D&O insurance policies. Policy exclusions decreased slightly as 8% of participants stated that there were reductions in exclusions. For the first time since the commencement of the hard market the claims frequency began to decrease. For-profit companies reported a 0.28 claims frequency which was down from 0.34 in 2005. Non-profit companies reported a claim frequency of 1.18 in 2006 as opposed to 1.53 in 2005. The susceptibility to claims was down for both for-profit and non-profit companies. This survey also found that continually, larger companies are more susceptible to claims. The soft market continued to prevail even amidst concerns that the Tyco claim would send the market into turmoil (Lenckus, 2007).

The 2007 Tillinghast D&O Liability Survey continued to show that the D&O insurance market was soft. Premiums declined a further 14% in 2007, and companies with assets over $10 – billion actually reported a 41% reduction. The banking sector however reported a 57% increase in premiums. The survey reported that this may have been as a result of the subprime crisis. Repeat participants also experienced a 14% reduction in retentions when compared to 2006.

Regarding D&O coverage enhancements, 61% of participants reported increases as opposed to 31% in 2006. Policy exclusions were also declining with 34% of participants reporting a decrease in policy exclusions, which was up from 8% in 2006.

Repeat participants reported an average 13% increase in policy limits. However the average policy limit purchased was $9.86 million compared to $11.5 million in 2006.

The 2008 Tillinghast D&O Liability Survey was not yet released when this dissertation was produced. However it will be interesting to see if the soft market continues to persist for long. The global financial crisis has already led to over one hundred legal actions towards the end of 2008 (Towler, 2008). A sudden increase in claim frequency and severity could lead to hardening of the D&O market. Thus far the D&O insurance market has experienced two hard cycles and two soft cycles. Currently the D&O industry is sitting in a soft market and it will be interesting to see under what circumstances it may harden.

5.3 The need for D&O insurance

The original aim of D&O insurance after the 1929 financial crisis, and still the primary aim of the policy today, is to protect the personal assets of directors from liability incurred within the scope of their employment by a company. The D&O insurance policy is distinctive due to the fact that it is purchased and owned by the company, but it is actually meant to protect the directors (Core, 1997). The company is also protected in other ways, most notably; a company will be reimbursed when it indemnifies a director. This will be looked at in more detail when the policy itself is examined in this dissertation.

The extent of directors' personal liability is actually unlimited; therefore even the wealth of a director's family may be at risk. Directors may sometimes be held liable as a result of losses incurred by the company due to actions of their co-directors. Ignorance may no longer be used as an excuse for not being aware of loss-causing actions. A director will be held liable if he ought reasonably to have known of any events which may lead to a loss.

There are certain instances where a company is permitted to indemnify a director regarding liability incurred, unless the company's Memorandum of Incorporation states otherwise. This is stipulated in c78 (5) of the Companies Bill; the current

Companies Act prohibits indemnification by the company of its directors under s247 (1). However the relevant section states that this does not apply to the purchasing of insurance by the company in order to indemnify a director from losses which arise out of services to that company. Whilst this company indemnification does provide some protection for directors, it will not be of any assistance in the following circumstances:

- if the company becomes insolvent;
- if the company has inadequate resources;
- if the company no longer exists;
- if the company itself is bringing the action;
- if the company withdraws protection;
- if the director or officer is no longer employed by the company; and
- if the company's Memorandum of Incorporation does not permit indemnification.

According to O'Sullivan (1997) there are five strong arguments in the favour of the purchasing of D&O insurance:

- The lack of insurance means that directors may not necessarily be protected when taking action on behalf of a company; this may lead to conservative management which is unlikely to be profitable for shareholders (Jensen, 1993).
- D&O insurance may help recruit more non-executive directors; serving on numerous boards may lead to increased risk of liability and protection from this liability should appeal to more non-executive directors. Evidence is found regarding the ability to appoint non-executive directors in the US in Priest (1987), and Daniels and Hutton (1993).
- D&O insurance may not necessarily have adverse results on market mechanisms which motivate managers to perform in the favour of shareholders (Oesterle, 1989).
- Nuisance claims against directors may be extremely costly personally to defend, which shows that D&O insurance should be used in order to provide some indemnification (Oesterle, 1989).

- There were concerns that the fact that the company pays for D&O insurance, and in turn, the policy pays any costs or settlements, that directors may not have any incentive to avoid losses to the company. However there are still reputation costs involved for directors whether they are eventually found liable or not. Litigation will still therefore be important in controlling the actions of directors (Bhagat *et al*, 1987).

5.3.1 Where does the risk come from?

The following is a brief, non-exhaustive summary where the risk to directors and officers liability, comes from (Youngman, 1999).

- Contract: failure to carry out the terms and conditions of a contract;
- Corporate manslaughter; very few cases exist worldwide, and even less in South Africa. However some insurance companies are starting to consider possible cover. In the UK, the Corporate Manslaughter and Corporate Homicide Act of 2007 has been passed. Directors and companies could soon find themselves under increased liability as a result. This should eventually make its way to South Africa. Liability could attach as a result of failure, or lack thereof, of health and safety regulations within the company, resulting in death to a person.

- Director and officer abuse of authority: making a personal profit by company means;
- Employment: discrimination on certain grounds such as gender;
- Financial irregularities: any insider trading, breach of confidentiality or unauthorised buying and selling of shares;
- Fraud;
- Government: this may arise out of legislation. For example anti-competitive practices;
- Intellectual property; infringements of patent or copyright laws;

- Libel and slander: may occur during times of company turbulence by discordant statements. Some policies exclude this cover, however it may be added on for an additional premium;
- Memorandum of Incorporation: the director or officer may perform contrary to the company rules and regulations;
- Mismanagement; may occur if management is not controlled properly by the board of directors;
- Misrepresentation: misleading or false material information which influences a person causing a loss;
- Non-payment: directors and officers may be held liable under employment laws if employees do not receive remuneration according to the agreed methods;
- Takeovers or mergers: personal liability will attach if decisions are not in the best interests of the company;
- Unfair practices: the director or officer might not act in a fair and honest manner;
- Wrongful dismissal;
- Wrongful trading; personal liability will attach if the company's business is carried out in an unlawful manner;

5.3.2 Potential claimants

The following is a brief, non-exhaustive summary of the possible persons who could bring an action against company directors and officers:

- Shareholders and other investors: Shareholders are generally the most common source of claims against directors and officers. This is due to the fact that directors are looking after their assets. According to the Tillinghast 2008 D&O Liability Survey, shareholders and other investors made up the highest number of claims against directors and officers. The total number of claims from this source was 218; this made up 40.4% of total claims against directors and officers. The majority of the claims came from inadequate or inaccurate disclosure, including financial reporting (80), followed by stock or other public offering (39), and then by breach of fiduciary duty (37).

- Employees (past, current or prospective) or unions: The Tillinghast 2008 D&O Liability Survey showed that there were 175 claims from this source; 32.5% of the total number of claims. Most came from wrongful employee dismissal or termination (74), followed by discrimination (46) and salary, wage or compensation dispute (12).
- Other third-party claimants: This category is extremely broad and according to the Tillinghast 2008 D&O Liability Survey, it produced 76 claims. That is 14.2% of total claims against directors and officers. The highest producer of claims in this category was ‘other’ third-party claimant issues (54) followed by general breach of fiduciary duty (10) and finally false advertising and deception (5).
- Competitors, suppliers and other contractors: The Tillinghast 2008 D&O Liability Survey showed that this source resulted in 45 claims, which is 8.5% of total claims. Most arose from contract disputes (16), followed by business interference (13), and lastly copyright and patent infringement (10).
- Customers, clients and ratepayers: The Tillinghast 2008 D&O Liability Survey showed that this category produced 15 claims in total which is 2.9% of total claims. The highest incidence in this category was as a result of contract dispute (5), then dishonesty and fraud, false advertising/deceptive trade practices and ‘other’ issues (2 each).
- Government and regulatory agencies: This category accounted for 9 claims in the Tillinghast 2008 D&O Liability Survey, which is 1.7% of total claims. Most of the claims came from ‘other’ government/regulatory issues (5) followed by dishonesty and fraud (2), and antitrust and bankruptcy (1 claim each).

5.4 The D&O insurance policy

This dissertation makes use of the Camargue Underwriting Managers’ D&O liability policy. The policy wording may be attained from the website:

www.camarguem.co.za. This section is intended to provide a basic understanding of D&O policy wording.

5.4.1 Operative clause

The operative clause states:

"Subject to any terms, exceptions and conditions (precedent or otherwise) and in consideration of and conditional upon the prior payment of the premium by or on behalf of the Insured, the Insurers agree to indemnify the Insured and/or the Insured Persons up to the limit of indemnity stated in the schedule in respect of claims first made during the period of insurance for wrongful acts occurring on or after the retroactive date stated in the schedule."

The operative clause may also be referred to as the 'insuring clause' or 'insuring agreement'. The operative clause broadly defines the obligations which are incurred by the insurer, and the conditions taken up by the insured. It is a summary of the agreement between the two parties: insured and insurer. The insurer agrees to indemnify the insured subject to the terms, exclusions, limitations, and conditions stated in the policy. Whilst this first clause sets the nature of the agreement, it is then refined and narrowed down within the policy.

5.4.2 Insuring agreements

Originally D&O policies were written on a 'dual' or 'bi-policy' format, therefore two policies were actually sold (Lockwood, 2003). The one was a Directors and Officers Liability policy and the other was a Reimbursement for Directors and Officers Liability Policy (Mattar & Hilson, 1979). This was eventually replaced by a single policy which sells both types of cover, known as Side A (Directors and Officers Individual Cover) and Side B (Company Reimbursement) cover. Today, although it is possible to purchase Side A cover only (Huskins, 2005), D&O policies are sold containing both sets of cover.

The Side A cover generally reads as follows:

"The Insurers shall pay on behalf of the Insured Persons loss for which they are not indemnified by the Insured and which the Insured Persons become legally obligated to pay on account of any claim first made against them, individually or otherwise, during the period of insurance or, if exercised, during the discovery period, for a wrongful act taking place on or after the retroactive date shown in the schedule."

The individual parts of the statement will be explicated in time; however the agreement generally states that the insurer will cover the director or officer for any losses incurred in their capacity of director or officer to the company. This part will not cover losses which are indemnifiable by the company. The claim must first be made against the director or officer during the period of insurance and notified to the insurers during that period.

This will cover legal costs which are incurred in the successful defence of allegations or suits, as well as any awards granted to the claimants against the director or officer. This applies to out of court settlements as well as orders of the court.

Side B cover generally reads as follows:

"The Insurers shall reimburse the Insured for loss arising from company indemnification to the Insured Persons, as permitted or required by law, and which the Insured Persons have become legally obligated to pay on account of any claim first made against them, individually or otherwise, during the period of insurance or, if exercised, during the discovery period, for a wrongful act taking place on or after the retroactive date shown in the schedule."

This will only cover a loss which the director or officer is liable for, but for which the company is legally (whether it is common law, legislation, or the Memorandum of Incorporation) required or permitted to indemnify that director or officer. This is where c78 (5) of the Companies Bill and s247 (1) of the Companies Act apply with regards to company indemnification of its directors and officers.

However D&O insurance cover has tended to move away from its original purpose; the protection of directors' and officers' personal assets due to liability incurred as a result of errors or omissions perpetrated in the course of their duties towards the company which they serve (McCutcheon, 2006). The other purpose was to ensure that the company is able to indemnify its directors and officers as a result of legal and other indemnification agreements (McCutcheon, 2006). However, in the US, companies started to utilise D&O for its own defence and settlement costs, especially those arising out of investigations by the SEC. this led to an increasing amount of insureds relying on the funds of a single D&O policy. Thus the D&O insurance company began to assume responsibility for all defence and settlement costs when exposure was resultant from joint liability between the directors and officers, as well as the company itself (McCutcheon, 2006).

As a result, Side C or 'Entity' coverage was created which provides cover directly to the company for liabilities, irrespective of whether or not a director or officer is named in the claim. This type of cover then started to create other problems; not only was cover intended for the director being eroded by claims against the company, in the event of a company going bankrupt, creditors used the D&O policy as an asset (McCutcheon, 2006). This meant that directors were left with practically no cover when it was actually required.

The next response was to produce Side A only cover; this would generally apply once the primary D&O cover was exhausted. Once again this created its own problems; this is due to the fact that the Side A policy will only be triggered once the insured company can no longer indemnify the individual director or officer. This means that companies will be spending monetary resources on cover which is only accessed in very rare circumstances. Even when the Side A policy is actually used there may be further difficulties; many individuals may require cover from that single policy, which will result in little actual protection once again for the directors and officers (McCutcheon, 2006).

These days Side A only cover may still be purchased, and indeed it actually is. However D&O policies are still sold with Side A and Side B cover, and it is recommended that ‘Entity’ cover should be purchased separately so that the protection offered to directors and officers is not eroded by claims against the company.

5.4.3 Notable definitions

Wrongful act:

A wrongful act is generally defined as any actual, alleged or attempted breach of duty, breach of trust, error, neglect, misstatement, misleading statement, mistreatment, breach of fiduciary obligation, wrongful trading, breach of warranty of authority, by an act, omission or negligence. This also includes any matter which is claimed against the director or officer solely by reason of serving in such capacity.

A wrongful act will not be covered by the D&O insurance policy if the insured committed the said act in his capacity on behalf of another organisation; unless the policy explicitly covers this.

Interrelated wrongful acts are those which somehow have a common nexus which is reasonable and closely related to the other.

The Insured:

The insured is the company or organisation named in the policy schedule. The parent company is that which is named in the policy schedule and may acquire or create subsidiaries which then also fall under the same policy. Therefore any director or officer of a company in the past,[227] present or future is included. The insured company also includes all its subsidiaries and therefore all the directors and officers of those subsidiaries. The subsidiaries include any companies which are acquired or created during the policy period.

[227] Former directors and officers of companies may still incur liability after they no longer work for the insured, for any loss which may have occurred during the period of their employment.

Under ‘director or officer[228]’ the policies generally include:

- executive officers: chairperson, CEO, managing director, CFO, in-house general counsel;
- outside director: a position which is held by a director or officer in an outside entity[229] as long as it is at the request of the insured;
- non-executive directors;
- de facto and shadow directors;
- an employee acting in a managerial or supervisory position;
- an employee that is named as a co-defendant with the insured person;
- the legal representatives, estate or heirs of the directors and officers: this is in the event of insolvency, incapacity or death of the insured person;
- the spouses of directors and officers.

Defence costs:

This is the portion of the loss which is due to reasonable costs, charges, fees and expenses incurred in defending or investigating a claim. This includes premium paid for insurance policies in order to institute an appeal.

Policy:

The policy includes the proposal form, the actual policy form, the schedule as well as any endorsements.

Subsidiary:

This is an organisation in which the parent company holds a majority of voting rights, or has the right to appoint or remove a majority of its board of directors, or controls a majority of the voting rights as a result of a written agreement with the shareholders.

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[228] An officer may be defined as any natural person who is employed by the insured in a managerial or supervisory position.
[229] This is an entity which is not within the definition of the insured.

5.4.4 Exclusions

The exclusions or exceptions of a policy are there to dictate certain occurrences which are not covered by the insurance policy. The precise and general exclusions of all policies depend on the line of business of the insured, the country/countries in which the insured will operate, the market conditions, the reinsurance treaties which apply, as well as what the insurance company is willing to cover (Youngman, 1999). Depending on the state of the insurance market (whether it is soft or hard) some exclusions may be left out, others may be reinstated, whilst others may be deleted for an additional premium. Some of the main exclusions will be briefly deliberated.

Breach of copyright or patents:

Breaches of copyrights, patents or trademarks should generally be covered under product liability insurance.

Corporate manslaughter:

Corporate manslaughter is becoming more important in the UK with the passing of the Corporate Manslaughter and Corporate Homicide Act of 2007. This area is completely untested in the South African insurance industry; however progress will probably be made within the next few years.

Damage to property:

It is not the intention of the D&O insurer to cover losses which fall under general liability policies. Therefore any loss or damage to material property is excluded for the purposes of this type of cover (Youngman, 1999).

Deliberate acts:

These are deliberate breaches of duty or contract by the directors or officers of a company (Youngman, 1999). This is sometimes part of the 'fraud' exclusion.

Dishonesty or fraud:

This includes any deliberate fraudulent actor omission or wilful violation.

Employment dispute:

Any claim arising out of an employment related dispute such as wrongful dismissal, employment related misrepresentation, discrimination, and harassment, wrongful deprivation of a career opportunity or failure to adopt adequate employment policies should be covered under employment practices liability (EPL) cover. This type of cover may be purchased as an extension to the D&O policy or as a standalone policy.

Illegal personal profits or gains:

Directors are not covered where one has attempted to attain a personal profit to which he is not entitled.

Fines:

This relates to fines or penalties which are related to the legal system; this includes punitive and exemplary damages. However some insurance policies are stating to include cover for certain types of fines as a result of courts overseas being more and more willing to implement them.

Inadequate insurance:

This would be as a result of failing to insure company assets correctly. The exclusion includes a failure to arrange, maintain or purchase insurance cover. A gap in cover may sometimes lead to a claim being brought against the broker who arranged the policy as opposed to the director or the underwriters.

Insured v insured:

D&O insurance policies exclude claims which are brought by a director against a fellow director, or by the company against its directors. This is unless a third party, such as a shareholder, brings the action on behalf of the company against the directors; this is called a derivative action which is covered by the D&O policy. Class actions are also covered by D&O policies; this means that a group of people will bring a claim to court collectively. Excluded is also the event in which an outside director is sued by an insured person, unless this is referring to a derivative claim.

Known actions:

Insurers do not cover potential claims that are already a certainty. This knowledge exclusion applies where there is a pending claim against a policy and a new policy is taken out as a renewal or replacement, as well as to knowledge of claims prior to the inception of a policy. Often severability is important here as one director may have been aware of a loss-causing event whilst the rest of the board may have been unaware (Youngman, 1999).

Liability of directors and officers to restore remuneration to which they are not legally entitled:

The director or officer has actually not suffered a loss in this case; therefore they are required to restore what does not belong to them (Ferreira, 2002).

Libel and slander:

Some policies may automatically include cover for liability incurred as a result of libel and slander. If it has been excluded it may be brought back for an additional premium.

Major shareholder exclusion:

The D&O policy will not respond to claims brought against the insured as a result of a wrongful act by a major shareholder. For these purposes a major shareholder is one who controls a majority of ordinary shares, or who has the right to appoint or remove directors, or who has sole control of the voting rights in the insured company.

Nuclear exclusion:

The D&O insurance policy does not cover any loss which is resultant from nuclear or radioactive circumstances.

Pensions:

Any claims resulting from or in any way involving pensions which are established to benefit directors, officers or employees are excluded. This may be covered under pension trustee policies. Here 'pension' includes profit sharing, or employee or welfare programmes, share options, share incentive schemes and trusts.

Personal guarantees or warrantees:

Cover for personal guarantees and warrantees may be acquired under warranty an indemnity policies. However generally cover for warranty of authority is included due to the fact that legal obligations involve complex risks (Youngman, 1999). It is becoming more common to include cover in general for this exclusion.

Physical or mental injury or damage:

This will include bodily injury, sickness, disease or death, as well as damage to property. The policy wording must state that the exclusion applies to claims 'for' the above and not just 'arising out of' the above. The former includes consequential losses and the latter does not.

Pollution, seepage or contamination:

The D&O policy is not intended to cover losses which arise out of, or are attributable to, any consequences relating to pollution[230]. However certain policies may allow this to a certain extent depending on the directorial responsibilities which are being dealt with (Youngman, 1999).

Products liability:

This should be covered by product liability insurance. This may sometimes be left out for an additional premium; for example in the event that a product failure causes excessive harm to the share price of a company as well as its reputation.

Professional indemnity:

The D&O insurance policy was created in order to protect directors in their capacities as such regarding the company; not as professionals. This type of cover may be sought under professional liability cover. This exclusion may be deleted for an increase in premium.

Questionable payments:

This may be called 'commissions and bribes exclusion' and includes any payments to political parties, the state or consumer groups among others. Unfortunately many of these types of payments are actually intended to be brines. This exclusion may sometimes be deleted if such is agreed with the insurer.

Retroactive date:

The policy excludes any claims for a wrongful act which occurred prior to the retroactive date stated in the schedule. The retroactive date is that from which claims

[230] Pollutants are defined in the Hazardous Substances Act, No 15 of 1973.

against the policy will be covered; it does not necessarily have to coincide with the date of the policy inception.

War and terrorism exclusion:

The D&O insurance policy does not cover any loss which is resultant from war or terrorism. This includes any costs which are incurred in attempting to prevent or control any act of war or terrorism. If the insurer alleges that certain costs are not covered as a result of this exclusion, the onus lies on the insured to prove that it should be covered.

5.4.5 Conditions

Some of the more prominent conditions of the D&O insurance policy will now be briefly looked at.

Acquisition of parent company:

This condition applies in the event that the parent (insured0 company either merges into or consolidates with another organisation, or another organisation acquires more than 50% of the parent company's securities representing a right to elect its directors.

The policy will generally continue to cover the insured company but only for wrongful acts which occurred prior to the acquisition. All premiums which are still due are then considered non-refundable. An extension of cover may be arranged but only regarding wrongful acts committed prior to the acquisition and premiums will be fully earned by the insurer as soon as such an agreement is made. Obviously any additional premiums and conditions must be satisfied by the insured. Any extension will be part of the limit of indemnity and not in addition to such.

Acquisition or creation of another organisation:

In the event that the insured company acquires securities in another company or creates another organisation resulting in the new company being a subsidiary, or there is a merger or consolidation with another company the policy may respond in different ways.

If the acquisition is worth less than 10% of the insured's total assets the new company is automatically covered under the policy. This is however only applicable to wrongful acts committed after the acquisition, unless the insurer and insured can agree cover for wrongful acts prior to the acquisition.

In any other case the new acquisition is covered automatically but only for ninety days after the acquisition or the remainder of the policy period, whichever is shorter. This also only applies to wrongful acts committed after the acquisition. This is called automatic cover period. If the insured wants to cover the new acquisition once the automatic cover period has ended, an agreement must be reached with the insurance company regarding premium or new conditions. Should an agreement not be reached, the cover for any new acquisitions will be withdrawn by the insurer.

Action against the insurers:

This condition specifies the circumstances under which legal action may be taken against the insurance company. An action may not be brought against the insurers unless all the terms of the insurance policy have been complied with. No person has a right to join the insurers in an action against the insured and the insurer will not be sued in court in response to an earlier pleading by the insured. If the insured becomes insolvent or is liquidated, the insurance company is not relieved of its obligations towards the insured under the policy.

Advancement of costs:

The insurance company will advance defence costs on behalf of the insured before a claim is settled, on condition that if it is later established that those costs were actually not due regarding the insurance policy, that the insured will repay those costs to the insurer. The advancement of defence costs also decreases the limit of indemnity.

Allocation:

This condition is necessary in order to decide how much cover will protect the insured company and how much cover will protect the directors and officers of the insured company. This is important for claim settlements and payments as well as regarding defence costs (Youngman, 1999). Allocation problems in D&O generally arise in three circumstances (Ferreira, 2002):

- some person are covered, whilst others are not;
- some claims are covered whilst others are not; and
- there are issues regarding the insured and uninsured capacity.

Allocation is generally determined in good faith between the insurance company and the insured. The allocation issue has been dealt with in several ways (Ferreira, 2002):

- 'Best efforts' allocation: the insurer and the insured will use their best efforts to reach an equitable allocation;
- Allocation alternative dispute resolution provisions: any disputes regarding allocation will be deliberated using alternative dispute resolution; and
- Predetermined allocation: a predetermined allocation of defence costs and predetermined allocation of indemnity losses provision is developed.

Sometimes the insured company will be a defendant in a claim against a director or officer. This leads to a problem of what defence costs will go where? This may be dealt with by agreeing an extension to the cover which states a predetermined allocation. This generally means the 70% of the claim is payable by the insurer and 30% by the insured company.

Generally in South Africa allocation is either negotiated between the insurer and the insured, arbitrated, or judicially determined.

Alteration and assignment:

Any alteration to the policy is not effective unless it is made by a written endorsement which is signed by an authorised representative of the insurance company.

Annual basis:

Generally D&O insurance policies are annual. It depends on the respective insurance company whether or not a new proposal is required prior to each annual renewal. Some insurance companies will accept a declaration of information, which states that the no new relevant information exists, and if such should come up, the insurers will be infirmed.

Authorisation clause:

This condition states that the parent company will act on behalf of the insured persons with respect to the maintenance of insurance, such as payment of premiums and that the insured persons acknowledge the fact that the parent company will act on their behalf.

Cessation of subsidiaries:

A company may detach from a subsidiary during the policy period. In that event the cover will continue but only for wrongful acts committed prior to the date on which the subsidiary ceased to be as such.

Claims made basis:

D&O insurance policies are offered on a ‘claims made’ basis. A ‘claims made’ policy will respond to claims notified to the insurer during the period of the policy. This is irrespective of when the wrongful act leading to the loss actually took place. This only applies to wrongful acts which took place on or after the retroactive inception date.

This cover differs from that of the ‘losses occurring’ basis. ‘Losses occurring’ implies that the insurance policy covers claims which arise out of a wrongful act which occurred during the policy period. This is regardless of when the claim is made by the insured. All liability policies are either written on a ‘claims made’ or ‘losses occurring’ basis.

Defence and settlement of claims:

This condition relates to the manner in which claims against the insured will be defended or settled. Whilst it is the duty of the insured to defend any claims, no settlement may be carried out without the consent of the insurance company. The insurer also reserves the right to participate in the selection of the defence attorney, the creation of a defence strategy, and the settlement negotiations. The insured must not prejudice the insurance company in any way regarding the settlement of a claim. At any point the insurers may settle a claim for a monetary amount with the consent of the insured. The insured may not unreasonably withhold consent in such a case.

Indemnification:

In the event that the insured company will not indemnify an insured for a loss, the insurer will advance defence costs or payment for the loss as required by the Side B insuring agreement.

Jurisdiction:

This condition states what laws will apply to any disputes and claims which arise in connection with the policy. Insurance companies always want the laws of the state in which they are present to apply even if the wrongful act occurs overseas where the parent company may be undertaking business. This is in order to avoid foreign and unknown legislation applying to the insurance policy.

Limit of indemnity:

The limit of indemnity is the maximum amount which the insurance company will be liable to pay under each policy. This includes all legal and other expenses and costs. All claims which arise out of the same wrongful act are deemed to be one claim. The limit of indemnity applies after the excess has been paid by the insured. If a claim will be covered in part under Side A and in part by Side B, the limit will first apply to Side B. The discovery period option (if exercised) does not increase or reinstate the limit of indemnity; it becomes a part of that limit.

Notification of claims:

The insured must inform the insurance company as soon as possible (no later than thirty days) of a possible claim, or as soon as the insured is aware of any circumstances which could potentially lead to a claim. The insured is also required to cooperate with, and supply the insurer with all the necessary information regarding a claim.

Other insurance:

In the event that the insured company is insured under another policy, the current policy will only cover the insured in excess of what the other insurance has covered. This is only the case unless the other insurance policy is specifically taken out as an excess insurance policy. This can often cause problems as to which insurance policy will apply first, however it is customary to ask the insured before the policy is bought if any other policy is already in place.

Representations and severability:

This condition refers to representations made by the insured to the insurance company in the proposal form. If the representations are not true, cover will not be afforded to any person who knew of the actual facts, as well as the company under Side B cover for indemnification of any person who knew of the actual facts.

Severability of exceptions:

This gives the insurance company the right to assume that the director or officer who signs the policy or administers it, is aware of all the possible claims known to the other directors and officers covered (Youngman, 1999). It may be unjust in some circumstances to withdraw cover from one director if that director was not aware of certain facts. For example if another director was intentionally withholding relevant information. This condition applies to severability when attempting to apply exclusions. No knowledge possessed by one insured is imputed on to another insured for the purposes of applying exclusions unless the person who possessed the knowledge in an executive officer.

Subrogation:[231]

This condition requires that the insured shall assist the insurance company in seeing out any subrogation rights which may be acquired as a result of indemnification.

Termination of policy:

The D&O insurance policy will terminate at any of the following times:

- at a date specified by the parent company in a prior written notice to the insurance company;
- when the period of insurance stated in the schedule expires;
- ten days after receipt by the parent company of a written notice of termination from the insurer as a result of failure to pay premiums;
- at any time as agreed by the insurer and the parent company.

Territory:

This condition states that wrongful acts on the part of the insured will only be covered in certain locations around the world where the insured has business operations. South

[231] Subrogation refers to the right of one party who has paid for the loss of a second party to be compensated from a third party who is responsible for the loss.

African policies will exclude the US and Canada as well as any of their territories. This is as a result of the high-risk profile of these countries.

5.4.6 Extensions

This section will briefly look some of the more important D&O insurance policy extensions.

Company securities:

The insurance company will indemnify the insured for any securities claim which is resultant from a wrongful act committed or alleged to have been committed by an insured person.

Discovery period:

This extension provides that if the D&O policy is not renewed by either the insured or the insurer, or the parent company terminates the policy, an extension period will be provided for a certain amount of time; twelve months for example. The cover will only apply to wrongful acts committed prior to the commencement of the extension but the claim will be deemed to have been made during the policy period. The reason for this extension is that claims in D&O can take a long time to surface and cover might only be needed a long time after a wrongful act has taken place (Youngman, 1999). This will be useful in cases involving fraud where one of the insured directors had no knowledge of the event and a claim only arises sometime after the expiry of the policy.

Estates and legal representatives:

This extension covers claims for wrongful acts against the estates, heirs, legal representatives or assigns of the insured in the event that the insured is deceased, incompetent, insolvent or liquidated.

Outside director liability extension:

This extension to outside directors will apply provided that:

- the cover does not extend to the outside organisation;
- the cover is in excess of any cover that the outside organisation has for these directors;
- the amount payable under this policy will be reduced by any amount payable by other liability policies taken out by the outside organisation;
- the cover does not apply to claims brought by the directors or officers of the outside organisation, unless it is a derivative action, or defence costs regarding such a claim; and
- the cover does not apply to wrongful acts committed after the insured has stopped performing as an outside director.

Pollution defence costs:

Defence costs for claims involving pollution are provided, however if the claimant is successful, cover will not be provided for the loss incurred.

Public Finance Management Act:

This extension only applies in South Africa and the insured person will then be deemed to include the accounting officer and the accounting authority as defined in Sections 36 and 49 respectively of the Public Finance Management Act No. 1 of 1999.

Reinstatement of limit of indemnity:

The reinstatement of the limit of indemnity will kick in once the current limit has been depleted during the policy period. It must be borne in mind that the reinstatement will only apply to claims made after the reinstatement. In other words, if the current limit is depleted for a certain claim, the insurer will not be liable to indemnify the insured for the rest of that claim even if a reinstatement has been included in the policy. The reinstatement will apply to the next claim against the insured company or person.

Shareholder derivative actions:

Cover is provided for losses to the insured resulting from shareholder derivative actions.

Spousal liability:

This extension will cover the spouse of the insured as a result of the spouse's legal connection to the insured and the spouse's ownership interest in the assets of the insured. This does not cover wrongful acts committed by the spouse; it protects the assets of the spouse in the event that a claimant will have an interest in the assets of the insured.

This is a peculiar extension for the simple reason that a claimant will only need to access the insured's personal assets in the event that:

- the parent company cannot indemnify the insure; and
- the D&O policy has either run out or cannot respond.

If the D&O policy does cannot cover the insured it will not be able to cover the spouse either.

VAT exclusive:

The limit of indemnity is VAT-exclusive. This extension provides that the insurers will indemnify the insured in excess of the limit of indemnity for any VAT requirement which may be incurred out of a claims settlement.

5.5 D&O literature

This section is divided into two: the first part looks at the impact of D&O insurance on corporate governance, whilst the second part looks at the corporate demand for D&O insurance. The aim is to briefly cover a large amount of D&O literature in order to discover what other uses D&O insurance has for the corporate world.

5.5.1 The influence of D&O insurance on corporate governance

Some literature is available which studies the impact of D&O insurance on corporate governance, as well as how to actually utilise D&O insurance in order to increase the governance standards of companies. Alles *et al* (2006) states that D&O insurance companies can reduce the governance risk faced by their clients by linking coverage to contractual requirements to follow best corporate governance practices.

The insurance industry helped to establish many safety regulations which have now become standard practice in society. Some examples are seat belts in cars and smoke detectors in buildings (Alles *et al*, 2006). The most common means of controlling and disciplining directors has thus far been regulation and the legal system. This is in line with the mitigating steps discussed in this dissertation; corporate governance and legislation. These mitigating steps are generally enforced by the courts. It seems that investors seek to diversify their portfolios by purchasing small shares in many companies. This generally results in little interest in the governance methods of any one company; however the losses of a corporate collapse are still costly to society. The problem with corporate governance codes is that directors often have no incentive to carry out the requirements, as well as the fact that directors may not possess the necessary means to carry out the governance requirements of a company.

Litigation may also be used as a method of ensuring that directors carry out their functions correctly. However it is often difficult to find a correct balance between placing a director's personal assets at risk, and providing protection for that director so that a required level of risk is taken in order for a business to be profitable (Alles *et al*, 2006). This leads to tensions between motivating and controlling directors. Alles *et al* (2006) suggests that one may create market-based governance by combining the extent of D&O cover with the extent of care carried out by directors into one mechanism.

It is possible that being covered by D&O insurance may lead a director to take less care; this is the moral hazard problem. However this has been taken care of by the insurance industry by making cover and premiums dependent on the insured's effort to mitigate moral hazard; for example persons that do not smoke will get lower health insurance premiums (Alles *et al*, 2006).

Therefore Alles *et al* (2006) suggest that governance-linked D&O insurance may oblige directors contractually to comply with corporate governance standards in return for higher coverage and lower premiums. Directors will be provided with the means to apply the best corporate governance techniques, whilst insurers will then be able to provide more comprehensive coverage. This will require an ex-post system of control by insurance companies where governance standards are used in order to determine premiums and cover after the signing of the insurance contract. It is different to the ex-ante controls that are used in underwriting which uses past behaviour as a determinant of future claims. This may however be extremely risky as was the case of Enron: the company seemed to cover all the necessary corporate governance requirements even at the time when the losses were discovered. The idea is to provide incentives for talented individuals to serve on boards of directors without fear of losing personal assets. Increasing litigation may deter non-executive directors from serving on certain boards, which may become problematic in South Africa. Basing cover and premiums on corporate governance standards may be a good way to increase the extent of coverage whilst also decreasing risk (Alles *et al*, 2006).

A similar, but more specific approach is taken in Huskins (2006). The paper suggests that D&O insurers should reward insureds that follow best corporate governance practices by offering D&O policies that are non-rescindable. The idea is that this will decrease corporate failures and therefore the risk of litigation against directors and officers. As a result of a reduction in claims, the well-governed companies may receive lower premiums on their D&O policies.

When a D&O insurer offers a policy to a company, the insurer will require information regarding that company's risk profile. The single application and policy covers multiple individuals; therefore the person who eventually signs the policy, does so on behalf of all those insured. Any relevant and material knowledge must be presented to the insurance company. If the information provided is incorrect in certain manners, the insurer can then rescind, or cancel the cover. This is because the D&O insurer may have wanted to charge a different premium with the true facts in hand, or may have declined cover completely (Huskins, 2006).

Insurance companies deal with this by declaring that some of the policy is non-rescindable. This does not always the directors as the non-rescindable part of the policy is generally the lower risk portion. Another way in which insurance companies deal with the knowledge which is provided during the application for a D&O policy is with a severability clause. The persons who had actual knowledge of relevant matters on application for the D&O policy and withheld this information are severed out of cover. In other words, those persons will not be covered whilst the rest of the innocent directors and officers are still covered by the policy (Huskins, 2006).

The fact that severability and rescission are based on the knowledge which is possessed by directors and officers may lead to parallel incentives for the directors of a company. If less knowledge leads to greater protection, the directors that take part to a great extent in a company's affairs may get penalised, whilst those that are less involved reap the benefits. Another problem for the insured is that policies with less rescindability may only be available in times when the insurance market is soft – when the market hardens this option may not be available (Huskins, 2006).

Therefore Huskins (2006) suggests that cover should be based on the governance standards of individual companies. Processes must be in place for directors to keep a check on how management is running the company. The company may be required to pass a 'governance test' which will lead to a scrapping of the insurer's right to rescind the policy. This type of D&O cover may provide directors with an incentive to utilise good corporate governance techniques, in exchange for non-rescindability, which will induce more qualified persons to serve on the board of directors of companies without the fear of personal liability (Huskins, 2006).

O'Sullivan (1997) empirically tests the monitoring hypothesis by exploring the link between board composition, managerial ownership, external shareholder control and the purchase of D&O insurance. The monitoring hypothesis states that the need for D&O insurance will increase as the cost of other methods of motivating managers increase. In that manner, as the demand for monitoring increases, the use of D&O insurance should also increase (O'Sullivan, 1997). The study was performed on a sample of 366 companies in the UK.

It was found that smaller companies use internal and external ownership to monitor managers. However larger companies are more likely to use non-executive directors and D&O insurance to monitor managers. This is probably due to the fact that eternal monitoring becomes more expensive. The results of the paper support the monitoring hypothesis. This confirmed the monitoring hypothesis provided in Holderness (1990) which suggests that D&O insurance may itself be used as a means of governing companies.

Core (2000) utilises a sample of D&O premiums attained from the proxy statements of Canadian companies in order to study D&O premium as a determinate of ex-ante litigation risk. The paper discovers a significant connection between D&O premiums and the value the companies' governance standards. Core (2000) also finds that D&O insurers charge higher premiums when companies have governance procedures which make shareholders worse off.

From the literature provided one may conclude that:

- D&O insurance may be used to drive good standards of corporate governance;
- D&O insurance itself may be used as a method of company governance;
- D&O insurance may use a company's standards of corporate governance in order to provide better coverage; and

- D&O insurance premiums are a good indicator of a company's level of corporate governance.

5.5.2 The corporate demand for D&O insurance

Mayers and Smith (1982) looked to explain the corporate demand for insurance. It was generally thought that the main reason for the purchase of D&O insurance was risk aversion; directors are concerned that their personal assets will be taken away in order to cover losses to the company or to third parties. However Mayers and Smith (1982) attempted to explain the purchase of insurance from a finance point of view. The first studies done were merely theoretical and generally concluded that private companies are more likely to purchase D&O insurance due to the fact that the shareholders of public companies can diversify away from the insurable risks by holding shares in other companies. This was the proposition put forward in Smith (1986). The owners of private companies will demand the purchase of D&O insurance if they are risk averse.

Mayers and Smith (1982) found the following reasons for the corporate purchase of insurance: first, insurance contracts spread the risk to persons who are more equipped to deal with it, such as the insurance company. Second, the expected transaction costs of bankruptcy will be lowered. Third, claims administration will be handled more efficiently due to the fact that the insurance company will have much experience in this regard. Fourth, the insurance contract may require monitoring of the provisions which protect a company from loss. Fifth, purchasing insurance contracts can guarantee a company's investments. Sixth, the company's tax liability may be lowered as a result of the purchase of insurance. This is because the payment of insurance lowers taxable income. Finally, purchasing insurance may lower the regulatory limitations on a company.

Mayers and Smith (1990) empirically tested the corporate demand for insurance. This had proved difficult until then as a result of the fact that it was extremely difficult to acquire data on the purchase of insurance contracts. Therefore the insurance industry's purchase of insurance was actually tested because insurance companies were required to report their purchase of reinsurance in their annual statements (Mayers and Smith, 1990). The sample was made up of 1276 property/casualty insurance companies. It was found that ownership structure, size, line of business, geographic concentration, and default risk were significant determinants of the companies' demand for insurance. The most significant determinant was that of ownership structure; the less diversified the owners' portfolio, the more reinsurance was purchased.

Bhagat *et al* (1987) looked at the effects of D&O insurance on shareholder wealth. The idea was that shareholder-manager conflicts had increased with increasing numbers of derivative and class action suites; this led to many debates on what the role of D&O insurance actually was. An empirical study was performed in order to observe the stock returns regarding management proposals to broaden company insurance and indemnification. The results showed that D&O insurance may reconcile the interests of directors and shareholders. This was contrary to the arguments at the time, which stated that D&O insurance may deter directors from acting in the interests of shareholders, as a result of the fact that if a loss occurs, the insurer will be required to pay for it and not the guilty director.

The empirical examination performed in Bhagat *et al* showed that the effect of D&O insurance on shareholder wealth is positive, and that there is no negative influence on shareholder wealth by increasing director indemnification. Therefore the study concluded that there is no reason to introduce legislation which seeks to reduce D&O insurance and indemnification. It seems that consistent with other literature, other market mechanisms will control director behaviour when one is covered by insurance; such as the reputation costs of defending a legal claim.

Han (1996) studies the corporate demand for insurance as well as the impact of insurance on the effectiveness of managerial performance in business operations and risk management. Different managerial compensation systems are compared. It was found that insurance has an important function in creating an efficient managerial incentive contract which therefore may determine the value of the company (Han, 1996). Regarding fixed compensation, insurance cover which ensures solvency is most favourable. If compensation is based on the company's liquidating value, full cover is most advantageous as it allows for dependence on performance compensation. If compensation is based on stock price, partial or no cover at all is feasible (Han, 1996).

Core (1997) studies the factors which influence a company's demand for D&O insurance utilising data from a sample of Canadian companies. The paper hypothesizes three bases of demand for D&O insurance: first, demand from a risk-averse outside director; second, demand from an efficient company insurance decision; and third, demand resulting from managerial entrenchment.

The first relates to the fact that D&O insurance will protect the non-executive director against litigation. If D&O insurance is not made available the director will have to be paid more in order to cover that risk-premium. Risk-averse directors will require more insurance in order to take up the position in the company. The second relates to the company's demand for insurance – reimbursement. Companies with a higher distress probability are more likely to purchase insurance; this is due to the fact that insurance will lower the expected costs of bankruptcy. As in Mayers and Smith (1982), companies with higher inside ownership are more likely to purchase insurance because of increased risk aversion. The third relates to the managerial entrenchment effect; as voting control increases in favour of insiders (managers in this case), the needs of outside shareholders are given less importance. Therefore more insurance is purchased which will protect the managers themselves (Core, 1997).

The results showed that companies with greater litigation risk and higher distress probabilities are more likely to purchase D&O insurance, as well as to purchase higher limits of indemnity. Contrary to Mayers and Smith (1982, 1990) it was found that companies with high levels of inside ownership are less likely to purchase insurance. However companies with low levels of inside ownership and high levels of inside control are more likely to purchase insurance and higher limits of indemnity (consistent with the managerial entrenchment hypothesis). One must take into account that Core (1997) did contain certain caveats; the sample size was small, and the study was only done on a particular type of insurance purchased by Canadian companies.

Yamori (1999) empirically examined the demand for insurance of non-financial companies utilising data from Japanese companies. The sample consisted of 504 companies that disclosed their insurance premium during the years 1986 and 1987. The paper looks at a number of different factors which could affect a company's demand for insurance; these will be set out with the results of each from Yamori (1999).

The first consideration is that of ownership structure; it is generally said that private companies with more owner-managers are more likely to purchase insurance than public companies, as the owners of private companies can not diversify away from the risk of a loss. There was no evidence found that ownership structure significantly reflects the purchase of insurance by companies. However certain caveats did exist in this finding, such as that all the companies in the sample were actually listed.

The second consideration is that of tax; the payment of insurance premiums is deductible from taxable profits (Yamori, 1999). It was found that tax considerations are not an important factor in the purchase of insurance by companies. However non-profit companies do not pay corporate tax, therefore this factor would be less relevant for those companies. The sample tested in this paper consisted of companies which recorded profits.

The third consideration is that companies with a higher probability of bankruptcy are more likely to purchase insurance in order to reduce the expected costs thereof. Yamori (1999) does not find any evidence of this consideration. However the companies in the sample which was tested performed exceptionally well, therefore the shareholders were probably not that concerned with the purchase of insurance.

The fourth consideration is that of the size of the company. Company size may affect the purchase of insurance in two ways. Firstly smaller companies may be more affected by the potential for bankruptcy. As stated in Mayers and Smith (1990) bankruptcy costs are not proportional to the size of the company, therefore a small company may suffer more from bankruptcy and, as a result, necessitate the purchase of insurance. However in large companies shareholders find it more difficult to monitor the managers due to the size and complexity of the company. These agency costs will then require that shareholders purchase insurance in order to monitor the managers and provide for a shield from losses (Yamori, 1999). The paper found strong evidence in favour of the size of a company affecting the purchase of insurance. It was found that small companies will purchase relatively more insurance than large companies.

The last consideration was that of regulated industries. Regulated industries are thought to demand more insurance due to the fact that regulators use marked-up pricing and that less competitive industries act in expense-preference manners (Yamori, 1999). The paper found evidence in favour of the hypothesis that more regulated companies will demand more insurance.

O'Sullivan (2002) looked to explain why large public companies in the UK purchase D&O insurance. The idea was to reconcile the findings in the paper with three motives from previous literature:

- D&O insurance is purchased as part of the corporate insurance programme;
- D&O insurance is purchased as a result of demand from directors; and
- D&O insurance is purchased as part of the corporate governance procedures.

The 1989 UK Companies Act required that companies report the existence of company-funded D&O policies. The sample was made up of 386 companies from the London International Stock Exchange at the end of 1992. The findings of the empirical analysis using a univariate analysis and a logit model show support for each of the three above reasons for the purchase of D&O insurance.

The possibility of litigation was a major factor in the purchase of D&O insurance; this conclusion was drawn because unpredictable share price performance and the carrying out of business in the US was mostly related to insured companies. It was also found the insured companies are generally larger; this is consistent with director and governance demand for insurance. Shareholders of large companies will find it difficult to monitor governance standards due to the size and complexity of the company. Therefore D&O insurance is purchased so that the insurer can monitor the governance standards of the company and so that protection may exist in the event of a loss. The directors of large companies will be more risk averse due to the fact that the shareholders of those companies have more value at risk.

Regarding ownership structure, insured companies have lower levels of managerial ownership; this is because owner-managers will have the same monitoring objectives as the shareholders, therefore monitoring costs will decrease. It could also go the other way in that owner-managers can not diversify their risks and will therefore require D&O insurance as a governance mechanism. It was also found that companies that had more non-executive directors on the board were more likely to purchase insurance. Non-executive directors can use D&O insurance in order to monitor the company, as well as to use it for protection in the event of incurring liability. This shows that the governance demand for D&O insurance is strong (O'Sullivan, 2002).

Boyer (2003) empirically tested seven different hypotheses based on data from public Canadian companies. The aim was to ascertain the corporate demand for D&O insurance. The data was available because the Ontario Securities Commission which oversaw the Toronto Stock Exchange made it compulsory for public companies to disclose information regarding the purchase of D&O insurance policies. The data was based on public companies that filed financial information between 1993 and 1998. The following will look at the seven different hypotheses tested as well as the results.

The first was the *shareholders' protection* hypothesis; the evidence was strong in favour of supposition. As discussed previously, this hypothesis suggests that D&O insurance should appeal to shareholders the most. If the directors of a company cannot afford to compensate a claimant in the event of a loss, the D&O policy will supply the shareholders with the amount of damages. One would expect a positive relationship between the company's market value of equity and the amount of D&O insurance purchased (Boyer, 2003). This relationship was found in the paper.

The second was that of the *compensation package* hypothesis; strong evidence was also found for this assumption. The idea is that D&O insurance may serve as a substitute for directors' compensation. Therefore there should be a negative relationship between the amount of compensation that a director receives and the amount of D&O insurance purchased. This trend was found in Boyer (2003) and is consistent with Core (1997).

The third hypothesis tested was the *risk aversion* hypothesis; the paper found no evidence of this inference in the empirical study. There was no link found between the proportion of independent directors serving on the boards of companies and a higher amount of D&O insurance. Once again no evidence is found which could lead one to believe that the more risk averse a director is, the more D&O insurance is demanded.

The fourth hypothesis is the *financial distress* hypothesis; the paper found weak evidence in favour of this suggestion. A high-risk company, or one that is in financial distress, would be expected to purchase more D&O insurance as it would require more protection. However Boyer (2003) finds only weak evidence to support this concept.

The fifth hypothesis is the *monitoring* hypothesis; Boyer (2003) finds weak evidence to support this suggestion. The insurance company could provide monitoring and other services to the insured in order to assist in monitoring the systems of corporate governance of the company. One would expect a negative relationship between the amount of D&O insurance purchased by a company and other methods of company monitoring. Only weak evidence was found of this hypothesis which is supported by Holderness (1990), O'Sullivan (1997) and Core (2000).

The sixth hypothesis is the *managerial signalling* hypothesis; Boyer (2003) finds strong evidence in favour of this concept. The idea is that directors will use the amount of insurance purchased to signal their level of skill. Boyer (2003) discusses Rothschild and Stiglitz (1976) and the concept of adverse selection. If only two types of directors exist – good and bad – (relating to the level of skill and therefore risk) the good director will require less protection and therefore purchase less insurance. Therefore a good director will purchase less insurance in order to show his or her higher level of quality[232]. Therefore if managerial signalling is more important at a

[232] Boyer (2003) states that managerial signalling is normally carried out by purchasing higher deductibles rather than lesser limits of indemnity.

company, less insurance should be purchased; the paper found this relationship to exist.

The last hypothesis tested is the *entrenchment* hypothesis; the evidence in the paper was mixed in this regard. Managerial entrenchment has been described as the level of influence that managers have on the board of directors (Boyer, 2003). Therefore insiders will utilise their control over the board in order to more D&O insurance for protection. This is in line with Core (1997) and Chalmers *et al* (2002). One would assume that the more influence managers have over the board of directors, the more D&O insurance would be purchased by a company. Boyer (2003) found mixed evidence in this regard.

It must be borne in mind that some of the aspects of the corporate demand for insurance apply more to the US than South Africa. Take for example the monitoring hypothesis – this is deeply connected to the notion that insurance companies may assist in improving the corporate governance standards of their insureds. Whilst in the US insurance companies do have the tendency to assist their insureds in the running of their business and adjust premiums accordingly, this is not necessarily the case in the UK; South Africa follows more closely the UK approach. In South Africa the D&O insurance company will not dictate to the insured how to run the business safely; the insurer will set a premium according to how the company runs its own operations. Either that or perhaps deny cover altogether. South African D&O insurance companies will therefore examine the risk of a potential applicant, and decide whether or not to cover that specific risk and what premium price tag to put on it. Local insurance companies will not take on the additional responsibility and cost of advising the applicant on how the business should be carried out.

A more negative approach to the need for D&O insurance was taken by Baxter (1995); it is claimed that D&O insurance only provides protection in a limited number of circumstances and even then, liability could be dealt with by other means. The one instance, in which the paper claims that D&O insurance is actually useful, is in the event that the company for which the defendant director serves goes insolvent. If a third party has a claim against a director and the company which the director serves is insolvent, then D&O insurance will be valuable. The paper states that in most other cases, is a third party has a claim against a director, that third party would rather claim against the director's company as it is more likely to have more funds available. This is debatable in this day and age when the according to the Tillinghast 2008 D&O Liability Survey, 'other' third party claims made up 14% of total claims against directors; this excludes shareholders, competitors and employees. Baxter (1995) offers some other explanations for why D&O insurance actually exists. These will now be summarised briefly Baxter (1995):

- US legislation, at the time when D&O insurance originated, made it difficult for companies to pay for the indemnification of directors and officers. Laws were then introduced to allow for indemnification and companies decided to take out more insurance in order to make certain that they could meet those indemnities. This was also the case in the UK and South Africa until their respective company legislation was altered.
- Insured persons become attractive defendants; the advertised need for insurance makes it harder for people not to be insured. All claimants know that if insurance is available, they are likely to be granted more, or more likely to be granted, compensation for a loss. In fact that is not actually the case but that is the state of mind of most potential claimants.
- The paper then states that D&O insurance may not necessarily be used as a tool for monitoring; at least in the UK. The fact that public companies have to state whether they have purchased D&O insurance will not mean that shareholders will be able to monitor directors through the insurance company. To the contrary, potential claimants will be made aware of the availability of insurance and will theoretically be more inclined to sue.
- D&O insurance has also been regarded as a means to spread a loss; funds may thus be available for injured third parties. The paper states that this is however only useful when the company for which the director serves has become insolvent. Once again, the fact that more funds are available may lead to an increased number of claims. It may not be much of a concern that associates sue each other if there is an insurance company that will ultimately bear the cost.
- The last motive for the spread of D&O insurance according to the paper is the experiences of the US. The hard market of the 1980s led to a situation in

which many companies were being denied cover. Society in the US is also generally more litigious than in the UK. The lack of cover during the mid-1980s hard market led to companies either holding money in a trust in order to cover directors, or to the use of captive insurance companies.

6 INDUSTRY EXPERT ANALYSIS

The final chapter will assess the views of this dissertation against those of industry experts. It is not possible to attain data on the effects of corporate governance codes and the new Act on D&O liability insurance. This is due to the fact that no actual data is available and the new Companies Act has not been passed yet. It is however feasible to make certain assumptions and forecasts by utilising previous literature and certain reports as this dissertation has done. The next logical step is to assess the opinion of this dissertation against those of industry experts. Using the opinions of experts is probably the best and only way to create a view of what might occur in the future when there is a lack of actual data available. In this manner, the insurance industry will also be informed as to what the general consensus is regarding the effects of corporate governance codes and the new South African Companies Act from within itself.

The industry expert analysis will be performed in two ways: first a Delphi Technique study will be performed in order to acquire the views of experts in the field of D&O liability insurance, corporate governance, and director liability. The second method will be to perform face-to-face and online interviews with the experts in order to make the study more robust. This will make the study more robust in two ways: firstly the opinions received by the Delphi Technique will be assessed and therefore so will those of the dissertation itself. It is true that the more methods that are used to find the same answer, the more accurate that answer will be (this is especially important due to the fact that no actual data was available for this study). The second reason why the interviews will make the study more robust is that the rationale as to why certain conclusions were reached by the dissertation and the industry experts will be discovered. This is perhaps a shortcoming of multiple choice questions; the reasons behind the answers are often hidden.

The total sample size of this study was of thirty industry experts. This may seem like a minimum amount; however in South Africa this number actually more than covers the entire D&O expert industry. The experts will range: D&O liability insurance experts will be made up of underwriters and brokers from various companies, legal experts, and experts in corporate governance. All thirty participants took part in the Delphi Technique study, whilst of those twenty took part in the interviews. The lower number of participants being interviewed was consequent to the time constraints, which are faced by the industry.

This chapter is set out in the following way: the first section sets out the Delphi Technique study, the experts' answers and the assessment of those answers. The second section will look at the interviews, the experts' answers as well as an assessment of those answers.

6.1 Delphi Technique study

The Delphi Technique study was performed in order to attain actual data from a situation in which no figures were actually available. The Delphi Technique is utilised in order to forecast certain events for which limited information is available. Thus one is required to use intuition as well as the opinions of experts. The procedure of the study is structured in order to accumulate and refine knowledge from a group of experts. This is done by making use of a series of questionnaires combined with controlled opinion feedback.

Methodology:

A sample size of thirty industry experts was selected. The knowledge base of the experts ranged between underwriters, brokers, legal experts, and experts in corporate governance. A list of the names of the participants in the study may be viewed under Appendix 4.

The experts received an explanatory email which contained instructions with regards to the study and what was required of them. The email contained a list of twenty-four questions which had to be answered by the experts. The questions were actually statements which would have to be rated by the experts on a scale:

1 = Highly Agree
2 = Agree
3 = Neutral
4 = Disagree
5 = Highly Disagree

The experts were asked to tick the boxes which reflected their informed opinion and once the questionnaire was completed it would be emailed back for assessment. The results of the first round of questioning may be viewed under Appendix 3. The results of the first round of questions were then sent back to the experts for consideration. The participants' answers were kept anonymous. Once the results had been taken into consideration by the participants, they were then asked to answer the questions again and email them back for assessment. The results of the second round of questioning may also be viewed under Appendix 3.

It was then determined that a third round of questioning would be redundant. This is due to the fact that there was no significant alteration in the experts' answers between the first and second round of questionnaires.

Utilising the data gathered from the experts by means of the Delphi Technique it was then possible to create a forecast and make certain assumptions with respect to the effects of corporate governance codes and the new South African Companies Act on D&O liability insurance. An assessment of the results will now be undertaken; the following section has been divided up into three sub-parts: director liability, effects on the insurance industry/policy wording, and effects on directors. These three sub-sections will now be looked at in turn. Under each sub-section the specific questions which are applicable will be analysed with respect to the results obtained in the study.

In order to create a better understanding of the Results Tables the following explanation is provided:

Descriptions:

- AGREE denotes the summation of ‘Highly Agree’ and ‘Agree’.
- DISAGREE denotes the summation of ‘Highly Disagree’ and ‘Disagree’.
- Green block represents significance of > 50%.
- ‘Mean’ refers to the average answer selected; a mean of ‘1.5’ indicates that the average answer lies halfway between ‘1’ and ‘2’.
- ‘Percentages’ refers to the percent of selected answers under ‘Agree’, ‘Neutral’ and ‘Disagree’.
- ‘Highest Percentage’ refers to the answer which was selected mostly per question, as well as the percentage of selection of that answer.

6.1.1 Director liability

The scope of this section is as the title suggests; looking at director liability. The first two statements of the questionnaire were designed to correlate with Chapters One and Two of the dissertation. The aim is to investigate whether or not the expert participants believe that director liability has increased due to the doctrinal and complexity issues.

The rest of the statements contained in this section of the questionnaire are aimed at exploring what the experts believe have been the effects of the various corporate governance codes, as well as what the effects will be of the new South African Companies Act, on director liability. These statements relate to Chapters Three and Four of the dissertation.

1) *Director liability has increased as a result of the courts and society being more willing to hold directors accountable.*

The first Statement received a 100% AGREE result; this was the case with respect to the first and second round of questioning. In fact there was no change in answers between the first and second round at in the first statement. The results were split ten to twenty between Highly Agree and Agree respectively. The Agree option was therefore selected by 66.7% of the participants. The resultant mean was 1.67.

This is a highly significant result with regards to the first inquiry of the dissertation; whether doctrinal issues have led to an increase in director liability. In-line with the conclusions of the dissertation, the Delphi Technique study found that director liability has in fact increased as a result of the courts and society being more willing to hold directors accountable for their actions or inactions. It is important to note that 100% of the legal experts involved in the study opted for the Highly Agree answer. This is relevant due to the fact that one would expect the legal experts to have more insight into any changes in director liability which may have occurred.

Possible explanations for this polarised result would be as per the dissertation: the expansion of the law of delict to include pure economic losses, the role of the media in bringing director accountability to the attention of the public, the awareness which resulted from the worldwide corporate scandals, and the changing perceptions of the roles of directors within a company (in that expectations have increased with accountability). It is beyond the scope of this sub-section to delve into explanations with respect to the increase in director liability as this has been covered elsewhere. However it is important to note that according to the participating experts, director liability has increased as a result of the doctrinal issues, which is in concurrence with one of the fundamental assertions made by the dissertation.

2) *Director liability has increased as a result of the increasing complexity of the modern economic world.*

The second Statement also received a 100% AGREE result with a mean of 1.67; this being a crucial substantiation that the notion which the dissertation is based on (increasing director liability) is widely held by industry experts. The result was actually identical to the first Statement in that twenty participants selected Agree, whilst the remaining ten opted for Highly Agree. The only change that took place between the first and second round of answers was that one person switched from Neutral to Agree.

This result is not surprising in the context of the current state of the world economy. The global financial markets are experiencing one of the most severe crises ever known, which is leading to significant company losses all over the world. Such is the complexity of the modern economic world that almost no country has been left unaffected. This together with the doctrinal issues raised earlier has led to a certain degree of criticism of company directors. Mervyn King stated, at the first presentation of the South African King Report on Corporate Governance of 2010 (King 3), that a lack of good corporate governance was a key issue in the causation of the financial crisis. This is according to Business Day on the 26/02/2009 – Professor King believes that good governance is meant to be about directors controlling companies in the best interests of its shareholders; however the subprime crisis is evidence of poor implementation and conflicts of interest.

It is thus undeniable that doctrinal and complexity issues are concurrently resulting in increasing director liability.

3) *The various corporate governance codes around the world have had the effect of reducing or containing claims against directors.*

The results show that the expert participants do not believe that corporate governance codes have reduced claims against directors. The response was 86.67% DISAGREE, which was an increase from 76.67 DISAGREE in the first round of questioning. This was as a result of three Neutrals shifting to Disagree, whilst one Neutral shifted to Agree. It may be worthwhile pointing out that none of the experts opted for the Highly Agree option in either round. The mean of the second round was 3.97. The most selected answer was Highly Disagree with 21 selections or 70%.

It is generally expected that as the participants of such questionnaires progress through consecutive rounds, that Neutral answers tend to migrate towards the extremes. It was difficult to extract a pattern with respect to the Neutrals in Statement 3 due to the fact that they varied between brokers and underwriters. Perhaps this is expected as none of the legal or corporate governance experts selected the Neutral option. This is probably due to the fact that such experts are more knowledgeable with regards to corporate governance codes and are therefore more likely to form a stronger opinion. One must bear in mind that this question required some insight into aspects of corporate governance – or perhaps into D&O claims experiences from around the world. South Africa, possessing a lack of case law as well as claims experience in the field of director liability, was always likely to produce experts that may tend to answer this specific Statement as Neutral.

The most important discovery of Statement 3 however is that the experts concurred with the conclusion of the dissertation; the various corporate governance codes around the world are unlikely to have contained or decreased claims against directors. This is perhaps where a double-edged sword effect may come into play; whilst corporate governance codes may provide controls they also establish certain duties and expectations with respect to company directors. Corporate governance codes also lead to public awareness of what is expected of directors and what may be done as a consequence of non-compliance. The more spectacular codes (such as the Cadbury Code in the UK) were also reactive to corporate failures. The public is then generally more inclined to look to claim against directors when a corporate failure occurs. It is possible that the potential double-effect of corporate governance codes on director liability could be another reason for the amount of Neutral responses received.

More importantly however, another fundamental assumption of the dissertation was enforced by the industry experts; the various corporate governance codes have not been successful as a mitigating step in reducing corporate failures and claims against directors. It is now time to move on to the second mitigating step; that of legislation or more specifically, the forthcoming South African Companies Act.

4) *The new Act will result in fewer claims against directors.*

Statement 4 is essentially the most fundamental one of the Delphi Technique questionnaire; this is due to the fact that one may now assess whether, according to the industry experts, the second mitigating step of legislation will be successful in decreasing claims against directors.

This Statement was a success in accordance with the assumptions made in the dissertation; 96.67% of the participants responded according to the DISAGREE options. The corresponding Mean was 4.43 with the highest amount of answers being located under the Highly Disagree option of 50% or 15 of the participants. The Disagree option was selected by fourteen of the experts. The results were so concrete, in fact, that there was no alteration in the response to this Statement between the first and second round of answers.

With respect to the Disagree option, fourteen of the respondents selected it as an answer, whilst only one opted for Agree. The single participant that selected the Agree option was not a legal expert; this is only relevant due to the fact that it would be necessary to inquire further into this opinion had it come from one of the major legal authorities who took part in this dissertation.

The reasoning behind the manner in which this Statement was responded to is assumed to be comparable to that provided in the dissertation. It may be the definition of ‘Knowledge’ and its derivatives as provided in the Companies Bill; the fact that a negligent director will be presumed to have actual knowledge of the situation which may lead to a loss.

An increase in potential liability could also be resultant from the future legislation of director’s conduct; in that directors’ common law duties will now be stated in legislature. One could look to the fact that class action suites will now be introduced into South African law as a result of the passing of the Companies Bill into law.

Directors’ personal liability may also potentially increase as a result of stakeholders utilising derivative actions as remedies. The dissertation inquired into this source of potential claims under Chapter 4; however this may now be reinforced by the results on Statement 4 as well as a recently published article in Business Day on 05/03/2009 entitled “New law will put company directors in firing line”. This article sought the opinion of Carl Stein of Bowman Gilfillan Attorneys. In this article Mr. Stein spoke the new “enormous” exposure which will be faced by company directors as a result of the passing of the new Companies Act.

Mr. Stein is of the opinion that South Africa is following overseas trends (especially US and UK) towards increased shareholder activism, which has resulted in the simplification of initiating and successfully completing a derivative action. Derivative actions will pose an increased threat to company directors for three key reasons according to this article:

- The range of parties who will behave the ability to initiate a derivative action will widen. Some examples may be a registered trade union or any person who is granted permission by the court to institute the action. It is important to note here that the party looking to institute the derivative action would merely have to prove is that some merit to the accusation. This coupled with the media coverage of the new Act and the resulting awareness of the public could lead to a flood of potential claims against directors.
- The potential reach of derivative actions will also increase as a result of the fact that legal action may be taken against anyone who is a part of the company; not only the directors and officers.
- The manner in which courts have interpreted ‘interests’ has been considerably broad in the past; a derivative action will be valid if it protects the interests of the company. This too will likely increase the potential personal liability of directors.

The ease with which a derivative action will be commenced is also of concern as one would only have to serve a demand on the company. This article is crucial here in order to confirm the industry experts’ opinions with regards to Statement 4 as well as the opinions formed by the dissertation itself. The article was also released closer to the time of the inception of the new Act.

Statement 4 serves to enforce the opinion of the dissertation in showing that the industry experts concur that the second mitigating step of legislation will not decrease directors’ potential liability; in fact the opposite may be true in that claims against directors could increase. This is bad news in the current economic climate in which company failures are increasing and stakeholders will be looking for someone to take the blame. The obvious choice may once again be the directors and officers of the company in question.

8) *The new Act will increase the exposure of directors to D&O claims.*

This Statement is linked to Statement 4 in that if the new Act does not serve to contain director liability, it may lead to an increase in exposure to D&O claims. Should this be the case, this Statement will serve to reinforce the opinion of the dissertation as well as that of the industry experts under Statement 4.

This statement was a key success in light of the dissertation; 96.67% of the respondents selected one of the AGREE options. This is in fact a mirror image of Statement 4 where 96.67% of the participants opted for DISAGREE. It serves to show that the same percentage of industry experts that believe that the new Act will not contain director liability are of the opinion that the Act may increase claims against directors.

The manner in which this result was reached was however different from that of Statement 4; the results were extremely focused on Agree with 24 selections or 80%. Only five participants opted for Highly Agree and one for Disagree. The resultant Mean therefore was 1.9. The only alterations that took place between the two rounds of answers were that two Neutrals shifted to the Agree option.

The reasoning behind the high AGREE selection in Statement 8 is most likely similar to that on Statement 4. This is due to the fact that the same reasons that will lead one to believe that the new Act will not decrease director liability, will most likely lead one to believe that directors' exposure to claims may increase consequent to the legislation. The probable reason why ten less participants opted away from Highly Agree (Highly Disagree under Statement 4) is that some may not be as highly informed as others with regards to the actual reasoning behind a possible increase in claims. For example, perhaps not all the industry experts were aware of the widening scope of a derivative action under the new Act, however most of the experts could come to a consensus that legislating directors' common law duties will not result in a reduction in director liability.

What is important to gain from this Statement 8 is that, once again in line with the dissertation, the industry experts believe that the new Act will most likely increase the exposure of directors to potential D&O claims. It is just as crucial that the same amount also stated that the new Act would be unlikely to contain director liability.

17) *The codification of directors' duties in the new Act will cause potential claimants to be better informed.*

This Statement was raised on numerous occasions throughout the dissertation in the opinion that the legislating of directors' common law duties would lead to better informed claimants. In other words, any party that would be in a position to claim against a director or officer of a company would obtain more knowledge on how to do so as a result of the new Act. Another source of information would be the media; this issue was also raised a number of times in the dissertation. The media coverage of the codification of directors' duties could lead to easy access to information for claimants, as well as a sense that a successful suite is more likely due to the fact that common law is being legislated.

Statement 17 received a 93.33% AGREE response, which is in accordance with the views of the dissertation. The answer with the highest selection was Agree with 80% or 24 of the respondents. The Mean therefore was 1.97 as opposed to 2.03 in the first round of answers. The Neutral and DISAGREE options each received 3.33% of the selections. The only alteration between the first and second round of answers was that two Neutrals opted for the Agree option. Highly Agree received four selections in both rounds.

This Statement clearly indicates that the industry experts concur with the views of the dissertation in that the codification of directors' common law duties may lead to more knowledgeable potential claimants. This may be as a result of simplification of the law, the codification leading to higher chances of prosecution, or the media coverage leading to easy access to information.

10) The introduction of class actions into South African company law will lead to increased claims against directors.

Statement 10 refers to c157 of the South African Companies Bill (Extended standing to apply for remedies). This Section, once the Bill is passed into legislation, will properly introduce class actions into South African law. The dissertation, in accordance with an article by Michael Hart of Deneys Reitz entitled "Companies Bill 2008 – Here Comes the Class Action!" stated that this new addition to South African Companies Law could potentially lead to an increase in claims against directors. This is due to the fact that a number of persons will have the ability to apply in order to incept a class action before a court, the Companies' Ombud, the Take-over Panel of the Commission. This new method of instituting a claim against directors may lead to an increased number of persons seeking this option, which would once again lead to increased director liability.

In accordance with the dissertation 96.67% of the participants selected the AGREE options. The Mean was 1.67 with the most chosen answer being Agree (56.67% or 17 selections). Highly Agree received 12 selections, which indicates the strong opinion in favour of the notion that class action suites will increase the likelihood of claims being made against directors. Only one participant opted for Disagree which was the only exception under Statement 10. It is worth mentioning once again that this industry expert was not involved in the legal field, which would be significant with regards to this Statement. There was no alteration between the first and second round of answers.

21) The definition of 'knowledge' in the new Act will increase director liability.

This Statement was looked at in the dissertation as well as in an article produced by Michael Hart of Deneys Reitz entitled "Companies Bill 2008 – Directors and Officers Insurance – Almost Right At Last". The concern is that the South African Companies Bill defines 'knowledge' as well as its derivatives as actual knowledge or as having the ability to have reasonably known, or having the ability to have known if the matter had been investigated.

This definition (which is unnecessary due to the fact that the Courts have until now defined 'knowledge' according to actual knowledge) may lead to two different drawbacks:

- There may be a gap in cover afforded to directors and officers of companies. This is due to the fact that c78 (6) (a) (i) states that a company may not indemnify a director where that director acted knowingly. C78 (7) (a) states that a company may purchase insurance to protect its directors for anything which may be indemnified under C78 (5) – this subsection states that a company may indemnify its directors with respect to anything allowed by the Memorandum of Incorporation except as provided for under c78 (6). Therefore directors will be left with less company indemnification as well as a gap in D&O insurance cover.
- The concern with this definition is that it may lead to increased director liability. This is consequent to the fact that in every instance where the word 'knowledge' or any of its derivatives are used in the new Act (with regards to a director or officer) there will be a higher standard applied. One will no longer be looking only at actual knowledge but at the reasonable potential to acquire it. This addition of negligence will possibly lead to an increased number of instances where interested parties may claim against directors.

The industry experts once again concurred with the opinion of the dissertation. The AGREE options received 86.67% of the selections. This was an increase from 83.33% in the first round of answers. The difference was that one Neutral opted for Agree during the second round of the questionnaire. The answer that received the highest number of selections was Agree with 70% or 21 of the participants. The Mean therefore was 2.1 as opposed to 2.13 during the first round.

The results of Statement 21 clearly show a strong indication towards the opinion held by the dissertation with respect to the definition of 'knowledge' provided by the South African Companies Bill. The Highly Agree option received five selections under this Statement, of which three came from either legal experts or experts in corporate governance. This is extremely relevant with regards to this legal-orientated section as well as due to the fact that the expert Sample Size was 30 (16.67% of the total).

This definition will be interesting when looking at it in the context of *severability of exceptions* under the general conditions of a D&O policy. This condition states that the knowledge possessed by one insured will mot be imputed on to another insured in order to apply exclusions. Perhaps this will ensure that policies will not respond when knowledge is imputed on to another director as a result of the new Act. However that may leave the director with a gap in cover. Or perhaps D&O policies will be required to respond more often due to the fact that legally; there will be more instances where knowledge can be imputed on to another director.

It must be pointed out that four participants selected the Disagree option; a possible explanation could be that some of the respondents did not look into the finer detail of the clauses of the Bill. One must bear in mind that the Disagree total was still less than Highly Agree, which is a more elevated extreme.

22) *The new Act states that if any person contravenes the Act and another person suffers a loss as a result thereof, the person who contravened the Act will be liable for that loss. This civil remedy will lead to an increase in director liability.*

Statement 22 relates to c218 (2) of the South African Companies Bill - if a person contravenes the new Act and, as a result another person suffers loss or damage, the person who committed the contravention is liable to the other person for the amount of loss or damage incurred. It is possible that this Section (be it passed into law) may increase director liability by making it feasible that third parties could claim against directors. In the instance where a director contravenes a section of the new Act, whether it is in a fraudulent or negligent manner, and as a result a third party suffers a loss the director will be personally liable for that loss.

Statement 22 received a 90% AGREE response which is in concordance with the views of the dissertation. The highest selected answer was Agree with 60% or 18 of the participants in the study. The single alteration in this Statement was that one Neutral opted for Agree. Two participants selected Disagree, whom once again were not legal experts; however nine respondents opted for Highly Agree, four of which could be regarded as experts in the legal system or corporate governance. The Neutral selection could once again be explicated by a lack of insight into the Companies Bill.

The Mean in Statement 22 was 1.87 as opposed to 1.9 during the course of the first round of answers. This Statement was yet another indication that the experts concur with the views of the dissertation – it is unlikely that the new Companies Act will contain director liability and therefore claims against directors; in fact it is possible that there may be an increase in such.

23) *The Business Rescue solution in the new Act will lead to increased director liability.*

The Business Rescue procedure is set out in Chapter 6 of the South African Companies Bill; as was already explicated in the dissertation it is a method which is aimed at reviving companies that could potentially fail or are 'financially distressed'. A financially distressed company is one which may either not have the ability to pay off its debts, or may become insolvent within six months. This notion of Business Rescue is in use abroad such as in the US, UK and Australia.

Directors will find themselves in a peculiar position in the event that the company commences Business Rescue proceedings. This is due to the fact that under c137 of the Companies Bill it is stated that a director will maintain all his functions as such under the authority of the Practitioner. The Practitioner is a person who will be appointed in order to oversee and control the company during Business Rescue. The directors of a company will be relieved of certain duties (including the common law fiduciary duty as well as that of care and skill); however they will still be required to perform in accordance with the Practitioner. It will also be possible for directors to be removed from office under the Business Rescue Chapter – this may occur on application of the Practitioner. One must ask how much easier it will be to successfully claim against a director once Business Rescue is completed in the event that a director is removed from office in accordance with Chapter 6. Directors will also take on numerous other duties, as pointed out in the dissertation, in order to ensure that the Business Rescue procedure is successful; this all in accordance with the instructions of the Practitioner.

Statement 23 received the highest number of responses under AGREE – which was 50%. This was the only Statement that had no significant number of responses under any of the options (significance refers to results greater than 50%). Neutral received 10% and DISAGREE received 40% of the total number of selections. The most highly selected answer was Agree with 46.67% of the respondents preferring that answer. The Mean was 2.87, which was an increase from 2.7 during the first round of the study.

The most significant alteration between the first and second round of answers was that six Neutral opted for Disagree, whilst only one moved to Agree. However one must keep in mind that Agree nevertheless received the highest number of responses with 14 whilst Disagree received 12. One person selected Highly Agree, whilst none opted for the opposite extreme. However 40% of the respondents did opt for Disagree which is a notable amount. There were also some notable legal experts on either of the Agree and Disagree options; this makes it extremely difficult to interpret. One may state that the disparities may have been so significant due to the fact that many of the participants could not familiarise themselves with an entire Chapter of the Companies Bill due to time constraints.

It is possible that perhaps some of the industry experts see the fact that directors will be relieved of some of their duties as a reason to believe that liability may decrease in this regard. This is a very valid statement and it still remain to be seen what the director liability outcome will be as a result of the introduction of the Business Rescue regime into South African Company law. Nevertheless one must keep in mind that the overall result of Statement 23 was in the favour of the opinions provided in the dissertation.

24) *The business rescue practitioner will require D&O insurance cover.*

Statement 24 deals with whether or not the business rescue Practitioner would need D&O insurance. The Practitioner is required to take over the running of the company once Business Rescue has commenced. This means that the Practitioner acts in place of the company's board of directors and management. Another requirement is that the company’s financial situation is assessed and a decision must be made whether or not there is a reasonable prospect of Business Rescue success. The Practitioner may select or remove any persons from the board and management into and out of any office of the company. The development and implementation of the Business Rescue plan is also a responsibility which rests with the Practitioner. It is clear therefore that a vast amount of responsibility is placed in this position of authority. It has been shown, in the case of directors that with responsibility also comes accountability. Statement 24 looks at whether Practitioners will require D&O insurance in order to protect themselves from possible liability incurred in the course of their duties towards the company.

This Statement received an 83.33% AGREE response with a Mean of 2.03. This consisted of 18 Agree and 7 Highly Agree selections – therefore the results are strongly in favour of a positive answer. In fact, 60% of the participants opted for Agree, whilst only 10% or three selected Disagree. The results were also made up of two Neutrals. There was no alteration with regards to selection of answers between the first and second round of the questionnaire.

It is crucial to note that the AGREE selections consisted of extremely noteworthy underwriters and brokers whom would be the most significant industry experts under this particular statement. However the AGREE answers were also provided by most of the legal experts whom would be expected to be well aware of the potential liability which could be incurred by the Business Rescue Practitioner. Where the responses under this Statement were in the negative, a possible explanation could be that those experts believed that the Practitioner would require some other form of Professional Indemnity (PI) cover. The industry expert responses under this Statement were in accordance with the view of the dissertation that the Business Rescue Practitioner will require D&O insurance cover.

6.1.2 Effects on the insurance industry/policy wording

The objective of this section is to inquire into what the possible effects of the South African Companies Bill may be on the D&O insurance industry, as well as on the

D&O policy itself, provided that it is passed into legislation. The first few Statements are aimed at the effects on the D&O policy, whilst the others inquire into the industry itself.

20) *The most important factor considered in the purchasing of D&O insurance is:*

   a. *Premium cost*
   b. *Policy limit*
   c. *Breadth of cover*

Statement 20 is designed to discover what the most important aspect is, which is considered by companies when purchasing D&O liability insurance. Here there is obviously no correct or preferred answer; it is simply a matter of determining what the selected industry experts feel are the key aspects.

It was decided that the question should be answered in three separate parts instead of selecting one alternative. This is in order to allow for complete choice of level of importance per factor; therefore all three options could have the same significance when purchasing D&O insurance.

It was expected that *Premium cost* would be the factor selected most time and this was actually the case. In fact, 100% of the participants opted for AGREE, which consisted of 14 Highly Agree and 16 Agree selections. This is consistent with the notion that one should purchase as much cover as one can afford. The fact remains that 'price' is one of the most telling factors in economics, therefore there is no reason why this should not apply to D&O insurance. The Mean was 1.53 and the most selected answer was Agree with 53.33%. This number is low only due to the fact that the rest of the experts opted for the even more positive extreme. The only alteration between the first and second round of the questionnaire was that 1 Neutral moved to Highly Agree.

The second most important fact considered according to the industry experts was the *Policy limit*. This was probably expected due to the fact that it is closely linked to cost via demand and supply theory. This option was selected 96.67% as AGREE, which was comprised of 3 Highly Agree and 26 Agree options. The DISAGREE options received 3.33% of the votes which was made up of 1 Disagree participant. The Mean was 1.97 and the answer with the highest selection was Agree with 86.67%. Therefore the number of Highly Agree choices decreased and there was 1 Disagree, which is a decrease in the overall positive response from *Premium cost*. The only movement from the first and second round of the questionnaire was that 2 Neutrals opted for Agree.

The least important fact, out of the three offered, according to the industry experts was *Breadth of cover*. This factor is also associated to cost, however it may also depend on other matters such as the state of the market, and what exclusions or extensions the insurer would like to remove or add. The AGREE selections decreased to 90%, comprising of 6 Highly Agree and 21 Agree choices. Therefore the most opted for answer was Agree with 70%; the resultant Mean was 2. The number of DISAGREE selections increased further to 10% consisting entirely of 3 Disagree choices. The single alteration between the first and second round of the questionnaire was that 1 Neutral opted for Agree.

One can safely assume that the best answer to Statement 20 is ‘a combination of all’. This is due to the fact that it would be unreasonable and unwise to only consider one factor when purchasing D&O insurance. It is generally best to purchase as much as one can afford, considering the Limit of Indemnity as well as the breadth of cover available at that particular rate. One must also keep in mind that all three factors are related; therefore the higher the premium price, the higher the limit of indemnity. However the aim of Statement 20 was to see in what manner the industry experts would rank the three factors mentioned which are considered when purchasing D&O insurance.

6) *The new Act will require increasing the limits of indemnity of D&O insurance.*

This Statement is designed to find out whether the new Act will result in an increase in the limits of indemnity on D&O insurance policies. The answer tended vastly in the favour of a positive answer – the AGREE options received 96.67% of the responses. This result was made up of 9 Highly Agree and 20 (66.67%) Agree answers. The only alterations between the two rounds of questioning were that two Neutrals switched to

Agree. The Disagree option only received one (3.33%) selection. The Mean in Statement 6 was 1.77.

The logical reasoning behind this belief that the limit of indemnity of D&O insurance policies may increase is due to the fact that the experts also believed that the new Act may lead to increasing director liability. Increasing liability may lead to an increased number of potential claims against directors. An increase in claims would lead to an increase in limits of indemnity on the part of D&O insurers. This is in accordance with the views of the dissertation with regards to a possibility of increased director liability as well as a potential general increase in limits of indemnity. However it is generally not thought that the Act on its own will lead to increased limits unless there is a major change in the number of lawsuits against directors; this still remains to be seen. An increase in the number of lawsuits could also result from the unfavourable economic climate which is slowly leading to a hardening of the D&O insurance market.

The new Act itself is unlikely to lead to major increases in limits of indemnity of D&O insurance policies. This is due to the fact that there are many factors involved when selecting the amount of insurance purchased; one would consider the premium involved, the economic climate, the market in which the company operates, how litigious the country in which the company operates is, as well as the likelihood of claims to name but a few. However it is still important to note that the majority of the industry experts who participated in the questionnaire believe that some increase in D&O insurance premiums will result due to the passing of the new Act.

7) *The new Act will have the effect of increasing the premium cost of D&O insurance.*

Statement 7 looked at a potential increase in the cost of D&O insurance premiums consequent to the passing of the new South African Companies Act. One would assume that perhaps if director liability increases and therefore the number of claims against directors also rise, that premiums covering these eventualities may increase too.

The response to Statement 7 was in accordance with the above assumption; 83.33% of the industry experts opted for AGREE. The most selected answer was Agree with 73.33% or 22 of the selections. Therefore there was a Mean of 2.23. The negative answers all consisted of Disagree with 16.67% or 5 selections.

The negative responses could be as a result of the fact that some industry experts believe that the increase in director liability will not be significant enough to result in an increase in D&O insurance premiums. It is difficult to say at this time how significant the effect of the new Act on will be with regards to claims against directors. Therefore one can not conclude that premiums will increase by a sizeable amount. It would take a long time for the market to adjust to any effects of the Companies Act even if the number of claims against directors increases at a reasonable pace. This is probably due to the fact that the D&O insurance market is highly competitive. There are a number of South African insurance companies and underwriters involved at the moment; once these options are exhausted one can try overseas markets.

One may therefore conclude that an increase in director liability with a consequent increase in claims against directors may lead to a slight increase in D&O insurance premiums eventually. One only has to look at the financial crisis and see that although company failures are on the increase, which puts directors at risk, there is yet to be any significant increase in D&O insurance premiums.

11) D&O insurers will be required to expand cover as a result of the new Act.

One method of expanding cover could be to remove certain exclusions from a D&O policy wording. A particular exclusion is the *insured v insured*; this is in place in order to avoid a situation where one insured sues another and the company then claims off the D&O policy. It is also risky to cover an insured v insured situation due to the knowledge possessed by either of the parties which may be used against each other. This is extremely unlikely to be removed from a D&O insurance policy.

Another example of is the *major shareholder exclusion* – a ‘major shareholder’ is one that owns a certain percentage of shares in the company. The amount of shares needed to be owned depends on the insurer; it can range from 15% up. This exclusion exists due to the fact that major shareholders can appoint directors and control their actions (to a certain extent through voting). A D&O insurer does not want to cover a situation where a shareholder has participated in the creation of a strategy of the company and consequent to the strategy going wrong, the shareholder attempts to sue the director. This exclusion may vary depending on the insurer as well as the situation in the market (hard or soft). If there is an increase in major shareholder suites as a result of the new Companies Act it is unlikely that D&O underwriters would want to remove this exclusion from their policies. This is amplified by the fact that due to the economic crisis, the market is beginning to harden.

Statement 11 received a 70% AGREE response from the industry experts. This was made up of 19 Agree selections and two Highly Agree selections. This was an increase from the first round of the questionnaire under which there were three Neutrals – the difference between the first and second round was that two of the Neutrals opted for Agree; therefore only one Neutral remained.

There were 26.67% DISAGREE responses which were made up of 7 Disagree and 1 Highly Disagree response. It was difficult to extract a pattern under this particular Statement due to the fact that significant industry experts could be found on either side of the poles. There were notable underwriters as well as brokers under AGREE and DISAGREE, although clearly the scales tipped towards AGREE. This disparity could be as a result of the fact that any increases in director liability are only likely to show after a number of years, consequent to the passing of the new Companies Act.

It is also unlikely that any insurance company will be willing to provide wider cover in the event that claims against directors actually do increase. There would most likely be market pressure to expand cover in order to protect directors from any increased liability as a result of the new Act; however whether or not this pressure would lead to and actual expansion depends on the supply and demand of D&O insurance at the time. It is unlikely to be a demand driven market due to the fact that the current economic climate is leading to a hardening of the D&O insurance market. This means that insurers will be looking to increase pricing and restrict cover.

One notable broker mentioned in a conversation that it is becoming more difficult to place cover as well as the fact that it is being restricted. Due to the financial crisis it is becoming difficult to find D&O insurance for banks and asset managers. However one must keep in mind that this is a result of the economic downturn – this may outweigh any pressures on underwriters to widen cover due to the passing of the new Companies Act.

It is important to remember that D&O insurance policies cover directors when they become legally liable. This means that any new liability that is resultant of the new Act will be automatically covered; therefore it will not be necessary to widen policy wordings. When asked why so many industry experts stated that cover may require widening as a result of the new Act, a notable underwriter stated that it is probably due to the fact that if any new exposure is created, one would want to make certain that directors are not left with a gap in cover.

12) *D&O insurers will be required to broaden policy wordings as a result of the new Act.*

Statement 12 was a control question in respect of Statement 11; in other words it was used to test the reliability of the responses of the previous Statement. Both Statements were in fact asking the same thing: will D&O insurers opt to expand cover/broaden policy wordings as a result of the new South African Companies Act?

The overall responses were fairly similar although there were some minor differences. AGREE received 63.33% of the selections, which was made up of 18 Agree and 1 Highly Agree result. This was similar to Statement 11 where the results for Agree and Highly Agree received 19 and 2 selections respectively. The most selected answer therefore was Agree with 60% which was down from 63.33% under Statement 11. The Mean was 2.73 as opposed to 2.53 in Statement 11. The DISAGREE options received 36.67% of the selections; this was made up of 10 Disagree and 1 Highly Disagree answer. Statement 11 received 7 Disagree answers, which was the only difference between the two Statements on the negative side. Statement 12 also contained one Neutral as opposed to none in its predecessor. The only difference between the first and second round of the questionnaire was the 2 Neutrals switched to Agree.

The differences were rather insignificant, however the DISAGREE options were selected a fair amount of times. The reasons for the disparities between the two statements as well as within the Statements themselves could be twofold: firstly some of the respondents perhaps did not completely understand the questions. This could explain why there were some differences between the two Statements. Secondly, the discussion under Statement 11 still holds true; the industry experts do anticipate changes as a result of the new Act, however the changes may not alter the D&O policy that significantly. Any changes that may occur could also take a long time to eventuate and would probably be resultant from the economic crisis at the same time. Nevertheless Statement 12 was a success in that it showed a reasonable similarity in the industry experts' thinking between the two relevant Statements.

5) *The new Act will have the effect of restricting the availability of D&O insurance.*

Statement 5 is looking at whether or not D&O insurance will be less accessible as a result of the new South African Companies Act. This may either be due to the fact that insurers will be less willing to supply the cover or because some insurers may pull out of the market all together.

It is probably unlikely that D&O insurance will be significantly restricted as a result of the new Act, if at all. In the event that director liability increases and claims against directors increase too, D&O insurers would probably be more likely to market the policy more aggressively. As the need for this type of insurance rises, so too will the willingness to sell it. The D&O market is also likely to harder (become a sellers market) as a result of the financial crisis. This too should result in an increase in the amount of insurance that underwriters are willing to provide, as well as some new entrants into the market perhaps.

The industry experts concurred with the views of the dissertation; DISAGREE received 93.33% (or 28) of the responses. This was made up of 25 Disagree and 3

Highly Disagree results. This is a very significant result in favour of the views of the dissertation. There was 1 Neutral answer as well as 1 Highly Agree; the Highly Agree selection was not resultant from an expert underwriter or broker, which would be significant with respect to the Statement.

The only logical explanation for this positive choice would be that the perception of the risk attached to D&O insurance would increase as a result of a possible increase in liability and therefore claims. In that manner one may assume that the D&O industry would be less willing to provide a type of insurance which is more risky. It is however unlikely that D&O insurance will become high-risk enough for no one to be willing to provide it. This would be the case even in light of a combination of the new Act as well as the financial crisis. There would always be players willing to provide insurance at a higher cost – if it would ever actually get to that point. The only difference in responses between the first and second round of the questionnaire was that 5 Neutrals opted for Disagree. This is an indication that the Delphi Technique was effective, as the experts were influenced by the opinions of others away from impartiality towards a formulated opinion.

9) *The new Act will lead to increased competition in the D&O insurance market.*

Statement 9 was aimed at finding out whether the new South African Companies Act would result in increased competition in the D&O insurance market. The new Act could lead to two possible outcomes in this regard; the first is that claims against directors are contained which would decrease the demand for this particular type of insurance. This buyers market would lead to players being willing to supply D&O insurance. The second possible outcome is that director liability may increase which would result in an increase in claims. This would increase demand for D&O insurance which would lead to a sellers market. In this case there would be an increase in the number of suppliers of D&O insurance.

Statement 9 obtained most of its selections under the DISAGREE with 56.67% - this was entirely constituted of 17 Disagree (also the most selected option) answers. The resultant Mean therefore was 3.17. There was 1 Neutral result as well as 12 Disagree selections, which made up the entire AGREE outcome. The difference between the first and second round of the questionnaire was that 2 and 3 Neutrals moved to Agree and Disagree respectively.

The disparities of 12 and 17 Agree and Disagree respectively could be resultant from the two possible outcomes which were pointed out with regards to the new Act. However one must remember that most of the industry experts concur that the new Act is unlikely to contain director liability. Another possible explanation for the disparity could be that some of the experts had the financial crisis in mind; this too may have a significant effect on the D&O market competition. If the D&O market hardens, as is expected due to the economic crisis, premium rates would increase. This would result in more capital being available in the D&O market and therefore more players would be tempted to join. The outcome would be an increase in competition. However the financial crisis could have a second impact; the lack of monetary funding as a result of the market crunch could mean that money will be required elsewhere – therefore perhaps it would be difficult to invest in D&O insurance companies.

With regards to Statement 9 and the new Act; as has been previously explicated, it is unlikely that the legislation will lead to a great increase in premium rates in a short amount of time. Therefore it may be unlikely, as the industry experts agree, that there will be a sudden increase in competition in the D&O insurance market as a result of the new Act.

6.1.3 Effects on directors

This subsection is intended to inquire into the effects of the new South African Companies Act on directors. One is not necessarily looking at liability but actual the possible outcomes on directors themselves. This is being done in order to envisage whether the new legislation will alter the way in which directors' duties and roles will be carried out, as well as how they will be required to operate.

16) *The codification of directors' duties in the new Act will be beneficial to directors.*

Having seen that the majority of the experts believe that the new Act will not contain claims against directors and may in fact lead to increased liability, one would think that the codification of directors' duties would not be seen as beneficial. However the industry experts tended to disagree; 83.33% opted for the AGREE options. This was made up of 24 Agree and 1 Highly Agree selection; the Mean therefore was 2.3. The highest percentage of answer selected was Agree with 80%. DISAGREE received 13.33% of the selections, which was made up of 3 Disagree and 1 Highly Disagree answers. One must make not of the fact that there were some notable legal experts that opted for DISAGREE, however they were in the minority overall. There was also one Neutral answer. The alteration between the first and second round of the questionnaire was that 4 Neutral moved to Agree.

There are a number of possible motivations why the codification of directors' common law duties could be beneficial to directors. The fact is that there would be a general better understanding of what exactly is required of directors once it is stated in legislation. In that manner, directors may be better equipped to deal with potential and existing claims. One would also get the sense that if the entire board of directors is forced to abide by legislation, the individual directors would feel safer knowing that the chances of a lawsuit are less likely. However this may be moot due to the fact that common law does not hold directors liable where they did not have a reasonable chance of knowing of a fraud or such. The D&O policy also covers directors that had no knowledge of such action – although this may change as a result of the new definition of 'knowledge' in the new Act.

One must also remember that there are reasons to believe that the codification will be detrimental to directors. Potential claimants will also be better informed with regards to directors' duties, which may lead them to attempt to claim more often. This would be accentuated by the fact that the media has highlighted the possibility of claiming against directors when companies suffer a loss. Directors are also already likely to know what their duties are; therefore the information factor may be irrelevant in their case. It may also be easier to hold directors accountable once their duties are placed in legislation as opposed to common law. One may think that a written statement on directors' duties would have sufficed.

It is important to remember, however that this Statement was inquiring with regards to the codification of directors' common law duties; this is but one of the changes which the new Act will produce. Perhaps a clarification was required and most of the industry experts concur with this fact. This is in spite of whether or not the participants may believe that a statement of duties would have been good enough.

15) *It will be more difficult to recruit directors (especially non-executive) as a result of the passing of the new Act.*

Statement 15 looks at whether or not it may be more difficult to attract directors into such roles in companies as a result of the new South African Companies Act. The thinking behind this question is that if director liability increases as a result of the new Act, and consequently, claims frequency and severity rises, directors will no longer find it worthwhile to take up these previously glamorous positions.

The 'non-executive' director may be more difficult to recruit due to the fact that there is less involvement in the day-to-day operation of the company; thus it is more difficult to realise that a situation has arisen which may lead to a claim. This may also be problematic due to the fact that according to the King Codes of Corporate Governance, a board system should contain a balance of executive and non-executive directors. In fact, it is preferred that there is a higher amount of non-executive directors serving on a board of a company. This is already difficult to accomplish in South Africa due to a lack of necessary skills. Some non-executive directors actually serve on more than twenty different boards at one time.

Statement 15 received a 90% AGREE response, which was made up of 20 Agree and 7 Highly Agree selections. Therefore Agree was the highest selected response with 66.67%, whilst the negative answers were completely made up of 3 Disagree selections. The resultant Mean was 1.97, which demonstrates the high tendency towards the positive options. The only alteration between the first and second round of the questionnaire was that 1 Neutral moved to Agree.

The results show that the industry experts predominantly believe that the new Act will lead to a situation in which it will be more difficult to recruit director on to company boards. This is probably as a result of the belief that the new legislation will not contain claims against directors and may on the other hand possibly lead to increased liability. Having said that and assessed the respondents' opinions, one must remember that if a big enough carrot is waved in one's face, it is bound to be snatched at some eventually. Should the risk attached to board membership increase, so too will the rewards. It is difficult to imagine that a significant number of directors will no longer be willing to serve; however this may end up being a noticeable trend. Directors will still have the protection of D&O liability insurance, which will increase in significance. An article in *Business Day* (11/08/2009) interviewed a number of notable attorneys who stated that the new legislation may lead to individuals thinking twice before joining company boards.

18) There will be a significant difference in the manner in which directors carry out their duties as a result of the new Act.

Statement 18 is inquiring into whether or not the industry experts believe that directors will alter the way in which they carry out their duties as a consequent to the passing of the new South African Companies Act. The reasoning would be that the new Act may either contain or perhaps increase claims against directors; this would be the result of decreased or increased liability respectively. Therefore would there be any modification in the way in which directors do their jobs in respect of the companies on which boards they serve?

The respondents generally believed that directors will change the way in which they carry out their duties towards the company as a result of the new Act; this is evident from the 66.67% AGREE result. The positive result was made up of 19 Agree and 1 Highly Agree response, leaving a Mean of 2.63. The answer with the highest amount of selections was Agree with 63.33%. There were however a significant number of respondents that opted for DISAGREE; 10 altogether which were completely made up of Disagree selections. The alteration between the first and second round of the questionnaire was that 4 Neutrals moved in the following manner: 3 to Agree and 1 to Disagree.

It is difficult to work out why a disparity existed in the results with regards to Statement 18. This is due to the fact that the majority of experts believed that the new Act would result in increased director liability. It was also found that the new Act would be unlikely to contain claims against directors. One would thus think that directors may as a result alter the manner in which they perform their duties in some way or another. However one must bear in mind that the Bill does not actually add any new duties; it merely legislates the old common law existing ones. Even if director liability is actually increased this would not add new requirements which director would have to follow. It is true that the requirements are stricter and there are additional ways in which a director may be held accountable for his actions. However this would alter how careful, cautious and thorough directors will act consequent to the passing of the new legislation. That is perhaps the reason why there were disparities in the answering of Statement 18 – whilst there are no added duties, directors will be required to be a lot more vigilant in the manner in which their functions are carried out.

19) *The new Act will increase the standards of corporate governance of companies.*

This Statement is designed to find out whether the industry experts believe that the new South African Companies Act will result in companies implementing higher standards of corporate governance. Perhaps companies may not even be required to implement higher standards but merely abide by existing ones – in the event that the organisation does not do so already. As has been noted throughout the dissertation, it is the directors of the company that are primarily charged with the implementation and carrying-out of corporate governance within companies. This question may therefore look at two different aspects:

- Will the new Act itself increase the standard of corporate governance in companies – after all Chapter 2 Part F of the Bill is entitled 'Governance of companies'?

- Will directors enforce corporate governance standards to a higher extent as a result of the possibility that they may be accountable otherwise? This would be due to a possible increase in director liability consequent to the passing of the Act.

Statement 19 received an 88.33% AGREE response which was composed of 23 Agree and 2 Highly Agree selections. This is significantly in favour of the positive responses, which means that the respondents clearly believe that the new Act will result in higher standards of corporate governance; for either actual reason. The highest selected answer was Agree with 76.67% with the resultant Mean being 2.23. Only 13.33% of the respondents opted for DISAGREE, which was entirely made up of Disagree selections. Therefore none of the experts strongly believe that the new Act will not result in higher standards of corporate governance in companies. There was also one Neutral response. The alteration between the first and second round of the questionnaire was that 2 Neutrals opted for Agree, whilst another 2 Neutrals selected Disagree.

The vast majority of industry experts are of the opinion that the new Act will result in higher standards of corporate governance. This is a reasonable assumption due to the fact that the Bill contains so many provisions which relate to some form of company governance. It must also be noted that in the event that the new Act leads to increased director liability and accountability, it is extremely likely that boards will implement higher standards of corporate governance in order to avoid the possibility of claims.

13) *Directors should be required to go on training courses in preparation for the passing of the new Act.*

Statement 13 is attempting to find out whether the industry experts believe that it will be necessitated that directors go on training courses in order to familiarise themselves with the new South African Companies Act. It would seem logical that everyone on the board of directors of a company should be educated with regards to Company Law. This is especially crucial when there are changes being made which affect all companies. These changes will also seemingly affect directors themselves; one should be educated with regards to the possible effects of the new Act on your office. Here are some of the potential questions which should be asked:

- Will liability increase or decrease?
- What new expectations are there of directors?
- What effects will the codification of directors' common law duties have?
- What will be the role of directors in the new Business Rescue process?
- What effect will the new Act's definition of 'knowledge' have on directors?
- What rules and procedures should the board have in place in order to ensure company compliance with the new Act as well as codes of corporate governance?
- How can directors ensure that these rules and procedures will be implemented correctly or at all?

This statement was extremely successful in terms of positive answers. The AGREE options received 100% of the respondents' selections. The answers were comprised of 17 Highly Agree and 13 Agree choices. Therefore the extreme positive option obtained the majority of the selections, indicating a high tendency towards the positive answers. The option which was selected most times by the respondents was 1 with 56.67%; therefore the Mean was 1.43. The only alteration between the first and second round of the questionnaire was that 2 Neutrals opted for Agree.

This is good news for directors as well as the D&O insurance industry. Even in the event that director liability does increase, education with regards to the new Act may be used as a method of risk management in order to minimise potential claims. The training courses would probably have to come from law firms which will contain the necessary expertise to educate others. Another method of education is through the Institute on Directors (IOD) of South Africa. The IOD is continuously holding training courses, not only for directors but all business persons. This would be a very effective way to ensure that everyone is kept up to date with the upcoming changes in South African Company Law.

14) *If D&O cover was not available directors would still be prepared to accept directorships on company boards.*

This Statement is aimed at assessing the importance of D&O liability insurance in terms of directors' acceptance of positions on company boards. It is evident that the majority of companies purchase D&O insurance on behalf of their directors; however the directors of small private companies often opt against cover due to the unlikelihood of a claim arising.

The industry experts generally concurred with the views of the dissertation that persons would be unlikely to take up a position on a company board in the event that no D&O insurance cover was available. The majority of the selections fell under DISAGREE with 66.67%. This consisted of 17 Disagree and 3 Highly Disagree answers indicating a strong tendency towards the need for D&O insurance. The prevalent answer was Disagree with 56.67%; the resultant Mean was 3.43. The single alteration between the first and second round of the questionnaire was that 1 Neutral opted for Disagree. One must also consider that there was an element of disparity in this Statement as 33.33% of the respondents opted for AGREE, which was all comprised of Agree selections. Therefore there was no extreme belief that directors would still take up positions as such in the event that D&O insurance was not available. However it may still be necessary to inquire into the motive behind why 10 participants opted for Agree.

It is likely that those industry experts that opted for Agree may have been referring to the many directors of small private companies that are not covered by D&O insurance. As it was pointed out earlier, this is resultant from the fact that the likelihood of a claim is low. Another reason could be that perhaps if no D&O insurance was available there would be other solutions to deal with director liability in place. Perhaps director liability would decrease, although the need for D&O insurance has been consequent to an increase in such. One would expect that companies would make provisions in the event that a claim against a director would arise, or perhaps director remuneration would increase in order to offset possible losses resultant from claims. It is also worth remembering that D&O insurance only came about after Great Depression, prior to which directors did exist without D&O insurance.

However as a result of increasing director liability as well as an increase in claims against directors, it is reasonable to believe that directors may think twice before accepting a position on the board of a company, which does not provide D&O liability insurance.

6.2 Interviews

The interviews were done either face-to-face or via email with twenty of the thirty total participants that were involved in the study. The responses have been summarised and the general views will be expressed. The study may be broken-down into three separate sections: director liability, effects on the insurance industry/policy wording, and effects on directors. These three separate sub-sections will now be looked at in turn.

6.2.1 Director liability

It was a remarkable finding that 100% of the participants of the interviews stated that director liability has increased in some way or another. When asked whether the increase in director liability was as a result of either doctrinal or complexity issues the answer was simply; both. One of the main re-occurring themes was that of the impact of the media on director liability. Whilst media will not actually legally increase director liability, it certainly plays a part in making potential claimants aware of the possibility and magnitude of a claim against a director or officer of a company. The spectacular overseas corporate collapses such as Enron and Worldcom, as well as those in South Africa such as Leisurenet and Fidentia have certainly made the public more aware of corporate crime.

Certainly some of the offenders in such cases deserve some form of liability, however the mass publicity has led to a general notion that when a corporate failure (in any sense) occurs, someone must be held accountable. The first place where one would look to sue is the director or officer of the company in question. It is easy to forget that the complexity of the modern business environment has led to a point in which it is difficult for an individual to be in full control of a multi-national corporation. Moreover, the subprime crisis of 2008 has already led to numerous law-suites in the US and Europe; this shows certain occurrences in other countries may lead to an individual being sued who could not have foreseen the danger. These issues are more amplified for executive directors than executives due to the fact that courts do differentiate between the two. There are still drawbacks however because some non-executive directors are still held liable in certain instances. It is more difficult for a non-executive director, who was hired for a certain type of expertise, to keep in touch with all the transactions of a company.

Some of the participants that did not think that director liability has increased to a great extent still admitted that in the very least the likelihood of a claim has certainly gone up. However the probability of a successful claim in court in South Africa is still reasonably low, according to most experts, and the most common reason cited is that court cases take extremely long to complete. This in turn means that costs of litigation are also particularly excessive.

Perhaps due to the fact that not all insurance industry experts are also legal experts, there was less to be said about the courts' willingness to hold directors more accountable. Nevertheless all experts did agree that doctrinal issues have led to an increase in director liability. The most common reason stated is the expansion of the law of delict. As was stated in earlier in the dissertation, instances such as the recognition of pure economic losses have led to more possible motives for a claim. Not only have the motives increased but so has the severity and frequency of claims against directors.

A main point to remember is that the perception of directors has changed; as was stated earlier in the dissertation directors are not mere figureheads and are expected to be aware of all the dealings of the company. The corporate world in general has become more accountable for its actions especially when it comes to a loss to any company stakeholders. The burden of this accountability is being borne mostly by the directors and officers of companies. Now that the general opinion on the increase in director liability has been attained it is necessary to turn one's attention to the effects of the mitigating steps which have been taken; corporate governance and legislation.

When asked whether or not the various corporate governance codes around the world, and especially those in South Africa, have contained director liability 90% of the interviewees answered 'no'. Those that did not answer 'no' however did not claim that corporate governance codes have contained director liability, but that it has gone some way to provide a system of control. One would assume that everyone could agree with this point. The main problem found here was that the experts believed that corporate governance acts as a 'double-edged sword'. In other words, whilst it may provide for control and transparency which may decrease claims against directors, corporate governance also places many onerous duties and responsibilities on directors and officers of companies. As a result this may create more opportunities for a claim to arise. Corporate governance codes lead to increased controls and to a segregation of individual responsibility. Without these controls in place, the risk of a loss to the company does increase; for this reason corporate governance is a good means to protect investors. However individual responsibility does increase regarding directors and officers of corporations.

Another main theme was the fact that corporate governance codes generally increase the awareness of the media and the public regarding directors' duties and responsibilities. This in-turn adds to the increasing director liability which was discussed above. Regarding the doctrinal issues, society and courts are generally more willing to hold directors accountable for a loss when their duties and responsibilities set out in codes of corporate governance. Even in South Africa, when the King Codes were published there was much media coverage, which in turn increased public awareness of director liability.

On a final note, the experts agreed with the view of the dissertation that the fact that corporate failures have continued to occur, and that directors have been held accountable for many of these failures, in South Africa and abroad, shows that corporate governance codes have not necessarily contained director liability. In fact the most spectacular corporate collapses took place at the beginning of the 2000's, in

South Africa and elsewhere, by which time the majority of countries around the world had corporate governance codes in place.

The next point of discussion is that of the second mitigating step; legislation and more precisely the new Companies Act. When asked if the new Act would result in decreasing claims against directors 100% of the interviewees responded ‘no’. Various reasons and opinions were provided, however the general feeling was that the new Act will hold directors personally responsible for certain losses which accrue to a company’s stakeholders such as shareholders, creditors and employees. The main cause of concern for the experts was that the degree of responsibility and participation by directors and officers will increase as a result of the new legislation. The new Act will reinforce existing law regarding breaches of directors’ duties in South Africa.

One of the general areas of distress among the interviewees was the fact that directors’ duties towards the company are being codified into legislation. As was stated earlier in the dissertation, these duties were normally held in common law and have also been developed over hundreds of years as such. It would be practically impossible, and unforeseen dilemmas would certainly occur, to encapsulate all the common law duties of directors in one piece of legislation. Therefore the new Act states that the duties contained in the codification are in addition to, not a replacement of, the common law. This in itself may be a point of concern; is the Act itself not secure enough to stand on its own? The UK Companies Act has also codified the duties of directors; however the legislation has now replaced the common law position. Perhaps if the legislation cannot encompass the full extent of the duties owed by directors at common law it would be more advisable to make a statement of directors’ duties in the form of corporate governance? If clarification on the issue is being sought by the legislators a statement of duties would satisfy this requirement. As it stands however, perhaps confusion might arise in the application of concurrent legislation and common law with respect to the same aspect. However that is for the courts ponder.

In an article in *Business Day* on 01/09/2008, Michael Katz stated that the concerns that directors will be increasingly liable as a result of the codification are unfounded. A good point was made that the codified principles will have to be applied in accordance with the established common law principles. It is hard to see how there would be any wayward application of deeply entrenched principles. Further, the article stated that a new defence is being introduced into South African law; that of the business judgment rule. As stated earlier in the dissertation it will be interesting to see if this new defence has any value in South African law, given the fact that its requirements for application already exist under common law.

The above points are well-taken, however the interviews conducted showed that the insurance industry experts are concerned from another perspective. The fact is that when a rule is set in legislation it is easier for it to be applied than in common law. It is not the application that is a problem but the fact that it will also be easier to hold a director liable when duties are spelled out in legislation – even where a person would not have been liable for the loss previously. As was the case with the codes of corporate governance, this new legislation will also make the public more aware of the increased possibilities of holding corporate directors and officers liable for certain losses. One only has to think of the media attention that the Companies Bill has received thus far; that is yet prior to being passed into legislation.

Just like the codes of practice, legislation may also act like a double-edged sword; whilst it provides increased protection for company stakeholders it also increases the instances where a director or officer may be held liable for losses. It is therefore unlikely that the new Act will actually decrease the number of claims against directors. In fact 100% of the interviewees stated that the new legislation will lead to increased exposure to claims for corporate directors and officers.

There were also other areas of concern for the industry experts. The introduction of class actions into South African law, whilst fair, will no doubt lead to an increased number of claims against directors; this is under c157 of the Bill. Further, c218 (2) was also often stated as a reason why director liability may increase as a result of the new Act. As explicated earlier in the dissertation this is a civil remedy which states that if a person contravenes any section of the new act, and any person suffers a loss as a result of that contravention, the person who contravenes the Act will be held liable for the loss. This could lead to potential liability to an indeterminate plaintiff for an indeterminate amount; the experts concurred with this statement.

Another concern for the D&O experts was the way in which the new Act will define 'knowledge'. It was explained earlier in the dissertation that the Bill defines 'knowledge' and its derivatives as either having actual knowledge or if one ought to reasonably have knowledge. The interviewees concurred with the dissertation in saying that this may not only leave a gap in insurance cover for directors and officers but that it will also lead to increased liability. This is due to the fact that every time a director reasonably ought to have had certain knowledge he/she will be deemed to actually have it. This means that in certain instances negligent behaviour may be considered as purposeful by the courts. In fact every time the word 'knowledge' occurs in the new Act the abovementioned scenario could take place.

A lesser area for concern was that of business rescue proceedings. The lack of interest in this area for the interviewees could be due to the fact that some had not yet been informed on this topic. However those that were involved in the legislation did express some interest. The cause of concern was as per the dissertation; the directors of a company under business rescue proceedings relinquish their main common law duties (the fiduciary duty and that of care and skill) and still have to carry out others – such as to make certain that the business of the company is not carried out in a fraudulent manner. This will certainly lead to confusion in court should a claim ever arise during this period of time. The business rescue practitioner will also take up the duties and responsibilities of the board of directors and the directors themselves will be required to carry out their functions in accordance with the requests of the practitioner. It will certainly be necessary for the practitioner to have D&O liability insurance in order to cover the many possible instances of liability that could arise out of such an onerous mandate.

It is necessary to conclude this sub-section with two important points; firstly one must look at whether legislation can actually prevent corporate fraud and negligence. Secondly one must also consider the macroeconomic factors which will take place after the new Act is passed in South Africa. With regards to the first point one must keep in mind that errant directors and officers will always exist. This is in the same way that criminals have and will always exist regardless of what laws have been passed throughout history. It is difficult enough to attempt to control the incidence of purposeful acts such as fraud; it is even harder to attempt to legislate against negligence. The truth of the matter is that if a human being is inclined to commit fraud this will happen no matter what legislation or code of practice is ever passed. Further, there will always be inattentive persons in the world of business therefore it will be impossible to legislate negligence away. Therefore it is unlikely that claims against directors will be contained by the second mitigating step of legislation.

At the end of 2008 the financial crisis uncovered a massive fraud in the US – that of Bernard Madoff. Madoff, a former chairman of the NASDAQ stock market, has been charged with securities fraud involving an expected $50 – billion loss to investors. In an article in *Business Week* on 12/12/2008 entitled "Credit crunch unmasks former NASDAQ chair" it was mentioned that Madoff's hedge fund was actually a Ponzi scheme.[233] The Securities and Exchange Commission rapidly assigned a receiver to the fund in order to salvage any remaining assets; however it seemed to be too late. This fraud was discovered as a result of the fact that many investors started to withdraw their money from the fund in order to hold less risky cash during the time of the financial crisis. Eventually there were no more assets to be pulled out. The reason this is being mentioned is to illustrate once again that no amount of legislation can actually stop fraud and negligence. One must bear in mind that this corporate scandal was discovered at the end of 2008 – this is a long time since the passing of the Sarbanes-Oxley Act, the stricter Securities and Exchange Commission Standards, and the numerous corporate governance codes which have been passed since the early 1990s. One must wonder where all the controls were when this particular fraud started to occur. It is thus difficult to expect the new South African Companies Act to bring the incidence of claims down. The financial crisis is creating losses in the most unexpected places – with a combination of the credit crunch and the new Act coming into play in South Africa, it is easy to understand why one may expect a slight increase in claims against directors.

With regards to the second point, macroeconomic factors will play a key role in the number of claims against directors. The passing and application of the new South African Companies Act will coincide with other aspects of the economy which may

[233] A Ponzi scheme operates by utilising new investors' funds to pay off old investors.

also affect the number of claims against directors. The sub-prime crisis has already led to many corporate collapses such as Lehman Brothers. In the US many lawsuits have already taken place as a result of the financial crisis. Other aspects of the global economy will also play key roles such as increasing fuel and food prices, as well as retrenchments resultant from the necessity of cutbacks. There is also an expected upcoming hard-market in the D&O insurance sector. These issues are relevant due to the fact that it will be difficult after 2010 to tell what impact the new South African company legislation had on claims against directors as a result of other macroeconomic factors which will have their own impacts.

In an article in Business Day on 23/12/2008 entitled "Executives 'need to be alert to increased risk' in economic crisis" this same point was made. The circumstances in which the economic world finds itself as a result of the global financial crisis could lead to an increased risk of liability for company directors and officers. The increased possibility of company failures could lead to increased temptations to fabricate financial results and risk management practices must be put in place in order to ensure that all areas are covered. The risk of negligence could also increase as South African companies will start implementing new accounting standards named Generally Recognised Accounting Practice (GRAP) as from 2010. According to a Business Day article on 24/12/2008 the GRAP method will aspire to augment financial reporting, accountability and transparency. All these factors will have to be taken into account in the next few turbulent global financial years.

It was generally the view of the industry experts that claims against directors will continue to increase whether it will be due to the macroeconomic factors or the new company legislation. Whether this will actually be the case is hard to predict. Many of the interviewees felt that the new act will lead to the proverbial floodgates opening and a sudden influx of claims will occur. Others thought that there will be one big claim which will be tested in court (with that occasion the right of a company to purchase insurance on behalf of its directors will also be confirmed, although the new Act has confirmed this) and this will lead to a number of other claims arising. Whatever the case will be one thing is for certain; the industry experts believe that the new Act will not contain the increasing director liability.

6.2.2 Effects on the insurance industry/policy wording

This subsection is aimed at ascertaining what the effects of the new Companies Act will be on the D&O insurance industry as well as on D&O policy wordings. As an introduction, the first question that was asked was what is the most important factor considered when purchasing D&O insurance? The responses were generally classified into three separate components: premium cost, policy limits and breadth of cover. However the answer seems to lie in a combination of a number of different factors.

It was generally thought that the most important factor considered by a potential insured is the price of the premium. After all if a company or individual director is unable to afford the premium, then insurance will not be purchased. However one must remember that premium cost, policy limits and breadth of cover are actually all linked; for an increase in premium one will be afforded increased limits of indemnity as well as greater scope of coverage.

The answer further depends on the status of the client; what is the financial position, in what line of business is the client involved, what are the chances of litigation? It is important to note that one may attain more cover as well as increased scope of cover for a comparatively low increase in premium. This may then render the importance of premium cost as inconsequential for bigger companies.

The potential insured will have to consider breadth of cover to a high extent depending on the line of business in which the client is involved. What exclusions and limitations are imposed, what extensions are offered? For the first time in South Africa D&O policies do actually differ between insurers; some policies may be much broader than others, therefore the breadth of cover becomes increasingly significant. A very good point was also made by two excellent brokers; the market may be more sensitive the breadth of cover. Increasing premium costs can easily be justified if the type of cover offered is significantly more important to the client than that offered by any competitors. The client may also be advised as to how much cover is purchased by companies which are of similar size in the same type of industry. That is generally a good indicator as to how much cover should be taken out.

A very notable underwriter summed up this question from a different perspective. When asked how much cover should be purchased the best answer should be: how much can the client afford? The cost of premium will become very trivial when a claim comes through and one has to deal with phenomenal defence costs over an extended period of time. The concern is not alleviated at that point as there will still be either settlement costs or the actual amount claimed by the aggrieved party. Neither of the three factors generally considered when purchasing D&O liability cover should be significant enough to actually lead to a scenario where a business in uninsured.

When asked about the main reasons as to why D&O liability insurance is purchased the experts stated that director protection was most important. The reasons which were looked at in Chapter 5, such as to better the corporate governance procedures of companies were not as applicable in South Africa as they may be in the US. Up until now it is apparent that the most important motive for the purchase of D&O insurance was to protect directors when the company which they represent is unable to provide indemnification. The new Companies Act does allow for the indemnification of directors in certain instances, as well as for the purchase of D&O insurance in general. Another very important aspect is that of defence costs; this is especially relevant in South Africa due to the nature of the system of the courts. Litigation tends to take years to complete and legal fees are extremely high. In the event that a settlement is not reached the amount of money spent of defending a claim may be extraordinary. Unfortunately in South Africa there is a lack of documented claims examples and although claims are starting to arise more and more often, there are still not enough that go to court in order to provide examples. This makes it difficult to understand fully the most important reasons why D&O liability insurance in purchased in South Africa.

With respect to the insurance industry the effects of the new Companies Act are interesting. Claims are expected to increase and therefore and therefore there is an expected increase in the cost of premiums. However it is not expected that this will occur straight after the passing of the new Act. It is rather anticipated that the industry will respond once the claims start occurring. Many of the experts stated that there may be one big claim which will go to court and set the trend for the industry. Should this big claim ever eventuate the industry will respond accordingly. The question of what will happen to the pricing of D&O insurance is difficult as it also depends on capacity and competition. However it was generally thought that pricing could go up if claims increase, although the increase will not be too significant until the market settles down after the inception of the new Act.

It is expected that the limits of indemnity will remain the same for the time being. This is at least until the effects of the new Act are actually discovered. However due to an expected hardening of the D&O market one may eventually see the limits of indemnity on D&O policies decrease. According to some brokers a current trend exists where clients are purchasing higher limits of indemnity; however this is probably due to the fact that there is a large capacity available and pricing remains competitive. Due to the highly publicised nature of the Companies Bill and the perception of many that director liability is widening companies may be more tempted to purchase higher limits. This may be especially true if directors put pressure on their companies to purchase higher limits in order to offer increased protection.

When looking into the availability of D&O it was generally thought that it will not decrease as a result of the new Companies Act. Once again it was thought that the insurance industry will be reactive; should claims experience deteriorate drastically then the availability will reduce.

Another aspect was that of potential changes in the competitive nature of the D&O insurance industry. The experts generally agreed that it is unlikely that competition will increase. This assumption was made for two reasons; firstly the market is highly competitive as it is. There are a number of D&O insurers in South Africa already and many of the brokers that were interviewed stated that if one does not find satisfactory cover in South Africa (which is unlikely), it is then possible to look abroad and purchase D&O insurance elsewhere. The second explanation for the belief that competition will not increase is that the D&O insurance market is expected to harden. During a hard market the number of new entrants is low to none. However a number of underwriters stated that some insurers/reinsurers may be tempted to enter the market when the rates do eventually improve.

Regarding policy wording, the experts tended to be divided on whether or not it will be broadened as a result of the new legislation. Many experts stated that the increasing director liability and expected increased in claims should lead to an expansion in cover. However others pointed out that South African D&O policies are generally a hybrid of those overseas; specifically in the US and the UK. These policies are already tailored for high levels of litigation and should be able to withstand any impacts of the new Companies Act. Some of the participants stated that insurers may try to differentiate their policy wordings. Therefore one may see certain new exclusions and extensions, however no examples were provided. It was generally agreed by all the experts that there will be no significant changes to policy wordings or to the operative clause.

It was mentioned by a notable broker as well as a few underwriters that there will be an expected change to Side B of the D&O policy. This change will be with regards to the zero deductible which is currently in place on all D&O policies issued in South Africa. The zero deductible has been in place due to the fact that s247 of the South African Companies Act does not allow for the indemnification of directors by a company. Therefore with very little anticipated claims against Side B the deductible was set at zero. There were some that were of the belief that the deductible should have been kept in place in the event that the company legislation ever changes. This is now the case, as the Companies Bill allows for the indemnification of directors by a company. Insurers will now as a result have to explain to clients why a new deductible must be put in place. This should be noted by all D&O underwriters who will have to make this change to their policies.

When asked about the capacity to underwrite D&O insurance it was agreed that there should be no significant changes. Even if claims increase to an unexpected extent as a result of the new Companies Act most of the South African policies are reinsured internationally. Unless capacity decreases globally due to macroeconomic factors, there should be no significant changes in underwriting capacity as a result of the new Act.

Once again it is important to draw a parallel between the effects of the new company legislation and that of macroeconomic factors. The experts were very adamant to point out, and rightly so, that much of the effects on the D&O insurance industry will occur due to outside variables. As mentioned above, if the international underwriting capacity decreases, it will impact the South African market. The credit crunch will have many unforeseen consequences which have been felt from the late half of 2008. The recessionary conditions will lead to increased areas and severity of risk for directors and officers worldwide.

One broker that was interviewed mentioned the events of 2008 which occurred at AIG. It was stated that two possible outcomes may result; firstly AIG may reduce renewal premiums in order to retain business, this would lead to a reduction of premiums in the market as other insurance underwriters attempt to remain competitive. The second scenario is that premiums could increase in order to render reserves capable to deal with the unavoidable increase in claims, which will result due to the global financial crisis. In the same manner the global financial crisis could influence the D&O market in a number of ways which are all unpredictable.

In an article in *Business Day* on 06/09/2009 a legal expert from Werksmans Attorneys stated that the tough economic times would lead to a great increase in corporate fraud. It was stated that company and close corporation liquidations rose by 17.6% in July 2008. The expert was confident that the new South African Companies Act would go a long way to improve this situation by means of the business rescue option; this still remains to be seen. One may be certain that the macroeconomic factors will play an important role in the number of claims against corporate directors and officer, which may in-turn have consequences on the D&O insurance industry as well as the policy itself. Whilst and explanation of the effects of the recession on the D&O insurance market is beyond the scope of this dissertation, it is still extremely important that it is mentioned. This is due to the fact that these effects will coincide with those of the new Companies Act. In fact all the interviewees at some stage or another tended to veer away from the topic of the Companies Bill and mention the possible effects of the global liquidity and credit crisis on the D&O insurance market.

6.2.3 Effects on directors

This subsection is aimed at discussing some of the possible effects of the new Companies Act on directors themselves. It seemed appropriate to commence by asking whether or not directors would still be prepared to take up office as such in the event that D&O cover was not available. Of the interviewees a reasonably high number, in fact nearly 65%, stated that directors would not be prepared to take up office if no protection was available. However the question seemed to be phrased in an unfavourable manner; the experts rather preferred to talk about whether a person is more likely to decline a position as such. When the question is phrased in that fashion 100% of the interviewees said that a person is more likely to decline a position on the board of directors of a company if no D&O cover is available. The basic premise here is that the higher the amount of remuneration offered the higher are the chances that a person will eventually take up office. In other words if one waves a carrot around for long enough, someone is bound to eventually accept it. This question should be noted as it shows the level of importance that this line of insurance has accumulated. This goes hand-in-hand with the fact that the exposure level of directors to claims has increased. As it was stated earlier by an expert, directors may be very scared to take up positions on boards of companies once the new Act has been passed. If no D&O cover was available, the likelihood of acquiring very experienced directors to serve on company boards would become minimal.

The question was raised as to whether the codification of directors' duties in the new Companies Act would be beneficial to directors. The interview responses were extremely varied; whilst most of the experts said that the codification would be beneficial in some way or another many still remained sceptical. These were some of the more prevalent reasons that the interviewees proposed would benefit directors:

- Directors will have a better understanding of what their duties are;
- New directors will take comfort in the fact that other board members are required to abide by certain standards, which will lead to a less likelihood of a claim against the board;

- Directors will be better equipped to defend themselves against claims as their duties will now be codified in legislation
- A general and more accessible understanding will be created for everyone by the codification, which would surely be to the benefit of directors.

Having stated these possible benefits most experts were concerned about the double-edged sword that has been mentioned prior to this sub-section. The point once again is that the codification will also be beneficial to potential claimants. The media attention attached to the codification has made many aware of the increasing possibility of holding directors liable. A codification often understandably concerns legal experts and insurers due to the fact that once certain standards are written down in an Act it is much easier to hold one accountable. In any event directors would have had access to legal assistance in order to defend a claim; therefore this new codification which will keep the director informed may not be so useful after all. The other point made was that directors accepting a position on the board of a company will generally be well aware of what their duties and legal consequences of not carrying out those duties are. The general consensus was that a statement of directors' duties would have sufficed in order to keep all parties well informed. However the fact that it will be legislated may end up being unfavourable to directors and officers of companies.

The experts were then asked whether or not they believe that as a result of the new company legislation it will be more difficult to recruit directors (especially non-executive) to serve on company boards. The general answer was that it would be more difficult and as per the acceptance of office question one must note that this does not mean that no one will be willing to serve anymore. It will mean that perhaps directors will require more D&O cover and more transparency from the rest of the board in order to ensure that their personal assets are protected.

A few of the interviewees, especially the brokers and legal experts, stated their concerns regarding the reputational costs which are incurred by directors when a claim is made against them. This is one aspect which is obviously not covered by the D&O liability policy but can however cause an indeterminate loss to any director. This is the case even when the director is eventually proven to be innocent. The legal system is often very slow and a case could take many years to conclude – whilst the time is passing the director and the respective company will be receiving much media attention, which will have a negative impact in the public eye. The increase in possible litigation which the new Companies Act will bring will only serve to increase these reputation costs which are extremely difficult to mitigate against. An article in the Business Day entitled "Bad blogs easily trash corporate reputations" on 12/01/2009 explained that it is becoming extremely difficult for companies to safeguard their corporate reputations. This is due to the fact that persons can easily spread dissatisfactions to a large number of people via various websites. Even once the problem is taken care of the information will remain on the internet and will be accessible by a large amount of people. The article was primarily referring to disillusioned consumers however this could easily be applied to company directors who have an increased concern of liability.

Finally the experts were asked whether or not they believe it necessary that directors should be educated regarding the new Companies Act. There was a 100% 'yes' response to this question which is completely understandable due to the focus which the current Bill has on directors. It was generally thought that much of these courses should be taken through the South African Institute of Directors (IOD). However it will be the responsibility of all companies to ensure that their board members are educated regarding the new legislation as part of the company's risk management programme. The majority of the underwriters that were interviewed noted that it will be up to each company to make certain that the new Act is understood and abided by all its directors and employees. This will be in order to prevent any surprise claims which may arise as a result of the passing of the new legislation. It is advised that companies seek legal advice well before the new Act is passed in 2010 in order to make the necessary changes and preparations. This is in order to avoid making changes with haste once the Act is already in place.

6.3 Conclusion

In order to test and substantiate the conclusions reached by the dissertation two separate studies were conducted. One was a Delphi Technique study; here 30 industry experts were required to answer 24 questions. The population covers for all practical purposes the entire market – this is due to the fact that virtually all existing experts on directors and officers insurance in South Africa were involved. The results were then handed back to the participants for review. Once the review process was completed the participants answered the questionnaire for a second time. This is done in order to align the experts' opinions on the matter as closely as possible. It was unnecessary to perform the questionnaire for a third time since there were no significant alterations between the first and second round.

The second study consisted of separate face-to-face interviews with 20 industry experts. The experts were asked questions regarding the subject matter of the dissertation and discussions were held. Whilst the second study is less scientific than the first, it does help make the conclusions reached more robust. This is due to the fact that one may get an insight into the reasoning behind the experts' beliefs with regards to the subject matter of the dissertation.

The studies were successful in that the same conclusions were reached that were provided in the dissertation; director liability has increased as a result of doctrinal and complexity issues. The two mitigating steps which have been taken in order to contain claims against directors are not expected to succeed in doing so. It is probable that the second mitigating step, that of legislation – more specifically the new Companies Act – will not decrease director liability and therefore claims against directors. In fact it is possible that claims against directors could increase as a result of the passing of the South African Companies Bill into law.

CONCLUSION

An assessment was done into the anticipated impacts of codes of corporate governance and legislation on Directors and Officers liability insurance in South Africa. More specifically, the impact of the new South African Companies Act, which is due to be passed in 2010 was considered.

The question was whether director liability has been increasing as a result of doctrinal (courts and society being more willing to hold directors accountable) and complexity (the complex modern economic environment making it easier for directors to be held accountable) issues. The increase in liability goes hand-in-hand with an increase in claims against directors. Next an assessment was made of two mitigating steps which have been utilised in an attempt to contain director liability. The mitigating steps are codes of corporate governance and legislation (the new Companies Act).

The conclusions reached by the dissertation were then tested by means of two separate studies. One was a Delphi Technique study in which thirty D&O insurance industry experts participated. The experts covered the entire professional industry in South Africa. The second was a face-to-face interview system in which twenty D&O insurance industry experts took part. This is a robust combination due to the fact that the first is scientific, whilst the second provides reasoning with regards to the thinking process of the experts involved.

It was found that the conclusions reached by the dissertation were supported by the two studies. Director liability and claims against directors has been increasing as a result of doctrinal and complexity issues. The two mitigating steps of codes of corporate governance and legislation are not expected to contain director liability; in fact the new Companies Act may actually lead to an increase in claims against directors.

Appendices

Table 1: List of worldwide corporate governance codes

Appendix 1 – Table 1: List of worldwide corporate governance codes

Country	Corporate governance code	Date
Argentina	Codigo de Mejores Practicas de Cobierno de las Organizaciones para la Republica Argentina	2004
Australia	Revised corporate Governance Principles and Recommendations	2007
	Principles of Good Corporate Governance and Best Practice Recommendations	2003
	Corporate governance: A Guide for Fund Managers and Corporations	2002
	Horwath 2002 Corporate Governance Report	2002
	Corporate Governance: A Guide for Investment Managers and Corporations	1999
	Corporate Governance – Volume 1: in Principle	1997
	Corporate Governance – Volume 2: in Practice	1997
	Corporate Governance: A Guide for Investment Managers & A Statement of Recommended Corporate Practice	1995
	Bosch Report	1995
Austria	Austrian Code of Corporate Governance	2007
	Austrian Code of Corporate Governance	2006
	Austrian Code of Corporate Governance	2005
	Austrian Code of Corporate Governance	2002
Bangladesh	The Code of Corporate	2004

	Governance for Bangladesh	
Belgium	Buysse Code: Corporate Governance Recommendations for Non-Listed Enterprises	2005
	Lippens Code: The Belgian Code on Corporate Governance	2004
	Director’s Charter	2000
	Guidelines on Corporate Governance Reporting	1999
	Cardon Report – Corporate Governance for Belgian Listed Companies	1998
	Corporate Governance	1998
Brazil	Code of best Practice of Corporate Governance	2004
	CVM Recommendations on Corporate Governance	2002
	Panorama De Governanca Corporativa No Brasil	2001
Bulgaria	Bulgarian National Code for Corporate Governance	2007
Canada	TSX Guide to Good Disclosure	2006
	Corporate Governance: A Guide to Good Disclosure	2003
	Beyond Compliance: Building a Governance Culture	2001
	Five Years to the Dey: Report on Corporate Governance	1999
	Building on Strength: Improving Governance and Accountability in Canada’s Voluntary Sector	1999
	Guidelines for Improved Corporate Governance	1994
China	Provisional Code of Corporate Governance for Securities Companies	2004
	Code of Corporate Governance for Listed Companies in China	2001
Cyprus	Corporate Governance Code	2006
	Addendum for Corporate	2003

	Governance Code which was introduced in September, 2002	
	Corporate Governance Code	2002
Czech Republic	Corporate Governance Code Based on the OECD Principles (2004)	2004
	Revised Corporate Governance Code Based on the OECD Principles	2001
Denmark	Committee on Corporate Governance's Recommendations for corporate governance of August 15, 2005, section VI revised by February 6, 2008	2008
	Revised Recommendations for Corporate Governance in Denmark	2005
	Report on Corporate Governance in Denmark	2003
	Corporate Governance in Denmark - recommendations for good corporate governance in Denmark Second part in The Nørby Committee's report	2001
	Guidelines on Good Management of a Listed Company (Corporate Governance)	2000
Estonia	Corporate Governance Recommendations	2005
Finland	Improving corporate Governance of Unlisted Companies	2006
	Corporate Governance Recommendations for	2003

	Listed Companies	
France	Recommandations Sur Le Gouvernement D'Entreprise	2004
	The Corporate Governance of Listed Companies	2003
	Bouton Report: Promoting Better Corporate Governance in Listed Companies	2002
	Vienot 2 Report	1999
	Recommendations on Corporate Governance	1998
	Vienot 1 Report	1995
Germany	German Corporate Governance Code – Amended 2007	2007
	Cromme Code: Governance Code – Amended 2006	2006
	Cromme Code: Governance Code – Amended 2005	2005
	Corporate Governance Code for Asset Management Companies	2005
	Cromme Code: Governance Code – Amended 2003	2003
	Cromme Code: German Corporate Governance Code	2002
	Baums Commission Report	2001
	German Code of Corporate Governance	2000
	Corporate Governance Rules for Quoted German Companies	2000
	DSW Guidelines	1998
	Gesetz zur Kontrolle und Transparenz im Unternehmensbereich	1998
Greece	Principles of Corporate Governance	2002
	Principles on Corporate Governance in Greece: Recommendations on its Competitive	1999

	Transformation	
Hong Kong	Code on Corporate Governance Practices and Corporate Governance Report	2004
	Model Code for Securities Transactions by Directors of Listed Companies	2001
	Corporate Governance Disclosure in Annual Reports	2001
	Code of Best Practice	1999
Hungary	Corporate Governance Recommendations	2007
	Corporate Governance Recommendations	2002
Iceland	Guidelines on Corporate Governance 2nd Edition	2005
	Guidelines on Corporate Governance	2004
India	Report of the Kumar Mangalam Birla Committee on Corporate Governance	2002
	Desirable Corporate Governance – A Code	1998
Indonesia	Indonesia's Code of Corporate Governance	2006
	Indonesian code for Good Corporate Governance	2001
	Code for Good Corporate Governance	2000
Ireland	Corporate Governance, Share Option and other Incentive Scheme Guidelines	1999
Italy	Supervisory Provisions Concerning Banks' Organisation and Corporate Governance	2008
	Corporate Governance Code	2006
	Handbook on Corporate Governance Reports	2004
	Corporate Governance Code	2002
	Report: Code of Conduct	1999
	Legislative Decree 58 of 24 February 1998 –	1998

	Consolidated law on financial intermediation pursuant to Articles 8 and 21 of Law 52 of 6 February 1996	
Jamaica	Code on corporate Governance	2006
Japan	Principles of Corporate Governance for Listed Companies	2004
	Revised Corporate Governance Principles	2001
	Report of the Pension Fund Corporate Governance Research Committee: Action Guidelines for Exercising Votes	1998
	Corporate Governance Principles: a Japanese View	1997
	Urgent Recommendations Concerning Corporate Governance	1997
Kenya	Principles of Corporate Governance in Kenya and a Sample Code of Best Practice for Corporate Governance	2002
	Sample Code of Best Practice for Corporate Governance in Kenya	2002
Latvia	Corporate Governance Principles and Recommendations on their Implementation	2005
Lebanon	The Lebanese Code of Corporate Governance	2006
Lithuania	The Corporate Governance Code for the Companies Listed on the National Stock Exchange of Lithuania	2004
Luxembourg	Corporate Governance: The Ten Principles of Corporate Governance of the Luxembourg Stock Exchange	2006
Macedonia	Corporate Governance Code for Companies	2006

	Listed on the Macedonian Stock Exchange	
Malaysia	Malaysian Code on Corporate Governance	2007
	Malaysian Code on Corporate Governance	2000
Malta	Principles of Good Corporate Governance: Revised Code for Issuers of Listed Companies	2005
	Principles of Good Corporate Governance for Public Interest Companies	2005
	The Code of Principles of Good Corporate Governance	2001
Mexico	Corporate Governance Code for Mexico	1999
Morocco	Moroccan Code of Good Corporate Governance Practices	2008
New Zealand	Corporate Governance in New Zealand, Principles and Guidelines: A Handbook for Directors, Executives, and Advisors	2004
	Corporate Governance in New Zealand, Principles and Guidelines	2004
	Corporate Governance Principles	2003
Nigeria	Code of Corporate Governance for Banks in Nigeria Post Consolidation	2006
Norway	The Norwegian Code of Practice for Corporate Governance	2007
	The Norwegian Code of Practice for Corporate Governance	2006
	The Norwegian Code of Practice for Corporate Governance	2005
	The Norwegian Code of Practice for Corporate Governance	2004
Pakistan	Code of Corporate Governance	2002
Peru	Principles of Good	2002

	Governance for Peruvian Companies	
	Peru: Codigo de Buen Gobierno Corporativo Para Empresas Emisoras de Valores	2001
Poland	Code of Best Practice for WSE Listed Companies	2007
	Best Practices in Public Companies 2005	2005
	Best Practices in Public Companies 2002	2002
	Gdansk Code: The Corporate Governance Code for Polish Listed Companies	2002
Portugal	Corporate Governance Code and Legal Framework Consolidation	2007
	White Book on Corporate Governance in Portugal	2006
	Code of Commercial Companies	2005
	Recommendations on Corporate Governance	2003
	CMVM Regulation No. 11/2003	2003
	CMVM Regulation No. 07/2001	2001
	Recommendations on Corporate Governance	1999
Romania	Corporate Governance Code: Corporate Governance Initiative for Economic Democracy in Romania	2000
Russia	Russian Code of Corporate Conduct	2002
Singapore	Code of Corporate Governance	2005
	Code of Corporate Governance	2001
Slovakia	Corporate Governance Code – Based on the OECD Principles	2002
Slovenia	Ljubljana Corporate Governance Code	2007
	Ljubljana Corporate Governance Code	2005

	Ljubljana Corporate Governance Code	2004
South Africa	The King Report on Corporate Governance (King 1)	1994
	The King Report on Corporate Governance (King 2)	2002
South Korea	Code of Best Practice for Corporate Governance	1999
Spain	Corporate Governance Unified Code	2006
	Code of Ethics for Companies	2006
	IC-A: Principles of Good Corporate Governance – Code of Good Practice for Boards and Directors	2005
	Decalogo Del Directivo	2004
	Aldama Report: Report by the Special Commission to Foster Transparency and Security in the Markets and in Listed Companies	2003
	Codigo de Buen Gobierno – The Governance of Listed Companies	1998
	Una Propuesta de Normas Para Un Mejor Funcionamiento de Los Consejos de Administracion	1996
Sri Lanka	Dreft Rules on Corporate Governance for Listed Companies	2006
	Guidelines Relating to Audit and Audit Committees	2004
	Code of Best Practice on Corporate Governance	2003
	Code of Best Practice on Audit Committees	2002
	Code of Best Practice – Financial Aspects of Corporate Governance	1997
Sweden	Swedish Code of Corporate Governance	2005
	Swedish Code of Corporate Governance –	2004

	Report of the Code Group	
	Swedish Code of Corporate Governance – A Proposal of the Code Group	2004
	Naringslivets Borskommitte Recommendations	2003
	Corporate Governance Policy – The Swedish Shareholders' Association	2001
Switzerland	Corporate Governance Directive – Information Relating to Corporate Governance	2007
	Governance in Family Firms	2006
	Swiss Code of Best Practice for Corporate Governance	2002
	Corporate Governance Directive – Information Relating to Corporate Governance	2002
Taiwan	Taiwan Corporate Governance Best Practice Principles	2002
Thailand	The Principles of Good Corporate Governance for Listed Companies	2006
	Code of Best Practice for Directors of Listed Companies	1999
	Best Practice Guidelines for Audit Committees	1999
	A SET Code of Best Practice for Directors of Listed Companies	
The Netherlands	SCGOP: Manual for Corporate Governance	2004
	Tabaksblat Code: Principles of Good Corporate Governance and Best Practice Provisions	2003
	SCGOP: Corporate Governance Handbook	2001
	Government Governance: Corporate Governance in the Public Sector, Why	2000

	and How?	
	Recommendations on Corporate Governance in the Netherlands: Recommendations for Sound Management, Effective Supervision and Accountability	1997
The Philippines	ICD Code of Proper Practices for Directors	2000
Trinidad and Tobago	Corporate Governance Guideline	2006
Turkey	Capital Markets Board of Turkey: Corporate Governance Principles	2003
Ukraine	Ukrainian Corporate Governance Principles	2003
United Kingdom	Guidelines for Disclosure and Transparency in Private Equity	2007
	The Combines Code on Corporate Governance	2006
	Good Practice Suggestions from the Higgs Report	2006
	Internal Control: Revised Guidance for Directors on the Combined Code	2005
	Corporate Governance in Central Government Departments: Code of Good Practice	2005
	Pension Scheme Governance – Fit for the 21st Century (NAPF)	2005
	Good Governance: A Code for the Voluntary and Community Sector	2005
	Corporate Governance: A Practical Guide	2004
	The Combined Code on Corporate Governance	2003
	Smith Report: Audit Committees – Combined Code Guidance	2003
	Higgs Report: Review of the Role and Effectiveness of Non-Executive Directors	2003
	The Responsibilities of	2002

	Institutional Shareholders and Agents – Statement of Principles	
	The Hermes Principles	2003
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	The Combined Code: Principles of Good Governance and Code of Best Practice	2000
	Hermes' Code of Conduct: International Corporate Governance Principles	1999
	The KPMG Review – Internal Control: A Practical Guide	1999
	Turnbull Report – Internal Control: Guidance for Directors on the Combined Code	1999
	Hampel Report	1998
	Greenbury Report – Study Group on Director's Remuneration	1995
	Cadbury Report – The Financial Aspects of Corporate Governance	1992
United States	TIAA-CREF: Policy Statement on Corporate Governance	2007
	Asset Manager Code of Professional Conduct	2004
	Final NYSE Corporate Governance Rules	2003
	Restoring Trust – The Breeden Report on Corporate Governance	2003
	The Conference Board Commission on Public Trust and Private Enterprise – Findings and Recommendations	2003
	The Business Roundtable – Principles of Corporate Governance	2002
	Council of Institutional Investors – Corporate Governance Policies	2002

	Principles of Corporate Governance: Analysis and Recommendations	2002
	Report of the NACD Blue Ribbon Commission on Director Professionalism	2001
	CalPERS – Global Corporate Governance Principles	1999
	The Business Roundtable – Statement on Corporate Governance	1997

Source: http://www.ecgi.org/codes/all_codes.php

Appendix 2 – Table 2: South African legislation relevant to company directors

Table 2: South African legislation relevant to company directors

This list is not meant to be exhaustive; this is due to the fact that new legislation is enacted frequently and that courts may find that directors possess duties, or may be held liable under statutes which are already in operation but do not currently apply to directors. Some legislation may apply only explicitly to certain companies, whilst others apply to all companies operating in South Africa. It is also important to highlight the fact that only South African legislation which affects directors is listed here; however South African directors may be affected by legislation from abroad. This depends on whether the company in question undertakes business ventures in other countries, or in the event that legislation from overseas has a far reaching effect, as is the case of the Sarbanes-Oxley Act. The list is meant to supplement and update other such lists already created such as that in Mammatt *et al* (2004).

Scope	**Legislation**
Constitutional	Constitution of the Republic of South Africa No. 108 of 1996
Commercial	Business Names Act No. 27 of 1960
	Close Corporations Act No. 69 of 1984 (Potentially repelled by the Companies Bill if passed into legislation)
	Companies Act No. 61 of 1973 (Repelled by the Companies Bill if passed into legislation)
	Harmful Business Practices Act No. 71 of 1988 as amended by Harmful Business Practices Amendment Act No. 23 of 1999
Environmental	Environment Conservation Act No. 73 of 1989 as amended by Environmental Conservation Amendment Act No. 50 of 2003

	Hazardous Substances Act No. 15 of 1973
	Marine Pollution (Control and Civil Liability) Act No. 6 of 1981 previously named Prevention and Combating of Pollution of the Sea by Oil Act No. 67 of 1971
	National Environmental Management Act No. 107 of 1998
	Occupational Health and Safety Act No. 85 of 1993
Financial	Banks Act No. 94 0f 1990 as amended by Banks Amendment Act No. 36 of 2000
	Bills of Exchange Act No. 34 of 1964 as amended by Bills of Exchange Amendment Act No. 56 of 2000
	Competition Act No. 89 of 1998 as amended by Competition Second Amendment Act No. 39 of 2000
	Currency and Exchanges Act No. 9 of 1933
	Consumer Affairs (Unfair Business Practice) Act No 71 of 1998 to be repelled by Consumer Protection Act (due to be passed)
	Customs and Excise Act No. 91 of 1964 as amended by Customs and Excise Amendment Act 19 of 1994
	Financial Advisory and Intermediary Services Act No. 37 of 2002
	Financial Intelligence Centre Act No. 38 of 2001 as amended by Financial Intelligence Centre Amendment Act No.

11 of 2008

Immovable Property (Removal or Modification of Restrictions) Act No. 94 of 1965

Import and Export Control Act No. 30 of 1994

Income Tax Act No. 28 of 1997

Insider Trading Act No. 135 of 1998

Insolvency Act No. 24 of 1936 as amended by Insolvency Second Amendment Act No. 69 of 2002

Marketable Securities Tax Act No. 32 of 1948

National Credit Act No. 34 of 2005

National Small Business Act No. 102 of 1996 as amended by National Small Business Amendment Act No. 26 of 2003

Protection of Businesses Act No. 99 of 1978

Public Finance Management Act No. 1 of 1999

Regional Services Councils Act No. 109 of 1985

Skills Development Act No. 97 of 1998

South African Reserve Bank Act No. 90 of 1989

Stamp Duties Act No. 77 of 1968

Transfer Duty Act No. 40 of 1949

Unemployment Insurance Act No. 63 of 2001

Usury Act No. 73 of 1968 as amended by Usury Amendment Act No. 10 of 2003

Value-Added Tax Act No. 89 of 1991

Intellectual Property	Copyright Act No. 98 of 1978 as amended by Copyright Amendment Act No. 9 of 2002
	Designs Act No. 195 of 1993
	Intellectual Property Laws Amendment Act No. 38 of 1997
	Merchandise Marks Act No. 17 of 1941 as amended by Merchandise Amendment Act No. 61 of 2002
	Patents Act No. 57 of 1978 as amended by Patents Amendment Act No. 58 of 2002
	Promotion of Access to Information Act No. 2 of 2000 as amended by Promotion of Access to Information Amendment Act No. 54 of 2002
	Trade Marks Act No. 194 of 1993
Labour	Basic Conditions of Employment Act No. 3 of 1983 as amended by Basic Conditions of Employment Amendment Act No. 11 of 2002
	Compensation for Occupational Injuries and Diseases Act No. 130 of 1993 as amended by Compensation for Occupational Injuries and Diseases Amendment Act No. 61 of 1997
	Employment Equity Act No. 55 of 1998
	Labour Relations Act No. 66 of 1995
	Skills Development Act No. 97 of 1998
Pensions	General Pensions Act No. 29 of 1979
	Pension Funds Act No. 24 of 1956 as amended by Pension Funds Amendment Act No. 65 of 2001

Appendix 3 – Table 3: Delphi Technique Results

Table 3: Delphi Technique Results

Labels (Answers):
1 = Highly Agree
2 = Agree
3 = Neutral
4 = Disagree
5 = Highly Disagree

Results:

Questionnaire Round 1:

Question	Mean		Percentages				Highest Percentage	
			Agree	Neutral	Disagree		Answer	%
Q1	1.666667		100.00%	0.00%	0.00%		2	66.67%
Q2	1.7		96.67%	3.33%	0.00%		2	63.33%
Q3	3.9		3.33%	20.00%	76.67%		4	60.00%
Q4	4.433333		3.33%	0.00%	96.67%		5	50.00%
Q5	3.8		3.33%	20.00%	76.67%		4	66.67%
Q6	1.833333		90.00%	6.67%	3.33%		2	60.00%
Q7	2.233333		83.33%	0.00%	16.67%		2	73.33%
Q8	1.966667		90.00%	6.67%	3.33%		2	73.33%
Q9	3.133333		33.33%	20.00%	46.67%		4	46.67%
Q10	1.666667		96.67%	0.00%	3.33%		2	56.67%
Q11	2.6		63.33%	10.00%	26.67%		2	56.67%
Q12	2.8		56.67%	6.67%	36.67%		2	53.33%
Q13	1.5		93.33%	6.67%	0.00%		1	56.67%
Q14	3.4		33.33%	3.33%	63.33%		4	53.33%
Q15	2		86.67%	3.33%	10.00%		2	63.33%
Q16	2.433333		70.00%	16.67%	13.33%		2	66.67%
Q17	2.033333		86.67%	10.00%	3.33%		2	73.33%
Q18	2.7		56.67%	13.33%	30.00%		2	53.33%
Q19	2.233333		76.67%	16.67%	6.67%		2	70.00%
Q20a	1.6		96.67%	3.33%	0.00%		2	53.33%
Q20b	2.033333		90.00%	6.67%	3.33%		2	80.00%
Q20c	2.033333		86.67%	3.33%	10.00%		2	66.67%
Q21	2.133333		83.33%	3.33%	13.33%		2	66.67%
Q22	1.9		86.67%	6.67%	6.67%		2	56.67%
Q23	2.7		46.67%	33.33%	20.00%		2	43.33%
Q24	2.033333		83.33%	6.67%	10.00%		2	60.00%

Questionnaire Round 2:

Question	Mean		Percentages				Highest Percentage	
			Agree	Neutral	Disagree		Answer	%
Q1	1.666667		100.00%	0.00%	0.00%		2	66.67%
Q2	1.666667		100.00%	0.00%	0.00%		2	66.67%
Q3	3.966667		6.67%	6.67%	86.67%		4	70.00%
Q4	4.433333		3.33%	0.00%	96.67%		5	50.00%
Q5	3.966667		3.33%	3.33%	93.33%		4	83.33%
Q6	1.766667		96.67%	0.00%	3.33%		2	66.67%
Q7	2.233333		83.33%	0.00%	16.67%		2	73.33%
Q8	1.9		96.67%	0.00%	3.33%		2	80.00%
Q9	3.166667		40.00%	3.33%	56.67%		4	56.67%
Q10	1.666667		96.67%	0.00%	3.33%		2	56.67%
Q11	2.533333		70.00%	3.33%	26.67%		2	63.33%
Q12	2.733333		63.33%	0.00%	36.67%		2	60.00%
Q13	1.433333		100.00%	0.00%	0.00%		1	56.67%
Q14	3.433333		33.33%	0.00%	66.67%		4	56.67%
Q15	1.966667		90.00%	0.00%	10.00%		2	66.67%
Q16	2.3		83.33%	3.33%	13.33%		2	80.00%
Q17	1.966667		93.33%	3.33%	3.33%		2	80.00%
Q18	2.633333		66.67%	0.00%	33.33%		2	63.33%
Q19	2.233333		83.33%	3.33%	13.33%		2	76.67%
Q20a	1.533333		100.00%	0.00%	0.00%		2	53.33%
Q20b	1.966667		96.67%	0.00%	3.33%		2	86.67%
Q20c	2		90.00%	0.00%	10.00%		2	70.00%
Q21	2.1		86.67%	0.00%	13.33%		2	70.00%
Q22	1.866667		90.00%	3.33%	6.67%		2	60.00%
Q23	2.866667		50.00%	10.00%	40.00%		2	46.67%
Q24	2.033333		83.33%	6.67%	10.00%		2	60.00%

Descriptions:

- Green block represents significance of > 50%.
- ‘Mean’ refers to the average answer selected; a mean of ‘1.5’ indicates that the average answer lies halfway between ‘1’ and ‘2’.
- ‘Percentages’ refers to the percent of selected answers under ‘Agree’, ‘Neutral’ and ‘Disagree’.
- ‘Highest Percentage’ refers to the answer which was selected mostly per question, as well as the percentage of selection of that answer.

Appendix 4 – List of Industry Experts Whom Participated in the Studies

List 1: List of Industry Experts Whom Participated in the Studies

Bhana, Zaid – Swiss Re

Blain, Michael – Centriq

Coleman, Simon – Camargue Underwriting Managers

De Pinchart, Geoffrey – Camargue Underwriting Managers

De Smidt, Peter – Infinity

Dixon, Tony – Corporate Governance Accreditation

Dobson, Bill – Standard Bank Insurance Brokers

Downham, Peter – Camargue Underwriting Managers

Duff, Roddy – Lloyd's

Engelbrecht, Lindie – Institute of Directors South Africa

Goldie, Warwick – Etana Insurance Company Limited

Hart, Michael – Deneys Reitz

Jack, Angela – Alexander Forbes

Jordan, Tamsin – Alexander Forbes

King, Mervyn – King Committee on Corporate Governance

Le Roux, Martin - Centriq

Lewis, Jonathan – Governance Integrity Solutions (UK)

Marescia, Mitch – Camargue Underwriting Managers

Matthews, Charles – Eton Group

Mullins, Ana – Phoenix Underwriting Managers

Pearson, Rod – Glenrand MIB

Schutte, Nick – Glenrand MIB

Seccombe, William – Willis

Smith, Howard – GIB Insurance Brokers

Solomon, Teri – Marsh

Taylor, Alan – Glenrand MIB

Trollope, George – Alexander Forbes

Van Sweeden, Ken – Camargue Underwriting Managers

Vivian, Robert – University of the Witwatersrand

Wilkinson, Richard - Institute of Directors South Africa

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